SOUTH AFRICAN REVENUE SERVICE

Comprehensive Guide
to
CAPITAL GAINS TAX

The first draft *Comprehensive Guide to Capital Gains Tax* was released for public comment in December 2002 with the closing date for comment being 14 February 2003. Many constructive comments were received from individuals and organisations for which SARS is most grateful.

This version of the draft Guide takes into account these comments as well as changes effected by the Revenue Laws Amendment Act 74 of 2002, the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003, the Revenue Laws Amendment Act 45 of 2003, Taxation Laws Amendment Act 16 of 2004 and Revenue Laws Amendment Act 32 of 2004.

In view of the volume of new material that has been inserted in the Guide it is considered appropriate to present it for another round of public comment before releasing it in its final form. Just like the first version, this version also contains draft views that are provided for the purpose of public comment and must not be relied upon as necessarily representing the official view of SARS on all the matters canvassed therein.

The intention is to publish the Guide in its final form during 2005 after taking into account the comments received and any further amendments effected at the time of issue.

Comments may be sent by e-mail to <**cgt@sars.gov.za>** and should be submitted by no later than **30 June 2005.**

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Preface

The purpose of this Guide is to assist the public and SARS' personnel in gaining a more in-depth understanding of capital gains tax (CGT). Whilst this Guide reflects SARS' interpretation of the law, taxpayers who take a different view are free to avail themselves of the normal avenues for resolving such differences. The foundation for this Guide can be found in the various Explanatory Memoranda that supported the legislation. In order to assist the reader these initial explanations have for the most part been completely revised, with the addition of many more examples and illustrations. Areas not previously dealt with are also explored with much of the new material inspired by the many e-mail[1] and written queries submitted by the public. It will be observed that the Guide has grown substantially in size since it was first released for comment in December 2002. The increase in volume is attributable to the amendments that have since been passed, the comments received on the first draft, and a general expansion of the commentary.

This work reflects the law as at 24 January 2005 and includes the amendments effected by the Revenue Laws Amendment Act 32 of 2004. The commentary on the corporate rules covering *inter alia* ss 41 – 47 of the Income Tax Act has been removed from this Guide, and will be released during 2005 as a separate *Comprehensive Guide to the Corporate Rules*.

The 2005 tax rates have been used - these apply for example, to companies with years of assessment ending between 1 April 2004 and 31 March 2005 and individuals and trusts with years of assessment ending on 28 February 2005.

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The author would like to acknowledge the contribution of his colleagues on the CGT research team in preparing the explanatory memoranda that supported the legislation and formed the foundation for this Guide. The following individuals deserve special mention: Kosie Louw (General Manager: Law Administration), Franz Tomasek (Assistant General Manager: Legislation), Prof Gerrie Swart from Unisa, Keith Engel (formerly Director: Legislative Oversight and Policy Co-ordination [Tax Policy], with National Treasury), Christell Brodrick (Manager: Legal Drafting) Andrew Masters (Manager: Tax Research), Johan de la Rey and Trevor van Heerden. A special word of thanks must go to Trevor and Gerrie for reviewing the current version of the Guide and for providing me with invaluable assistance during the compilation process. And last but not least I must express my gratitude to those individuals and organisations that provided many constructive comments on the first draft.

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ABBREVIATIONS

General

CFC	Controlled foreign company
CGT	Capital gains tax
DTA	Double taxation agreement
MV	Market value
PE	Permanent establishment
TAB	Time-apportionment base cost
VDV	Valuation date value

Tax Court

C	Cape Tax Court (formerly Cape Income Tax Special Court)
F	Federation of Rhodesia and Nyasaland Income Tax Special Court (from 1957 to 1964)
G	Gauteng Tax Court
N	Natal Income Tax Special Court
SR	Southern Rhodesia Income Tax Special Court
T	Transvaal Income Tax Special Court
U	Special Court for the Union of South Africa (from 1 June 1926 to 1950)

Other case law

(A)	Appellate Division of the Supreme Court of South Africa
AC	Law reports, Appeal Cases, House of Lords
AD	Reports of the Appellate Division of the Supreme Court of South Africa
All ER	All England Law Reports
ALR	Australian Law Reports (1973 to date)
ATR	Australian Tax Reports
BCLR	Butterworths Constitutional Law Reports
BH	Bophuthatswana High Court
(C)	Cape Provincial Division of the Supreme Court of South Africa
(CC)	Constitutional Court
CIR	Commissioner for Inland Revenue
CLR	Commonwealth Law Reports
CPD	Reports of the Cape Provincial Division of the Supreme Court of South Africa
C:SARS	Commissioner for the South African Revenue Service
(E)	Eastern Cape Division of the Supreme Court of South Africa
EDC	Eastern District Court Reports, Cape of Good Hope, 1880 - 1909
ER	English Reports
(FC)	Federal Supreme Court of the Federation of Rhodesia and Nyasaland
FCA	Federal Court of Australia
FCR	Federal Court Reports
FCT	Federal Commissioner of Taxation (Australia)
IRC	Inland Revenue Commissioners
JTLR	Juta's Tax Law Reports
KB	Law Reports, King's Bench Division
(N)	Natal Provincial Division of the Supreme Court of South Africa
NO	*Nomine officio* ('in the name of office')
NNO	Plural of *nomine officio*
NPD	Reports of the Natal Provincial Division of the Supreme Court of South Africa
QBD	Law Reports, Queen's Bench Division
RAD	Rhodesia Appellate Division
SA	South African Law Reports
SATC	South African Tax Cases
SC	Reports of the Supreme Court of the Cape of Good Hope from 1880

(SCA)	Supreme Court of Appeal
SIR	Secretary for Inland Revenue
STC	Simon's Tax Cases
(T)	Transvaal Provincial Division of the Supreme Court of South Africa
TC	Reports of Tax Cases, England
TPD	Reports of the Transvaal Provincial Division of the Supreme Court of South Africa
TS	Transvaal Supreme Court Reports
UKHL	House of Lords (United Kingdom)
(W)	Witwatersrand Local Division of the Supreme Court of South Africa
WLD	Reports of the Witwatersrand Local Division of the Supreme Court of South Africa
WLR	Weekly Law Reports

Chapter 1 - Reasons for the introduction of CGT

For a more comprehensive discussion of the reasons for the introduction of CGT please refer to the Briefing by the National Treasury's Tax Policy Chief Directorate to the Portfolio and Select Committees on Finance Wednesday, 24 January 2001.[2] Briefly the reasons for the introduction of CGT are as follows:

1.1 International benchmarking

Many of South Africa's trading partners introduced CGT years ago. It was introduced in the United States of America in 1913, in the United Kingdom in 1965, in Canada in 1971 and in Australia in 1985. Many African countries also have CGT, though often in a more limited form, for example, Botswana, Egypt, Nigeria and Zimbabwe. Some of these developing countries limit their CGT for administrative reasons to share and property transactions only.

1.2 Horizontal equity

Haig-Simons[3] define income comprehensively as

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

In terms of this definition, 'comprehensive' income equals consumption plus net wealth accumulated during the period. In accordance with this definition, capital gains should be treated no differently from other forms of income.

Horizontal equity demands that individuals in similar economic circumstances should bear a similar tax burden, irrespective of the form the accretion of economic power takes. In other words, taxpayers should bear similar tax burdens, irrespective of whether their income is received in the form of wages, or capital gain. In this context, the exclusion of capital gains from the income tax base fundamentally undermines the horizontal equity of the tax system.

An individual who invests R100 000 on fixed deposit at 10% per annum has the same ability to pay as one who invests R100 000 in shares and derives a dividend of 3% and capital gain of 7%. Without CGT the latter individual pays no tax whilst the former pays up to 40% on the interest income (excluding the exempt portion). The same principle applies to individuals earning income by way of salary compared to those deriving income in the form of capital gains.

1.3 Vertical equity

Vertical equity connotes that taxpayers with greater ability to pay taxes should bear a greater burden of taxation. Furthermore, international experience indicates that the biggest share of capital gains tax revenues can be attributed to the wealthiest of individuals.

Thus, including capital gains in taxable income contributes to the progressivity of the income tax system, while enabling government to pursue other tax policy objectives, premised on widening tax bases and reducing standard tax rates.

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[2] See SARS Online at <http://www.sars.gov.za/cgt/historicaldevelopment/NationalTreasury24Jan2001.pdf> (accessed 22 March 2005).

[3] See R M Haig 'The Concept of Income - Economic and Legal Aspects' in *The Federal Income Tax* (1921) Columbia University Press, New York and H Simons *Personal Income Taxation* (1938) The University of Chicago Press, Chicago.

Given the skewed distribution of wealth in South Africa, the introduction of capital gains tax will markedly improve the vertical equity of the income tax system in South Africa.

1.4 Reduce the shift from income to capital

When capital gains are not taxed taxpayers have an incentive to recharacterise income as capital. There are many ways in which this can be done, some more complex than others. The classic example of this used to be the restraint of trade payment. Popular prior to the amendment of the Income Tax Act in 2000[4] it was commonplace for employees to be paid 'restraint of trade' payments. In many cases these were little more than disguised remuneration.

Taxpayers are also encouraged to shift from income bearing investments to those that produce capital gains. This erodes the tax base and results in an artificial allocation of resources. An example is to be found when money is invested offshore. One way of doing this is to invest the money in a fund and earn interest on the capital, which would be taxed. The alternative is to invest the money in a roll-up fund where interest is not paid to the investor but retained by the fund. As a result the value of the shares in the fund increases by the amount of the retained interest. When the shares are sold it can be argued that the difference between the original cost of the shares and the selling price is a non-taxable capital gain. The return on investment is the same but the tax consequences are very different. Sometimes the income to capital shift requires the hand of time – for example instead of disposing of shares within a year an investor waits a few years. Frequently the intention is the same – to make a profit on disposal of the shares, though in the latter case investors will invariably claim that the investment was made to earn dividend income.

Many of the techniques for converting income to capital rely on deception or non-disclosure for their success – for example, a taxpayer sells his business for a lump sum and agrees to remain on as a consultant for no remuneration – the so-called 'income burn out' scheme. In this case his remuneration has simply been disguised as part of the lump sum – a ploy not unlike the bogus restraint payment.

Although the effective tax rate differential between ordinary income and capital gains means that these techniques will remain attractive, the enhanced disclosure brought about by the CGT system will make them more difficult.

1.5 Economic efficiency

The application of scarce resources to tax planning and tax avoidance is clearly a dead-weight loss to society.

The efficiency case for introducing a capital gains tax is particularly strong if one considers the impact on the allocation of investment funds. If capital gains go untaxed, individuals are encouraged by the tax system to invest their savings in assets that provide returns in the form of capital gains (e.g. property), rather than income producing assets (e.g. equipment and machinery). Scarce investment funds are clearly misallocated when tax factors are given undue weight over risk-return considerations in the allocation of investment capital. Capital gains tax will narrow the gap in the tax treatment of different assets, reducing these distortions in individual portfolio decisions.

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[4] Paragraph (*c*A) inserted into the definition of gross income in s 1 by s 13(1)(*f*) of Act 30 of 2000 deemed to have come into operation on 23 February 2000 and applicable in respect of any amount received or accrued on or after that date.

1.6 Tax base broadening

The introduction of CGT will enable the tax base to be broadened thus facilitating lower overall tax rates. More taxpayers will be brought into the net – for example, non-residents owning immovable property in South Africa.

For more detailed information on the case for introducing CGT see the papers presented by Krever[5] and Brooks[6] to the Portfolio Committee on Finance.

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[5] R A Krever 'A Capital Gains Tax for South Africa' (25 January 2001) <http://www.ftomasek.com/RickKreverDraft.html> (accessed 22 March 2005).
[6] N Brooks 'Taxing Capital Gains is Good for the Tax System, the Economy and Tax Administration' (26 January 2001) <http://www.ftomasek.com/NeilBrooksRevised.pdf> (accessed 22 March 2005).

Chapter 2 - Historical development of CGT in South Africa

2.1 Previous Commissions of Enquiry

The idea of taxing capital gains is not new in South Africa. In 1969, the Franzsen Commission[7] proposed a limited form of capital gains tax on immovable property and marketable securities, while the Margo Commission[8] in 1986 recommended that capital gains should not be taxed. Most recently, the Katz Commission in its third report[9] considered the merits and demerits of a capital gains tax in South Africa. It declined to make firm recommendations in view of the complexity of its administration and the lack of capacity of the Inland Revenue at that time.

The Minister of Finance announced in his Budget Speech on 23 February 2000 that a CGT was to be introduced with effect from 1 April 2001.

2.2 The Guide – 23 February 2000

A guide to the key principles of the proposed CGT was published on 23 February 2000 and public comment was invited. As a result, SARS and the National Treasury received and considered over 300 submissions and held meetings with a number of associations and industry groupings. Readers of this initial guide should be aware that a number of key principles proposed therein were subsequently departed from. So, whilst it makes interesting reading, it should not be relied upon as an authoritative summary of the present law.

2.3 The First Draft - 12 December 2000

After consideration of the submissions, a number of changes were made to the proposals. A draft Bill incorporating the changes to the Income Tax Act, necessary to introduce CGT, was prepared and published for comment on the websites of SARS and the National Treasury on 12 December 2000. Comments were called for and over 150 submissions were received.

2.4 The Second Draft - 2 March 2001

In addition to this the Portfolio Committee on Finance and the Select Committee on Finance, after extensive preparation, jointly held public hearings on CGT during the period 23 January 2001 to 19 March 2001. The public hearings generated a great deal of debate and public interest in CGT. After consideration of these comments, an amended draft Bill was released on 2 March 2001 for comment. Cognizance was also taken of these latest comments and, where appropriate, they were included in the Bill.

The interest and participation of the public in commenting on the draft Bills and participating in the public hearings of the Committees were of invaluable assistance in formulating the legislation. In this regard SARS and the National Treasury wish to express their appreciation to each and everyone for their contributions.

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[7] Taxation in South Africa: First Report of the Commission of Enquiry into fiscal and monetary policy in South Africa, November 1968, printed for the Government Printer, Pretoria by Cape and Transvaal Printers TD, Cape Town B932/5,000 at 48.
[8] Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa, 20 November 1986, The Government Printer, RP34/1987, Pretoria.
[9] Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, 1995, The Government Printer, Pretoria.

2.5 The introduction of CGT into legislation

The Taxation Laws Amendment Bill (B17 – 2001) was tabled in the National Assembly on 5 April 2001, passed by the National Assembly on 16 May 2001, passed by the National Council of Provinces on 22 May 2001, and assented to by the Acting President on 13 June 2001. It was accompanied by a comprehensive Explanatory Memorandum that forms the foundation of this Guide. CGT was finally introduced into our law by The Taxation Laws Amendment Act 5 of 2001, which was promulgated on 20 June 2001. A summary of the changes made to CGT legislation since its introduction is contained in **2.6** below.

As with any new tax, further amendments will be required to the Eighth Schedule as SARS and taxpayers alike grapple with the practicalities of the new legislation.

2.6 Table of amendments to CGT legislation

Table 1 - Amendments to CGT legislation

Act	**Bill no. and date tabled**	**Vol no., Government Notice no., Government Gazette no. and date promulgated**	**Details**
Taxation Laws Amendment Act 5 of 2001	B 17 – 2001 Tabled 5.4.2001	Vol 432, GN 550, GG 22389 dd 20.6.2001	Inserts Eighth Schedule.
Revenue Laws Amendment Act 19 of 2001	B 36 – 2001 Tabled 22.6.2001	Vol 433, GN 709, GG 22532 dd 27.7.2001	Amends paras 2, 20, 23, 32, 45, 46, 55, 60, 66, 84, 86 of the Eighth Schedule.
Second Revenue Laws Amendment Act 60 of 2001	B 84 – 2001 Tabled 7.11.2001	Vol 438, GN 1333, GG 22923 dd 12.12.2001	Amends paras 1-4, 6, 7, 11, 12, 15, 18, 20, 24, 26, 28, 29, 30-32, 35, 38, 39, 40, 42-45, 47, 49, 52, 53, 55, 61, 65, 67, 74, 76, 80, 81, 84, 86 of the Eighth Schedule; substitutes paras 25, 27, 34, 56, 58 and 59 of the Eighth Schedule; inserts Part III of Chapter II, para 67A of the Eighth Schedule and repeals para 85 of the Eighth Schedule.
Taxation Laws Amendment Act 30 of 2002	B 26 – 2002 Tabled 20.6.2002	Vol 446, GN 1047, GG 23709 dd 5.8.2002	Amends paras 29, 32 and 84 of the Eighth Schedule
Revenue Laws Amendment Act 74 of 2002	B 67 – 2002 Tabled 6.11.2002	Vol 450, GN 1581, GG 24181 dd 13.12.2002	Amends paras 1, 2, 4, 10, 11, 12, 13, 14, 20, 24, 26, 27, 29, 30, 31, 32, 33, 38, 40, 41, 51, 53, 55, 56, 57, 72, 74, 76, 78, 79, 84, 95, 96, 86 of the Eighth Schedule. Substitutes paras 25, 43, 61, 63, 67A, 81 and Part XIII (now comprising paras 84 – 97) of the Eighth Schedule and

			Part III of Chapter 2 (now comprising ss 41 – 47). Inserts para 64A of the Eighth Schedule.
Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003	B 26 – 2003 Tabled 15.5.2003	GG 25047 dd 31.05.2003	S 4(3) (trust asset in respect of which the donor or deceased estate has elected to be the holder) S 28 (base cost limitation in respect of exchange control amnesty applicants)
Regulations issued in terms of s 30 of the Exchange Control and Amendment of Taxation Laws Act		GG 25511 dd 29.09.2003 Notice No. R.1368	Reg 4 (base cost of asset in respect of which election has been made; deemed disposal events pertaining to such asset). Reg 7 (suspension of attribution rules during period of election).
Revenue Laws Amendment Act 45 of 2003	B 71 – 2003 Tabled 18.11.2003	GG 25864 dd 22.12.2003	Amends paras 1, 2, 11, 12, 19, 20, 27, 30, 33, 39, 43, 55, 62, 67, 67A, 72, 74, 75, 78, 84, 86, 88, 92, 93, 94, 96 of the Eighth Schedule. Inserts paras 20A, 67B and 67C. Substitutes paras 63, 65 and 66 Amends ss 41 – 47.
Taxation Laws Amendment Act 16 of 2004	B 8 – 2004 Tabled 18.06.2004	GG 26612 dd 27.07.2004	Amends para 1, 39, 65, 67C, 75, 76 and 78.
Revenue Laws Amendment Act 32 of 2004	B 24 - 2004 Tabled 09.11.2004	GG 27188 dd 24.01.2005	Amends para 1, 2, 3, 4, 11, 12, 13, 20, 20A, 25, 33, 38 and 56. Inserts para 35A and 39A. Amends ss 41, 43, 45, 46 and 47. Inserts ss 24B, 24M and 35A.

2.7 Retrospective amendments

A number of amendments to CGT legislation have been made retrospective to valuation date and a variety of other dates. As a general rule the backdating of amendments tends to be in favour of the taxpayer. The purpose is to provide certainty with regard to the interpretation of the legislation by correcting errors and omissions.

There is a general presumption against a statute being construed as having retroactive effect. However, there is nothing to prevent Parliament from changing the law retrospectively to a date in the past.[10]

It follows that where an amendment is made effective from a prior date it will, unless the contrary is indicated, be applicable to all transactions entered into on or after that date regardless of the fact that the return may have been submitted or assessed in the meanwhile.

[10] See D Clegg and R Stretch *Income Tax in South Africa* (CD ROM version: August 2004) Butterworth Publishers (Pty) Ltd, Durban in para 2.16.2.

Chapter 3 - Design and overview of the core rules

3.1 Integration into the Income Tax Act

CGT has been incorporated into the Income Tax Act as it is regarded as a tax on income. This approach has administrative advantages as the existing provisions and procedures of the Income Tax Act can be used to collect CGT. If CGT were introduced as a separate tax, provisions would have had to be introduced for matters such as returns, assessments, payment and recovery of tax, and objection and appeals, which are already provided for in the Act. The Income Tax Act has been amended to ensure that the administrative procedures operate for CGT.

The CGT provisions are contained in the Eighth Schedule and produce either a taxable capital gain or an assessed capital loss.

Section 26A forms the link between the Eighth Schedule and the principal Act and ensures that a taxable capital gain is included in a person's taxable income. An assessed capital loss on the other hand cannot be set off against taxable income but is carried forward to subsequent years for set off against any future capital gains.

3.2 Drafting style

It will be observed that the style of drafting used in the Eighth Schedule differs from that used in the rest of the Act. The intention is to make the Act more accessible and a start has, therefore, been made in this Schedule to strike a balance between simplicity and clarity on the one hand, and technical correctness on the other. Whilst the move towards plain English drafting[11] has assisted in making the law more readable, CGT remains a complex tax.

Some examples of the new style include the liberal use of headings, shorter sentences, avoidance of words like 'such' (that), 'deemed' (treated as), 'notwithstanding' (despite) and so on. Where possible the use of provisos has been avoided.

Some new words such as exclusions, disregardings and roll-overs have also been introduced. The words 'exclusion' and 'disregarding' are useful because they can be used to refer to both gains and losses at the same time.[12] A 'roll-over' is a deferral.

An overview of the CGT process flowchart and the core rules are set out below.

3.3 Use of other countries' tax legislation

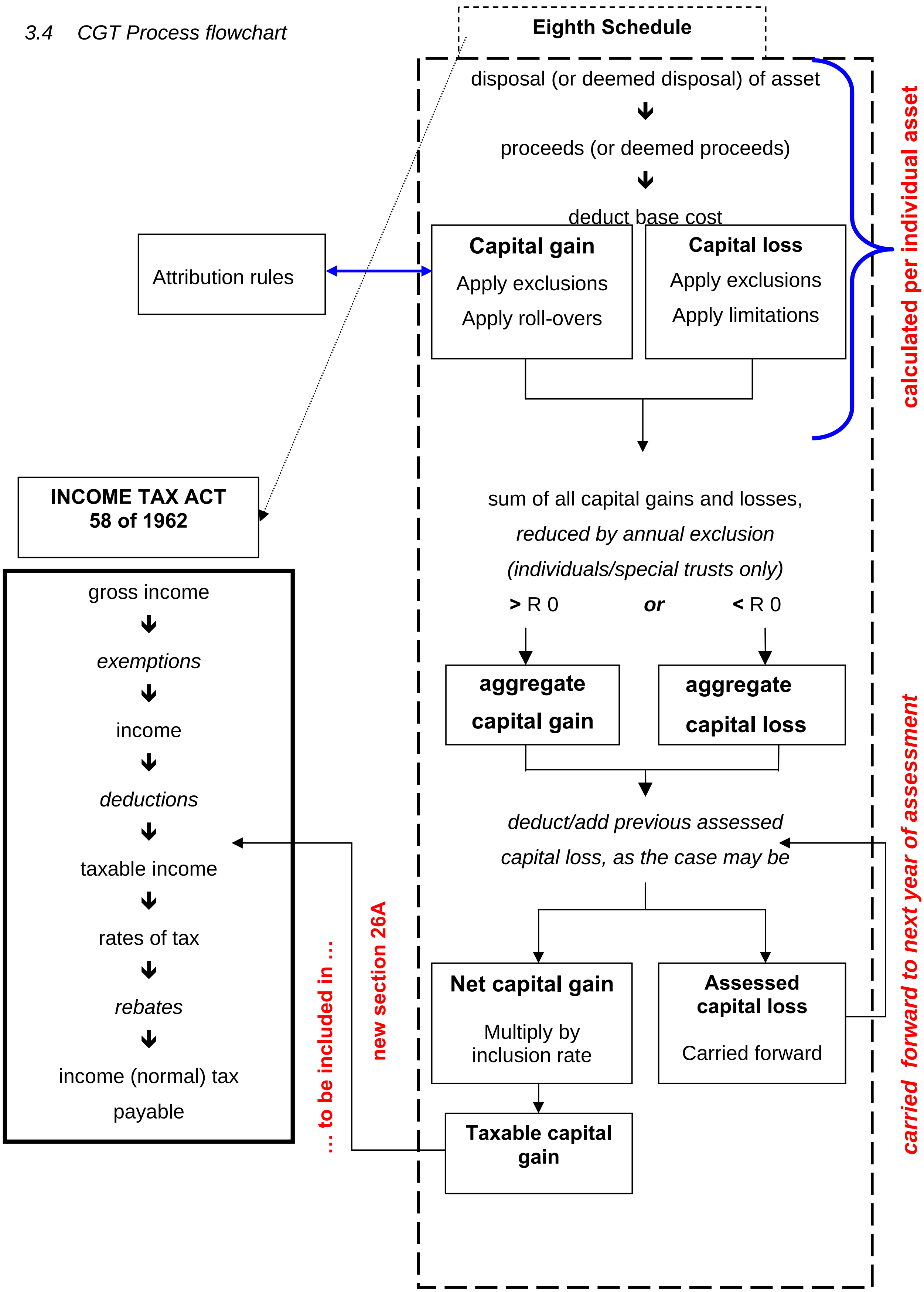
In designing the Eighth Schedule reference was made to the legislation of a number of countries most notably Australia and the United Kingdom and to a lesser extent Canada, the United States of America and Ireland amongst others. Experts from Australia, the United Kingdom and United States of America provided invaluable assistance. For a number of reasons no single country's CGT legislation could serve as a model for South Africa. Each country presented its own difficulties. For example, the Canadian legislation is integrated into that country's Income Tax Act, the United Kingdom's legislation[13] is contained in a separate

[11] The Australian CGT legislation has been drafted in plain English.
[12] For example, the annual and primary residence exclusions prevent gains from being subjected to CGT whilst at the same time preventing losses from being claimed, within certain limits.
[13] The Taxation of Chargeable Gains Act, 1992.

Act that spans more than 500 pages whilst Australia's CGT[14] only applies to assets acquired after 1985. The Australian approach may seem to be simpler in that it dispenses with the problem of determining valuation date values but it carries with it a number of disadvantages. First, it resulted in a lock-in effect – taxpayers were reluctant to dispose of their pre-1985 assets because it would mean reinvesting in taxable post-1985 assets. Secondly, astute tax planners devised all manner of schemes to shift value from post-CGT assets to pre-CGT assets, necessitating some fairly complex anti–avoidance legislation. And finally the result was a far more restricted tax base.

[14] As contained in the Income Tax Assessment Act, 1997 <http://law.ato.gov.au/atolaw/browse.htm?toc=04%3APLR%3ATaxation%3AINCOME%20TAX%20ASSESSMENT%20ACT%201997> (accessed 22 March 2005).

3.4 CGT Process flowchart



The above-mentioned flowchart sets out the core steps in determining a taxable capital gain to be included in taxable income or an assessed capital loss to be carried forward to a subsequent year of assessment.

3.5 Determination of a capital gain or loss

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

Capital gains and losses are triggered by a disposal or an event treated as a disposal. Unless such a disposal or event occurs, no gain or loss arises.

An **asset** is defined as widely as possible and includes any property of whatever nature and any interest therein. CGT applies to all assets of a person disposed of on or after 1 October 2001 (valuation date), whether or not the asset was acquired by the person before, on or after that date. However, only the gain accruing from 1 October 2001 will be subject to tax. The method of limiting the gain to accruals on or after valuation date is set out in Part V of the Eighth Schedule (see Chapter 8).

The concept of **disposal** is more fully dealt with in para 11 of the Eighth Schedule and covers any event, act, forbearance or operation of law which results in a creation, variation, transfer or extinction of an asset. It also includes certain events treated as disposals, which are more fully dealt with in para 12, such as cessation or commencement of residence and the change in the use of an asset.

Once an asset is disposed of it gives rise to **proceeds**, which is more fully dealt with in Part VI of the Eighth Schedule (see Chapter 9). Where an asset is disposed of the amount that is received by or that accrues to the seller of the asset constitutes the proceeds from the disposal.

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

- acquisition of an asset,
- improvement of an asset, and
- direct costs in respect of the acquisition and disposal of an asset.

The rules around base cost are, however, fully dealt with in Part V of the Eighth Schedule (see Chapter 8).
The following example illustrates the calculation of a capital gain:

Example – Determination of capital gain

Facts: 100 shares are purchased on 1 October 2001 at a base cost of R10 000 and are sold on 1 October 2006 for R30 000.
Result:

Asset	100 shares
Disposal event	Sale of the shares

Proceeds	R30 000 (Sale price)
Base cost	R10 000 (Purchase price)
Capital gain	= R30 000 – R10 000
	= R20 000

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

Various capital gains or losses must be disregarded or are limited for purposes of determining a capital gain or loss. These limitations and disregardings are dealt with in Parts IV, VII and VIII of the Eighth Schedule (see Chapters 7, 11 and 12 respectively).

The Eighth Schedule also provides for the roll-over of certain capital gains. In these circumstances the recognition of these gains is delayed for CGT purposes and they are held over until the happening of a future event. These rules are dealt with in Part IX of the Eighth Schedule (see Chapter 13). The corporate rules in ss 41 – 47 also provide roll-over relief.

It is also at this level that certain capital gains resulting from a donation, settlement or other disposition can be attributed to, for example, the donor. These attribution rules are more fully set out in Part X of the Eighth Schedule (see Chapter 15).

3.6 Aggregate capital gain or aggregate capital loss

It is important to understand that a capital gain or loss is first determined separately in respect of each asset disposed of by a taxpayer during a year of assessment. This step-by-step approach is important for the following reasons:

- First, a CGT event is triggered in respect of the disposal of an asset.
- Secondly, once all individual capital gains and losses have been determined they must be added together to allow for the determination of a person’s taxable capital gain in its logical sequence.

In determining a person’s aggregate capital gain or loss, two important steps, therefore, take place.

- First, all a person’s capital gains and/ or losses are added together.
- Thereafter, the total amount of such capital gains and/or losses is reduced by the annual exclusion of R10 000 in the case of a natural person.

Example – Determination of aggregate capital gain

	R
Capital gain on sale of holiday house	50 000
Capital loss on sale of shares	(20 000)
Sum of capital gains and losses	30 000
Annual exclusion	(10 000)
Aggregate capital gain	20 000

If the sum of the capital gains and losses is a negative figure, the aggregate loss must also be reduced by the annual exclusion of R10 000.

Where a person dies during a year of assessment, the annual exclusion for that year is increased to R50 000.

3.7 Determination of net capital gain or assessed capital loss

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

Example 1 – Determination of net capital gain

	R
Aggregate capital gain for 2003	100 000
Assessed capital loss for 2002	(50 000)
Net capital gain for 2003	50 000

Example 2 – Determination of assessed capital loss

Aggregate capital loss for 2003	(50 000)
Assessed capital loss for 2002	(50 000)
Assessed capital loss for 2003	(100 000)

3.8 Determination of taxable capital gain

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

The table below sets out the inclusion rates for determining a taxable capital gain, the statutory rates on taxable income and the resulting effective CGT rates for different classes of taxpayer. The statutory rates shown are those that are effective for years of assessment commencing on or after 1 April 2004.

Table 1 – Inclusion, statutory and effective CGT rates for 2005

Type of Taxpayer	**Inclusion rate %**	**Statutory Rate %**	**Effective CGT rate %**
Individuals	25	0 – 40	0 – 10
Retirement Funds	N/A	0	N/A
Trusts			
• Unit	N/A	30	N/A
• Special	25	18 – 40	4.5 – 10
• Other	50	40	20
Life Assurers			
• Individual policyholder fund	25	30	7.5
• Company policyholder fund	50	30	15
• Corporate fund	50	30	15
• Untaxed policyholder fund	0	0	0
Companies	50	30	15
Small business corporations	50	15 – 30	7.5 – 15
Employment companies	50	35	17.5
Permanent establishments (branches)	50	35	17.5
Tax holiday companies	50	0	0

The statutory rates in the above table are those in respect of the 2005 tax year (companies with years of assessment falling between 1 April 2004 and 31 March 2005; individuals and trusts with years of assessment ending on 28 February 2005). The effective CGT rate on a capital gain (ignoring exclusions) is determined by multiplying the inclusion rate by the statutory rate. For example, an individual in the top tax bracket would pay CGT at the effective rate of 25% x 40% = 10%. In the case of a company the effective rate of CGT is 50% x 30% = 15%. However, taking into account the STC on any capital profit distributed, the effective rate is 15% + 9,44% = 24.44%. This is arrived at as follows:

	R
Capital gain	100
Taxable capital gain 50% x R100	50
CGT R50x 30%	15
Capital profit available for distribution R100 – R15	85
STC 12,5/112,5 x R85	9.44
Total effective rate of tax on capital gain R15 + R9,44	24,44

The above calculation is based on the assumption that the capital gain (subject to CGT) and the capital profit (subject to STC) are the same. In practice this may not always be the case. It is also assumed that the entire capital profit is subject to STC. In some cases, however, the capital profit may be exempt from STC (for example, upon deregistration or liquidation in terms of s 64B(5)(*c*)).

3.9 Inclusion of taxable capital gain in taxable income

Once a person's taxable capital gain has been determined, that taxable capital gain is included in the person's taxable income in terms of s 26A of the Income Tax Act 58 of 1962, which reads as follows:

> 'There shall be included in the *taxable income* of a person for a year of assessment the taxable capital gain of that person for that year of assessment, as determined in terms of the Eighth Schedule.'

Thereafter, the ordinary rates of tax are applied to the person's taxable income (which now includes taxable capital gains) to determine a person's normal income tax liability.

A taxable capital gain will also reduce an assessed loss – this not so obvious fact flows from the definition of taxable income which is defined in s 1 of the Act as follows:

> '**"taxable income"** means the aggregate of—
>
> (*a*) the amount remaining after deducting from the income of any person all the amounts allowed under Part I of Chapter II to be deducted from or set off against such income; and
>
> (*b*) all amounts to be included or deemed to be included in the taxable income of any person in terms of this Act'.

It is evident from this definition that taxable income can be a negative figure. Paragraph (*a*) would become negative when the amounts allowed in terms of Part I of Chapter II exceed the income of a person. Furthermore, Part I of Chapter II includes s 20 which deals with assessed losses. There would also have been no need to amend s 103(2) to prevent the set off of a 'tainted' capital gain against an assessed loss if such a set off was not possible in the first place.

If a person sustains an assessed capital loss for a tax year, that loss cannot be set-off against the person's ordinary income of a revenue nature. An assessed capital loss, therefore, neither decreases a person's taxable income nor does it increase a person's assessed loss of a revenue nature. Such an assessed capital loss is, therefore, ring-fenced and can only be set-off against capital gains arising during future years of assessment.

Unlike an assessed loss of a company which is forfeited where no trade is carried on during a year of assessment, no similar provision exists in the case of an assessed capital loss which can in theory be carried forward indefinitely. The provisions of s 103(2) should act as a deterrent to prospective traffickers in such losses.

Chapter 4 - The Eighth Schedule – Scope and definitions

PART I: GENERAL (paras 1 and 2)

4.1 Definitions

Paragraph 1

4.1.1 Introduction

Paragraph 1 contains a number of definitions for use in the Eighth Schedule. Where words or phrases used in the Eighth Schedule are also used in the rest of the Act, the words and phrases are also defined in s 1. With the exception of the definition of a special trust, the words defined in s 1 have the same meaning when used in the Eighth Schedule.

The definitions are in most cases self-explanatory or refer to paragraphs or Parts of the Eighth Schedule where amounts are determined. The table below sets out the terms that are defined in the Eighth Schedule and indicates where these are also defined in s 1. Cross-references to the sections of the Guide where these definitions are dealt with are also provided.

Table 1 – Terms defined in para 1 and/or s 1

Definition in para 1	**Paragraph/Part/Section where comprehensively defined**	**Defined in s 1?**	**Reference in Guide**
Aggregate capital gain	Paragraph 6	Yes	5.4
Aggregate capital loss	Paragraph 7	Yes	5.4
[Assessed capital loss – not defined in para 1]	Paragraph 9	Yes	5.5
Asset	N/A – see below	No	See below
Base cost	Part V	No	8
Boat	N/A – see below	No	See below
Capital gain	Paragraph 3	Yes	5.1
Capital loss	Paragraph 4	Yes	5.2
Disposal; disposed	11 and amounts treated as disposals ito Schedule	No	6
Individual policyholder fund	Section 29A(4)(*b*)	No	
Insurer	Section 29A(1)	No	
Net capital gain	Paragraph 8	No	5.5
Personal-use asset	Paragraph 53	No	12.2
Pre-valuation date asset	N/A – see below	No	See below
Primary residence	Paragraph 44	No	11.2
Proceeds	Part VI	No	9.1
Recognised exchange	N/A – see below	No	See below
Residence	Paragraph 44	No	11.3
Ruling price	N/A – see below	No	See below

Special trust	N/A – see below	Yes, but wider than para 1 definition	14.13
Taxable capital gain	Paragraph 10	Yes	5.6
Valuation date	N/A – see below	No	See below
Value shifting arrangement	N/A – see below	No	See below and 21.3

Many words used in the Eighth Schedule are defined in s 1 of the Act. This includes words such as

- Equity share capital
- Financial instrument
- Foreign equity instrument
- Resident
- Spouse.

4.1.2 Definition – 'asset'

> '**"asset"** includes—
> (*a*) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and
> (*b*) a right or interest of whatever nature to or in such property'

The definition of 'asset' is of importance, as CGT is, with few exceptions,[15] not triggered until an asset is disposed of. A wide definition has been ascribed to the word, which includes all forms of property and all rights or interests in such property. The exclusion of currency is dealt with below. A few examples of assets are listed below:

- land and buildings, for example, a factory building, a person's home, or holiday home;
- shares;
- a participatory interest in a collective investment scheme;
- an endowment policy;
- collectables, for example, jewellery or an artwork;
- personal use assets, for example, a boat;
- contractual rights;
- goodwill;
- a trade mark
- a loan;
- a bank account, whether local or foreign.

It is submitted that the word 'property' refers to anything that can be disposed of and turned into money. Things that are incapable of ownership are excluded, that is, *res extra commercium,* namely, *res communes* (things common to all inhabitants such as the sea and air) and *res publicae* (State property held for the benefit of inhabitants).[16] Furthermore, according to *LAWSA*,[17] in terms of Roman law certain rights were considered so personal that they were considered incapable of pecuniary evaluation. Examples include personal liberty, personal authority, and rights flowing form the marital relationship. Such rights were not considered to be 'things' and would therefore not constitute 'property' for CGT purposes.

[15] Paragraph 12(5) triggers a capital gain upon the reduction or discharge of a liability under specified circumstances, and para 93 triggers a capital gain or loss on settlement of a foreign currency liability.
[16] J T R Gibson *Wille's Principles of South African Law* 7 ed (1977) Juta & Company Limited at 163.
[17] W A Joubert and J A Faris *The Law of South Africa* (CD ROM version: August 2004) Butterworth Publishers (Pty) Ltd, Durban vol 27 in para 207 'Things'.

4.1.2.1 Corporeal

Wille considers that corporeal things are those that can be handled or touched.[18] But according to *LAWSA*, the modern concept of corporeality goes further:[19]

> ‘An object is considered to be corporeal if it occupies space and can be perceived by any of the five senses.’

Examples: Land and buildings, plant and machinery.

4.1.2.2 Incorporeal

Incorporeal things are things which cannot be seen, heard, touched, smelled or tasted. They are imaginary conceptions, such as real and personal rights.[20]

Examples: A servitude, shares in companies, a member’s interest in a close corporation, goodwill of a business, patents, trade marks, designs, copyrights, a personal right which can be settled by a money payment, real right over a movable e.g. a pledge. The right to trade has also been held to constitute incorporeal property – see **24.5**.[21]

4.1.2.3 Immovable

According to *LAWSA*[22]

> ‘immovable things . . . are things which cannot be moved from one place to another without damage or change of form.’

Examples: Land, buildings with foundations in the soil, trees, growing crops, real rights over immovable property (e.g. a usufruct or a lease longer than 10 years registered in the Deeds Office). According to *Wille*[23] an article attached to an immovable will be movable where it can be separately identified and removed with ease unless the owner intends it to be permanently annexed. Examples given are buildings without foundations, sheds, windmills, railway lines, and all fixtures or annexures to buildings.

4.1.2.4 Movable

A thing is considered to be a movable if it can be moved from one place to another without being damaged and without losing its identity.

Examples: Furniture, motor vehicles, ships and livestock.

In terms of Roman-Dutch law, corporeal and incorporeal things can also be classified as movable or immovable.

Examples:
Incorporeal movable property: Real rights over movable property, a usufruct over a movable asset, all personal rights.

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[18] *Supra* at 165.
[19] *The Law of South Africa* vol 27 in para 206 ‘Corporeality’.
[20] *Wille supra* at 165.
[21] ITC 1338 (1980) 43 SATC 171 (T) at 174.
[22] *The Law of South Africa* vol 27 in para 224 ‘Movables and Immovables’.
[23] *Supra* at 166.

Incorporeal immovable property: Real rights over immovable property; a registered usufruct over immovable property, mineral rights, a registered *praedial* servitude and building restrictions.[24]

4.1.2.5 Rights

The definition of an asset includes rights of whatever nature to or in property. A *jus* is a right recognised by law. Under Roman-Dutch law, rights that can be disposed of consist of

- personal rights (*jus in personam*), and
- real rights (*jus in rem*).

Both are assets for CGT purposes.

Personal rights

A personal right (*jus in personam*) is a right in or against a particular person. The parties to a contract have rights against each other.

A personal right imposes a personal duty upon the grantor in favour of the grantee to perform.

For example:

- if A sells B an asset for a fixed sum, delivery and payment to take place in five years' time, B will have a personal right against A, namely, the right to expect A to deliver the asset to B on due date. Once delivery takes place, B will acquire a real right in the asset.

- All trust beneficiaries whether vested or discretionary, have a personal right of action against the trustees to perform their duties in accordance with the trust deed. A vested beneficiary will, in addition, have a personal right against the trustees to claim transfer of a trust asset or the income from a trust asset, depending on the nature of the vested right. Enjoyment of the right may be postponed until a future date. Beneficiaries do not have ownership of the trust assets which vest in the trustees.[25]

- In the case of an unconditional bequest of immovable property, a real right does not vest in the legatee on the death of the testator but only a personal right enforceable against the executors; *a jus in personam ad rem acquirendam.*

Real rights

A real right (*jus in rem*) is a right in a thing which is enforceable against all persons, or put differently, against the whole world.

For example, the conclusion of an agreement of sale involves the creation of a *jus in personam* in favour of the buyer against the seller. The performance of the seller's obligation involves the transfer of the *jus in rem* to the buyer. The buyer's *jus in personam* is exchanged for a *jus in rem* upon transfer of the property. Once transfer has occurred, the new owner will have an exclusive right of enjoyment of the asset.

[24] *The Law of South Africa* vol 27 in para 225 'Incorporeal movables and immovables', and *Wille supra* at 167.
[25] *CIR v Mac Neillie's Estate* 1961 (3) SA 833 (A) 840F-G.

Why recognise personal rights for CGT purposes?

If personal rights were not recognised it would not be possible to subject certain transactions to CGT. This is illustrated in the examples below

Example 1 – Disposal of personal right in exchange for real right

Facts: Anton and Brenda entered into a contract. Brenda later breached the contract. Anton sued Brenda for damages for breach of the contract. The court ruled in Anton's favour, and Brenda later paid Anton.

Result: When she breached the contract, Brenda created a personal right in favour of Anton. When the court ruled in Anton's favour, his personal right was confirmed and the amount of damages was quantified. When payment of the award was made by Brenda, Anton's personal right was extinguished in exchange for cash proceeds. The extinction of the personal right is a CGT event (disposal). The base cost of Anton's personal right would consist of his legal fees that could not be recovered from Brenda. The proceeds accruing to Anton are the amount of damages awarded to him.

If personal rights were ignored in this example, there would be no disposal of an asset and no means of subjecting the proceeds to CGT.

Example 2 – Disposal of personal right in exchange for real right

Facts: Errol bought a USA Lotto ticket for R10. He won R10 000 000 when his lucky number was drawn.

Result: Errol acquired a personal right against the organisers for the payment of R10 000 000 in terms of the Lotto rules. When he is paid out, that personal right is extinguished, which results in a disposal. Errol will have a capital gain of R10 000 000 less the cost of his Lotto ticket of R10.

Again, without recognising Errol's personal right there would be no means of generating a disposal.

See **6.3** for a detailed commentary on the treatment of personal and real rights in the context of deferred delivery schemes.

Is the right to claim payment an asset?

Whilst the right to claim payment is a personal right, it will not always be recognised as an asset for CGT purposes, particularly where the amount represents proceeds in connection with the disposal of a pre-existing asset. For example, if A sells an asset to B for R100, the R100 will comprise proceeds, and it is not necessary to enter into a further asset analysis of the R100. But if A damages B's asset, A creates a right to claim payment from A in B's hands. That right to claim payment will be an asset for CGT purposes in B's hands because there is no other pre-existing asset. The position was aptly summed up in the United Kingdom case of *Zim Properties Ltd v Proctor*[26] where Warner J stated the following:

> 'I have no difficulty in accepting that not every right to a payment is an "asset" within the meaning of the term in the capital gains tax legislation. Perhaps the most obvious example of one that is not is the right of the seller of property to be paid the purchase price. The relevant

[26] (1984) 58 TC 371 at 392F-G.

> asset then is the property itself. What that shows, however, to my mind, is no more than the interpretation of the capital gains tax legislation requires, as does the interpretation of any legislation, the exercise of common sense, rather than the brute application of verbal formulae.'

4.1.2.6 Exclusion of currency

The definition of an asset excludes 'currency' but includes gold or platinum coins. The word 'currency' is not defined in the Act, but according to the *Shorter Oxford English Dictionary* it means

> '3. of money: the fact or quality of being current as a medium of exchange; circulation.
> 4. the circulating medium; the money of a country in actual use 1729.
> b. spec. applied to a current medium of exchange when differing in value from the money of account; e.g. the former currency and banco of Hamburg (see BANCO *a.)* 1755.'

According to this meaning, currency would not include

- an old coin or note no longer in circulation, or
- a new coin or note not intended for circulation such as mint collectors' issues of new coins or notes.

It follows that notes or coins held as collectors' items are assets for CGT purposes. However, such collectors' items if held by individuals or special trusts constitute personal use assets in terms of para 53(2), and any gain or loss on their disposal must be disregarded (para 53(1)).

Why is local currency excluded? A rand that comprises legal tender is always worth a rand, and so the exchange of say, a R100 note for 10 R10 notes would in any event yield no gain, no loss. Administratively it therefore makes no sense to trigger a disposal each time cash changes hands. Secondly, had cash been an asset the *fiscus* could have been exposed to numerous claims for the loss of cash. Not only would claims of this nature be difficult to validate, but also numerous disputes could arise as to whether the cash that was lost was a personal use asset.

The exclusion of foreign currency

Unlike Australia and the United Kingdom, our definition of an asset also excludes foreign currency. However, gains and losses on foreign currency are determined separately in terms of Part XIII, and for that purpose para 84 contains a definition of a foreign currency asset.

The exclusion of local currency in Australia and the United Kingdom

In Australia, s 108-5 of the Income Tax Assessment Act, 1997 defines an asset for CGT purposes. Foreign currency is specifically included but the definition is silent as to whether Australian currency is an asset. The ATO accepts that Australian currency is not an asset for the purposes of s 108-5 when it is used as legal tender.[27] The ATO view is that Australian currency serves as a medium of exchange to facilitate a transaction. This view finds support in *FCT v Cooling*[28] where Hill J observed that[29]

> 'it would seem, Australian currency may not be an asset as defined.'

In the United Kingdom s 21(1)(*b*) of the Taxation of Chargeable Gains Tax Act, 1992 includes as assets 'any currency, other than sterling'.

[27] See ATO Tax Determination TD 2002/25 dated 20 November 2002.
[28] 1990 22 FCR 42, 21 ATR 13.
[29] At ATR 31.

Example – Loss of cash

Facts: Denys drew R500 in cash from the bank. On his way home the cash slipped through a hole in his pocket resulting in the loss of the money.

Result: Denys cannot claim a capital loss as the cash is not an asset for CGT purposes.

Gold or platinum coins

Whilst currency is excluded from the definition of 'asset', this does not apply to coins made mainly from gold or platinum. Coins of this nature are clearly more valuable than ordinary legal tender and their value fluctuates with the price of gold or platinum.

Whilst all gold or platinum coins constitute assets, capital gains and losses arising on the disposal of coins that constitute personal use assets must be disregarded (para 53(1)). Personal use assets refer to assets of individuals and special trusts that are not used mainly for the purpose of carrying on a trade (para 53(2)). However, a coin

> 'made mainly from gold or platinum of which the market value is mainly attributable to the material from which it is minted or cast'

is not a personal use asset and is subject to CGT (para 53(3)(*a*)). Identical wording is used in paras 17(2)(*a*) and 18(2)(*a*) to permit the claiming of losses in respect of forfeited deposits and disposal of options in respect of such coins. In terms of para 32(3A)(*c*) the weighted average method may be used for determining the base cost of gold or platinum coins the prices of which are regularly published in a national or international newspaper.

Cash on deposit with banking institutions

A deposit of cash with a bank is not excluded from the definition of asset since it does not constitute currency. It is rather a right to claim the amount deposited from the bank. A person would be entitled to claim a loss in respect of a bank balance should the amount be lost, for example by the bank being placed into compulsory liquidation. See in this regard the definition of 'financial instrument' in s 1 that includes a deposit with a financial institution. The definition of personal use asset excludes financial instruments (para 53(3)(*e*)).

Finally, merely because an item falls within the definition of an asset does not mean that the capital gain or loss will be subject to CGT. Capital gains and losses are disregarded in certain circumstances.

4.1.3 Definition – 'boat'

> '**"boat"** means any vessel used or capable of being used in, under or on the sea or internal waters, whether—
> (*a*) self-propelled or not; or
> (*b*) equipped with an inboard or outboard motor'.

This definition is extremely wide, and even includes a submarine. References to boats can be found in three places in the Eighth Schedule:

- Losses on boats exceeding 10 m in length are disallowed to the extent that they are not used for trade (para 15(*b*)).
- A boat can constitute a person's residence (para 44).
- A boat exceeding 10 m in length is excluded from being a personal use asset (para 53(3)(*d*)).

4.1.4 Definition – 'pre-valuation date asset'

> '**"pre-valuation date asset"** means an asset acquired prior to valuation date by a person and which has not been disposed of by that person before valuation date'.

This definition is used primarily in determining the base cost of assets acquired prior to the valuation date. The term 'pre-valuation date asset' can be found in paras 25 – 27 and 30.

4.1.5 Definition – 'recognised exchange'

> '**"recognised exchange"** means—
> (*a*) an exchange licensed under the Securities Services Act, 2004;[30]
> (*b*) . . . [31]
> (*c*) an exchange in a country other than the Republic which is similar to an exchange contemplated in paragraph (*a*) or (*b*) and which has been recognised by the Minister for purposes of this Schedule by notice in the *Gazette*'.

Both the JSE Securities Exchange SA and the Bond Exchange of South Africa (BESA) fall under para (*a*). Prior to 1 February 2005 BESA fell under para (*b*).

The list of recognised exchanges in countries outside the Republic was published in GN R997 *Government Gazette* 22723 of 2 October 2001.

4.1.6 Definition – 'ruling price'

> '**"ruling price"** means—
> (*a*) in the case of a financial instrument listed on a recognised stock exchange in the Republic, the last sale price of that financial instrument at close of business of the exchange, unless there is a higher bid or a lower offer on that day subsequent to the last sale in which case the price of that higher bid or lower offer will prevail; or
> (*b*) in the case of a financial instrument listed on a recognised exchange outside the Republic, the ruling price of that financial instrument as determined in item (*a*) and if the ruling price is not determined in this manner by that exchange, the last price quoted in respect of that financial instrument at close of business of that exchange'.

The definition relates to financial instruments that are listed on a recognised exchange. Item (*a*) deals with local listed instruments whilst item (*b*) deals with foreign listed instruments. The term 'financial instrument' is defined in s 1. The term 'ruling price' is used in paras 29 and 31, which deal with the market value of assets. The definition provides that the ruling price of a listed financial instrument on a recognised exchange in the Republic is the last sale price of that instrument at close of business of the exchange, unless there is a higher bid or a lower offer on that day subsequent to the last sale, in which case the higher bid or lower offer will prevail. This is the method used by the JSE Securities Exchange SA. A 'bid' is the buyer's price, namely, the price offered by a buyer to buy a number of securities at a certain stated price. An 'offer' is the seller's price, that is, the price at which a seller is prepared to sell securities on the market

In the case of financial instruments listed on a recognised exchange outside the Republic, the ruling price is the same as described above if the exchange calculates the price in this

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[30] Paragraph (*a*) was amended by s 51(1)(*a*) of the Revenue Laws Amendment Act 32 of 2004. The amendment came into operation on the date that the Securities Services Act 36 of 2004 came into operation, namely, 1 February 2005 (as per Proclamation R.6.2005 published in GG 27233 dated 31 January 2005). The provision previously refered to a stock exchange licensed under the Stock Exchanges Control Act 1 of 1985.

[31] Paragraph (*b*) was deleted by s 51(1)(*b*) of Act 32 of 2004. The amendment came into effect on 1 February 2005. The provision previously referred to a financial exchange licensed under the Financial Markets Control Act 55 of 1989.

manner, and if not, is the last price quoted in respect of the financial instrument at the close of business of the exchange.

4.1.7 Definition – 'special trust'

> '**"special trust**" means a trust contemplated in paragraph (*a*) of the definition of 'special trust' in section 1'.[32]

The above definition of 'special trust' only covers trusts for persons suffering from a mental illness or serious physical disability. For a more detailed commentary see **14.13.**

4.1.8 Definition – 'valuation date'

> '**"valuation date"** means—
> (*a*) in the case of any person who after 1 October 2001 ceases to be an exempt person for purposes of paragraph 63, the date on which that person so ceases to be an exempt person; or
> (*b*) in any other case, 1 October 2001'.

Valuation date of body ceasing to be exempt

The position between 22 December 2003 and the commencement of years of assessment ending on or after 1 January 2005

Prior to its amendment by Act 16 of 2004, para (*a*) read as follows:

> 'in the case of any person contemplated in section 10(1)(*c*A) which after 1 October 2001 ceases to be an exempt person for purposes of that section and paragraph 63, the date on which that person so ceases to be an exempt person . . .'.[33]

In terms of s 10(1)(*c*A) the receipts and accruals of certain government and quasi-government bodies are exempt from income tax. A body enjoying exemption in terms of s 10(1)(*c*A) must also disregard any capital gain or loss in terms of para 63.

Where such a body ceases to be exempt in terms of s 10(1)(*c*A) and para 63, that body's valuation date is the date the body ceased to be exempt. All the provisions that applied to taxable persons who owned assets on 1 October 2001 will apply in the same manner to these bodies except that their valuation date will be the date that they lost their exempt status.

The position on or after the commencement of years of assessment ending on or after 1 January 2005

The current version of para (*a*) applies to all exempt persons who become taxable, and not merely those who were previously exempt in terms of s 10(1)(*c*A). Hence, s 10(1)(*d*) entities and public benefit organisations shifting to taxable status fall within the ambit of this rule.

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[32] Inserted by Act 74 of 2002 and came into operation from the commencement of years of assessment ending on or after 1 January 2003.
[33] Paragraph (*a*) of the definition inserted by s 90 of Act 45 of 2003, effective as from 22 December 2003.

Valuation date in any other case (para (b))

Paragraph (*b*) of the above definition is self-explanatory and signifies the date on which CGT became effective.

4.1.9 Definition – 'value shifting arrangement'

> '**"value shifting arrangement"** means an arrangement by which a person retains an interest in a company, trust or partnership, but following a change in the rights or entitlements of the interests in that company, trust or partnership (other than as a result of a disposal at market value as determined before the application of paragraph 38), the market value of the interest of that person decreases and—
> (*a*) the value of the interest of a connected person in relation to that person held directly or indirectly in that company, trust or partnership increases; or
> (*b*) a connected person in relation to that person acquires a direct or indirect interest in that company, trust or partnership'.

Value shifting is a technique used to avoid CGT and is a new concept in our tax law. See **21.3** for a detailed explanation of these anti-avoidance provisions, including this definition.

4.2 Application to residents and non-residents

Paragraph 2

Paragraph 2 defines the scope of the legislation and prescribes who is subject to CGT and which assets of such persons are subject to CGT.

CGT applies only to disposals that take place on or after the valuation date, which is 1 October 2001. The dates (time rules) on which disposals are treated as having taken place are set out in para 13 and are of importance in deciding whether disposals fall within the CGT net.

Paragraph 2 draws a distinction between a resident, which is a defined word in s 1, and a non-resident.

- A *resident* is subject to CGT on the disposal of any asset whether in the Republic or outside,
- A *non-resident* is subject to CGT on the disposal of
  - any immovable property or any interest or right in immovable property situated in the Republic, and
  - any asset of a permanent establishment through which that non-resident is carrying on a trade in the Republic.

As to the common law meaning of the term 'immovable property', see the notes under **4.1** on the definition of 'asset'.

The term 'an interest in immovable property situated in the Republic' is defined broadly in para 2(2). It includes a direct or indirect interest of at least 20% held by a person (alone or together with a connected person in relation to that person) in the equity share capital of a company or other entity, where 80% or more of the net asset value (determined on the market value basis) of the company or other entity at the time of disposal is attributable directly or indirectly to immovable property situated in the Republic. The 80% excludes immovable property held as trading stock as this is a CGT anti-avoidance measure. Where a non-resident holds shares in a company that holds leasehold property, the non-resident will be subject to CGT on disposal of the company's shares. This follows from the fact that the *value* of the company's net assets (being the leasehold rights) is directly or indirectly attributable to immovable property in the Republic.

The term 'permanent establishment' is defined in s 1 as follows:

> '**"permanent establishment"** means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development'.

No exception is made for the holding of shares in listed SA companies. Thus a non-resident holding shares in a SA listed company whose assets consist solely of mineral rights, would be liable for CGT when disposing of those shares, provided that at the time of disposal that non-resident held at least 20% of the company's shares.

The provisions of any applicable double taxation agreement (DTA) must be considered before deciding whether the sale of shares by a non-resident in a company holding SA immovable property can be subject to CGT. For example, Article 13(2) of South Africa's DTA with the United Kingdom provides as follows:

> 'Gains derived by a resident of a Contracting State from the alienation of:
> (*a*) shares, other than shares quoted on an approved Stock Exchange, deriving their value or the greater part of their value directly or indirectly from immovable property situated in the other Contracting State, or
> (*b*) an interest in a partnership or trust the assets of which consist principally of immovable property situated in the other Contracting State, or of shares referred to in sub-paragraph (*a*) of this paragraph,
> may be taxed in that other State.'

A United Kingdom resident would therefore be potentially subject to CGT in SA on the disposal of shares in an unlisted company holding SA immovable property. On the other hand, if the company was listed, the disposal of the shares would not attract CGT in SA.

Example 1 – Indirect interest of non-resident in immovable property in South Africa

Facts: Avon, a resident of the United Kingdom, owns a 25% interest in XYZ (Pty) Ltd ('XYZ') the balance sheet of which appears as follows as at 28 February 2003:

Capital employed	R	
Share capital	50 000	
Retained income	70 000	
Long-term loan	60 000	
	160 000	
Employment of capital		
Land and buildings	120 000	(market value R180 000)
Plant and machinery	60 000	(market value R85 000
	180 000	

Determine whether Avon will be liable for CGT on the disposal of his shares in XYZ if the long-term loan financed the acquisition of
(a) the land and buildings, or
(b) the plant and machinery.

Result: The market value of the net assets of XYZ is determined as follows:

	R
Net asset value (R50 000 + R70 000)	120 000
Revaluation surplus (R60 000 + R25 000)	85 000
Net asset value at market value	205 000

(a) Assuming long-term loan financed land and buildings

Market value of land and buildings	180 000
Less: Long-term loan	60 000
Net asset value on market value basis	120 000
Market value of net assets	205 000

Percentage of net asset value on market value basis of land and buildings over total net asset value on market value basis R120 000/R205 000 x 100 = 58,5%

In this scenario Avon will not be subject to CGT on the disposal of his shares.

(b) Assuming long-term loan financed plant and machinery

	R
Market value of land and buildings	180 000
Market value of net assets	205 000

Percentage of net asset value on market value basis of land and buildings over total net asset value on market value basis R180 000/R205 000 x 100 = 87,8%

Since Avon owns 20% or more of the shares in XYZ, and 80% or more of XYZ's net assets on a market value basis constitute immovable property, Avon will be liable for CGT when he disposes of his shares. The view is held that the liabilities must be allocated against the assets that they finance. For example, if the property was bonded to purchase plant, the liability must be allocated against the plant. Where a liability cannot be linked to a particular asset, it should be allocated proportionately across the various assets.

Example 2 – Indirect interest in immovable property through multi-tier structure

Facts: Aaron, a non-resident owns 100% of Seaco a SA resident company. Seaco's only asset consists of shares in two wholly owned SA subsidiaries, Subco and Tubco. Subco's assets consist of plant and machinery, debtors and cash in bank, the market value of which is R100 000. Tubco's sole asset comprises land and buildings in Durban with a market value of R500 000. Aaron disposes of his shares in Seaco. Will he be subject to CGT on the disposal?

Result: Seaco's assets consist indirectly of immovable property of R500 000 and other property of R100 000. The immovable property comprises 83% of Seaco's indirect assets (R500 000/600 000 x 100). In terms of para 2(2) Aaron's shares in Seaco are deemed to be immovable property and he will be subject to CGT on the disposal thereof.

4.3 Source of capital gains and losses

Section 9(2)

The question whether income arises from a South African or foreign source remains important despite the introduction of the worldwide basis of taxation. Although South African residents may be subject to tax on a worldwide basis, only foreign source income is eligible for a section 6*quat* rebate. In addition, non-residents remain subject to South African tax only to the extent that their income is from a South African source.

In terms of para 2, the CGT provisions apply in respect of all assets of residents and the following assets of non-residents that are situated in SA:

- immovable property held by the non-resident or any interest or right of that person to or in immovable property; and
- any asset of a permanent establishment (PE) of that person through which a trade is carried on in SA during the relevant year of assessment.

Section 9(2) contains rules for determining the source of capital gains and losses.

Source - immovable property, including shares in certain property owning companies (s 9(2)(a))

In terms of s 9(2)(*a*) the source of the capital gain or loss on the disposal of immovable property is determined according to where the immovable property is situated.

Immovable property in relation to a person includes equity shares in a company or other entity where

- 80% or more of the net asset value of the company or entity is attributable directly or indirectly to immovable property, and
- that person alone or together with any connected person holds 20% or more of the shares of that company or entity.

For the purposes of this definition the net asset value is determined on the market value basis, and immovable property held as trading stock is excluded. The use of the words 'directly or indirectly' is intended to prevent the shareholder placing SA immovable property outside the definition by placing it in a subsidiary.

Source – movable property (s 9(2)(b))

In the case of movable property, if the property is attributable to a PE, the source of the capital gain or loss on the sale of that property will be where the PE is situated. If the movable property is not attributable to a PE, the source of the capital gain or loss on the sale of that property is determined according to the residence of the seller. These rules do not conflict with the approach adopted in the OECD Model Convention with regard to the right of taxation of capital gains.

4.4 Precedence of principal Act over Eighth Schedule

There are a number of situations where both the Eighth Schedule and the principal Act apply to the same amount, and the question then arises as to which takes precedence. The general rule of interpretation where the principal Act and a Schedule are in conflict was summed up as follows by Kotze JA in *African and European Investment Co Ltd v Warren and Others*:[34]

> 'No doubt a schedule or rule attached to a statute and forming part of it is binding, but in case of clear conflict between either of them and a section in the body of the statute itself, the former must give way to the latter.'

[34] 1924 AD 308 at 360. See also *R v Kok* 1955 (4) SA 370 (T) at 374 F-G; *Executive Council of the Western Cape Legislature v President of the RSA* 1995 (10) BCLR 1289 (CC) par 33; 1995 (4) SA 877 (CC).

Examples of where the principal Act takes precedence can be seen in paras 20(3)(*a*) and 35(3)(*a*) where capital allowances reduce base cost and recoupments reduce proceeds. The reference in para 12(5) to s 20(1)(*a*)(ii) also confirms this principle.

Chapter 5 - Taxable capital gains and assessed capital losses

PART II: TAXABLE CAPITAL GAINS AND ASSESSED CAPITAL LOSSES

5.1 Capital gain

Paragraph 3

5.1.1 Asset disposed of in current year (para 3(a))

A person's capital gain during the current year is equal to the amount by which the proceeds received or accrued in respect of the disposal exceed the base cost of the asset.

The words 'in respect of'' make it clear that amounts received or accrued prior to the disposal of an asset must be brought to account as proceeds in the year of disposal in calculating a capital gain. A receipt or accrual causally connected to a disposal will qualify as part of the proceeds from such disposal in spite of the fact that such receipt or accrual may have preceded that disposal. The determining factor is whether the proceeds were received or accrued 'in respect' of the disposal.

5.1.2 Asset disposed of in prior year (para 3(b))

Sometimes an asset is disposed of in a previous year of assessment and the capital gain or loss will have been determined and taken into account in that year of assessment. However, if any of the events shown in the table below occur in a subsequent year they will give rise to a capital gain in that year.

Table 1 – Events giving rise to a capital gain in a year subsequent to the year of disposal

Paragraph 3(*b*)	**Event giving rise to capital gain in subsequent year**
(i)	Receipt or accrual of further proceeds not previously accounted for.
(ii)	Recovery or recoupment of part of the base cost not previously accounted for.
(iii)	In the case of a pre-valuation date asset • any capital gain redetermined in the current year, plus • if a capital loss arose the last time para 25 was applied, the amount of that capital loss.

5.1.2.1 Capital gain arising from receipt or accrual of further proceeds (para 3(b)(i))

Where further proceeds are received or accrue in the current year in respect of an asset disposed of in a prior year, they will give rise to a capital gain in the current year. This rule does not apply to the extent that the proceeds have been taken into account

- in determining a capital gain or loss in any year, or
- in the redetermination of the capital gain or loss in terms of para 25(2).

The first exception is self-explanatory. If the amount has already been taken into account in determining a capital gain or loss, it cannot again be taken into account as this would result in double taxation. The further receipt or accrual could arise as a result of the application of s 24M(1) (unquantified consideration deemed to accrue in the year it becomes quantified) or under common law principles (e.g. where the additional amount was contingent on a future event at the time of the initial disposal).

The second exception applies where further proceeds are received in respect of a pre-valuation date asset disposed of in a prior year. The further proceeds in this case are taken into account under para 3(*b*)(iii) or 4(*b*)(iii). The capital gain or loss is determined from scratch taking into account the further proceeds and the previous capital gain or loss is reversed out as a capital loss or gain respectively.

Example – Proceeds accruing following disposal of asset

Facts: Magdelene acquired business premises on 1 October 2001 at a cost of R1 000 000. On 28 February 2006 she sold the property to Kayzita on the following terms:

- R1 200 000 payable on 28 February 2006.
- The following amounts payable, each on condition that the net rental return exceeds 10% in the relevant year: R100 000 (2007), R110 000 (2008); R120 000 (2009); R130 000 (2010).

Result:

	2006	2007	2008	2009	2010	Total
	R	R	R	R	R	R
Proceeds	1 200 000	100 000	110 000	120 000	130 000	1 660 000
Base cost	(1 000 000)	-	-	-	-	(1 000 000)
Capital gain	200 000	100 000	110 000	120 000	130 000	660 000
Paragraph	3(*a*)	3(*b*)(i)	3(*b*)(i)	3(*b*)(i)	3(*b*)(i)	

5.1.2.2 *Capital gain arising from recovery or recoupment of base cost (para 3(b)(ii))*

A further capital gain will arise in the current year where any portion of the base cost that was taken into account in determining a capital gain or loss in a previous year is recovered or recouped in the current year. The recovery or recoupment may take place in the form of a cash refund, repossession of the asset or cancellation or reduction of all or part of the debt incurred in acquiring the asset, whether by prescription or otherwise.[35]

This rule does not apply in the case of a pre-valuation date asset. In that case the recovery or recoupment will be taken into account under para 3(*b*)(iii) or 4(*b*)(iii). The capital gain or loss is determined from scratch taking into account the recovery or recoupment of the base cost. At the same time the previous capital gain or loss is reversed out as a capital loss or gain respectively.

Example 1 – Base cost recovery through repossession

Facts: In the 2003 year of assessment Debbie's brand new delivery van that cost her R150 000 was stolen. It was uninsured and she claimed a capital loss in respect of the cost of the vehicle in her 2003 return of income. She was unable to claim a scrapping allowance in terms of s 11(*o*) as it then read, as the vehicle had not been 'scrapped'. During the 2005 year of assessment the police recovered the badly damaged vehicle which at that point had a market value of R10 000.

Result: The market value of the recovered vehicle is an 'amount' (it has a money value) which has been received by or has accrued to Debbie. The R10 000 represents a recovery of part of the base cost of the vehicle and must be treated as a capital gain in 2005 in terms of para 3(*b*)(ii).

[35] ITC 1634 (1997) 60 SATC 235 (T).

Example 2 – Base cost recovery through reduction in purchase price

Facts: Bryan purchased a beach cottage in 2003 and shortly thereafter discovered that it was infested with white ants. The seller had not informed him of the infestation. He sold the property in 2004 and realised a capital gain of R15 000 on which he was assessed in that year. In the meanwhile he sued the seller of the property for misrepresentation and after a protracted legal battle received a discount on the purchase price of R18 000 during 2007.

Result: The recovery of R18 000 will be reflected as a capital gain in his 2007 return of income under para 3(*b*)(ii).

5.1.2.3 Capital gain arising from a redetermination under para 25(2) (para 3(b)(iii))

In terms of para 25(2) the capital gain or loss on disposal of a pre-valuation date asset must be redetermined when any of the events listed in Table 1 under **8.19.2** occur in a year subsequent to the year of disposal. In essence, these events cover situations where

- more proceeds are received or accrue,
- previous proceeds become irrecoverable,
- further expenditure is incurred, or
- previous expenditure is recovered or recouped.

A redetermined capital gain is treated as a capital gain under para 3(*b*)(iii). Where a capital loss was previously determined or redetermined the last time para 25 was applied, it is reversed out as a capital gain under para 3(*b*)(iii). The net effect of the redetermination and reversal is thereby recognised in the current year. For the reasons behind redetermination and examples see **8.19.2**.

5.1.3 Assets disposed of before valuation date

Where an asset has been disposed of before the valuation date, and a portion of the proceeds are received or accrue on or after that date, those proceeds will not constitute a capital gain in terms of para 3. In terms of para 2 the Eighth Schedule only applies to disposals of assets on or after the valuation date. Similarly, where any expenditure is recovered or recouped in respect of an asset disposed of prior to the valuation date, it will not give rise to a capital gain in the year of recovery or recoupment.

5.1.4 Disregarding of capital gains under other provisions

A capital gain may be disregarded under certain circumstances as dealt with under Parts VII and VIII of the Eighth Schedule (see Chapters 11 and 12), for example, on disposal of a primary residence. Certain disregarded capital gains are not completely disregarded but may be recognised at a future date, for example, on disposal of a replacement asset where the capital gain on the disposal of the original asset was disregarded under the involuntary disposal relief provisions in para 65. In this instance, the amount of that disregarded capital gain must, in the year that the replacement asset is disposed of, be treated as a capital gain when determining that person's aggregate capital gain or loss.

5.2 Capital loss

Paragraph 4

5.2.1 Asset disposed of in current year (para 4(a))

A person's capital loss in respect of the disposal of an asset during a year of assessment is equal to the amount by which the base cost of that asset exceeds the proceeds received or accrued in respect of that disposal.

The words 'in respect of' make it clear that amounts received or accrued prior to the disposal of an asset must be brought to account as proceeds in the year of disposal in calculating a capital loss. A receipt or accrual causally connected to a disposal will qualify as part of the proceeds from such disposal in spite of the fact that such receipt or accrual may have preceded that disposal. The determining factor is whether the proceeds were received 'in respect' of the disposal.

5.2.2 Asset disposed of in prior year (para 4(b))

A number of events can give rise to further capital losses after an asset has been disposed of. These are set out in the table below.

Table 1 – Events giving rise to a capital loss in a year subsequent to the year of disposal

Paragraph 4(*b*)	**Event giving rise to capital loss in subsequent year**
(i)	Proceeds have been lost through cessation of entitlement, irrecoverability or become repayable.
(ii)	Further expenditure is incurred.
(iii)(*aa*)	*Pre-valuation date assets:* Redetermined capital loss
(iii)(*bb*)	Reversal of prior year capital gain

5.2.2.1 Capital loss arising from events affecting proceeds (para 4(b)(i))

In terms of para 4(*b*)(i) a person will have a capital loss in the current year of assessment equal to so much of the proceeds

- that the person is no longer entitled to as a result of the
  - cancellation, termination or variation of any agreement,
  - prescription or waiver of a claim,
  - release from an obligation, or
  - any other event,
- that have become irrecoverable, or
- that have been repaid or become repayable.

The proceeds must have been taken into account in determining a capital gain or loss in a previous year. This provision does not, however, apply to a pre-valuation date asset as in that case the reduced proceeds will be taken into account in the redetermination of the capital gain or loss under paras 3(*b*)(iii) and 4(*b*)(iii) read with para 25(2).

Examples:

- The debtor to whom an asset has been sold is sequestrated or placed in liquidation.
- The debt is allowed to prescribe through a lack of recovery action.

- The seller is forced to repay part of the selling price as a result of misrepresentation or overcharging.

5.2.2.2 Capital loss arising from incurral of further expenditure (para 4(b)(ii))

A person will have a capital loss equal to so much of any allowable para 20 expenditure incurred during the current year of assessment in respect of the asset. The expenditure must not have been taken into account during any year in determining a capital gain or loss in a previous year. This provision does not, however, apply to a pre-valuation date asset as in that case the additional expenditure will be taken into account in the redetermination of the capital gain or loss under paras 3(*b*)(iii) and 4(*b*)(iii) read with para 25(2).

Examples:

- Additional expenditure may be incurred after the disposal of the asset that was not anticipated at the time of disposal of the asset.
- The asset was disposed of in a prior year, but at the time, some of the base cost expenditure was
  - unquantified in the year of disposal becomes quantified in the current year and thus incurred in that year in terms of s 24M(2), or
  - subject to a condition in the year of disposal becomes incurred in the current year when the condition is fulfilled.

5.2.2.3 Capital loss arising from a redetermination under para 25(2) (para 4(b)(iii))

In terms of para 25(2) the capital gain or loss on disposal of a pre-valuation date asset must be redetermined when any of the events listed in Table 1 under **8.19.2** occur in a year subsequent to the year of disposal. In essence, these events cover situations where

- more proceeds are received or accrue,
- previous proceeds become irrecoverable,
- further expenditure is incurred, or
- previous expenditure is recovered or recouped.

A redetermined capital loss is treated as a capital loss under para 4(*b*)(iii)(*aa*). Where a capital gain was previously determined or redetermined the last time para 25 was applied, it is reversed out as a capital loss under para 4(*b*)(iii)(*bb*). The net effect of the redetermination and reversal is thereby recognised in the current year. For the reasons behind redetermination and examples see **8.19.2**.

5.2.3 Assets disposed of before valuation date

Where an asset has been disposed of before the valuation date, and a portion of the expenditure is incurred on or after that date, it will not constitute a capital loss in terms of para 3(*b*). In terms of para 2 the Eighth Schedule only applies to disposals of assets on or after the valuation date. The loss of proceeds from such pre-valuation date disposals by reason of a cessation of entitlement, irrecoverability or repayment will also not constitute a capital loss. Nevertheless, a debt arising from a pre-valuation date disposal that becomes irrecoverable after the valuation date may give rise to a capital loss under the core rules. But unless the loan was worth its face value on valuation date the capital loss allowable will be something less than the face value, and would have to be determined using the TAB, market value or 20% of proceeds methods, subject to the kink tests in paras 26 and 27 where applicable.

5.2.4 Disregarding of capital losses under other provisions

Certain capital losses may be disregarded in terms of Parts IV, VII and VIII of the Eighth Schedule (see Chapters 7, 11 and 12 respectively).

5.3 Annual exclusion

Paragraph 5

Although gains or losses in respect of most personal use assets are excluded from the CGT system, a threshold (annual exclusion) is provided to exclude the total of smaller gains and losses from CGT. The purpose of the annual exclusion is to reduce compliance costs, simplify the administration of the tax and underpin the SITE system by keeping small gains and losses out of the system.
The table below sets out the annual exclusion for various persons:

Table 1 – Annual exclusion

Person	Annual exclusion R	Comment
Natural person	10 000	
Natural person – in year of death	50 000	Not subject to apportionment.
Special trust	10 000	Where the beneficiary dies, the annual exclusion will only remain available until the earlier of: • The date when all the assets have been disposed of, or • 2 years (para 82)
Deceased estate	10 000	The annual exclusion of R10 000 is available in the year of death and each year thereafter. It is not subject to apportionment in the year of death. (para 40(3))
Insolvent estate	10 000	In the year of sequestration the annual exclusion for the person prior to sequestration and his/her estate may not together exceed R10 000. Thereafter the insolvent estate will enjoy an annual exclusion of R10 000. (para 83(1))

Some points to note regarding the annual exclusion:
- It does not apply to companies, close corporations or trusts other than special trusts.
- It only applies to natural persons (individuals), special trusts and persons treated as natural persons for the purpose of the Eighth Schedule (deceased and insolvent estates).
- It reduces both gains *and* losses. If losses were not reduced it would mean that an indefinite record of small losses of SITE taxpayers and other individuals not liable for tax would have to be kept.
- The annual exclusion is not apportioned where the period of assessment is less than a year, for example, when a person dies or their estate is sequestrated.
- It is not cumulative, in other words, it is restricted to the sum of the capital gains or losses in a year. Any excess that is not utilised cannot be carried forward. It does not

reduce an assessed capital loss that has been brought forward from a previous year – it is applied against the sum of the capital gains and losses for the year.

- The annual exclusion in the year of death is R50 000. The reason for the increase is that a person is deemed to have disposed of all their assets at market value on the date of death (para 40(1)). This could cause a bunching effect, and to alleviate any hardship the deceased is effectively given 5 years' worth of annual exclusions.

5.4 Aggregate capital gain and aggregate capital loss

Paragraphs 6 and 7

All capital gains and losses for a year of assessment are aggregated and the resultant gain or loss in the case of a natural person and special trust is reduced by the amount of the annual exclusion in order to arrive at a person's aggregate capital gain or aggregate capital loss. Capital gains required to be taken into account in the determination of the aggregate capital gain or aggregate capital loss of a person must also be included, for example, a capital gain of another person which is attributed to that person.

5.5 Net capital gain and assessed capital loss

Paragraphs 8 and 9

Where a person has an assessed capital loss brought forward from a previous year of assessment this is taken into account in arriving at the net capital gain or assessed capital loss for the current year of assessment. Where a person has an assessed capital loss for the current year of assessment it is carried forward to the next year of assessment.

5.6 Taxable capital gain

Paragraph 10

Where a person has arrived at a net capital gain for the current year of assessment this is multiplied by the inclusion rate applicable to that person to arrive at a taxable capital gain. This amount is then included in the taxable income of the person in terms of s 26A for the year of assessment and taxed at normal income tax rates applicable to that person. The inclusion rates are set out in the table below. See also **3.8** for a more detailed list of rates applicable to a range of entities.

Table 1 – Inclusion rates

Type of person	**Paragraph 10**	**Inclusion rate (%)**
Natural person The following are treated as natural persons in terms of the paragraphs indicated: • An insolvent estate (para 83(1)) • A deceased estate (para 40(3))	(*a*)	25
Special trust – as defined in s 1 (includes trusts for persons with mental illness or serious physical disability, and testamentary trusts for minors)	(*a*)	25
Insurer – individual policyholder fund	(*b*)(i)	25
Insurer – untaxed policy holder fund	(*b*)(ii)	0
Any other case, which includes a • company	(*c*)	50

• close corporation • company policyholder fund of an insurer • corporate fund of an insurer • trust (normal) • permanent establishment (branch).		

Chapter 6 - Disposal and acquisition of assets

PART III: DISPOSAL AND ACQUISITION OF ASSETS

6.1 Disposals

Paragraph 11

6.1.1 Disposal events

The disposal of an asset triggers the liability for CGT and it is, therefore, a core rule that is fundamental to the application of CGT. It is for this reason that a wide meaning has been given to the word 'disposal'.[36]

A *disposal* is any

- event
- act
- forbearance,[37] or
- operation of law

which results in the

- creation
- variation
- transfer, or
- extinction of an asset

A disposal also includes the events set out in the table below.

Table 1 – Events giving rise to the disposal of an asset

Paragraph 11(1)	**Disposal event**
(*a*)	Sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership
(*b*)	Forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment
(*c*)	Scrapping, loss, or destruction
(*d*)	Vesting of an interest in an asset of a trust in a beneficiary (see para 80 and 81)
(*e*)	Distribution of an asset by a company to a shareholder (see para 75)
(*f*)	Granting, renewal, extension or exercise of an option
(*g*)	Decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement (see **21.3**)

6.1.1.1 Forbearance

According to the *Shorter Oxford English Dictionary 3ed* 'forbearance' means

> 'abstinence from enforcing what is due, esp the payment of a debt'.

[36] The Australian approach of having a restricted list of numbered events was not followed because of the danger that certain events may be unintentionally omitted.
[37] The term was borrowed from the Value-Added Tax Act 89 of 1991.

6.1.1.2 Conversion

No gain no loss conversions

Certain conversions, while constituting disposals, will not give rise to a capital gain or loss. For example:

- The conversion of a company to a close corporation or vice versa in terms of s 40A or the conversion of a co-operative to a company in terms of s 40B will not give rise to a capital gain or loss in the shareholders' hands in terms of para 78(2). From the corporate entity's perspective such conversions will also not trigger a disposal.
- The conversion of a shareholder's interest in a share block company to an interest in a sectional title scheme will not give rise to a capital gain or loss in terms of para 67B.
- The conversion of old mineral, mining, prospecting, exploration and production rights held before the introduction of the Mineral and Petroleum Resources Development Act 28 of 2002 to new rights under that Act will not give rise to a capital gain or loss in terms of para 67C (roll-over relief is granted).

Conversions dealt with in para 12

Certain conversions are dealt with in para 12. These include the conversion of

- a capital asset to trading stock (para 12(2)(*c*)),
- trading stock to a capital asset (para 12(3)),
- a personal use asset to an asset (para 12(2)(*d*)), and
- an asset to a personal use asset (para 12(2)(*e*)).

Convertible preference shares

Where a person acquires a convertible preference share and the time and terms of conversion are fixed up front, the view is held that no disposal will occur at the time of conversion. The details pertaining to the preference share (date of acquisition and cost) will simply be carried over to the ordinary share.[38]

Where, however, the option to convert is left to the whim of the shareholder or company, or where the company makes a unilateral offer of conversion, the rights cannot be said to be acquired up front because the right of conversion is either subject to a suspensive condition, or did not exist at the time the preference share was acquired. In these cases a disposal will be triggered at the time of conversion. In terms of para 13(1)(*a*)(v) the time of disposal in the case of a conversion is the date of conversion.

Example 1 – Conversion of an asset

Facts: Muriel acquired a preference share on 1 March 2003 at a cost of R100. On 1 March 2008 the company unilaterally offered Muriel the opportunity to convert her preference share into an ordinary share. Muriel surrendered her preference share and received an ordinary share with a value of R150.

Result: In terms of para 13(1)(*a*)(v) the time of disposal in the case of the conversion of an asset is the date on which the asset is converted. The proceeds in respect of the disposal will be equal to the value of the ordinary share. Muriel will therefore have a capital gain of R150 - R100 = R50. The base cost of the ordinary share will be R150. The base cost and

[38] A similar view is expressed by E Mazansky in 'Share Conversions' (2003) 17 *Tax Planning* 133, LexisNexis Butterworths Publishers, Durban.

proceeds are determined as an exchange transaction under the core rules. See the notes below and under para 20 regarding exchange transactions.

Example 2 – Obligation to convert fixed up front

Facts: The facts are the same as in Example 1, but the share acquired by Muriel was a convertible preference share subject to compulsory conversion on 1 March 2008.

Result: The conversion will not be regarded as a disposal. The base cost of the ordinary share will be R100 and it will be regarded as having been acquired on 1 March 2003.

6.1.1.3 Creation

How does the creation of an asset result in a disposal? The concept sounds counter intuitive but is valid[39] despite suggestions to the contrary by some commentators. The confusion seems to stem from the impression that it is the party in whose hands the asset is created who has a disposal. This is clearly not the case because that party has *acquired* an asset, not disposed of one. The concept in fact refers to the creation of an asset by one person for the benefit of another. In creating the asset for the other person, the existing rights of the creator are diminished and it is this diminution that represents the disposal of an asset. Examples of the creation of an asset giving rise to a disposal include the following:

- The granting of
  - a lease,
  - a servitude,
  - mineral rights,
  - a license, or
  - an option.
- The undertaking of a restraint of trade.

For example, when the owner of a property grants a lease over that property, the owner creates a contractual right in favour of the lessee. That right is an asset for CGT purposes. The creation of this right has given rise to a disposal of part of the full right in the property that the owner previously enjoyed. In other words, there has been a part-disposal. As can be seen, the 'creation' has given rise to both an acquisition and a disposal.

Similarly, in the case of a restraint of trade, it is the creation of the legal right in the restraining party's hands that triggers the part-disposal of the right to trade freely in the hands of the restrained party. See **24.5**.

6.1.1.4 Exchange

In terms of para 11(1)(*a*) an *exchange* of an asset also constitutes a disposal. With regard to the determination of the base cost of an asset acquired under an exchange transaction see **8.2.2. A**s regards the determination of proceeds in a form other than cash, see the notes on the meaning of the word 'amount' in para 35 in **9.1**. In some cases the corporate rules in ss 41 – 47 provide roll-over relief for barter transactions. For example, in a share-for-share transaction, a target company shareholder disposes of shares in a target company in exchange for shares in an acquiring company. The target transferor is given roll-over relief provided the requirements of s 43 are met.

The treatment of such barter transactions for CGT purposes is best explained by way of an example.

[39] The concept is well recognised in Australian CGT legislation.

Example – Exchange of an asset

Facts: Lammie purchased a piece of land in 2002 for R100 000. In 2005 he entered into an exchange transaction with Barry, the terms of which were as follows:

- Lammie agreed to give Barry his land valued at R150 000 plus cash of R10 000.
- In exchange, Barry agreed to give Lammie his holiday home, valued at R160 000.

In 2007 Lammie sold the holiday home for R170 000.

Result: The CGT consequences for Lammie are as follows:

Land

In 2002 the land was acquired by Lammie for a base cost of R100 000 in terms of para 20(1)(*a*).

As a result of the 'exchange' with Barry, there has been a disposal of the land in terms of para 11(1)(*a*). In a barter transaction, the proceeds are equal to the market value[40] of the asset received. Although Lammie received a holiday home valued at R160 000, only R150 000 of this amount relates to the land. The remaining R10 000 relates to the cash paid to Barry. Therefore, in 2005 Lammie will have a capital gain of R50 000 (R150 000 (proceeds) – R100 000 (base cost).

Holiday home

The base cost of the holiday home is equal to the amount of 'expenditure' incurred in acquiring it in terms of para 20. This is equal to the value by which Lammie's assets have been reduced as a result of the transaction. Lammie gave up land valued at R150 000 plus cash of R10 000, and so his assets decreased by R160 000. Therefore, in 2007 Lammie will have a capital gain of R10 000 (R170 000 (proceeds) - R160 000 (base cost).

6.1.2 Non-disposal events

There are a number of specific events listed that are **not** treated as a disposal. These are set out in the table below.

Table 1 – Non-disposals

Paragraph 11(2)	**Non-disposal event**
(*a*)	The transfer by a person of an asset as security for a debt or by a creditor who transfers that asset back to that person upon release of the security.
(*b*)	The issuing or cancellation by a company of its shares and the granting of an option by that company to acquire shares or debentures in that company. Upon entering into a contract for the issue of shares, the company acquires an asset in the form of a personal right to expect those shares to be taken up. When the company issues the shares it disposes of that personal right in exchange for proceeds equal to the issue price. More often than not the company would not have paid anything for the personal right, resulting in a zero base cost. As a consequence, in the absence of this provision, the company would be subject to CGT on the full issue price. Clearly this would

[40] As to the meaning of 'amount' see the comments on para 35.

	have severely discouraged company formation and the raising of capital through rights issues, hence the need to exclude the issue of shares as a disposal.
(*c*)	The issuing by a collective investment scheme (CIS) of a participatory interest in that CIS, and the granting of an option by that CIS to acquire a participatory interest in that CIS.
(*d*)	The issuing of any bond, debenture, note or other borrowing of money or obtaining of credit.
(*e*)	The distribution of a trust asset by a trustee to a beneficiary to the extent that the beneficiary has a vested right to the asset. This is dealt with in more detail in paras 80 and 81.
(*f*)	Deleted.
(*g*)	A disposal made to correct an error in the registration of immovable property in that person's name in the deeds registry.
(*h*)	The lending of any security in terms of a 'lending arrangement' as defined in s 1 of the Uncertificated Securities Tax Act 31 of 1998 and the return of a similar security to the lender within the 12 month period contemplated in that definition.[41]
(*i*)	The vesting of the assets of the spouse of an insolvent in the Master of the High Court or in a trustee. In terms of s 21 of the Insolvency Act 24 of 1936, where a person becomes insolvent the assets of the spouse of the insolvent also vest in the Master of the High Court or a trustee, and only when it is proved that the assets do belong to the spouse are they released to the spouse. The vesting of the spouse's asset in the Master or trustee and the subsequent release of the assets is not a 'disposal' for CGT purposes.
(*j*)	The disposal of an equity instrument contemplated in s 8C which has not yet vested as contemplated in s 8C.[42] This provision ensures that duplication of income and capital gains is avoided.

6.1.3 Non-disposals not mentioned in the Eighth Schedule

Certain non-disposals arise out of common law or from statutory provisions outside the Eighth Schedule.

6.1.3.1 Changes in appointment of executors, curators and administrators

Assets held by trustees, executors, curators and administrators are not held for their own benefit. The view is held that changes in appointments do not result in the disposal of the underlying assets which are held on behalf of vested or contingent beneficiaries, heirs, legatees, etc. A payment of an amount to a trustee to resign from his or her office and to agree to the appointment of a new trustee is likely to fall within the ambit of para (*d*) of the definition of 'gross income' or alternatively be a payment for the disposal of an asset.[43]

6.1.3.2 Company conversions under ss 40A and 40B

Where a company converts to a close corporation, or a close corporation converts to a company, the two entities are treated as one and the same company for the purposes of the

[41] Paragraph 11(2)(*h*) was amended with effect from 22 December 2003. Previously the provision made reference to the definition of a 'lending arrangement' in terms of the Stamp Duties Act 77 of 1968.
[42] Paragraph 12(2)(*j*) inserted by Revenue Laws Amendment Act 32 of 2004, came into operation on 26 October 2004 and applies in respect of any equity instrument acquired on or after that date.
[43] ITC 746 (1952) 16 SATC 312 (C).

Income Tax Act.[44] The same applies to a co-operative that converts to a company.[45] The Companies and Close Corporations Acts similarly provide that the company's corporate existence and rights remain unchanged.[46] It follows that conversions of this nature would not trigger CGT in the entities concerned. A conversion under s 40A or 40B is tax neutral n the hands of the shareholder by virtue of para 78(2).

6.1.3.3 Amalgamation of co-operatives

Section 27(5B)

Chapter VIII of the Co-operatives Act 91 of 1981 deals with a number of transactions, including

- conversion of a company to a co-operative,
- incorporation of a co-operative as a public or private company having a share capital,
- incorporation of a co-operative as a close corporation,
- conversion of a co-operative to another type of co-operative (e.g. agricultural to a trading co-operative),
- amalgamation of two or more co-operatives,

The first three of the above transactions are addressed in s 40B of the Income Tax Act, and this has already been addressed in the preceding notes The latter two are dealt with in s 27(5B).

Section 27(5B) provides that where a co-operative has come into being on or after the commencement of the Co-operatives Act, 1981 as a result of a conversion or amalgamation in terms of Chapter VIII of that Act,

> 'such co-operative and any company, co-operative or co-operatives out of which it so came into being shall, for the purposes of assessments under this Act for the year of assessment during which such co-operative came into being and subsequent years of assessment but subject to such conditions as the Commissioner may impose, be deemed to be and to have been one and the same co-operative.'

The effect of this provision is that the new co-operative will step into the shoes of the old co-operatives and there will be no disposal of assets at the time of the amalgamation. The provision has the effect of a roll-over for CGT purposes, and the following details will be carried over from the previous co-operative/s to the new co-operative:

- any admissible para 20 expenditure,
- the dates of acquisition and incurral of that expenditure,
- any valuation determined by the previous co-operative in terms of para 29(4),
- any assessed loss or assessed capital loss.

The roll-over relief provided by s 27(5B) does not extend to shareholder level. Fortunately the shares in a co-operative tend to have a nominal value (see notes on para 31 in **8.25**.

6.1.3.4 Consolidation or subdivision of land

The consolidation or subdivision of land will not in itself give rise to a disposal, since the owner retains all rights in the land. Subdivision is usually merely a preparatory step prior to an actual disposal.

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[44] Section 40A of the Income Tax Act.
[45] Section 40B of the Income Tax Act.
[46] See s 29(1) and 29D of the Companies Act 61 of 1973 and s 27(5) of the Close Corporations Act 69 of 1984.

6.2 Events treated as disposals and acquisitions

Paragraph 12

6.2.1 Disposal and reacquisition (para 12(1)

Paragraph 12 deals with a number of events that are treated as disposals for the purposes of the Eighth Schedule. If an event described in the paragraph occurs the person will be treated as having

- disposed of the asset for an amount received or accrued equal to the market value of the asset at the time of the relevant event, and
- to have immediately reacquired the asset at a cost equal to that market value.

This mechanism is used in some cases to trigger a capital gain or loss and in others to establish a base cost. For the purpose of determining the base cost of an asset in terms of para 20(1)(*a*)*,* the market value so established must be treated as expenditure actually incurred.

Where a portion of the amount received or accrued has been included in the person's gross income, the provisions of para 35(3)(*a*) will reduce that amount in arriving at the proceeds in respect of the deemed disposal.

In terms of para 13(1)(*g*) the time of the events contemplated below (except in the case of transfers between the four funds of an insurer) is the date before the day that the event occurs. In the case of transfers between such funds it is the date the event occurs.

Example 1 – Reduction of amount received or accrued by amounts included in income

Facts: On 1 March 2003 John bought a government bond for R100 when the prevailing interest rate was 10%. He earned R5 in interest every six months on 31 August and 28 February. On 27 February 2004 John emigrated when prevailing interest rates were 5%.

Result: As a result of the decline in interest rates the market value of the bond has increased. The market value of his instrument including the accrued interest is R125 (R120 capital plus R5 accrued interest). The proceeds will be the amount received or accrued of R125 (para 12(1)) less the interest of R5 (para 35(3)(*a*) = R120 and the capital gain will be R120 – R100 = R20.

6.2.2 Events treated as disposals (para 12(2))

The table below sets out the events that are treated as a disposal and immediate reacquisition.

Table 1 – Events treated as disposals – para 12(2)

Para 12(2)	**Event treated as disposal**	**Comment**
(*a*) (i)	A person ceases to be resident. This is applicable to all assets, except • immovable property in SA or any right or	The word 'resident' is defined in s 1. *Individuals* cease to be resident when they • cease to be ordinarily resident, or • are not ordinarily resident, and cease to be physically present in SA for the number of days specified in the definition of a resident'.

(ii) (iii)	interest in such property (para 2(1)(*b*)(i)); • any asset attributable to a permanent establishment (PE) in SA (para 2(1)(*b*)(ii)) • any qualifying equity share contemplated in s 8B, which was granted to that person less than 5 years before the date on which that person ceases to be a resident, • any equity instrument contemplated in s 8C, which had not yet vested as contemplated in that section at the time that the person ceases to be a resident.[47]	*Companies* cease to be resident when • they are not incorporated, established or formed in SA, and • their place of effective management changes to a country outside SA. DTA's have rules on residence which in certain circumstances override domestic law. A person may therefore be resident under domestic law but non-resident for DTA purposes. 48 In the case of s 8B & 8C instruments, the intention is not to trigger an early capital gain, but rather to ensure that the entire gain up to the date of vesting is taxed on revenue account. From a tax jurisdiction viewpoint a person who ceases to be a resident should remain subject to SA taxation after exit on any s 8A or 8C gain that arises at the date of vesting as the revenue gain relates to SA source services.
(*b*)	An asset of a person who is not a resident that • becomes an asset of the person's PE in SA other than by acquisition, or • ceases to be an asset of the person's PE in SA other than by a disposal ito para 11.	For example, the person brings an asset he or she owns in another country to SA for purposes of the PE. For example, the person withdraws the asset from the PE for personal or other use.
(*c*)	Non-trading stock that becomes trading stock.[49]	In terms of s 22(3)(*a*)(ii) the person will be treated as having acquired the trading stock at market value for ordinary income tax purposes. For CGT purposes the person is treated as having disposed of the asset at market value which brings symmetry to the transaction
(*d*)	A personal use asset that becomes a non-personal use asset (excludes disposals ito para 11)	For example, a personal use asset that becomes a capital asset used in a trade of a person.
(*e*)	A non-personal use asset that becomes a personal-use asset.	For example, a capital asset used in a person's trade that becomes a personal use asset.
(*f*)	An asset transferred by an insurer from one fund to another ito s 29A(4).	The activities of insurers are treated as being conducted in four separate funds for income tax purposes. Transfers of assets by insurers between these funds are treated as disposals at market value.

[47] Paragraph 12(2)(*a*)(ii) and (iii) were inserted by Act 32 of 2004 and apply in respect of any person who ceases to be a resident on or after 26 October 2004.
[48] The definition of 'resident' in s 1 excludes any person who is deemed to be exclusively a resident of another country in terms of a double taxation agreement.
[49] See, for example, *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A), 37 SATC 193.

Subparagraphs (3) and (4) establish the base cost of certain assets under certain circumstances.

6.2.3 Trading stock ceasing to be trading stock (para 12(3))

Subparagraph (3) deals with the situation where trading stock of a person ceases to be trading stock of that person, otherwise than by way of disposal in terms of para 11. In such a case that person will be treated as having

- disposed of that trading stock on the day before it ceased to be trading stock,
- disposed of it for a consideration equal to the amount included in that person's income in terms of s 22(8), and
- immediately reacquired those assets for a cost equal to that amount.

Section 22(8) deems the cost of trading stock which ceases to be trading stock to have been recovered in a variety of circumstances which can be divided into two categories–

- conventional disposals (dealt with in terms of para 11)
- changes in usage (dealt with in terms of para 12(3))

Conventional disposals of trading stock

Since the conventional disposals are catered for in terms of para 11 and the core rules, there is no need to deal with them in para 12. The treatment of such disposals is summarised in the table below.

Table 2 - Conventional disposals of trading stock (para 11)

Type of disposal	**Value included in income in terms of s 22(8)**	**Base cost of acquiror**
Donation	Market value	Market value – para 38
Disposal other than in the ordinary course of trade, for a consideration less than the market value	Market value	Market value – para 38
Distribution by a company *in specie,* including • a dividend • liquidation dividend • total or partial reduction of capital (including any share premium) • redemption of redeemable preference shares, or • an acquisition of shares in terms of s 85 of the Companies Act 61 of 1973	Market value	Market value – para 38 or 76(3)

Changes in usage of trading stock

In some cases trading stock ceases to be trading stock without a conventional disposal in terms of para 11. Typically such cases merely involve a change of usage. Examples of such changes in usage include

- personal consumption,
- personal use, and
- use of trading stock as capital assets.

Paragraph 12(3) mirrors the treatment afforded to such assets in terms of s 22(8) by giving them a base cost equal to the amount included in income. The person owning that trading stock is treated as having a base cost equal to the values listed in the table below.

Table 3 – Changes in usage of trading stock (para 12(3))

Type of use	**Amount to be included in income in terms of s 22(8) / Amount treated as base cost in hands of acquiror**
Private or domestic use or consumption	• Cost, less any provision for obsolescence, or • Where the cost price cannot be readily determined, the market value
Application for any other purpose other than the disposal thereof in the ordinary course of trade	Market value
Assets which cease to be held as trading stock	Market value

Sight should, of course, not be lost of the following dictum of Centlivres CJ in *CIR v Richmond Estates (Pty) Ltd*:[50]

> '[I]t may be as difficult to change from a trader to an investor for taxation purposes "as it is for a rope to pass through the eye of a needle" (*Gunn's Commonwealth Income Tax*, 4th ed., sec 583).'

6.2.4 Persons becoming residents (para 12(4))

A person who becomes a resident of the Republic is treated as having disposed of all assets, other than those mentioned below, on the day before becoming a resident and to have acquired the assets at market value. The assets not treated as having been disposed of and reacquired are

- any immovable property or an interest or right in immovable property situated in the Republic;
- an asset of a permanent establishment through which that person carries on a trade in the Republic during the year of assessment.

Where on the disposal of an asset contemplated in subpara (4) both the base cost in respect of that asset and the proceeds are less than the market value, the provisions of para 24 apply (see **8.18**).

6.2.5 Reduction or discharge of debt without full consideration (para 12(5))

6.2.5.1 Introduction (para 12(5)(a))

Subparagraph (5) deals with the situation where a debt owed by a person to a creditor has been reduced or discharged by that creditor

- for no consideration, or
- for a consideration which is less than the amount by which the face value of the debt has been so reduced or discharged.

[50] 1956 (1) SA 602 (A), 20 SATC 355 at 361.

The purpose of para 12(5) is to ensure that where a debtor is relieved of the obligation to pay any portion of the amount owing, that debtor will be subject to CGT on a capital gain equal to the amount discharged. Such reductions may result from donations or offers of compromise.

Another objective of para 12(5) is to provide symmetry in the tax system by ensuring that there is a matching of gains and losses. In the absence of para 12(5), creditors would be able to claim losses, whilst debtors would not be taxed on the corresponding gains.

6.2.5.2 Meaning of 'debt owed' and interest debts

The words 'debt owed' as used in para 12(5) refer to amounts in respect of which there is an unconditional liability to pay. This would, of course include debts incurred which are not yet due and payable.

In determining the portion of an interest debt that has been incurred, regard must be had to the provisions of s 24J(2). In terms of s 24J interest is deemed to accrue from day to day over the period of the loan on a yield to maturity basis. Section 24J applies for the purpose of the Act as a whole and any interest debt must therefore be regarded as being incurred in the same manner. Section 24J overrides the rule laid down in *Cactus Investments (Pty) Ltd v CIR*[51] where it was held that a lender of money becomes entitled to the right to receive interest on a stipulated future date as soon as the funds have been made available to the borrower, unless the parties agree on some other date.

Example 2 – Incurral of interest debt and s 24J

Facts: On 1 January 2003, Alpha Ltd lent R350 000 to Beta Ltd, repayable after three years on 31 December 2005. A bullet payment of interest of R150 000 is payable at the end of the loan term.

On 1 January 2004, Alpha and Beta agree that Beta will, in fulfilment of Beta's obligation to pay the interest of R150 000 on 31 December 2005, immediately pay Alpha an amount of R50 000 of interest together with the capital of R350 000. As a result, there will no longer be a bullet interest payment at 31 December 2005. At the date of payment of the R50 000, interest of R44 187 had been incurred in terms of s 24J(2).

Result: Paragraph 12(5) will not apply to this transaction, since

- at the date of discharge only R44 187 of the debt had been incurred in terms of s 24J, and
- that debt was discharged for an amount of R50 000.

6.2.5.3 The creditor's capital loss

Paragraph 12(5) only deals with the debtor and does not address the CGT consequences for the creditor. Any loss to which the creditor may be entitled must be determined under the core rules. Losses on disposal of claims owed by connected persons are addressed specifically in para 56. The general rule in para 56(1) is that capital losses on claims owed by connected persons must be disregarded. However, where the debtor is subject to CGT on the corresponding capital gain in terms of para 12(5), the creditor will be entitled to the capital loss (para 56(2)(*a*)). Where the creditor and debtor are connected persons the capital loss will not be clogged (para 56 applies despite para 39).

[51] *Cactus Investments (Pty) Ltd v CIR* 1999 (1) SA 315 (SCA), 61 SATC 43.

Regarding the determination of the capital loss on disposal of a loan see **24.4**. In the case of a pre-valuation date loan it will be necessary to determine the valuation date value of the loan on the basis of TAB, market value or 20% of proceeds, and it follows that only the portion of the overall loss that relates to the post-CGT period will be allowable. It is therefore unlikely that the creditor will be entitled to the full face value of the loan as a capital loss. This would only happen where the market value method is adopted and the market value of the loan was equal to its face value on valuation date. Where an executor waives a debt owed to the deceased in accordance with the last will and testament, the deceased estate is treated as having disposed of the debt at its base cost in terms of para 40(2)(*a*) – see **15.1**. This means that despite the fact that the debtor will be subject to tax on a capital gain in terms of para 12(5), the deceased estate will not be entitled to a corresponding capital loss.

6.2.5.4 Treatment of the debtor where para 12(5) applies

Were it not for para 12(5), the discharge of a debt by a creditor would have no CGT implications for the debtor. After all, the debt owed is a liability, not an asset, and without an asset CGT cannot be imposed. In order to subject the debtor to CGT, para 12(5)(*b*) creates four things in the hands of the debtor.

- *Asset*: The debtor is deemed to have acquired a claim to the debt reduced or discharged.
- *Base cost*: The base cost of the asset is deemed to be nil.
- *Proceeds*: The proceeds are determined as follows:
  - If the debtor paid nothing – the amount discharged or reduced.
  - If the debtor paid something – the difference between the amount paid and the amount discharged or reduced.
- *Disposal*: The claim acquired by the debtor is deemed to be disposed of.

In other words, the debtor will have a capital gain equal to the amount of the debt that has been discharged or reduced less any amount paid to the creditor.

This treatment is consistent with that of the core rules in respect of the reacquisition of a person's own debt.

6.2.5.5 TAB not permissible for the debtor

The debtor will acquire the creditor's claim when the creditor waives it. Since the acquisition of the debt can only occur on or after the valuation date when para 12(5) became effective, the debt so acquired is a post-valuation date asset. It follows that TAB cannot be applied to reduce the capital gain, where the debt arose before valuation date. The result is that the treatment of debtor and creditor is not symmetrical – the creditor's loss is subject to time-apportionment but the debtor's gain is not.

6.2.5.6 Discharge for more than consideration received

This provision applies where a debt owed by a person to a creditor has been reduced or discharged by that creditor for a consideration which is less than the amount by which the face value of the debt has been so reduced or discharged. For example, assume that a debtor owes a creditor R100. The provision would apply where the debtor paid the creditor R10 but the creditor reduced the debt by R20.

The provision also applies regardless of whether the consideration given by the debtor is market related. For example, the debtor may offer to pay the creditor a lesser sum in full and

final settlement in exchange for an early discharge of the debt. The word 'consideration' has been held to mean the *quid pro quo* given under a reciprocal obligation.[52]
Where, for example, a company repays debentures by issuing its own shares, the debenture holders will have received consideration as long as the market value of the shares equals or exceeds the face value of the debentures. The fact that the transaction is executed by book entry will not alter this fact, although this may have well result in a recoupment in the company's hands in terms of s 8(4)(*m*) or 20(1)(*a*)(ii).[53]

Example 3 – Discounting of debt

Facts: Andrew owes Duncan R100 payable in 5 years' time. Duncan agrees to accept R70 on condition that Andrew settles the debt after 1 year. Had Duncan discounted the debt with a bank he would have received R70.

Result: Andrew has discharged the debt for less than its face value, thereby triggering a capital gain in his hands in terms of para 12(5). The fact that a market related consideration was paid does not prevent this. R30 will therefore be treated as a capital gain in Andrew's hands. Duncan will have a capital loss of R30 (proceeds R70 less base cost R100).

Example 4 – Debt cancellation

Facts: Ecks Ltd borrows R10 million from its controlling shareholder, Expert Ltd to finance non-deductible expenditure. Prior to Ecks Ltd's listing, Ecks Ltd repays R4 million and Expert Ltd cancels the remainder of the debt in order to improve Ecks Ltd's balance sheet.

Result: Ecks Ltd is treated as having acquired R6 million of its own debt for no consideration and of having disposed of the debt for R6 million. The capital gain on this transaction is therefore R6 million. In terms of SARS' practice the company's assessed loss will not be reduced in terms of s 20(1)(*a*)(ii) as the loan was not used to finance deductible expenditure.[54]

Example 5 – Discharge from obligation for consideration less than face value of debt

Facts: On 1 March 2002 Ecks Ltd issues 10 000 debentures of R10 000 each, bearing an annual interest of 12%, expiring in 10 years' time. In 2004, interest rates have increased significantly and each R10 000 note is selling in the market for R8 000. Ecks Ltd repurchases half the issued debt in the open market.

Result: As soon as it holds its own debt, the debt is automatically extinguished by way of merger. At that time it realises proceeds of R50 million, being the release from an obligation as a result of a disposal of the debt it purchased, less R40 million, being the cost of acquiring the debt. Put differently, the face value of the debt acquired was R50 million. The amount given as consideration for the discharge of that debt was R40 million. Despite the fact that the consideration was market related, the capital gain on this transaction is R10 million.

6.2.5.7 Debts denominated in foreign currency

See para 43(5A) and the commentary thereon in **19.2**

[52] *Ogus v SIR* 1978 (3) SA 67 (T), 40 SATC 100 at 109.
[53] CIR v *Datakor Engineering (Pty) Ltd* [1998] 4 All SA 414 (A), 60 SATC 503.
[54] See R Stretch, J Silke and The Hon Mr Justice Zulman *Income Tax Practice Manual* (CD ROM version: August 2004) Butterworth Publishers (Pty) Ltd, Durban 'Losses – Insolvency – Compromise' in para 3. (3) at A - 547.

6.2.5.8 Debts not discharged by the creditor

For para 12(5) to apply the debt owed must be reduced or discharged by the creditor. In a discharge of debt, a creditor will more often than not be a party to the discharge, albeit indirectly, or through an act of omission. The fact that a debt is discharged by operation of law does not necessarily mean that the creditor has not taken an action to discharge a debt. For example, in ITC 1387[55] and ITC 1448[56] it was held that the act of adiation was a donation even though what followed was by operation of law in terms of s 37 of the Administration of Estates Act.

6.2.5.9 Deregistration and voluntary liquidation

A company liable to CGT in terms of para 12(5) cannot escape the consequences of the provision through deregistration, since it cannot be deregistered before its directors have submitted a written statement confirming that it has no assets or liabilities.[57] In the case of a voluntary liquidation, the company must settle all its debts within twelve months.[58] Clearly if the company in question is unable to pay its debts and the creditor forgives the debt in order to facilitate the deregistration or liquidation process, para 12(5) will apply.

6.2.5.10 Debts discharged through prescription

A debt that is allowed to prescribe through the effluxion of time falls within para 12(5). The failure to enforce payment of a debt is regarded as an act of omission by the creditor.

6.2.5.11 Gains otherwise accounted for (para 12(5)(a))

Where the amount discharged or reduced has been otherwise accounted for under the provisions of the Act set out in the table below, para 12(5) will not apply. The purpose is to avoid double taxation.

Table 4 – Other provisions under which discharge of debt accounted for

Provision	**Treatment of reduction or discharge**
Paragraph 3(*b*)(ii)	Capital gain
Section 8(4)(*m*)[59]	Recoupment
Section 20(1)(*a*)(ii)	Reduction of assessed loss by compromise benefit
Paragraph 20(3)	Reduction of base cost

Regarding para 20(3), where an asset has been purchased on credit, one needs to bear in mind that there are two sides to the transaction – the asset and the liability. If double taxation is to be avoided, regard must be had to both these sides. For example, assume an asset is purchased for R100 on credit, and that the creditor subsequently reduces the purchase price by R20. The reduction in the base cost of the asset will increase any future capital gain on its

[55] (1984) 46 SATC 121 (T).
[56] (1988) 51 SATC 58 (C).
[57] Section 73(5) of the Companies Act, or in the case of a close corporation, in terms of s 26(2) of the Close Corporations Act.
[58] Section 350(1)(*b*) of the Companies Act.
[59] The reference to s 8(4)(*m*) was inserted by Act 45 of 2003 with effect from 22 December 2003. Where cases involving s 8(4)(*m*) arise prior to this date, the provisions of the principal Act must be applied in the first instance, and para 12(5) must be applied to any excess. If a Schedule is in clear conflict with a section of the principal Act, the latter prevails. See commentary in **4.4.** Clearly both provisions cannot be applied, for there is a necessary implication in a taxing statute against double taxation. See *CIR v Delfos* 1933 AD 242, 6 SATC 92 at 112.

disposal. If the decrease in the liability were also to be treated as a capital gain, double taxation would result.

Example 6 – Reduction in base cost as a result of purchase price reduction (para 20(3))

Facts: Duncan sells Andrew his 10,4 m yacht for R500 000. Andrew agrees to pay the purchase price in five equal annual instalments. In year 5 Duncan generously decides to reduce the purchase price by R50 000.

Result: Since this would constitute a reduction in the base cost of the asset in terms of para 20(3)(*b*). Andrew will not again be subjected to CGT on the gain arising from the discharge of his debt in terms of para 12(5).

Example 7 – Reduction in purchase price after disposal (para 3(*b*)(ii))

Facts: The facts are the same as in example 1, but this time Andrew has been unable to comply with the payment terms. After 5 years he sells the yacht still owing Duncan R100 000 which is due and payable at that time. In the sixth year Duncan gives him a discount on the purchase price of R50 000.

Result: The amount of R50 000 constitutes a capital gain in terms of para 3(*b*)(ii) and so will not again be subjected to CGT in terms of para 12(5).

Example 8 – Assessed loss reduced by compromise benefit (s 20(1)(*a*)(ii))

Facts: Robin (Pty) Ltd purchased trading stock from John for R20 000 on credit. The company subsequently fell on hard times and was unable to settle the amount it owed to John. In order to avoid costly legal proceedings the company entered into a compromise in terms of which it paid John R5 000 in full and final settlement. At the end of the relevant year of assessment the company had an assessed loss of R100 000 which was reduced by the amount compromised (R15 000) in terms of s 20(1)(*a*)(ii).

Result: The amount of R15 000 will not constitute a capital gain in terms of para 12(5).

6.2.5.12 Disposal of assets between spouses

The provisions of para 67 (transfer between spouses) take precedence over para 12(5).

Example 9 – Release of debt between spouses

Facts: Gordon and Jean are married out of community of property. Gordon borrowed R100 000 from Jean to buy a yacht. Jean subsequently told Gordon that he need not repay her.

Result: In terms of para 67(1)(*a*) Jean is deemed to have disposed of the loan at no gain no loss. Gordon is deemed in terms of para 67(1)(*b*)(ii) to have acquired the debt for an amount equal to the expenditure incurred by Jean (R100 000). As soon as Jean disposes of the loan to Gordon there is an extinction of the amount owed by Gordon because of merger. In terms of para 35(1)(*a*) the amount by which Gordon's liability has been reduced or discharged comprises proceeds. Since para 12(5) is subject to para 67, para 12(5) does not apply. There is therefore no gain no loss in Gordon's hands. The treatment under para 67 is summarized below.

Jean

Jean's asset = Loan to Gordon
Base cost of loan (para 20(1)(*a*)) R100 000
The asset is deemed to be disposed of for no gain no loss in terms of para 67(1)(*a*).

Gordon

Liability – amount owed to Jean (R100 000)
Jean waived the liability, but para 12(5) does not apply as it is 'subject to' para 67.
Gordon acquires an asset – the amount owed by him.
Base cost of asset (para 67(1)(*b*)(ii)) = Jean's expenditure) R100 000
Asset is disposed of by merger.
Proceeds in terms of para 35(1)(*a*) – amount by which
Gordon's liability has been discharged R100 000
No gain no loss.

6.2.5.13 Loans to trusts discharged by donation

Taxpayers have for many years taken advantage of the annual donations tax exemption of R30 000[60] (previously R25 000) to donate amounts to their trusts. In this way estate duty is avoided on the death of the donor. Where the trust is indebted to the donor such donations can have CGT consequences. The issue is discussed in some depth in the example below.

Example 10 – Sale of asset to trust and subsequent forgiveness of debt

Facts: Some years ago Bob sold a property to The Bob Family Trust at market value of R500 000. The transaction was funded by a loan from Bob. The purpose of the transaction was to peg the value of his estate for estate duty purposes. In order to reduce the value of his loan that will eventually be included as an asset in his estate upon his death he has been donating R30 000 each year to his trust, which in turn uses the donation to repay his loan account. In terms of para 12(5) the cancellation of debt triggers a capital gain. Will the annual R30 000 reduction in Bob's loan account in the trust trigger a capital gain in the trust? Or is this simply the repayment of a loan by the trust?

Result: The cancellation of part of the trust debt will give rise to a capital gain in the trust in terms of para 12(5). Whether the reduction in the loan account constitutes a cancellation of debt will depend on how the transaction is structured. Some commentators have suggested that no gain will arise if cash of R30 000 were donated to the trust as this would not amount to the cancellation of debt. It is submitted that this strategy is not without its risks. Our courts have not always taken kindly to cheque swopping antics as the taxpayer in ITC 1583[61] discovered to his cost. The taxpayer in that case, an attorney who practised in partnership, withdrew funds from his practice in order to repay his bond which had been used to purchase his residence. He then immediately increased the bond and paid the money back into his practice. The objective of the transaction was to change the purpose of the borrowing in order to make the interest deductible. The court disregarded the transaction holding that it had merely been carried out to secure a fiscal advantage. The taxpayer in ITC

[60] The exemption is granted in terms of s 56(2)(*b*). The amount of R30 000 was substituted for R25 000 by s 24 of the Taxation Laws Amendment Act 30 of 2002, and applies to any donation made on or after 1 March 2002.
[61] (1993) 57 SATC 58 (C).

1690,[62] a case virtually identical to ITC 1583, shared the same fate. If a trust has no need for the cash why donate cash to the trust? The transaction can only have a tax motive. In some overseas jurisdictions the exchange of cheques has been found to be acceptable. See, for example the United Kingdom case of *Macniven (Her Majestry's Inspector of Taxes) v Westmoreland Investments Limited*[63] and the Australian case of *Richard Walter (Pty) Limited v FC of T*.[64] It may well be that these cases can be distinguished on the grounds that they had a *bona fide* business purpose.

Regardless of whether a cash swopping transaction circumvents para 12(5), a taxpayer donating cash in this manner will have to have a paper trail to support the transaction.

Should a gain be triggered in the trust, there is some consolation for Bob in that para 56(2) allows him to claim a capital loss in his hands in respect of the debt disposed of. The loss is not clogged (ring-fenced), since para 56(2) applies despite para 39.
Some commentators have questioned whether it is necessary for cash to change hands. The argument goes something like this: If the donor undertakes to pay the trust R30 000 then the trust acquires an asset (the right to claim payment from the donor). On the other hand, the trust has an obligation to repay the original loan. Thus there are two loans in the trust – a debit loan of R30 000 (an asset) and a credit loan of R500 000 (a liability). The two loans can be set off and this would not give rise to a capital gain.

A donation where property is not yet delivered is referred to as an executory contract of donation. Certain legal formalities set out in s 5 of the General Law Amendment Act 50 of 1956 need to be complied with for such a donation to be valid.

Section 5 of the General Law Amendment Act provides as follows:

> ‘No donation concluded after the commencement of this Act shall be invalid merely by reason of the fact that it is not registered or notarially executed: Provided that no executory contract of donation entered into after the commencement of this Act shall be valid unless the terms thereof are embodied in a written document signed by the donor or by a person acting on his written authority granted by him in the presence of two witnesses.’

What this means is that where delivery has not yet taken place and there is merely a promise to donate (a contract) there will not be a valid donation unless the matter is reduced to writing and the contract is signed by the donor. In terms of common law a donation will only take effect when it is accepted by the donee – this would, for example, be on the date of signature by the donee.

Such a ‘promise to donate’ may amount to nothing more than a disguised cancellation of debt. The substance of the transaction may be one of debt forgiveness. See cases such as *Relier (Pty) Ltd v CIR*,[65] *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR*[66], where our courts have looked at the true intention of the parties.

6.2.5.14 Loan bequests

It is not uncommon for parents to lend their children money. Upon death, more often than not, the parent will simply bequeath the debt to the child and the debt will be cancelled. Prior to the Revenue Laws Amendment Act 74 of 2002, some commentators expressed doubts as

[62] (1999) 62 SATC 497 (G).
[63] [2001] UKHL 6; [2001] 1 All ER 865.
[64] (1996) 33 ATR 97 at 107.
[65] 1997 (5) JTLR 119 (SCA), 60 SATC 1.
[66] 1996 (3) SA 942 (A), 58 SATC 229.

to whether the action on the part of the deceased parent would trigger CGT in the heir's hands under para 12(5). Their argument was that para 40 deems the heir or legatee to have acquired his or her assets at market value, and that this provision should take precedence. On the face of it para 40 was in conflict with para 12(5), which deems the debt to be acquired for a base cost of nil. Paragraph 40 is now subject to para 12(5) which means that para 12(5) must take precedence. The discharge of a debt in this manner will therefore trigger a capital gain in the heir's hands in terms of para 12(5). It has been suggested that a way round this problem would be for the parent to leave cash or other assets to the heir, which could be used by the heir to repay the debt due. Whether such a strategy would succeed will depend on the facts of each case. No doubt the intention of the parties regarding repayment during the deceased's lifetime will be a relevant factor. A loan made without any expectation of repayment may be regarded as a donation in disguise.

6.2.5.15 Amount owed by dormant company

The position before 22 December 2003

It frequently happens, for example, that a holding company wishes to deregister a dormant subsidiary. The subsidiary owes the holding company an amount on loan account and has no assets with which to settle the debt. Before a company can be deregistered, it must have no assets or liabilities. Prior to the advent of CGT the holding company would simply have waived the indebtedness and proceeded with the deregistration. The question has been asked how the subsidiary can be deregistered without triggering a capital gain in its hands. The short answer is that there is no obvious solution to this problem. Repaying the debt by issuing additional shares to the holding company cannot be justified unless the shares are issued at market value. And donating cash to the subsidiary will simply be a disguised waiver of debt. Both these ploys are likely to fall foul of s 103 or be regarded as sham transactions.

There is, however, some consolation for the holding company, in that it may be able to claim a capital loss. The loss will not be clogged since para 56(2) permits the loss despite the clogged loss rule in para 39. The extent of the loss may be limited if the loan was incurred prior to valuation date. In that case the holding company would have to determine the valuation date value of the loan using TAB or market value.

Example 11 – Dormant company owing an amount to its shareholder prior to deregistration

Facts: Burnout (Pty) Ltd is a dormant company wholly owned by Marisa. Marisa wishes to deregister Burnout. The company's balance sheet reads as follows:

Capital employed	R
Share capital	100
Amount owed to Marisa	100 000
	100 100
Employment of capital	
Accumulated loss	100 100

Prior to deregistration Marisa waived the debt owed to her by Burnout. In terms of para 12(5) the waiver of the loan triggered CGT in Burnout of R100 000 x 15% = R15 000 in terms of para 12(5). Marisa agreed to donate an amount of R15 000 to Burnout in order that it could settle the CGT debt of R15 000.

Result: The view is held that the donation of the R15 000 to settle the CGT liability will not give rise to a further CGT liability since Burnout would not be indebted to Marisa in respect of the donation received.

Assuming that the debt due by Burnout arose after valuation date, Marisa will claim a capital loss of R100 000 which she can set off against other capital gains arising from transactions with third parties.

If Marisa were to sell the company for R100 (its market value) to a third party, there would be no CGT consequences for Burnout under para 12(5), since from its perspective it still owes R100 000, only now to the third party acquirer of its shares and loan instead of Marisa. There are, however, commercial risks for the third party in purchasing a dormant company as it may contain hidden liabilities. There will also be CGT consequences for the purchaser when the loan acquired at a discount is repaid.

6.2.5.16 The issue of overvalued shares scheme

Some advisors have suggested that the problems outlined in the above example could be overcome if Burnout were to issue 100 000 shares of R1 each to Marisa at par. They contend that once Burnout has been deregistered, Marisa could claim the cost of the shares as a capital loss. Such a scheme is open to attack as a sham transaction because Marisa would be paying R100 000 for shares that were worthless. Such a transaction is no more than a thinly disguised attempt at recharacterising the loss of the loan as a loss of a share investment. The scheme would in any event not work in the above example because the consideration given in discharge of the loan (the market value of the shares) is less than the face value of the loan.

6.2.5.17 Amounts owing between group companies

As a result of the problems described above, para 12(5) was amended with effect from 22 December 2003 to provide relief to companies that are members of the same group of companies.[67] This amendment does not, however, address the situation where an individual or a trust holds the shares and loan account of a dormant company.

Reason for the amendment

Paragraph 12(5) has resulted in companies that owe money to other group companies not being deregistered or liquidated because of the potential tax consequence and this results in additional cost to groups of companies. It also unnecessarily increases the number of companies on register.

The relief for group companies

To alleviate the problem described above the provisions of para 12(5) do not apply where the debtor and creditor are part of the same 'group of companies'. The term 'group of companies' is defined in s 1 and essentially refers to a group where the controlling company directly or indirectly holds at least 75% of the equity share capital of a controlled group company.

[67] This amendment came into operation on 22 December 2003 and applies in respect of any reduction or discharge on or after that date.

The impact on the creditor

In terms of para 56(1) the creditor company will not be able to claim a capital loss in respect of the cancellation or discharge of the debt owed to it (unless para 56(2)(*b*) or (*c*) applies). Had para 12(5) resulted in a capital gain in the hands of the debtor, the creditor would have been entitled to a capital loss in terms of para 56(2)(*a*). However, since the capital gain will not arise, para 56(2)(*a*) does not apply and para 56(1) results in the loss being denied. This provides a symmetrical treatment of both debtor and creditor.

Exceptions to the exclusion of group companies rule

There are two exceptions to the general rule that para 12(5) does not apply to groups of companies. These exceptions only apply when the transactions are part of a scheme to avoid any tax that would otherwise have arisen under para 12(5).

The two circumstances are as follows:

Debt acquired from non-member of group

The provisions of para 12(5) will apply where the debt (or any substituted debt) was acquired directly or indirectly from a person who is not a member of the group of companies.

Example 12 – Debt acquired from non-member of group of companies

Facts: Holdco owns all the shares in Subco. In 2003 Subco owed R100 000 to Propco. Propco is not a member of the Holdco group of companies. As part of a tax avoidance scheme Holdco purchased Subco's debt from Propco for R60 000 and thereafter waived its right to claim the debt from Subco.

Result: Holdco will have a capital loss of R60 000 in terms of para 56 while Subco will have a capital gain of R100 000 in terms of para 12(5).

The company becomes a member of the group of companies after the debt arose.

The provisions of para 12(5) will apply where that person or another person became members of that group of companies after that debt (or any substituted debt) arose.

Example 13 – Debtor and creditor subsequently become part of the group

Facts: Alpha lent Beta R100 000 at a time when the two companies were unrelated. A year later, as part of a tax avoidance scheme, Alpha purchased all the shares in Beta and subsequently waived its right to claim the debt.

Result: In this case para 12(5) will apply, and Beta will be subject to CGT on the debt waived of R100 000.

Example 14 – Unrelated creditor of group company joins group of companies

Facts: Holdco owns all the shares in Subco. In 2003 Subco owed R100 000 to Propco. Propco is not a member of the Holdco group of companies. It subsequently emerged that Subco was in financial difficulties and was unable to repay Propco. Propco was considering writing off the loan, but could not make use of the resulting capital loss as it had no other capital gains, and did not foresee having any for some years. The write off would have had adverse CGT consequences for Subco as it would have triggered a capital gain of R100 000 in its hands. In order to avoid the CGT in Subco's hands, Holdco purchased the shares of Propco after which Propco wrote off the debt of Subco.

Result: The relief from the operation of para 12(5) does not apply and Propco will have a capital loss of R100 000 and Subco will have a capital gain of the same amount.

6.3 Time of disposal and acquisition

Paragraph 13

6.3.1 Introduction

The time of disposal is an important core rule as it dictates when a capital gain or capital loss must be brought to account. It also provides the corresponding date of acquisition by the acquirer of an asset.

Paragraph 13 contains three categories of timing rules covering

- disposals involving a change of ownership effected or to be effected because of an event, act, forbearance or by operation of law (para 13(1)(*a*)(i) – (ix)),
- disposals arising from specific events (para 13(1)(*b*) – (*g*)), and
- acquisition of assets (para 13 (2)).

The first two are summarised in the table below:

Table 1 – Time of Disposal

Paragraph 13(1)	**Type of disposal**	**Time of disposal**
(*a*)	Disposal of an asset by means of a change of ownership effected or to be effected from one person to another because of an event, act, forbearance or by operation of law	
(i)	Agreement subject to a suspensive condition (see below for meaning of 'suspensive condition')	Date on which condition satisfied
(ii)	Agreement not subject to a suspensive condition	Date of conclusion of agreement
(iii)	Donation of an asset	Date of compliance with all legal requirements for a valid donation
(iv)	Expropriation of an asset	Date on which the person receives the full compensation agreed to or finally determined by a competent tribunal or court
(v)	Conversion of an asset	Date on which that asset is converted
(vi)	Granting, renewal or extension of an option	Date on which the option is granted, renewed or extended
(vii)	Exercise of an option	Date on which the option is exercised
(viii)	Termination of an option granted by	Date on which that option terminates

	a company to a person to acquire a share, participatory interest[68] or debenture of that company	
(ix)	Any other case	Date of change of ownership
(*b*)	Extinction of an asset including by way of forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment	Date of the extinction of the asset
(*c*)	Scrapping, loss or destruction of an asset	Date (i) when the full compensation in respect of that scrapping, loss or destruction is received; or (ii) if no compensation is payable, the later of the date when the scrapping, loss or destruction is discovered or the date on which it is established that no compensation will be payable
(*d*)	Vesting of an interest in an asset of a trust in a beneficiary	Date on which that interest vests
(*e*)	Distribution of an asset by a company to a shareholder	Date on which that asset is so distributed as contemplated in para 75
(*f*)	Decrease of a person's interest in a company, trust or partnership as a result of a value shifting arrangement,	Date on which the value of that person's interest decreases
(*g*)(i)	The following events referred to in para 12: (2)(*a*) person ceasing to be a resident (*b*) asset of a non-resident becoming or ceasing to become part of a permanent establishment (*c*) asset becoming trading stock (*d*) asset ceasing to be a personal use asset (*e*) asset becoming a personal use asset 12(3) asset ceasing to be trading stock 12(4) asset of a person becoming a resident	Date immediately before the day that the event occurs
(*g*)(ii)	Paragraph 12(2)(*f*) transfer of assets between funds of an insurer 12(5) reduction or discharge of debt without full consideration	Date that that event occurs

[68] The previous reference to a unit was substituted by a reference to a participatory interest by Act 32 of 2004, effective as from the date that the Collective Investment Schemes Control Act 45 of 2002, came into operation, namely, 3 March 2003.

Although not specifically stated, the time of disposal and acquisition rules in para 13 also apply to assets acquired prior to the valuation date. This is necessary to identify what constitutes a pre-valuation date asset and to fix the time of acquisition of such assets.

6.3.2 Dates of disposal not covered by para 13

While para 13 sets out time of disposal rules for many of the disposal events contained in para 11, it is not an exhaustive provision. For example, the creation of an asset is a disposal event in para 11(1), but para 13 does not specify a time of disposal for the creation of an asset. Where para 13 is silent, the time of disposal (and the corresponding time of acquisition) must be deduced from the disposal event itself. Thus, the time of disposal for the creation of an asset is the date when the asset is created.

This is best illustrated by the disposal of certain personal rights. Paragraph 13(1)(*a*) provides times of disposal where a change of ownership has been effected or is to be effected. Whilst a person can own a personal right and in certain circumstances transfer such a right to another person (for example, by cession), many personal rights do not involve a transfer of ownership from one person to another. Personal rights are frequently 'created' rather than transferred.

Example – Personal right created through obligation

Facts: Beverley agreed not to trade within a 5 km radius of Agatha's business for 2 years in exchange for a payment of R100 000,

Result: When Beverley signed the restraint of trade agreement, she partially sterilised her asset, being her right to trade, and created a right in favour of Agatha (the disposal event). The time of disposal of Beverley's right to trade and the time of acquisition of Agatha's contractual right is not determined by para 13, but is derived from the disposal event, being the creation of Agatha's asset. The time of disposal will therefore be the date on which Agatha's contractual right was created.

Agatha simultaneously acquired a personal right against Beverley (being the undertaking not to trade), and that right will be disposed of when the restraint agreement ends. The time of disposal of Agatha's right will be the date of extinction of her asset (para 13(1)(*b*))

6.3.3 Suspensive v resolutive conditions

A *suspensive condition* suspends the full operation of the obligation under a contract and renders it dependent on an uncertain future event. [69] A clause stating that the sale will only be confirmed if a mortgage bond is granted is a typical suspensive condition.

A suspensive condition must be distinguished from a term of a contract. In *Design and Planning Service v Kruger*[70] Botha J distinguished a suspensive condition from a term of a contract as follows:

> 'In the case of a suspensive condition, the operation of the obligations flowing from the contract is suspended, in whole or in part, pending the occurrence or non-occurrence of a particular specified event (cf *Thiart v Kraukamp*, 1967 (3) SA 219 (T) at p 225). A term of the contract, on the other hand, imposes a contractual obligation on a party to act, or to refrain from acting, in a particular manner. A contractual obligation flowing from a term of the contract can be enforced,

[69] *LAWSA* vol 5(1) iin 191.
[70] 1974 (1) SA 689 (T) at 695.

> but no action will lie to compel the performance of a condition (*Scott and Another v Poupard and Another*, 1971 (2) SA 373 (A) at p 378 in fin).'

Example 1 – Disposal subject to a suspensive condition

Facts: Lindsay disposed of his luxury townhouse at Ballito to Kevin on 29 February 2004, subject to Kevin being able to obtain a bond. On 30 June 2004 Kevin obtained the bond, and on 15 August 2004 the property was transferred into his name.

Result: The date of disposal is 30 June 2004 when the suspensive condition is fulfilled.

A resolutive condition on the other hand is one where the continuance of the operation of the agreement is made to depend upon the happening of an uncertain future event. In the case of a resolutive condition there is no postponement of the disposal.

Example 2 – Disposal subject to resolutive condition

Facts: On 15 January 2004 the Acorn Trust disposed of its investment in Oak Tree (Pty) Ltd to an empowerment consortium. The sale agreement provided that the sale would be cancelled and any monies paid by the purchasers would be forfeited to the seller if the company did not produce a turnover of R100 million by 30 June 2006.

Result: The date of disposal is 15 January 2004.

6.3.4 Time of conclusion of contract

The time of disposal in the case of an unconditional agreement is the date on which the agreement is concluded (para 13(1)(*a*)(ii)). The date of conclusion of an agreement is a matter to be determined in accordance with the law of contract, and will depend on the facts of the particular case. It is beyond the scope of this Guide to provide a full exposition of the law in this regard. Suffice to say, the courts have laid down some general rules for determining the date of conclusion of a contract, and these are as follows:[71]

- A contract will be concluded when agreement is reached between the parties.
- Agreement is reached when the parties are aware that they are in agreement with each other.
- They will be aware that they are in agreement when the offeror receives communication of the offeree's acceptance.

There are exceptions to these rules. For example:

- A contract negotiated through the post is concluded by the posting of the letter of acceptance, and not when the letter is received by the offeror.[72]
- The general rule can be varied by the offeror stipulating the method of acceptance.[73]

6.3.5 Time of accrual or incurral

The time of disposal and acquisition rules merely determine the time of disposal or acquisition. They do not determine the time of accrual of proceeds or incurral of expenditure. These times must be determined independently in terms of s 24M in the case of

[71] R H Christie *The Law of Contract in South Africa* 4 ed (CD ROM version: August 2004) Butterworth Publishers (Pty) Ltd, Durban at 32.
[72] *Dunlop v Higgins* (1848) 9 ER 805; *Cape Explosives Works Ltd v SA Oil and Fat Industries Ltd* (1) 1921 CPD 244; *Kergeulen Sealing and Whaling Co Ltd v CIR* 1939 AD 487, 10 SATC 363.
[73] *Driftwood Properties (Pty) Ltd v McLean* 1971 (3) SA 591 (A); *Laws v Rutherfurd* 1924 AD 261.

unquantifiable amounts, or in other cases, in accordance with common law principles, based on the actual facts. Where proceeds accrue in a later year they are treated as a capital gain in that year in terms of para 3(*b*). Where expenditure is incurred in a later year it is treated as a capital loss in that year in terms of para 4(*b*).

Nevertheless, as will be seen below in the context of deferred delivery arrangements, the time of disposal rules do play a part in valuing a personal right that is acquired or disposed of in exchange for a right of ownership. In other words, para 13 can establish the quantum of an amount accrued or incurred.

6.3.6 Deferred delivery arrangements

6.3.6.1 Introduction

In the classic deferred delivery arrangement, one person (A) sells an asset to another person (B) at a fixed price today, delivery to take place at a specified future date. The asset may or may not[74] be in the possession of the seller at the time of entering into the contract. Examples of the sale of assets not in existence at the time of sale include the sale by a

- farmer of future crops or fruit to a canning factory or to an exporter,
- employer of shares to an employee, where the shares have yet to be issued, and
- manufacturer of plant and machinery that is still to be manufactured.

This does not invalidate the sale, since the seller can purchase, produce or manufacture the asset prior to the date of delivery. The fact that delivery is deferred and requires performance on the part of the seller does not make delivery a suspensive condition. Delivery is merely a term of the contract. A breach of the contract by failing to deliver gives rise to ordinary contractual remedies of a compensatory nature, that is, (depending on the circumstances) specific performance, damages, cancellation or certain combinations of these.[75]

6.3.6.2 Time of disposal

In the case of an unconditional agreement involving the disposal of an asset by means of a change of ownership effected or to be effected, the time of disposal occurs when the agreement is concluded (para 13(1)(*a*)(ii)).

Under a deferred delivery arrangement an agreement of sale may be unconditionally entered into today, but delivery and hence the change of ownership will only take place at a later date. The words 'to be effected' that are used in para 13(1)(*a*) make it clear that the disposal must be recognised on the date of conclusion of the contract even if the change of ownership is to be effected at a later date.

The paragraph does not deem the transfer of ownership to have taken place but when it does take place, the time of disposal is deemed, for example, in the case of an unconditional contract to be when the contract is concluded. The time of accrual of proceeds and the incurral of expenditure is determined independently of the time of disposal.

6.3.6.3 The creation and disposal of personal rights

Upon entering into a deferred delivery contract, a number of personal rights are brought into existence. For example, the seller acquires a personal right to claim payment at a future date, while the buyer acquires a right to claim delivery at a future date.

[74] Known as e*mptio rei sperata. '*Sperare' means to hope, look for, expect.
[75] *R v Katz* 1959 (3) SA 408 (C) at 417.

The effect of para 13(1)(*a*) is that while disposal results in the creation of a number of personal rights, they are all deemed to have been exchanged, terminated or expired on the date of the conclusion of the contract. If for some reason there is no transfer of ownership then there is no disposal for the timing rule to apply to.
There are situations where a capital gain or loss on the disposal of a right created out of the transaction may be subject to CGT. If, for example, A sells an asset to B, delivery to be effected in 5 years' time, and B disposes of the right to claim delivery to C for proceeds, a capital gain could arise assuming that the transaction is on capital account.

Some commentators have expressed concern that the exchange of personal for real rights could in itself give rise to gains and losses where delivery of an asset is deferred. The problem is illustrated in the example below.

Example – Exchange of personal and real rights upon delivery of an asset

Facts: Bryan sells an asset to Shanitha for R100 in 2005, delivery to take place in 2006. When the asset is delivered, it has increased in value to R110. The purchase price is due and payable on delivery.

Result:

The acquisition of the personal right to claim delivery

In 2005 Shanitha acquired an asset in the form of a personal right to claim delivery from Bryan in 2006. In terms of ITC 1444 and ITC 1725 she has incurred no expenditure in respect of that asset at the time of entering into the contract since the contract requires reciprocal performance. The base cost of Shanitha's personal right to claim delivery, being R100, will only be incurred when the time for delivery arrives in 2006.

The disposal of the personal right in exchange for the real right

The exchange of Shanitha's personal right for a real right actually takes place in 2006 but in terms of para 13(2) read with para 13(1) is brought back to 2005 and is deemed to occur on the date on which the contract was entered into.

In this barter and exchange transaction the proceeds derived in exchange for the extinction of the personal right are equal to the 'amount' received or accrued in terms of para 35. That amount is the value of the thing received. In this case the real right, being the actual asset, was worth R100 on the date the contract was entered into and this value constitutes the proceeds derived from disposal of the personal right.

The disposal of the personal right which is deemed to take place in 2005 gives rise to no gain or loss in that year because no proceeds have accrued and no expenditure has been incurred at that point. When the base cost of the personal right is incurred in 2006 it is accounted for as a capital loss in that year in terms of para 4(*b*)(ii)(*aa*). Proceeds accrue on the extinction of the personal right in 2006 and are accounted for as a capital gain in terms of para 3(*b*)(i).

The base cost of the real right

Upon taking delivery of the asset Shanitha incurs expenditure in respect of the actual asset (real right). The amount of that expenditure is determined in terms of a barter or exchange transaction, since her personal right to claim delivery has been extinguished in exchange for a real right. Under such a transaction the expenditure in respect of the asset acquired is equal to the amount by which she has been impoverished, namely, the market value of the personal right that has been extinguished. The exchange of rights is deemed to take place in 2005 in terms of para 13(2) read with para 13(1). This second incurral provides Shanitha with the base cost of the actual asset. The date of acquisition remains 2005, but the date of incurral of the base cost is 2006. In summary:

2005

	R
Proceeds from extinction of personal right (para 35)	Nil
Base cost of personal right (para 20)	Nil
Capital gain or loss (para 3(*a*) or 4(*a*))	Nil
Base cost of real right (acquired, not yet incurred)	NIl

2006

	R
Capital gain from proceeds accrued In respect of extinction of personal right (para 3(*b*)(i))	100
Capital loss from incurral of base cost of personal right (para 4(*b*)(ii)(*aa*))	(100)
Sum of gains and losses	Nil
Base cost of real right (para 20) (date of acquisition = 2005, date of incurral = 2006)	(100)

6.3.6.4 Time of accrual and incurral

As noted under **6.3.5, the** time of accrual of proceeds and incurral of expenditure is determined independently of the time of disposal rules.

In the context of deferred delivery arrangements, our courts have held that there is no accrual or incurral until date of delivery.

Time of accrual of proceeds

Our courts have held that there can be no accrual until delivery. In ITC 424[76] a lessee disposed of his rights under a lease agreement, payment of the purchase price to be made in cash upon delivery of possession by the seller. The court held that the seller was not entitled to payment of the purchase price, or any part thereof, until such delivery of possession. In the *Lategan* case it had been held that the word ‘accrued’ meant ‘entitled to’ claim payment of the debt in future. Regarding these words the court stated the following:[77]

> ‘That seems to us to refer to a definite right *in praesenti*[78] to claim payment in future, but where there is as yet no delivery the right to claim the payment does not arise until the delivery is made.’

It is unlikely that s 24(1) overrides the common law position for CGT purposes. Section 24 must be read in context, and the fact that s 24(2) grants an allowance against ‘income’ is a

[76] (1938) 10 SATC 338 (U). See also *Silke on South African Income Tax* in § 2.8, and ITC 316 (1934) 8 SATC 166 (U).
[77] At 339.
[78] ‘At the present time’.

strong indication that s 24 was not intended to apply to the Eighth Schedule. In terms of para 35(3)(*a*) proceeds exclude any amount included in income.

The parties to an agreement could, of course, vary the common law position, but for the purpose of the discussion that follows it is assumed that the common law position prevails, and that there is no accrual until delivery occurs.

Time of incurral of expenditure

In ITC 1444[79] a company sought to claim a deduction in respect of the purchase of production materials at a fixed or determinable price for delivery at a future date. The purchase price was payable against receipt of the bills of lading and invoices. McCreath J held that the liability to pay was conditional upon the performance by the seller, and until the bills of lading and invoices were delivered there was no absolute and unqualified legal liability to pay.

The decision in ITC 1444 was applied with approval by Davis J in ITC 1725.[80] In that case a farmer who had placed a verbal standing order for cattle feed to be delivered at a future date sought to claim a deduction in respect of his obligation under the contract. Payment was only effected after delivery and receipt of the invoice. Davis J held that the taxpayer could have cancelled prior to delivery, and that an unconditional liability only arose upon delivery.

The principle of reciprocity and the *exceptio non adimpleti contractus*[81] recognises that in many contracts there is a need for reciprocal performance.

Prior to its deletion para 20(3)(*c*) excluded from base cost any amount that has not been paid and is not due and payable.[82]

6.3.6.5 Treatment of capital loss in year of disposal by seller

Where the seller has acquired the asset to be disposed of at the time of disposal, a capital loss will invariably result, since there will be a base cost but no proceeds. In terms of para 39A[83] the capital loss will be suspended until all the proceeds have accrued. The proceeds must be accounted for as a capital gain when they accrue upon delivery in terms of para 3(*b*)(i).

Example – Deferred delivery, asset in seller's possession at date of sale

Facts: Bryan sells a share with a base cost of R40 to Wayne on 28 February 2006 for R100, delivery and payment to take place on 28 February 2008. The contract is unconditional. When must the disposal by Bryan be recognised? What is the capital gain or loss?

Result: In terms of para 13(1)(*a*) the disposal must be recognised in Bryan's 2006 return of income, because the change of ownership is 'to be effected' in 2008 and the sale is unconditional. However, the proceeds of R100 have not accrued to Bryan on 28 February 2006 and so will be nil at that point. The base cost is R40, and Bryan will have a capital loss of R40 which will be suspended in terms of para 39A until the proceeds accrue in 2008. In

[79] (1987) 51 SATC 35 (T).
[80] (2000) 64 SATC 223 (C).
[81] Procedural defence relating to the non-fulfilment of reciprocal obligations.
[82] Paragraph 20(3)(*c*) was deleted by the Revenue Laws Amendment Act 32 of 2004, and applies to any disposal during any year of assessment commencing on or after 24 January 2005.
[83] Paragraph 39A was inserted by s 64 of Revenue Laws Amendment Act 32 of 2004 and applies to any disposal during any year of assessment commencing on or after 24 January 2005.

his 2008 return of income Bryan will reflect a capital gain of R100, being the proceeds received in respect of a disposal in an earlier year (para 3(*b*)(i)). The sum of the gain and suspended loss will give an aggregate capital gain of R60 (ignoring the annual exclusion).
Note: Had Bryan disposed of the share prior to 1 March 2005 para 39A would not have applied and he would have had a capital loss of R40 in 2005 and a capital gain of R100 in 2008.

6.3.6.6 Asset not in existence at time of disposal

The question arises as to how the time of disposal rules deal with the disposal of an asset before it is acquired. At the outset it must be stressed that a short sale (or bear sale as it is sometimes referred to) of this nature tends to be highly speculative, and in most instances will be taxed as ordinary income.

It is a pre-requisite for the imposition of CGT that a person must have an asset. Paragraph 2(*a*) provides that the Eighth Schedule applies to the disposal on or after valuation date of

> 'any asset *of* a resident'.

It follows that until the asset is acquired there can be no disposal. However, once it is acquired it is deemed in terms of para 13(1)(*a*)(ii) to have been disposed of at the time of conclusion of the contract. Although the effect of para 13(1)(*a*)(ii) is to backdate the disposal to an earlier year, this will in practice not necessitate a reopening of the assessment in respect of the year of disposal since no expenditure was incurred in that year, nor did any proceeds accrue in that year. Incurral takes place in the year of acquisition of the asset, and accrual takes place upon delivery. But what if an amount was paid by the buyer at the time of conclusion of the contract? How is such a receipt recognised? In this situation it is necessary to identify the asset that is being disposed of. At the time of concluding the agreement, an asset is created in the seller's hands, being the right to claim payment at a future date. When payment is made, that right is discharged (disposal – para 11(1)(*b*)), and would give rise to a capital gain in the year of receipt.

The expenditure on acquisition of the asset will be accounted for as a capital loss in the year of incurral in terms of para 4(*b*)(ii) and the proceeds as a capital gain in terms of para 3(*b*)(ii).

Example – Deferred delivery, asset not in seller's possession at date of sale

Facts: Alton sold a share to Nico on 28 February 2003 for R100, delivery to take place on 28 February 2005. The contract is unconditional. On 28 February 2003 Alton does not have the share in his possession – he intends to purchase it before delivery date. On 31 January 2005 Alton manages to purchase the share for R80 and delivers it to Nico on due date. When and how must the disposal by Alton be recognised?

Result: Alton is deemed to have effected transfer of ownership of the asset, and the sale must be recognised on 28 February 2003. However, he has incurred no expenditure in respect of the asset disposed of, nor has any part of the proceeds accrued to him on that date. His 2003 return of income will therefore reflect no gain no loss. In 2005 Alton will have incurred expenditure of R80 and this must be accounted for as a capital loss in his 2005 return in terms of para 4(*b*)(ii). In the same year the proceeds will accrue to him and he must account for them as a capital gain of R100 in terms of para 3(*b*)(i). The sum of the gain and loss will give an aggregate capital gain of R20 (ignoring the annual exclusion).

6.3.6.7 Cancellation of contract before delivery

The consequences of the cancellation of a contract prior to delivery taking place are considered in the example below.

Example – Cancellation of a contract involving deferred delivery

Facts: On 29 February 2004 Albert sold an asset to Brenda for R100, delivery to take place in 5 years' time. Albert's base cost at time of signing the agreement is R20. On 28 February 2005 the parties agree to cancel the agreement, each walking away and no money changing hands. The asset is worth R80 at the date of cancellation. The sale agreement is not subject to any suspensive conditions.

Result:

At the time of acquisition

Albert (seller)

On 29 February 2004 Albert has unconditionally disposed of an asset (sale – para 11(1)(*a*)). Time of disposal = date of agreement ('change of ownership . . . to be effected' – para 13(1)(*a*)). No proceeds have accrued, since Albert does not have a definite right *in praesenti* – ITC 424[84] and *Silke* in §2.8). Therefore Albert has a capital loss of R20. Had he sold the asset on or after 1 March 2005 the loss would have been suspended in terms of para 39A. It is assumed that s 24(1) is not applicable.

Brenda (buyer)

In terms of para 13(2) Brenda is deemed to have acquired the asset on the same date that Albert disposed of it. Brenda has, however, incurred no expenditure in respect of the acquisition (ITC 1444/ITC 1725).

At the time of cancellation

Brenda (buyer)

The cancellation of the sale triggers a disposal of the asset (para 11(1)(*b*) – cancellation). The time of disposal is the date on which the parties agree to cancel the contract (para 13(1)(*b*) – date of extinction of the asset).

Brenda has given up the asset in exchange for being relieved of the obligation of having to pay the purchase price. However, being relieved of the obligation to pay does not amount to proceeds in terms of para 35(1)(*a*) which only includes

> 'the amount by which any debt owed by that person has been reduced or discharged'.

No debt was owed by Brenda at the date of cancellation because she had not yet taken delivery of the asset (ITC 424. *Silke* § 2.8). Since there was no pre-existing debt to be reduced or discharged there can be no proceeds.

Therefore since Brenda has incurred no expenditure nor derived any proceeds the disposal by cancellation does not give rise to a capital gain or loss in her hands.

[84] (1938) 10 SATC 338 (U).

Albert (seller)

In terms of para 13(1)(*a(*ii)), Albert disposed of the asset to Brenda on 29 February 2004. When Brenda cancels the contract, Albert must logically reacquire the asset from her on the date of cancellation, since her date of disposal is his date of acquisition. Albert has been relieved of the obligation of having to deliver the asset, but the obligation never arose because the time for delivery never arrived. Albert therefore acquires the asset for no consideration on the date of cancellation. Paragraph 3(*b*)(ii) provides that a person will have a capital gain when

- any part of the base cost of an asset is recovered or recouped, and
- that part of the base cost was taken into account in a prior year disposal.

The reacquisition of the asset by Albert represents a recoupment of the base cost of the asset that was previously accounted for. He will therefore have a capital gain of R20. What is the base cost of the asset in Albert's hands? It is submitted that it will be the expenditure originally incurred in acquiring the asset in terms of para 20, that is, R20. In other words, Albert's base cost is restored to the pre-sale position as a result of the cancellation.

6.3.7 Donations

The time of disposal in the case of a donation is the date on which all the legal requirements for a valid donation have been complied with. Section 55(3) of the Act contains a similar provision in respect of donations tax.

Section 5 of the General Law Amendment Act 50 of 1956 provides as follows:

> 'No donation concluded after the commencement of this Act shall be invalid merely by reason of the fact that it is not registered or notarially executed: Provided that no executory contract of donation entered into after the commencement of this Act shall be valid unless the terms thereof are embodied in a written document signed by the donor or by a person acting on his written authority granted by him in the presence of two witnesses.'

An executory contract of donation (a promise to make a donation) is one where delivery has not yet taken place. The time of disposal of an asset by donation may therefore be summarised as follows:

Table 1 – Time of disposal of asset by donation

Type of donation	**Date legal formalities complied with**
Donation subject to a suspensive condition	Not valid until condition fulfilled, even if condition accepted by donee
Donation subject to resolutive condition	Effective immediately
Illegal donation	Not valid even if property transferred to donee
Oral donation without delivery	Not valid
Oral donation with delivery	Date delivery of asset accepted by donee
Executory contract of donation (no delivery)	Date of acceptance of the offer by the donee, the terms of which are contained in a deed of donation signed by the donor

In *The Law of Contract in South Africa* the following is stated regarding the need for acceptance:[85]

[85] R H Christie *The Law of Contract in South Africa* 4 ed at 63.

> 'An unaccepted offer obviously cannot create a contract, since it emanates from the offeror alone and the necessary agreement cannot be held to exist without some evidence of the state of mind of the offeree. Hence the general rule that no contract can come into existence unless the offer is accepted.[86]
>
> The general rule applies to donations in the same way as to other contracts.[87] If this were not so there would be a legal obligation to receive even such unwanted and burdensome donations as the white elephants which the King of Siam is said to have donated to courtiers who offended him.[88] This has never been our law, as is made clear by Paul D 50 17 69: *"Invito beneficium non datur"*.'[89]

6.3.8 Time of disposal = day before the specified event

In terms of para 13(1)(*g*)(i) the time of disposal is the day immediately before the specified event concerned, for example, upon a person becoming or ceasing to be a resident. The purpose of this provision is to either include or exclude all the gains and losses that accrued up to midnight of the day before the event. So for example, when a person becomes a resident, that person would start to accrue capital gains and losses from the commencement of the day of arrival in the Republic. The pre-entry gains and losses are thereby excluded.

6.3.9 When does a person become a resident?

The word 'resident' is defined in s 1. An individual will become a resident when he or she becomes 'ordinarily resident' or satisfies the physical presence test. The latter test is satisfied when the individual has been physically present in SA for more than

- 91 days in the current year of assessment,
- 91 days in each of the immediately preceding three years of assessment, and
- 549 days in total during the immediately preceding three years of assessment.

A company or trust will become resident when it has its place of effective management in SA. Companies or trusts that are incorporated, established or formed in SA are automatically regarded as resident in SA regardless of where they are effectively managed. For more information on the meaning of 'resident' see Interpretation Notes 3 (ordinary residence test), 4 (physical presence test) and 6 (place of effective management).

6.3.10 Time of disposal = time of acquisition (para 13(2))

Subparagraph (2) provides that where an asset is disposed of to a person, the person to whom the asset is disposed of is treated as having acquired that asset at the time of disposal of that asset as contemplated in para 13(1). This time of acquisition rule only applies where an asset has been disposed of. In terms of para 11(2) certain events are deemed to be non-disposals, such as the issue of a share or debenture. In such cases para 13(2) will not operate and reliance will have to be placed on common law principles for determining the date of acquisition. Section 41(1) contains a definition of 'date of acquisition' that applies to the corporate rules in ss 41 – 47, and this overrides the core rule in para 13(2).

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[86] *Christian v Ries* (1898) 13 EDC 8 15; *Dietrichsen v Dietrichsen* 1911 TPD 486 494-495; *Whittle v Henley* 1924 AD 138 148; *Rudolph v Lyons* 1930 TPD 85 91; *Tel Peda Investigation Bureau (Pty) Ltd v Van Zyl* 1965 (4) SA 475 (E) 478G.
[87] *De Kock v Executors of Van de Wall* (1899) 16 SC 463; *Birrell v Weddell* 1926 WLD 69; *Union Free State Mining and Finance Corpn Ltd v Union Free State Gold and Diamond Corpn Ltd* 1960 (4) SA 547 (W).
[88] Since a white elephant was regarded as a sacred animal it could not be put to work and the unfortunate recipient would derive no benefit from it but would have the burden of feeding it.
[89] A benefit is not conferred on anyone against his will. Cf Pothier s 578.

6.4 Disposal by spouses married in community of property

Paragraph 14

This paragraph deals with the disposal of an asset by a spouse married in community of property. The applicable rules are set out in the table below.

Table 1 – Disposal of asset by spouse married in community of property

Does asset fall within the joint estate?	Disposal
Yes	Treated as having been made in equal shares by each spouse
No	Treated as having been made solely by disposing spouse

In the absence of proof to the contrary, a religious marriage or a permanent same-sex or heterosexual union are regarded as being without community of property (definition of spouse in s 1).

Chapter 7 - Limitation of losses

PART IV: LIMITATION OF LOSSES

7.1 Personal use aircraft, boats and certain rights and interests

Paragraph 15

The vast majority of personal use assets are excluded from capital gains tax in terms of para 53. However, certain personal use assets that are likely to generate substantial capital gains as a result of market forces are included. These personal use assets may be subdivided into

- assets whose reduction in value is most likely attributable to the personal use and consumption of the asset, and
- assets whose reduction in value is most likely as a result of the influence of market forces.

This paragraph deals with the first category of assets. It would be theoretically correct to determine capital gains or losses on the disposal of assets in this category by reference to a base cost that has been reduced by applying a notional wear and tear allowance to reflect personal use and consumption. This would be complex for both taxpayers and SARS to administer and, in common with other jurisdictions, losses on disposal are disregarded and only gains in excess of the unadjusted base cost are taxed.

The following assets used for purposes other than the carrying on of a trade fall under this paragraph:

- an aircraft with an empty mass exceeding 450kg. This would exclude for example, a hang glider or micro light aircraft. It is understood that aircraft with an unladen mass in excess of 450kg have to be licensed as aircraft. The word ‘aircraft’ is not defined and hence will bear its ordinary meaning.
- a boat exceeding 10 metres in length. See in this regard the wide definition of ‘boat’ in para 1. The purpose of the 10 metre cut off is simply to exclude small pleasure craft such as rowing boats, ski boats, small yachts, rubber dinghies and the like which are unlikely to yield capital gains on disposal.
- usufructs, fideicommissums and similar interests whose value decreases over time. For example, a husband dies and leaves the bare dominium in his holiday home to his son and the right of use to his wife for the rest of her life.
- a lease of immovable property. For example, a holiday home acquired in terms of a 99-year lease.
- Time-share and share block interests with a fixed life whose value decreases over time.
- rights or interests in the above assets

Where an asset of this nature is used for both trade and private purposes an apportionment on a fair and reasonable basis will be necessary, with the trade portion of any loss being allowable.

Example 1 – Capital loss disregarded on disposal of aircraft not used for trade

Facts: Tielman purchased a light aircraft for R1 000 000, which he used for visits to his private game farm. He disposed of the aircraft for R900 000 six months later when he disposed of the game farm.

Result:

	R
Proceeds	900 000
Base cost	1 000 000
Loss	(100 000)
Disregarded capital loss	-

The existing provisions in respect of capital allowances will apply where the assets are used both for trade and for personal use.

Example 2 – Disregarding of capital losses where business and private use

Facts: Duncan paid R1 000 000 for his aircraft which he used 50% of the time in his air charter business, and 50% for private purposes. Two years after acquiring the aircraft he crashed it during a night flight and thankfully escaped unscathed. He was uninsured and sold the wreck as spares for R100 000.

Result:

\Capital allowances	Total	Allowed
	R	R
Cost	1 000 000	
Section 12C allowances	(400 000)	200 000
Tax value	600 000	
Proceeds	100 000	
Scrapping allowance	(500 000)	(250 000)

Note: The scrapping allowance is determined with reference to the original cost and total wear and tear ignoring any private element. Once the scrapping allowance has been established, it is apportioned to disallow the portion relating to private use.[90]

Base cost	Total	Business	Private
	R	R	R
Expenditure	1 000 000	500 000	500 000
Less: Section 12C	(200 000)	(200 000)	-
Section 11(*o*)	(250 000)	(250 000)	-
Base cost	550 000	50 000	500 000

Capital gain or loss

Proceeds	100 000	50 000	50 000
Base cost	(550 000)	(50 000)	(500 000)
Loss	(450 000)	-	(450 000)
Disregarded capital loss	-	-	-

7.2 Intangible assets acquired prior to valuation date

Paragraph 16

Substantial abuses of the valuation of intangible assets have been encountered in the past and continue to be encountered, albeit on a lesser scale, on the acquisition of businesses.

[90] See *Silke on South African Income Tax* in § 8.106; *Income Tax Practice Manual* at A - 676; ITC 322 (1935) 8 SATC 243 (U).

These abuses were the genesis of the amendments to s 11(*g*A) of the Act in 1999 and the review of the taxation of intangible property announced in the Budget Review 2001.

Where an intangible asset is acquired before valuation date from a connected person or as part of a business, either directly or indirectly, any capital loss on disposal of that intangible asset must be disregarded. This restriction does not affect self-developed intellectual property or intellectual property acquired on or after valuation date.

Example – Pre-1.10.2001 intangible asset acquired from connected person

Facts: On 1 August 2001, Vee Ltd acquires the business of Ewe (Pty) Ltd for the written down tax value of its assets of R10 million, while Vee Ltd's subsidiary Double Ewe (Pty) Ltd acquires the intellectual property of Ewe (Pty) Ltd for R100 million. Double Ewe (Pty) Ltd values the intellectual property at R100 million on valuation date and later disposes of it for R10 million.

Result: As Double Ewe (Pty) Ltd is a connected person in relation to Vee Ltd and the intellectual property acquired is associated with a business taken over by Vee Ltd, the capital loss of R90 million on disposal of the intellectual property is disregarded.

7.3 Forfeited deposits

Paragraph 17

Losses as a result of the forfeiting of deposits in respect of assets that are not intended for use wholly and exclusively for business purposes are disregarded.

Losses arising from forfeited deposits in respect of the following personal use assets will, however, not be disregarded as the changes in value of these types of personal use assets are more likely attributable to market forces:

- gold or platinum coins, of which the market value is mainly attributable to the material from which they are minted (e.g. Kruger Rands);
- immovable property, excluding a primary residence (e.g. a holiday home);
- financial instruments[91] (e.g. a share and a participatory interest in a portfolio of a collective investment scheme);
- any right or interest in these assets.

7.4 Disposal of options

Paragraph 18

This paragraph imposes a restriction on the capital losses determined in respect of the abandonment, expiry or disposal of options on most personal-use assets. These assets are not subject to CGT as the reduction in their value can be mainly attributed to personal use.

If a person entitled to exercise an option abandons it, allows it to expire or disposes of it in any other manner (other than by way of exercising it), any resulting capital loss must only be brought into account in the following circumstances:

The option was to

- acquire an asset intended for use wholly and exclusively for business purposes,

[91] As defined in s 1.

- dispose of an asset used wholly and exclusively for business purposes,
- acquire or dispose of a coin made of gold or platinum of which the market value is mainly attributable to the metal from which it is minted,
- acquire immovable property other than immovable property intended to be a primary residence of the person entitled to exercise the option,
- dispose of immovable property other than immovable property that is the primary residence of the person entitled to exercise the option,
- acquire or dispose of a financial instrument, or
- acquire or dispose of a right or interest in the above assets.

7.5 Losses on the disposal of certain shares

Paragraph 19

See Chapter 21: Anti-avoidance measures where these dividend stripping provisions are dealt with.

Chapter 8 - Base cost

PART V: BASE COST

Paragraph 20, s 23C

This paragraph sets out what may and may not form part of the base cost of an asset. The determination of qualifying expenditure in terms of para 20 is relevant, *inter alia*, for

- the determination of the base cost of assets acquired on or after the valuation date,
- the determination of the base cost of assets acquired before the valuation date where the time-apportionment base cost method is adopted, and
- the application of the kink tests in paras 26 and 27.

8.1 Domestic and unproductive expenditure

Although domestic or private expenses and amounts incurred in the production of exempt income are not allowable as deductions in terms of s 23(*b*) and (*f*), these sections are overridden and expenditure of this nature may qualify to be added to the base cost of an asset under appropriate circumstances.

8.2 Direct costs of acquisition and disposal

Items 20(1)(*a*) - (*c*)

The following amounts actually incurred form part of base cost. The expenditure must, however, all be directly related to the cost of acquisition, creation or disposal of the asset. Value-added tax not allowed as an input credit for VAT purposes will form an integral part of the cost of these items.

Table 1 – Direct costs of acquisition and disposal

Paragraph 20(1)	**Qualifying expenditure**
(*a*)	Cost of acquisition or creation of an asset. Note in this regard that the cost of an option acquired under s 8A or 8C will be excluded from this item in terms of para 20(3)(*a*) since the cost would already have been allowed as a deduction in determining taxable income. The base cost of such options is determined under para 20(1)(*h*).
(*b*)	Expenditure actually incurred in respect of the valuation of the asset for the purpose of determining a capital gain or capital loss in respect of the asset. It is not a qualifying requirement that the market value of the asset that has been valued be adopted as the valuation date value of that asset. The result is that valuation costs will constitute post-valuation date expenditure for the purposes of determining TAB under para 30. This will necessitate the use of the proceeds formula in para 30(2).
(*c*)	
(i)	Remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor, for services rendered. Liquidator's remuneration or Master's fees incurred by an insolvent estate or company in liquidation are not provided for.
(ii)	Transfer costs
(iii)	Stamp duty, transfer duty or similar duty
(iv)	Advertising costs to find a seller or to find a buyer
(v)	Cost of moving the asset from one location to another. Note that the allowable

	costs relate only to those incurred in acquiring or disposing of an asset. This would, for example, exclude the costs incurred by a company of moving assets to a new branch, even though those costs may qualify for capital allowances in terms of s 11(*e*)(v), 12C(6) or 12E(3). Where a seller bears the cost of moving an asset, any moving costs would form part of the seller's base cost. This would not apply where the asset constitutes trading stock in the seller's hands, since the moving costs would be claimed under s 11(*a*) and would thus be excluded from base cost by virtue of para 20(3)(*a*).
(vi)	Cost of installation of the asset, including the cost of foundations and supporting structures. Again, this would not apply to the cost of installing an asset when the asset is not being acquired or disposed of – such as when it is relocated from one branch to another. Where installation costs are borne by the seller and the sale is not on revenue account, the relevant costs will form part of the seller's base cost.
(vii)	A portion of the donations tax payable by a donor of an asset as determined in terms of para 22 (see example 1 below). The donations tax may be added to base cost despite s 23(*d*).[92]
(viii)	A portion of the donations tax payable by a donee of an asset (see example 2 below). The donations tax may be added to base cost despite s 23(*d*).
(ix)	If the asset was acquired or disposed of by the exercise of an option (other than the exercise of an option after valuation date which was acquired before valuation date), the expenditure actually incurred in respect of the acquisition of the option. This subitem merges the cost of the option with the cost of the asset acquired or disposed of. Note that in terms of para 58 a person must disregard any gain or loss on the exercise of an option.

8.2.1 Composite acquisitions

Where the asset disposed of was obtained with other assets as part of a composite acquisition (for example, a single contract of purchase at an inclusive price embracing more than one asset), the purchase price would have to be apportioned to the respective assets broadly by reference to their market values at the date of acquisition.[93] The onus rests on the taxpayer in terms of s 82 to justify any allocation. The court will not accept a fictitious allocation of the purchase price. In ITC 1235[94] the parties allocated R1 to a plantation. The court held that the agreement was fictitious and not a real agreement and accepted the Commissioner's valuation.

8.2.2 Assets acquired by barter or exchange

Paragraph 20(1)(*a*) refers to

> 'the *expenditure* actually incurred in respect of the cost of acquisition or creation of that asset'.

The word 'expenditure' includes expenditure in cash or in kind. In ITC 1783[95] Goldblatt J stated the following regarding the meaning of the word 'expenditure':

[92] Section 23(*d*) prohibits the deduction of any tax, duty, levy, interest or penalty imposed under the principal Act.

[93] See ITC 108 (1928) 3 SATC 343 (U) where the court made an allocation of the purchase price, and ITC 429 (1939) 10 SATC 355 (SR) where the appellants were entitled to apportion the purchase price.

[94] (1975) 37 SATC 233 (T) at 236.

[95] (2004) 66 SATC 373 (G) at 376.

> '"Expenditure" in its ordinary dictionary meaning is the spending of money or its equivalent e.g. time or labour and a resultant diminution of the assets of the person incurring such expenditure.'

The learned judge cited the following extract from *Silke*[96] with approval:

> 'It is submitted that the word 'expenditure' is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash.[97] For example, if a merchant were required to pay for his goods by tendering land or shares in a company, the value of the land or shares would constitute expenditure in terms of s 11(*a*) and would be deductible.'

Silke continues:[98]

> 'In accordance with the principle of the decision in *Caltex Oil (SA) Ltd v SIR*[99] a case dealing with expenditure incurred in a foreign currency, it would appear that in a transaction of barter the commodity promised in satisfaction of the obligation incurred would have to be valued in rands, and its value would constitute the amount of the expenditure incurred.'

Where asset A plus an amount of cash is given in exchange for asset B, the expenditure in respect of asset B is the market value of asset A plus the cash consideration. For an example showing the determination of both proceeds and base cost in an asset exchange, see **6.1**.

8.2.3 Assets acquired through deferred delivery

It sometimes happens that a person enters into an unconditional contract for the acquisition of an asset but delivery and payment are deferred to a future date. This is particularly prevalent in 'deferred delivery' employee share purchase schemes.

When do the buyer and the seller incur expenditure? This is a complex issue requiring an analysis of

- personal and real rights under the contract,
- the common law position and relevant case law,
- the time of disposal rule in para 13(1), and
- the time of acquisition rule in para 13(2).

For an in depth discussion on the time of incurral under deferred delivery schemes see **6.3**.

8.2.4 Donations tax paid by donor (para 20(1)(c)(vii))

A donor who disposes of an asset by way of donation is entitled to add a portion of the donations tax payable to the base cost of the asset disposed of. This is permitted despite the general prohibition against the claiming of a deduction in respect of taxes contained in s 23(*d*). The proportion of the donations tax that may be added to base cost is determined in accordance with a formula set out in para 22, namely:

$$\text{Allowable addition to base cost} = \frac{\text{Capital gain}}{\text{Market value of asset}} \times \text{Donations tax}$$

In this formula:

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[96] *Silke on South African Income Tax i*n § 7.4.
[97] *Caltex Oil (SA) Ltd v SIR* 1975 (1) SA 665 (A), 37 SATC 1. See also C Divaris 'The Caltex Case' (1975) 14 *Income Tax Reporter* 1 at 11–12; § 7.24.
[98] In § 7.24.
[99] 1975 (1) SA 665 (A), 37 SATC 1.

- The market value is the amount on which the donations tax is payable.
- The capital gain is determined by subtracting all amounts allowable in determining the base cost of the asset, excluding any amount of donations tax qualifying under para 20(1)(*c*)(vii). Where the expenditure exceeds the market value the amount of donations tax to be added to base cost is nil.

The formula has the effect that no amount of any donations tax paid will qualify for inclusion in base cost where an asset is disposed of at a capital loss. The type of donation envisaged by para 20(1)(*c*)(vii) is one 'contemplated in para 38'. Paragraph 38 does not define the word 'donation' and the word must therefore be given its common law meaning. This means that unlike a donation for donations tax purposes, if the donee gives any consideration the disposal will not be a donation (*The Master v Thompson's Estate*[100]).

Example – Donations tax paid by donor of asset

Facts: Gerrie donates a yacht to his son at a time when its market value is R1 250 000. The base cost of the yacht before taking into account any donations tax paid is R750 000.

Gerrie paid donations tax of R244 000, calculated as follows.

	R
Market value of asset donated	1 250 000
Section 56(2)(*b*) abatement	(30 000)
	1 220 000
Donations tax @ 20%	244 000

Result:

Allowable addition to base cost = (Market value of asset – base cost) / Market value of asset x Donations tax

= (R1 250 000 - R750 000) / R1 250 000 x 244 000

= R500 000/R1 250 000 x R244 000
= R97 600

Base cost of yacht = R750 000 + R97 600
= R847 600

The purpose of this provision is to achieve parity with the estate duty that would have become payable on the gain had the donor died on the date of donation. The formula ignores the effect of the R30 000 donations tax abatement, the R1,5 million estate duty abatement and the time value of money.

The effect is illustrated as follows. Assume that the donor of the yacht in the above example died on the date of donation and that the R1,5 million estate duty abatement has been utilised against other assets.

[100] 1961 (2) SA 20 (FC) at 24F - 26C, 48F- 49C.

	R
Value of yacht (includes gain of R500 000)	1 250 000
CGT paid (R500 000 x 10%)	(50 000)
	1 200 000

Estate duty @20% R240 000

Estate duty levied on gain = (R500 000 – R50 000) X 20%
= R450 000 x 20%
= R90 000

Total tax collected on gain = R50 000 + R90 000 = R140 000
Comparing this with the donation of the yacht, and assuming that the R30 000 abatement has been utilised against other donations, the tax collected will be as follows:

Donations tax = R1 250 000 x 20%
= R250 000
(Includes donations tax on gain of R500 000 x 20% = R100 000)

Capital gain = R1 250 000 – (R750 000 + R100 000)
= R400 000
Capital gains tax = R400 000 x 10%
= R40 000

Total tax collected on gain = R100 000 + R40 000 = R140 000

8.2.7 Donations tax paid by donee *(para 20(1)(c)(viii))*

Where a donor fails to pay donations tax within the prescribed period, s 59 provides that the donor and donee shall be jointly and severally liable for the donations tax. A donee who has paid the donations tax is entitled in terms of para 20(1)(*c*)(viii) to include a portion of the donations tax in the base cost of the asset acquired. The portion that may be claimed is determined in accordance with the following formula:

$$\text{Allowable addition to base cost} = \frac{\text{Capital gain of donor}}{\text{Market value of asset}} \times \text{Donations tax}$$

As with para 20(1)(*c*)(vii), the word 'donation' is not defined for the purposes of para 20, and it must therefore be given its ordinary meaning. This means that unlike a donation for donations tax purposes, if the donee gives any consideration the disposal will not be a donation (*The Master v Thompson's Estate*[101]). Donations tax may also not be added to the base cost of the donee's asset where the donor disposed of the asset at a capital loss.

Example – Donations tax paid by donee acquiring asset

Facts: Hannelie acquires a yacht by donation from her father at a time when its market value is R1 250 000. The donations tax due by her father was R244 000, calculated as follows:

[101] 1961 (2) SA 20 (FC) at 24F - 26C, 48F- 49C.

	R
Market value of asset donated	1 250 000
Section 56(2)(*b*) abatement	(30 000)
	1 220 000
Donations tax @ 20%	244 000

As her father failed to pay the donations tax to SARS within the prescribed period, Hannelie was held liable for the sum of R244 000 in terms of s 59 of the Income Tax Act.

Result: Assuming that her father was liable for CGT on a gain of R500 000 as a result of the donation, she may add the following amount to the base cost of her yacht.

$$\text{Allowable addition to base cost} = \frac{\text{Capital gain of donor}}{\text{Market value of asset}} \times \text{Donations tax}$$

$$= \frac{\text{R500 000}}{\text{R1 250 000}} \times \text{R244 000}$$

$$= \text{R97 600}$$

8.3 Costs of establishing, maintaining or defending a legal title or right in an asset

Item (1)(*d*)

Expenditure actually incurred in establishing, maintaining or defending a legal title to or right in that asset is allowed as part of base cost. See for example the following cases where legal expenses of this nature have been held to be of a capital nature:

- ITC 1677[102] - legal expenses incurred in resisting competing publisher's claim for an interdict against a new work on the ground of an infringement of its copyright.
- ITC 1648[103] – legal costs incurred by a farmer in opposing an application to force him to eliminate certain boreholes on his farm.

The expenditure will qualify even if the person is unsuccessful in defending his or her right or title in the asset.

Example – Costs incurred in defending legal title

Facts: Ignatius operates a night club in an up market area. The city council wishes to expropriate the night club's premises.

Result: The cost of legal fees in resisting the expropriation may be added to the base cost of the premises.

[102] (1999) 62 SATC 276 (N)
[103] (1998) 61 SATC 58 (C)

8.4 Cost of improvements or enhancements to value of asset

Item (1)(*e*)

The cost of improving or enhancing an asset may also be added to base cost, provided that the improvement or enhancement is reflected in the state or nature of the asset at the time of disposal.

Owners of sectional title units have an undivided share in the common property. Sometimes they are required to pay a special levy for the purpose of effecting improvements to the common property, such as the installation of a swimming pool or the erection of a security fence. Expenditure of this nature will normally be of a capital nature as it provides an enduring benefit. Since it enhances the owner's right of use it may be added to the base cost of the sectional title unit. The same principle applies to owners of share block units who enjoy a right of use of the common property.

Example – Improvements reflected in state or nature of asset at date of disposal

Facts: Jeannee acquires a second property at a cost of R300 000 in November 2001 from which she derives rental income. Jeannee replaced the kitchen, which was in disrepair, at a cost of R30 000 and installed a security system costing R10 000. In 2004 she installed a jacuzzi in one of the bedrooms at a cost of R25 000. In 2008 the jacuzzi cracked and all the water leaked out. It was not worth repairing, so she had it removed.

Result: Jeannee's base cost will be R300 000 + R10 000 = R310 000. The replacement of the kitchen is not added to the base cost as it considered to be a repair and the jacuzzi is not added to base cost as it no longer exists as part of the property. Note that Jeannee would have had a part-disposal when she scrapped the jacuzzi and any loss should have been determined at that point.

8.5 Option acquired before, asset acquired or disposed of after 1 October 2001

Item (1)(*f*)

As noted above, the cost of an option that is exercised will form part of the base cost of the underlying asset (para 20(1)(*c*)(ix)). An exception to this rule applies where the asset is acquired on or after 1 October 2001 as a result of the exercise of an option acquired before that date. In such a case the valuation date value of the option must be included in base cost. This treatment applies to options to acquire or dispose of assets.

In terms of para 20(2)(*c*) the base cost of an asset excludes the valuation date value of an option or right to acquire any marketable security contemplated in s 8A(1). It follows that para 20(1)(*f*) does not bring the value of such options or rights into base cost. This task is left to para 20(1)(*h*)(i).

The valuation date value of options falling outside s 8A will be determined in the usual way by using market value, TAB or 20% of proceeds. The gain and loss limitation rules in paras 26 and 27 will also apply.

What are the proceeds on disposal of the option for the purpose of determining TAB and 20% of proceeds, and in applying the kink tests? The view is held that the proceeds will be the difference between the strike price (cost) and the market value of the share on the date of acquisition or disposal. For example, if on the date of exercise of the option, the share has a market value of R120 and the price paid for the share is R100, the proceeds on disposal of the option will be R20. The option holder is disposing of the option in exchange for the value received in the share. The value for this purpose is the price the option holder would have received for the option had it been disposed of on the open market at the time of exercise. In the example, a potential purchaser would be prepared to pay R20 for the option, since that amount together with the cost of the share (R80) would equal the market value of the share (R100).

Example 1 – Option acquired before valuation date; asset acquired or disposed of thereafter

Facts: On 1 July 2001 Kosie paid R10 000 for a six-month option to acquire a beach cottage at a price of R300 000. On 1 October 2001 the market value of the option was R5 000. He exercised the option on 1 December 2001 and paid R300 000 for the cottage.

Result: The base cost of Kosie's cottage will therefore be R300 000 + R5 000 = R305 000.

Example 2 – Option acquired before valuation date; asset acquired or disposed of thereafter: illustration of use of various valuation date value methods

Facts: On 1 July 2001 Bryan paid R10 000 for a six-month option to acquire 100 shares in Kim Ltd at a price of R300 000. Bryan does not work for Kim Ltd and purchased the option from an unconnected third party. On 1 October 2001 the market value of the 100 shares was R340 000. He exercised the option on 1 December 2001 and paid R300 000 for the shares. At that time their market value was R380 000.

Result: The valuation date value of Bryan's option is determined as follows:

TAB

Cost of option R10 000
Proceeds on disposal of option R380 000 – 300 000 = R80 000
Y = B + [(P – B)/N/T+N]
Y = R10 000 + [R80 000 – R10 000) x ½]
Y = R10 000 + R35 000
Y = R45 000

Market value

On 1 October 2001 the shares had a market value of R340 000. The market value of the option is therefore R340 000 – R300 000 = R40 000.

20% of proceeds

Proceeds on disposal of option = R80 000
20% x R80 000 = R16 000.

Since TAB produced the highest base cost, Bryan should adopt that method for determining the valuation date value of his option.

Example 3 – Option acquired before valuation date; asset acquired or disposed of thereafter: application of the kink tests

Facts: The facts are the same as in Example 2, except that the market value of the shares on the date of exercise of the option is R330 000.

Result: Paragraph 26(3) applies and the valuation date value of the option will be R30 000 (proceeds less post-CGT expenditure).

8.6 Current costs incurred wholly and exclusively for business

Item (1)(*g*)

Admissible holding costs

This item, subject to certain limitations, allows the following holding costs to be added to base cost:

- The cost of maintaining, repairing, protecting or insuring the asset.
- Rates and taxes on immovable property.
- Interest as defined in s 24J on loans used to directly finance the cost of acquiring an asset and any improvements thereto. Raising fees are not regarded as interest and are excluded by para 20(2)(*a*).
- Interest as defined in s 24J on amounts used to repay existing loans.

These costs must

- be actually incurred, and
- must relate directly to the cost of ownership of the relevant assets.

Qualifying assets

The above costs may be added to the base cost of the following types of assets:

- Assets that are *used* wholly and exclusively for *business* purposes. The word 'used' must be distinguished from the word 'held'. For example, an unlisted share may be held but cannot be 'used'. The word 'business' is not defined, but has a more restrictive meaning than the word 'trade' which is defined in s 1. As a general rule, in the case of an individual, one or two isolated transactions cannot be described as the carrying on of a business. There must be some proof of continuity.[104] Isolated transactions can, however, in exceptional cases constitute a business in the hands of an individual, as in *Stephan's* case.[105] Where a company is formed for certain purposes the frequency of transactions is not of the same importance as for an individual in deciding whether it is carrying on business.[106] Persons carrying on business would normally claim the relevant expenditure under the principal Act against ordinary income. This provision therefore has a fairly narrow scope, and would typically apply to pre-production expenditure not qualifying under s 11(*b*A) or s 11A.
- Shares listed on a recognised stock exchange. It follows that interest on borrowings used to acquire unlisted shares will not qualify.
- A participatory interest in a portfolio of a collective investment scheme.

These costs must not have been deducted from income – see para 20(3)(*a*).

[104] *CIR v Stott* 1928 AD 252, 3 SATC 253 at 260. See S Wilson 'Carrying on Business' (2000) 14 *Tax Planning* 1 at 6.
[105] *Stephan v CIR* 1919 WLD 1, 32 SATC 54.
[106] *Platt v CIR* 1922 AD 42, 32 SATC 142 at 148.

A monthly management fee paid to a portfolio manager will not qualify under this item, since a listed share or interest in a collective investment scheme cannot be 'maintained' or 'protected'.

Limitation in respect of listed shares and participatory interests in collective investment schemes

In the case of listed shares and participatory interests in a portfolio of a collective investment scheme, only *one-third* of the expenditure is allowable. This reflects the fact that where such assets are held on capital account the bulk of such expenditure is incurred in order to earn dividend income. Since the income generated by a portfolio of a collective investment scheme in property is fully taxable, the holding costs associated with an investment of this nature would be deductible in terms of s 11(*a*) and hence excluded from base cost by para 20(3)(*a*).

Example 1 - Non-qualifying interest – private purpose

Facts: Lucy obtains a bond that she uses to purchase a holiday home, which she lets out from time to time.

Result: The interest may not be added to the base cost of the holiday home.
Reason: The house is not used wholly and exclusively for business purposes.

Example 2 - Non-qualifying interest – indirectly incurred

Facts: Mark purchased a piece of vacant land on which he intends to build a factory. He financed the acquisition by means of a bank overdraft. The next day he won the Lotto and repaid the overdraft. Shortly thereafter, after squandering his winnings at a casino he had to resort to the overdraft to purchase a private motor vehicle.

Result: The interest on the overdraft may not be added to the base cost of the vacant land.
Reason: There is no longer a direct relationship between the overdraft and the land.

Example 3 - Non-qualifying interest – not incurred in acquiring or improving an asset

Facts: Nico incurs interest in financing the cost of repairs, maintenance and insurance of a building to be used for business purposes.

Result: The interest may not be added to the base cost of the asset.
Reason: The interest is not related to the cost of acquiring or improving an asset.

Example 4 - Qualifying interest - Vacant land acquired for business purposes

Facts: Obert incurs interest directly in financing the purchase of vacant land wholly and exclusively for the purpose of erecting a factory building.

Result: The interest may be added to the base cost of the land.
Reason: The interest is directly related to the cost of acquisition of the land. Note that such pre-production interest would not qualify in terms of the Income Tax Act under s 11(*b*A) since that section does not include land - ITC 1619 (1995) 59 SATC 309 (C).

Example 5 - Substitution of a loan used to acquire or improve an asset

Facts: Penelope purchased a piece of vacant land on which she intends to build a factory to be used wholly and exclusively for business purposes. She financed the acquisition by means of a R100 000 17% loan from the Thrifty Bank. After six months the Friendly Bank offered her the same loan at 14%. She repaid the Thrifty Bank loan with the proceeds from the Friendly Bank loan.

Result: Penelope is entitled to claim the interest on the second loan. (See ITC 1020 (1962) 25 SATC 414 (T).)

Example 6 - Interest incurred in financing the cost of shares

Facts: Quintin acquires 2000 shares in Ess Limited, a company listed on the JSE, at a cost of R100 000 which he finances by means of a bank loan. During the year ended 28 February 2003 he incurs interest on the loan of R15 000.

Result:	R
Interest incurred	15 000
Non-allowable portion (2/3 x R15 000)	(10 000)
Interest that may be added to base cost	5 000

8.7 Amounts included in gross income as a result of the acquisition of an asset
Item (1)(*h*)(i) – (iii)

The acquisition of certain assets results in an inclusion in gross income. This item clarifies how the base cost of these assets is to be treated.

Table 2 – Base cost of assets where acquisition resulted in amount being included in income

Paragraph 20(1)(*h*)	**Type of asset**	**Amount included in base cost**
(i)	A marketable security or equity instrument the acquisition or vesting of which resulted in the determination of any gain or loss to be included in or deducted from any person's income in terms of s 8A or 8C.	The market value of the marketable security or equity instrument that was taken into account in determining the amount of the gain or loss (including where the gain and loss so determined was nil).[107]
(ii)(*aa*)	Assets acquired by a lessee from a lessor where there has been a recoupment in terms of s 8(5)	Amount included in lessee's income in terms of s 8 (5), which reduced the purchase price of the asset (see note 2 below).
(ii)(*bb*)	Assets the acquisition of which results in a taxable fringe benefit under para (*i*) of the definition of 'gross income	The value placed on the asset under the Seventh Schedule for purposes of determining the amount included in the person's gross income.

[107] The reference to s 8C was inserted by Act 32 of 2004 and applies in respect of any disposal of an equity instrument acquired on or after 26 October 2004.

(ii)(*cc*)	Obligatory improvements effected by a lessee in terms of a lease which constitute gross income in the lessor's hands in terms of para (*h*) of the definition of gross income	Amount included in gross income Less*:* Amount of any allowance granted in terms of s 11(*h*).
(iii)	Share in a controlled foreign company (CFC)	In the case of a share in a CFC (controlled foreign company) the proportional amount of: • net income taxed in terms of s 9D • less: taxable capital gain included in net income • add: Net capital gain • less: foreign dividends distributed that are exempt in terms of s 10(1)(*k*)(ii)(*cc*)).[108] (See note 3 below.)

Notes

1. The actual cost incurred in acquiring the asset is disregarded.

2. Where a lessee acquires an asset from a lessor at less than market value, the difference between the market value and the amount paid for the asset will be included in the lessee's gross income in terms of s 8(5). This recoupment of lease rentals previously 'overpaid' is treated as part of the base cost of the asset.

3. The purpose of these adjustments is to fully reflect capital gains and losses arising in the CFC in the base cost of the interest of a resident in a CFC and to avoid double taxation.

Example 1 – Base cost of shares acquired in terms of s 8A

Facts: On 1 October 2001 Trevor is granted an option to acquire 1000 shares in his employer, ComWorld Ltd at a price of R1,00 per share when the market price is R1,50 per share. He pays 10 cents per share for the options. On 28 February 2003 he exercises the options when the market price is R5,00 per share, and on 30 June 2006 he sells his shares at R8,00 per share.

Result: Trevor's s 8A gain (taxed as ordinary income) and capital gain (subject to CGT) during the year ending 28 February 2007 will be determined as follows:

Section 8A gain

	R
Market value of shares at date option exercised (1000 x R5)	5 000
Less: cost of options 1000 x 10 cents	(100)
Less: cost of shares 1000 x R1,00	(1 000)
Section 8A gain included in income	3 900

[108] The reference to s 10(1)(*k*)(ii)(*cc*) was inserted by Act 45 of 2003 with effect from 22 December 2003. Previously the provision referred to s 9E(7)(*e*)(i).

Capital gain

	R
Proceeds 1000 x R8,00	8 000
Base cost 1 000 x R5,00	5 000
Capital gain	3 000

Note that the actual cost of the shares, which is made up of the option cost of R100 and the purchase price of the shares of R1 000, is disregarded in determining the base cost of the shares. It is simply the market price of the shares that was taken into account in determining the s 8A gain that constitutes the base cost. The actual costs are excluded in terms of para 20(3)(*a*) since they would have been allowed as a deduction in determining the s 8A gain. The market value taken into account is the same as the actual cost R1 100 plus the s 8A gain (R3 900) = R5 000.

Example 2 – Base cost of restricted shares acquired by employee under s 8C

Facts: Trevor is employed by Xenon Ltd and is not a share dealer. In 2005, he acquires a restricted Xenon Ltd share from the company in exchange for a R100 loan when that restricted share has a value of R100. In 2007 the restrictions on the share are lifted when the share has a R250 value. Trevor eventually sells the share for R400.

Result: The share vests in 2007 when the all restrictions are lifted. Trevor must include R150 of ordinary income in that year (R250 less the R100 cost of the share). Trevor obtains a R250 market value base cost in that share on that date. He has R150 of capital gain on the sale (R400 proceeds less R250 base cost).

Example 3 – Base cost of restricted s 8C shares transferred to connected person prior to lifting of restriction

Facts: In 2005, Jeremy acquires a restricted share of Zenon Ltd while employed by that company. The share is provided at no cost to him.

Under the restriction, Jeremy must surrender the share to Zenon Ltd at no cost if he leaves before 2008. In 2006, he sells the share to his wife, Anne, for R55. In 2007, Anne transfers the share to the Jeremy Family Trust in exchange for a R110 loan with the Trust being a connected person to Jeremy. In 2008 the restriction lifts when the share has a R100 value. Trust subsequently sells the share for R150 with all parties paying off their related loans.

Result: The share vests in 2008 when the restriction lifts, triggering R100 of ordinary income for Jeremy. Trust obtains a R100 base cost in the shares because a vesting occurred (with respect to 'any person's income in terms of s 8C'). The Trust has a capital gain of R50 on the sale (R150 proceeds less the R100 base cost).

Example 4 – Base cost of asset acquired from lessor at less than market value

Facts: Andrew leased land and buildings from Franz at a rental of R10 000 per annum. The rent paid, which Andrew claimed as a deduction under s 11(*a*) was as follows:

	R
2001	10 000
2002	10 000
2003	10 000
2004	10 000
5005	10 000
	50 000

At the end of the 2005 tax year, Andrew acquired the property from Franz at a price of R2 000 even though its market value was R50 000. This was in recognition of the fact that most of the rentals paid by Andrew were excessive and really in part payment of the purchase price. In terms of s 8(5) an amount of R48 000 (R50 000 – R2 000) was included in Andrew's income for the 2005 tax year. In 2010 Andrew sold the property for R65 000.

Result: The base cost of Andrew's property is as follows:

	R	
Amount paid	2 000	(para 20(1)(*a*)))
Amount included in income in terms of s 8(5)	48 000	(para 20(1)(*h*)(ii))
Base cost	50 000	

Andrew's capital gain is therefore R65 000 – 50 000 = R15 000

Example 5 – Determination of base cost of CFC

Facts: A South African resident individual owns all the shares in a foreign company, which qualifies as a CFC. The shares were acquired for R200 on 19 December 2001. The receipts and accruals of the foreign company consist of the following:

	R
Foreign dividends	200
Capital gain on disposal of shares	400
Capital loss on disposal of shares	100
Net capital gain	300
Taxable capital gain (25% x 300)	75

The net income of the CFC as contemplated in s 9D is R275

Result: The base cost of the shares is determined as follows:

	R
Expenditure incurred to acquire the shares	200
Add: Net income	275
Less: Taxable capital gain	(75)
Add: Net capital gain	300
Calculated base cost	700

8.8 Assets acquired as a result of a value shifting arrangement

Item (1)(*h*)(iv)

Where a person acquires or disposes of an asset as a result of a value shifting arrangement, certain adjustments must be made to the base cost of the asset. These adjustments are contained in para 23 (see **8.16**).

Amounts excluded from base cost

Subparagraphs (2) and (3)

8.9 Exclusions - certain current costs

Subparagraph (2)

Except to the extent referred to above, the following expenses do not form part of base cost:

- borrowing costs, including interest or raising fees;
- repairs, maintenance, protection, insurance, rates and taxes, or similar expenditure
- the valuation date value of any option or right to acquire any marketable security contemplated in s 8A(1). The purpose of this exclusion is to prevent an employee claiming the valuation date value of the option as well as pre-1 October 2001 expenditure in terms of para 20(1)(*f*).

Example – Interest not forming part of base cost

Facts: Petro purchased her primary residence on 1 October 2001 with the assistance of a mortgage bond of R1.5 million. She disposed of the residence five years later at a profit of R2 million, R1 million of which is subject to CGT.

Result: She may not claim the interest on the bond as part of the base cost of the residence.

Other exclusions from base cost

Subparagraph (3)

The expenditure included in base cost in terms of para 20(1)(*a*) to (*g*) must be reduced by the following amounts:

8.10 Exclusions - expenditure already allowed (para 20(3)(a))

Excluded is any expenditure allowable in determining taxable income otherwise than in terms of the Eighth Schedule. This provision prevents the double deduction of expenditure.

8.11 Exclusions - expenditure recovered or recouped (para 20(3)(b))

This item mirrors the recoupment provisions of s 8(4)(*a*) and (*m*) of the Act.

A reduction in expenditure must take place where an expense has been

- reduced
- recovered or become recoverable or
- paid by any other person

It does not matter whether the recovery took place before or after the expense was incurred.

No reduction in expenditure need be made to the extent that the amount was taken into account in terms of

- section 8(4)(*a*)
- para (*j*) of the definition of gross income (which deals with the recoupment of certain mining capital expenditure) or
- where the expense was not allowed in terms of para 20(3)(*c*) because it was not paid nor was it due and payable (para 20(3)(*c*) was deleted with effect from 24 January 2005).

This prevents base cost being reduced by amounts that were never included therein in the first place and hence prevents double taxation.

Example – Reduction in expenditure

Facts: Uriah buys an asset from Vlok for R50 000 in 5 equal annual instalments of R10 000. After 7 years Uriah has still not paid the last instalment. Vlok agrees to accept R5 000 in full and final settlement.

Result: The base cost of the asset will be R50 000 - R5 000 = R45 000.

8.12 Exclusions - expenditure unpaid and not due and payable (para 20(3)(c))

Paragraph 20(3)(*c*) was deleted by the Revenue Laws Amendment Act 32 of 2004. The deletion came into operation on 24 January 2005 and applies in respect of any disposal during a year of assessment commencing on or after that date.

Prior to the deletion of para 20(3)(c)

Prior to the deletion of para 20(3)(*c*), any expenditure that has not been paid and is not due and payable in a year of assessment must be excluded from base cost. This was essentially an anti-avoidance measure. To apply, both requirements must be met. It is therefore important to determine when a debt has been paid and when it is due and payable.

Paid

When a debt is paid by cash or cheque it will be regarded as paid.[109] The more difficult question arises when the amount owed is replaced by a new loan. It is not possible to lay down hard and fast rules in this regard as the answer will depend on the facts of the particular case. In many cases the issue will be irrelevant for the purposes of para 20(3)(*c*) because the debt may well be due and payable at the time it is replaced by the new loan. Novation occurs when an existing obligation is discharged and replaced by a new one, but it has been held that novation is not a form of payment. [110]

Due and payable

An amount may be due under a contract (*dies cedit*) but not payable (*dies venit*). The amount will only be due and payable when the time for payment arrives. For example, A sells goods to B on credit on 1 March 2003 payment to be made by no later than 31 March 2003. The amount will become due and payable on 31 March 2003.

Example – Expenditure unpaid, not due and payable

Facts: On 1 October 2002 Roger bought an asset from Sebueng for R50 000. The purchase price is payable in annual instalments of R10 000 over five years, with each instalment falling due on 30 September. On 1 October 2004 after two instalments had been paid, Roger sold the asset to Tolstoy for R25 000, and continued to pay off the loan to Sebueng over the next 3 years.

[109] ITC 1688 (1999) 62 SATC 478 (N).
[110] *Market Furnishers v Reddy* 1966 (3) SA 550 (N) at 553D.

Result: The base cost of Roger's asset in the year of disposal will be R10 000 x 2 = R20 000. The outstanding payments will be treated as capital losses in the years in which they are paid.

After the deletion of para 20(3)(c)

Following the deletion of para 20(3)(*c*) expenditure no longer has to be paid or due and payable to qualify as a deduction.

Example – Expenditure unpaid, not due and payable

Facts: The facts are the same as in Example 1 but this time Roger disposed of the asset to Tolstoy on 2 March 2005.

Result: The base cost of Roger's asset is R50 000 as para 20(3)(*c*) no longer applies.

Despite the deletion of para 20(3)(*c*), the pay-as-you-go principle is retained in s 24B(3) for the cross-issue of debt and debt issued for shares. The principle is extended to indirect and connected person transactions reaching the same result. See **8.31.5**.

8.13 Exclusions - value–added tax allowed as input tax credit

Section 23C ensures that value-added tax cannot be claimed as a deduction in terms of the Income Tax Act when it has been allowed as an input tax deduction in terms of s 16(3) of the Value-Added Tax Act 89 of 1991. See also the remarks regarding VAT in the determination of market value in terms of para 31.

8.14 Provisions relating to farming development expenditure

Paragraph 20A

This paragraph was inserted by Act 45 of 2003 and applies to any disposal on or after 22 December 2003.

8.14.1 The position prior to 22 December 2003

Farmers are entitled to claim certain capital development expenditure (CDE) in the year of incurral in terms of para 12(1)(*a*)- (*i*) of the First Schedule. These deductions are allowed in full but are in effect limited to the taxable income derived from farming operations (para 12(3)), with the exception of the amounts referred to in para 12(1)(*a*) and (*b*). These two exceptions relate to the eradication of noxious plants and the prevention of soil erosion.

The limitation of the deduction is effected by deeming the amount by which the expenditure exceeds the taxable income from farming operations to be income in the current year of assessment. This excess is then deemed to be a para 12(1) deduction in the following year of assessment.

Furthermore, the recoupment provisions of s 8(4)(*a*) do not apply to the deductions under para 12. Paragraph 12, however, contains its own special recoupment provisions in respect of the following assets:

- Housing used for domestic purposes by a person who is not an employee (para 12(6)):.
- Movable assets (para 12(1B) and (1C)).

Thus, for example, expenditure in respect of the building of a dam will never be subject to recoupment, whilst expenditure on a movable dipping tank can be recouped in the special manner discussed below.

Whilst recoupments of CDE in respect of movable assets may not be included in taxable income in terms of s 8(4)(*a*), they are dealt with by first reducing any qualifying balance of CDE brought forward from the previous year in terms of para 12(3B). Where the qualifying balance is insufficient, the excess is included in farming income.

8.14.2 The CGT implications

An asset arising from CDE is also an asset for CGT purposes. The CGT implications largely revolve around what has been allowed or recouped for normal tax purposes in terms of the First Schedule.

Where a farmer has had a deduction against farming income in respect of CDE in terms of para 12(1) of the First Schedule, the base cost of the asset must be reduced by the amount of that deduction in terms of para 20(3)(*a*). The fact that there may have been insufficient farming income to absorb the deduction, which resulted in the excess being deemed to be income in the relevant year, is irrelevant. The unutilised portion of CDE is allowed as a deduction in the following year and will be carried forward until there is sufficient farming income.

The amount received or accrued on disposal of the asset will constitute proceeds on disposal in terms of para 35, except to the extent it has been recouped in terms of para 12 of the First Schedule.

In terms of para 35(3)(*a*) the proceeds from the disposal of an asset by a person, as contemplated in para 35(1) must be reduced by

> 'any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain'.

Must proceeds be reduced by an amount that was included in income as a result of farming income being insufficient to absorb CDE? Subparagraph (3) refers to proceeds 'from the disposal of an asset'. It follows that proceeds should not be reduced as the amount has nothing to do with the disposal of the asset.

The result is that when a farmer disposes of a CDE asset it will more than likely have a zero base cost with the consideration received or accrued comprising the capital gain (except to the extent it represents a recoupment). Where a farmer discontinues farming operations during a year of assessment and does not recommence those operations during the following year of assessment, the unutilised balance of CDE is forfeited.[111] Prior to the introduction of para 20A the Act did not allow for any portion of this forfeited balance to be claimed as a capital loss.

[111] This follows from s 26 of the Act. See *Income Tax Practice Manual* at A - 290.

Example 1 – Capital development expenditure and CDE assets that become movable

Facts:

Year 1	R
Expenditure on movables	20 000
Farming income	12 000
Qualifying balance c/f to year 2	8 000
Year 2	R
Farming income	30 000
Amount received on disposal of movables	12 000
Cost of movables disposed of	10 000
Capital development expenditure	15 000

Result: Farming income for year 2 will be calculated as follows:

Qualifying balance b/f	(8 000)
Recoupment (restricted to qualifying balance)	8 000
Qualifying balance	Nil
Farming income before any development expenditure	30 000
Add: Balance of recoupment (R10 000 – R8 000)	2 000
	32 000
Less: Current expenditure on items (*c*) to (*j*)	(15 000)
Taxable income before taxable capital gains	17 000

	R
Consideration received on disposal of movables	12 000
Less: recoupment (para 35(3)(*a*))	(10 000)
Proceeds	2 000

Note: For the purposes of para 35(3)(*a*) R10 000 was 'taken into account when determining the taxable income' of the farmer: R8 000 was accounted for by reducing the qualifying balance b/f from year 1, and R2 000 was included in income.

	R
Cost of movables	10 000
Less: Amount allowed as CDE ito para 12(1)	(10 000)
Base cost (para 20)	Nil

Capital gain = R2 000 – R0 = R2 000

Example 2 – Capital development expenditure and immovable assets

Facts: In year 1 Mr Brown purchased some farm land adjacent to his existing farm at a cost of R500 000. In year 5 he built a dam on this land at a cost of R100 000. The dam qualified as a deduction in terms of para 12(1)(*d*) of the First Schedule. In year 10 he disposed of the land on which the dam was built to a neighbouring farmer for R800 000.
Mr Brown has had farming losses in years 5 - 10.

Result: Mr Brown's capital gain on disposal of the land will be as follows:

	R
Proceeds	800 000
Base cost	500 000
Capital gain	300 000

Note that in this case the base cost comprises only the cost of the land as the cost of the dam had been allowed against taxable income and hence must be excluded from base cost in terms of para 20(3)(*a*). The unutilised CDE of R100 000 will be carried forward to the following year and will be available for set off against future farming taxable income.

8.14.3 The position on or after 22 December 2003

Paragraph 20A was inserted by s 96 of Revenue Laws Amendment Act 45 of 2003, came into operation on 22 December 2003 and applies to any disposal on or after that date.

8.14.3.1 To whom does para 20A apply?

It applies to persons carrying on pastoral, agricultural or other farming operations as contemplated in s 26 who have an unutilised balance of capital development expenditure.

8.14.3.2 What is CDE?

For the purpose of para 20A capital development expenditure ('CDE') refers to the expenditure in para 12(1)(*c*) to (*i*) of the First Schedule. This comprises the expenditure set out in the table below.

Table 1 –CDE in respect of which an election can be made

Paragraph 12(1) of First Schedule	**Description of expenditure**
(*c*)	Dipping tanks.
(*d*)	Dams, irrigation schemes, boreholes and pumping plants.
(*e*)	Fences.
(*f*)	The erection of, or extensions, additions or improvements (other than repairs) to, buildings used in connection with farming operations, other than those used for the domestic purposes of persons who are not employees of such farmer.
(*g*)	The planting of trees, shrubs or perennial plants for the production of grapes or other fruit, nuts, tea, coffee, hops, sugar, vegetable oils or fibres, and the establishment of any area used for the planting of such trees, shrubs or plants.
(*h*)	The building of roads and bridges used in connection with farming operations.
(*i*)	The carrying of electric power from the main transmission lines to the farm apparatus or under an agreement concluded with ESKOM in terms of which the farmer has undertaken to bear a portion of the cost incurred by ESKOM in connection with the supply of electric power consumed by the farmer wholly or mainly for farming purposes.

8.14.3.3 Purpose

The purpose of para 20A is to allow a person to add the cost of unutilised CDE to the base cost of a farm property where farming operations have ceased. This could happen upon the death of a farmer or where the farmer simply decides to discontinue farming operations. Without para 20A any unutilised CDE will be forfeited unless farming operations are recommenced in the next year of assessment.

8.14.3.4 The problem created by the wording of the First Schedule

Normally capital expenditure that has not been allowed against ordinary income can be added to the base cost of the relevant asset in terms of para 20. CDE qualifying in terms of para 12(1)(*c*) to (*i*) of the First Schedule is limited to income from farming operations. The result is that where the farming income is insufficient to absorb the CDE, the unutilised balance is carried forward to the next succeeding year. One might expect that the unutilised CDE could be added to base cost under the core rules. However, because of the structure of para 12 of the First Schedule this is not so. In terms of that provision, if the CDE exceeds the income from farming, *the full CDE is allowed as a deduction* and an amount equal to the excess expenditure is added to the income so that they cancel each other out. The excess expenditure is carried forward to the next year of assessment and deemed to be expenditure incurred in that next year. The result is that para 20(3)(*a*) prevents the addition of unutilised CDE to the base cost of the farm property, even though the farmer has for all intents and purposes not enjoyed the benefit of a deduction of the CDE.

8.14.3.5 Why is CDE forfeited on cessation of farming operations?

As a general rule, the First Schedule only applies to a person who carries on farming operations. This follows from the wording of s 26(1) which provides that the taxable income of farmers must be determined in accordance with the First Schedule. Where a person ceases to carry on farming operations during a year of assessment, any unutilised CDE may not be carried forward to the next succeeding year of assessment if the person does not carry on farming operations in that succeeding year.[112] A fatal interruption occurs because the First Schedule ceases to be applicable and there is no other mechanism in the Act in terms of which the CDE can be carried forward. In short, the unutilised CDE is forfeited. Even if the person recommences farming operations after such a fatal interruption, that person will not be entitled to the unutilised CDE forfeited in a previous year.[113] Instead of consigning such expenditure to a black hole, para 20A allows it to be added to the base cost of the farm property. This is a logical approach because such expenditure would in all likelihood have contributed to the value of the farm property and the amount realised on its disposal.

8.14.3.6 Key requirements for CDE to be added to base cost

The person must have

- unutilised CDE,
- ceased farming operations during the current or a previous year of assessment,
- disposed of the farm property in the current year of assessment, and
- made an election as to how much of the CDE is to be added to the base cost of the ex-farm property disposed of.

8.14.3.7 The election

The election may be made in respect of the whole or a part of the CDE. There is no requirement that the elected CDE actually relate to the ex-farm property disposed of as the provision contains no cost identification rules. For example, if a farmer has ceased farming and has two farms, and sells one of them, he can elect that all or part of the CDE (including CDE relating to the second farm) be allocated to the base cost of the first farm. The provision is not specific as to when the election must be made and in what form it must be made. However, the view is held that the election must be made in the return of income covering the earlier of

[112] *Income Tax Practice Manual* at A – 290.
[113] See *Silke on South African Income Tax* in §15.30.

- the year of assessment in which the farm property is sold, and
- where farming operations have recommenced in the same or the immediately succeeding year of assessment, in that year.

In the first case, the election needs to be made in order that the capital gain on disposal of the farm can be computed. In the second case, the election needs to be made in order that the taxable income from farming can be computed – in other words the farmer must choose between adding the CDE to base cost and utilising it against farming income.

The amount of CDE in respect of which an election can be made is subject to two limitation rules that are discussed below.

Why is the amount of CDE that can be added to base cost subject to an election? It is possible that a person may cease farming operations in one year of assessment, dispose of the farm property and then commence farming operations in the current or immediately succeeding year of assessment. In these circumstances a farmer may wish to utilise the remaining CDE against any taxable capital gain arising on the disposal of the farm property rather than carry it forward for utilisation against any farming income that may be generated in future years. In making the election the farmer must consider

- whether he or she will in fact recommence farming operations before the end of the succeeding year of assessment, and
- in the event that the person should recommence farming operations, whether sufficient farming income will be generated in the foreseeable future to absorb the CDE.

Should the farmer fail to recommence farming operations in the succeeding year any unutilised CDE will be lost forever. Even if farming operations are recommenced in the next year, it may be many years before the farmer will have sufficient farming income against which the CDE can be utilised. Another factor to bear in mind is that a farmer is likely to incur further CDE in starting up a new farming operation. From a cash flow point of view a farmer may wish to save CGT now rather than normal tax at a much later date.

Another reason for the election relates to the loss limitation rule in para 20A(2). The election would, for example, be required where a person dies holding two farm properties. If the executor allocated all the CDE to the first farm, this may result in a loss which would trigger para 20A(2) thereby resulting in a limitation on the amount of the CDE that can be allocated to that farm. The executor may wish to ensure that the CDE is allocated in a manner that will not result in a capital gain on one property and a capital loss on the other.

8.14.3.8 The selection of a cost identification method

For the purpose of the loss limitation rules in para 20A(2) and (3) it is necessary for a farmer to maintain a separate record of pre- and post-valuation date unutilised CDE. Where a portion of CDE has been utilised against farming income on or after 1 October 2001, the question arises as to what identification method must be used to determine whether the unutilised CDE on the date of cessation of farming operations relates to pre- or post-valuation date expenditure.

Paragraph 20A does not contain any cost identification rules for determining what constitutes pre- and post-valuation date expenditure. In the absence of a specific rule, the *contra fiscum* rule must be applied, and a person is free to choose the method that will yield the best result.

8.14.3.9 The loss limitation rule (para 20A(2))

The amount of CDE in respect of which an election can be made is limited to the amounts reflected in the table below.

Table 2 – Limitation of CDE iro which election can be made

When immovable property acquired	CDE limited to
Before valuation date	Proceeds reduced by any other amount allowable ito para 25, namely, the • valuation date value ito para 26 or 27, • *plus* any para 20 expenditure incurred on or after the valuation date.
On or after valuation date	Proceeds reduced by allowable para 20 expenditure.

Example 1 – Limitation on CDE where market value adopted as valuation date value

Facts: Frikkie purchased a sugar cane farm in the Pongola area in 1995 at a cost of R80 000. On 29 February 2004 he decided to discontinue farming operations and converted his farm into a tourist resort. At the end of the 2004 tax year, Frikkie had unutilised CDE of R200 000, all incurred after the valuation date. On 28 February 2005 he sold the property for R1 000 000 after the resort had proved unsuccessful. The market value of the property on valuation date was R800 000. Improvements to the property during the 2005 tax year amounted to R30 000.

Result: The amount of CDE that can be added to the base cost of the property is limited to the following:

		R
Proceeds		1 000 000
Less: Valuation date value	800 000	
Post-1.10.2001 improvements	30 000	(830 000)
		170 000

Frikkie can therefore only elect to add R170 000 of the unutilised CDE of R200 000 to the base cost of the property. This will result in no gain no loss on disposal of the property. Frikkie must make the election in his 2005 return of income.

Example 2 – Limitation on CDE where TAB adopted as valuation date value

Facts: John paid R100 000 for his farm on 1 July 1997. He passed away on 30 June 2006 at which stage the market value of the farm was R150 000. At the date of his death he had unutilised CDE made up as follows:

Tax year	CDE incurred	Farming income	Unutilised CDE c/f
	R	R	R
1999	50 000	20 000	30 000
2000	80 000	30 000	80 000
2003	50 000	50 000	80 000
2004	-	10 000	70 000

Result: Applying the FIFO principle, the unutilised CDE of R70 000 is made up as follows:

On or after valuation date	R50 000
Before valuation date	R20 000

TAB disregarding CDE (para 20A(2))
TAB = B + [(P-B) x N/N+T]
TAB = R100 000 + [(R150 000 – R100 000) x 5/10]

TAB = R125 000

Limitation:	R
Proceeds	150 000
Less: TAB	125 000
Maximum allowable CDE	25 000

Applying FIFO, the entire R25 000 relates to the post-valuation date period.

TAB including CDE
P = R100 000/R125 000 x R150 000
P = R120 000

TAB = R100 000 + [(R120 000 – R100 000) x 5/10]
TAB = R100 000 + R10 000
TAB = R110 000
Capital gain = R150 000 – (R110 000 + R25 000) = R15 000

What if John uses LIFO? In that case, the entire R25 000 would be regarded as having been incurred in 1999. Therefore B = R100 000 + R25 000 = R125 000.

TAB = R125 000 + [(R150 000 – R125 000) x 5/10]
TAB = R125 000 + R12 500
TAB = R137 500

Capital gain = R150 000 – R137 500 = R12 500

John would therefore use LIFO.

8.14.3.10 Restriction where market value adopted as valuation date value (para 20A(3))

A further restriction on the range of expenditure in respect of which an election can be made applies where a person adopts the market value as the valuation date value of the immovable property. In this case, only CDE incurred on or after valuation date can be taken into account. In these circumstances the FIFO method of cost identification will ensure that the maximum amount of CDE is treated as post-valuation date expenditure.

Example – inadmissibility of pre-valuation date CDE where market value adopted as valuation date value

Facts: Diana passed away on 30 June 2004 leaving behind a wine farm in Paarl.

She had incurred CDE in terms of para 12(1)(*c*) – (*i*) of the First Schedule as follows:

Tax year	CDE incurred	Farming income	Unutilised CDE c/f
	R	R	R
1999	50 000	20 000	30 000
2000	80 000	30 000	80 000
2003	50 000	50 000	80 000
2004	-	10 000	70 000

The market value of the farm was as follows:

	R
On 1 October 2001	1 000 000
On 30 June 2004	1 500 000

Result: In this instance it is assumed that the unutilised CDE of R70 000 was incurred as follows using the FIFO basis:

	R
After valuation date	50 000
Prior to valuation date	20 000

The base cost of the property is R1 000 000 + R50 000 = R1 050 000, resulting in a capital gain of R450 000. No election may be made in respect of the CDE incurred prior to the valuation date as the market value basis has been adopted.

8.15 Prevention of double deductions

Paragraph 21

This paragraph embodies more or less the same principles as are contained in s 23B of the Act (prohibition of double deductions). Its purpose is twofold.

First, where an amount qualifies as allowable expenditure in determining a capital gain or a capital loss under more than one provision of the Eighth Schedule, the amount or portion thereof, shall not be taken into account more than once in determining that capital gain or loss. (An anti 'double-count' provision.)

Secondly, no expenditure shall be allowed in terms of para 20(1)(*a*) or (*e*) where it has in fact qualified under any other provision of the Eighth Schedule but has been limited in terms of that other provision. (An anti-'carry forward' provision.) As an example, in the case of a disposal of an asset by way of donation, where the donor pays donations tax, in terms of para 20(1)(*c*)(vii), the donations tax allowable as expenditure for purposes of determining base cost is calculated in terms of para 22. Any balance that is not allowable as expenditure in terms of this paragraph may not then qualify as 'expenditure actually incurred' in terms of para 20(1)(*a*).

8.16 Amount of donations tax to be included in base cost

Paragraph 22

Paragraph 20(1)(*c*)(vii) entitles a donor to add a portion of the donations tax paid to the base cost of a donated asset. This paragraph contains the formula to be used in calculating the allowable portion of such tax. See para 20 for an example and explanation of the formula.

8.17 Base cost in respect of value shifting arrangement

Paragraph 23

This paragraph sets out the formulae to be applied to the parties to a value shifting arrangement. For a full explanation of value shifting, the formulae and illustrative examples, see Chapter 21 – Anti-avoidance measures.

8.18 Base cost of asset of a person who becomes a resident

Paragraph 24

The term 'resident' is defined in s 1 and includes not only persons who are ordinarily resident but also persons who are physically present in South Africa for the periods specified in the definition.

This paragraph prescribes the treatment of persons who become residents disposing of assets after they have become South African residents. It does not apply to

- immovable property in the Republic (para 2(1)(*b*)(i)) and
- assets of a permanent establishment situated in the Republic (para 2(1)(*b*)(i)).

Gains and losses on these two classes of assets are taxed on a source basis and are not influenced by the residence status of the owner.

This paragraph also does not apply to persons who became residents prior to the valuation date. Such residents will be subject to the normal rules and would have to determine the valuation date value of their assets in terms of paras 25, 26, 27 and 28.

In terms of paras 12(4) and 13(1)(*g*) where non-residents become residents, their assets, other than those contemplated in para 2(1)(*b*)(i) and (ii), are treated as having been disposed of on the day before they become resident in the Republic and then reacquired at market value on the same day.

The first subparagraph makes it possible for a person who becomes a resident to add any expenditure allowable in terms of para 20 incurred on or after the date of becoming resident to the value of the asset as determined in subparas (2) and (3) at the date of becoming resident.

In terms of para 12(4) read with para 13(1)(*g*) persons becoming resident in SA are deemed to have disposed of and re-acquired their assets (other than the SA source assets listed below) at market value on the date immediately before the day on which residence is taken up. The SA source assets that need not be valued at the time of taking up residence are

- any immovable property or an interest or right in immovable property situated in the Republic, and
- an asset of a permanent establishment through which that person carries on a trade in the Republic during the year of assessment.

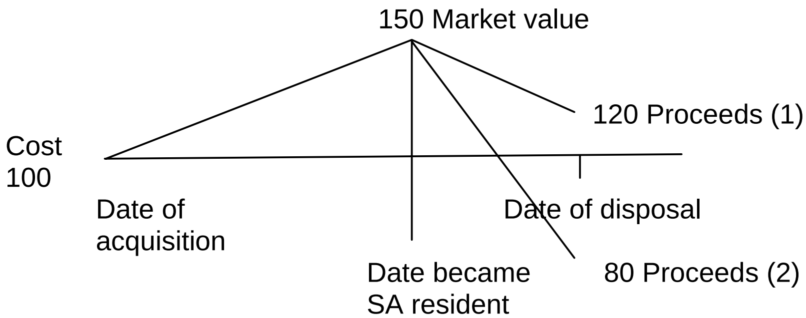
In determining the base cost of their non-SA source assets held at the time of taking up residence these persons will, therefore, not be able to rely upon the time-apportionment base cost method or the '20% of proceeds rule' outlined in para 26. They are restricted to using either the market value where permissible or the historic/original cost of the asset. There is no time limit for the determination of the market value – see notes at the end of this section.

This paragraph envisages two distinct cases. The first is where both the proceeds and the allowable expenditure, as contemplated in para 20, incurred prior to becoming a resident are less than the market value determined at the date of becoming a resident. In this case the person who becomes a resident is treated as having acquired that asset at a cost equal to the higher of:

- the expenditure allowable in terms of para 20 incurred in respect of that asset prior to the date of becoming a resident; or
- those proceeds less the expenditure allowable in terms of para 20 incurred on or after that date in respect of that asset.

Two permutations are possible in the first case. Proceeds may be higher than expenditure before residence but lower than market value or expenditure before residence may be higher than proceeds but lower than market value.

Example 1 - Proceeds and cost less than market value



In case (1) proceeds must be used thereby eliminating the loss of 30 (150 – 120).
In case (2) historical cost must be used resulting in a loss of 20 rather than 70 had the market value been allowed as the base cost.

Example 2 – Proceeds and cost less than market value

	Permutation 1 R		Permutation 2 R	
Proceeds	100 000		75 000	
Market value	200 000		200 000	
Expenditure before residence	50 000		100 000	
Expenditure after residence	25 000		25 000	
Deemed acquisition cost is the higher of:				
Expenditure before residence; or	50 000		100 000	
Proceeds less Expenditure after residence	75 000		50 000	
Therefore, deemed acquisition cost equals	75 000		100 000	
Proceeds	100 000		75 000	
Base cost	100 000	(75 + 25)	125 000	(100 + 25)
Capital gain / (loss)	Nil		(50 000)	

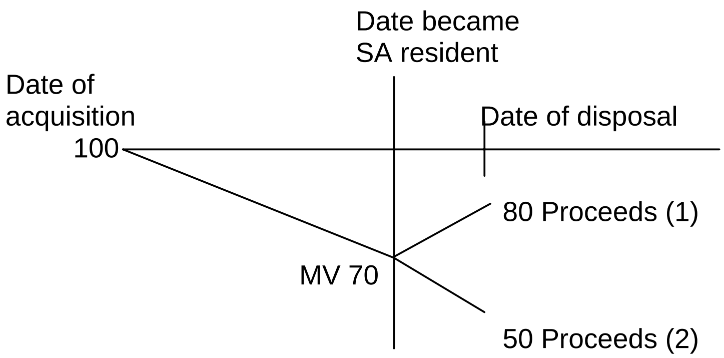
In both permutations, the market value is not considered and the actual capital gain or loss allowable is determined in relation to historic cost.

The second case is where both the proceeds and the market value at the date of becoming a resident are less than the allowable expenditure, as contemplated in para 20, incurred prior to becoming a resident. In this case the person who becomes a resident is treated as having acquired that asset at a cost equal to the higher of:

- the market value; or
- those proceeds less the expenditure allowable in terms of para 20 incurred on or after that date in respect of that asset.

Again, two permutations are possible in the second case. Proceeds may be higher than market value but both lower than expenditure before residence or market value may be higher than proceeds but both lower than expenditure before residence.

Example 3 - Proceeds and market value less than cost



In case (1), proceeds must be used thereby resulting in no gain, no loss compared to the gain of 10 that would have arisen had market value been used.
In case (2), market value must be used resulting in a loss of 20 (50 – 70) compared to the loss of 50 that would have resulted had historical cost been used.

Example 4 – Proceeds and market value less than cost

	Permutation 1		Permutation 2	
	R		R	
Proceeds	100 000		75 000	
Market value	50 000		100 000	
Expenditure before residence	200 000		200 000	
Expenditure after residence	25 000		25 000	
Deemed acquisition cost is the higher of:				
Market value; or	50 000		100 000	
Proceeds less expenditure after residence	75 000		50 000	
Therefore, deemed acquisition cost equals	75 000		100 000	
Proceeds	100 000		75 000	
Base cost	100 000	(75 + 25)	125 000	(100 + 25)
Capital gain / (loss)	Nil		(50 000)	

Since the expenditure in respect of the asset must be known in order to apply the above gain and loss limitation rules, it follows that they cannot be applied where there is no record of expenditure. Despite this, the Commissioner may apply the provisions of s 78 to estimate the amount of the expenditure using available information.

Time period for performing valuations

In terms of para 12(4) persons who commence to be resident must be treated as having disposed of their assets at market value and to have reacquired them at a cost equal to that market value. The cost is treated as expenditure incurred and paid for the purposes of para 20(1)(*a*). These persons are responsible for valuing their assets. Where a person fails to value an asset, the Commissioner can estimate the value in terms of s 78.

Unlike para 29(4) which requires that pre-valuation date assets be valued within three years of valuation date, para 12(4) sets no time limit within which new residents must value their assets after taking up residence. In theory these persons could value their assets at date of disposal, though this carries with it the problem of securing sufficient evidence to support the valuation long after the event. The onus of proving the correctness of a valuation rests on the resident in terms of s 82(*b*). Regardless of when the valuation is done, the fact remains that a valuation is mandatory.

8.19 Determination of base cost of pre-valuation date assets

Paragraph 25

8.19.1 The general formula (para 25(1))

The base cost of a pre-valuation date asset is the sum of the valuation date value of that asset, as determined in terms of para 26, 27 or 28, and the expenditure allowable in terms of para 20 incurred on or after the valuation date in respect of that asset. This paragraph enables expenditure incurred after the valuation date to be added to base cost. Expressed as a formula the base cost of a pre-1 October 2001 asset is:

Base cost = valuation date value (VDV) + post-1 October 2001 expenditure

Identical assets to which the provisions of para 32(3A) are applicable are excluded from this paragraph. The reason for this is that pre-valuation date assets cannot be separately identified once they have been merged in a pool with post-valuation date assets.

As will be seen in paras 26, 27 and 28 the valuation date value of an asset can be various things. For example it could be:

- Market value on 1 October 2001
- Time-apportionment base cost (TAB)
- 20% x (Proceeds – post-CGT expenditure)
- Proceeds – post-CGT expenditure

8.19.2 Redetermination of capital gains and losses on disposal of pre-valuation date assets (para 25(2) and (3))

Effective date

This provision came into operation on the date of promulgation of the Revenue Laws Amendment Act 32 of 2004, namely, 24 January 2005, and applies in respect of any disposal during any year of assessment commencing on or after that date. This means, for example, that in the case of natural persons it will apply to the 2006 and subsequent tax years.

Paragraph 25(2) and (3) deal with the redetermination of capital gains and losses in respect of pre-valuation date assets. Such redeterminations are required when any of the events in the table below occur:.

Table 1 – Circumstances in which capital gains and losses must be redetermined

Paragraph 25(2)	**Event during current year triggering redetermination**
(*a*)	Additional proceeds received or accrued.
(*b*)	Proceeds were previously taken into account, and • they have become irrecoverable, • they have become repayable, or • the person is no longer entitled to those proceeds as a result of the

	➢ cancellation, termination or variation of any agreement or ➢ due to the prescription or waiver of a claim or a release from an obligation or any other event.
(*c*)	Additional expenditure forming part of base cost is incurred.
(*d*)	Expenditure previously taken into account as part of base cost has been recovered or recouped.

When a redetermination is required, it simply means that the capital gain or loss on disposal of the asset must be redetermined from scratch, taking into account all amounts of proceeds and expenditure from the date on which the asset was first acquired. Redetermination is necessary for the following reasons:

- Any capital gain or loss determined under the first disposal may have been eliminated by the kink tests in paras 26 and 27. In the absence of redetermination this could cause hardship or confer an undue benefit on a taxpayer.
- Where the TAB method was used with the first disposal, any subsequent capital gain or loss would otherwise not be time-apportioned. For example, additional proceeds received or accrued in a year subsequent to the year of disposal would comprise a full capital gain in the year received or accrued. Note in this regard that the values of 'N' and 'T' in the TAB formula (period before and after valuation date) remain unchanged. In other words, these periods are determined by the date of disposal, and not by the date of receipt or accrual of subsequent proceeds or the incurral of subsequent expenditure.

Adjustment of capital gain or loss (para 25(3))

The redetermined capital gain or loss must be taken into account in the current year in terms of para 3(1)(*b*)(iii)(*aa*) (capital gain) or para 4(1)(*b*)(iii)(*aa*) (capital loss). There is no requirement that a person must consistently apply the same valuation method. For example, a person may have elected TAB for the first disposal and market value for the redetermination. Redetermination is not required where the weighted average method is adopted under para 32(3A).

Any capital gain or loss that was previously determined is reversed out as a capital loss or gain as the case may be, in terms of para 3 (*b*)(iii)(*bb*) (previous capital loss treated as capital gain) or para 4(*b*)(iii)(*bb*) (previous capital gain treated as capital loss).

Example 1 – Redetermination of capital gain or loss where the kink tests applied to the initial disposal

Facts: In 1995 Ruzanne purchased land at a cost of R100 000. She determined a market value in respect of the land on 1 October 2001 of R150 000. On 28 February 2005 she sold the land for R120 000 plus a further sum of R35 000 to be paid on 28 February 2007 if the purchaser was able to attain a required level of profitability from the use of the land. The purchaser was able to attain the required level of profitability and Ruzanne duly received the additional proceeds of R35 000 on 28 February 2007. In determining the valuation date value of the land she adopted the market value method
Result:

2005 tax year

During the 2005 tax year Ruzanne's capital loss of R30 000 was disregarded in terms of para 26(3). In terms of that provision the valuation date value of the land was deemed to be R120 000.

2007 tax year

The receipt of the additional proceeds of R35 000 triggers a redetermination of the capital gain or loss in respect of the disposal of the land in terms of para 25(2). The revised capital gain is determined as follows:

	R
Proceeds R120 000 + R35 000	155 000
Base cost	150 000
Capital gain	5 000

Example 2 – Redetermination of capital gain upon accrual of further proceeds where a capital gain was determined in the year of disposal

Facts: Assume the same facts as Example 1, except that Ruzanne sold the land on 28 February 2005 for R155 000 plus contingent proceeds of R35 000.

Result:

2005 tax year

In 2005 Ruzanne had a capital gain of R5 000 (R155 000 proceeds less R150 000 base cost).

2007 tax year

In 2007 Ruzanne will have a redetermined capital gain of R40 000.

	R
Proceeds R155 000 + R35 000	190 000
Base cost	150 000
Capital gain	40 000

The redetermined capital gain of R40 000 is treated as a capital gain in the current year in terms of para 3(*b*)(iii)(*aa*). The prior year capital gain of R5 000 is treated as a capital loss in the current year in terms of para 4(*b*)(iii)(*bb*). The net effect in the current year is that an amount of R35 000 will be subject to CGT.

Example 3 – Redetermination of capital gain where TAB adopted in respect of initial disposal

Facts: Natasha acquired 100 Alpha Ltd shares on 1 June 1999 at a cost of R200 000. On 30 June 2004 she sold them for R500 000 plus a further amount of R100 000 payable on 28 February 2006 depending on whether the shares produced a dividend yield of at least 5% during the 2005 and 2006 years of assessment. Natasha elected to use TAB to determine the valuation date value of her shares.

Result:

2004 tax year

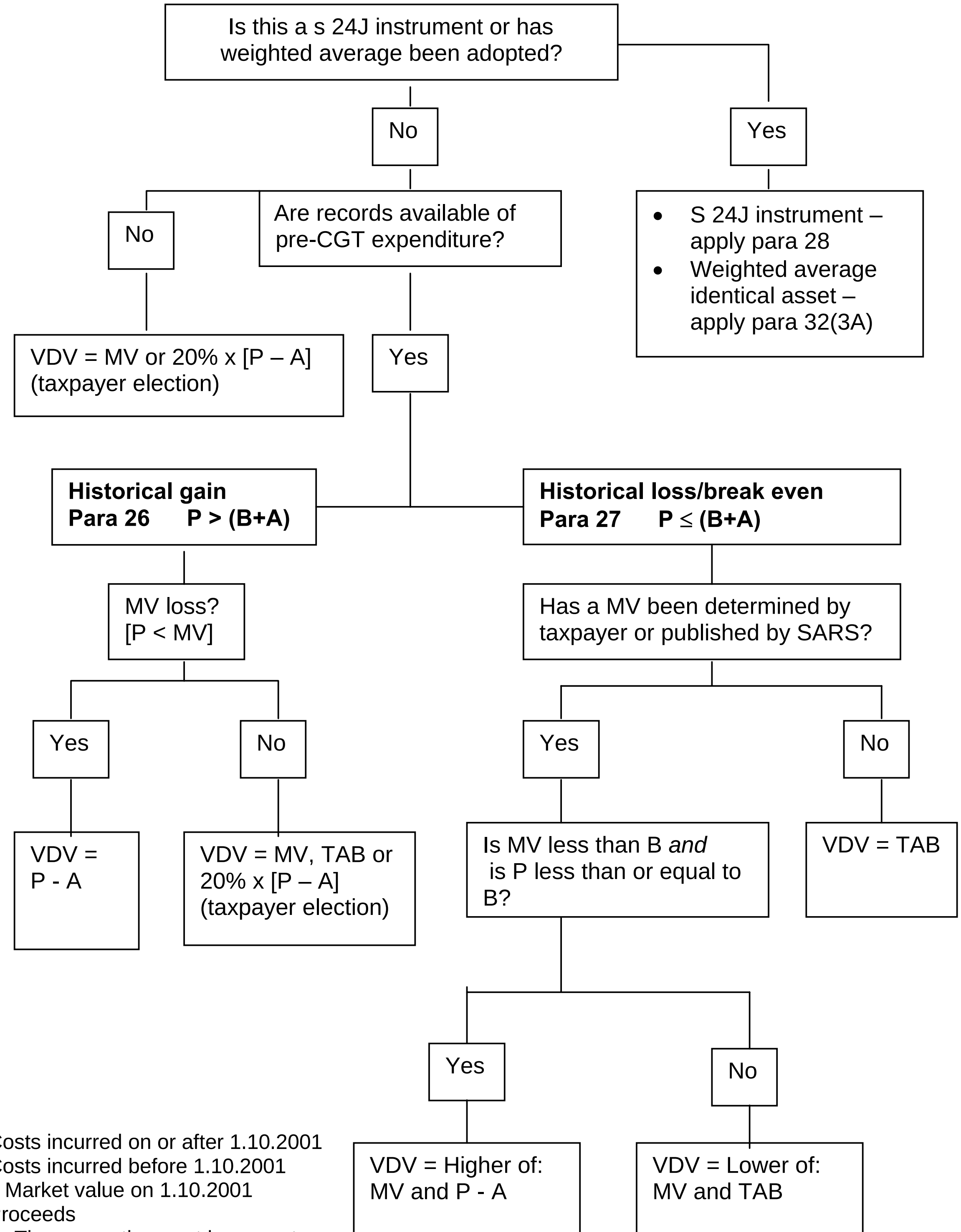
TAB = B + [(P – B) x N/N+T]
TAB = R200 000 + [(R500 000 – R200 000) x 3/6]
TAB = R200 000 + R150 000
TAB = R350 000
Capital gain = R500 000 – R350 000 = R150 000

2006 tax year

P = R500 000 + R100 000 = R600 000
TAB = B + [(P – B) x N/N+T]
TAB = R200 000 + [(R600 000 – R200 000)] x 3/6
TAB = R200 000 + R200 000
TAB = R400 000
Capital gain = R600 000 – R400 000 = R200 000

The prior year capital gain of R150 000 is treated as a capital loss under para 4(*b*)(iii)(*bb*) while the redetermined capital gain of R200 000 is treated as a capital gain in terms of para 3(*b*)(iii)(*aa*). The net result is that an amount of R50 000 will be subject to CGT in 2006. Note that the number of years after valuation date ('T' in the TAB formula) remains unchanged at 3 years despite the fact that the additional proceeds were received 5 years after valuation date.

Overview of paras 26 and 27



KEY:
A = Costs incurred on or after 1.10.2001
B = Costs incurred before 1.10.2001
MV = Market value on 1.10.2001
P = Proceeds
TAB = Time-apportionment base cost
VDV = Valuation date value

8.20 Valuation date value where proceeds exceed expenditure or expenditure in respect of an asset cannot be determined

Paragraph 26

8.20.1 Application (para 26(1))

This paragraph sets out the method for determining the valuation date value of an asset disposed of on or after the valuation date where

- that asset was acquired before the valuation date;
- proceeds exceed expenditure, allowable in terms of para 20 incurred before, on and after that date **(an historical gain)**; and
- that asset is not an instrument as defined in s 24J of the Income Tax Act (these assets are dealt with in terms of para 28).
- the asset is not part of a class of identical assets to which the provisions of para 32(3A) apply, that is, whose base cost is determined using the weighted average method.

8.20.2 Valuation date value methods available (para 26(1))

Where all four criteria are met, a person is entitled to determine the valuation date value of the asset as

- the market value of the asset on the valuation date as contemplated in para 29,
- 20% of the proceeds from disposal of the asset after deducting from the proceeds the expenditure allowable in terms of para 20 incurred on or after the valuation date, or
- the time-apportionment base cost of the asset, as contemplated in para 30.

In essence, where a gain is anticipated with reference to expenditure incurred both before, and on or after the valuation date, a person may elect any one of three alternative valuation date values and may do so at the date of disposal of that asset.

8.20.3 Expenditure unknown (para 26(2))

Where neither the person who disposed of an asset nor the Commissioner can determine the expenditure incurred before the valuation date, the person must determine the valuation date value of the asset as

- the market value of the asset on the valuation date as contemplated in para 29, or
- 20% of the proceeds from disposal of that asset after deducting from the proceeds the expenditure allowable in terms of para 20 incurred on or after the valuation date.

Taxpayers who do not have a record of expenditure will have to give serious consideration to valuing their assets within the three-year period prescribed by para 29(4). Failure to do so will result in such persons having to resort to the unpopular ‘20% of proceeds’ method, which in essence means that they would be subject to CGT on an 80% gain.

The 20% of proceeds method was inserted as a last resort for those taxpayers who had no record of expenditure or failed to obtain a market valuation. It is important to note that when adopting this method one must deduct post-1.10.2001 expenditure from proceeds before applying the 20%.

A person who does not have a record of pre-valuation date expenditure may not adopt TAB by assuming that the pre-CGT expenditure was nil. Persons finding themselves in this position are obliged to use the market value or 20% of proceeds methods unless the Commissioner can determine the relevant expenditure.

8.20.4 Self-generated goodwill and TAB

In many cases, goodwill is not purchased, but is self-generated by the business. The question arises as to whether TAB can be used to determine a valuation date value for such goodwill.

Identifying the expenditure giving rise to goodwill can be extremely problematic. In many cases the expenditure will have been deducted on revenue account and the expenditure incurred in establishing the goodwill will be regarded as nil by virtue of para 20(3)(*a*). In other cases some of the contributing expenditure may well have not qualified as a deduction or allowance against ordinary income (for example, expenditure on land and non-qualifying buildings). If such expenditure exists it will fall within para 20 and one cannot simply assume that it is nil. If expenditure was incurred on or after the valuation date the proceeds formula in para 30 would be applicable, but the problem of identification arises once more.

It is also not possible to determine the value of 'N' in the TAB formula as it would be unclear when the goodwill arose. The problem is exacerbated by the fact that goodwill fluctuates from year to year with the result that earlier goodwill may often be diminished or extinguished and later replenished.

Given that the expenditure incurred with respect to the goodwill will generally not be determinable, para 26(2) permits the use of the market value and 20% of proceeds methods.

8.20.5 Proof of expenditure

The question arises as to the level of proof of expenditure that will be required in respect of pre-valuation date assets. The records that are required to be kept are set out in s 73B and these requirements must be adhered to in respect of post-valuation date acquisitions or improvements.

It is accepted that persons may no longer have copies of original purchase invoices and paid cheques in respect of pre-valuation date expenditure, particularly where the expenditure in question was incurred many years prior to the introduction of CGT. In such cases alternative forms of proof can be considered. It is not possible to lay down hard and fast rules as to the type of proof that will be acceptable and each case will have to be judged on its own merits. Where, for example, a company has submitted annual financial statements with its tax returns and the cost of assets can be tied up to a fixed assets register that contains sufficient detail (e.g. date of acquisition, description and cost) that should suffice as proof of expenditure.

Example 1 – 20% of proceeds method

Facts: Waheeda acquired an asset many years prior to the valuation date and neither her nor the Commissioner could establish the original cost of the asset. She effected improvements to the asset after valuation date at a cost of R15 000 for which she has purchase invoices. The asset was sold in 2005 for R115 000. Determine the capital gain using the 20% of proceeds method.

Result:

	R
Proceeds	115 000
Post-1.10.2001 expenditure	(15 000)
	100 000

	R
VDV = 20% x R100 000	20 000
Post-1.10.2001 expenditure	15 000
Base cost	35 000
Capital gain = R115 000 – R35 000 =	80 000

What about assets acquired for no consideration prior to 1 October 2001, for example, assets acquired by donation or inheritance? In these cases the original cost would be nil,[114] and the time-apportionment base cost (TAB) method would still be open to a taxpayer. This might yield a result more or less favourable than if a market value had been determined.

8.20.6 Limitation on 'phantom' losses (para 26(3))

Apart from setting out the methods available to a person for valuing their pre-CGT assets para 26 also contains a loss limitation rule.

Where

- a person adopts the market value as the valuation date value of the asset disposed of, and
- the proceeds from the disposal of that asset do not exceed the market value (that is, there is a market value loss),

the valuation date value of the asset will equal those proceeds less the expenditure allowable in terms of para 20 incurred on or after the valuation date in respect of that asset.

Since the expenditure in respect of the asset must be known in order to apply this rule it follows that the rule cannot be applied where there is no record of expenditure.

Example 2 – Paragraph 26 – Historical cost gain and market value loss

Facts: Werner disposed of a pre-valuation date asset after the valuation date. Market value had been adopted at valuation date and proceeds do not exceed that market value. The relevant information is as follows:

	R
Expenditure before valuation date	100 000
Expenditure after valuation date	25 000
Market value at valuation date	200 000
Proceeds upon disposal	150 000

Result: The valuation date value of the asset is determined as the proceeds less expenditure after valuation date 125 000

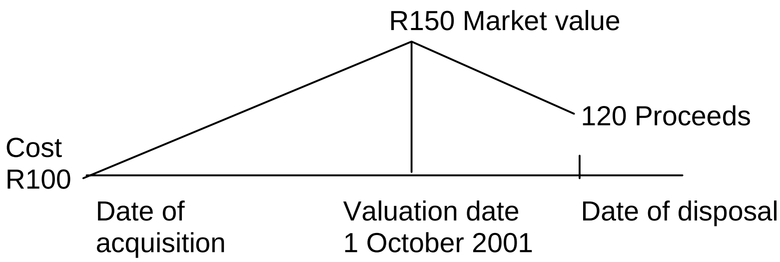
Base cost of the asset disposed of equals	150 000	(R125 000 + R25 000)
Proceeds	150 000	
Base cost	150 000	
Capital gain / (loss)	Nil	

[114] Paragraphs 38 and 40 which deem disposals by way of donation and death to be at market value only apply to disposals on or after the valuation date in accordance with para 2.

This loss limitation rule eliminates ‘phantom’ capital losses where the market value has been adopted at valuation date but proceeds exceed actual or historic cost. Any capital gain with reference to the actual or historic cost, however, is also disregarded.

The rule, also known as a ‘kink’ test – a term borrowed from the United Kingdom - can be graphically illustrated as follows:

Example 3
Paragraph 26 - Historical cost gain, market value loss (‘kink test’)



Step 1: Is there an historical cost gain? Yes, R120 – R100 = R20 and para 26 applies.
Step 2: Is there a market value loss? Yes, R120 – 1R50 = -R30
Since both conditions are satisfied, the loss limitation rule applies. Therefore
VDV = Proceeds (120) – post-1.10.2001 expenditure (nil) = R120.
Capital gain / loss = Proceeds – base cost
Capital gain / loss = Proceeds – [VDV + post-1.10.2001 expenditure]
Capital gain / loss = R120 – [R120 + R0] = R0

8.20.7 What range of proceeds fall within para 26?

It is important to realise that para 26 contains two broad requirements. The first – whether there is a gain based on historical cost – determines whether the paragraph is applicable (the entry requirement). Once that test is satisfied the next step is to determine whether the loss limitation rule applies (MV loss).

In Example 3 the loss limitation rule will apply where proceeds fall within the range 101 – 149. Proceeds falling within this range will always give rise to an historical cost gain and a market value loss.

What if proceeds were, say R160? The loss-limiting rule would not apply because there would be a market value gain. In fact any proceeds of R150 or more will give rise to a market value gain, or a break-even situation where proceeds = R150. In this situation the taxpayer would still fall within para 26, having a gain based on historical cost, and would have the freedom to choose the higher of market value, TAB or 20% of [proceeds less post-1.10.2001 expenditure] as the valuation date value.

What if proceeds were R80? The paragraph would not apply in its entirety because the taxpayer would have failed to pass the entry requirement, having an historical loss of R20 – remember, one of the key requirements for entry into para 26 is an historical gain. In this case the matter would be dealt with in terms of para 27, which deals with historical losses and break-even situations.

8.20.8 Understanding 'proceeds less post-1.10.2001 expenditure'

The loss-limiting formula 'proceeds less post-1.10.2001 expenditure' will always result in a no gain, no loss situation. This formula is applied elsewhere in the Eighth Schedule (for example, in paras 24 and 27). To understand this formula it is necessary to go back to the core base cost formula in para 25:
Base cost = valuation date value (VDV) + post-1.10.2001 expenditure
A no gain no loss situation arises where:
Base cost = proceeds.
This can be restated as:
VDV + post-1.10.2001 expenditure = proceeds
And then rearranged as:
VDV = Proceeds – post-CGT expenditure.
Essentially one works backwards to arrive at a VDV that will yield neither a gain nor a loss after the post-1.10.2001 expenditure is added thereto.

8.21 Valuation date value where proceeds do not exceed expenditure

Paragraph 27

8.21.1 Application (para 27(1) and (2))

This paragraph sets out a method to determine the valuation date value of an asset disposed of on or after the valuation date where

- that asset was acquired before the valuation date,
- proceeds do not exceed expenditure, allowable in terms of para 20, incurred before, on and after that date (an historical cost loss or break-even situation),
- that asset is not an instrument as defined in s 24J of the Income Tax Act (these assets are dealt with in terms of para 28), and
- the asset is not part of a pool of identical assets to which the provisions of para 32(3A) apply, that is, whose base cost is determined using the weighted average method.

Where a taxpayer does not have a record of expenditure the paragraph will also not apply. The valuation date value of such an asset will have to be determined in terms of para 26(2).

Paragraph 27 deals with three separate scenarios. These rules – also known as 'kink tests'[115] - are designed to protect the *fiscus* from 'phantom' losses that would otherwise arise if taxpayers were given free reign to adopt either the time-apportionment base cost (TAB) or market value methods.

8.21.2 Assets where market value determined or published (para 27(3))

The first two scenarios are contained in subpara (3) and apply where

- a person has determined the market value of an asset on the valuation date, as contemplated in para 29, or
- the market value of an asset has been published in terms of that paragraph.

Assets whose value has been determined in terms of para 31 must also be included since para 29(1)(*c*) includes such assets.

8.21.2.1 Assets in respect of which a market value has been determined

There has been much confusion amongst taxpayers as to when they will be regarded as

[115] A term borrowed from the United Kingdom. The kink refers to the shape of the graph that results when plotting the cost, market value and proceeds.

having 'determined' a market value and hence subject to the kink tests in para 27. The word 'determined' must be distinguished from the word 'adopted'. 'Adopted' implies an election (in other words a freedom of choice) whilst 'determined' refers to a factual situation where there is no right of election.

A person will have 'determined' a value if that person has performed/obtained a valuation as at 1 October 2001 during the three years ending 30 September 2004, regardless of whether that person intends using that valuation.

SARS takes the view that just as para 26 allows the taxpayer to select the method that gives the smallest gain so it is appropriate that para 27 requires that the taxpayer select the method that gives the smallest loss.

Prior to the amendment of para 27 by the Second Revenue Laws Amendment Act 60 of 2001, there was some uncertainty regarding the treatment of listed shares and participatory interests in portfolios of collective investment schemes. It could have been argued that it was not the taxpayer who 'determined' the market value, but rather SARS. As a result para 27 was rewritten to make it quite clear that a taxpayer did not have freedom of choice between TAB and market value when that taxpayer had determined a market value or it was a published instrument and the taxpayer was in the situation where there was

- an historical loss / break-even situation, and
- market value was less than pre-valuation date expenditure.

In these circumstances the choice is simply the higher of market value or proceeds less post-valuation date costs, and TAB is NOT an option.

The position regarding local listed shares and participatory interests in portfolios of collective investment schemes is now quite unambiguous.

But how are other assets to be treated? Taxpayers will be bound by this test if they have 'determined' a market value. The intention of this expression was that if taxpayers had performed or obtained a valuation date valuation (either personally or by making use of a valuer) then they would be brought within the confines of the provision.

How would SARS know if the taxpayer had 'determined' a market value? In the case of the high value items referred to in para 29(5) SARS will have the prescribed form in its possession. With other assets SARS could request a taxpayer to confirm whether a valuation had been done or may discover evidence of such valuation during an audit.

A taxpayer's submission of a valuation to SARS does not commit the taxpayer to using the valuation where para 26 applies.

8.21.2.2 Assets with published values

The assets in respect of which the value has been published is a reference to those assets whose prices have been published by the Commissioner in the *Government Gazette*. See para 29(4) in **8.23.8**.

8.21.2.3 The first scenario (para 27(3)(a))

The first scenario arises where

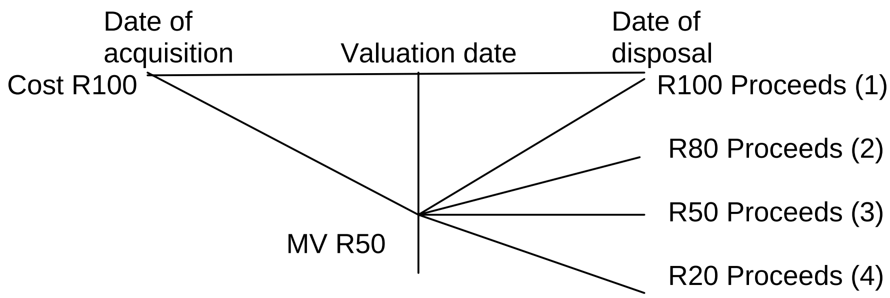
- proceeds are less than or equal to pre-1 October 2001 expenditure (in other words a loss or break-even situation), and
- market value is less than pre-1 October 2001 expenditure.

Where this happens, the valuation date value is the **higher** of

- market value, and
- proceeds less expenditure incurred on or after 1 October 2001 (as discussed under para 26 this will result in no gain, no loss).

This can be graphically illustrated as follows:

Example 1 - Scenario 1 : MV < B ≥ P



P = proceeds, B = pre-1.10.2001costs, MV = market value on valuation date

Within these parameters there are only four possible permutations:
1. Proceeds = cost
2. Proceeds < cost
3. Proceeds = MV
4. Proceeds < MV

The rule states that one must use the **higher** of
- proceeds less post-1 October 2001 expenditure, and
- market value.

Applying the rule the valuation date value (VDV) in the four permutations shown in the graph will be as follows (the higher option is highlighted):
1. Proceeds = R**100**, MV = R50, VDV = R100, no gain, no loss
2. Proceeds = R**80**, MV = R50, VDV = R80, no gain, no loss
3. Proceeds = R50, MV = R50, VDV = R50, no gain no loss (interestingly, the legislation does not make provision for this possibility, but logic dictates that either proceeds or market value could be used since they are identical)
4. Proceeds = R20, MV = R**50**, VDV = R50, loss = R20 – R50 = -R30

The use of TAB in these circumstances is not permitted. Had TAB been permitted, it would have resulted in pre-CGT losses being spread into the post-CGT period when it is known for a fact that those losses are wholly attributable to the pre-CGT period. This is the case in situations 1, 2 and 3.

What is the effect of the rule? Whilst the use of TAB is denied the taxpayer is not subjected to CGT on the actual market value gain, and is treated as making no gain, no loss (situations 1 – 3). This prevents hardship to taxpayers. In situation 4 the taxpayer is allowed the actual market value loss. Whether or not this market value loss would be higher or lower than a TAB-computed loss will depend on the facts of each case. The question is, however, academic since TAB is not an option.

8.21.2.4 The second scenario (para 27(3)(b))

The second scenario also applies where a market value has been determined or published and deals with any situation not covered by the first scenario.

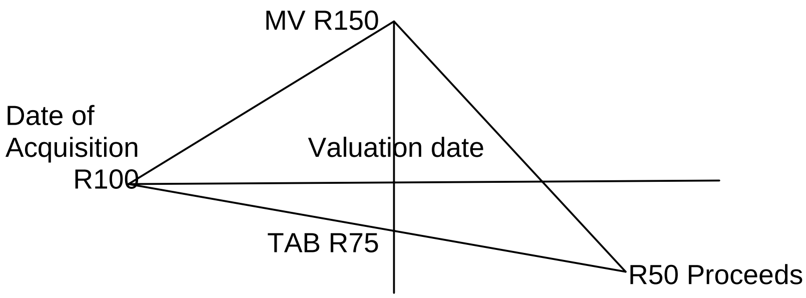
The valuation date value of an asset in these circumstances must be determined as the **lower** of

- market value
- TAB (time-apportionment base cost in terms of para 30)

The interrelationship between the four variables: market value, pre- and post-CGT expenditure, and proceeds gives rise to many complex permutations under this scenario, and it is not intended to explore all of them. It suffices to say that the intention of these rules is to protect the *fiscus* against phantom losses and this is achieved by compelling the adoption of the lower of market value and TAB.

Two of the many possibilities are graphically illustrated below.

Example 2 - Scenario 2 : P < B < MV



P = proceeds, B = pre-1.10.2001 costs, MV = market value on valuation date

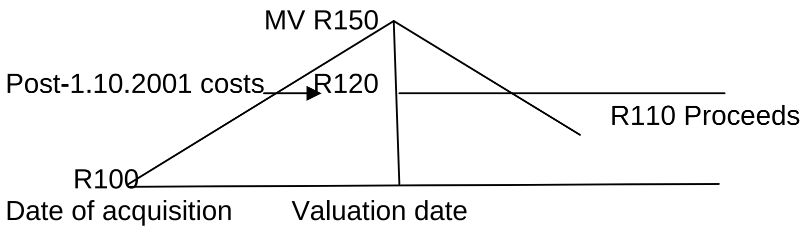
Assume that the asset in this case was purchased 5 years prior to valuation date and sold 5 years after.

TAB = B + ([P – B] x N/(T+N) (see para 30(1) for details of the TAB formula)

TAB = R100 + (R[50 – R100] x 5/10) = R75

Since TAB is lower than market value, TAB must be used. The taxpayer would be entitled to claim the lower TAB-based capital loss of R25 (R50 – R75). As can be seen, this is a great deal less than the 'phantom' market value loss of R50 – R150 = R100 against which the *fiscus* is protected.

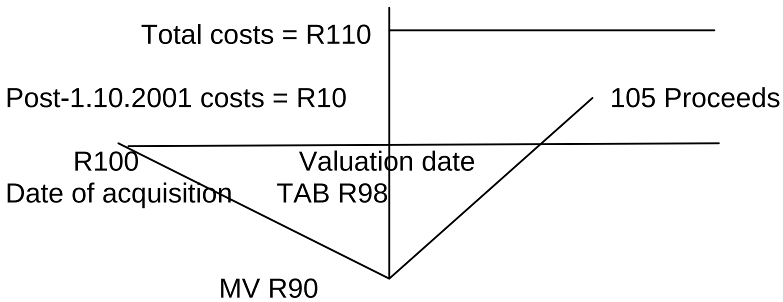
Example 3 - Scenario 2 : P < [A + B] < MV



P = proceeds, A = post-1.10.2001 costs, B = pre-1.10.2001costs, MV = market value on valuation date

Assuming an equal 5-year period before and after 1.10.2001, TAB would be calculated as follows:
P = R100/R120 x R110 = R92
TAB = R100 + ([R92 – R100] x 5/10) = R96
In this case TAB is lower than market value so TAB will prevail thereby shielding the *fiscus* from the higher market value loss of R110 – [R150 + R20] = -R60. The allowable TAB based capital loss is
R110 – [R96 + R20] = -R6

Example 4 - Scenario 2 : MV < P < [A + B]



P = proceeds, A = post-1.10.2001 costs, B = pre-1.10.2001costs, MV = market value on valuation date

TAB:
Assume asset acquired 2 years before and disposed of 2 years after valuation date.
P = R100/R110 x R105 = R95.45
TAB = B + [(P – B) x N/N + T]
TAB = R100 + [(R95.45 – R100) x 2/4]
TAB = R100 – [R4.55 x 2/4]
TAB = R100 – R2.28
TAB = R97.72
MV = R90
Lower of MV and TAB = R90
Capital gain = R105 – R90 – R10 = R5
(Had TAB been permitted a capital loss of R105 – R97.72 - R10 = - R2.72 would have been allowed).

8.21.3 The third scenario (para 27(4))

Where the taxpayer has not determined a market value or the price of the asset is not one published in the *Gazette*, subpara (4) provides that the valuation date value of the asset is its time-apportionment base cost.

Some further examples of the application of para 27 are set out below.

Example 5 – Historical loss and market value loss where MV > pre-1.10.2001 costs

Facts: Xerxes acquired an asset 10 years before the valuation date for R100 000 and disposed of it 5 years after the valuation date for R80 000. Market value of R120 000 had been adopted at valuation date.

Result:

	R
Expenditure before valuation date	100 000
Market value at valuation date	120 000
Proceeds upon disposal	80 000

As market value has been adopted, the valuation date value of the asset must be determined as the lower of

- market value, or
- the time-apportionment base cost (TAB),

of that asset.
Therefore, the lower of

- R120 000, or
- TAB cost = R100 000 + [(R80 000 – R100 000) x (10/(5+10))]
  = R100 000 + (-R20 000 x 2/3)
  = R100 000 – R13 333
  = R86 667

equals R86 667

	R
Proceeds	80 000
Base cost	86 667
Capital loss	(6 667)

In this example para 27 is applicable, as proceeds do not exceed expenditure allowable in terms of para 20 incurred both before and after the valuation date. As the market value has been determined and it exceeds expenditure allowable in terms of para 20 (para 27(3)(*a*) is therefore not applicable) the lower of market value or TAB is the valuation date value to be utilised – per para 27(3)(*b*). The effect is to limit the capital loss to the loss that would be allowable on a time-apportionment basis.

Example 6 – Historical loss and MV loss where MV < pre-1.10.2001 expenditure

Facts: The facts are the same as in Example 1 but the expenditure allowable in terms of para 20 incurred *before* the valuation also exceeds the market value (para 27(3)(*a*) is applicable). Market value of R90 000 had been determined at valuation date.

	R
Expenditure before valuation date	100 000
Market value at valuation date	90 000
Proceeds upon disposal	80 000

The valuation date value of the asset must be determined as the higher of

- market value, or
- those proceeds less the expenditure allowable in terms of para 20 incurred after the valuation date.

Therefore, the higher of
- R90 000, or
- R80 000 (R80 000 – RNil),

equals R90 000.

	R
Proceeds	80 000
Base cost	90 000
Capital loss	(10 000)

In this example para 27 is applicable, as proceeds do not exceed expenditure allowable in terms of para 20 incurred both before and after the valuation date. As the market value has been determined and it does not exceed expenditure allowable in terms of para 20 incurred before the valuation date, the higher of market value or proceeds less expenditure after valuation date is the valuation date value to be utilised.

8.22 Valuation date value of an instrument

Paragraph 28

8.22.1 Some common bond terms

Bond – A bond is debt issued for a period of more than one year. Typically bonds are sold by governments, local governments, electricity and water authorities (e.g. ESKOM) and companies. A person who buys a bond is lending money. From a CGT perspective the lender acquires an asset, being the right to claim the amount lent from the borrower at a future specified date. Interest-bearing bonds usually pay interest twice per year. The market price of bonds fluctuates with prevailing interest rates. When prevailing interest rates fall, the price of bonds rises, and when interest rates rise, the price of bonds falls. For example, if a bond yielding10% p.a. is bought for R100, and a year later the prevailing interest rate falls to 5%, a prospective purchaser of the bond would be prepared to pay R200 for it because the interest produced by the bond (R10) would produce a yield of 5% on a sum of R200.

Clean price – Bond price excluding accrued interest.

Coupon – the periodic interest paid to bondholders during the period of the bond.

Coupon rate – The stated percentage rate of interest, usually paid twice a year.

Mark-to-market – Adjustment of the book or collateral value of a bond to reflect its market value.

'T + 3' – This means that settlement must take place within 3 days of the trade date.

8.22.2 The purpose of para 28

Paragraph 28 provides the rules for determining the *valuation date value* of a s 24J 'instrument'. It does not deal with instruments acquired on or after valuation date – these are dealt with under the core rules (more on this below).

8.22.3 What is an 'instrument'?

An **'instrument'** as defined in s 24J means 'any form of interest-bearing arrangement, whether in writing or not, including—

(*a*) any stock, bond, debenture, bill, promissory note, certificate or similar arrangement;
(*b*) any deposit with a bank or other financial institution;
(*c*) any secured or unsecured loan, advance or debt;
(*d*) any acquisition or disposal of any right to receive interest or the obligation to pay any interest, as the case may be, in terms of any other interest-bearing arrangement; or
(*e*) any repurchase agreement or resale agreement,

which was—

(i) issued or deemed to have been issued after 15 March 1995;
(ii) issued on or before 15 March 1995 and transferred on or after 19 July 1995; or
(iii) in so far as it relates to the holder thereof, issued on or before 15 March 1995 and was unredeemed on 14 March 1996 (excluding any arrangement contemplated in subparagraphs (i) and (ii)),

but excluding any lease agreement (other than a sale and leaseback arrangement as contemplated in section 23G)'.

8.22.4 Methods for determining the valuation date value of an instrument

The two alternative methods that may be used to determine the valuation date value of an instrument are set out in the table below. Unlisted instruments are in addition subject to a loss limitation rule ('kink test').

Table 1 – Methods for determining the valuation date value of an instrument

<table>
<tr><th>Method</th><th colspan="2">How determined</th></tr>
<tr><td>'Adjusted initial amount' on 1.10.2001</td><td colspan="2">The 'adjusted initial amount' is a term defined in s 24J. In essence it is the initial amount paid for the instrument, plus the cumulative amount of all interest accrued and amounts paid less all amounts received from date of acquisition to 1 October 2001.</td></tr>
<tr><td rowspan="4">Market value on 1.10.2001</td><td colspan="2">The price that could have been obtained upon a sale of the instrument between a willing buyer and a willing seller dealing at arm's length in an open market.</td></tr>
<tr><td>Type of instrument</td><td>Date market value determined</td></tr>
<tr><td>• Listed on a recognised exchange</td><td>Last trading day before 1.10.2001</td></tr>
<tr><td>• Other instruments</td><td>Valuation date</td></tr>
</table>

The word 'instrument' as defined in s 24J and used in para 28 must be distinguished from a 'financial instrument', a much wider term defined in s 1. A financial instrument includes not only an instrument, but also other securities such as shares and participatory interests in collective investment schemes. The distinction is important because para 28 overrides the general rules contained in para 29 for determining the market value on valuation date of financial instruments.

Just like para 29, para 28 also uses different dates for determining the price of listed and unlisted instruments (see Table 1 above). As far as the listed instruments are concerned it was not necessary to use a five-day average. The prices of these instruments are determined by prevailing interest rates and it would not have been possible for a single player to manipulate the entire interest rate market in SA prior to valuation date. The market value of listed instruments must be determined on the last trading day before Monday, 1 October 2001. In the case of instruments listed in SA, the last trading day before that date was Friday 28 September 2001. The prices of bonds listed on the Bond Exchange of South

Africa (BESA) were not published in the *Gazette*. However, these prices are available on the BESA website.[116] SARS accepts BESA's T + 3 mark-to-market valuation on 28 September 2001 as the valuation date value of these instruments.

8.22.5 Accrued interest included in the valuation date value of an instrument

The adjusted initial amount or market value of an instrument will usually include accrued interest up to the valuation date. The subsequent receipt of that interest on or after valuation date will constitute a disposal of part of the base cost of that instrument in terms of para 33. Interest received on or after the valuation date that was included in the valuation date value of the instrument will only constitute proceeds where it has not previously been included in gross income (para 35(3)(*a*)). This would have occurred where the instrument was acquired with accrued interest that was only paid on or after the valuation date.

For the treatment of interest received in respect of instruments acquired on or after the valuation date, see the comments below.

8.22.6 Accrued interest included in proceeds

When an instrument is disposed of, the consideration received will frequently include accrued interest up to the date of disposal. Since that accrued interest would be accounted for as part of gross income, it follows that in terms of para 35(3)(*a*) the proceeds must exclude that accrued interest.

8.22.7 Instruments acquired on or after valuation date

The base cost of instruments acquired on or *after* valuation date falls completely outside para 28 and must be determined in accordance with para 20 or 31. The amount paid for the instrument (including any accrued interest at the date of acquisition) will constitute the expenditure actually incurred for the purposes of para 20. In cases such as death (para 40) or donation (para 38), the market value of the instrument acquired must be determined in terms of para 31.

The purchase price of a post-valuation date instrument may frequently include accrued interest. When that interest is received it will constitute proceeds and para 35(3)(*a*) will not apply. The reason for this is that the pre-acquisition interest would not have been included in the acquiror's gross income. Thus the amount included in base cost is matched by the amount included in proceeds and no gain or loss will result.

8.22.8 Identification methods

A person will be entitled to use specific identification or FIFO for the purpose of identifying s 24J instruments that have been disposed of. The weighted average method may also be used but only for listed s 24J instruments. These listed instruments are treated as a separate class of asset under para 32(3A)(*d*). Once weighted average has been adopted, it will have to be applied to all the person's listed instruments.

8.22.9 The unlisted instrument kink test (para 28(2))

Paragraph 28(2) contains its own 'kink' test similar to that contained in para 27 designed to protect the *fiscus* against 'phantom' losses. This loss limitation provision is, however, only

[116] See <http://besa_archive.vddi.co.za/statistics/2001/200109/20010928/mtm.html> (accessed 22 March 2005).

applicable to instruments that are not listed on a recognised exchange. It is considered that the potential for abuse exists mainly with unlisted instruments.

Where a person has adopted the adjusted initial amount of such an instrument as the valuation date value and the proceeds from the disposal of that instrument are less than that amount, the valuation date value of that instrument is the time-apportionment base cost of that instrument. The effect of this rule is to prevent the full amount of a loss incurred before valuation date from being claimed after that date.

Without this provision a person would effectively be entitled to a deduction against income as well as the expenditure being included in base cost in the determination of a capital gain or capital loss. For example, a person could claim the interest portion as a bad debt under s 11(i) and the same amount would be included in base cost. Alternatively, a person would be allowed a deduction for expenditure that has been recovered. This would apply, for example, to interest that had accrued prior to valuation date that is received on or after valuation date.

Example 1 – Determination of adjusted initial amount

Facts: On 31 December 2000 Argh (Pty) Ltd, a company with a financial year end of 30 June, acquired a financial instrument listed on the Bond Exchange of SA with a term of two years at a discount of R1 200 000 to the face value of R10 000 000. Interest is receivable 6-monthly, calculated at 3% of the face value of the instrument. At maturity date, 31 December 2002, the instrument will be redeemed at par.

Result:

Step 1 – Calculation of the yield to maturity

The cash flows may be summarised as follows:

	R
31 December 2000	(8 800 000)
30 June 2001	300 000
31 December 2001	300 000
30 June 2002	300 000
31 December 2002	10 300 000
	2 400 000

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

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

Interest accrued calculated as follows:
R8 800 000 x 6.50308% = R572 271

Step 3 – Calculation of interest accrued up to valuation date

Interest accrued calculated as follows:
(R8 800 000 + R572 271 – R300 000) x 6.50308% x 3/6 = R294 988

Step 4 – Calculation of 'adjusted initial amount' on valuation date

	R
Initial amount paid	8 800 000
Total cash inflows resulting from transactions	(300 000)
Total interest accrued to 30 September 2001	867 259
Adjusted initial amount	9 367 259

Example 2 – Application of the 'kink' test to unlisted instruments

Facts: The facts are the same as in Example 1, except that the financial instrument is an unsecured debenture in Shady Dealings (Pty) Ltd. On 12 September 2001 Shady Dealings informed Argh that it had lost a major customer as a result of the World Trade Centre tragedy and will be suspending all interest and capital repayments until further notice. On 30 April 2002 Shady Dealings is placed in compulsory liquidation, and Argh is informed that concurrent creditors will not receive a dividend.

Result:

Date of investment 31 December 2000
Date of disposal 30 April 2002
Expenditure before valuation date R8 800 000
No of years (including part years) before valuation date: 1
No of years (including part years) after valuation date: 1
Proceeds = RNil
TAB = R8 800 000 + ([R0 – R8 800 000] x 1/(1 + 1))
TAB = R8 800 000 – R4 400 000
TAB = R4 400 000
Capital loss = R0 (proceeds) – R4 400 000 (TAB) = R4 400 000

8.23 Market value on valuation date

Paragraph 29

8.23.1 Introduction

This is a transitional measure and deals with the requirements regarding the valuation of assets on valuation date. (Paragraph 31 contains the permanent market value rules.)

8.23.2 Market value of financial instruments listed in the Republic – para 29(1)(a)(i)

Shares and other financial instruments listed on a recognised exchange in the Republic must be valued on the basis of the volume weighted average price (VWAP). This is achieved by dividing

- the aggregate transaction value (i.e. total selling price) of each financial instrument for the last five business days preceding valuation date, by
- the total quantity of instruments traded during the same period.

Since Monday 24 September was a public holiday and 29 and 30 September 2001 fell on a weekend, the instruments traded from Friday 21 September 2001 to Friday 28 September 2001 were used. The averaging of prices in this way was necessary to ensure that shares were fairly valued on 1 October 2001. This averaging method was adopted to prevent the upward manipulation of share prices (known as 'ramping') by substantial players in the market for the purpose of inflating the base cost of their shares. Share prices can also be distorted, upwards or downwards, at a single moment in time as a result of a thinly traded market.

The necessary calculations were performed and the prices are available to taxpayers in *Government Gazette* 23037 dated 25 January 2002 and on the CGT page of SARS Online (CGT / Information). These values must be used to determine the market value of these instruments.
In certain circumstances the Commissioner, after consultation with the recognised exchange in the Republic and the Financial Services Board, must determine the market value of a financial instrument.

Where
- an instrument was not traded during the last five business days preceding valuation date;
- an instrument is suspended for any period during September 2001; or
- the market value of the instrument for the five days preceding valuation date as determined using the method described in the previous paragraph, exceeds the average of the ruling price of that instrument determined for the first fourteen business days of September 2001 by 5% or more,

the Commissioner must determine the market value of that instrument. The Commissioner must have regard to the actual value of the instrument, and if suspended, the reason for the suspension. If there has been an increase in value above 5%, the Commissioner must consider the reason for the increase. Any decision of the Commissioner in this regard is subject to objection and appeal.

A committee consisting of officials from the JSE Securities Exchange SA, the FSB and SARS reviewed the prices and only one adjustment was made before the final prices were published in the *Gazette* on 25 January 2002 ('Indeqty' was decreased from 219 to 135). Suspended listings are regarded as having a value of zero unless subsequently revised by the Commissioner for SARS upon receipt of a properly motivated representation. Any representation in respect of these instruments must be submitted to the Commissioner at <cgt@sars.gov.za>.

A definition of 'ruling price' of a listed financial instrument is used in a number of subparagraphs in the paragraph instead of the phrase 'last price quoted'.

Kumba and Iscor

The price of Kumba shares is not reflected in the *Gazette* as it was only listed on 26 November 2001. Iscor distributed the Kumba shares to its shareholders as a dividend *in specie* in terms of a pre-valuation date unbundling transaction. SARS and Iscor have agreed on a price for Kumba at 1 October 2001 of R28,04,[117] and it is suggested that taxpayers use this figure. The price of Iscor is as per the *Gazette*, namely, R25,22. For the purposes of para 76, the Kumba distribution constituted a dividend, and hence was not a capital distribution as defined in para 74. If TAB is adopted in valuing the Iscor shares on valuation date, there is no means by which the pre-CGT expenditure in respect of the Iscor shares can be proportionately reduced to account for the Kumba unbundling. Although such a reduction must be made in respect of post-valuation date unbundlings, no adjustment is required for pre-CGT unbundlings as the law stands at present. See commentary in **18.3**.

8.23.3 Financial instruments not listed in the Republic – para 29(1)(a)(ii)

Financial instruments listed on a recognised exchange outside the Republic must be valued at the 'ruling price' on the last business day preceding 1 October 2001. In the case of a dual listing, for example, a share listed on both the JSE and London Stock Exchanges, the price as computed in (a) above must be used.

[117] This agreement was advertised in *Business Day* of 29 January 2002.

The term ‘ruling price’ is defined in para 1. In the case of financial instruments listed on a recognised exchange outside the Republic it means the **last sale price** of that financial instrument at close of business of the exchange, subject to the following:

- Where there is a higher bid or a lower offer on that day subsequent to the last sale, the price of that higher bid or lower offer will prevail.
- If the ruling price is not determined in this manner by that exchange, the **last price quoted** in respect of that financial instrument at close of business of that exchange. The phrase ‘last price quoted’ for a specific day is defined in subparagraph (3)(*a*) as ‘the average of the buying and selling prices quoted at close of business on that day’.

For the meaning of ‘bid’ and ‘offer’ see **4.1**.

8.23.4 South African collective investment schemes in securities and property shares – para 29(1)(b)(i)

These units must be valued according to the price published by the Commissioner in the *Government Gazette,* which is:

- the average of the price at which a unit could be sold to the management company of the scheme (usually the ‘sell’ price quoted in most newspapers);
- for the last five trading days before valuation date.

Units of South African property unit trusts are listed on the JSE and the value of their units will be included with the financial instruments referred to in *(a)* above.

8.23.5 Foreign collective investment schemes – para 29(1)(b)(ii)

These units must be valued according to:

- the last price published before valuation date;
- at which a unit could be sold to the management company of the scheme; or
- where there is not a management company, the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market.

In essence the above requirements are the same as those for local unit trusts except that there is no need to determine a five-day average. SARS for practical reasons cannot publish such prices and taxpayers will have to obtain these themselves, and retain the necessary supporting documents.

8.23.6 Other assets

All other assets must be valued at market value in terms of para 31.

8.23.7 Valuation of controlling interest in listed shares– para 29(2)

A controlling interest in a listed company usually gives the shareholder the right to appoint the board of directors, pass resolutions and generally control the direction of the company. A person acquiring such an interest will usually pay a premium for the privilege, though in some cases it can happen that the shares will be disposed of at a discount. If such an interest were to be valued according to the normal prices quoted on an exchange, the result in most cases would be that the base cost of the shares would be understated. In order to avoid the problems inherent in valuing such an interest on valuation date, the premium or discount must be determined at date of disposal by comparing the actual selling price with the price quoted the day before the announcement of the disposal. This premium or discount would then be applied to the base cost of the shares disposed of.

For this subparagraph to apply, the controlling interest must:

- be held in a listed company;
- exceed 35%;
- be disposed of in its entirety:

and the buyer and seller may not be connected persons.

The formula to be applied is set out in the example below:

Example 1 – Valuation of controlling interest in listed shares

Facts: Sweet Pea Ltd holds 51% of the issued share capital of Pea Ltd, a company listed on the JSE for the past 6 years. Sweet Pea Ltd decides to dispose of its entire interest in Pea Ltd to Oh (Pty) Ltd.

Date of sale	1 October 2002
Total number of Pea Ltd shares held by Sweet Pea Ltd	3 000 000
Last buying price per Pea Ltd share on 30 September 2002 (per JSE)	R1.95
Last selling price per Pea Ltd share on 30 September 2002 (per JSE)	R2.05
Price per share in terms of sale agreement	R2.20
Average price per Pea Ltd share per para 29(1)(*a*)(i)	R1.50

Result:

Step 1 - Calculate market value on valuation date

	R
Valuation date market value (3 000 000 x R1.50)	4 500 000

Step 2 – Calculate control premium or discount

Average last price quoted = (R1.95 + R2.05)/2
= R2.00

$$\text{Base cost adjustment} = \frac{\text{Price per sale agreement} - \text{Last price quoted}}{\text{Last price quoted}}$$

$$= \frac{(R2.20 - R2.00)}{R2.00}$$

$$= 10\%$$

Step 3 – Determine base cost

Control premium R4 500 000 x 10%	450 000
Base cost	4 950 000

Step 4 – Determine capital gain

	R
Proceeds R3 000 000 x R2.20	6 600 000
Base cost	4 950 000
Capital gain	1 650 000

8.23.8 Time limit on obtaining valuations (para 29(4))

A person may only adopt or determine the market value basis for determining the base cost of an asset if

- the person has valued that asset within two years of the 'valuation date' as defined in para 1. For non-exempt persons holding assets on 1 October 2001 the two-year period was extended to 30 September 2004.[118] But tax exempt bodies that lose their tax exempt status must value their assets within two years of losing their exemption if they wish to use the market value method;[119]
- the price of the asset has been published by the Commissioner in terms of para 29 in the *Gazette;; or*
- the person has acquired that asset from his or her spouse in terms of para 67 and the transferor spouse had adopted or determined a market value in terms of para 29. For this purpose the transferee spouse is treated as having adopted or determined the market value adopted or determined by the transferor spouse.

The purpose of excluding assets whose prices were published in the *Gazette* is to relieve taxpayers from the need to determine a market value in respect of those assets. The prices of the following assets were published in the *Gazette*[120] and on the SARS website under CGT / Information:

- SA listed shares
- SA unit trusts
- SA listed warrants
- SA listed agricultural and financial futures.

Although the price of Kruger Rands appears on the SARS website, these prices were not published in the *Gazette* with the result that such assets must have been valued using the prescribed CGT 2 form by a taxpayer wishing to adopt the market value method.

Since para 29(4) only requires valuations for the purposes of paras 26(1)(*a*) and 27(3), it follows that there is no requirement to determine a market value in respect of s 24J interest bearing instruments within the three-year limit. These assets are dealt with in terms of para 28, which contains no time limit. The prices of listed s 24J instruments are, however, available from the SARS website via the link to the BESA website.

8.23.9 Early submission of valuation forms (para 29(5))

Persons wishing to retain the market value method as an option for determining the valuation date value of their pre-valuation date assets are required to complete the prescribed form (CGT 2) by 30 September 2004.

See the notes below under para 29(6) for more information on the CGT 2 form. The general rule is that the form must be submitted with the tax return reflecting the disposal of the asset (para 29(6)) However, where the value of the asset or assets exceeds the amounts set out in the table below, the CGT 2 form must be submitted with the first tax return submitted after 30 September 2004. A non-resident who is not required to lodge a tax return because of an absence of SA source income, and who holds SA immovable property will only be required to submit a return (and the CGT 2 form) when the property is disposed of.

The earlier submission of a CGT 2 form in the case of these high value items will not necessarily bind a person to using market value as a method in the year of disposal of an

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[118] The initial period of two years was extended to 30 September 2004 by the Minister in GN 207 which appeared in *Government Gazette* 26026 dated 20 February 2004.
[119] See para (*a*) of the definition of valuation date in para 1.
[120] *Government Gazette* 23037 dated 25 January 2002.

asset. In other words, as a general rule, the TAB or 20% of proceeds methods remain as alternatives for determining the valuation date value of an asset. However, the completion of the form does mean that the person has ‘determined’ a market value for the purposes of the kink tests in paras 26 and 27. More specifically, a person’s freedom to choose TAB may be precluded where an historical loss has been incurred. For example, if the asset cost R100 m in 1980, had a market value of R50 m on valuation date, and was sold for R70 m in 2005, the valuation date value under para 27 would be R70m (proceeds less post-CGT expenditure). The person would therefore not be permitted to use TAB to generate a time-apportioned capital loss.

Table 1 – High value assets in respect of which proof of valuation must be submitted

Type of asset	Applies	Where market value exceeds
Intangible assets	Per asset	R 1 million
Unlisted shares	All shares held by the shareholder in the company	R10 million
All other assets	Per asset	R10 million

For the purpose of deciding whether the applicable R1million and R10 million limits have been exceeded, it will be acceptable if the market value is translated into rand at the ruling exchange rate on valuation date. The valuation form should be completed in the currency of expenditure and this fact should be indicated on the form. When the asset is disposed of the appropriate exchange rate in terms of para 43(6) should be used in the return of income reflecting the disposal.

Example 2 – Submission date for valuation of high value items

Facts: Andrew owns 10 shares in Enne (Pty) Ltd, a company with a 31 August financial year-end. His accountant carried out a valuation of his shares on 31 August 2003 and valued them at R1.5 million each as at 1 October 2001. The accountant’s valuation of the assets in the company was the following:

Fixtures and fittings	R10 000 000
Goodwill	R2 500 000
Trademarks	R1 700 000
Liquor licence	R800 000

The fixtures and fittings are made up of numerous small items, each valued at less than R200 000.

Enne (Pty) Ltd submitted its return for the year ending 31 August 2003 on 31 August 2004 and obtained an extension to submit its 2004 return by 31 August 2005.

Andrew submitted his return for the year ending 29 February 2004 on 28 February 2005.

Result: Assuming that Andrew and Enne (Pty) Ltd wish to adopt the market value basis for all their assets, proof of valuation must be submitted to SARS in respect of the following assets:

Asset	Reason	Proof to be submitted with return for year ending:
Shares in Enne (Pty) Ltd	MV > R10 million	29 February 2004
Intangible assets		
• Goodwill	MV > R1 million	31 August 2004
• Trademarks	MV > R1 million	31 August 2004

8.23.10 Submission of proof of valuation upon disposal (para 29(6))

8.23.10.1 The general rule

As noted above, para 29(5) contains early valuation form submission requirements in respect of three categories of high value assets. Paragraph 29(6) contains the submission requirements for assets not covered by para 29(5) that have been

- disposed of prior to 30 September 2004, and
- any other asset that has been valued.

There has been some uncertainty as to whether the CGT 2(e) form or its predecessor entitled 'Annexure' must have been signed by the taxpayer on or before 30 September 2004. Paragraph 29(4) requires that the person must have valued the asset within the prescribed period, but does not state that the CGT 2(e) form must be used for this purpose.

Where a person valued an asset on or before 30 September 2004, or obtained a valuation from a third party and did not complete and sign the CGT 2(e) form by 30 September 2004, that person must complete the CGT 2L form. The person must declare that the valuation was performed by 30 September 2004, and where the person obtained a third party valuation by this date, that person must declare that he or she accepted it by that date.
The completion of the CGT 2 form does not mean that a person has elected in advance to adopt the market value method, although the person will be regarded as having 'determined' a market value for the purpose of para 27. In other words, except where para 27 applies, a person will still have the choice of using the time-based apportionment or 20% of proceeds methods.

Taxpayers who backdate or inflate valuations expose themselves to the imposition of additional tax of up to 200% in terms of s 76, interest in terms of s 89quat and criminal prosecution. SARS reserves the right to call for valuations prior to the disposal of the relevant assets.

8.23.10.2 Valuer's signature

The use of a valuer is optional and the lack of a valuer's signature on the CGT 2(e) form will not invalidate the valuation. Where the valuer has signed a separate report, it will be acceptable if the taxpayer cross references the CGT 2(e) form to the relevant report. The CGT 2L form makes provision for the insertion of the date of the valuer's report.

Where a valuer refuses to sign either the CGT 2(e) form or his or her report, the credibility of the valuation will be brought into question.

The CGT 2(e) form will also not be invalidated where a person has not inserted details of the original cost of the asset by the deadline date.

8.23.10.3 Self-generated forms

Some persons have produced their own forms and captured the information electronically. Such self-generated forms will also be regarded as being in the prescribed form provided that they contain the same details as the CGT 2 form.

In other cases where the person has valued numerous assets, it will be acceptable if the person signs a single covering form. The total of the market value of the relevant assets must be inserted on the form and this must agree to a schedule containing the details on the CGT 2 form. The assets on the schedule should be described in sufficient detail to allow for correct identification when individual assets on the list are disposed of.

8.23.10.4 Assets denominated in foreign currency

Where assets are denominated in foreign currency, the valuation must be done in the currency of expenditure in terms of para 43(6). With the exception of para 43(4) assets, rand figures cannot be determined until date of disposal when the currency of disposal is known. For this reason the relevant foreign currency values must be reflected on the form. However, in the case of para 43(4) assets the rand figures can be determined with certainty, and in these cases it will be acceptable if the rand figures are entered on the form. The exchange rate used should be disclosed. Once the asset has been disposed of, the foreign currency values shown on the form must be translated into rand using the applicable exchange rate in terms of para 43(6).

8.23.11 The impact of para 29 on the determination of STC on liquidation or deregistration of a company

Where a company is liquidated or deregistered, s 64B(5)(*c*) provides that where an asset of the company was acquired before valuation date and disposed of after valuation date, any capital profit accruing in respect of the period after the valuation date will be subject to STC, whilst the portion of the capital profit relating to the pre-valuation date period will be exempt from STC. For the purpose of allocating the capital profit between the pre- and post-valuation date periods, the company must determine the market value of the asset on valuation date in terms of para 29. A company that fails to comply with para 29 will be subject to STC on the entire capital profit. Such a company will not be able to adopt the TAB or 20% of proceeds methods for the purpose of splitting the capital profit into exempt and non-exempt portions.

8.23.12 Right of Commissioner to amend valuation or call for further particulars (para 29(7))

Where the Commissioner is not satisfied with a valuation, he may

- call for further particulars relating thereto, or
- adjust the valuation.

The right to adjust the valuation has been made subject to objection and appeal.

8.23.13 Period for performing valuations may be extended by Minister (para 29(8))

The Minister of Finance may extend the period within which all valuations must be performed (that is, by 30 September 2003) by notice in the *Government Gazette*. The period was extended to 30 September 2004.[121]

8.24 Time-apportionment base cost

Paragraph 30

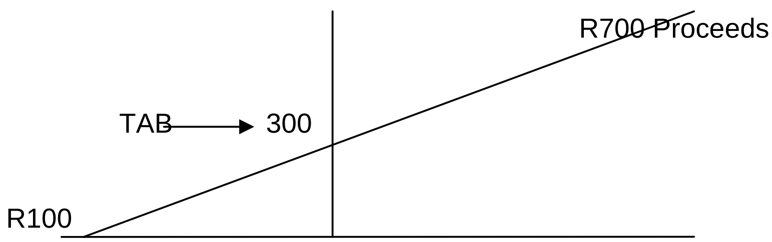
8.24.1 Introduction

Time-based apportionment is one of four methods that may be used for determining the valuation date values of assets acquired prior to valuation date, the other three being the market value method (paras 29 and 31), the weighted average method (para 32(3A)) and

[121] GN 207 *Government Gazette* 26026 of 20 February 2004.

the 20% of proceeds method (para 26). What the time- apportionment base cost method seeks to achieve is a linear spread of the historical gain or loss between the pre- and post-CGT periods. The growth or decline that occurred prior to 1 October 2001 is added to or subtracted from the pre-CGT expenditure to arrive at the time-apportionment base cost (TAB), which constitutes the valuation date value (VDV). To this TAB or VDV is added the expenditure incurred after the valuation date to arrive at the base cost in terms of para 25. The basic principle is illustrated in the simple example below.

Example 1 – Time-apportionment Base Cost (TAB)



Date of acquisition 10 years 20 years

In the above example the asset has been sold for a profit based on historical cost of R600 (R700 – R100). The period before 1 October 2001 is 10 years and the period after 20 years. It follows that two-thirds of the profit relates to the post-CGT period, that is, R600 x 2/3 = 400. This is the short cut method of determining the gain. The other way is to determine the valuation date value (TAB) and to subtract this from the proceeds. The valuation date value is determined by adding the gain relating to the pre-CGT period to the original cost, that is, R100 + (R600 x 1/3) = R300. The capital gain will then be:

	R
Proceeds	700
Base cost (VDV)	300
Capital gain	400

8.24.2 How are expenditure and proceeds determined for the purposes of TAB?

In performing a TAB calculation, the general rule is that pre- and post-valuation date expenditure and proceeds are determined in terms of the core rules in paras 20 and 35. In the case of depreciable assets this means that the relevant costs must be reduced by capital allowances (para 20(3)(*a*)), while the amount received or accrued on disposal of the asset must be reduced by any recoupments of capital allowances (para 35(3)(*a*)). The general rule regarding the exclusion of capital allowances and recoupments from expenditure and proceeds respectively is, however, varied when the special depreciable assets TAB and proceeds formulae (para 30(3) and (4)) are applicable.

8.24.3 Theoretical correctness v simplicity

It needs to be emphasised that the formulae used for determining TAB reflect a trade off between theoretical correctness and administrative simplicity. In many ways the TAB method is a departure from reality that lacks theoretical correctness and this can lead to some distorted results, some in favour of the *fiscus* and others in favour of the taxpayer. The reasons for this include the following:

- The formulae do not take account of the time value of money and compound growth.
- A part of a year is treated as a full year. One day could be treated as a year.

- Improvements to an asset occurred before valuation date are assumed to have taken place at the date of acquisition of the asset
- The date of acquisition is limited to a period 20 years prior to valuation date where expenditure is incurred in more than one year prior to valuation date.

Earlier drafts of the legislation and the first Guide dated 23 February 2000 attempted to address some of these issues by separating the original cost and improvements into segments and applying an inflation factor to each segment. This was discarded after public consultation for reasons of complexity.

It must also be borne in mind that TAB can only be determined once an asset has been disposed of. The longer the asset is held the greater the proportion of the gain or loss that will be spread into the post-CGT period. Similarly, the more improvements that take place to an asset after valuation date, the greater the proportion of the proceeds and hence gain that will be allocated to the post-CGT period. These factors can make it difficult to predict how TAB will compare with the market value of an asset on 1 October 2001.

A taxpayer who has made a loss based on historical cost may either be prevented from or obliged to use TAB depending on the circumstances. For example, a taxpayer falling within the provisions of para 27(3)(*a*) who has made a gain on market value after 1 October 2001, may not use TAB but at the same time will not be subject to CGT on the market value gain. In other cases para 27(3)(*b*) compels a taxpayer to use TAB instead of market value. This could typically occur where a market value loss is substantially greater than a TAB loss. For more information on the operation of the gain and loss limitation rules see **8.19** and **8.20**.

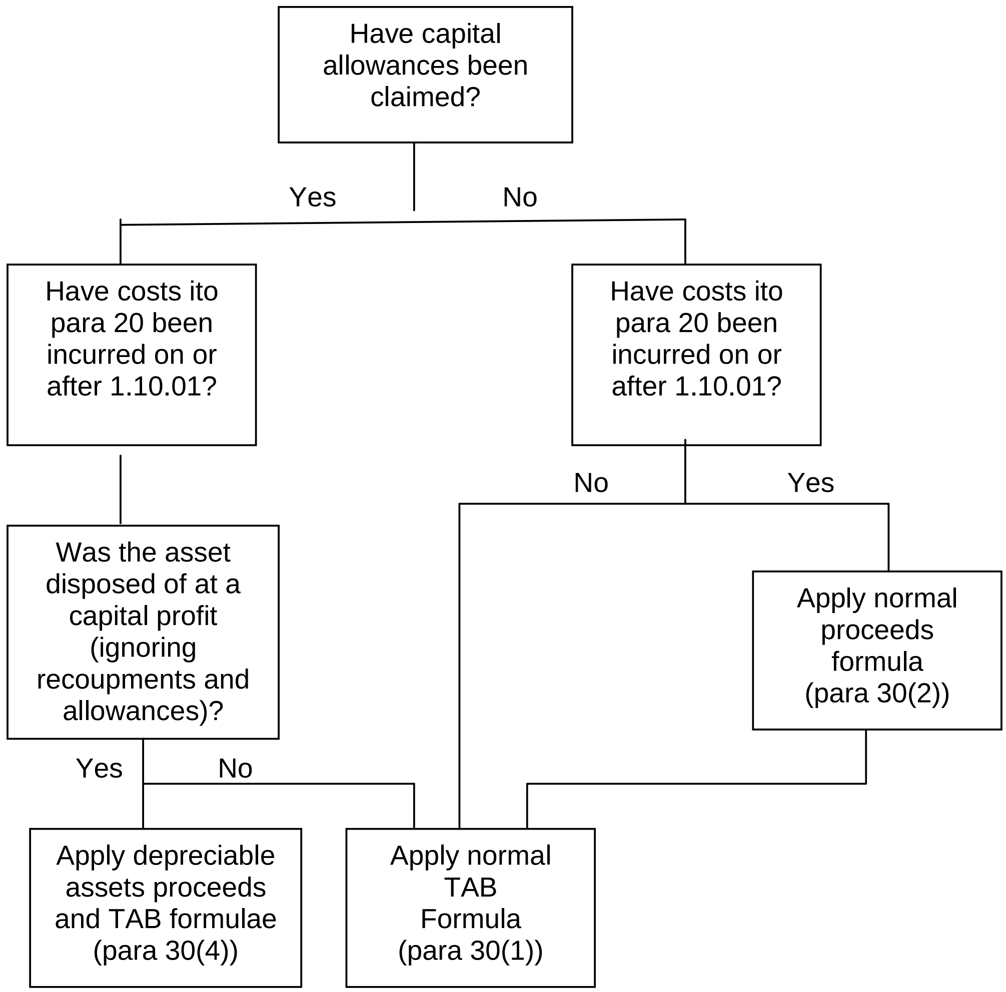
8.24.4 The formulae

Paragraph 30 contains two sets of formulae:

- the standard TAB and proceeds formulae – para 30(1) and (2), and
- the depreciable assets TAB and proceeds formulae – para 30(3) and (4).

The diagram below shows how the applicable formulae must be selected to fit the appropriate circumstances.

Selecting the appropriate formula



8.24.5 The standard TAB formula (para 30(1))

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

where

(*a*) 'Y' = time-apportionment base cost (TAB)

(*b*) 'B' = pre-1 October 2001 admissible expenditure in terms of para 20. Admissible expenditure must be reduced by capital allowances claimed as a deduction for income tax purposes (para 20(3)(*a*)).

(*c*) 'P' = proceeds on disposal of the asset as determined in para 35. Note that
- In the case of assets subject to capital allowances proceeds must be reduced by any recoupments included in gross income (para 35(3)(*a*)).
- ‘P’ must be determined in accordance with the proceeds formula below where improvements occur before and after valuation date.

(*d*) 'N' = number of years determined from the date that the asset was acquired to the day before valuation date. Note that
- ‘N’ is limited to a maximum of 20 where improvements have occurred prior to valuation date

- A part of a year is treated as a full year.

(*e*) 'T' = number of years determined from valuation date until the date the asset was disposed of after valuation date. Again, a part of a year is treated as a full year.

8.24.5.1 The twenty year limit

Where improvements to an asset take place before valuation date, they are 'thrown back' to the date of acquisition. This measure was introduced in preference to the slice method discussed earlier in terms of which improvements would have been inflation-weighted. As a result of this concession it was necessary to place a cap on how far back these improvements could be taken. If this were not done, one could arrive at the situation where, say, a piece of land was acquired 100 years prior to valuation date, a shopping centre was erected thereon shortly before valuation date, and then sold say 5 years after valuation date at a substantial gain. Without the 20 year limit only 5/105 of the gain would be subject to CGT. With the limit 5/25 will be taxable – still a substantial benefit though not nearly as generous. Where all pre-valuation date expenditure is incurred in a single year, there is no limit. So if the 100-year-old land were sold 5 years after CGT was introduced without improvement, only 5/105 of the gain would attract CGT. The 20-year limit will also not be triggered where improvements take place after valuation date, though in this case a portion of the proceeds will be allocated to the post-CGT period (see proceeds formula below).

8.24.5.2 Parts of a year

As noted above, parts of a year are treated as a full year. For example, if an asset was acquired 3 years and 1 day prior to valuation date, 'N' will be treated as 4 years. Likewise if the asset was disposed of three years and 1 day after valuation date, 'T' will be treated as 4 years. This treatment is intended to eliminate the need for complex fractions, and assists where the exact day on which an asset was purchased is unknown.

8.24.6 The standard proceeds formula (para 30(2))

The symbol 'P' in the above TAB formula must be determined in accordance with the following formula where expenditure is incurred both before and on or after valuation date.

The proceeds formula is based on the premise that

- post-valuation date expenditure generates post-valuation date gain or loss, while
- pre-valuation date expenditure generates gain or loss both before and on or after valuation date.

The formula, set out below, is applicable more often than may at first sight be apparent. The table below shows two examples of selling expenses that could trigger the proceeds formula.

Table 1 – Examples of post-valuation date expenditure that will trigger the proceeds formula

Type of asset	Typical selling expense
Share	Stamp duty, UST and broker's fees
Residence	Estate agent's commission

It is not permissible for these expenses to be set off against the gross proceeds and to work with a net proceeds figure.

8.24.6.1 No right of election to omit post-valuation date expenditure

The proceeds formula has the effect that the higher the post-valuation date expenditure in relation to the pre-valuation date expenditure, the higher the capital gain or loss. Some have suggested that a person can achieve a lower capital gain by simply omitting the post-valuation date expenditure from the formula. The view is held that a person does not have the right to omit post-valuation date expenditure from the proceeds formula in para 30(2), nor from the general formula in para 25 for determining a capital gain or loss in respect of a pre-valuation date asset. The reasons for this are as follows:

- The formulae and their variables are prescribed by statute. There is nothing in the Act that confers a right of election upon a taxpayer to pick and choose what to include or exclude from the variables. It would defeat the purpose of the legislature if SARS were to allow cherry picking.
- The variable ‘A’ in the formula refers to expenditure ‘allowable’ in terms of paragraph 20 incurred on or after the valuation date. The word ‘allowable’ refers to qualifying expenditure. If expenditure has been incurred and it qualifies then it must be brought to account.
- Taxpayers are obliged to keep a record of post-valuation date expenditure in terms of section 73B of the Act. A person who fails to comply with this provision may be liable to a fine or imprisonment in terms of s 75(1)(*f*).
- Finally, a taxpayer who deliberately omits post-valuation date expenditure from the formulae with the object of understating a capital gain will be open to a charge of tax evasion and the imposition of additional tax and interest in terms of ss 76 and 89*quat* respectively.

8.24.6.2 Payment of commission by buyer

It has been suggested that in the case of a sale of immovable property, the transaction should be restructured so that the buyer pays the estate agent’s commission. Such arrangements may fall foul of s 103, particularly where the seller’s original mandate to the agent was on the basis that the seller would pay the commission. Note that for transfer duty purposes the commission must be added back to the consideration payable in determining the amount of the duty.[122]

8.24.6.3 The proceeds formula

The proceeds formula is as follows:

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

where
(*a*) 'P' = proceeds to be used in the TAB formula
(*b*) 'R' = proceeds as determined in terms of para 35
(*c*) 'A' = admissible expenditure incurred on or after 1 October 2001 in terms of para 20.
(*d*) 'B' = pre-1 October 2001 admissible expenditure in terms of para 20.
Note: ‘A’ and ‘B’ exclude any capital allowances and ‘P’ excludes any recoupments included in gross income.

[122] Section 6(*a*) of the Transfer Duty Act 40 of 1949.

8.24.7 When to apply the standard formulae

Table 1 - Summary of application of TAB formulae

How expenditure incurred	Application
During a single year of assessment before 1.10.2001	Use TAB formula. No limit on period before 1.10.2001
In more than one year of assessment before 1.10.2001	Use TAB formula. Period before 1.10.2001 limited to 20 years
Before, and on or after 1.10.2001	Use proceeds formula and thereafter TAB formula

8.24.8 Counting of years

In determining whether expenditure has been incurred in more than one year, regard must be had to *years of assessment*. However, in determining the number of years prior to and after valuation date (N and T in the formula) the years are determined as follows:

- Pre-1 October 2001 – start at date of acquisition and count completed years up to and including 30 September 2001. The final part year up to and including 30 September 2001 is counted as a full year;
- Post-1 October 2001 – start at 1 October 2001 and count number of completed years ended 30 September up to and including the date of disposal. The final part year immediately preceding the date of disposal is counted as a full year.

8.24.9 Calculations must be made per asset

The formulae must be applied to each asset separately. It is unacceptable to perform a calculation lumping different assets together. For example, a factory may be disposed of for a lump sum, but the proceeds will have to be allocated across the buildings, plant and machinery etc and separate calculations will have to be determined for each of the assets concerned.

Example 2 – TAB: No improvements made prior to valuation date

Facts: Barbara acquired a piece of land in Johannesburg 30 years prior to the valuation date for R200 000 and disposed of that piece of land 10 years after the valuation date for R2 000 000. Barbara incurred no other expenditure allowable in terms of para 20 during her ownership of the land and as she had not valued the land at valuation date, she adopted the time-apportionment basis in determining the valuation date value.

Result: The capital gain that arises in Barbara's hands is determined as follows.

Applying para 30(1):

Y = B + [(P – B) x (N / (T + N))]
= R200 000 + [(R2 000 000 – R200 000) x (30 / (10 + 30))]
= R200 000 + (R1 800 000 x 30/40)
= R200 000 + R1 350 000
= R1 550 000

Therefore, the time-apportionment base cost (TAB) equals R1 550 000.

	R
Proceeds	2 000 000
TAB cost	1 550 000
Capital gain	450 000

Note that where expenditure was incurred in only one year of assessment prior to the valuation date, 'N', in the above formula, is not limited to 20 years. Where Barbara had made improvements after the valuation date, for instance by building a shopping centre, this would not have affected the valuation date value in terms of the time-apportionment base cost. Expenditure incurred after the valuation date would be added to the valuation date value in terms of para 25 in order to determine the base cost of the asset.

Example 3 - TAB: Improvements made in > 1 year prior to 1.10.2001 plus after 1.10.2001

Facts: The facts are the same as in the example above, except that Barbara erected a shopping centre upon her piece of land, 2 years before the valuation date for R5 000 000 and one year after the valuation date she effected improvements to the shopping complex amounting to R1 000 000. She disposed of the shopping complex along with the land 10 years after the valuation date for R12 000 000.

Result: As a portion of the expenditure allowable in terms of para 20 was incurred both before and on or after the valuation date, the proceeds to be used in determining the TAB cost must be determined in accordance with the formula contained in para 30(2).

P = R x (B / (A + B))
= R12 000 000 x [(R200 000 + R5 000 000) / (R1 000 000 + (R200 000 + R5 000 000))]
= R12 000 000 x (R5 200 000 / R6 200 000)
= R12 000 000 x 0.8387
= R10 064 516

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

Paragraph 30(1) is then applied as follows:

Y = B + [(P – B) x (N / (T + N))]
= (R200 000 + R5 000 000) + [(R10 064 516 – (R200 000 + R5 000 000)) x (20 / (10 + 20))]
= R5 200 000 + [(R10 064 516 – R5 200 000) x 20/30]
= R5 200 000 + R3 243 011
= R8 443 011

Therefore, the time-apportionment valuation date value (VDV) equals R8 443 011.

	R	
Proceeds	12 000 000	
Time-app. VDV + Post-expenditure	9 443 011	(R8 443 011 + R1 000 000)
Capital gain	2 556 989	

Note that where expenditure was incurred in more than one year of assessment prior to the valuation date, 'N', in the above formula, is limited to 20 years. In this example, Barbara loses 10 years in respect of her piece of land. However, this also means that although the major portion of her allowable expenditure relates to a period shortly before the valuation

date, this too is spread back to the date of the first allowable expense forming the base cost of the asset. (In this case, it is spread back 18 years).
An alternative simpler explanation is set out below:

Facts

Pre – CGT costs	R
Original cost	200 000
Shopping centre	5 000 000
Post-CGT costs	
Improvements	1 000 000
Selling price	12 000 000

The figures in blocks have to be determined:

	Before	After	Total
	R	R	R
Proceeds	$\boxed{10\ 064\ 516}$		12 000 000
Expenditure	5 200 000	1 000 000	6 200 000
Gain	$\boxed{4\ 864\ 516}$		5 800 000

Apportion by time

Step 1: Calculate portion of proceeds generated by pre-CGT expenditure

$$\text{Proceeds} \times \frac{\text{Expenditure before CGT}}{\text{Total expenditure}}$$

= R12 000 000 x R5 200 000/R6 200 000
= R10 064 516

Step 2: Determine portion of gain generated by pre-CGT expenditure

	R
Proceeds generated by pre-CGT expenditure	10 064 516
Pre-CGT expenditure	5 200 000
Gain generated by pre-CGT expenditure	4 864 516

Step 3: Time-apportion gain before CGT

$$\text{Gain before CGT} \times \frac{\text{Period before CGT}}{\text{Total period}}$$

R4 864 516 x 20/30 = R3 243 011

Step 4: Calculate valuation date value

VDV = Expenditure before CGT + Pre-CGT portion of gain
= R5 200 000 + R3 243 011
= R8 443 011

Step 5: Calculate base cost

Base cost = R8 443 011 + R1 000 000 = R9 443 011

Step 6: Calculate capital gain

Capital Gain = R12 000 000 – R9 443 011 = R2 556 989

8.24.10 The depreciable assets TAB and proceeds formulae (para 30(3) and (4))

Where expenditure has been incurred both before, and on or after the valuation date, and the asset qualifies for capital allowances, the portion of the capital gain to be allocated to the post-valuation date period can be influenced by the speed with which the expenditure has been written off against income. As a result, for example, where the entire amount of the expenditure incurred before valuation date has been written off against income, the entire gain will be thrown into the post-valuation date period. This results in an inequitable apportionment of the gain. To rectify this problem an additional formula was introduced to cater for such circumstances.[123] In terms of this formula the apportionment of the gain is determined by excluding recoupments and capital allowances from certain variables in the TAB formula. Paragraph 30(3) sets out the conditions under which the 'depreciable asset formula' is applicable.

8.24.10.1 Conditions under which the depreciable assets TAB and proceeds formulae will apply (para 30(3))

Three conditions must be met:

- Ignoring capital allowances, expenditure must have been incurred on or after the valuation date.
- The asset must be a depreciable asset in respect of which capital allowances were claimed.
- The proceeds (not reduced by recoupments) must exceed the expenditure (not reduced by capital allowances) – in other words the asset must have been disposed of at an overall capital profit.

8.24.10.2 The formulae

The formulae, which appear in subpara (4), are as follows:

$$Y = B + \frac{(P_1 - B_1) \times N}{T + N},$$

and

$$P_1 = \frac{R_1 \times B_1}{(A_1 + B_1)}$$

The gain applicable to the pre-CGT period is determined by means of a two-step process.

Step 1 – Apply the depreciable assets proceeds formula

First, the portion of the 'receipts' (proceeds not reduced by recoupments) generated by the expenditure incurred before valuation date is determined. This is done by multiplying those

[123] Introduced by the Revenue Laws Amendment Act 74 of 2002, effective as from 1 October 2001.

'receipts' by the costs incurred before valuation date, divided by the total cost of the asset. Note that the costs used in this calculation are not reduced by capital allowances.

Next, the gain generated by those pre-CGT expenses is apportioned between the pre- and post-valuation date periods on a time basis. This gives the gain applicable to the pre-CGT period, which is then added to 'B' in the formula (pre-valuation date expenditure reduced by capital allowances) to give the time-apportionment base cost of the asset.

Finally, the provisions of para 25 are applied in the normal way in determining a capital gain, taking recoupments and capital allowances into account. The example below illustrates the application of the formula.

Example 4 – Determination of TAB using the depreciable assets TAB and proceeds formulae

Facts: The following facts pertain to an asset subject to capital allowances:

	Pre-1.10.01	Post-1.10.01	Total
	R	R	R
Cost	100	200	300
Capital allowances	100	20	120
Expenditure ito para 20	0	180	180
Period (years)	10	5	15
Received on disposal	321		
Recouped ito s 8(4)(*a*)	120		
Proceeds ito para 35	201		

Result: The capital gain will be determined as follows:

Step 1 – Determine whether the depreciable asset TAB and proceeds formulae are applicable

The asset in the example meets all the necessary requirements:

- Expenditure before 1.10.01 = R100; and on or after 1.10.01 = R200;
- Capital allowances of R100 were claimed;
- There is an overall profit of R321 – R300 = R21

Step 2 – Determine the receipts generated by pre-CGT costs

$$P_1 = R_1 \times \frac{B_1}{(A_1 + B_1)}$$

= R321 x R100/(R100 + R200)
= R321 x R100/R300
= R107

Step 3 – Apply the depreciable assets TAB formula

$$Y = B + \frac{[(P_1 - B_1) \times N]}{T + N},$$

= R0 + [(R107 – R100) x 10/(10 + 5)]

= R0 + R7 x 10/15
= R4.6667

Step 4 – Determine the capital gain

Capital gain = Proceeds – [TAB + expenditure incurred on or after 1.10.01)
= R201 – (R4.6667 + R180)
= R201 – R184.6667
= R16.3333

Note that the normal rules are applied under step 3 so proceeds are reduced by recoupments and expenditure on or after 1 October 2001 is reduced by capital allowances.

In summary, had the gain been worked out under the standard formulae, the entire gain would have been allocated to the post-valuation date period and the person would have paid CGT on a gain of R21. The depreciable assets TAB and proceeds formulae therefore provide a far more equitable spread of the gain.

8.25 Market value

Paragraph 31, s 23C

8.25.1 Introduction

Paragraph 29 contains special rules for determining the market value of certain assets on valuation date. These special rules do not cover all assets and are essentially an anti-avoidance measure aimed at selected assets whose values are susceptible to manipulation. Paragraph 31 provides the general rules on how 'market value' is to be determined in respect of those assets not covered by para 29 as well as in other situations. The term 'market value' is used throughout the Eighth Schedule in a wide variety of circumstances, such as on valuation date (base cost), death, donation, cessation or commencement of residence and non–arms' length transactions between connected persons. These general rules are summarised in the table below. In determining market value, s 23C provides that no account must be taken of value-added tax where the vendor was entitled to an input tax credit in terms of s 16(3) of the Value-Added Tax Act, 1991. Where a vendor is not entitled to claim an input credit or in the case of non-vendors, VAT may be included when determining market value.

8.25.2 Prescribed valuation methods

Table 1 – Prescribed methods for determining market value (para 31)

Paragraph 31(1) item	**Type of asset**	**Market value**
(*a*)	Financial instrument listed on a recognised exchange for which a price is quoted	Ruling price[124] at close of business on last business day before disposal
(*b*)	Long-term insurance policy with SA insurer	Greater of: • Surrender value • Insurer's market value (assume policy runs to maturity).

[124] As defined in para 1 of the Eighth Schedule.

(*c*)(i)	Portfolio comprised in any collective investment scheme In securities[125] or property.[126]	Management company's repurchase price.
(*c*)(ii)	Foreign collective investment scheme in shares, units or any other form of participatory interest.[127]	Management company's repurchase price or if not available, selling price based on willing buyer, willing seller acting at arm's length in open market.
(*d*)	Fiduciary, usufructuary and other like interests	Present value of future benefits discounted at 12% p.a. over life expectancy of person to whom interest granted or lesser period of enjoyment. Commissioner may fix another rate when satisfied that 12% cannot be achieved. Life expectancy is determined as follows: • Individuals - in accordance with tables used for estate duty purposes.[128] • Other persons (e.g. companies or trusts) - 50 years.
(*e*)	Asset subject to fiduciary, usufructuary or other like interest	Market value of full ownership, less value of fideicommissum or usufruct etc as determined above.
(*f*)	Immovable farming property	• Land Bank value (defined in Estate Duty Act) or • Price based on willing buyer, willing seller at arm's length in open market. On disposal by death, donation or non-arm's length transaction, the Land Bank value may only be used if it is used in determining the base cost of the disposer on- • Valuation date, or, where applicable, • date acquired by inheritance, donation or non-arm's length transaction at Land Bank value.
(*g*)	Any other asset	Price based on willing buyer, willing seller at arm's length in open market.
	Unlisted shares	Price based on willing buyer, willing seller at arm's length in open market, ignoring any: • Restrictions on transferability • Stipulated method of valuation.[129] If shareholder entitled to greater share of assets on winding-up, the value must not be less than the amount the shareholder would have received had the company been wound up.

125 As defined in para (*e*)(i) of the definition of 'company' in s 1, and as contemplated in Part IV of the Collective Investment Schemes Control Act 45 of 2002.
126 As contemplated in Part V of the Collective Investment Schemes Control Act 45 of 2002.
127 As defined in para (*e*)(ii) of the definition of 'company' in s 1.
128 See regulations issued in terms of s 29 of the Estate Duty Act 45 of 1955.
129 This provision is similar to that found in s 5(1)(*f*)*bis* of the Estate Duty Act 45 of 1955.

8.25.3 *Determination of market value*

The market value of an asset is the best price at which an interest in the asset would have been sold unconditionally for a cash consideration on the date of valuation assuming

- a willing seller (under no duress at all)
- that, prior to the date of valuation, there had been a reasonable period (having regard to the nature of the asset and the state of the market) for the proper marketing of the interest and for the sale to be concluded;
- that no account is taken of any additional bid by a prospective purchaser with a special interest;
- a sale either
    - of the asset as a whole for use in its working place; or
    - of the asset as a whole for removal from the premises of the seller at the expense of the purchaser; or
    - of individual items for removal from the premises of the seller at the expense of the purchaser; and
- that both parties to the transaction had acted knowledgeably, prudently and without compulsion.

8.25.4 *Valuation of foreign insurance policies*

Paragraph 31(1)(*b*) deals with long-term policies issued by a South African insurer. See in this regard the meaning of the word 'insurer' as defined in para 1 and the related commentary on para 55 in **12.4**. Foreign policies must therefore be valued in accordance with the general rule in para 31(1)(*g*).

8.25.5 *Valuation of shares held in co-operatives*

The Co-operatives Act 91 of 1981 (the Co-op Act) governs the activities of co-operatives. Should a member of a co-operative die, be sequestrated, resign, be expelled or cease to qualify as a member that member will only be entitled to a return of the nominal value of the shares.[130] This raises the question as to how the provisions of para 31(3)(*a*) are to be applied, given that any provision relating to the restriction of transferability of shares and the determination of value must be disregarded.

A member's entitlement to the profits is not linked to the shares held but rather to the volume of business done through or with the co-operative (referred to as the 'patronage proportion'[131]). See In this regard s 84 (members' entitlement to bonuses) and s 224(4)(*a*) (members' entitlement to the free residue on liquidation). It is therefore considered inappropriate to look at the underlying assets to determine the value of a member's shares in a co-operative, and they must be valued on the same basis used for estate duty purposes, namely, at nominal value.

8.25.6 *Life expectancy tables*

GNR.1942 of 23 September 1977: Valuation of annuities or of fiduciary, usufructuary or other limited interests in property in the estates of deceased persons (R)

NOTE: These regulations were published in *Government Notice* No. R1942 contained in *Regulation Gazette* No. 2533 of 23 September, 1977.

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[130] Section 81(1)(*a*) – (*f*)) of the Co-operatives Act 91 of 1981.
[131] As defined in s 1 of the Co-operatives Act 91 of 1981.

Calculations for the purposes of the valuation of annuities or of fiduciary, usufructuary or other limited interests in property in the estate of any person who died or dies on or after 1 April 1977 shall be made in accordance with the Tables subjoined hereto:

(The regulations promulgated under Government Notice 641 of 13 April 1956 shall continue to apply in relation to the estate of any person who died before 1 April 1977.)

Table A

The Expectation of Life and the Present Value of R1 per Annum for Life Capitalised at 12 per cent over the Expectation of Life of Males and Females of Various Ages

	Expectation of Life		**Present value of R1 Per Annum for Life**		
Age	**Males**	**Females**	**Males**	**Females**	**Age**
0	64,74	72,36	8,327 91	8,331 05	0
1	65,37	72,74	8,328 28	8,331 14	1
2	64,50	71,87	8,327 76	8,330 91	2
3	63,57	70,93	8,327 14	8,330 64	3
4	62,63	69,97	8,326 44	8,330 33	4
5	61,69	69,02	8,325 67	8,329 99	5
6	60,74	68,06	8,324 80	8,329 61	6
7	59,78	67,09	8,323 81	8,329 18	7
8	58,81	66,11	8,322 71	8,328 69	8
9	57,83	65,14	8,321 46	8,328 15	9
10	56,85	64,15	8,320 07	8,327 53	10
11	55,86	63,16	8,318 49	8,326 84	11
12	54,87	62,18	8,316 73	8,326 08	12
13	53,90	61,19	8,314 80	8,325 22	13
14	52,93	60,21	8,312 65	8,324 27	14
15	51,98	59,23	8,310 29	8,323 20	15
16	51,04	58,26	8,307 70	8,322 03	16
17	50,12	57,29	8,304 89	8,320 71	17
18	49,21	56,33	8,301 80	8,319 26	18
19	48,31	55,37	8,298 41	8,317 64	19
20	47,42	54,41	8,294 71	8,315 84	20
21	46,53	53,45	8,290 61	8,313 83	21
22	45,65	52,50	8,286 13	8,311 61	22
23	44,77	51,54	8,281 17	8,309 12	23
24	43,88	50,58	8,275 64	8,306 33	24
25	43,00	49,63	8,269 59	8,303 26	25
26	42,10	48,67	8,262 74	8,299 81	26
27	41,20	47,71	8,255 16	8,295 95	27
28	40,30	46,76	8,246 77	8,291 71	28
29	39,39	45,81	8,237 37	8,286 97	29
30	38,48	44,86	8,226 94	8,281 70	30
31	37,57	43,91	8,215 38	8,275 83	31

32	36,66	42,96	8,202 57	8,269 30	32
33	35,75	42,02	8,188 36	8,262 10	33
34	34,84	41,07	8,172 62	8,254 00	34
35	33,94	40,13	8,155 36	8,245 09	35
36	33,05	39,19	8,136 47	8,235 17	36
37	32,16	38,26	8,115 58	8,224 26	37
38	31,28	37,32	8,092 74	8,211 99	38
39	30,41	36,40	8,067 81	8,198 66	39
40	29,54	35,48	8,040 30	8,183 86	40
41	28,69	34,57	8,010 67	8,167 62	41
42	27,85	33,67	7,978 44	8,149 83	42
43	27,02	32,77	7,943 44	8,130 12	43
44	26,20	31,89	7,905 47	8,108 81	44
45	25,38	31,01	7,863 80	8,085 27	45
46	24,58	30,14	7,819 24	8,059 56	46
47	23,79	29,27	7,771 09	8,031 19	47
48	23,00	28,41	7,718 43	8,000 26	48
49	22,23	27,55	7,662 36	7,966 17	49
50	21,47	26,71	7,602 01	7,929 50	50
51	20,72	25,88	7,537 13	7,889 67	51
52	19,98	25,06	7,467 48	7,846 46	52
53	19,26	24,25	7,393 87	7,799 65	53
54	18,56	23,44	7,316 31	7,748 34	54
55	17,86	22,65	7,232 34	7,693 55	55
56	17,18	21,86	7,144 14	7,633 63	56
57	16,52	21,08	7,051 78	7,568 96	57
58	15,86	20,31	6,952 25	7,499 27	58
59	15,23	19,54	6,850 04	7,423 21	59
60	14,61	18,78	6,742 06	7,341 35	60
61	14,01	18,04	6,630 10	7,254 57	61
62	13,42	17,30	6,512 32	7,160 20	62
63	12,86	16,58	6,393 01	7,060 46	63
64	12,31	15,88	6,268 22	6,955 37	64
65	11,77	15,18	6,137 89	6,841 61	65
66	11,26	14,51	6,007 26	6,723 93	66
67	10,76	13,85	5,871 65	6,598 93	67
68	10,28	13,20	5,734 03	6,466 35	68
69	9,81	12,57	5,591 82	6,328 18	69
70	9,37	11,96	5,451 65	6,184 66	70
71	8,94	11,37	5,307 75	6,036 07	71
72	8,54	10,80	5,167 44	5,882 78	72
73	8,15	10,24	5,024 37	5,722 22	73
74	7,77	9,70	4,878 76	5,557 43	74
75	7,41	9,18	4,734 90	5,388 93	75

76	7,07	8,68	4,593 54	5,217 27	76
77	6,73	8,21	4,446 63	5,046 79	77
78	6,41	7,75	4,303 09	4,870 92	78
79	6,10	7,31	4,158 98	4,693 89	79
80	5,82	6,89	4,024 40	4,516 47	80
81	5,55	6,50	3,890 51	4,343 99	81
82	5,31	6,13	3,768 02	4,173 15	82
83	5,09	5,78	3,652 76	4,004 82	83
84	4,89	5,45	3,545 46	3,839 88	84
85	4,72	5,14	3,452 32	3,679 21	85
86	4,57	4,85	3,368 64	3,523 71	86
87	4,45	4,58	3,300 66	3,374 26	87
88	4,36	4,33	3,249 07	3,231 75	88
89	4,32	4,11	3,225 97	3,102 96	89
90*	4,30	3,92	3,214 38	2,989 12	90

*

N.B. The age is to be taken as at the next birthday after the date when the right was acquired.

Example.—Find the present value of an annuity or usufruct of R100 per annum for life of:
(A) a female who becomes entitled thereto at the age of 42 years 3 months, or
(B) a male who becomes entitled thereto at the age of 65 years 9 months.

	(A)	**(B)**
Age when acquired	42 years 3 months	65 years 9 months
Age next birthday	43 years	66 years
Present value of R1 per annum for life	R8,130 12	R6,007 26
Therefore present value of R100 per annum for life equals	R813,01	R600,73

Table B

Present Value of R1 per Annum Capitalised at 12 per cent over Fixed Periods.

Years.	**Amount.**	**Years.**	**Amount.**	**Years.**	**Amount.**	**Years.**	**Amount.**
	R		R		R		R
1	0,892 9	26	7,895 7	51	8,307 6	76	8,331 8
2	1,690 0	27	7,942 6	52	8,310 4	77	8,332 0
3	2,401 8	28	7,984 4	53	8,312 8	78	8,332 1
4	3,037 4	29	8,021 8	54	8,315 0	79	8,332 3
5	3,604 8	30	8,055 2	55	8,317 0	80	8,332 4
6	4,111 4	31	8,085 0	56	8,318 7	81	8,332 5
7	4,563 8	32	8,111 6	57	8,320 3	82	8,332 6
8	4,967 6	33	8,135 4	58	8,321 7	83	8,332 6
9	5,328 2	34	8,156 6	59	8,322 9	84	8,332 7
10	5,650 2	35	8,175 5	60	8,324 0	85	8,332 8
11	5,937 7	36	8,192 4	61	8,325 0	86	8,332 8

12	6,194 4	37	8,207 5	62	8,325 9	87	8,332 9
13	6,423 6	38	8,221 0	63	8,326 7	88	8,333 0
14	6,628 2	39	8,233 0	64	8,327 4	89	8,333 0
15	6,810 9	40	8,243 8	65	8,328 1	90	8,333 0
16	6,974 0	41	8,253 4	66	8,328 6	91	8,333 1
17	7,119 6	42	8,261 9	67	8,329 1	92	8,333 1
18	7,249 7	43	8,269 6	68	8,329 6	93	8,333 1
19	7,365 8	44	8,276 4	69	8,330 0	94	8,333 1
20	7,469 4	45	8,282 5	70	8,330 3	95	8,333 2
21	7,562 0	46	8,288 0	71	8,330 7	96	8,333 2
22	7,644 6	47	8,292 8	72	8,331 0	97	8,333 2
23	7,718 4	48	8,297 2	73	8,331 2	98	8,333 2
24	7,784 3	49	8,301 0	74	8,331 4	99	8,333 2
25	7,843 1	50	8,304 5	75	8,331 6	100	8,333 2

N.B. Fractions of a year are to be disregarded when using this table.

Example.—Testator, who died on 1 April 1977 left to (A) an annuity or usufruct value R100 per annum, to terminate when (A) attains majority, which will occur, say, at 30 September 1987. This period is found to be 10 years 6 months, but is taken as 10 years.

Present value of R1 per annum for 10 years R5,650 2
Therefore present value of R100 per annum for 10 years R565,02

8.26 Base cost of identical assets

Paragraph 32

8.26.1 What are identical assets?

Paragraph 32 contains the rules for the determination of the base cost of assets that form part of a group of similar assets. Such assets are sometimes referred to as fungible assets. When an asset of this nature is sold it may not be possible to physically identify the particular asset that is being disposed of. Hence it is necessary to lay down identification rules. Examples include Kruger Rands, participatory interests in portfolios of collective investment schemes and shares.

A dual test has been devised in para 32(2) to identify these assets:

- First, if any one of the assets in a particular holding were to be sold, it would realise the same amount as any one of the other assets in that holding.
- Secondly, all the assets in the group must share the same characteristics.

Example 1 – Separate holdings of identical assets

The following would each constitute a separate holding of identical assets:

- all A class ordinary shares in Elle Ltd
- all B class ordinary shares in Elle Ltd
- all 12% preference shares in Elle Ltd
- all 10% preference shares in Elle Ltd

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

8.26.2 Permissible methods for determining base cost of identical assets

Taxpayers must adopt one of three alternative methods:

- specific identification
- first in first out
- weighted average

There are no restrictions on the use of the specific identification and first in, first out methods. These may be used for any identical asset. However, the weighted average method may only be used for certain classes of asset. The three methods are discussed below:

8.26.2.1 Specific identification

Under the specific identification method the cost of each asset disposed of is discretely identified. This could be done, for example, by reference to share certificate numbers. The question arises as to how shares that have been dematerialised under the STRATE system can be identified, since there are no longer share certificate numbers in existence. Such shares can be identified by the date of acquisition and cost.

8.26.2.2 First in first out (FIFO)

Under the FIFO method it is assumed that the oldest asset is sold first.

8.26.2.3 Weighted average

Application

The weighted average method may only be used in respect of the classes of assets set out in Table 1 below:

Table 1 - Classes of assets for which weighted average may be used

Paragraph 32(3A) item	**Class of asset**
(*a*)	Local and foreign financial instruments listed on a recognised exchange (e.g. shares) • that comprised such financial instruments from the date of acquisition to the date of disposal, and • for which a price was quoted on that exchange, but excluding any listed s 24J instruments (these are dealt with in item (*d*) below).
(*b*)	Participatory interests in *Subitem (i)* • a collective investment scheme in securities or property, and • a foreign collective investment scheme carried on outside SA, where the prices are regularly published in a national or international newspaper; *Subitem (ii)*

	• a collective investment scheme in securities or property where the prices are not published in a newspaper but the management company is registered under s 42 of the Collective Investment Schemes Control Act 45 of 2002.* *Subitem (iii)* • a foreign collective investment scheme approved by the Registrar in terms of s 65 of the Collective Investment Schemes Control Act 45 of 2002 to solicit investments from the public in SA.
(*c*)	Gold and platinum coins, whose prices are regularly published in a national or international newspaper
(*d*)	Section 24J instruments • that comprised such instruments from the date of acquisition to the date of disposal, • that were listed on a recognised exchange, and • for which a price was quoted on that exchange.

*These are high entry-level specialist schemes that operate as 'wholesalers' and are generally invested in by other collective investment schemes and organizations.

Assets in items (*a*) and (*d*) must remain in this class from the date of acquisition to the date of disposal. For example, if weighted average had been used in respect of ABC Limited, a listed share, and that share became unlisted, weighted average would no longer be permissible in respect of those shares and the taxpayer would be forced to switch to specific identification or FIFO.

It is evident from the above table that the weighted average method may *not* be used for determining the base cost of the following types of identical asset:

- Financial instruments not listed on a recognised exchange e.g. private company shares, listed shares on an unrecognised exchange.
- Gold and platinum coins whose prices are not published in a newspaper e.g. a collection of identical old Roman coins displayed in the boardroom of a company.
- Other hard assets.

The specific identification and FIFO methods will have to be adopted in respect of these assets.

How the weighted average is determined

Moving average method

There are at least two ways of determining the weighted average cost of identical assets. However, the *moving average* method must be used for the purposes of this paragraph. Under this method an average unit cost is computed after each acquisition of an asset by adding the cost of the newly acquired assets to the cost of the existing assets on hand and dividing this figure by the new total number of assets. An alternative method involves a periodic calculation of the weighted average cost. This is not acceptable for CGT purposes.

Determination of weighted average on valuation date and thereafter

The weighted average must be determined as follows:

- *On valuation date* - the aggregate market value determined in terms of para 29 of the pre-valuation date identical assets divided by the number of pre-valuation date identical assets.
- *After valuation date* - after each acquisition of an identical asset or incurral of allowable expenditure after valuation date, the expenditure incurred must be added to the base

cost of the identical assets on hand and divided by the number of identical assets on hand.

Paragraph 32(4) is silent on the effect that a disposal of an identical asset has on the base cost pool of identical assets. Common sense, however, indicates that the pool must be proportionately reduced by the units and base cost of assets sold.

8.26.3 Consistency

A person may adopt only one asset identification method per class of asset – this is implicit in terms of para 32(6). Only once all the assets in that class have been disposed of can a different method be adopted in respect of that class.

Where a person uses the weighted average method for any one of the four classes of identical asset, the person must use it for all identical assets in that class (para 32(3A)). This provision is aimed at preventing base cost manipulation.

Example 2 – Consistent use of weighted average method

Facts: Geoff only buys shares listed on recognised exchanges. His entire holding on valuation date consisted of 1000 ABC Limited shares. In 2002 he purchased a further 500 ABC Ltd shares. In 2003 he sold 500 ABC shares and decided to use the weighted average method. In 2004 he acquired 200 XYZ Limited listed shares.

Result: He must use weighted average in respect of the XYZ shares. Only once he has disposed of his entire holding of listed shares can he adopt specific identification or FIFO in respect of any future purchases.

The Act is silent as to when the election of the weighted average method must be made. It follows that a taxpayer will only be bound by the weighted average method once the first disposal of a class of asset takes place and evidence of the method adopted is reflected in the relevant return of income.

8.26.4 TAB and the kink tests

The weighted average method may not be used where the base cost of an asset is determined using time-based apportionment (TAB) - para 25. This is due to the fact that under time-based apportionment it is necessary to know the date of acquisition of each asset. Where the assets are pooled this would by no means be an easy task. Several different pools of assets at different values would have to be maintained, creating unnecessary complexity.

For the same reason the kink tests in paras 26 and 27 are not applicable when the weighted average method is adopted.

8.26.5 Reporting requirements

Portfolio administrators and managers of portfolios of collective investment schemes must report to SARS on the weighted average method described above. That is, starting with market value on 1 October 2001 and adding subsequent purchases at cost (ss 70A and 70B). For more information in this regard see Chapter 22 of this Guide.

8.26.6 The relationship between the identification methods and valuation date methods

As far as pre-valuation date assets are concerned, some taxpayers seem to have had difficulty in understanding the relationship between para 32 asset identification methods and the methods prescribed for determining valuation date values in paras 26, 27 and 28. Some of the confusion may be caused by the fact that para 32 apart from specifying identification methods also prescribes a valuation date value method, namely, weighted average. The relationship can be summarised as follows:

Table 1 – Asset identification methods that can be used with selected valuation date value methods

Valuation date value method	**Permissible Identification method**
Market value	Specific identification or FIFO
Time-apportionment base cost	Specific identification or FIFO
20% of [proceeds – post-CGT expenditure]	Not applicable - identification of pre-CGT costs is not required for this method
Weighted average	Weighted average. On valuation date the result is the same as the market value method. Once additions take place thereafter, the two methods yield different results.

Example 3 – Comparison of use of specific identification, FIFO and weighted average

Facts: Daphne holds the following units in a portfolio of a collective investment scheme:

Date purchased	No. of units	Cost per unit	Cost
		R	R
1 October 2001	100	1,50	150
1 November 2001	50	1,60	80
1 December 2001	150	1,70	255
1 January 2002	100	1,35	135
	400		620

On 28 February 2002 Daphne sells 125 units.

Result:

Specific identification method

Daphne's records show that she sold the 50 units acquired on 1 November 2001 and 75 of those acquired on 1 December 2001.

Details of units sold	Quantity sold	Cost per unit	Base Cost
		R	R
Acquired 1 November 2001	50	1,60	80,00
Acquired 1 December 2001	75	1,70	127,50
	125		207,50

First in first out method

Under this method the assumption is that the oldest units are sold first. In this case the oldest units are the 100 purchased on 1 October 2001 and 25 of those purchased on 1 November 2001.

Details of units sold	Quantity sold	Cost per unit R	Base Cost R
Acquired 1 October 2001	100	1,50	150
Acquired 1 November 2001	25	1,60	40
	125		190

Weighted average method

The weighted average unit cost is R620/R400 = R1,55
The base cost of 125 units is therefore 125 x R1,55 = R193,75

8.27 Part-disposals

Paragraph 33

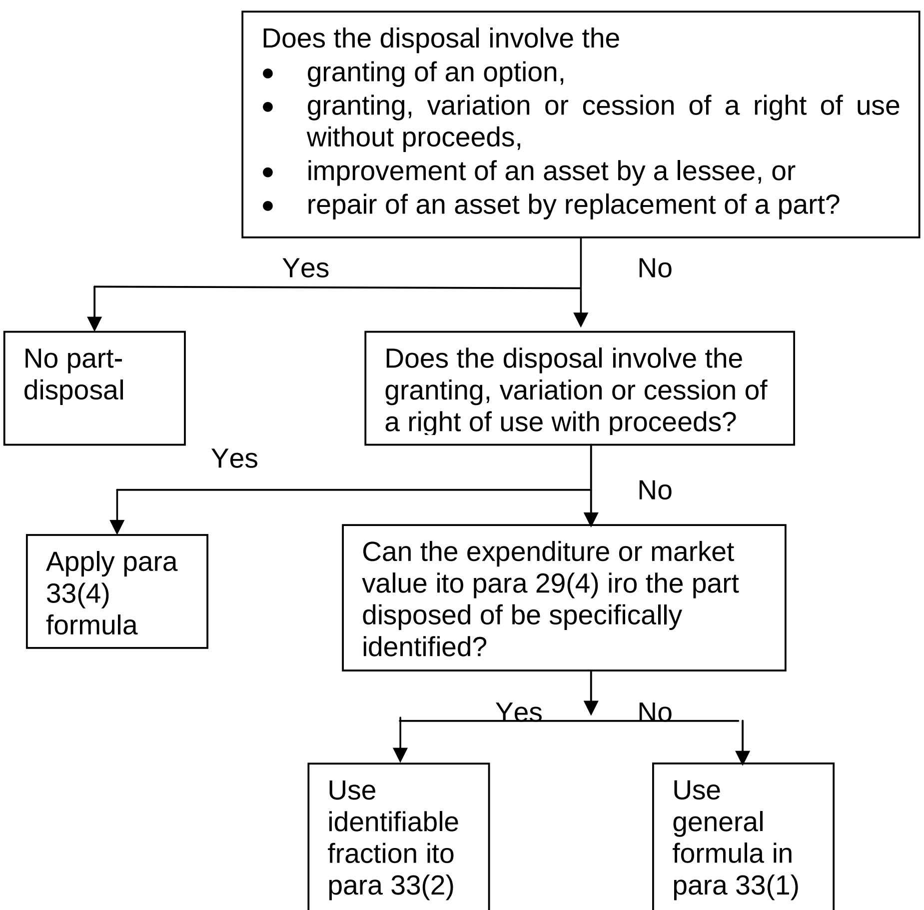
8.27.1 Purpose and application

When part of an asset is disposed of it is necessary to allocate part of the base cost of the asset to the part disposed of in order to determine the capital gain or loss in respect of that part. Paragraph 33 contains rules that

- determine the base cost attributable to the part disposed of, and
- prevent the allocation of a portion of the base cost in the case of certain part-disposals.

The flowchart below sets out the various formulae/methods that must be used to determine the part disposed of.

Part-disposals – para 33



8.27.2 The standard part-disposal formula (para 33(1))

The portion of the expenditure allowable in terms of para 20 and any valuation date market value adopted or determined in terms of para 29(4) attributable to the part disposed of is determined in accordance with the following formula:

$$\frac{\text{Market value of part disposed of}}{\text{Market value of entire asset immediately prior to disposal}} \times \text{Expenditure ito para 20 or market value ito para 29(4) in respect of entire asset}$$[132]

The remainder of the expenditure or market value in terms of para 29(4) would be allowable on a future disposal of the part retained.

8.27.3 Identifiable fraction (para 33(2))

The formula described above does not apply where a part of the allowable expenditure in terms of para 20 or market value adopted or determined in terms of para 29(4) can be directly attributed to

- the part which is disposed of, or
- the part which is retained.

In such a case, specific identification could be used to determine the part of the base cost disposed of. This provision dispenses with the need for unnecessary valuations.

Some practical issues are addressed below.

8.27.4 Record keeping

Taxpayers should keep a permanent record of the balance of the cost allocated to the part of the asset retained, for use in computing the gain or loss on any subsequent disposal or part-disposal.

8.27.5 Disposal of usufructs and similar interests and subsequent enhancements

If the part-disposal is a disposal of an interest in an asset for a limited period, so that at the end of the period the person is able to dispose of the whole unencumbered asset, the cost to be attributed to the final disposal would be the residue after the apportionment of part of the base cost to the first and any subsequent part-disposals. If at any time between disposals there is any enhancement expenditure, that expenditure would have to be added to the remaining base cost after the last part-disposal for the purposes of determining the base cost of the next disposal. The result is that an amount included in base cost would only be allowed once in the calculation of a capital gain or loss.

[132] Paragraph 33 was substituted by s 99 of the Revenue Laws Amendment Act 45 of 2003 with effect from the commencement of years of assessment ending on or after 1 January 2004. Prior to its amendment, para 33 contained a number of references to the 'base cost' of an asset. These were replaced with references to allowable expenditure in terms of para 20 or market value adopted or determined in terms of para 29(4). The purpose of the amendment was to facilitate the use of TAB where part of a pre-valuation date asset is disposed of.

Example 1 – Part-disposal: Apportionment of base cost

Facts: Eric has held a two-hectare piece of vacant land at Hermanus for a considerable length of time. A developer approached him with an offer to purchase half the property for R400 000. An estate agent has valued the entire property at R1 000 000. The market value of the property on 1 October 2001 was R700 000, and Eric has elected to use the market value basis to determine base cost on valuation date.

Result:

	R
Base cost of entire asset	700 000
Market value of part disposed of	400 000
Market value of entire asset	1 000 000

Base cost of part sold $= \dfrac{\text{R400 000}}{\text{R1 000 000}} \times \text{R700 000}$

$= \text{R280 000}$

Eric would realise a capital gain of R120 000 (R400 000 – R280 000) if he were to dispose of portion of the vacant land to the developer.

Example 2 – Part-disposal: Identifiable fraction

Facts: Fiona purchased two adjoining pieces of land ten years prior to valuation date within 6 months of each other. She paid R50 000 for the first piece and R75 000 for the other and thereafter had them consolidated. On 30 September 2006 she decided to re-subdivide the property and sell off the piece that cost her R50 000. She has elected to use the time-apportionment basis to determine base cost. She sells the piece for R170 000.

Result:

	R
Proceeds	170 000
Expenditure (recognisable fraction)	(50 000)
Gain	120 000

The property was acquired 10 years prior to valuation date and sold 5 years thereafter. Therefore the portion of profit to be added to expenditure is 10/15. The time-apportionment base cost of the asset is therefore R50 000 + (R120 000 x 10/15) = R130 000.

	R
Proceeds	170 000
Time-apportionment base cost	(130 000)
Capital gain	40 000

Example 3 – Part-disposals and TAB

Facts: Wayne paid R100 000 for a piece of vacant land 5 years prior to valuation date. He erected a fence around the property at a cost of R20 000 during the period after valuation date. 5 years after the valuation date he subdivided the land and disposed of part of it for proceeds of R16 000. The market value of the land immediately prior to the disposal was R160 000. Wayne decides to use TAB to determine the valuation date value of the asset.

Result: The capital gain on the part disposed of is determined as follows:

Percentage disposed of = R16 000/R160 000 x 100 = 10%
Portion of pre-CGT expenditure disposed of = R100 000 x 10% = R10 000
Portion of post-CGT expenditure disposed of = R20 000 x 10% = R2 000
Apply proceeds formula R10 000/(R10 000 + R2 000) x R16 000 = R13 333
TAB = R10 000 + [(R13 333 – R10 000) x 5/10] = R11 667
Capital gain = R16 000 – [R11 667 + R2 000] = R2 333
For the purpose of any subsequent disposal the expenditure remaining will be as follows:
Pre-CGT expenditure R100 000 – R10 000 = R90 000
Post-CGT expenditure R20 000 – R2 000 = R18 000

8.27.6 Events not treated as part-disposals (para 33(3))

The four events in the table below do not trigger an allocation of part of the allowable para 20 expenditure or market value in terms of para 29(4) when a part of an asset is disposed of. This is done to prevent the triggering of premature capital losses or for administrative reasons where it would be impracticable to compute capital losses arising from numerous small part-disposal events. These events do not prevent the part-disposal itself from taking place but merely prevent an allocation of part of the base cost of the asset to the part-disposal. Any proceeds received in these circumstances will therefore comprise a capital gain in respect of the part-disposal without a base cost deduction.

Table 1 – Events not treated as part-disposals

Paragraph 33(3)	**Event not treated as part-disposal**
(*a*)	Granting of an option in respect of an asset
(*b*)	Granting, variation or cession of a right of use or occupation of an asset without the receipt or accrual of any proceeds.
(*c*)	Improving or enhancing of an asset which is leased to a person. [Deleted 24.01.2005 – see notes below.]
(*d*)	Replacement of part of an asset where that replacement comprises a repair.

8.27.6.1 Granting of an option (para 33(3)(a))

In terms of para 11(1)(*a*) the granting of an option constitutes a disposal. It follows that where proceeds are received in respect of the granting of an option they will be subject to CGT with no base cost offset. The base cost of the asset will only be brought to account when the option is exercised and the asset itself is disposed of.

8.27.6.2 Granting, variation or cession of a right of use or occupation without proceeds (para 33(3)(b))

This provision was introduced with effect from the commencement of years of assessment ending on or after 1 January 2003 to prevent the creation of artificial losses. Where a person grants, varies or cedes the right of use or occupation of an asset, he or she is disposing of an asset, the base cost of which can be determined in terms of para 33(1) and (2). The consideration the person receives for the use or occupation of the asset is normally rental or a lease premium that forms part of the person’s gross income and therefore does not constitute ‘proceeds’ for CGT purposes. In the absence of this provision, the person would have a base cost but no proceeds thereby creating an artificial capital loss. The amount of the base cost claimed in these circumstances would reduce the base cost of the asset and if the asset is subsequently disposed of only a reduced amount of base cost will be deductible from the proceeds on disposal. Under this provision, however, the full base cost will be allowed when the whole asset is disposed of.

The word 'use' must be distinguished from a usufruct. A personal right of *usus* (right of use) is a lesser right than a usufruct. It entitles the holder to use the asset but not to appropriate its fruits.[133] Thus the granting of a right to the future dividend income from a share will not fall within para 33(3)(*b*).

Example 4 - Granting of a lease where no proceeds are received

Facts: XYZ (Pty) Ltd acquired a warehouse on 1 October 2001 at a cost of R100 000. It immediately advertised for tenants, and on 1 November 2002 entered into a 5-year lease agreement with another company. The agreement provided for a rental of R1 000 payable monthly in advance. It is estimated that the present value of the rental contract is R40 000. Immediately prior to signing the lease, the property had a market value of R120 000.

Determine the gain or loss assuming that XYZ (Pty) Ltd has a year-end of
- 30 November 2002
- 28 February 2003

Result:

Years of assessment ended prior to 1 January 2003

In terms of para 11(1)(*a*) the act of granting of a lease over the property is a disposal and the portion of the base cost disposed of would have to be determined in terms of para 33. The market value of the part disposed of is R40 000. Therefore under para 33 the portion of the base cost disposed of is:

R40 000/R120 000 x R100 000 = R33 333.

Since the future rental income will be included in gross income, it will be excluded from proceeds in terms of para 35(3)(*a*). The result is a capital loss of R33 333.

Years of assessment ending on or after 1 January 2003

The act of entering into the lease is not regarded as a part-disposal under para 33 and as a result no gain or loss results. The base cost of R100 000 will remain intact and available for use when the full property is disposed of.

8.27.6.3 Improving or enhancing of a leased asset by a lessee (para 33(3)(c))

[Effective 22 December 2003, deleted 24 January 2005]

The position between 22 December 2003 and 24 January 2005

Where a lessee improves the immovable property of a lessor the improvements will in terms of common law accede to the property. Although the lessee will continue to enjoy the use of the improvements until the termination of the lease the lessee loses the ownership of the asset when it is affixed to the property. This results in a disposal of the *bare dominium* of the asset.

[133] *The Law of South Africa*, vol 24 in para 441.

In order to prevent the premature triggering of capital losses, para 33(3)(*c*) provides that there is no part-disposal in these circumstances. Accordingly, with effect from 22 December 2003, the lessee may not allocate any portion of the base cost of the asset to the disposal. The cost of improvements to the leased asset qualifies as part of the base cost in terms of para 20 and will be brought into account for capital gains tax purposes on the termination of the lease.

On or after 24 January 2005

Paragraph 33(3)(*c*) was deleted with effect from 24 January 2005. The effect is a reversion to the pre-22 December 2003 position.

Example – Leasehold improvements by lessee

Facts: Grocer (Pty) Ltd entered into a 10-year lease for a shop and spent R100 000 on the shop front and fixtures on which no income tax allowances could be claimed. The value of the *bare dominium* disposed of is equal to the total value of the improvements (R100 000) less the value of the right of use for the next 10 years (para 31(1)(*e*)). The bare dominium of the improvements calculated over the remaining term of the lease is R32 198.
What is the CGT position of the lessee if the improvements were effected on
(a) 31 March 2004, or
(b) 31 March 2005?

Result: When effecting the improvements to the land and buildings, the company disposed of the *bare dominium* in the improvements, and retained the right of use.

Improvements effected 31 March 2004

In terms of para 33(3)(*c*) the expenditure will form part of the base cost of the asset i.e. the lease, and if on termination of the lease no compensation for the improvements is received the capital loss of R100 000 will be allowed at the time of the expiry of the lease.

Improvements effected 31 March 2005

Grocer (Pty) Ltd therefore has a capital loss of R32 198 on 31 March 2005. The company will have a further capital loss of R67 802 (R100 000 – R32 198) on termination of the lease in 10 years' time.

8.27.6.4 Replacement of part of an asset comprising a repair (para 33(3)(d))

[Effective 22 December 2003]

Where a person replaces part of an asset in the course of repairing that asset, the removal of the worn out or damaged part constitutes a disposal of part of the main asset. For example, the replacement of a broken window in a building will constitute the disposal of a part of the building.

In order to prevent the triggering of numerous small capital losses para 33(3)(*d*) prevents the allocation of any part of the base cost of the main asset to the part-disposal where the replacement of part of the asset is a repair. This provision does not affect those persons who are entitled to claim repairs under s 11(*d*), since their base cost allocation would have been eliminated by para 20(3)(*a*). Any proceeds derived from the disposal of the worn out part will be recognised as a capital gain at the time of its disposal with no base cost deduction.

Example – Replacement of part of asset comprising a repair

Facts: John purchased a country cottage for investment and letting purposes at a cost of R150 000. At the time of purchase the cottage was in a poor state of repair. During the first year of assessment during which he held the cottage John incurred R6 000 in replacing a rusty geyser, but was unable to claim this expense under s 11(*d*) because he had not yet secured a tenant and the cottage was not yet in a habitable state. He managed to sell the old geyser to a scrap metal merchant for R100.

Result: In terms of para 33(3)(*d*) he does not have to determine the portion of the cost of the cottage attributable to the old geyser. The R100 proceeds constitutes a capital gain that must be recognised in the year of assessment in which the geyser is disposed of.

8.27.7 Granting, variation or cession of a right of use or occupation where proceeds received or accrued (para 33(4))

Despite para 33(3)(*b*), para 33(4) triggers a part-disposal where proceeds are received or accrued in respect of the granting, variation or cession of a right of use or occupation of an asset. The intention of this provision was to prevent hardship by allowing a base cost deduction for a lessor who receives proceeds. In practice most receipts or accruals received by or accruing to a lessor would fall within the definition of gross income (e.g. rental income), whilst lease premiums will fall within para (*g*) of that definition. Deemed proceeds may also arise in terms of para 38 where a lessor who is a connected person in relation to a lessee charges a below market related rental.

In these circumstances, the portion of the base cost attributable to the part of the asset in respect of which those proceeds were received or accrued is determined in accordance with the following formula:

$$\frac{\text{Proceeds}}{\text{Market value of entire asset}} \times \text{Expenditure ito para 20 or market value ito para 29(4) in respect of entire asset immediately prior to disposal}$$

Proceeds are used in the numerator of the above formula instead of market value in order to arrive at a fair apportionment of the base cost. Take for example the case of a lessor who enters into a long lease that provides for the payment of an upfront lease premium of R1. Had market value been used in the numerator, a large portion of the base cost would be allocated to the disposal (the market value of the part disposed of would be high because of the length of the lease). The use of proceeds in the numerator prevents the creation of abnormal capital losses.

Example 5 – Part-disposal where lease granted and proceeds received

Facts: Errol purchased 'Speedy Boy', a racehorse for R100 000 on 1 October 2001. On 31 August 2002 after Speedy Boy had won a number of races, Errol agreed to lease the steed to Andrew for a market related rental of R50 000 per annum for five years. Immediately prior to entering into the lease the market value of the racehorse was R200 000. Since Andrew was desperate to impress his friends and reverse his flagging fortunes on the race track he agreed to pay Errol an up front premium (see note at end of this example) of R25 000 for the right of use of Speedy Boy. This was in addition to, and over and above the market related rental that Errol could have obtained from other interested lessees. For the purposes of this example it is assumed that Errol did not claim depreciation on Speedy Boy.

Result: In terms of para 33(4), since Errol has received proceeds of R25 000, he will have triggered a part-disposal. The base cost of the part disposed of is determined as follows:

Base cost	R100 000
Proceeds (lease premium)	R25 000
Market value of Speedy Boy	R200 000

Part of base cost disposed of = R100 000 x R25 000/R200 000 = R12 500
Capital gain = R25 000 – R12 500 = R12 500.

Note:

For the purpose of this example, it has been assumed that a horse is not 'plant' and hence that the lease premium does not fall within para (*g*) of the gross income definition. In reality, however, a horse may well constitute plant. In the United Kingdom case of *Yarmouth v France*[134] Lindley LJ held that a vicious horse constituted plant for the purpose of the Employer's Liability Act 1880. He stated that in its ordinary sense plant

> 'includes whatever apparatus is used by a businessman for carrying on his business – not his stock-in-trade which he buys or makes for sale; but all goods and chattels, fixed or movable, live or dead, which he keeps for permanent employment in his business . . .'.

The above quote was cited with approval in *Blue Circle Cement Ltd v CIR*,[135] a landmark case that dealt with the meaning of the word 'plant'.

A somewhat more restrictive view of the word 'plant' can be found in ITC 1046[136] where the court held that bins that were not used in a manufacturing process did not constitute plant. In that case the court relied on the *Shorter Oxford English Dictionary* meaning, namely,

> 'the fixtures, implements, machinery and apparatus used in carrying on any industrial process'.

8.27.8 Consistent adoption of the 20% of proceeds method (para 33(5))

[Effective 22 December 2003]

Where a person has adopted the 20% of proceeds method for a part-disposal, that person must thereafter continue to use that method for all subsequent disposals. A person who adopts this method does not need to allocate part of the expenditure or market value to the part disposed of and, therefore, falls outside s 33(1).

The 20% of proceeds method determines the base cost of the part disposed of but does not determine the part of the expenditure allowable in terms of para 20 or the part of the market value disposed of. It is therefore unclear how much of these components remain behind after a part-disposal effected using this method. For this reason it is desirable that consistency be prescribed.

Example – Consistent application of 20% of proceeds method under a part-disposal

Facts: Louise purchased a piece of land at a cost of R5 000 in 1999. In 2015 she disposed of half of the land for proceeds of R100 000. The market value on valuation date of the property was R20 000. She decided to adopt the 20% of proceeds method, which gave her a

[134] (1887) 19 QBD 647 at 658.
[135] 1984 (2) SA 764 (A), 46 SATC 21.
[136] (1964) 26 SATC 217 (F).

base cost of R20 000 and a capital gain of R80 000. In 2017 she disposed of the remaining land for proceeds of R50 000.

Result: In terms of para 33(5) she must adopt the 20% of proceeds method and will have a base cost of R10 000 and a capital gain of R40 000. Had she been permitted to switch to TAB or market value for the second disposal it would have been unclear how much of the expenditure and market value remained after the first disposal.

8.27.9 Part-disposal of goodwill

The goodwill of a business is a single asset, separate and distinct from the other assets of the business. It does not attach to the identifiable assets of the business. On the other hand, goodwill has no existence independently of the conduct of a business and cannot be severed from the business that created it. See in this regard the leading Australian case of *FCT v Murry*[137] and the subsequent rulings issued by the Australian Tax Office.[138]

It follows that the part-disposal of goodwill is generally not possible. It is, however, accepted that it is possible to own and operate separate and distinct businesses, each with its own goodwill.

When a taxpayer sells a distinct and separate business and the goodwill attaching to that business was not separately valued at the valuation date, SARS accepts that certain difficulties may arise.

The following approach will be adopted:

If only one business is being carried on and a part of it is disposed of, it is a question of fact whether a discrete business, to which goodwill attaches, has been disposed of. This question is determined having regard to all the facts and circumstances, including whether

- sufficient relevant assets are sold to enable the purchaser to continue with the business,
- the assets sold are accompanied or carry with them the legal right, privilege or entitlement to conduct the business, and
- what is sold is sold as a self-contained business.

If part of a business is disposed of, an important consideration is whether the effect of the transaction is to put the purchaser in possession of a going concern, the activities of which the purchaser could carry on without interruption.

The disposal of pre-valuation date goodwill

Paragraph 33 provides for the apportionment of the base cost of an asset when there is a part-disposal of that asset. In applying para 33, and bearing the above principles in mind, the following should be noted:

- The discrete business disposed of must have been in existence in its present form on 1 October 2001. In other words, one cannot allocate a portion of the goodwill in existence on 1 October 2001 to the disposal of a business that commenced after that date. This means, inter alia, that one cannot allocate a portion of the goodwill in existence on 1 October 2001 to the disposal of a group of assets that did not, in themselves, constitute

[137] (1996) 622 FCA 1, cited online at <http://www.austlii.edu.au/cgi-bin/disp.pl/au/cases/cth/federal%5fct/1996/622.html?query=%7e+murry> (accessed 22 March 2005).
[138] Taxation Rulings TR 1999/16 and TR 1999/16A available online at <http://law.ato.gov.au/atolaw/browse.htm?toc=04%3ARUL%3ATaxation%3A1999> (accessed 22 March 2005).

a discrete business on 1 October 2001, even though the assets were assets of the business on that date.

- Following on from the above, it is apparent that all discrete businesses that formed part of the whole business on the valuation date should be identified, even if the goodwill attached to them was not determined. Such a list of discrete businesses should accompany the valuation of the goodwill of the whole business.
- Expenditure incurred in developing pre-valuation date self-generated goodwill will invariably have been allowed against ordinary income. Paragraph 20(3)(*a*) eliminates such expenditure from base cost. Paragraph 26(3) will eliminate any capital loss on a part-disposal of self-generated goodwill when market value is adopted as the valuation date value.
- On disposal of the discrete business, which was in existence on 1 October 2001, para 33 requires that the market value of the discrete business disposed of and the market value of the entire business be determined immediately prior to that disposal. This is done in order to determine the proportion of the goodwill to be allocated to the discrete business disposed of.

8.28 Debt substitution

Paragraph 34

In terms of the Eighth Schedule the disposal by a person of an asset to a creditor in order to reduce or discharge a debt owed to that creditor would result in a disposal by the debtor as well as a disposal by the creditor.

The debtor would dispose of the asset for a consideration equal to the amount by which the debt owed to the creditor is reduced as a result of that disposal (see para 35(1)(*a*)). The debtor would therefore determine a capital gain or a capital loss in respect of that disposal depending on whether or not that consideration would constitute proceeds and whether those proceeds will exceed the base cost of that asset.

The creditor, in turn, would dispose wholly or partially of his claim against the debtor for proceeds equal to the market value of the asset obtained in return. The creditor would, therefore, show a gain or a loss where the market value of the asset obtained from the debtor exceeds or is less than the amount by which the creditor's claim would be reduced. The creditor may have to account for this gain or loss as a capital gain or loss if that gain or loss is not taken into account for purposes of determining the creditor's taxable income before the inclusion of any taxable capital gain, for example, if a loss is not taken into account as a bad debt under s 11(*i*).

The base cost, for the creditor, of the asset acquired from the debtor would in the absence of the debt substitution rule be equal to the consideration given by the creditor, namely, the amount of the claim given up by the creditor. In terms of this paragraph, however, the asset must be treated as one acquired by the creditor at a base cost equal to its market value at the time. The market value of the asset is treated as an amount of expenditure actually incurred and paid for the purposes of para 20(1)(*a*). This prevents any double counting, in the creditor's hands, of an amount equal to the gain or loss determined in respect of the exchange of the creditor's claim for that asset.

Example 1 – Discharge of debt by disposal of asset

Facts: Gerrie owes Helen R1 000. Helen agrees to release Gerrie from that debt in return for the transfer, by Gerrie to Helen, of an asset to the value of R900 that Gerrie originally acquired for R500.

Result:

Gerrie's gain = proceeds - base cost = R1 000 - R500 = R500.
Helen's loss = base cost - proceeds = R1 000 - R900 = R100.

The base cost of Helen's new asset is R900.

8.29 Base cost limitation in terms of amnesty provisions

Section 28(2) of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003

An exchange control and tax amnesty was introduced by the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003. This provided amnesty in respect of certain exchange control and tax violations relating to foreign assets held on 28 February 2003. An exchange control amnesty levy of 5% or 10% was payable in respect of amounts taken offshore illegally in excess of the permissible limits. To prevent understatement of the value of the foreign assets disclosed for the purpose of determining the levy, a limitation was placed on the base cost of those assets in terms of s 28(2) of that Act.

In terms of this rule a disclosed foreign asset is deemed to have a base cost that does not exceed that asset's disclosed market value on 28 February 2003 plus para 20 expenditure incurred after that date. As a result of this rule, persons who applied for exchange control amnesty who undervalued a disclosed foreign asset (to reduce the amnesty levy) will be forced to incur additional tax upon eventual sale of that asset. Stated differently, under-valuations will only result in deferral versus outright exemption.

This limitation only applies where the relevant asset was held on 28 February 2003 and the person was an exchange control amnesty applicant. Persons who only applied for tax amnesty are not affected by the rule. Where the asset was disposed of during the year preceding that date, the normal rules for determining the base cost of the asset will apply (market value on 1 October 2001, TAB, or 20% of proceeds).

In terms of s 28(2) the base cost of the asset may not exceed

- the *value in foreign currency* of the asset on 28 February 2003 as disclosed for the purpose of determining the amnesty levy, plus
- any post-28 February 2003 para 20 expenditure.

In summary, a person must use the lower of two possible base costs:

- The 'normal' base cost determined under the Eighth Schedule (in the case of pre-valuation date assets, using TAB, market value on 1 October 2001 or 20% of proceeds), and
- The 'limited' base cost determined under s 28(2).

Section 28(2) envisages a comparison between two foreign currency amounts. The normal base cost of the asset must accordingly be determined in foreign currency rather than rands in order to achieve a comparison with the limited base cost. The lower of the two foreign currency base costs must be adopted.

Translation of the lower base cost

Neither para 43, Part XIII nor s 25D address the issue of how the 'value in foreign currency' on 28 February 2003 is to be translated as they refer to expenditure or market value on valuation date. The amount under consideration is a 'value', not an expenditure.

The method of translation should as far as possible follow the translation rules in para 43 and Part XIII. In the case of para 43(1) assets (expenditure and proceeds in same foreign currency) the capital gain or loss should be determined in the foreign currency and translated to rands at the average exchange rate in the year of disposal. In the case of other assets (e.g. para 43(4) assets) the market value on 28 February 2003 should be translated at the spot rate ruling on that date, while expenditure incurred after 28.02.03 must be translated at the average rate in the year of incurral terms of s 25D.

Example 1 – Understatement of market value of foreign asset on 28 February 2003

Facts: Des owned a block of flats in London from which he derived rental income. He initially acquired the flats in contravention of Exchange Control for £18 million on 1 July 1999. The flats have an actual value of £25 million on 28 February 2003, but Des provides a sworn valuation from a friendly valuer that the flats are worth only £15 million. This £15 million value was accepted as true by the amnesty unit. Since he had already utilised his R750 000 permissible foreign capital allowance, Des paid an exchange control amnesty levy of £1,5 million (10% x £15 million) instead of a £2,5 million levy (10% x £25 million). He sold the flats for £30 million on 15 June 2004, and wishes to use TAB to determine the base cost of the flats. No improvements have been made to the flats since Des acquired them.
Result: Des' base cost is determined as follows:

The time-apportionment base cost of the flats is £24 million, arrived at as follows:
TAB = B + [(P – B) x N/N + T]
TAB = £18 000 000 + [(£30 000 000 – £18 000 000) x 3/6
TAB = £18 000 000 + £6 000 000
TAB = £24 000 000
However, the base cost of Des' flats may not exceed the amount declared to the amnesty unit as the value on 28 February 2003 (£15 000 000) plus any post-28 February 2003 para 20 expenditure (£nil). He is therefore not permitted to use the higher TAB figure as his base cost and is restricted to the value declared to the amnesty unit of £15 000 000. His capital gain is therefore £15 million as opposed to what it could have been, namely, £6 million had he disclosed the true value to the unit.

Example 2 – Irrelevance of utilisation of permissible foreign exchange allowance in determining base cost limitation

Facts: The facts are the same as Example 1, except that Des has never utilised any of his permissible foreign capital allowance of R750 000 (and the amnesty levy is reduced accordingly).

Result: The result is the same as Example 1. The use of the permissible foreign capital allowance to reduce the amnesty levy has no impact on tax cost.

Example 3 – Translation of lower base cost

Facts: Matthew applied for exchange control amnesty in respect of a foreign endowment policy he acquired in France at a cost of €100 000 on 1 October 1996. He completed a CGT 2 form by 30 September 2004 indicating that the valuation date market value was €200 000.

At the time of applying for amnesty he engaged a friendly valuer who supplied him with an understated valuation as at 28 February 2003 of €150 000. He disposed of the policy on 30 September 2006 for €500 000. In 2004 he invested an additional amount of €20 000 in the policy. The relevant exchange rates were as follows:

Spot rate on 28.02.03	€1 = R7
Average rate 2004	€1 = R8
Average rate 2006	€1 = R9

Matthew decided to use market value as the valuation date value.

Result:

Compare normal base cost and limited base cost

Normal base cost = €200 000 (VDV) + €20 000 = €220 000
Limited base cost = €150 000 + €20 000 = €170 000

Since limited base cost is the lower base cost, Matthew must use €170 000 as his base cost.

Translation of limited base cost

	R
€150 000 x R7 =	1 050 000
€20 000 x R8 =	160 000
	1 210 000

Proceeds €500 000 x R9 = R4 500 000
Capital gain = R4 500 000 – R1 210 000 = R3 290 000

8.30 Election in respect of assets held by foreign discretionary trust in terms of amnesty provisions

Section 4 of the Exchange Control Amnesty and Amendment of Taxation Laws Act, 2003; Regulations issued in terms of s 30 of the aforementioned Act.[139]

The exchange control and related tax measures only apply to residents of SA. Since a foreign trust is unlikely to be a resident, such trusts would in the absence of s 4 be unable to apply for amnesty. Section 4 enables a donor or deceased estate of a donor to elect that the discretionary trust's assets be treated as being held by that donor or deceased estate. For the purpose of the provision a donation includes a donation contemplated in s 58 of the Income Tax Act.[140] This ensures that an asset that is disposed of for an inadequate consideration will also be treated as a donation. The reference to a deceased estate of a donor is unclear. It would seem to have limited application to deceased estates that are in the process of being wound up during the amnesty period, for once the estate has been wound up it ceases to exist.

Assets affected by the election include the donated asset, and any asset whose value is wholly or partly derived from a donation made by the donor.[141] This means that the election extends to assets acquired out of the proceeds of donated assets.

The donor is treated as having

139 GN R.1368, GG 25511 dated 29 September 2003.
140 Regulation 2(*b*).
141 Regulation 3.

- acquired the foreign asset for an amount equal to the market value on 1 March 2002 plus any post-1 March 2002 expenditure incurred by the trust, and
- dealt with the foreign asset in the same manner as the trust deals with it from 28 February 2003.[142]

It follows that any pre-1 March 2002 capital gain or loss is disregarded. In addition, if the trust, for example, held the asset as trading stock on 28 February 2003 the donor is treated as holding the asset as trading stock on that date. Should the trust subsequently convert the trading stock into a capital asset, that will trigger an inclusion in income in terms of s 22(8) and an acquisition under para 12(3) in the donor's hands. Likewise, if the trust converts a capital asset in respect of which an election has been made into trading stock, this will trigger a disposal at market value for CGT purposes in the donor's hands in terms of para 12(2)(*c*) and an acquisition of trading stock at that same market value in terms of s 22(3)(*a*)(ii).

The donor is deemed to hold the asset until the earlier of the following events:

- The trust disposes of the asset – including the vesting of the asset in the electing donor.
- The donor dies or ceases to be a resident, or
- In the case of a deceased estate, close corporation or trust, the person ceases to exist by operation of law. This includes the termination of a deceased estate once wound up, the termination of a trust by reason of insolvency, destruction of trust property or realization of trust purpose and the dissolution of a close corporation as a result of liquidation.[143]

The attribution rules in paras 70, 72 and 80 do not apply to any capital gain arising in the trust during the period that a person has made an election in terms of s 4.[144] See in this regard the commentary under **15.9**.

8.31 Assets acquired through the issue of shares

Section 24B

8.31.1 Purpose

Section 24B was introduced with retrospective effect to 1 October 2001[145] in order to enable a company that acquires an asset by issuing its own shares to establish a base cost for that asset. The absence of a base cost would otherwise have had harsh economic consequences.

8.31.2 The position before s 24B

From a CGT perspective, the common law position set out below is now largely of academic interest because s 24B was backdated to the CGT implementation date.

In ITC 703[146] a company that paid a firm of technical consultants by means of the issue of shares was allowed to claim a deduction in respect of a portion of the fees (the non-

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142 Regulation 4.
143 Regulation 4(*c*).
144 Regulation 7.
145 Section 24B was introduced into the Act by the Revenue Laws Amendment Act 32 of 2004. For purposes of determining any capital gain or loss from the disposal of any asset (other than trading stock), s 24B was deemed to have come into operation on 1 October 2001 and applies in respect of any such asset acquired on or after that date. In the case of trading stock it applies to assets acquired on or after 24 January 2005.
146 (1950) 17 SATC 208 (N).

allowable portion related to the establishment of a factory and was of a capital nature) This case cannot, however, be seen as authority for the view that expenditure is incurred when an asset is acquired through the issue of shares, since the court did not consider this aspect

In ITC 1783[147] it was held that where a company issues its own shares in exchange for an asset, the company will not have incurred any expenditure in respect of the acquisition of the asset, since it has not lost or expended anything.[148]

Paragraph 38 was largely ineffective in establishing a base cost equal to market value for the asset acquired. Unless the value of the shares issued does not represent an arm's length consideration for the asset disposed of, para 38 cannot be applied. The recipient of the shares issued would also have to be a connected person in relation to the company prior to the transaction.

In certain circumstances an acquiring company will be able to secure a deduction in terms of the corporate restructuring rules, for example, under s 42(2) (company formation transactions); s 43(2) (share-for-share transactions); and s 44(2) (amalgamation transactions).

8.31.3 General rule - Shares issued in exchange for asset (s 24B(1))

A company that acquires an asset by issuing its own shares is deemed to have actually incurred an amount of expenditure in respect of the asset acquired. The expenditure is equal to the market value of the asset determined at the time of acquisition (s 24B(1)(*a*)).

The seller is likewise deemed to have disposed of the asset at the same market value (s 24B(1)(*b*)).

The above rules apply equally to trading stock and capital assets. In terms of s 41(2) the corporate rules in ss 41 – 47 override s 24B, except for s 24B(2) and (3). The latter exceptions apply base cost limitation rules to the cross issue of shares and debt.

Example 1 – Issue of shares in exchange for asset

Facts: Wendy transfers land to Newco in exchange for all the shares in Newco. The land has a market value of R100 000 and a base cost of R20 000 at the time of the transfer. The land is a capital asset in the hands of both Wendy and NewCo.

Result. Wendy has a capital gain of R80 000 (R100 000 proceeds less R20 000 base cost) as a result of the disposal of the land. Newco's base cost in respect of the land acquired is R100 000. The issue of shares by Newco does not give rise to a capital gain or loss as it is not a disposal (para 11(2)(*b*)).

Example 2 – Issue of shares in exchange for asset - overriding effect of corporate rules

Facts: The facts are the same as **Example 1**, except that Wendy and Newco elect the roll-over relief of s 42.

[147] (2004) 66 SATC 373 (G). Following this judgment, SARS issued Draft Interpretation Note "Deductions: Expenditure actually incurred: Assets or services acquired in exchange for shares' issued on 16 March 2004. The draft Note is no longer available on the SARS website.
[148] See *Silke* in § 7.4 which was cited with approval in ITC 1783.

Result: Wendy has no capital gain on the disposal of the land (s 42(2)(*a*)). The base cost of her shares in Newco is R20 000 (s 42(2)(*a*)). The base cost of the land in Newco is similarly R20 000 (s 42(2)(*b*)). The issue of shares by Newco is not a disposal (para 11(2)(*b*)).

8.31.4 Exception - Shares issued in exchange for a share or debt issue (s 24B(2))

This exception to the general rule applies where

- a share or debt instrument is issued by a person directly or indirectly to a company,
- in exchange for the issue of shares by that company, or
- in exchange for the issue of shares by a company that is a connected person in relation to that company.

This provision is therefore directed at cross issues of shares and issues of shares in exchange for the issue of debt instruments. It only applies where shares or debt are *issued* by a person as opposed to a conventional disposal of shares or debt.

Where this applies the company is deemed not to have incurred any expenditure in respect of the shares or debt instrument acquired.

This zero base cost rule was necessary because the issue of shares or debt is a non-disposal in the hands of the issuer in terms of paras 11(2)(*b*) and (*d*). The dual tax-free nature of the transaction creates an easy opportunity for the inflation of the value of both sets of shares or the value of the shares and debt issued.

Example 1 – Straight forward cross-issue of shares

Facts: Holdco owns all the shares of Sub 1 and Sub 2. Sub 1 issues shares in exchange for the issue by Sub 2 of Sub 2 shares.

Result: Sub 1 and Sub 2 are involved in a direct cross-issue of shares. Sub 1 receives a zero base cost in the Sub 2 shares received, and Sub 2 similarly receives a zero base cost in the Sub 1 shares.

Example 2 – Indirect cross-issue of shares

Facts: Holdco owns all the shares of Sub 1 and Sub 2. Sub 1 issues shares to Sub 2 in exchange for cash, and Sub 2 issues shares to Sub 1 in exchange for cash of the same amount.

Result: Sub 1 and Sub 2 are involved in an indirect cross-issue of shares. Sub 1 receives a zero base cost in the Sub 2 shares received, and Sub 2 similarly receives a zero base cost in the Sub 1 shares.

Example 3 – Indirect cross-issue of shares

Facts: Holdco owns all the shares of Sub 1 and Sub 2. Sub 1 and Sub 2 issue shares to Holdco in exchange for cash. Shortly thereafter, Holdco disposes of the Sub 2 shares to Sub1 for cash, and the Sub 1 shares to Sub 2 for cash.

Result: Sub 1 and Sub 2 are involved in an indirect cross-issue of shares. Sub 1 receives a zero base cost in the Sub 2 shares received, and Sub 2 similarly receives a zero base cost in the Sub 1 shares received.

Example 4 – Shares issued in exchange for debt

Facts: Holdco owns all the shares of Sub. Holdco issues a promissory note to Sub in exchange for additional Sub shares.

Result: Holdco and Sub are involved in a share-for-debt cross-issue. Sub receives a zero base cost in the promissory note acquired in exchange for the issue of its shares. The base cost of HoldCo's shares in Sub is regulated by s 24B(3).

8.31.5 Exception - Debt issued in exchange for a share or debt issue (s 24B(3))

This rule applies where

- a company issues any debt instrument directly or indirectly to a person,
- in exchange for the issue of shares or of a debt instrument to that company, or
- in exchange for the issue of shares or of a debt instrument to a connected person in relation to that company.

The company that acquired the share or debt instrument is, in these circumstances, deemed

- to have incurred expenditure in respect of the acquisition, but
- only to the extent that the amounts are paid by that company in terms of the debt instrument issued.

The above rule is necessary because debt instruments issued in exchange for the direct cross-issue of shares or debt create the same problems as the cross issue of shares. This cross issue is again wholly tax-free to both parties in the transaction, thereby creating a similar opportunity for artificially inflating value.

Example 1 – Direct cross-issue of debt

Facts: Holdco owns all the shares of Sub 1 and Sub 2. Sub 1 issues a debt instrument in exchange for a debt instrument issued by Sub 2.

Result: Sub 1 and Sub 2 are involved in a direct cross-issue of debt. Sub 1 receives base cost in the debt instrument issued by Sub 2 as Sub 1 makes payments on the debt instrument issued by Sub 1. Sub 2 similarly receives base cost in the debt instrument issued by Sub 1 as Sub 2 makes payments on the debt instrument issued by Sub 2. However, base cost in the Sub 1 debt instrument is reduced as payment is made on that note, and the base cost in Sub 2 is similarly reduced as payment is made on that debt instrument.

Example 2 – Issue of debt in exchange for shares

Facts: Holdco owns all the shares of Sub. Holdco issues a promissory note to Sub in exchange for additional Sub shares.

Result: Sub is involved in a debt-for-share cross issue. Holdco receives a base cost in the shares acquired as payments are made on the note.

Example 3 – Non-applicability of s 24B(3) where debt not issued

Facts: Company X borrows funds to acquire pre-existing debentures of Company Y that are widely traded on a listed market.

Result: Section 24B(3) does not apply because no direct or indirect cross-issue of debt exists. Company Y never issued the debt directly or indirectly to Company X.

Chapter 9 - Proceeds

PART VI: PROCEEDS

9.1 Proceeds from disposal

Paragraph 35

9.1.1 Inclusions in proceeds (para 35(1))

The proceeds from the disposal of an asset is the amount received by or accrued to or which is treated as having been received by or accrued to or in favour of a person in respect of the disposal.

'Amount'

The meaning of the word 'amount' was judicially considered in *Lategan v CIR*[149] in relation to its use in the gross income definition and the following dictum of Watermeyer J has been cited with approval in a number of other cases:[150]

> 'In my opinion, the word 'amount' must be given a wider meaning, and must include not only money but the *value* of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value.' [Emphasis added.]

Where the amount takes a form other than cash, it must have a money value – that is, it must be capable of being sold (*Ochberg v CIR*[151]) or otherwise turned into money or money's worth (*Stander v CIR*[152]). The word 'amount' bears the same meaning in relation to proceeds.

'In respect of'

The words 'in respect of' make it clear that a receipt and accrual causally connected to a disposal will qualify as part of the proceeds from that disposal in spite of the fact that such receipt or accrual may have preceded that disposal.

Specific inclusions

The proceeds include
- the amount by which any debt owed by that person has been reduced or discharged (see example below); and
- any amount accruing to the lessee from the lessor for improvements effected to the leased property.

Example – Proceeds equal to amount of debt discharged

Facts: Jack owes Jill R100. Jack sells an asset to Jane for an amount of R150. He requests Jane to settle his debt with Jill and to give him R50 in cash.

[149] *W H Lategan v CIR* 1926 CPD 203 at 209, 2 SATC 16 at 19.
[150] See also *CIR v Butcher Bros (Pty) Ltd* 1945 AD 301, 13 SATC 21 at 34; *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9 at 21.
[151] 1933 CPD 256, 6 SATC 1 at 8.
[152] 1997 (3) SA 617 (C), 59 SATC 212 at 218/9.

Result: The amount of R100 paid by Jane to Jill will constitute part of the proceeds on disposal of Jack's asset.

'Received or accrued'

The concept of received or accrued is the same as used for ordinary income in the Act. The words 'received by' mean

> 'received by the taxpayer on his own behalf for his own benefit'. [153]

The word 'accrued' means

> 'to which he has become entitled'.[154]

As value-added tax does not accrue to or in favour of a vendor, it is not included in proceeds.

9.1.2 Proceeds from value shifting arrangement (para 35(2))

The proceeds from a disposal by way of a value shifting arrangement are dealt with specifically in para 35(2). The proceeds are the difference between the market value of the interest in the company, trust or partnership before the value shifting event takes place and the market value of that interest after the event has occurred. The proceeds are the amount by which the market value has decreased. (See Chapter 21 – Anti–avoidance measures for further details and examples on value shifting)

9.1.3 Reduction in proceeds (para 35(3))

Proceeds must be reduced by the amounts shown in the table below.

Table 1 – Reduction in proceeds

Paragraph 35(3)	**Proceeds must be reduced by**
(*a*)	Any amount of the proceeds that *must be* or *was* • included in the gross income of that person, or • taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain.
(*b*)	Any amount of the proceeds that has been repaid or has become repayable to the person to whom that asset was disposed of.
(*c*)	Any reduction, as a result of the cancellation, termination or variation of an agreement or due to the prescription or waiver of a claim or release from an obligation or any other event, of an accrued amount forming part of the proceeds of that disposal.

Amounts included in gross income / taxable income (para 35(3)(*a*))

Proceeds on the disposal of an asset must be reduced by any recoupment of capital allowances. The use of the words 'must be' require a person to determine whether an amount will be taxed as ordinary income at some point in the future. This emphasises the point that as a general rule, the principal Act will take precedence over the Eighth Schedule.

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[153] *Geldenhuys v CIR* 1947 (3) SA 256 (C), 14 SATC 419 at 430.
[154] *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9 at 19.

It should be noted that whilst dividends are included in gross income by virtue of para (*k*) of the definition of gross income, they may nevertheless be deemed to constitute proceeds in terms of the definition of 'capital distribution' in para 74 read with para 76. For example, an amount distributed in anticipation of liquidation out of pre-1993 revenue profits or pre-1 October 2001 capital profits constitutes a dividend as defined. But dividends of this nature fall within the definition of a 'capital distribution' in para 74, as they are exempt from STC in terms of s 64B(5)(*c*). As a result, para 76 deems them to be proceeds in the hands of the shareholder on disposal of the relevant share. In effect then, para 76 overrides para 35(3)(*a*). The dividend element of a share buy-back is, however, dealt with under the core rules – see **18.5**.

Reversal of proceeds by repayment or cancellation (para 35(3)(b) and (c))

Paragraph 35(3)(*b*) and (*c*) only apply where the proceeds are received during the year of assessment in which the asset is disposed of, or where the proceeds are received in advance of the disposal.

Proceeds that are repaid in a subsequent tax year must be treated as a capital loss in terms of para 4(*b*)(i)(*cc*).

Proceeds to which a person is no longer entitled in a year subsequent to the year of disposal must be accounted for as a capital loss under para 4(*b*)(i)(*aa*) where the non-entitlement results from

- the cancellation, termination or variation of any agreement,
- the prescription or waiver of a claim,
- a release from an obligation, or
- any other event.

9.1.4 Disregarding of present value (para 35(4))

Where a person becomes entitled to any amount which is payable after the end of the year of assessment, that amount must be treated as having accrued to that person during that year. This provision mirrors the first proviso to the definition of 'gross income' in s 1 which was introduced following the *People's Stores* case[155] in which it was held that the amount to be included in gross income was the discounted future value. Paragraph 35(4) ensures that it is the face value of an amount of proceeds payable in the future that is brought to account, rather than the present value.

9.2 Disposal of partnership asset

Paragraph 36

9.2.1 Date of accrual of proceeds

In terms of para 36 the proceeds from the disposal of a partner's interest in a partnership asset is treated as having accrued to the partner at the time of the disposal. This is intended to provide certainty as to when capital gains or losses accrue.[156]

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[155] *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9.

[156] in *Sacks v CIR* 1946 AD 31, 13 SATC 343 it was held that the profits accrue on the date on which the partners agree to take account of the profits. This common law position is superseded by para 36 for CGT purposes and by s 24H(5) for ordinary income.

9.2.2 Guidelines for the treatment of partnerships

The core rules of the Eighth Schedule apply to partners who are persons for tax purposes. Also applicable to partners are the existing provisions of the Act dealing with the submission of returns and the issuing of assessments.

A partnership[157] is not a separate legal entity and is not a taxpayer. It is therefore the individual partners who must bear the consequences of CGT.

The taxation of partnerships poses a number of practical difficulties. Every time a new partner joins or a partner leaves, the existing partnership is dissolved and a new partnership comes into existence.[158] These strict common law principles would have the effect of triggering a disposal of the entire interest of each partner each time a partner joined or left.

For practical reasons it is not intended that this strict legal approach be followed. Instead, each partner must be regarded as having a fractional interest in each of the partnership assets.[159]

9.2.2.1 Partners joining the partnership

When a new partner joins the existing partners must be treated as having disposed of a part of their share in the partnership assets and a capital gain or loss must be determined in respect of the part disposed of. The base cost of the part disposed of must be determined in accordance with para 33.

The new partner will acquire a corresponding interest in those assets and this will constitute that partner's base cost.

9.2.2.2 Assets contributed to the partnership

When a partner introduces an asset to the partnership, this will trigger a part-disposal of a portion of that partner's interest in the asset, while the other partners will acquire a corresponding interest in the part disposed of.

9.2.2.3 Partners leaving the partnership

A partner leaving a partnership will have disposed of his or her interest and a capital gain or loss must be determined. The remaining partners who acquire that partner's interest will reflect an increase in base cost.

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[157] As to the requirements for a valid partnership see *Joubert v Tarry and Co Ltd* 1915 TPD 277.

[158] *Executors of Paterson v Webster, Steel & Co* (1881) 1 SC 350 355: *Whitelock v Rolfes, Nebel & Co* 1911 WLD 35; *Wagstaff & Elston v Carter & Talbot* 1909 TS 121;*Standard Bank v Wentzel & Lombard* 1904 TS 828 833–834; *Kirsh Industries Ltd v Vosloo & Lindeque* 1982 (3) SA 479 (W).

[159] This approach is followed by the United Kingdom and Australia. Regarding the United Kingdom practice, see Partnerships: Statement of Practice D12 (17 January 1975) <http://www.inlandrevenue.gov.uk/pdfs/sp_d12_2002amdt.pdf> (accessed 22 March 2005). For the United Kingdom Inland Revenue *Capital Gains Manual* on partnerships generally, see <http://www.inlandrevenue.gov.uk/manuals/CG1manual/HTML/1CGCON03/04_0001_CGCONT3.htm> (accessed 22 March 2005). As regards the Australian treatment see Subdivision 106-A of the Income Tax Assessment Act, 1997 <http://law.ato.gov.au/atolaw/view.htm?find=((%22Income%20Tax%20assessment%20act%201997%22)%20AND%20(%22106-A%22))&docid=PAC/19970038/106-5> (accessed 22 March 2005).

9.2.2.4 Assets disposed of by the partnership

When an asset is disposed of to a third party the proceeds must be allocated between the partners according to the partnership agreement, or if one does not exist, according to partnership law. In *Isaacs v Isaacs*[160] the court said the following:

> 'It is clear law that on dissolution each party gets a proportionate share of the assets according to his or her contribution, and it is only when their respective contributions were equal or it is impossible to say that one has contributed more than the other that they share equally – *vide Fink v Fink* (1945 WLD 226).'

In the absence of a specific asset-surplus-sharing ratio, the proceeds will normally be allocated according to the profit-sharing ratio.

For the purposes of para 20 the base cost of each partner's interest in the asset will comprise the amount paid for that interest less any part of the interest in the asset that has been disposed of. It is important to realise that when a partner acquires an interest in a partnership that interest is comprised of the share in the assets less the liabilities. The net interest is not an asset for CGT purposes – it is the gross cost of the assets that must be considered. For example, a person acquires a half share in a partnership made up as follows:

	R
Asset	100 000
Creditor	(60 000)
Amount paid	40 000

The CGT asset has a base cost of R100 000, not R40 000.

Table 1 – Consequences of change in partner's fractional share

Change in fractional share	Consequence	Example
Increase	Acquisition	• New partner acquires an interest • Purchase of additional interest from retiring partner • Change in profit sharing ratio resulting in an increase in a partner's interest
Decrease	Disposal	• Withdrawal of partner • Death of partner • Insolvency/liquidation of partner or partnership • Dilution of interest through introduction of new partner • Change in profit sharing ratio resulting in a decrease in a partner's interest

Example 1 – Division of capital profits and losses

Facts: Jack and Jill set up a business in partnership. Jack contributes a piece of land to the partnership. In terms of their partnership agreement Jack has a 75% interest in the land and Jill 25%. The agreement states that profits must be shared evenly.

[160] 1949 (1) SA 952 (C) at 961, cited with approval in ITC 1721 (1999) 64 SATC 93 (G).

Result: When the land is sold, Jack's capital gain or loss will be determined on the basis of his 75% interest. For other partnership assets, the capital gains and losses must be split equally.

Example 2 – Withdrawal of partner

Facts: A, B and C commence business in partnership. They each inject R10 000 in cash into the partnership bank account which is later used to purchase a piece of land at a cost of R30 000. 5 years later the land is worth R90 000 and partner B decides to leave the partnership. Partner A pays him R30 000 for his share ($^1/_3$ x R90 000).

Result:

Disposal by B

	R
Proceeds	30 000
Base cost	10 000
Capital gain	20 000

Acquisition by A

Base cost of interest before acquisition	10 000
Acquisition of B's interest	30 000
Revised base cost	40 000

C is unaffected by the transaction as his percentage interest remains one-third.

Example 3 – Admission of partner

Facts: A, B and C commence business in partnership. They each inject R10 000 in cash into the partnership bank account which is later used to purchase a piece of land at a cost of R30 000. 5 years later the land is worth R90 000, and A, B and C decide to admit D as an equal partner for a consideration of R22 500 (one-fourth of R90 000). A, B and C each receive R7 500 of the amount paid by B (R22 500/3).

Result:

A, B and C each owned a one-third interest in the partnership assets prior to D joining. This was reduced to one-fourth resulting in a part-disposal.

	A	B	C	Total
Proceeds	7 500	7 500	7 500	22 500
Base cost	2 500	2 500	2 500	7 500
Capital gain	5 000	5 000	5 000	15 000

Determination of part disposed of:
A, B and C each had a 1/3 share ($33^1/_3$%).
With the admission of B this reduced to one-quarter (25%).
Reduction = 33,33% – 25% = 8,33 (1/12th)
Percentage reduction = 8,33/33,33 x 100 = 25%
In other words, one third minus one twelfth = one quarter.
Part disposed of = 25% x R10 000 = R2 500

The same result is achieved if one applies the para 33 formula:
Proceeds/Market value before disposal x base cost

R7500/R30 000 x R10 000 = R2 500

D will have a base cost of R22 500.

Example 4 – Disposal of partnership asset

Facts: The facts are the same as Example 2. Partners A and C sell the land for R120 000 two years later.

Result:

	A	C	Total
Proceeds	80 000	40 000	120 000
Base cost	40 000	10 000	
Capital gain	40 000	30 000	

Example 5 – Unequal initial contributions, equal profit sharing

Facts: Duncan and Lorraine enter into a partnership agreement in terms of which

- the capital account of a partner must be credited with the market value of any assets contributed by that partner, and
- profits on the disposal of any partnership assets are shared equally.

For the purposes of this example, capital allowances and other income and expenses are ignored.

The partners' respective contributions at the date of formation of the partnership were as follows:

	Market value	Base cost
	R	R
Duncan – land and buildings	200 000	100 000
Lorraine – plant and machinery	300 000	150 000

Three years later the partnership was dissolved and the assets sold for the following amounts:

	R
Land and buildings	350 000
Plant and machinery	400 000
Total proceeds	750 000

Result:

Accounting consequences

Balance sheet
as at date of formation

Capital employed

Capital accounts	R
Duncan	200 000
Lorraine	300 000
	500 000

Represented by:

	R
Land and buildings	200 000
Plant and machinery	300 000
	500 000

Income statement
for the year ending on date of dissolution

Profit on sale of partnership assets	R
Land and buildings	150 000
(R350 000 – 200 000)	
Plant and machinery	100 000
(R400 000 – 300 000)	
Net income for the year	250 000
Distributed as follows	
Duncan 50% x R250 000	125 000
Lorraine 50% x R250 000	125 000
	250 000

Each partner's share is credited to his/her capital account.

Balance sheet
as at date of dissolution

Capital employed

Capital accounts	R
Duncan R200 000 + R125 000	325 000
Lorraine R300 000 + R125 000	425 000
	750 000
Represented by:	
Cash	750 000

The CGT consequences

On entry into the partnership

Duncan has disposed of 50% of his interest in the land and buildings in exchange for a 50% interest in Lorraine's plant and machinery. In determining what has been acquired and disposed of by each partner, it is best not to have regard to the partners' capital accounts, as this can cause confusion. For example, one may be tempted to say that Duncan has a 2/5 interest in the partnership assets because of the ratio that the balance on his capital account bears to the combined capital accounts, but the correct interest is 50%.

Duncan and Lorraine are connected persons in relation to each other. Paragraph 38 requires that transactions between connected persons must take place at market value. Therefore the capital gains of the partners must be determined as follows:

Duncan

Disposal of fractional interest in land and buildings on date of entry

	R
Proceeds (50% x 200 000)	100 000
Base cost (50% x 100 000)	50 000
Capital gain	50 000

He has acquired a base cost in the plant and machinery of R300 000 x 50% = R150 000 and has retained a base cost of 50% x R100 000 = R50 000 in the land and buildings.

Disposal of fractional interest in partnership assets on dissolution

	R
Proceeds – land and buildings (R350 000 x 50%)	175 000
Less: base cost	50 000
Capital gain	125 000
Proceeds – plant and machinery (R400 000 x 50%)	200 000
Less: base cost	150 000
Capital gain	50 000
Total capital gains:	
On entry	
– land and buildings	50 000
On dissolution	
- land and buildings	125 000
- plant and machinery	50 000
	225 000
Proof:	
Balance on capital account (represented by cash)	325 000
Less: base cost of land and buildings before entry	100 000
Increase in net wealth	225 000

Lorraine

Disposal of fractional interest in plant and machinery on date of entry

Lorraine has disposed of 50% of her interest in the plant and machinery in exchange for a 50% interest in Duncan's land and buildings.

	R
Proceeds **(50%** x R300 000)	150 000
Less: base cost (50% x R150 000)	(75 000)
Capital gain	75 000

Disposal of fractional interest in partnership assets on dissolution

Land and buildings

Proceeds (R350 000 x 50%)	175 000
Less: base cost	(100 000)
Capital gain	75 000

Plant and machinery

	R
Proceeds (R400 000 x 50%)	200 000
Less: base cost	75 000
Capital gain	125 000

Total capital gains:

On entry	
– plant and machinery	75 000
On dissolution	
- land and buildings	75 000
- plant and machinery	125 000
	275 000
Proof:	
Balance on capital account (represented by cash)	425 000
Less: base cost of plant and machinery before entry	150 000
Increase in net wealth	275 000

Example 6 - Partner contributing labour, the other contributing an asset

Facts: Paul and Simon, both musicians, enter into a partnership. Paul contributes a guitar worth R20 000 whilst Simon contributes his exceptional musical talent. They agree to share profits and assets equally. The base cost of Paul's guitar is R5 000. Some years later, following flagging album sales they decide to end the partnership and sell the guitar for R36 000, each partner receiving R18 000.

Result:

Consequences on entry into partnership

By entering into the partnership, Paul disposes of 50% of his interest in the guitar. Although he does not physically receive any proceeds, he is deemed in terms of para 38 to have disposed of his 50% share in the guitar at market value. He realises a capital gain of R10 000 – R2 500 = R7 500. Simon acquires a base cost in the guitar of R10 000.

Consequences on dissolution

Paul's capital gain is R18 000 – R2 500 = R15 500, whilst Simon's is R18 000 – 10 000 = R8 000.
Proof: Paul's capital account was credited with R20 000 + [50% x (R36 000 – R20 000)] = R28 000. His guitar cost him R5 000 originally, so his increase in wealth is R23 000. His capital gains total R7 500 + R15 500 = R23 000. Simon started with nothing and his capital account was credited with R8 000 [50% x (R36 000 – R20 000)]. His capital gain is R8 000.

Example 7 – Depreciable asset

Facts: Five high-flying individuals decide to purchase a helicopter in an equal partnership at a cost of R5 000 000 during the 2002 tax year. They each claim a s 12C allowance in their 2002 returns of income of R200 000 (R5 000 000 x 20% = R1 000 000 x 1/5 = R200 000).

In 2003 one of the partners decides to sell his share in the helicopter to his fellow partners for R1 050 000.

Result: His capital gain will be calculated as follows:

	R
Consideration received	1 050 000
Less: recoupment	200 000[161]
Proceeds	850 000
Cost	1 000 000
Less: s 12C allowance	200 000
Base cost	800 000

Capital gain R850 000 – R800 000 = R50 000

9.2.2.5 Partners as connected persons and goodwill

Partners are connected persons in relation to each other. This follows from the definition of 'connected person' in s 1 of the Act, which reads as follows:

> '**"connected person"** means—
> . . .
> (*c*) in relation to a member of any partnership—
> (i) any other member; and
> (ii) any connected person in relation to any member of such partnership . . .'.

Paragraph 38 provides that transactions between connected persons that are not at an arm's length price must be treated as taking place at market value. It frequently happens in large partnerships that new partners are not required to pay for goodwill on entry nor are retiring partners paid for goodwill by the remaining partners. An amount would only be received for goodwill if the partnership were dissolved or sold as a going concern. SARS accepts that partners in such large partnerships are acting at arm's length and that the proceeds derived by a retiring partner should not be artificially increased to include goodwill for which no consideration has been received. Likewise a retiring partner who has not paid for goodwill on entry must not include goodwill in market value on 1 October 2001 unless it is disposed of for a consideration. The provisions of para 27 would in any event preclude the claiming of a market value loss on disposal of an asset acquired and disposed of for no consideration. Paragraph 16 also precludes the claiming of a loss in respect of goodwill acquired prior to valuation date from a connected person.

9.3 Assets of trust and company

Paragraph 37

In terms of the Eighth Schedule capital gains and losses determined in respect of most personal-use assets are disregarded. Whilst capital gains are taxable, capital losses in respect of certain assets such as boats and aircraft not used for trade purposes are disregarded (see para 15 for the reasons why these losses are disregarded.)

The purpose of this paragraph is to prevent persons from circumventing these provisions by holding these assets in a closely held company or trust. The paragraph provides that

- where a trust or company, the interest in which or shares of which, are owned directly or indirectly by a natural person,

[161] In Case 10990, 2003 (8) JTLR 211 Goldblatt J held that a company that disposed of 99%of its interest in an aircraft partnership was subject to recoupment in terms of s 8(4)(*a*) in respect of the s 14*bis* allowances it had claimed on its undivided share in the aircraft.

- that trust or company owns assets such as boats or aircraft or assets which if owned by natural persons would be personal-use assets,
- there is a decrease in the value of the assets of the trust or company after that person acquired the interest in the trust or company,
- the interest in the trust or company is thereafter disposed of by a person,

that person is treated as having disposed of the interest at proceeds equal to market value, as if the market value of the assets of the trust or company had not decreased.

The effect of the paragraph is to disregard any loss that person may suffer as a result of the decrease in the value of the assets. This paragraph does not apply where more than 50% of the assets of the trust or company are used wholly and exclusively for trading purposes.

9.4 Disposal by way of donation, consideration not measurable in money and transactions between connected persons not at arm's length price

Paragraph 38

This provision applies where a person disposes of an asset
- by donation,
- for a consideration not measurable in money, or
- to a connected person[162] for a consideration which does not reflect an arm's length price.

The term 'not measurable in money' does not include a barter transaction where the value of the asset given can be determined.

The phrase 'acting at arm's length' was considered in *Hicklin v SIR*[163] where Trollip JA stated the following:

> 'It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself.'

The consideration, which is not an arm's length price between connected persons, could be greater than or less than the market value of the asset disposed of.

The person disposing of the asset is treated as having disposed of the asset for an amount received or accrued[164] equal to the market value of the asset at the date of disposal. The acquiror is treated as having acquired the asset at the same market value. The market value is treated as an amount of expenditure actually incurred and paid for the purposes of para 20(1)(*a*).

The market value of the asset is also substituted for the actual consideration to which the parties agreed.

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[162] As defined in s 1.
[163] 1980 (1) SA 481 (A), 41 SATC 179 at 195.
[164] The term 'amount received or accrued' was substituted for the word 'proceeds' by Act 32 of 2004, effective 24 January 2005.

Disposals to which para 38 does not apply

Table 1 – Disposals to which para 38 does not apply

Paragraph 38	Disposals of assets to which para 38(1) does not apply	Effective date
(1)	An asset transferred between spouses ito para 67.	1 October 2001.
(1)	A debt owed by a person that has been discharged for a consideration less than face value and deemed to be acquired at a nil base cost and disposed of for the amount discharged ito para 12(5).	Commencement of years of assessment ending on or after 1 January 2003.[165]
(2)(*a*)	A right contemplated in s 8A.	1 October 2001.
(2)(*b*)	An asset in the circumstances contemplated in s 10(1)(*n*E).	1 October 2001.
(2)(*c*)	A qualifying equity share contemplated in s 8B by an employer, associated institution or any other person by arrangement with the employer, as contemplated in para 1 of the Seventh Schedule, to an employee.	Disposals of qualifying equity shares acquired on or after 26 October 2004.
(2)(*d*)	An equity instrument contemplated in s 8C in respect of which that section applies and which had not yet vested as contemplated in that section at the time of that disposal.	Disposals of equity instruments acquired on or after 26 October 2004.
(2)(*e*)	Any asset in respect of which s 24B applies.	Assets acquired on or after 1 October 2001

The provisions of paras 12(5) and 67 override those of para 38(1).[166]

In the case of share incentive schemes and share option schemes the share trust and companies disposing of shares and options are often connected persons in relation to the employees and directors. Were it not for this exclusion the rules of the paragraph would apply to transactions between these parties. The effect in certain circumstances would have been that the consideration between the parties would have been inflated and employees would have been taxed on gains they never made or allowed losses they did not suffer. It is for this reason that the rules do not apply to ss 8A, 8B and 8C securities in the circumstances set out in the above table. Section 10(1)(*n*E) deals with the so-called ‘stop-loss’ provisions commonly found in share incentive schemes. For example, a share purchase trust deed may provide that employees must sell their shares back to the trust at cost if they do not remain in the employer’s service for a set period. At the time of repurchase the market price may be more or less than the cost price and this would trigger an artificial gain or loss in terms of para 38(1) were it not for the exception in para 38(2)(*b*).

Since s 24B (assets acquired through the issue of shares) contains its own market value rules, the provisions of para 38 do not apply to such transactions. In some cases s 24B provides that an asset acquired through the issue of shares shall have a nil base cost, and this would have conflicted with para 38, hence its exclusion.

Pre-valuation date disposals

[165] Paragraph 38(1) was made subject to para 12(5) by s 81 of the Revenue Laws Amendment Act 74 of 2002.
[166] Paragraph 38(1) is ‘subject to’ paras 12(5) and 67.

The provisions of para 38 only apply to disposals on or after the valuation date. Although this is not stated explicitly, there is a general presumption against the retrospective application of a statute (see **2.7**). The notion of determining market values retrospectively for an unlimited period also conflicts with the whole scheme of the Act. For example, para 29(4) and (8) provide that valuation date valuations must be carried out within 3 years of valuation date. In addition, had para 38 applied retrospectively, there would have been no need for the transitional rules in para 97.

The receipt of a donation

The receipt of a donation is generally of a capital nature[167] unless it is a payment for services rendered or is in the form of an annuity. The question arises as to whether the receipt of such a donation gives rise to a capital gain in the hands of the donee. When the donee accepts the donation, he or she acquires a personal right to claim payment of the donation from the donor for no consideration. When the donor pays the donation the personal right is disposed of in exchange for the proceeds in the form of the amount received. So ostensibly the receipt of a donation could give rise to a capital gain. However, para 38 takes care of this problem by treating the donee as having acquired the personal right at market value. Since the proceeds would usually have the same market value as the personal right, the receipt of a donation will generally not give rise to a capital gain or loss in the donee's hands.

Example 1 - Donation of asset

Facts: Johan donates a yacht exceeding ten metres in length to Indira as a token of his affection for her. There is no marital-like union between them at the time in spite of Johan's efforts to establish one. The yacht has a base cost of R1 000 000 and has a market value of R2 500 000 at the time of the donation.

Result: Johan and Indira do not qualify as spouses. The base cost of R1 000 000 in the hands of Johan is therefore not transferred to Indira. Johan treats the transaction as a disposal for a consideration of R2 500 000. He will therefore realise a capital gain of R1 500 000 in respect of the donation, while Indira will be treated as having acquired the yacht at a base cost of R2 500 000.

Example 2 – Disposal of asset for consideration not measurable in money

Facts: Keith sells an aircraft with a base cost of R1 000 000 and a market value of R3 500 000 to Lionel for a consideration that cannot be turned into money.

Result: Keith cannot treat the transaction as a disposal for a consideration having a value of nil and claim the base cost of the aircraft as a capital loss. Keith and Lionel will have to treat the transaction as a disposal and acquisition at R3 500 000. Keith will therefore realise a capital gain of R2 500 000 in respect of this disposal.

Example 3 – Disposal between connected persons not at arm's length

Facts: Jay Ltd sells immovable property with a base cost of R1 000 000 to Eye (Pty) Ltd, a subsidiary of Jay Ltd, for R2 200 000. Eye (Pty) Ltd plans to use the immovable property for purposes of erecting a factory.

It turns out that the property is much sought after due to its situation and that Jay Ltd received unsolicited offers in respect of it from independent third parties right up to the

[167] ITC 458 (1940) 11 SATC 178 (U).

moment of its sale to Eye (Pty) Ltd. The price on offer to Jay Ltd at the time of the sale to Eye (Pty) Ltd amounted to R2 900 000.

Result: The price agreed to between Jay Ltd and Eye (Pty) Ltd is lower than the price that the property might have been expected to fetch had Jay Ltd and Eye (Pty) Ltd been independent persons dealing at arm's length. The market value (i.e. R2 900 000) of the property is therefore substituted for the consideration agreed to between Jay Ltd and Eye (Pty) Ltd.

Example 4 – Disposal of depreciable asset between connected persons

Facts: Company A and Company B are connected persons in relation to each other. Company A sells a fully depreciated asset that it had acquired at a cost of R100 after valuation date to Company B for R100. The market value of the asset at the date of disposal was R120.

Result: In terms of para 38(1)(*a*) Company A has proceeds of R120 (amount received) – R100 (recoupment) = R20 and a base cost of nil (R100 cost reduced by capital allowances of R100 in terms of para 20(3)(*a*)) = R0, giving a capital gain of R20.
Note: This example reflects the law on or after 24 January 2005. Prior to that date para 38 deemed the asset to be disposed of for 'proceeds' equal to market value. Proceeds refers to the end result after applying para 35(3)(*a*). In the example this has the effect of deeming Company A to have proceeds of R120, which leads to double taxation.

9.5 Capital losses determined in respect of disposals to certain connected persons

Paragraph 39

In terms of this rule a person's capital loss determined in respect of the disposal of an asset to a connected person is treated as a 'clogged' loss.

Persons subject to ring-fencing of capital losses and timing of determination of relationship between parties (para 39(1))

A person must disregard any capital loss determined in respect of the disposal of an asset to the persons set out in the table below. Capital losses of this nature are 'clogged' (ring-fenced) (see commentary on para 39(2) below). The table also sets out the time when the relationship between the parties must be determined. Although the parties mentioned in para 39(1)(*b*) may also be connected persons, the maxim *generalia specialibus non derogant*,[168] prevails and the more specific provisions of para 39(1)(*b*) must be given preference over those of para 39(1)(*a*). One of the reasons for determining the relationship immediately after the disposal is that in some cases the relationship is only established after the transaction. This typically occurs, for example, in an asset for shares swop where one person disposes of an asset to a company in exchange for shares in that company.

Table 1 – Persons who must disregard capital losses

Paragraph 39(1)	**Type of acquirer**	**When relationship with acquirer must be determined**	**Effective date**
(*a*)	Connected person in relation to disposer	Immediately before disposal	1 October 2001

[168] General provisions do not take from or reduce specific or special ones.

(*b*)(i)	A company that is a member of same group of companies as the disposer	Immediately after disposal	Commencement of years of assessment ending on or after 1 January 2004
(*b*)(ii)	A trust with a company beneficiary that is a member of the same group of companies as the disposer	Immediately after disposal.	

The position prior to commencement of years of assessment ending on or after 1 January 2004.

Paragraph 39(1)(*b*) was introduced by Act 45 of 2003 with effect from the commencement of years of assessment ending on or after 1 January 2004. Prior to that date para 39(1) only dealt with disposals to connected persons and the relationship between the parties had to be determined prior to any disposal.

Example 1 – Timing of determination of connected person status

Facts: Holdco owns all the shares in Target Co that it had acquired in 2003 at a cost of R100 000. On 28 February 2005 Holdco disposed of its shares in Target to Subco in exchange for a 75% interest in Subco. The market value of the Subco shares was R80 000. Determine whether or not Holdco's capital loss of R20 000 will be clogged in terms of para 39.

Result: The share-for-share provisions in s 43 do not apply to the disposal by Holdco as the shares were disposed of at a capital loss (s 43 applies only to gain or break-even shares).

Prior to the disposal, Holdco and Subco are unrelated parties. Immediately after the transaction, Holdco has a 75% interest in Subco, which makes Holdco and Subco members of the same group of companies. In these circumstances para 39(1)(*b*)(i) applies and the capital loss is clogged.

Example 2 – Disposal to trust with beneficiary that is a member of the same group of companies as disposer

Facts: Holdco sells an asset with a base cost of R100 000 to the Subco Trust for R80 000. The trustees of the Subco Trust have the discretion to appoint any member of the Holdco group as a beneficiary. At the time the Subco Trust acquired the asset, the only nominated beneficiary was Oxfam. Immediately after the transaction, the trustees appointed Subco as a beneficiary and awarded the asset to it.

Result: Holdco's capital loss of R20 000 will be clogged in terms of para 39(1)(*b*)(ii) because

- after the transaction Subco was a beneficiary of the Subco Trust, and
- Holdco owns 75% of the shares in Subco, which makes Holdco and Subco members of the same group of companies.

Ring-fencing of capital losses (para 39(2))

Any capital loss arising from a transaction between the persons mentioned in para 39(1) is not brought into account in determining those persons' aggregate capital gain or aggregate capital loss for the tax year in which that disposal takes place. The loss is in effect ring-fenced and can only be deducted from capital gains determined in respect of other disposals during that or any subsequent year to the same person to whom the disposal giving rise to that loss was made. The person to whom the subsequent disposals are made would in addition have to still qualify as a connected person at the time of those disposals.

Restricted meaning of 'connected person' (para 39(3))

The definition of 'connected person' will not extend, for purposes of this rule, to
- any relative of a natural person other than a parent, child, stepchild, brother, sister, grandchild or grandparent of that person, or
- any fund of an insurer contemplated in s 29A in respect of the disposal of an asset in terms of s 29A(6) or (7).

Transactions between spouses are dealt with in terms of para 67 and for this reason they are not excluded from the definition of connected person.

South African long-term insurers are required for income tax purposes to create four funds to conduct their business. The funds are regarded as separate persons for income tax purposes and disposals of assets between the funds are regarded as disposals on which CGT is imposed. In terms of s 29A(6) and (7) of the Income Tax Act the insurers are required to transfer assets between the different funds if there is a change in policyholders or a balancing of assets and liabilities is required. In view of the fact that these disposals are involuntary, for the purposes of this paragraph the different funds of the insurers are not regarded as connected persons. Any capital losses made on disposals between funds will, therefore, not be 'clogged' under these circumstances.

Losses on certain debts not clogged (para 56(2))

Paragraph 39 does not apply to a capital loss arising on the disposal of a claim owed to a creditor, where the debtor and creditor are connected persons, and the amount
- comprises a capital gain in the debtor's hands in terms of para 12(5),
- must be or was included in the gross income of an acquirer of the claim,
- must be or was included in the gross income of the debtor or reduced an assessed loss of the debtor in terms of s 20(1)(*a*)(ii), or
- must be or was included as a capital gain in the hands of the acquirer of the claim.[169]

Example 1 – Ring-fencing of losses between connected persons

Facts: During year 1 Aitch Ltd sold undeveloped immovable property having a base cost of R1 000 000 to Gee (Pty) Ltd, a wholly owned subsidiary, at its market value of R500 000. During year 2 Aitch Ltd sold a further piece of undeveloped immovable property to Gee (Pty) Ltd with a base cost of R500 000 and a market value of R400 000. This sale was effected at a price of R600 000. During year 3 Aitch Ltd sold a shopping complex with a base cost of R1 500 000 to Gee (Pty) Ltd at a market related price of R1 800 000. This was followed during year 4 by the sale of all the shares held by Aitch Ltd in Gee (Pty) Ltd to a foreign developer not linked to Aitch Ltd. Gee (Pty) Ltd subsequently made an offer to Aitch Ltd to buy the remaining immovable property held by Aitch Ltd. Aitch Ltd accepted the offer and sold the property that had been acquired by it at a base cost of R300 000 to Gee (Pty) Ltd at its market value of R800 000.

Result: The position can be summarised as follows:

[169] This provision came into operation as from the commencement of years of assessment ending on or after 1 January 2005.

Year	Asset	MV at date of sale R	Aitch's base cost R	Aitch's gain / (loss) R	Comment
1	Undeveloped land	500 000	1 000 000	(500 000)	Loss ring-fenced.
2	Undeveloped land	400 000 (sold for 600 000)	500 000	(100 000)	Loss ring-fenced – market value substituted for actual selling price.
3	Shopping complex	1 800 000	1 500 000	300 000	Gain may be set off against accumulated clogged losses b/f of R600 000.
4	Immovable property	800 000	300 000	500 000	Gain may not be set off against remaining clogged loss of R300 000. Gee is no longer a connected person in relation to Aitch.

9.6 Short-term disposals and acquisitions of identical financial instruments

Paragraph 42

The type of transaction envisaged in this paragraph is commonly referred to as a 'wash sale' or 'bed and breakfasting' and usually involves the disposal of listed shares in order to crystallise losses immediately before the tax year-end followed by the repurchase of the same listed shares immediately thereafter.

Under subpara (1), if a person sells financial instruments (e.g. listed shares) and buys those same financial instruments back within the 45-day period before or after the sale date, the loss cannot be immediately claimed for the purposes of CGT. It should be noted that the person disposing of the financial instruments need not be the person reacquiring them. This rule extends beyond just the seller and includes connected persons. For the purposes of this paragraph, however, the term 'relative' is narrowed in scope. The definition of 'connected person' will not extend, for purposes of this rule, to

- any relative of a natural person other than a parent, child, stepchild, brother, sister, grandchild or grandparent of that person
- any fund of an insurer contemplated in s 29A in respect of the disposal of an asset in terms of s 29A(6) or (7).

Spouses are dealt with in terms of para 67.

Note that the rule applies to a 45-day period *before* or *after* the sale date, to prevent 'buying the financial instruments back' before they have even been sold. These periods are extended (i.e. do not include days) for periods in which the risk on the shares is hedged with offsetting positions.

Where the paragraph applies, the seller is treated as having received proceeds equal to the base cost of the financial instrument disposed of (i.e. there is no gain or loss for CGT purposes). The purchaser (if the same or a connected person), on the other hand, is required to add the capital loss realised by the seller to the actual cost incurred in 'repurchasing' the financial instruments. Effectively, the loss is 'held over' until such time as there is no restriction imposed upon the sale in terms of this rule. The deemed cost of the asset in the acquiror's hands is treated as expenditure actually incurred for the provisions dealing with base cost.

Example 1 – Short-term sale and repurchase of loss-making shares

Facts: Mark buys 500 shares of Effe Ltd listed on a recognised exchange for R10 000 and sells them on 20 February 2002 for R3 000. On 1 April 2002, he buys 500 shares of Effe Ltd for R3 200.

Result: Since the shares were repurchased within 45 days of loss-sale date, para 42 applies. Mark cannot claim his R7 000 loss. Instead, he must adjust his base cost for the 'repurchased' shares. The base cost in terms of subpara 1(*a*) and (*b*) for his 'new' shares will be R3 200 (the actual cost) plus R7 000 (the held-over loss), therefore R10 200.

Mark would also be affected by this paragraph if he had purchased his 'new' shares on 24 January 2002 and then made the loss sale on 20 February 2002. On the other hand, if Mark had waited and repurchased the 500 shares 46 days after the sale, para 42 would not apply and the R7 000 capital loss would be allowable. The base cost of the 500 shares repurchased would equal the cost actually incurred.

What is the situation where fewer shares are repurchased than were originally sold for a loss? Would all of the loss be 'held-over'? The answer is no. Only the portion of the loss attributable to the 'washed' sales would be disallowed. If the person only bought back a portion of the shares sold, then only a portion of the loss would be disallowed. The concept of 'grouping' the same financial instruments would not be applied. For example, 500 listed shares equate to 500 individual financial instruments and are not considered to be a single financial instrument.

Example 2 – Short-term sale and partial repurchase of shares

Facts: The facts are the same as Example 1 except that Mark only bought back 300 of the 500 shares (60%).

Result: Mark can claim 40% of the loss on the sale, or R2 800. The remaining R4 200 of the loss disallowed in terms of para 42 is added to the base cost of Mark's 300 'new' shares. Therefore the base cost of his 'new' shares is R6 120. (300 'new' shares at a cost of R1 920 plus the held over loss of R4 200).

Chapter 10 – Unquantified and unaccrued amounts

10.1 Overview

The treatment of unaccrued or unquantified amounts of proceeds and expenditure involves an interplay between various provisions in the principal Act and the Eighth Schedule. The provisions that are involved are set out in the table below.

Table 1 – Provisions relating to unaccrued or unquantified amounts

Provision	**Description**
Section 20B	Limitation of losses from disposal of depreciable assets arising from the scrapping allowance under s 11(*o*)
Section 23F(2) & (2A)	Limitation of losses from disposal of trading stock
Section 24M	Incurral and accrual of amounts in respect of assets acquired or disposed of for unquantified amounts
Paragraphs 3(*b*) and 4(*b*)	Capital gain or loss arising in year subsequent to the year of disposal
Paragraph 25(2)	Redetermination of capital gains and losses in respect of pre-valuation date assets
Paragraph 39A	Disposal of assets for unaccrued amounts of proceeds

The objectives of these provisions are *inter alia* to

- provide clarity regarding the treatment of unquantified amounts receivable or payable,
- prevent the up-front claiming of revenue and capital losses, and
- provide rules for the redetermination of capital gains and losses in the case of pre-valuation date assets.

10.2 Incurral and accrual of amounts in respect of assets acquired or disposed of for unquantified amount

Section 24M

Table 1 – Summary of provisions of s 24M

Section 24M	**Description**	**Effect**
(1)	Disposal of asset for unquantifiable consideration	Deems unquantified amounts not to accrue until they are quantified.
(2)	Acquisition of asset for unquantifiable consideration	Deems an unquantified amounts not to be incurred until they are quantified.
(3)	Recovery or recoupment of amounts allowed as deductions	Recovery or recoupment ito s 8(4) occurs as amounts are quantified.
(4)	Determination of deductions in respect of depreciable assets	Allowances that would have been granted in prior years on amounts that become quantified in later years are allowed in full in the year of quantification.

10.2.1 Introduction

Assets are occasionally acquired or disposed of for a consideration that is not quantifiable at the date of acquisition. A typical example would be where an asset is acquired for a consideration based on future profits. The common law position with amounts receivable of such a nature is that whilst there may arguably be an accrual, there will be no 'amount' unless it has an ascertainable money value.[170]

Our courts have also considered the deductibility of unquantifiable expenditure. In *CoT v 'A' Company*[171] the court allowed a merchant banker to claim a loss on a loan where the debtor had been liquidated, but the amount of the final liquidation dividend had not been quantified. Citing this case with approval, the court in *Edgars Stores Limited v CIR*[172] stated that it was necessary to draw a distinction between expenditure that was conditional, and expenditure in respect of which the obligation is unconditional but which can only be quantified in a subsequent year. Thus the court approved the principle that it is permissible for the quantum of the deduction to be fixed on the basis of a fair and reasonable estimate. The degree of certainty as to whether the expenditure will be incurred is, however, a factor, for as was said in ITC 1601,[173] there must be

> 'a clear measure of certainty as to whether the expenditure in contention is quantified or quantifiable'.

Section 24M defers the recognition of the accrual or incurral until the amount has been quantified. It does not deal with amounts that are quantifiable but have not accrued or been incurred because the agreement is subject to a suspensive condition, or where proceeds do not accrue and expenditure is not incurred because of a need for reciprocal performance (e.g. where delivery of an asset is deferred).[174] In the latter cases the normal common law principles apply and the accrual or incurral is deferred until the condition is fulfilled or performance takes place. Capital losses arising from amounts that have not accrued (whether by reason of s 24M or some other reason) are ring-fenced in terms of para 39A until all unquantified amounts have been quantified. Revenue losses arising under s 11(*o*) – the so-called scrapping allowance – which is probably better described as a balancing charge since the scrapping requirement was removed - are similarly ring-fenced in terms of s 20B until all unquantified amounts that are receivable are quantified. Losses on the disposal of trading stock are ring-fenced under s 23F.

Section 24M does not determine the capital or revenue nature of the amounts that become quantifiable. It simply determines when amounts accrue or are incurred. Where a person sells a business for a lump sum plus a share of the future profits, the lump sum will usually be of a capital nature and the share of the future profits of an income nature.[175] There is also a possibility that the future payments could be an annuity, in which case they will be included in gross income by para (*a*) of the definition of gross income.[176] For these reasons it is likely that most unquantifiable transactions involving future receipts will be on revenue account.

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[170] *CIR v Butcher Bros (Pty) Ltd* 1945 AD 301, 13 SATC 21.
[171] *CoT v 'A' Company* 1979 (2) SA 409 (RAD), 41 SATC 59.
[172] 1988 (3) SA 876 (A), 50 SATC 81 at 90.
[173] (1995) 58 SATC 172 (C) at 179.
[174] The non-accrual or incurral may result from the *exceptio non adimpleti contractus* which recognises that some contracts require reciproval performance. See **6.3.6** and commentary on deferred delivery arrangements.
[175] *Deary v Deputy Commissioner of Inland Revenue* 1920 CPD 541, 32 SATC 92; *Jones v The Commissioners of Inland Revenue* [1920] 1 KB 711, 7 TC 310.
[176] See *Silke* in § 4.3.

The term 'cannot be quantified' is not defined in s 24M. Of course virtually anything can be quantified by attaching a number to it through estimation. Such a wide interpretation would defeat the object of s 24M. It is submitted that s 24M is directed at preventing the estimation of expenditure in order to establish a deduction. This interpretation is consistent with the way in which the word 'quantified' was used in the *Edgars Stores* case and ITC 1601 *supra*. Section 24M therefore overrides the common law position in relation to expenditure.

10.2.2 Disposal of asset for unquantifiable consideration (s 24M(1))

Section 24M(1) deals with the situation where a person disposes of an asset for a consideration all or part of which cannot be quantified in that year of assessment. Where this happens the amount is deemed

- not to accrue to the person in that year, and
- to accrue in the year in which the amount becomes quantified.

The rule applies for the purposes of the Income Tax Act, which includes the Eighth Schedule. It therefore covers both capital assets and trading stock.

When the amount becomes quantifiable in the subsequent year, it will be treated as a capital gain in terms of para 3(*b*)(i). Where the asset is a pre-valuation date asset, it will be necessary to redetermine the capital gain or loss in terms of para 25(2).

10.2.3 Acquisition of asset for unquantifiable consideration (s 24M(2))

Section 24M(2) deals with the situation where a person acquires an asset for a consideration all or part of which cannot be quantified in that year of assessment. Where this happens the amount is deemed

- not to have been incurred by the person in that year, and
- to have been incurred in respect of the acquisition of the asset in the year in which the amount becomes quantified.

The rule applies for the purposes of the Income Tax Act, which includes the Eighth Schedule. It therefore covers both capital assets and trading stock.

When the amount becomes quantifiable in the subsequent year, it will simply be added to the base cost of the asset in that subsequent year. Where the asset has been disposed of prior to the amount being incurred the CGT consequences will be as follows:

- *Post-valuation date asset* - the amount incurred will be treated as a capital loss in terms of para 4(*b*)(ii).
- *Pre-valuation date asset* – the capital gain or loss must be redetermined in terms of para 25(2). The previous capital gain or loss will be reversed out, and the new capital gain or loss taken into account.

Example 1 – Straight-forward gain on unquantified amounts

Facts: Andrew acquired shares in December 2001 at a base cost of R250 000. In March 2005, he sold the shares to Bryan for a purchase consideration payable in instalments over 5 years with the first instalment due on 28 February 2006. The instalments are based on a formula linked to the average all share index of the JSE Securities Exchange SA in each instalment year. The amounts ultimately received are R300 000, R200 000, R150 000, R110 000 and R240 000. Assume that the payments are of a capital nature and do not comprise an annuity.

*Result: S*ection 24M applies because unquantified payments are involved. The initial 2006 year will trigger a small R50 000 capital gain for Andrew. Subsequent years will trigger additional capital gains.

	2006	2007	2008	2009	2010	Total
	R	R	R	R	R	R
Proceeds	300 000	200 000	150 000	110 000	240 000	1 000 000
Base cost	(250 000)	-	-	-	-	(250 000)
Capital gain	50 000	200 000	150 000	110 000	240 000	750 000

The base cost of the shares acquired by Bryan is accumulated over the 5 years as and when the amounts become quantified as illustrated below.

	2006	2007	2008	2009	2010	Total
	R	R	R	R	R	R
Amount payable	300 000	200 000	150 000	110 000	240 000	1 000 000
Base cost	300 000	500 000	650 000	760 000	1 000 000	

10.2.4 Recovery or recoupment of amounts allowed as deductions (s 24M(3))

This subsection applies where

- a person has disposed of a depreciable asset, and
- all or a part of the consideration in respect of the disposal will only be quantified in a future year of assessment.

In these circumstances the recovery or recoupment of any capital allowances claimed in respect of such an asset in terms of s 8(4) must be determined with reference to amounts that are deemed to accrue in terms of s 24M. In other words, recoupments will take place as and when the selling consideration is quantified. From a CGT perspective this is relevant for the purposes of determining the proceeds to be taken into account as a capital gain under para 3(*b*)(ii). In terms of para 35(3)(*a*) any amount recovered or recouped in terms of s 8(4) will reduce the proceeds.

10.2.5 Determination of deductions in respect of depreciable assets (s 24M(4))

This subsection applies where

- a person has acquired a depreciable asset in a previous year, and
- all or a part of the consideration in respect of the acquisition will only be quantified in a future year of assessment.

In these circumstances, when amounts of expenditure become quantified the person is given a 'catch up' allowance in respect of the additional expenditure incurred. This is equal to the sum of all allowances that the person would have been entitled to had the expenditure been incurred in the initial year. This means, for example, that provided that sufficient time has elapsed since the asset was brought into use (e.g. four years in the case of a s 12C asset) the person could qualify for a 100% deduction in respect of the additional expenditure. This is relevant from a CGT perspective in determining the amount to be allowed as a capital loss in terms of para 4(*b*)(ii), since the relevant expenditure must be reduced by the amount of any capital allowances in terms of para 20(3)(*a*).

Example – Determination of capital allowances when purchase price of asset unquantified

Facts: In 2006 Lulu acquired a manufacturing machine from Kyle on the following terms:

- R190 000 in 2006
- 10% of the turnover generated by the machine over the next 4 years (2007 – 2010). These amounts eventually were R40 000 (2007), R250 000 (2008), R280 000 (2009) and R240 000 (2010).

Result: The cost of the manufacturing machine acquired by Lulu that qualifies for capital allowances is accumulated over the 5 years as follows:

	2006	2007	2008	2009	2010	Total
	R	R	R	R	R	R
Cost incurred	190 000	40 000	250 000	280 000	240 000	1 000 000
Depreciation	40%	20%	20%	20%		
Cumulative %	40%	60%	80%	100%	100%	
On R190 000	76 000	38 000	38 000	38 000	-	190 000
On R40 000		24 000	8 000	8 000	-	40 000
On R250 000			200 000	50 000	-	250 000
On R280 000				280 000	-	280 000
On R240 000					240 000	240 000
Total depreciation	76 000	62 000	246 000	376 000	240 000	1 000 000

10.3 Disposal of asset for unaccrued amounts of proceeds

Paragraph 39A

10.3.1 Introduction

Paragraph 39A came into operation on 24 January 2005 and applies in respect of any disposal during any year of assessment commencing on or after that date.[177]

It frequently happens that assets are sold on terms that result in all or part of the proceeds from the disposal only accruing in a future year of assessment. This is the case, for example, with many deferred delivery share arrangements. It also occurs in the case of the disposal of immovable property where the seller will only be entitled to the proceeds stipulated in the sale agreement upon transfer of ownership.[178] In the absence of a provision to regulate such arrangements, the effect in many cases will be to trigger up-front capital losses. In essence para 39A ring-fences any capital loss arising from such a disposal until all the proceeds have accrued to the seller.

10.3.2 Disregarding of capital loss (para 39A(1))

In terms of para 39A(1), a person must disregard a capital loss arising on disposal of an asset during a year of assessment where all the proceeds from that disposal will not accrue to that person during that year.

10.3.3 Set off of ring-fenced capital loss against subsequent capital gains (para 39A(2))

A person who has a ring-fenced capital loss arising from the disposal of an asset in a prior year in terms of para 39A(1) may utilise that capital loss against any capital gains arising in the current year from the disposal of that asset For example, proceeds that were unquantifiable in the year of disposal may become quantifiable in the current year and will be deemed to accrue in that year in terms of s 24M(1)(*b*). In terms of para 3(*b*)(i) such proceeds will be treated as a capital gain in that year.

The deduction of the suspended loss is conditional upon the loss not otherwise having been allowed as a deduction. This would occur, for example, in the case of a pre-valuation date asset where the capital gain or loss is redetermined from scratch in the current year. In this

[177] Inserted by s 64(1) of Revenue Laws Amendment Act 32 of 2004.
[178] As a result of the need for reciprocal performance (*exceptio non adimpleti contractus*).

case the portion of the base cost that was suspended in the year of disposal will be taken into account in the redetermination of the capital gain or loss in the current year.

Example 1 - Overall gain on unaccrued amounts after suspended loss

Facts: Angus acquired an office block in December 2001 at a base cost of R500 000. In March 2005, he sold the office block to Moira. In terms of the contract the purchase price was payable in annual instalments over the next 5 years, with the first payment due on 28 February 2006. Each instalment was only payable if the purchaser achieved a net rental return of at least 10% during the relevant instalment year. The contingent instalments are R300 000, R200 000, R150 000, R110 000 and R240 000. The required rate pf return was eventually achieved in each year. Assume that the proceeds are on capital account and are not an annuity.

Result: The instalments are conditional and therefore accrue at the end of each year of assessment. In 2006 Angus will have a R200 000 suspended loss in terms of para 39A(1). Subsequent years will trigger capital gains that must first be used against the suspended loss (para 39A(2)).

	2006	2007	2008	2009	2010	Total
	R	R	R	R	R	R
Proceeds	300 000	200 000	150 000	110 000	240 000	1 000 000
Base cost	(500 000)	-	-	-	-	(500 000)
(Loss) gain	(200 000)	200 000	150 000	110 000	240 000	500 000
Suspended loss	200 000	(200 000)	-	-	-	-
Capital gain	-	-	150 000	110 000	240 000	500 000

In terms of para 20 Moira's base cost will be accumulated over the 5 years as and when she becomes unconditionally liable to pay the instalments (2006: R300 000; 2007: R300 000 + R200 000 = R500 000 etc.)

Example 2 - Overall gain on unquantified amounts with a zero instalment year

Facts: Vincent acquired an office block in December 2001 at a base cost of R500 000. In June 2005 he sold the office block to Jules for a purchase price payable in 5 instalments with the first payment due on 28 February 2006. The amount of each instalment was determinable in accordance with a formula linked to the JSE Securities Exchange property index. The amounts ultimately received are R400 000, R20 000, R150 000, R0 and R250 000, Assume that these are on capital account and not an annuity.

Result: In terms of s 24M(1) the instalments will accrue in the year in which they are quantified. Vincent will have a suspended loss of R100 000 in the first year in terms of para 39A(1). Subsequent years will trigger capital gains that will first be used against the suspended loss in terms of para 39A(2) with the zero instalment year having no net effect.

	2006	2007	2008	2009	2010	Total
	R	R	R	R	R	R
Proceeds	400 000	200 000	150 000	0	250 000	1 000 000
Base cost	(500 000)	-	-	-	-	(500 000)
Gain (loss)	(100 000)	200 000	150 000	110 000	240 000	500 000
Suspended loss	100 000	(100 000)	-	-	-	-
Capital gain	-	100 000	150 000	110 000	240 000	500 000

In terms of s 24M(2) read with para 20 the base cost of the office block acquired by Jules will be accumulated over the 5 years as and when the payments are quantified as follows: 2006: R400 000; 2007: R600 000; 2008: R750 000; 2009: R750 000 and 2010: R1 000 000.

Example 3 - Fixed plus unaccrued amounts

Facts: Jody acquired a property in December 2001 at a base cost of R500 000. In September 2005 she sold the property to Lance. In terms of the contract, Lance must pay the following amounts over the next 5 years commencing on 28 February 2006:

- Fixed instalments of R20 000 per annum, plus
- contingent instalments of R90 000, R200 000, R150 000, R1 000 and R24 000. These instalments are contingent on preset occupancy levels being achieved in each of the years in question. In each year the target occupancy levels were achieved.

Result: The fixed instalments of R20 000 x 5 = R100 000 are all included as proceeds in 2006 together with the first payment of R90 000 (para 35 and common law meaning of 'accrue'). Jody will only become entitled to the contingent instalments when the occupancy levels have been achieved at the end of each year and it is at this point that they will accrue to her. She will have a R310 000 suspended loss in 2006 in terms of para 39A(1). Subsequent years will trigger capital gains that will first be used against the suspended loss (para 39A(2)).

	2006	2007	2008	2009	2010	Total
	R	R	R	R	R	R
Proceeds	190 000	200 000	150 000	1 000	24 000	565 000
Base cost	(500 000)	-	-	-	-	(500 000)
(Loss) gain	(310 000)	200 000	150 000	1 000	24 000	65 000
Suspended loss	310 000	(200 000)	(110 000)	-	-	-
Capital gain	-	-	40 000	1 000	24 000	65 000

In terms of para 20 Lance's base cost is accumulated over the 5 years as and when he becomes unconditionally liable to pay Jody. His base cost will be as follows: 2006: R190 000; 2007: R390 000; 2008: R540 000; 2009: R541 000 and 2010: R565 000.

Example 4 - Buyer's sale of property before all amounts are incurred

Facts: The facts are the same as Example 3, except that Lance sells the property to Trudy after the 2007 instalment. Lance's sale of the property does not alter the payment relationship with Jody. Lance immediately receives R620 000 upon sale of the property to Trudy.

Result: The sale of the property by Lance has no effect on the gain calculations made by Jody. Lance's base cost at the time of disposal of the property to Trudy is R540 000 (i.e., R190 000 + R200 000 + R150 000). This generates a capital gain of R80 000 (R620 000 proceeds less R540 000 base cost). Further amounts paid by Lance to Jody will generate capital loss during the years those amounts are paid (para 4(*b*)(ii)). Hence, Lance will have a R1 000 capital loss in 2009 and a R24 000 capital loss in 2010.

Example 5 – Suspended loss not allowed as already taken into account

Facts: Tanya acquired a holiday home by inheritance in 1998. Prior to 30 September 2004 she determined its base cost to be R600 000 using the market value method. In the 2006 tax year she disposed of it on the following terms:

- R350 000 payable on 28 February 2006, and

- R650 000 payable on transfer.

Transfer was effected during 2007.

Result: Of the proceeds, R650 000 only accrues in 2007, as it is dependent on reciprocal performance (i.e. transfer). In the 2006 tax year there will be a suspended loss in terms of para 39A(1) of R350 000 – R600 000 = R250 000. In the 2007 tax year Tanya must redetermine the capital gain or loss in terms of para 25(2). The redetermined capital gain is R1 000 000 – R600 000 = R400 000 and is taken into account in 2007 in terms of para 3(*b*)(iii)(*aa*). Since the suspended loss of R250 000 has been taken into account in the redetermination as part of the base cost of R600 000, the suspended loss is not allowed as a deduction.

10.3.4 Lifting of ring-fencing of capital loss (para 39A(3))

Where a person can prove that no further proceeds will accrue the remaining portion of any unutilised capital loss may be taken into account in determining that person's aggregate capital gain or loss for that year. In other words, the ring-fencing of the capital loss comes to an end.

Example - Overall loss on unaccrued amounts

Facts: Marcellus acquired property in December 2001 at a base cost of R500 000. In December 2005 he sold the property to Wolf in 5 instalments of R40 000, R20 000, R15 000, R1 000 and R24 000, with the first payment due on 28 February 2006. Each instalment was, however, contingent on a required level of profitability being achieved in the relevant instalment year. The required level of profitability was eventually achieved in each year.

Result: Since the amounts receivable are contingent they do not accrue until the condition has been satisfied (normal common law principles). The initial 2006 year will trigger a R460 000 suspended loss for Marcellus in terms of para 39A(1). This suspended loss will be partly offset with successive gains in terms of para 39A(2). However, the transaction will generate a net R400 000 capital loss in 2010 once all instalments have been received. In terms of para 39A(3) that capita loss may be utilised against other capital gains in that year. In other words, the loss ceases to be suspended.

	2006	2007	2008	2009	2010	Total
	R	R	R	R	R	R
Proceeds	40 000	20 000	15 000	1 000	24 000	100 000
Base cost	(500 000)	-	-	-	-	(500 000)
(Loss) gain	(460 000)	20 000	15 000	1 000	24 000	(400 000)
Suspended loss	460 000	(20 000)	(15 000)	(1 000)	(424 000)	-
Capital loss	-	-	-	-	(400 000)	(400 000)

In terms of para 20 and the common law principles governing the incurral of expenditure, Wolf' will have a base cost accumulated over the 5 years as and when he becomes unconditionally liable to pay Marcellus. Hence, Wolf will have a base cost as follows: 2006: R40 000; 2007: R60 000; 2008: R75 000; 2009: R76 000 and 2010: R100 000.

10.4 Disposal of certain debt claims

Paragraph 35A

10.4.1 Application (para 35A(1))

Three conditions must be met before this provision can apply.

- First, a person must have disposed of an asset during any year of assessment, and a portion of the proceeds will only accrue in a subsequent year of assessment. The reason for the non-accrual could be due to the fact that the proceeds are not quantifiable in the year of disposal, or because they are subject to some contingency or as a result of the need for reciprocal performance (*exceptio non adimpleti contractus*).
- Secondly, the person must subsequently have disposed of any right to claim payment in respect of that disposal. For example, the debt arising from the disposal is disposed of to a third party such as a factoring house.
- Thirdly, the claim must include any amount that has not yet accrued to that person at the time of the disposal of the claim. This requirement refers to the claim itself, and not to the right to claim payment in respect of the claim. Where the claim is disposed of after all amounts have accrued to the seller of the asset the provision does not apply.

The purpose of the provision is to prevent the understatement of proceeds subject to CGT on the disposal of an asset. The understatement occurs because the unaccrued proceeds are diverted to the disposal of the debt, which has an enhanced base cost equal to the market value of the asset disposed of. Furthermore, in the absence of para 35A the capital loss suspension provisions of para 39A are rendered ineffective in relation to the asset, since once the unaccrued proceeds are ceded, no further proceeds can accrue and any suspended capital loss will be claimable in terms of para 39A(3). This is more clearly explained in the example in **10.4.3**.

10.4.2 Deemed allocation of consideration from disposal of claim to disposal of asset (para 35A(2))

This provision requires that a portion of the consideration received by or accrued to a person from the disposal of the unaccrued portion of the claim be treated as an accrual of consideration n respect of the disposal of the asset. The allocation must be done on some reasonable basis taking into account the present value of the claim, the probability of recovery and the probability of the contingent or unquantified portion of the claim ultimately being received.

10.4.3 Disregarding of portion of capital gain or loss on disposal of right to claim payment (para 35A(3))

The capital gain or loss relating to the disposal of the unaccrued portion of the claim must be disregarded. However, the remaining accrued portion of the capital gain or loss must be taken into account in determining the aggregate capital gain or loss.

The acquiror of the claim must, in terms of s 24M or normal common law principles, take the unaccrued portion of the claim into account when it accrues, either in determining gross income (e.g. in the case of a factoring house) or as proceeds on disposal of a capital asset.

Example – Disposal of debt claim relating to unaccrued proceeds on disposal of asset

Facts: On 28 February 2006 Jeremy sold his holiday home having a base cost of R500 000 to Anne for a consideration of R1 200 000. The amount is payable on transfer which occurred on 1 May 2006.

On the same day (28 February 2006) Jeremy disposed of his right to claim payment of the R1 200 000 amount due on transfer to Debt Factors (Pty) Ltd for a cash consideration of R1 180 000. The market value of the holiday home on 28 February 2006 was R1 200 000.

Result: Paragraph 35A applies because

- a portion of the proceeds in respect of the holiday home did not accrue at the time of its disposal (in a deferred delivery transaction proceeds normally only accrue on transfer under the principle *exceptio non adimpleti contractus*),
- the right to claim payment from the disposal of the holiday home has been disposed of, and
- the claim disposed of had not accrued at the time of disposal.

In terms of para 35A(2) R1 180 000 is treated as proceeds on disposal of the holiday home. Therefore the capital gain or loss on disposal of the holiday home will be as follows:

	R
Proceeds	1 180 000
Base cost	500 000
Capital gain	680 000

The base cost of the debt is the market value of the asset given in exchange, namely, R1 200 000.

	R
Proceeds	1 180 000
Base cost	1 200 000
Capital loss	(20 000)

This capital loss on disposal of the unaccrued portion of the claim must be disregarded in terms of para 35A(3).

Debt Factors (Pty) Ltd will have an income gain as follows:

	R
Gross income (received from Anne)	1 200 000
Cost (paid to Jeremy)	1 180 000
Taxable income	20 000

Check: The macro gain should be R1 200 000 – R500 000 = R700 000. The actual macro gain is R680 000 (asset - Jeremy) – R0 (debt - Jeremy) + R20 000 (Debt Factors) = R700 000.

In the absence of para 35A Jeremy would have had a capital loss of R500 000 on disposal of the asset (not suspended - para 39A(3)), and a R20 000 capital loss on disposal of the debt

10.5 Limitation of scrapping allowance (s 20B)

Section 20B

Section 20B was introduced by the Revenue Laws Amendment Act 32 of 2004. It came into operation on 1 January 2005 and applies in respect of any disposal during any year of assessment commencing on or after that date.

Section 20B contains a similar ring-fencing provision to para 35A that applies to ordinary losses under s 11(*o*) – the so-called scrapping allowance. The scrapping allowance applies to certain depreciable assets with a useful life not exceeding 10 years. Where an asset is disposed of for a consideration the whole or a part of which will only accrue in a year subsequent to the year of disposal, the initial ordinary loss will be ring-fenced (s 20B(1)). As amounts accrue in subsequent years, they must be set off against the ring-fenced loss (s 20B(2)). Once the suspended loss has been exhausted further accruals will give rise to recoupments limited to the amount of capital allowances claimed (s 24M(3)). Any amounts received in excess of the allowances claimed will give rise to capital gains under para 3(*b*)(i). Once all amounts have accrued the balance of any suspended s 11(*o*) loss can be claimed as a deduction against ordinary income (s 20B(3)).

Example - Depreciable asset with a suspended ordinary section 11(*o*) allowance, recoupment and capital gain

Facts: Kyle acquired a manufacturing machine on 1 March 2005 at a cost of R500 000. After depreciating the machine by R200 000 (40% in terms of s 12C), he sells the machine to Lulu on 30 June 2005. Under the terms of the contract, Lulu must pay the following amounts which are each contingent on the number of products produced by the machine in the respective years. R190 000 (2006), R40 000 (2007), R250 000 (2008), R280 000 (2009) and R240 000 (2010).

Result: Section 20B applies because a portion of the consideration receivable has not accrued in the year of disposal. The initial 2006 year will trigger a R110 000 suspended s 11(*o*) loss for Kyle (s 20B(1)). This suspended loss will be offset by successive income (s 20B(2)). Once all suspended losses have been utilised, further accruals will generate recoupment of the amount claimed under s 12C of R200 000 (s 24M(3)). Further amounts generate capital gains in terms of para 3(*b*). The net cumulative will be R200 000 of ordinary recoupment and R500 000 of capital gain.

	2006	2007	2008	2009	2010	Total
	R	R	R	R	R	R
Receipts	190 000	40 000	250 000	280 000	240 000	1 000 000
Tax value	(300 000)	-	-	-	-	(300 000)
Loss/Recoup	(110 000)	40 000	250 000	280 000	240 000	700 000
Suspended loss	110 000	(40 000)	(70 000)	-	-	-
Recoupment	-	-	180 000	20 000	-	200 000
Capital gain	-	-	-	260 000	240 000	500 000

Chapter 11 - Primary residence exclusion

PART VII: PRIMARY RESIDENCE EXCLUSION

Primary residence - definitions

Paragraph 44

This paragraph contains a number of definitions that are pertinent to the whole of Part VII.

11.1 Definitions - 'an interest'

> '**"an interest"** means—
> (*a*) any real or statutory right; or
> (*b*) a share owned directly in a share block company as defined in the Share Blocks Control Act, 1980 (Act No. 59 of 1980) or a share or interest in a similar entity which is not a resident; or
> (*c*) a right of use or occupation,
> but excluding—
> (i) a right under a mortgage bond; or
> (ii) a right or interest of whatever nature in a trust or an asset of a trust, other than a right of a lessee who is not a connected person in relation to that trust'.

The definition of 'an interest' contains three items.

- The first item envisages the case of actual ownership.
- The second item envisages the case where ownership is held via a share owned directly in a share block company or a similar foreign entity.
- The third item envisages the case of, for example, a 99-year lease or any similar right, which may be disposed of by a qualifying person without ownership in the actual residence being affected.

Where a person rents a residence, that person would have an interest in that residence in terms of the last item (a right of use or occupation) despite not owning that residence. The effect of this is that where a qualifying person has an interest in a residence, that person's primary residence can be determined if he or she ordinarily resides therein as his or her main residence, and if that residence is used mainly for domestic purposes.

Excluded from the definition of an interest are:

- a right under a mortgage bond; and
- a right or interest of whatever nature in a trust or an asset of a trust, other than a right of a lessee who is not a connected person in relation to that trust

This means that a beneficiary who has a vested right in a property held by a trust will not qualify for the primary residence exclusion, even if he or she resides in the residence. Although the property may have been vested in the beneficiary it remains an asset of the trust in which that beneficiary has an interest. *Bona fide* lessees are removed from the ambit of the exclusion.

11.2 Definitions – 'primary residence'

> '**"primary residence"** means a residence—
> (*a*) in which a natural person or a special trust holds an interest; and
> (*b*) which that person or a beneficiary of that special trust or a spouse of that person or beneficiary—
> (i) ordinarily resides or resided in as his or her main residence; and
> (ii) uses or used mainly for domestic purposes'.

In terms of para (*a*) of the above definition a company, close corporation or trust (other than a special trust) owning a residence used as a primary residence by a shareholder, member or beneficiary would not qualify for the contemplated exclusion of a capital gain or loss made upon disposal of such primary residence for CGT purposes.

The persons referred to in para (*b*) of this definition would include the spouse of either the natural person or the beneficiary of the special trust. The effect of this is to allow a primary residence to retain its status as a primary residence where one spouse resides in that residence and the other spouse who owns that residence does not reside therein, for whatever reason. This is subject to the various other provisions relating to primary residences. The intention of this extension to the definition is to make provision for cases where

- the spouse owning the primary residence is forced to seek employment away from where the home is located;
- that spouse does not own another property qualifying as a primary residence; and
- the other spouse continues to reside in this primary residence.

It must also be noted that the definition of 'spouse' in s 1 has been widened for constitutional reasons and now includes 'a same-sex or heterosexual union which the Commissioner is satisfied is intended to be permanent'.

Polygamous marriages

What is the position where a husband is married to more than one wife in terms of customary law and each wife lives in a different residence owned by the husband? Following the coming into force of the recognition of Customary Marriages Act 120 of 1998 on 15 November 2000, each of the wives is recognised as a spouse. The husband will have to choose which of the residences is to be regarded as his primary residence. A person may not claim a primary residence exclusion for more than one residence at a time.

Mainly for domestic purposes

In order to qualify as a primary residence the residence must be used '*mainly* for domestic purposes'. In *SBI v Lourens Erasmus (Eiendoms) Bpk*[179] Botha JA held that the word 'mainly' prescribed a purely quantitative standard of more than fifty per cent.

Example – Residence not qualifying as primary residence

Facts: Dheveni owns a two-storey building. She runs a shop on the ground floor and lives upstairs. The area of the ground floor is 55 m^2, whilst the area of the top floor is 50 m^2.

Result: In this case less than 50% of the residence is used for domestic purposes and the entire residence will not qualify as a primary residence.

Non-residents and the primary residence exclusion

Non-residents are potentially liable to CGT on the disposal of immovable property they hold in South Africa (para 2).

[179] 1966 (4) SA 444 (A), 28 SATC 233 at 245.

In certain circumstances a non-resident can have a primary residence in South Africa. A key requirement of the definition of 'primary residence' is that the residence must be one in which the person

> '*ordinarily resides* or resided in as his or her main residence'.

In determining whether a person 'ordinarily resides' in a residence, the usual common law principles used for determining whether a person is ordinarily resident can be applied. In *Cohen v CIR*[180] Schreiner JA explained the meaning of ordinary residence as follows:

> 'But his ordinary residence would be the country to which he would naturally and as a matter of course return from his wanderings, as contrasted with other lands it might be called his usual or principal residence and it would be described more aptly than other countries as his real home. If this suggested meaning were given to "ordinarily" it would not, I think, be logically permissible to hold that a person could be "ordinarily resident" in more than one country at the same time.'

However, in the case where a non-resident has no other primary residence, these tests do not seem appropriate.

No primary residence offshore

Where a non-resident does not own a primary residence elsewhere and buys one for the purpose of residing therein during an extended visit to South Africa, the South African residence may comprise a primary residence. This is so notwithstanding that the person is not ordinarily resident in this country. The residence in South Africa would be the one where the person 'ordinarily resides' while in South Africa and would comprise his or her 'main residence' whilst in this country.

More than one primary residence

Where the non-resident owns a primary residence in his or her home country, the South African home would not comprise a primary residence, as it would not be one where the person 'ordinarily resides' as his or her 'main' residence. A person is in any event only allowed one primary residence (para 45(3)).

However, where the person has let out his or her overseas home while in South Africa, it will not comprise a primary residence for that period, since it would not be used mainly for domestic purposes (para (*b*)(ii) of the definition of 'primary residence'). It would therefore be possible for the person to qualify for the R1 million exclusion on the South African home.

11.3 Definitions – 'residence'

> '**"residence"** means any structure, including a boat, caravan or mobile home, which is used as a place of residence by a natural person, together with any appurtenance belonging thereto and enjoyed therewith'.

The type of 'structure' envisaged is one of a more permanent nature where the level of facilities make that structure habitable. An underground structure or a structure built into a cliff-face would possibly qualify as a residence whereas a tent would possibly not qualify as a residence. An 'appurtenance' would be considered as an appendage or something forming part of the residence such as a separate garage, various outbuildings, a swimming pool or a tennis court. There is a dual requirement for something to constitute an 'appurtenance'. It must be enjoyed with the residence and must belong to the residence.

[180] 1946 AD 174, 13 SATC 362 at 371.

The further away that an appurtenance is from the main residence, the less likely it will be regarded as 'belonging' to the main residence. The leading United Kingdom case on proximity of buildings is *Lewis (Inspector of Taxes) v Lady Rook.*[181] In that case the main house was an 8-bedroom mansion set in 10,5 acres of land, but the court concluded that a gardener's cottage 175 metres from the house was clearly not within its curtilage. In cases where there is an identifiable main house it was held that no building could form part of a dwelling house with the main house unless that building is appurtenant to, and within the curtilage of, the main house. A cartilage is a small court, yard, or piece of ground, attached to a dwelling house and forming one enclosure with it.

Example – Non-qualifying appurtenance

Facts: James owns two flats in Lofty Towers, one on the second floor and the other on the sixth floor. His two teenage daughters live in the second floor flat, and he uses the one room as a storeroom. The family has their meals in the sixth floor flat.

Result: The second floor flat is not an appurtenance in relation to the sixth floor flat. Although it may be enjoyed with the sixth floor flat, it does not, viewed objectively, belong to that flat. It is physically remote from the sixth floor flat and is a separate residence.[182]

11.4 General principle – primary residence exclusion

Paragraph 45

11.4.1 The primary residence exclusion (para 45(1))

The first R1 million of a capital gain or loss arising from the disposal of a primary residence must be disregarded. Any excess must be brought to account for CGT purposes.

Example 1 – Capital gain on disposal of primary residence

Facts: Obert purchased a residence to be utilised solely as a primary residence on 1 October 2001 for a total cost of R1 250 000. Five years later Obert sells this primary residence for R2 500 000 in order to purchase another primary residence.

Result: Assuming Obert pays income tax at the maximum marginal rate of 40% and that he has no other capital gains or losses in the tax year in question, his additional income tax liability as a result of the capital gain realised is determined as follows.

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[181] *Lewis (Inspector of Taxes) v Lady Rook* [1992] 1 WLR 662, [1992] STC 171.

[182] The United Kingdom Inland Revenue requires that the flats be contiguous. See para CG64306 of the *Capital Gains Manual* at <http://www.inlandrevenue.gov.uk/manuals/cg4manual/html/CG64200/11_0044_CG64306.htm> (accessed 22 March 2005). Where flats are located on different floors or are separated by other flats the United Kingdom Inland Revenue will only grant private residence relief in exceptional circumstances. Factors considered are the length of occupation and use. See <http://www.inlandrevenue.gov.uk/manuals/cg4manual/html/CG64200/11_0046_CG64308.htm> (accessed 22 March 2005).

	R
Proceeds	2 500 000
Base cost	(1 250 000)
Capital gain	1 250 000
Disregarded in terms of para 45(1)	(1 000 000)
Balance subject to CGT	250 000
Annual exclusion	(10 000)
Aggregate capital gain	240 000
Taxable capital gain (240 000 x 25%)	60 000
Tax payable (60 000 x 40%)	24 000

In this example, only 4,8% (R60 000 / R1 250 000) of the total capital gain is finally subjected to taxation.

11.4.2 Apportionment of the primary residence exclusion where more than one person has an interest in a primary residence (para 45(2))

The R1 million limitation operates on a 'per primary residence' basis and not on a 'per person holding an interest in the primary residence' basis. This means that where, for example, two individuals have an equal interest in the same primary residence, they will each be entitled to a primary residence exclusion of a maximum of R500 000. This would typically apply to spouses married in community of property.

Example 2 – Spouses married in community of property

Facts: The facts are the same as Example 1, except that Obert is married to Portia in community of property and the primary residence falls within their joint estate.

Result: Assuming that Portia has no other capital gains or losses in the tax year in question, Obert and Portia's taxable capital gains are determined as follows.

	Total R	Obert R	Portia R
Capital gain apportioned in terms of para 14	1 250 000	625 000	625 000
Disregarded in terms of para 45(2)	1 000 000	500 000	500 000
Balance subject to CGT	250 000	125 000	125 000
Annual exclusion		10 000	10 000
Aggregate capital gain		115 000	115 000
Taxable capital gain (R115 000 x 25%)		28 750	28 750

Example 3 – Residence qualifying as primary residence for part of the period of ownership

Facts: Otto owned a house in Durban that was his primary residence for 5 years after 1 October 2001. The base cost of the house was R1 300 000 on valuation date. Thereafter he moved to Pretoria where he bought a new primary residence. He decided to let the house in Durban for investment purposes. After 10 years of letting he sold the property for R4 900 000.

Result: His capital gain is calculated as follows:

The capital gain is R4 900 000 (proceeds) – R1 300 000 (base cost) = R3 600 000. The portion of the gain that relates to the period when the residence was a primary residence is 5/15, that is, R3 600 000 x 5/15 = R1 200 000.

	Primary residence	Not a primary residence	Total
	R	R	R
Capital gain	1 200 000	2 400 000	3 600 000
PR exclusion	(1 000 000)	-	(1 000 000)
	200 000	2 400 000	2 600 000
Annual exclusion			(10 000)
Aggregate capital gain			2 590 000

This example illustrates that it is first necessary to determine the portion of the capital gain or loss attributable to the primary residence before applying the R1 million exclusion to that part.

11.4.3 Only one residence at a time may be a primary residence of a person (para 45(3))

Only one residence may be a primary residence of a person for any period during which that person held more than one residence. This means that there could never be an overlapping period where two residences owned by one person are both used as primary residences, except when the provisions of para 48 apply. The latter provision allows for an overlap in specific cases.

Example 4 – Ownership of more than one primary residence

Facts: After living in Cape Town for some years, Quartus purchases a home in Cape Town for R500 000 on 1 October 2001 and a home in Johannesburg for R500 000 on 1 October 2001. He owns a business that operates in both Cape Town and Johannesburg and spends six months of each year in each home, although he remains a Capetonian at heart and most of his social acquaintances and family are in Cape Town. Ten years later he retires and sells both homes in order to acquire a retirement cottage in a quiet coastal village. The Cape Town home is sold for R2 600 000 and the Johannesburg home for R1 800 000.

Result: Since Quaartus' personal and economic relations are closer to Cape Town it is accepted that his Cape Town home is his primary residence.

Cape Town

	R
Proceeds	2 600 000
Base cost	500 000
Capital gain	2 100 000
Primary residence exclusion	1 000 000
Balance subject to CGT	1 100 000

Johannesburg

	R
Proceeds	1 800 000
Base cost	500 000
Capital gain	1 300 000

Quartus will therefore include capital gains of R2 400 000 in his aggregate capital gain or loss for the year.

11.4.4 Part-disposal of a primary residence

In certain circumstances part of the primary residence may be disposed of. This could happen, for example, where

- a part of the main residence is disposed of (e.g. by converting a single house into a pair of maisonettes),
- the bare dominium or usufruct in the residence is disposed of,
- a part of the primary residence is bequeathed to a surviving spouse, or
- a part of the rights attaching to the residence are lost as a result of the obstruction of the view from the residence.

Paragraph 45(1) does not deal explicitly with the part-disposal of a primary residence. This raises the question whether the primary residence exclusion is available under such circumstances. In terms of para 46(*c*) the exclusion is not available where land is disposed of separately from the 'residence'. It is provided that the land must be

> 'disposed of at the same time and to the same person as that residence.'

But this does not address the situation where a part of the residence is disposed of.

Even in the core disposal rules in para 11, the part-disposal principle is not explicitly stated. Yet it is clearly recognised in para 33 which sets out how the base cost of a part of an asset that has been disposed of is to be determined. It can therefore be accepted that the exclusion will be available when a part of the residence is disposed of.

The next question is how the exclusion must be apportioned under such a part-disposal.

The underlying principle is that a person's primary residence exclusion should not exceed R1 million in respect of a single physical structure. Thus if a person decides to embark on a piecemeal disposal of a residence the person's exclusion should not exceed R1 million in respect of the sum of the parts. Unlike the annual exclusion, the primary residence exclusion is not available annually and is tied to the physical structure. This view is supported by para 45(2), which requires that where more than one natural person or special trust jointly holds an interest in a primary residence at the same time (a natural consequence of a part-disposal), the R1 million exclusion must be apportioned in relation to each interest so held.

Example 1 – Part-disposal of primary residence

Facts: Wouter owns a house with a base cost of R2 million and a current market value of R10 million. He sells a 40% interest in the residence to Lynette for R4 million. They occupy the house as their primary residence

Result: Wouter's primary residence exclusion in respect of the part disposed of is R400 000 (R4 000 000 / R10 000 000 x R1 000 000).

His capital gain is determined as follows:

	R
Proceeds	4 000 000
Base cost (40% x R2 000 000)	(800 000)
Gain	3 200 000
Primary residence exclusion	(400 000)
Capital gain	2 800 000

After the disposal, in terms of para 45(2) the primary residence exclusion will be allocated between Wouter and Lynette in accordance with their respective interests as follows:

	R
Wouter – 60%	600 000
Lynette – 40%	400 000
	1 000 000

Example 2 – Further part-disposal of primary residence

Facts: The facts are the same as in Example 1 but the saga continues. Two years later Wouter sells his 60% interest to Lynette for R6 000 000.

Result: Wouter's capital gain is determined as follows:

	R
Proceeds	6 000 000
Base cost (R2 000 000 – R800 000)	(1 200 000)
Gain	4 800 000
Primary residence exclusion	(600 000)
Capital gain	4 200 000

Lynette's primary residence exclusion increases from R400 000 to R1 000 000 as she now owns 100% of the primary residence.

Example 3 – Simultaneous acquisition of primary residence by natural persons

Facts: Jean and her daughter Jill purchased a house for R1 000 000, each paying R500 000 for their respective 50% interests. Only Jean resided in the residence as her primary residence. Five years later they sold the house for R3 000 000.

Result: Their respective capital gains are determined as follows:

Jean

	R
Proceeds R3 000 000 x 50%	1 500 000
Base cost	(500 000))
Gain	1 000 000
Primary residence exclusion	(500 000)
Capital gain	500 000

Jill's will have a capital gain of R1 000 000 as she does not qualify for the primary residence exclusion.

Example 4 – Part-disposal of appurtenance

Facts: Ernie owns a two-hectare property on which his primary residence is situated. The grounds include a swimming pool and tennis court. After receiving an offer from a developer that he could not refuse, Ernie decided to subdivide his property and sell the portion of the land containing the swimming pool and tennis court.

Result: The portion of the land disposed of will not qualify for the primary residence exclusion as it has not been disposed of at the same time and to the same person as the structure used as a place of residence (para 46(*c*)). The appurtenances (tennis court and swimming pool) have not been disposed of 'together with' the residence. The view is held that in order to constitute the disposal of a 'residence', the appurtenances must be disposed of at the same time as the main residential structure (see definition of 'residence').

11.4.5 Awards of damages in respect of loss of a view

Following the *Paola*[183] case, there have been a number of cases where persons have instituted actions for damages as a result of their view being obstructed by the erection of structures by other persons. Awards of this nature are subject to CGT where the residence is not held as trading stock. When the offending structures are erected, the person who erected them creates a right in favour of the injured party. The right so acquired is disposed of when it is extinguished by way of discharge. The proceeds from that disposal will be the amount received or accrued. Where the claim is disputed, the proceeds will only accrue once the claim is settled. The base cost of the right disposed of would include, for example, legal fees in bringing the action to court, as well as a part of the base cost of the residence and the land on which it is situated. The portion of the base cost disposed of must be determined in terms of para 33.

For the purposes of para 45(1) the R1 million exclusion must be apportioned to the damages receivable, and the remaining portion of the exclusion will be available when the primary residence is subsequently disposed of.

Example – Award of damages for obstruction of view

Facts: Amanda owns a house with stunning sea views in Margate that she uses as her primary residence. Matthew owns the land between Amanda's house and the high water mark. He proceeded to erect a double-storey house in front of Amanda's house that completely obstructed her sea view. This had the effect of devaluing Amanda's house and she sued Matthew for damages. After a protracted legal battle, the court awarded Amanda R500 000 which Matthew duly paid. The base cost of Amanda's house was R400 000 and its market value immediately before receipt of the damages was R2 500 000. Amanda incurred legal fees of R10 000 that could not be recovered from Matthew. Two years later Amanda disposed of the house for R2 million.

Result: Amanda's capital gain is determined as follows:

Award of damages

Base cost of part disposed of

	R
House (R500 000/R2 500 000 x R400 000)	80 000
Legal fees	<u>10 000</u>
	<u>90 000</u>
Primary residence exclusion utilised (R500 000/R2 500 000 x R1 000 000)	<u>200 000</u>

[183] *Paola v Jeeva NO and Others* 2004 (1) SA 396 (SCA).

	R
Proceeds	500 000
Base cost	(90 000)
Gain	410 000
Primary residence exclusion	(200 000)
Capital gain	210 000

Disposal of house

The capital gain on disposal of Amanda's house is determined as follows:

	R
Proceeds	2 000 000
Base cost	(320 000)
Gain	1 680 000
Primary residence exclusion	(800 000)
Capital gain	480 000

11.5 Size of residential property qualifying for exclusion

Paragraph 46

The term 'primary residence' does not include the land on which it is situated. This paragraph extends the primary residence exclusion to include such land, including unconsolidated adjacent land, subject to three important exceptions.

The size limitation (para 46(a))

The primary residence exclusion only applies to so much of the land that does not exceed two hectares. Where the land exceeds two hectares, it will be necessary to determine the capital gain attributable to the two-hectare portion, and apply the R1 million exclusion against that portion.

The use with the residence requirement (para 46(b))

The land must be used mainly for domestic or private purposes together with the residence. Examples include land containing a swimming pool, tennis court or stables. Whether it is used 'together' with the residence is a question of fact.

The simultaneous disposal requirement (para 46(c))

The land must be disposed of
- at the same time, and
- to the same person as the residence.

Adjacent land

The word 'adjacent' as used in the term 'unconsolidated adjacent land' does not mean adjoining, and it is not necessary for two properties to be in contact with each other. On the contrary the word must be given the meaning of close to or near.[184] It has been held that a mine located four miles away from another was not adjacent thereto.[185] Each case must be judged on its own merits to determine whether the required degree of proximity is present.

[184] *City of Wellington v Borough of Lower Hutt,* [1904] AC 773.
[185] *Kimberley Waterworks Co, Ltd v De Beers Consolidated Mines, Ltd*, [1897] AC 515 at 518.

Example 1 – Apportionment where land exceeds 2 hectares

Facts: Rick acquires a smallholding, three hectares in size, shortly after 1 October 2001. The total cost of acquisition amounted to R2 450 000 and he took occupation of the property immediately after it had been acquired and occupied it throughout the period of ownership until the asset was sold, four years later. Over the period of ownership improvements amounting to R150 000 were effected to the property and repairs amounting to R18 000 were also carried out. The smallholding was sold for R6 000 000 and agent's commission of R480 000 was paid. The total property was used mainly for domestic purposes in association with the primary residence.

Result: As the maximum size of the land qualifying for the primary residence exclusion is two hectares, an apportionment needs to be done.

The following calculation apportions the capital gain realised to the primary residence and the remaining land on the basis of the total size of the property. Please note that the apportionment in the first part of this calculation has been assumed.

	Land	Residential Building	Total
	R	R	R
Proceeds	5 000 000	1 000 000	6 000 000
Acquisition cost	1 750 000	700 000	2 450 000
Cost of improvements	120 000	30 000	150 000
Repairs (not part of base cost)	-	-	-
Agent's commission on sale	400 000	80 000	480 000
Capital gain	2 730 000	190 000	2 920 000

	Primary Residence	Remaining Land	Total
Land	1 820 000	910 000	2730 000
Residential buildings	190 000	-	190 000
Capital gain	2 010 000	910 000	2 920 000
Primary residence exclusion	1 000 000	-	1 000 000
Balance subject to CGT	1 010 000	910 000	1 920 000

Alternative bases of performing the apportionment would also be acceptable, provided that such bases are reasonable.

Item (*b*) of para 46 refers to the land not exceeding two hectares and places the requirement that such land, with or without appurtenances thereon, must be used mainly for domestic or private purposes in association with the primary residence. In other words, any portion of the land not used mainly for domestic purposes in association with the primary residence would not qualify for the exclusion. For example, one hectare of a two-hectare plot, which has a residence qualifying as a primary residence thereon, is used to grow vegetables for sale to a local market. This could not be used mainly for domestic purposes and hence only one hectare would qualify for exclusion as a primary residence.

11.6 Apportionment in respect of periods where not ordinarily resident

Paragraph 47

Where a residence is utilised as a primary residence on or after 1 October 2001, a qualifying person would be required to apportion any capital gain or loss to be disregarded, as a result of not being resident in the residence. The apportionment would be made with reference to the period that he or she was ordinarily resident in that primary residence. This paragraph is subject to both paras 48 and 50. The term 'ordinarily resident' is not a new term for income tax purposes and guidelines in terms of case law already exist in this regard.[186]

Example 1 – Apportionment of capital gain for period not ordinarily resident

Facts: Seni bought a property for R1 000 000 on 1 October 2001. She used the property as her primary residence right up until she emigrated from the Republic on 28 February 2003. She put the property on the market in 2005 and finally sold it for R1 820 000 on 28 February 2005.

Result: Upon emigration, Seni is no longer considered ordinarily resident in the Republic and hence, would not be considered ordinarily resident in her residence from the date of emigration. No deemed disposal of the property takes place on emigration as the Republic retains its tax jurisdiction over the property in terms of para 2(1)(*b*).

	R
Proceeds	1 820 000
Base cost	1 000 000
Capital gain	820 000
Portion of gain relating to period of ordinary residence and qualifying for primary residence exclusion (17/41 X R820 000)	340 000
Balance subject to CGT	480 000

If she has no other capital gains in the year of disposal, this amount will be reduced further by the annual exclusion of R10 000.

Example 2 – Ordinarily resident despite physical absence

Facts: Thomas's employer transfers him from East London to Durban. He had owned his home in East London for 20 years and decides not to sell it but rather to allow his son, who is studying part-time through a correspondence university, to live there for no consideration. He and his wife move to Durban where they rent a residence as Thomas only has two years to go until he retires. They spend their holidays in East London and stay in the home. Upon retirement Thomas and his wife intend returning to their home in East London. By that stage, their son should have completed his studies whereupon he intends to move out of this home. The question arises as to whether Thomas may consider the residence in East London to have been his primary residence for the full period of ownership.

Result: The crux of the matter revolves around para 47, which would require apportionment where Thomas was not considered ordinarily resident in the East London home.
Paragraph 47(1)(*b*) does not require physical occupation but hinges on the concept of ordinary residence. In Thomas's case, as his intention was to return to the East London home (which he in fact did) and in view of the fact that he would probably be considered to be ordinarily resident there after valuation date, no apportionment of any capital gain realised would be necessary. It should be noted, however, that the facts of each case would have to be carefully considered in determining ordinary residence in respect of a primary residence. Should Thomas have been absent from his East London home for, say, 15 years, it would be far more difficult for him to argue that he was ordinarily resident in that home.

[186] See SARS Interpretation Note 3 'Resident: Definition in Relation to a Natural Person – Ordinarily Resident' (4 February 2002) and the cases cited therein.

Example 3 – Not ordinarily resident

Facts: Ursula owns a property in Johannesburg in which she and her husband, Victor, spend most of any given year. Both spouses are employed in Johannesburg and they are married out of community of property. Victor owns a residence in Plettenberg Bay in which he lived for three years before meeting his wife and moving to Johannesburg. He has lived in Johannesburg for two years at the time CGT is implemented. The couple now use the home in Plettenberg Bay as a holiday home, and spend most of their annual leave there. It is never occupied by anyone else and stands vacant for the rest of the year. Upon moving to Johannesburg, Victor had employed an armed response service in Plettenberg Bay to see to the security of his home. His intention is to claim this home as a primary residence and hence not pay capital gains tax upon its eventual disposal. Five years after valuation date, Victor decides to sell his home in Plettenberg Bay.

Result: From the information at hand Victor would be considered not to be ordinarily resident in Plettenberg Bay. Victor resides in a home belonging to his wife where he is permanently located. He is employed in Johannesburg and has never returned to Plettenberg Bay other than for holidays. Victor would not be considered ordinarily resident in Plettenberg Bay and hence any capital gain made upon disposal of his residence in Plettenberg Bay would be subjected to CGT in full.[187]

11.7 Disposal and acquisition of primary residence

Paragraph 48

The purpose of this paragraph is to enable a natural person or a beneficiary of a special trust to be treated as having been ordinarily resident in a residence where that person was absent therefrom for a continuous period not exceeding two years, in four specific instances.

The *first* item deals with the case of an overlapping period of ownership. This would override the general rule contained in para 45(3).

Example 1 – Old residence offered for sale due to acquisition/intended acquisition of new residence

Facts: Xolani is transferred from Knysna to Cape Town and struggles to sell her home in Knysna. In the mean time, she acquires a home in Cape Town and is able to eventually sell her Knysna home 18 months later.

Result: The overlapping period of ownership may be included as periods that both homes were considered to be ordinary residences and hence no apportionment is required.

The *second* item would cater for the situation where land has been purchased with the intention of erecting a primary residence thereupon. Land on its own would not be a primary residence as the definition of residence means ‘any structure’. Where there is no structure there could not be a primary residence. Therefore, for the duration of the time taken to erect a structure, (i.e. a home) that period would not qualify as the owner’s ordinary residence without this overriding provision. It effectively would allow a person a two-year period in which to complete the erection of a residence to be used as a primary residence without penalising that person.

[187] See ITC 961 (1961) 24 SATC 648 (F).

The *third* item is similar to the second and would cater for cases where a primary residence is rendered accidentally uninhabitable, for example, is destroyed, by fire, flood, earthquake, landslide, wind or other similar act.

The *fourth* item is the death of the person with an interest in the primary residence. For a two-year period after death or until the residence is disposed of by the executor of the estate, whichever is the shorter, the deceased is treated as having been ordinarily resident in the residence.

It is unnecessary to specifically cater for improvements or renovations to a primary residence as the owner effecting them would still be considered to be ordinarily resident in that primary residence. A residence, as defined, exists and accordingly qualifies as a primary residence.

11.8 Non-residential use

Paragraph 49

The purpose of this paragraph is to reduce the capital gain disregarded in terms of the primary residence exclusion where a part of the primary residence was used for the purpose of carrying on a trade in relation to that part. The paragraph also caters for the situation where the property was at some stage used as a primary residence but not for the entire period of ownership after the valuation date.

It should be noted that a primary residence would be tainted as long as a part of it is used for the purpose of trade. It is irrelevant whether the person is or was entitled to any deduction in respect of the expenditure relating to the part used for trade purposes.

Example 1 – Residence used partly for trade purposes

Facts: Yolandi acquired a residence on valuation date for R350 000 and resided therein for ten years. During this time she operated her media relations consulting business from the premises. Approximately 35% of the floor space was used for business purposes. Yolandi also claimed 35% of her current costs as a business expense against her business income for tax purposes. As an opportunity arose for her to expand her business ten years after she had acquired the property, she purchased another residence in which to live and converted her old residence into business premises. Fifteen years after converting the property she sold it for R2 650 000. Improvements over the years and all other costs associated with the acquisition and disposal of the property amounted to R250 000.

Result:

	R
Proceeds upon disposal	2 650 000
Base cost (R350 000 + R250 000)	600 000
Capital gain	2 050 000
Period not ordinarily resident (2 050 000 x 15/25)	1 230 000
	820 000
Part partially used for trade purposes (820 000 x 35%)	287 000
Capital gain attributable to being a primary residence	533 000

Yolandi will be able to exclude R533 000 of the total capital gain realised in terms of the primary residence exclusion. The balance, or R1 517 000 will be subject to CGT and will be aggregated with any other capital gains or losses arising in the year of disposal before the R10 000 annual exclusion is applied.

Example 2 – Apportionment of capital gain between domestic and business use

Facts: Alfredo owns a 5 bedroomed house in Oranjezicht, Cape Town. In 1998 after the last of his children had left home, he decided to convert the residence into a guest house. He set aside 4 of the bedrooms for guests, while he and his wife kept the remaining bedroom for their personal use. The market value of the residence on 1 October 2001 was R5 000 000. On 28 February 2005 Alfredo disposed of the residence for an amount of R6 500 000. During the period since valuation date Alfredo managed to let out the 4 bedrooms 60% of the time. During the remaining 40% of the time the bedrooms were vacant, but available for letting. The floor area of the 4 bedrooms was 120 m^2, while the total area of the residence was 300 m^2.

The guests had the use of the lounge, diningroom, kitchen and swimming pool. Alfredo did not, however, claim any expenditure for normal tax purposes in respect of these shared facilities as he regarded the guests' use as incidental. Determine his capital gain or loss on disposal of the residence.

Result:

Overall capital gain:	R
Proceeds	6 500 000
Base cost	5 000 000
Capital gain	1 500 000

Floor area used for business and private purposes:

	m^2
Business	120
Private	180
	300

Allocation of overall capital gain between business and private portions:

Business R1 500 000 x 120/300 = R600 000
Private R1 500 000 x 180/300 = R900 000

The capital gain attributable to the primary residence portion is reduced to nil by the R1 million exclusion (R900 000 – R1 000 000). The business portion of the gain of R600 000 will be subject to CGT in full, less the annual exclusion provided it has not been utilised against other capital gains.

Although the 4 bedrooms were only let 60% of the time, they were nevertheless set aside exclusively for business use even when not occupied. They cannot therefore be regarded as having been used for domestic purposes. The position might have been different had Alfredo used those rooms for domestic purposes for 11 months of the year and only let them for one month while he went on his annual vacation. In that case it would have been acceptable to only subject 1/12 of the gain attributable to the 4 bedrooms to CGT

In this example, the Commissioner has not attributed any part of the capital gain to the shared use areas such as the kitchen, lounge and diningroom. What would have happened if Alfredo had claimed a portion of the rates, electricity and other expenses attributable to the shared use areas against the rent he derived? In that event the Commissioner would have regarded a similar portion of those areas as being used for business purposes. And if more than 50% of the entire residence was used for business purposes Alfredo would not have been entitled to the primary residence exclusion. In that case the residence would not have been used 'mainly' as a primary residence as defined. It suffices to say that it is difficult to lay down hard and fast rules for apportionment of the overall capital gain or loss in cases such as this. Each case must be judged on its merits.

11.9 Rental periods

Paragraph 50

The purpose of this paragraph is to

- allow a qualifying person to rent out his or her primary residence without that rental activity disqualifying that period of ownership as non-residential usage (in terms of para 49); and
- provide a safe harbour for a qualifying person to be temporarily absent from his or her primary residence without affecting the 'ordinary residence' status of that person in relation to that primary residence.

There are, however, a number of conditions that apply.

- The primary residence may not be let for more than five years. If a primary residence were let for more than five years, the full period would not be treated as residential usage (i.e. the qualifying person would not be treated as having used the primary residence for domestic purposes for the full period).
- The qualifying person would have to actually reside in that primary residence for a continuous period of at least one year prior to and after the period that the primary residence was let. This condition would ensure that the residence is a primary residence of the qualifying person prior to letting the property and that the qualifying person would return to and reside in that property after the rental period. In cases that straddle the valuation date, regard must be had to the period prior to 1 October 2001 to determine whether the person qualifies for the exclusion. For example, on 1 October 2001 a person may be overseas and be letting his or her residence. Provided that the person has resided in the residence for more than a year before letting the residence, and the letting period before and after 1 October does not exceed five years, the person will have met the relevant requirements;
- No other residence would be treated as the primary residence of the qualifying person during the period that a primary residence was let and retained its status as a primary residence of that qualifying person. As this paragraph would treat the property let as a primary residence of the qualifying person letting that property, this condition would prevent any overlap where another property owned by the qualifying person was actually used as a primary residence whilst tenants occupy the let property. This paragraph, therefore, would not override the general principle contained in para 45(3);
- The qualifying person would have to be temporarily absent from the Republic or employed or engaged in carrying on business in the Republic at a location further than 250 km from that residence. The first part of this condition caters for South Africans who are still ordinarily resident in the Republic, i.e. persons who have not emigrated, such as diplomats. The second part is an anti-avoidance provision. It would allow a South African resident, residing in the Republic, the opportunity to let a primary residence provided that the qualifying person was employed or was engaged in carrying on business in the Republic, at a location further than 250 km from the primary residence being let. The 250 km must be measured as the crow flies. In this regard s 5 of the Interpretation Act 33 of 1957 provides as follows:

> '**Measurement of distance.—**In the measurement of any distance for the purpose of any law, that distance shall, unless the contrary intention appears, be measured in a straight line on a horizontal plane.'

Example 1 – Spouses each owning residence and working within 250 km

Facts: Alta and Zebediah were recently married. Each spouse owned his or her own residence in Pretoria, had lived in his or her respective residences for more than one year prior to marriage, and had acquired his or her residence after valuation date. Upon marriage, Alta had moved into Zebediah's residence and let her residence for a period of five years. Both spouses intend returning to Alta's residence thereafter for five years whilst letting Zebediah's residence. Both are employed within 20km of their respective residences.

Result: Paragraph 50 is not applicable as both spouses are employed within a 250km radius from their respective residences. They will, however, be able to apportion any gains that might arise upon the disposal of their respective residences in relation to the period that each residence qualified as a primary residence.

11.10 Valuation of primary residences on farms

Farm residences are usually not sold separately from farms. This makes it difficult to apportion the base cost and proceeds between the farm residence and the rest of the farm. Reliable historic information on the market value of farm residences which can be used as comparable transactions for valuation purposes is, therefore, not always available. In the interest of finding practical solutions the methodology set out below is suggested.

Valuation date value of an asset acquired before 1 October 2001(valuation date)

Subject to the kink tests in paras 26 and 27, a person can determine the valuation date value of a farm residence by using the market value, TAB or 20% or proceeds methods.

Market value

In terms of para 29(1)(*c*) read with para 31(1)(*f*) farmers must choose one of the following methods to value their farms:

- *Land Bank value* - the value contemplated in para (*b*) of the definition of 'fair market value' in s 1 of the Estate Duty Act which is the value determined by a Land Bank valuator; or
- *Market value* - the price which could have been obtained upon the sale of the immovable property between a willing buyer and willing seller dealing at arm's length in an open market.

There is a restriction on the use of Land Bank value. It may only be used on the death of the person or when the property is disposed of by way of donation or non-arm's length transaction if

- that value was adopted on valuation date as the valuation date value; or
- that person acquired the immovable property by way of donation, inheritance or a non-arm's length transaction at Land Bank value.

If a person who has elected Land Bank value sells the immovable property that person's proceeds will be the amount received for the sale of the immovable property and the base cost will be the Land Bank value. In most cases the Land Bank value is lower than the market value. This will affect the quantum of the capital gain or loss.

Methods of valuation

The methodology suggested by SARS hereunder, for the valuation of primary residences on farms, does not preclude the taxpayer from using any other method for determining the market value as at 1 October 2001, or on other dates as required for CGT purposes, so long as that market valuation can be properly substantiated.

SARS will be prepared to accept the following methodology used in determining the market value of a farmer's primary residence:

Farms with a market value not exceeding R300 000

In the case of farms, the market value of which does not exceed R300 000 on the valuation date or if acquired after valuation date, the cost of acquisition did or does not exceed R300 000, it will be accepted that

- the market value of the primary residence is equal to one-third of the market value of the farm on the valuation date, or
- if acquired after valuation date, the expenditure incurred in acquiring the primary residence is equal to one third of the expenditure incurred to acquire the farm, and
- if the farm is disposed of for proceeds not exceeding R300 000, one-third of the proceeds were received or accrued in respect of the disposal of the primary residence.

This will only apply on condition that the owner occupies the primary residence and uses it mainly for his or her domestic purposes.

Proceeds in excess of R300 000

Where a primary residence was valued in the manner described above and the farm is disposed of for proceeds in excess of R300 000, it will be accepted that the base cost is the amount as calculated above, but another method of determining the amount of proceeds to be allocated to the primary residence must be used. Similarly if a person wishes to allocate an amount other than the one-third of the market value or proceeds to the value of the primary residence, he or she will have to use another method of determining the market value of the primary residence.

Comparable sales

In situations where two farms in the same area are similar with regard to factors such as the quality of soil, vegetation, topography, development, and water supply, the market value of the land per hectare, would be similar. If both farms were sold, and only one had a primary residence on it, the market value of the primary residence could be calculated by reducing the sale price of the farm on which the house is situated by the estimated cost of the land determined by using the price per hectare obtained for the other farm.

In most instances the value of a farm residence is less than the value of a comparable residence in the nearest town. Where there are no transactions in the circumstances contemplated in the previous paragraph that can be used as comparisons in the valuation of a farm residence, a comparison with sales of residences in the nearest town could be used in the appropriate circumstances. An adjustment would have to be made to the value of the farm residence to recognise the difference in values of the residences as a result of their different locations.

Adjusted replacement cost

The market value of the primary residence of a farmer may be determined by using the adjusted replacement cost method.

The market value of the portion of the bare land, not exceeding two hectares, which is used for domestic or private purposes, must be determined.

The replacement cost of the improvements constituting the primary residence must be determined and reduced by an appropriate rate to make provision for the age, physical condition, functionality, marketability and location of the residence. This adjusted replacement cost must then be added to the market value of the part of the bare land determined above to establish the total market value of the primary residence.

As the determination of the appropriate rate to reduce the replacement cost for the factors mentioned above can be contentious, this method should only be used as a last resort if no other method can be used.

Time-apportionment base cost (TAB)

TAB can be used to determine the valuation date value of a primary residence on a farm where the acquisition or erection costs of the residence can be determined. If, for example, a farmer erected his primary residence after acquisition of his farm he could have maintained records of the cost of erection or if a farmer can determine what portion of the purchase price was paid for the primary residence then this method can be used.

Conclusion

SARS has the right to call for information in connection with valuations and challenge whether the appropriate method was used as well as whether the actual value is correct. Where the method used for valuation of the residence on 1 October 2001 differs from the method used when the farm is disposed of, reasons for the change in the method will have to be provided.

11.11 Transferring a residence out of a company after 30 September 2002

The tax consequences that flow from the transfer of a residence out of a company after the expiry of the window period on 30 September 2002 are as follows:

- The company will be subject to CGT on any capital gain arising from the disposal.
- Should the residence be distributed by way of a dividend, STC will be payable on the portion of any capital profit that relates to the post-valuation date period.
- Transfer duty will be payable by the shareholder on the acquisition, or if the company is a vendor, the company will have to charge VAT on the transaction.
- The shareholder will face CGT consequences upon disposal of the shares in the company.

Example – Transfer of a residence out of a company after 30 September 2002

Facts: Ronnie owns all the shares in Ronprops (Pty) Ltd ('Ronprops'). The only asset of Ronprops is a house in Umhlanga in which Ronnie lives. He has no other residence. Ronnie purchased the shares in the company from Barry on 30 May 1995 at a price of R100 000. His tax consultant had advised him not to take advantage of the window of opportunity to remove the property from the company because he felt that the future transfer duty savings would outweigh the CGT benefits. The market value of the property on 1 October 2001 was R2 000 000, and the current market value on 30 June 2009 is R3 000 000. The company has never incurred any expenditure or derived any income. The market value of Ronnie's shares on valuation date was R1 950 100. Ronnie has indicated that he would like to place the company in voluntary liquidation. The balance sheet of Ronprops appeared as follows on 30 June 2009, the day before the residence was transferred to Ronnie.

Balance sheet – 30 June 2009

	R
Share capital	100
Loan account	49 900
Non-distributable reserve	2 950 000
	3 000 000
Represented by:	
House – at current market value	3 000 000
(Original cost, 1 August 1990 = R50 000)	

For the purposes of this example, it is assumed that the tax rates prevailing during the year ending 29 February 2005 will apply in 2009.

Result:

CGT in the company

The property is deemed to be disposed of at market value (para 75(1)). The proceeds will be R3 000 000. The base cost is the higher of

- R2 000 000 using market value, or
- TAB = [R50 000 + (R3 000 000 – R50 000) x 12/20] = R1 770 000.

Therefore market value will be used as the base cost.
Capital gain = R3 000 000 – R2 000 000 = R1 000 000.
The taxable capital gain is R1 000 000 x 50% = R500 000.

The company is a small business corporation as defined in s 12E(4), and it therefore qualifies for the lower rate of tax on the first R150 000 of taxable income. Thus the company will have to pay CGT as follows:

Taxable Income R		Tax payable R
150 000	x 50% x 15% =	11 250
350 000	x 50% x 30% =	52 500
500 000		63 750

STC in the company

Any capital profits derived on or after 1 October 2001 will attract STC. The company has reserves available for distribution before CGT and STC of R2 950 000 (R3 000 000 – R50 000). The portion of these reserves that will be subject to STC is determined as follows:

	R
Proceeds on disposal of residence	3 000 000
Market value of residence on valuation date	(2 000 000)
Capital profit before CGT iro post-valuation date period	1 000 000
Less: CGT on disposal of asset	(63 750)
Capital profit subject to STC	936 250
STC 12,5/112,5 x R936 250	104 027.78

Summary of capital profits available for distribution

	Before R	After R	Total R
Capital profit	1 950 000	1 000 000	2 950 000
CGT	-	(63 750)	(63 750)
STC	-	(104 028)	(104 028)
Dividend	1 950 000	832 222	2 782 222

The shareholder will therefore receive

- a distribution of R832 222, and
- a capital distribution of R1 950 000 plus the share capital of R100 = R1 950 100.

The CGT consequences for the shareholder

Upon dissolution[188] of the company, Ronnie will be treated as having disposed of his shares for proceeds[189] of R1 950 100 (the amount of the capital distribution). The base cost of his shares will be the higher of

- market value of R1 950 100, and
- TAB = [R100 000 + (R1 950 100 – R100 000) x 7/15] = R863 380.

Therefore base cost = market value = R1 950 100.
Capital gain/loss = R1 950 100 (proceeds) – R1 950 100 (base cost) = RNil.

The transfer duty consequences for the shareholder

Ronnie will have to pay transfer duty on the market value of the residence of R3 000 000, determined as follows:

R	%	R
140 000	0	0
180 000	5	9 000
2 680 000	8	214 400
3 000 000		223 400

The total cost to Ronnie is therefore R63 750 (CGT) + R104 028 (STC) + R223 400 (transfer duty) = R391 178. Should Ronnie continue to leave the residence in the company, any future capital growth will be taxed at the rate of 24,44% (15% CGT + 9,44% STC).
The STC rate of 9,44% is arrived at as follows:

	R
Gain	100,00
CGT 15% x R100	(15,00)
Available reserves	85,00
Dividend	(75,56)
STC 12,5% x 75,56	(9.44)
	-

By comparison, if the residence were in Ronnie's name he would be entitled to the R1 million primary residence exclusion and would pay CGT on any capital gain exceeding R1 million at a maximum rate of 10% (25% x maximum marginal rate of 40%).

[188] Paragraph 77(1).
[189] Paragraph 76(1)(*b*).

Chapter 12- Other exclusions

PART VIII: OTHER EXCLUSIONS

12.1 General principle

Paragraph 52

This paragraph provides that when determining the aggregate capital gain or aggregate capital loss of a person, any capital gains and capital losses must be disregarded in the circumstances and to the extent set out in Part VIII.

12.2 Personal use assets

Paragraph 53

All capital gains or capital losses determined in respect of personal use assets of a natural person or a special trust must be disregarded. Personal-use assets are all the assets of a natural person or special trust except to the extent they are used for the purposes of carrying on of a trade or are assets listed in para 53(2). See the commentary in **7.1** on para 15 for the rationale behind this exclusion.

The assets listed in para 53(2) that are subject to CGT are the following:

- A coin made mainly from gold or platinum of which the market value is mainly attributable to the material from which it is minted or cast.
- Immovable property.
- An aircraft, the empty mass of which exceeds 450 kilograms.
- A boat exceeding ten metres in length.
- A financial instrument which is defined in the Schedule.
- Any fiduciary, usufructuary or other like interest, the value of which decreases over time.
- Any long-term policy. For example, an endowment policy or a life policy.
- Any short-term policy contemplated in the Short-Term Insurance Act 53 of 1998, to the extent that it relates to any asset that is not a personal-use asset. For example, a policy of insurance against fire or theft in respect of commercial property or a 15 m yacht. Apportionment will have to be applied in the case of premiums paid in respect of assets used partly for trade and non-trade purposes;
- a right or interest in any of the assets mentioned above.

While capital gains arising from those assets will be subject to CGT, the losses made on the sale of certain of these assets are disregarded as indicated in para 15.

Paragraph 53(4) provides that for the purposes of para 53(2), an asset of a natural person or a special trust to whom an allowance is or was paid or payable in respect of the use of that asset for business purposes, must be treated as being used mainly for purposes other than the carrying on of a trade. This provision therefore excludes motor vehicles in respect of which a travelling allowance in terms of s 8 is payable as well as other assets such as cellular telephones.

12.3 Retirement benefits

Paragraph 54

Retirement benefits paid in lump sums are disregarded in determining any capital gain or capital loss. The exclusion covers

- receipts in the form of a lump sum benefit as defined in the Second Schedule which is in essence amounts paid in consequence of membership of domestic pension funds, provident funds or retirement annuity funds, and
- lump sum benefits paid from any fund, arrangement or instrument situated outside the Republic which provides similar benefits under similar conditions to a pension, provident or retirement annuity fund approved in terms of the Income Tax Act.

12.4 Long-term assurance

Paragraph 55

Disregarding of gains and losses on disposal of policy by original owner

Where a long-term policy as defined in the Long-term Insurance Act 52 of 1998, issued by a South African insurer, is disposed of by the original owner or one of the original owners, and this results in the receipt or accrual of an amount in respect of the policy, any capital gain or loss as a result of this disposal is disregarded.

What is a long-term policy?

The term 'long-term policy" is defined in s 1 of the Long-term Insurance Act as follows:

> '**"long-term policy"** means an assistance policy, a disability policy, fund policy, health policy, life policy or sinking fund policy, or a contract comprising a combination of any of those policies; and includes a contract whereby any such contract is varied'.

The Long-term Insurance Act contains definitions of these different types of policies. In particular, a life policy is defined as follows:

> '**"life policy"** means a contract in terms of which a person, in return for a premium, undertakes to—
> (*a*) provide policy benefits upon, and exclusively as a result of, a life event; or
> (*b*) pay an annuity for a period;
> and includes a reinsurance policy in respect of such a contract'.

This would include, for example, a purchased annuity.

Foreign policies

No exclusion is granted to the disposal of long-term policies with foreign long-term insurers. The rationale behind this approach is that since the build up in these policies is not subject to income tax in South Africa, it is only fair that they be subject to CGT on disposal by applying the normal principles for determining a capital gain or loss on disposal of the asset.

The exclusion of foreign policies stems from the definition of the word 'policy' as defined in para 55(2). In terms of that subparagraph 'policy' means for the purpose of para 55(1)

> 'a policy as defined in section 29A with an insurer'.

In terms of para 1 an 'insurer' means

> 'an insurer as defined in section 29A(1)'.

In terms of s 29A an 'insurer' means

> 'any long-term insurer as defined in section 1 of the Long-term Insurance Act'.

In terms of s 1 of the Long-term Insurance Act a 'long-term insurer' means

> 'a person registered or deemed to be registered as a long-term insurer under this Act'.

Since a foreign insurer would not be registered under the Long-term Insurance Act it follows that capital gains and losses arising on the disposal of policies issued by a foreign insurer will not qualify for exclusion.

Second-hand policies

Why are second-hand policies subject to CGT?

The general rule is that the exclusion provided for in this paragraph will not apply to the disposal of second-hand policies, i.e. a policy that is purchased by or ceded to another person from the original owner. The reasons why second-hand policies are subject to CGT are that

- the preferential tax treatment afforded to insurance policies encourages long-term savings. Second-hand policies do not necessarily comply with this objective, as the longer-term investment objective is broken.
- these policies contain a speculative element that would otherwise escape taxation. Second-hand policies are normally purchased at a discount to the returns that accumulated up to the date of purchase and future returns. This discount element should be taxed in full.
- the large majority of persons who invest in these policies are high-income earners paying tax at 40%. By investing in second-hand policies on a short-term basis they enjoy the benefit of the low preferential tax rate of 30%. By levying CGT on these policies the gap is closed to a large extent.

Second-hand policies enjoying exclusion

A person must disregard any capital gain or loss determined in respect of a disposal that resulted in the receipt by or accrual to that person of an amount derived in the circumstances set out below.

The spouse, nominee, dependant or deceased estate exclusion (para 55(1)(a)(ii))

An amount derived by the

- spouse,
- nominee,
- dependant as contemplated in the Pension Funds Act 24 of 1956, or
- deceased estate

of the original beneficial owner of a long-term policy with a South African insurer will not give rise to a capital gain or loss, provided that no amount has been or will be directly or indirectly paid in respect of any cession of the policy;

A dependant is defined in s 1 of the Pension Funds Act 24 of 1956 as follows:

'"**dependant**", in relation to a member, means—

(*a*) a person in respect of whom the member is legally liable for maintenance;

(*b*) a person in respect of whom the member is not legally liable for maintenance, if such person—

(i) was, in the opinion of the board, upon the death of the member in fact dependent on the member for maintenance;

(ii) is the spouse of the member, including a party to a customary union according to Black law and custom or to a union recognised as a marriage under the tenets of any Asiatic religion;

(iii) is a child of the member, including a posthumous child, an adopted child and an illegitimate child;

(*c*) a person in respect of whom the member would have become legally liable for maintenance, had the member not died'.

Where an individual during his or her lifetime cedes a policy to another person (other than a spouse or dependant under the Pensions Fund Act), that other person will not be regarded as the nominee of that individual. The word 'nominee' is used in para 55(1)(*a*)(ii) to refer to the situation where the life insured remains the original beneficial owner, and nominates another person as the beneficiary upon the life insured's death. Where the original beneficial owner has ceded the policy to a person (other than a spouse or dependant under the Pensions Fund Act), the other person is a cessionary, not a nominee.

If another person cedes a policy back to the original beneficial owner, the original beneficial owner will, on reacquisition of the policy, still be regarded as the original beneficial owner for the purposes of para 55(1)(*a*)(i). This is so despite the fact that the person was not the original beneficial owner for the entire duration of the policy. The cedent, however, will not qualify for exclusion from CGT in respect of any gain arising on the cession.

The former spouse exclusion (para 55(1)(a)(iii))

An amount derived by the former spouse of the original beneficial owner to whom the long-term policy with a South African insurer was ceded in consequence of

- a divorce order, or
- in the case of a marital-like union, an agreement of division of assets which has been made an order of court

will be excluded from CGT.

The employee / director exclusion (para 55(1)(b))

An amount will be excluded from CGT where it is derived by any person in respect of any policy, where the person

- is or was an employee or director whose life was insured in terms of that policy, and
- any premiums paid by that person's employer were deducted in terms of s 11(*w*).

This exclusion applies to so-called conforming policies under s 11(*w*). This includes key-man policies such as where an employer takes out a policy on the life of an employee or director as part of a deferred compensation scheme.

Where an employee or director leaves the service of the employer and takes over the policy, the value of the policy at the date of termination will be included in the employee's or director's gross income in terms of para (*i*) of the definition of gross income as a fringe benefit. In terms of para 20(1)(*h*)(ii)(*bb*) the base cost of the policy in the hands of the employee or director will be the value so included in gross income. When the policy finally pays out, or when it is ceded to a third party, any capital gain or loss must be disregarded in terms of the exclusion. In order to enjoy the exclusion the employee or director does not have to be currently in the service of the employer (the provision includes a person who 'was' an employee or director.[190]

The 'buy and sell' arrangement exclusion (para 55(1)(c))

This provision concerns so-called "buy and sell arrangements" which occur where partners or shareholders take out insurance against the death, disability or severe illness[191] of their fellow partners and shareholders. The purpose is to provide them with funds to buy out their fellow partner or shareholder's interest in the partnership or company in the event of the death, disability or severe illness of that fellow partner or shareholder. When the business comes to an end, there is no purpose for the policies and they are often ceded to the person whose life was insured in terms of the policy. This provision allows the life assured to acquire the policy from the original beneficial owner, and ensures that the policy is treated in the same way as if that life assured had been the original beneficial owner. For the exclusion to apply the person acquiring the policy must not have paid any of the premiums in respect of the policy while the other person was the beneficial owner.

The pension, provident or RAF policy exclusion (para 55(1)(d)

An amount will be excluded for CGT purposes where it is received or accrues to a person on whose life a policy was originally taken out in consequence of his or her membership of a pension, provident or retirement annuity fund.

Group life policies

Where the employee pays all the premiums under a group life policy and that employee or his or her nominees are the beneficiaries under the policy, it is accepted that the employee is the beneficial owner of the policy.

In the context of shares, the term 'beneficial owner' was considered in the case of *Standard Bank of South Africa Ltd and Another v Ocean Commodities Inc and Others*.[192] In that case Corbett JA stated the following:[193]

> 'A share in a company consists of a bundle, or conglomerate, of personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends (*Randfontein Estates Ltd v The Master* 1909 TS 978 at 981; *Liquidators, Union Share Agency v Hatton* 1927 AD 240 at 250 - 1). Normally the person in whom the share vests is the registered shareholder in the books of the company and has issued to him a share certificate specifying the share, or shares, held by him.
>
> Indeed, such a share certificate, duly issued, affords prima facie evidence of his title to the shares specified therein (s 94 of the Companies Act 61 of 1973). In some instances, however, the registered shareholder may hold the shares as the nominee, i.e. agent, of another, generally described as the "owner" or "beneficial owner" of the shares. This fact does not appear on the company's register, as it is the policy of the law that a company should concern itself only with the registered owner of the shares. (See s 104 of the Companies Act and generally *Sammel and Others v President Brand Gold Mining Co Ltd* 1969 (3) SA 629 (A) at 666C - 667A; *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 (1) SA 441 (A) at 453A - B.) The term "beneficial owner" is, juristically speaking, not wholly

[190] This was clarified by the amendment of the provision by Act 45 of 2003, effective 22 December 2003.
[191] With effect from 22 December 2003 this provision was amended by Act 45 of 2003. The word 'illness' was qualified to cover severe illness, and payouts arising from disability or severe illness were brought in (previously the item only covered receipts or accruals on death).
[192] 1983 (1) SA 276 (A).
[193] At 288.

> accurate, but it is a convenient and well-used label to denote the person in whom, as between himself and the registered shareholder, the benefit of the bundle of rights constituting the share vests (see *Oakland Nominees* case *supra* at 447H - 453A).'

From the above it is clear that the term 'beneficial owner' does not refer to a registered or legal owner who merely acts as nominee or agent. The beneficial owner is the person who has a vested right in the benefits under the policy.

The view is accordingly held that under a group life policy where the employee pays all the premiums, any capital gain or loss arising in respect of that policy must be disregarded in terms of

- para 55(1)(*a*)(i) where a disability benefit is paid to the employee, or
- para 55(1)(*a*)(ii) where death benefits are paid to the spouse, nominee, dependant or deceased estate of the employee.

Determination of capital gains and losses on second-hand policies

Determination of base cost

The base cost of a second-hand policy acquired prior to 1 October 2001 could be determined using any of the acceptable prescribed methods. Most likely these would involve either the time-apportionment basis or the market value method.

In accordance with para 31(1)(*b*) the market value of a policy is the higher of

- surrender value, and
- fair market value determined by the insurer assuming that the policy runs to maturity.

The market value method would also have to be used on donation, death and cessation or commencement of residence.

Disposal events

A disposal of a second-hand policy could occur in a variety of circumstances, some of which are listed below.

- Cession (para 11(1)(*a*))
- Maturity (para 11(1)(*b*))
- Surrender (para 11(1)(*b*))
- Withdrawal in whole or part) (paras 11(1)(*b*), 33)
- Donation (para 11(1)(*a*))
- Death (para 40)
- Cessation of residence (para 12(1)(*a*))
- Commencement of residence (para 12(4))

The Guaranteed Capital Fund

It is common for second-hand policyholders to extend these policies into the Guaranteed Capital Fund for the purpose of making regular capital withdrawals. Every time a withdrawal is made in this manner a disposal will be triggered and it will be necessary to determine the capital gain or loss. These withdrawals amount to a part-disposal of the policy, and in terms of para 33 it will be necessary to determine the part of the base cost that has been disposed of. The formula for this purpose is:

Base cost of part disposed of =

$$\frac{\text{Amount withdrawn}}{\text{Market value of policy immediately prior to withdrawal}} \times \text{Base cost}$$

This can become fairly complex and a market value will have to be obtained immediately prior to each withdrawal taking place. For an example of a part-disposal where TAB has been adopted see Example 3 in **8.26 – Part-disposals**.

Example 1 – Part-disposal of second-hand policy

Facts: In 1996 Brenda took out a 5-year endowment policy as the original beneficial owner. Keith purchased the policy from Brenda in 2000 for R100 000. In January 2001 Keith extended the policy into the Guaranteed Capital Fund with the intention of making withdrawals. The market value of the policy on 1 October 2001 was R90 000. Keith made the following withdrawals

Date	Amount	Market value immediately prior to withdrawal
	R	R
1 July 2002	5 000	100 000
1 July 2003	6 000	108 000
1 July 2006	120 000	120 000

Keith adopts the market value method for determining the valuation date value of the policy.

Result: Keith's capital gain or loss is determined as follows:

2003

	R
Proceeds	5 000
Base cost	4 500
5 000/100 000 x 90 000	
Capital gain	500

2004

Proceeds	6 000
Base cost	4 750
6 000/108 000 x [90 000 – 4 500*]	
Capital gain	1 250

*this is the part disposed of in 2003.

2006

Proceeds	120 000
Base cost [90 000 – 4 500 – 4 750]	80 750
Capital gain	39 250

12.5 Disposal by creditor of debt owed by connected person

Paragraph 56 (Debt defeasance)

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

Circumstances under which para 56(1) does not apply (para 56(2))

Despite para 56(1) the creditor will be allowed a capital loss on disposal of debt where the circumstances set out below prevail.

Table 1 – Circumstances in which para 56(1) does not apply

Paragraph 56(2)	**Circumstances in which a creditor will be entitled to a capital loss on disposal of a debt**
(*a*)	A capital gain has been included in the determination of the aggregate capital gain or loss of the debtor ito para 12(5).
(*b*)	An amount which the creditor proves must be or was included in the gross income of any acquirer of that claim.
(*c*)	An amount must be or was included in the gross income or income of the debtor or taken into account in the determination of the balance of assessed loss of the debtor ito s 20(1)(*a*)(ii).
(*d*)	A capital gain which the creditor proves must be or was included in the determination of the aggregate capital gain or loss of any acquirer of the claim.[194]

A creditor who disposes of a claim at a discount to a third party must prove that the amount of the loss will be treated as gross income or a capital gain in the hands of the acquiror of the claim. It is submitted that this calls for a hypothetical enquiry as to whether the acquiror would have been subjected to tax on the amount of the unrealised income or capital gain at the date of acquisition had that acquiror immediately disposed of the claim at that point at its face value. For example, if the acquiror were a tax-exempt body or non-resident then the requirement would not be met.

Ring-fencing under para 39 not applicable

Any loss that the creditor becomes entitled to claim is not subject to the ring-fencing provisions of para 39 and may, therefore, be set off against other capital gains derived from transactions with unconnected persons.

Example 1 – Cancellation of debt owed by connected person where debtor not taxable on corresponding capital gain (para 56(1))

Facts: In 2002, Catinka lent R5 000 to her son, Ben, who is resident in Bermuda. In 2003, Catinka cancelled the loan after Ben failed to make any payments on the loan.

[194] This provision came into operation as from the commencement of years of assessment ending on or after 1 January 2005.

Result: Catinka must disregard the loss on the loan cancellation because the debtor is a connected person who is not subject to CGT on the corresponding gain in terms of para 12(5). Ben is a non-resident and therefore falls outside the taxing jurisdiction of South Africa in terms of para 2.

Example 2 – Capital loss allowable where debtor taxed on capital gain ito para 12(5) (para 56(2)(*a*))

Facts: Harold owes his sister Mary R100 000. After he had repaid R80 000 he fell into financial difficulties and was unable to make any further payments. Mary advised him that she was waiving her right to claim the balance of R20 000. The amount of R20 000 comprised a capital gain in Harold's hands in terms of para 12(5).

Result: Since the gain has been taxed in Harold's hands under para 12(5), Mary is entitled to a capital loss of R20 000 in terms of para 56(2)(*a*).

Example 3 – Cession of debt at less than face value to money-lender (para 56(2)(*b*))

Facts: Alan, Bert and Carl are brothers. Alan owes Bert R100 payable in 5 years' time. Carl carries on a debt factoring business. Bert disposes of the debt owed to him by Alan to Carl for R70, the market value of the debt at the time. After a number of years Alan repays Carl the full amount of R100.

Result: The consequences for each of the parties are as follows:

Alan

Alan is left unscathed by the transaction. He previously owed R100 to Bert, and after the debt was ceded owed the same amount to Carl. From his perspective, one creditor has simply been substituted for another. No portion of the debt was discharged for less than the face value thereof, so para 12(5) does not apply. He therefore has no gain no loss.

Bert

Bert had a base cost in respect of the loan of R100 and received proceeds of R70. The disposal took place at market value, so para 38 does not apply. He will therefore have a capital loss of R30. He is entitled to this loss because the amount will be included in Carl's gross income in the future as a money-lender. Note in this regard that the amount does not have to be included in Carl's gross income in the same year of assessment – para 56(2)(*b*) states that the amount 'must be' included in gross income. This means that Bert must determine whether Carl will have to include the amount in his gross income in the future (para 56(2)(*b*)). Bert's loss is not clogged because para 56(2) applies despite para 39.

Carl

Carl acquired the loan for R70 and received R100 giving a profit of R30. Since he is a money-lender the profit will be spread over the period of the loan in terms of s 24J and will be included in his gross income.

Example 4 – Loan waived and amount included in debtor's income (para 56(2)(*c*))

Facts: Stopper (Pty) Ltd and Topper (Pty) Ltd are wholly owned subsidiaries. Stopper operates a land dealing business whilst Topper manufactures furniture. Topper had for many years held a piece of land on which it intended to erect a warehouse for the purpose of storing its products. However, due to falling sales the directors decided to dispose of the land to Stopper at market value of R100 000 on loan account. A year later Stopper managed to sell the property to an unconnected party for R150 000 after the property market had taken off. The R50 000 profit was included in Stopper's taxable income. Topper thereafter decided to waive its right to claim the debt of R100 000 due by Stopper which resulted in the amount being included in Stopper's income in terms of s 8(4)(*m*).

Result: Topper will be able to claim the capital loss of R100 000, which will not be clogged (para 56(2)(*c*) allows the loss 'despite para 39').

Example 5 – Cession of debt at less than face value to person who will be subject to tax on capital gain (para 56(2)(*d*))

Facts: Abe and Bart are brothers. Bart owes Abe R10 000. Abe needs the cash and sells the claim to his sister Claudette, a resident, for R8 000.

Result: Since Claudette is subject to tax in SA, it is reasonable to assume that when Bart repays the loan she will realise a capital gain of R2 000. In terms of para 56(2)(*d*) Abe will be entitled to a capital loss of R2 000.

12.6 Disposal of small business assets on retirement

Paragraph 57

The purpose of this paragraph is to provide relief to small business persons who have invested their resources in their businesses.

Definitions (para 57(1))

Subparagraph (1) contains two definitions that apply for the purpose of para 57.

> '**"active business asset"** means—
> (*a*) an asset which constitutes immovable property, to the extent that it is used for business purposes; or
> (*b*) an asset (other than immovable property) used or held wholly and exclusively for business purposes,
> but excludes—
> (i) a financial instrument; and
> (ii) an asset held in the course of carrying on a business mainly to derive any income in the form of an annuity, rental income, a foreign exchange gain or royalty or any income of a similar nature'.

The concession applies 'to the extent' that immovable property is used for business purposes. This means that the exclusion will not apply to the part of the immovable property used for non-business purposes, and an apportionment will be required. Nevertheless, the presence of a farmhouse on a farm will not debar the farmer from claiming the exclusion in respect of the rest of the farm. A person who operates a shop on the ground floor of a double storey building and lives on the first floor will be entitled to the exclusion in respect of the gain attributable to the area used for the shop.

Exclusions

The intention is to exclude assets generating a 'passive' type of income and to rather target active business assets.

The term 'financial instrument' is defined in s 1 and includes *inter alia* loans, options, forward exchange contracts, shares, participatory interests in collective investment schemes, index linked investments and bank deposits.

> '**"small business"** means a business of which the market value of all its assets, as at the date of the disposal of the asset or interest contemplated in subparagraph (2), does not exceed R5 million.'

In ascertaining whether the business qualifies, one needs to consider the market value of all the assets, regardless of their nature and also regardless of the liabilities of the business.

In terms of subpara (2), only a natural person may disregard a capital gain in terms of the relief provided and only in respect of the disposal of an 'active business asset', if that asset or interest in a partnership or a company

- had been held for a continuous period of at least five years prior to the disposal contemplated,
- that natural person had been substantially involved in the operations of the business of that small business during that period, and
- that natural person had attained the age of 55 years or the disposal was in consequence of ill-health, other infirmity, superannuation or death.

In respect of a disposal, three instances are envisaged.

- First, the disposal of an active business asset of a small business owned by a natural person as a sole proprietor. What is envisaged is an economic unit loosely termed 'business' as opposed to individual assets. In the case of a sole proprietor, a business might mean a 'taxi business' or a 'printing business' or an 'accounting business' or a 'farming business' as distinct from all the assets of the sole proprietor, for instance, a primary residence, household furniture, or an investment in a portfolio of a collective investment scheme.
- Secondly, the disposal of an interest in each of the active business assets of a business, qualifying as a small business, owned by a partnership, upon that natural person's withdrawal from that partnership to the extent of his or her interest in that partnership.
- Thirdly, the disposal of an entire direct interest in a company consisting of at least 10% of the equity of the company, to the extent that the interest relates to active business assets of the company which must qualify as a small business.

Disposals of assets held by trusts do not qualify for relief in terms of this paragraph.

Subparagraph (3) imposes a limit of R500 000 on the amount of the capital gain that may be excluded and further states that such exclusion may not exceed R500 000 during that natural person's lifetime. The exclusion is therefore cumulative and is not in respect of each business or asset disposed of.

Subparagraph (4) imposes a further limit on the natural person in stating that all capital gains qualifying must be realised within a two-year period commencing on the date of the first disposal subject to the relief available in terms of para 57.

Subparagraphs (5) and (6) are closely related. The former allows a natural person operating more than one small business to include all qualifying disposals for every such small business in determining the capital gain to be disregarded. The latter, however, limits all these small businesses to a cumulative R5 000 000 in respect of the market value of all assets.

Example 1 – Disposal of small business assets

Facts: On attaining the age of 55 in 2010 Elias wishes to retire. He operates a fleet of taxis in the Gauteng Province as a sole proprietor and has done so for the past eight years. He is substantially involved in the operations of this business although he does not do any driving himself. The original cost of these taxis amounted to R1 000 000. Elias owes nothing on these vehicles and they have been fully depreciated for tax purposes. He has found a buyer for this business who takes it over 'lock, stock and barrel' for R1 200 000 in February of that particular year.

Elias is also substantially involved in another business along with a business partner Fani. They incorporated a close corporation and a company six years ago. The close corporation operates a successful brewery. The market value of the brewing plant and equipment amounts to R2 000 000. A liability amounting to R750 000 in respect of this equipment is still outstanding. The only other asset owned by the close corporation is a 100% shareholding in a company. The company's only asset is the brewery building that is let to the close corporation for a market-related rental. The market value of these shares amounts to R1 750 000. Elias and Fani each hold a 50% interest in the close corporation. Fani purchases Elias's interest in the close corporation upon his retirement for R1 800 000, 15 months after the disposal of his taxi business. The member's interest originally cost each party R100 000.

Result:

Taxi Business

		R
Selling price		1 200 000
Recoupment		1 000 000
Proceeds		200 000
Base cost		Nil
Original cost	1 000 000	
Depreciation	1 000 000	
Capital gain		200 000

Brewery

Active business assets to total assets (R2m /(R2m + R1.75m))53.33%

	R
Proceeds attributable to active business assets (R1.8m x 53.33%)	960 000
Base cost attributable to active business assets (R100 000 x 53.33%)	53 333
Capital gain attributable to active business assets	906 667

Elias is involved in two businesses, both qualifying as 'small businesses'. He has attained the age of 55, has owned or held an interest in the active assets for more than five years and has been substantially involved in the operations of both businesses. He may, therefore, disregard up to R500 000 of the capital gains realised provided that the disposals occur within a period of two years, which they do. Elias may, therefore, disregard the capital gain of R200 000 realised in the year that he disposes of his taxi business.
The following year he has no qualifying capital gains but in the year after that he may disregard R300 000 (R500 000 – R200 000) of the qualifying capital gain realised upon the disposal of his interest in the brewery. Notice that in this particular year his total capital gain

amounts to R1 700 000 (R1 800 000 – R100 000). After deducting the R300 000 that may be disregarded, the balance of R1 400 000 will be subject to CGT.

12.7 Exercise of options

Paragraph 58

This paragraph provides that the capital gain or loss of a person determined in respect of the termination of an option as a result of the exercise by that person of that option be disregarded. This disregarding is necessary because any amount paid for an option to acquire or dispose of an asset, other than a personal-use asset, will be allowed as part of the base cost of the asset in terms of para 20.

Some common option terms

Strike price - the price at which the buyer of an option can buy (in the case of a call) or sell (in the case of a put) the underlying asset.

Call option - an agreement that gives a person the right (but not the obligation) to buy an asset at a specified price (strike price) within a specified time period.

Put option - an agreement that gives a person the right (but not the obligation) to sell an asset at a specified price (strike price) within a specified time period.

'In the money' - A call option is 'in the money' if the price of the underlying asset is higher than the exercise (strike) price. A put option is 'in the money' if the price of the underlying asset is below the exercise price.

'In the water' – A call option is 'in the water' if the price of the underlying asset is lower than the exercise (strike) price. A put option is 'in the water' if the price of the underlying asset is above the exercise price.

Example 1 – Exercise of option to buy an asset

Facts: Geert purchases an option to acquire a farm for farming purposes. Geert pays R100 000 for the option to acquire the farm at a price of R1 000 000.

Result: When the option is exercised, the base cost in respect of the farm will be as follows.

	R
Cost of acquisition (para 20(1)(*a*))	1 000 000
Cost of option (para 20(1)(*c*)(ix))	100 000
Base cost	1 100 000

The option which is an asset and which had a cost of R100 000 has terminated as a result of the exercise of that option. The proceeds on exercise of an option that is in the money are equal to the difference between the strike price and the market value of the underlying asset on the date of exercise. The purpose of para 58 is to disregard and thereby effectively defer any capital gain or loss on exercise of the option until the underlying asset is disposed of.

The grantor

The person who granted Geert the option will have a disposal in terms of para 11(1)(*f*), proceeds of R100 000 in terms of para 35 and a zero base cost in terms of para 33(3)(*a*).

The granting of an option is not treated as a part-disposal of the underlying asset. As a result, no portion of the base cost of the asset for which the option is granted may be allocated to the granting of the option. However, any incidental expenditure directly related to the disposal of the option, such as legal fees to draw up the option, would constitute an admissible base cost deduction in the determination of the capital gain on the disposal of the option. In this instance, however, no incidental expenditure was incurred and the grantor will therefore have a capital gain of R100 000.

Lapse of the option

Had Geert decided to allow the option to lapse, para 58 will not apply. Geert will have a disposal in terms of para 11(1)(*b*) (the option would have terminated or expired), a base cost of R100 000 in terms of para 20(1)(*a*) and no proceeds in terms of para 35. He will therefore have a capital loss of R100 000 when the option lapses.

Purchase of option by grantor

Had the farmer paid Geert R150 000 to cancel the option, para 58 would not apply since the option would not have been exercised, but rather disposed of. Geert will have a disposal in terms of para 11(1)(*a*), proceeds of R150 000 in terms of para 35 and a base cost of R100 000, leaving him with a capital gain of R50 000. The farmer would have incurred expenditure of R150 000 in acquiring the option. That option would be extinguished by merger. The farmer will have no proceeds, a base cost of R150 000 in terms of para 20(1)(*a*) and a capital loss of R150 000. Paragraph 20(1)(*c*)(ix) is not applicable since the farmer did not acquire the asset by exercise of the option (he already owned the asset).

Example 2 – Exercise of option to sell an asset

Facts: Mark owns a piece of land that cost him R80 000 in March 2003. Mark paid John R1 000 for an option to sell the land to him for R100 000 within the next two years. In February 2005 Mark exercised the option and disposed of the land to John for R100 000.

Result: When the option was exercised it was extinguished and this would normally have given rise to a capital loss of R1 000. However, in terms of para 58 the loss must be disregarded. Instead, the cost of the option is added to the base cost of the land in terms of para 20(1)(*c*)(ix).
Mark's capital gain is determined as follows:

	R
Proceeds	100 000
Cost of land – para 20(1)(*a*)	(80 000)
Cost of option – para 20(1)(*c*)(ix)	(1 000)
Capital gain	19 000

12.8 Compensation for personal injury, illness or defamation

Paragraph 59

In terms of this paragraph a natural person or a special trust must disregard a capital gain or a capital loss in respect of a disposal of a claim resulting in that person or trust receiving compensation for personal injury, illness or defamation of that person or beneficiary. A similar approach is taken in the United Kingdom[195] and Australia.[196] The reason for this

[195] Section 51(2) of the Taxation of Chargeable Gains Tax Act, 1992.
[196] Section 118-37 of the Income Tax Assessment Act, 1997.

exclusion is that any compensation received would normally be intended to restore the person who has suffered harm to the position he or she was in prior to the injury, illness or defamation.

Example 1 – Amounts received in respect of unfair dismissal and defamation

Facts: After his employer had made his life unbearable Lester was forced to resign. He subsequently sought employment elsewhere but each time he approached a prospective employer they would phone his previous employer who would 'bad mouth' him. He decided to take the matter to the CCMA where it was held that he had been constructively dismissed and he was awarded an amount of R50 000 in respect of unfair dismissal. Not being satisfied with the sum he had received, Lester threatened to launch a further action for defamation. The employer agreed to settle and paid Lester a further R20 000 in full and final settlement whilst also agreeing to desist from commenting on him to prospective employers.

Result: The amount of R50 000 received in respect of unfair dismissal is taxable in Lester's hands in terms of para (*d*) of the definition of gross income. The R20 000, being of a capital nature and unrelated to his employment, falls outside para (*d*) [197] and is excluded from CGT in terms of para 59.

It must be noted, however, that this exclusion does not extend to all forms of damages and compensation. A right to claim damages or compensation is an asset for CGT purposes, being a personal right. The receipt of those damages is a disposal of that right which may give rise to a capital gain. The base cost of the right may consist, for example, of the legal fees incurred in bringing the action to court.

12.9 Gambling, games and competitions

Paragraph 60

This paragraph provides as a general rule that capital gains and losses arising from gambling, games and competitions will not be subject to CGT. However, *capital gains* of this nature will be subject to CGT where they

- are derived by companies, close corporations or trusts, or
- arise in respect of foreign gambling, games and competitions; or
- are derived from illegal gambling, games and competitions in South Africa.

This paragraph encompasses all manner of activities such as horse racing, the National Lottery, casino winnings and the like. It is immaterial whether the winnings are in the form of a prize or cash.

In order for there to be proceeds as defined in para 35, a prize must have a money value – that is, it must be capable of being sold (*Ochberg v CIR*[198]) or otherwise turned into money or money's worth (*Stander v CIR*[199]). For example, if a person wins an air ticket in an overseas competition, and the conditions of the competition stipulate that only the winner can use the ticket and that it cannot be converted into cash or ceded to another person, there will be no 'amount', and hence no proceeds.

Local gambling activities contribute to the *fiscus* indirectly in the form of betting taxes and value-added tax. In the case of the National Lottery a portion of the proceeds is used for the

[197] See ITC 1289 (1979) 41 SATC 149 (T).
[198] 1933 CPD 256, 6 SATC 1 at 8.
[199] 1997 (3) SA 617 (C), 59 SATC 212 at 218/9.

upliftment of the needy, which can be likened to a form of indirect taxation. Since foreign gambling does not contribute in this manner there is no reason to confer an exemption on such gains. In order to protect the tax base capital losses are in all instances disregarded.

Example 1 – Gambling winnings

Facts: Errol is a keen gambler and wins the following amounts:

Pick 6 winnings from the Greyville racecourse tote	R50 000
Roulette winnings from Sun City casino	R10 000
United Kingdom Lotto winnings	R55 000
Illegal 'bucket shop' race horse winnings (Point Rd, Durban)	R5 000

Result: Errol's Pick 6 and roulette winnings will be excluded from CGT, being from legal gambling in South Africa. However, his United Kingdom Lotto winnings and illegal race horse winnings will be subject to CGT. In the case of his Lotto winnings he can claim the cost of his Lotto ticket as part of base cost.

12.10 Collective investment schemes in securities

Paragraph 61

Any capital gain or loss must be disregarded by a portfolio in a collective investment scheme contemplated in para (*e*)(i) of the definition of 'company' in s 1. That provision refers to any

> 'portfolio comprised in any collective investment scheme in securities contemplated in Part IV of the Collective Investment Schemes Control Act, 2002, managed or carried on by any company registered as a manager under section 42 of that Act for purposes of that Part'.

The Collective Investment Schemes Control Act 45 of 2002 came into operation on 3 March 2003 and replaced the Unit Trusts Control Act 54 of 1981, and the Participation Bonds Act 55 of 1981. It provides a comprehensive modern legislative framework to regulate and supervise the collective investment industry, which includes equity unit trusts, property unit trusts and participation mortgage bond schemes. The provisions of the Act are based on internationally accepted principles and best practices.

This paragraph therefore applies to collective investment schemes in securities (CISS), which are treated as companies. An interest in a CISS must be distinguished from one in a collective investment scheme in property shares (CISP). The latter is actually a trust in which the holders of the shares have vested rights. Actions by the trustees are actions on the part of the beneficiaries and the CISP trust itself is not liable to CGT, since the capital gains and losses arising on the transactions it carries out do not accrue to it, but rather to its beneficiaries. The conduit pipe principle is, however, overridden by para 67A and holders of CISP interests must account for capital gains and losses on disposal of their interests.

Investors in these collective investment vehicles abroad will be subject to capital gains tax on the disposal of their investments.

12.11 Donations and bequests to public benefit organisations and exempt persons

Paragraph 62

Any capital gain or capital loss determined in respect of the donation or bequest of an asset to one of the persons set out in the table below must be disregarded. Prior to 22 December 2003 this exclusion only applied to donations or bequests to public benefit organisations.

Table 1 – Exclusion of capital gains and losses in respect of disposals to certain bodies

Paragraph 62	**Type of body**
(*a*)	The Government or any provincial administration.
(*b*)	A public benefit organisation exempt from tax ito s 10(1)(*c*N).
(*c*)	A person approved by the Commissioner in terms of s 10(1)(*c*A): An Institution, body or board that • conducts scientific, technical or industrial research • provides commodities, amenities or services to the State or members of the general public, • carries on activities (including the rendering of financial assistance) designed to promote commerce, industry or agriculture or any branch thereof, including • any company with similar objects whose shares are held by the above Institution, body or board or s 10(1)(*d*): • pension fund, provident fund, retirement annuity fund or benefit fund • various approved bodies (e.g. mutual loan association, fidelity fund, trade union, chamber of commerce or industries, local publicity association or non-proprietary stock exchange, • approved company, society or other association ➢ providing social and recreational amenities, or ➢ promoting the common interests of members of such body carrying on any particular kind of business, profession or occupation.
(*d*)	A person referred to in • s 10(1)(*b*) - Local authorities, • s 10(1)(*c*E) - Any political party registered ito s 36 of the Electoral Act 45 of 1979, • s 10(1)(*e*): ➢ A body corporate established ito the Sectional Titles Act 95 of 1986, ➢ A share block company established ito the Share Blocks Control Act 59 of 1980, ➢ Any other association of persons (including a s 21 company) formed for managing the collective interests of its members, including collecting levies iro common immovable property.

Capital gains or capital losses determined in respect of bequests of assets to approved public benefit organisations are also excluded on the date of death of a deceased person in terms of para 40.

Example 1 – Donation to Public Benefit Organisation

Facts: Sea (Pty) Ltd donated vacant immovable property with a market value of R1 000 000 to a SA university. The company had purchased the property 20 years earlier for R200 000 and paid R20 000 to transfer the property into its name.

Result: The donation is a 'disposal' in terms of para 11(1)(*a*). In terms of para 38 the company is treated as if it disposed of the property for proceeds equal to the market value of R1 000 000. The capital gain is R1 000 000 - (R200 000 + R20 000) = R780 000. This gain is disregarded in terms of para 62.

12.12 Exempt persons

Paragraph 63

This provision requires that a person must disregard any capital gain or loss in respect of the disposal of an asset

- where any amount constituting gross income of whatever nature
- would be exempt from tax ito s 10
- were it to be received by or accrue to the person.

Section 10 contains a number of exemptions from income tax. The exemptions provide

- complete exemption from tax in respect of the receipts or accruals of certain persons (e.g. public benefit organisations),
- partial exemption from tax in respect of certain types of receipts or accruals of certain persons (e.g. the levy income of a body corporate),
- exemption (complete or limited) in respect of certain types of income (e.g. the interest exemption).

The exclusion under para 63 is aimed at the first category, namely, persons enjoying complete exemption from tax. In order to determine whether a person falls within para 63 it is necessary to make a hypothetical enquiry as to whether the person would be exempt regardless of the type of gross income that the person may receive in the future. This goes further than a mere projection based on the assets or activities of the body at the end of the relevant year of assessment (see Example 2). In evaluating whether a person's future gross income from any source would be exempt from tax in terms of s 10 it is necessary to make the assumption that it will continue to comply with the requirements governing its current exempt status. For example, one would not take into account the fact that a public benefit organisation may lose its exempt status if it began trading activities on an excessive scale.

The untaxed policyholder fund of a long-term insurer does not derive its exemption in terms of this provision, but rather from having a zero inclusion rate in terms of para 10(*b*)(ii).

The receipts and accruals of pension, provident and retirement annuity funds are exempt from tax in terms of s 10(1)(*d*) so these funds will not be liable for CGT.

A person enjoying partial exemption from tax, such as a body corporate or share block company under s 10(1)(*e*), does not qualify under this paragraph. Such persons are addressed under para 64.

Example 1 – Exempt body

Facts: Retina South Africa, a registered public benefit organisation approved by the Commissioner in terms of s 30(3) enjoys exemption of all its receipts and accruals in terms of s 10(1)(*c*N). In the 2004 year of assessment it sold certain land and buildings at a capital gain of R100 000.

Result: The gain will be excluded in terms of para 63, since none of the body's receipts and accruals will be subject to tax, now or in the future. This of course, is based on the necessary assumption that it will continue to operate within the parameters of s 30 and any conditions laid down by the Commissioner.

Example 2 – Non-qualifying person deriving exempt income

Facts: Holdco Ltd's assets consist exclusively of shares in other group companies and it derives all its income in the form of exempt dividends. During the 2004 year of assessment it disposed of the shares in one of its subsidiaries, Subco (Pty) Ltd and realized a capital gain of R1 000 000.

Result: The gain will not be excluded by para 63 despite the fact that all Holdco's receipts and accruals during the 2004 year of assessment were exempt from tax in terms of s 10(1)(*k*). Had Holdco derived some other income such as interest or management fees in the future, that income would be taxable. It cannot therefore be said that Holdco's receipts and accruals 'would have' been exempt from tax in terms of s 10.

12.13 Assets used to produce exempt income

Paragraph 64

While para 63 seeks to disregard capital gains of persons exempt from income tax in terms of s 10, this paragraph seeks to disregard capital gains or losses in respect of the disposal of assets used to produce income that is exempt from income tax in terms of that section. Excluded from this concession are

- assets used to produce the annual interest exemption (s 10(1)(*i*)(xv)),
- shares from which dividends are received or accrue (s 10(1)(*k*)), and
- a copyright of a person who is the first owner (s 10(1)(*m*)).

12.14 Awards in terms of the Restitution of Land Rights Act

Paragraph 64A

Persons who were dispossessed of their land as a result of racially discriminatory laws or practices may seek compensation in terms of the Restitution of Land Rights Act 22 of 1994. The compensation may be in the form of a restitution of a right to land, an award or compensation.

A person who has put in a claim for land restitution effectively disposes of his or her claim for the amount of the award or compensation received.

Any capital gain or loss in respect of a disposal of this nature must be disregarded.

12.15 Disposal of interest in equity share capital of foreign company

Paragraph 64B

Background

In the 2003 Budget Review, the Minister of Finance announced his intent to allow the tax-free repatriation of foreign dividends back to South Africa, if the South African shareholder receiving the dividend has a stake of more than 25% in the foreign company. This type of dividend exemption is known as the participation exemption. It is frequently found in continental European systems, such as France, Netherlands, Belgium and Denmark. This exemption often exists alongside the tax-free sale of foreign shares involving the same percentage stake because profits from the sale of shares merely represent retained dividends. South African shareholders are allowed to make a tax-free sale of foreign shares in a more than 25% foreign company as long as that sale is made to foreign persons.

Definitions (para 64B(1))

This subparagraph contains two definitions that apply for the purpose of para 64B.

Definition - 'foreign company'

A 'foreign company' means

> 'a foreign company as defined in section 9D'.

In terms of s 9D a 'foreign company' means

> 'any association, corporation, company, arrangement or scheme contemplated in paragraph (*a*), (*b*) or (*e*) of the definition of "company" in section 1, which is not a resident'.

Table 1 – Types of companies that can qualify as foreign companies

Applicable paragraph of definition of 'company' in s 1	**Description**
(*a*)	Association, corporation or company incorporated or deemed to be incorporated under SA law (but not a close corporation). Body corporate formed or established or deemed to be formed or established under SA law.
(*b*)	Association, corporation or company incorporated under foreign law. Body corporate established under foreign law.
(*e*)	Local and foreign collective investment schemes in securities

It will be observed from the above table that domestic 'para (*a*)' companies can qualify as foreign companies. Such companies will normally be resident in SA as a result of being incorporated, established or formed in SA.[200] A domestic company can, however, be deemed to be exclusively a resident of a foreign country in terms of a double taxation agreement.[201]

Definition – 'Foreign financial instrument holding company'

A 'foreign financial instrument holding company' means

> 'a foreign financial instrument holding company as defined in section 41'.

This definition is examined in detail in the *Comprehensive Guide to the Corporate Rules*. Essentially it is a foreign company as defined in s 9D, where more than

- half of the market value, or
- two-thirds of the actual cost

[200] Paragraph (*b*) of the definition of 'resident' in s 1.
[201] See exclusion from definition of 'resident' in s 1.

of all the assets of that company, together with the assets of all controlled group companies in relation to that foreign company, consist of financial instruments. There are a number of exceptions such as the exclusion of certain trade debts and licensed financial institutions such as banks and insurance companies.

Exclusion of capital gains and losses on disposal of foreign company shares (para 64B(2))

The more than 25% interest requirement (para 64B(2)(a)(i))

A person holding more than 25% of the equity share capital of a foreign company must disregard any capital gain or loss arising on the disposal of those shares. This exclusion does not apply to an investment in a foreign financial instrument holding company as defined in s 41.

In determining whether a person holds more than 25% of a foreign company's equity share capital, no regard must be had to indirect holdings. Paragraph 64B(2)(*a*)(i) refers to the equity shares being 'held' by the person and this means a direct holding. Had it been intended to include indirect holdings the words 'directly or indirectly' would have been used. Where the person is a company, the percentage interest must be determined

> 'together with any other company in the same group of companies as that company'.

This amounts to a simple summation of the direct interests of all the companies in the group of companies in the foreign company. As long as the companies in the group together hold more than 25% of the foreign company's shares immediately prior to a disposal, any disposal of such shares by any one of the group companies, no matter how small, will meet the minimum holding requirement.

Example 1 - Foreign financial instrument holding company

Facts: In 2003 Dumisane, a resident, acquired 100% of Nifty Investments Ltd, a company incorporated in the Cayman Islands, at a cost of R750 000. The company's assets consisted solely of 10 different shares listed on the New York Stock Exchange. Two years later he sold his shares for proceeds of R1 000 000. Determine whether the capital gain of R250 000 is excluded from CGT in terms of para 64B.

Result: The capital gain is subject to CGT because Nifty Investments Ltd is a foreign financial instrument holding company. Such companies do not qualify for the participation exemption.

Example 2 – Determination of percentage interest in the case of a group company (1)

Facts: Holdco Ltd, a SA company owns all the shares in Abacus (Pty) Ltd, which in turn owns 20% of Brutus Inc, an oil refining company registered in Bermuda. Holdco owns 6% of Brutus directly. Determine whether Holdco and Abacus meet the minimum shareholding requirement to qualify for the participation exemption in para 64B.

Result: Since Holdco and Abacus are members of the same group of companies their combined interest in Brutus must be determined to see whether it exceeds 25%. In this case their combined interests amount to 26%, so both companies meet the minimum interest requirement for exclusion.

Example 3 – Determination of percentage interest in the case of a group company (2)

Facts: A, B and D are members of the same group of companies.
C is a foreign company.
A owns 80% of B.
B owns 16% of C.
B owns 100% of D.
D owns 5% of C.
A owns 4% of C directly.
D sells its 5% share in C to a non-resident. Does D qualify for the participation exemption?

Result: Combined group holding in C = 4% (A) + 16% (B) + 5% (D) = 25%.
Since the group together does not hold more than 25% of D, the participation exemption does not apply. No regard must be had to B's indirect interest in C via D in working out the group's interest.

When must the > 25% interest be determined?

The percentage holding is determined immediately before the disposal. This means that a person can dispose of a small percentage interest and still qualify for the exclusion of any capital gain or loss, as long as prior to that disposal the person held an interest exceeding 25%.

Example 4 – Disposal of interest in foreign company

Facts: On 1 March 2003 Ashini acquired a 75% interest in Jackson Inc, a foreign manufacturing company at a cost of R75 000. On 1 October 2004 she disposed of a 5% interest for proceeds of R20 000. On 1 October 2005 she disposed of a 50% interest for proceeds of R200 000. Finally on 31 March 2006 she disposed of her remaining 20% interest in the company for proceeds of R80 000.
Determine which of Ashini's capital gains are excluded for CGT purposes in terms of the participation exemption in para 64B.

Result: Ashini made the following capital gains:

1 October 2004	R20 000 – R5 000 = R15 000
1 October 2005	R200 000 – R50 000 = R150 000
31 March 2006	R80 000 – R20 000 = R60 000

The capital gain of R15 000 will be excluded in terms of para 64B because the shares were disposed of after 18 months and Ashini held a 75% interest in the company before the disposal.

The capital gain of R150 000 will be excluded because immediately before the disposal Ashini had held her shares for more than 18 months and held an interest of 70%.
The capital gain of R60 000 will be subject to CGT because Ashini held only 20% of the shares immediately prior to the disposal, which is less than the >25% requirement for exclusion.

Exclusion of s 8E affected instruments

The proviso to para 64B(2)(*a*) requires that

> 'in determining the total equity share capital in a foreign company, there shall not be taken into account any share which would have constituted an affected instrument, as contemplated in section 8E share' as defined in s 8E'.

The definition of 'affected instrument' was deleted by s 9(1)(*a*) of the Revenue Laws Amendment Act 32 of 2004. The amendment came into operation on 26 October 2004 and applies in respect of any instrument issued or acquired during any year of assessment commencing on or after that date. Unfortunately the reference in the proviso to para 64B(2) to an affected instrument has not been updated, so until the matter is addressed by Parliament, the previous definition must continue to prevail.

Section 8E deals with the situation where debt is disguised in the form of shares. It deems dividends received or accrued on certain types of shares ('affected instruments') to be interest in the hands of the shareholder. An 'affected instrument' as defined in s 8E(1) includes the following types of shares:

- redeemable preference shares redeemable in whole or in part within three years from date of issue,
- other shares where the holder has a right of acquisition within three years of date of issue *and*
  - those shares do not rank pari passu with other ordinary shares or at least with one other class of ordinary shares as regards dividends,
  - the dividends are payable with reference to a rate of interest or the subscribed capital.

In determining the percentage interest in a foreign company no regard must be had to any 'affected instruments' as defined in terms of s 8E. Furthermore, for this purpose shares will be regarded as affected instruments despite the fact that they may have passed the three-year rule in s 8E.

Example 4 – Impact of s 8E 'affected instruments' in determining qualifying percentage holding for participation exemption

Facts: Angus holds the following shares in Scotty Ltd, a retail company incorporated in the United Kingdom:
100 000 A Class ordinary shares
100 000 B Class ordinary shares
There are 500 000 A Class shares in issue and 100 000 B Class shares in issue. The A Class shares do not carry any restriction on the extent of dividend participation, and are not redeemable. The B Class shares are redeemable after 3 years and one day and are entitled to dividends at 2% below the prime rate of interest of the Regal Bank of Scotland.
Determine whether Angus holds a sufficient interest in Scotty Ltd in order to qualify for the participation exemption in para 64B.

Result: The B Class ordinary shares must be disregarded in determining Angus's percentage interest in Scotty Ltd, as they are affected instruments in terms of s 8E. Since Angus only holds 100 000/500 000 (20%) of the A Class ordinary shares, he will not qualify for the participation exemption.

The 18-month holding requirement (para 64B(2)(a)(ii))

In order to qualify for the exclusion, the person must have held the shares for at least 18 months prior to disposal. Where the person is a group company that acquired the shares from another group company a special rule applies. In that case, the combined periods that the two group companies held the shares must exceed 18 months. This group concession does not extend beyond the immediately preceding holding. For example, if Group Co 1 buys a foreign company from Group Co 2 which had bought it from Group Co 3, only the holding periods of Group Co's 1 and 2 can be taken into account when Group Co 1 disposes of its interest in the foreign company.

Example 5 – 18-month rule where foreign company shares acquired from another group company

Facts: Holdco owns 100% of Subco and Tubco. On 1 March 2003 Tubco acquired a 26% interest in Veeco. On 29 February 2004 Tubco sold its interest in Veeco to Subco. On 1 October 2004 Subco disposed of Veeco to a third party. Does Subco meet the 18-month holding period requirement in terms of para 64B?

Result: Tubco had held Veeco for 12 months, while Subco held it for 7 months. Therefore, the combined holding period is 19 months, which exceeds 18 months. As a result Subco meets the 18-month holding requirement in para 64B(2)(*a*)(ii).

The non-resident purchaser requirement (para 64B(2)(b))

Where the person disposing of the shares is a resident, any capital gain or loss will only be excluded where that resident disposes of the shares to a non-resident.

Effective date

Paragraph 64B comes into operation on 1 June 2004 and applies in respect of the disposal of any interest in the equity share capital of any foreign company on or after that date.

Chapter 13- Roll-overs

PART IX: ROLL-OVERS

13.1 Involuntary disposal

Paragraph 65

Act 45 of 2003 extensively amended para 65 with effect from 22 December 2003. For the sake of completeness the commentary on the previous version of para 65 is set out below.

The position prior to 22 December 2003

Where a capital gain arises on the expropriation, loss, or destruction of an asset (other than a financial instrument), this gain is held over until the disposal of its replacement asset.

This provision also applies to the spouse of a person who is declared insolvent. In terms of s 21 of the Insolvency Act the assets of the spouse vest in the Master of the High Court. The spouse has to prove that the assets do not fall into the joint estate. Situations can occur where the Master disposes of assets before proof can be submitted and the spouse then has a claim to the proceeds from the disposal of the assets. If the spouse uses the proceeds to acquire a replacement asset, the capital gain will also be held over.

In order to qualify for the holdover of the gain the taxpayer must satisfy the Commissioner that

- an amount equal to the proceeds from the disposal of the original asset has been or will be used to acquire a replacement asset that is similar to the original asset,
- a contract to acquire the replacement asset has been or will be concluded within a year of the disposal of the original asset, and
- the replacement asset has been or will be brought into use within three years of the disposal of the original asset.

Where the taxpayer concerned is not a resident of the Republic, the original asset would have been situated in the Republic for capital gains tax to be applicable in terms of para 2(1)(*b*). The replacement asset must therefore also be an asset situated in the Republic as contemplated by that paragraph.

The Commissioner may extend the periods mentioned above by a maximum of six months if all reasonable steps were taken to conclude a contract or bring the replacement asset into use.

Where the taxpayer does not meet the commitment to either conclude a contract or bring an asset into use within the specified period, the gain that has been held over is recognised at the end of the specified period. An additional amount equal to the interest on the gain at the prescribed rate from the date of disposal of the original asset to the end of the specified period is calculated and is also recognised as a capital gain. This additional amount compensates the *fiscus* for the deferral in the taxation of the gain and obviates the need to reopen past assessments.

The position on or after 22 December 2003

Table 1 – Summary of para 65

Paragraph 65	Description
(1)	Conditions under which an election to defer a capital gain may be made
(2)	Disregarding of capital gain in year of disposal
(3)	Allocation of capital gain over multiple replacement assets
(4)	Depreciable assets - spreading of capital gain in proportion to capital allowances on replacement asset
(5)	Recognition of any remaining untaxed portion of a capital gain in year of disposal of replacement asset
(6)	Failure to conclude contract or bring replacement asset into use
(7)	Replacement assets comprising personal use assets

Introduction

Paragraph 65 enables a person to elect to defer a capital gain where an asset has been expropriated, stolen or destroyed. In the case of depreciable assets, s 8(4)(*e*) provides matching deferral relief in respect of any recoupment of capital allowances. The election must be made in the tax return reflecting the disposal of the old asset.

Conditions under which an election to defer a capital gain may be made (para 65(1))

A person can elect that para 65 applies to the disposal of an asset (other than a financial instrument) under the following conditions:

- The asset must be disposed of by way of operation of law (e.g. expropriation), theft or destruction.
- Proceeds must accrue to the person by way of compensation (e.g. an insurance payout).
- The proceeds must be equal to or exceed the base cost of the asset (i.e. a capital gain or break-even situation). Where a capital loss arises this provision does not apply, as most persons would want to claim the capital loss in the year of assessment in which it arises. This provision also applies where the proceeds are equal to the base cost of an asset. This is necessary because despite not having a capital gain, a person may have a recoupment under s 8(4), and one of the pre-requisites for the equivalent relief provided by s 8(4)(*e*) is an election under para 65 or 66.
- Where less than all the proceeds are expended in acquiring a replacement asset para 65 will not apply. It is possible, however, to acquire a replacement asset costing more than the proceeds realised upon the disposal of the old asset.
- The relief applies where an amount at least equal to the receipts and accruals from the asset disposed of ‘has been’ or ‘will be’ expended to acquire one or more replacement assets. The use of the words ‘has been’ indicates that it is possible to acquire a replacement asset prior to disposing of the old asset. Where the replacement asset is acquired in advance of the involuntary disposal of the old asset, there should be a causal link that confirms that the new asset is indeed a ‘replacement’.
- All the replacement assets must be from a deemed SA source in terms of s 9(2), namely,
  - any SA immovable property (including shares in a property company under certain conditions),
  - any other asset of a resident not forming part of a permanent establishment (PE) outside SA, and
  - any other asset of a non-resident that forms part of a PE in SA.

This provision is designed to prevent a non-resident who would be subject to CGT on SA immovable property or assets of a PE in SA from replacing such assets with non-taxable assets from a non-SA source.

- The relief applies where the contract for the replacement asset has been or will be concluded within 12 months of the disposal of the asset. The words ‘has been’ cover the situation where the replacement is acquired before the disposal of the old asset.
- All the replacement assets must be brought into use within three years of the disposal of the asset. A replacement asset may be acquired (contract concluded) and brought into use prior to the disposal of the asset being replaced.
- The Commissioner may extend the 12-month and three-year periods by no more than six months if all reasonable steps were taken to conclude those contracts or bring those assets into use.
- The asset must not have been deemed to have been disposed of and to have been reacquired by the person. For example, the relief will not apply in a ‘degrouping’ situation where a deemed disposal and immediate reacquisition is triggered.

Disregarding of capital gain (para 65(2))

A person who makes the election referred to above must disregard the capital gain in the year of disposal, subject to

- subpara (4) which spreads the capital gain in proportion to capital allowances on any depreciable replacement assets,
- subpara (5) which triggers the capital gain (or in the case of a depreciable asset, any untaxed remaining portion thereof) when the replacement asset is disposed of, and
- subpara (6) which triggers the capital gain if a contract for the replacement asset is not concluded or the replacement asset is not brought into use within the prescribed periods.

Example 1 – Hold over of gain resulting from involuntary disposal

Facts: Heidi’s holiday house, which has a base cost of R550 000, burnt down completely on 15 February 2002. The house was insured for its replacement cost of R600 000 and the insurance company settled her claim for this sum on 18 October 2002. On 21 November 2002 Heidi contracted with a building contractor to rebuild her house and the project was completed on 7 March 2003. She spent the December 2003 holidays at her holiday house.

Result: The destruction of Heidi’s holiday house is considered to be a disposal in terms of para 11. However, the time of the disposal is regulated by para 13, which provides that in this case the date of disposal is the date on which the insurance company paid out the full compensation due. As a result the house is treated as having been disposed of on 18 October 2002. In terms of para 35 the proceeds of the disposal comprise the insurance payment that she received in consequence of the disposal of the house by destruction.

The result is that Heidi is treated as having disposed of her holiday house in the year of assessment ending on 28 February 2003 at a capital gain of R50 000. She is able to satisfy the Commissioner that she has concluded a contract to replace the destroyed holiday house within one year of its disposal and that she will bring its replacement into use within three years of its disposal. Heidi is therefore entitled to disregard the capital gain of R50 000 in the year of disposal. The gain will be held over and brought to account when the replacement home is disposed of.

Allocation of capital gain over multiple replacement assets (para 65(3))

This paragraph applies where the amount received or accrued from the disposal of the old asset is used to acquire more than one replacement asset. The disregarded capital gain must be spread across the replacement assets in accordance with the following formula:

Capital gain attributable to a replacement asset =

$$\text{Disregarded capital gain} \quad \times \quad \frac{\text{Receipts and accruals expended on replacement asset}}{\text{Receipts and accruals expended on all replacement assets}}$$

This formula must be used for the purpose of subparas (4) and (5) which deal with depreciable assets.

Example 2 – Allocation of capital gain across multiple replacement assets

Facts: Neptune Ltd acquired a machine on 1 October 2001 at a cost of R100 000. On 29 February 2004 a flood irreparably damaged the machine. The insurer paid out R120 000, being the replacement cost. Neptune Ltd decided to replace the old machine with two smaller machines X and Y. The X machine cost R90 000 and the Y machine R30 000.

Result: The capital gain on disposal of the old machine will be allocated among the replacement machines as follows:
Machine X: R90 000/R120 000 x R20 000 = R15 000
Machine Y: R30 000/R120 000 x R20 000 = R5 000
These capital gains will be brought to account in future years of assessment in accordance with the respective capital allowances claimable in respect of each of the machines.

Depreciable assets - spreading of capital gain in proportion to capital allowances on replacement asset (para 65(4))

Where a person acquires a depreciable replacement asset, the capital gain on disposal of the old asset must be recognised as the allowances on the replacement asset are claimed. The portion of the capital gain allocated to the replacement asset that must be recognised in a year of assessment is determined in accordance with the following formula:

$$\text{Disregarded capital gain attributed to replacement asset} \quad \times \quad \frac{\text{Capital allowance claimed in year of assessment}}{\text{All qualifying capital allowances for all years of assessment based on cost or value of replacement asset at date of acquisition}}$$

Where improvements have been made to a depreciable replacement asset any allowances on those improvements must be taken into account in the numerator of this formula. This will have the effect of accelerating the recognition of the capital gain.

Example 3 – Replacement of depreciable asset with single replacement asset

Facts: Arson Ltd purchased a machine on 29 February 2004 at a cost of R100 000. On 28 February 2005 the machine was destroyed by fire. The company received R120 000 from its insurer as compensation. Arson Ltd purchased a more advanced replacement machine on 30 June 2005 at a cost of R150 000. Determine the capital gain to be brought to account in the 2004 to 2008 years of assessment.

Result: The capital gain on disposal of the old machine amounts to R20 000. In terms of para 65 this must be disregarded and spread over future years of assessment in proportion to the capital allowances to be claimed on the replacement asset.

The capital allowances on the new machine will be as follows:

2005 R150 000 x 40% = R60 000
2006 R150 000 x 20% = R30 000
2007 R150 000 x 20% = R30 000
2008 R150 000 x 20% = R30 000

The capital gain of R20 000 must be recognised as follows:

2005 R20 000 x R60 000/R150 000 (40%) = R8 000
2006 R20 000 x R30 000/R150 000 (20%) = R4 000
2007 R20 000 x R30 000/R150 000 (20%) = R4 000
2008 R20 000x R30 000/R150 000 (20%) = R4 000

Recognition of any remaining untaxed portion of a capital gain in year of disposal of replacement asset (para 65(5))

Any portion of a previously disregarded capital gain allocated to a replacement asset that has not been brought to account must be treated as a capital gain in the year of assessment in which the replacement asset is disposed of. In the case of a depreciable asset this would occur where the replacement asset has not been fully depreciated at the time of its disposal.

Continuing relief for consecutive disposals and replacements

It is possible to make an election in terms of para 65 where the asset being disposed of is itself a replacement asset. Any capital gain arising from the disposal of an old asset is treated as a capital gain in respect of the replacement asset when the replacement asset is disposed of. This has the effect of providing an ongoing chain of relief in respect of depreciable replacement assets.

Failure to conclude contract or bring replacement asset into use (para 65(6))

This provision provides for the recognition of any disregarded capital gain where the person

- fails to conclude a contract within 12 months or
- fails to bring any replacement asset into use within three years.

In this event, the disregarded capital gain is brought to account in the year of assessment in which the 12-month or three-year period ends.

A further capital gain as compensation for the loss of interest to the fiscus

There is a sting in the tail awaiting a person who claimed deferral relief but failed to bring a replacement asset into use. A further capital gain must be brought to account in order to compensate the fiscus for the loss of interest it has suffered as a result of the unwarranted deferral benefit enjoyed by the person. This also obviates the need to revise the assessment relating to the year in which the old asset was disposed of. The capital gain is equal to the disregarded capital gain multiplied by the ‘prescribed rate’ of interest. The interest calculation will run from the date of disposal of the old asset until the expiry of the relevant 12-month or three-year period. The relevant prescribed rates that ruled during this period must be used.

The term 'prescribed rate' is defined in s 1 as follows:

> '**"prescribed rate"** in relation to any interest payable in terms of this Act, means for the purposes of—
> (*a*) interest payable to any taxpayer under the provisions of section 89*quat*(4), a rate determined at four percentage points below the rate contemplated in paragraph (*b*); or
> (*b*) any other provision of this Act, such rate as the Minister may from time to time fix by notice in the *Gazette* in terms of section 80(1)(*b*) of the Public Finance Management Act, 1999 (Act No. 1 of 1999)'.

The table below sets out the prescribed rates for the purpose of para (*b*) of the above definition since CGT was introduced.

Table 2 - Annual prescribed rates

Applicable Period	**%**
1 September 1999 to 29 February 2000	14.5
1 March 2000 to 30 September 2002	13
1 October 2002 to 31 March 2003	15,5
1 April 2003 to 30 June 2003	16,5
1 July 2003 to 31 August 2003	15
1 September 2003 to 30 September 2003	14
1 October 2003 to 30 November 2003	13
1 December 2003 to 31 October 2004	11,5
1 November 2004 to date	10,5

An updated list of prescribed rates is also available on the SARS website under Income Tax / IT Tables etc / Table of Interest Rates.[202]

Replacement assets comprising personal use assets (para 65(7))

Where a replacement asset or assets constitute personal use assets, the provisions of para 65 do not apply. The purpose of this provision is to prevent a person from benefiting from the deferral of the gain on disposal of a trade asset when that person replaces it with a personal use asset. Since there would be no benefit to the economy from such a switch there would be no point in the *fiscus* granting the person a deferral benefit. The term 'personal use asset' is defined in para 53(2), and excludes immovable property. Where a person replaces a single asset with multiple assets, the relief will be denied in full where any one of those replacement assets is a personal use asset.

Example 4 – Personal use replacement asset

Facts: Skip owned a fishing business in Scottburgh. His 6-metre ski boat, which had cost him R200 000 in 2002, sank on 29 February 2004 after it was struck by a freak wave. The insurance company paid him out R300 000 (the replacement cost). As a result of the declining fish stocks in the area he decided to cease catching fish commercially and to retire. Using the insurance proceeds and his savings, he purchased a 9-metre launch with a cabin for R400 000. Skip and his friends used the launch as a pleasure craft.

[202] See <http://www.sars.gov.za/it/it_tables/Table%20of%20Interest%20Rates.pdf> (accessed 22 March 2005).

Result: Skip will be subject to CGT on the capital gain of R100 000 and will not be entitled to the deferral benefits offered by para 65.

13.2 Reinvestment in replacement assets

Paragraph 66

Act 45 of 2003 extensively amended para 66 with effect from 22 December 2003. For the sake of completeness the commentary on the previous version of para 66 is set out below.

The position prior to 22 December 2003

Where a capital gain arises on the disposal of an asset that qualifies for a capital allowance or deduction in terms of s 11(*e*), 12B, 12C, 12E, 14 or 14*bis*, this gain is held over. In order to qualify for the holdover of the gain the taxpayer must satisfy the Commissioner that

- an amount equal to the proceeds from the disposal of the original asset has been or will be used to acquire a replacement asset that qualifies for a capital allowance or deduction equivalent to the capital allowance or deduction for which the original asset qualified,
- a contract to acquire the replacement asset has been or will be concluded within a year of the disposal of the original asset, and
- the replacement asset has been or will be brought into use within a year of the disposal of the original asset.

The capital allowances and deductions considered to be equivalent for the purposes of this paragraph are as follows:

Original Asset		**Replacement Asset**
Section 11(*e*) – Machinery, plant, implements, utensils and articles.	➔	Section 11(*e*) – Machinery, plant, implements, utensils and articles.
Section 12B – Machinery, plant, implements, utensils and articles used for qualifying activities and/or trades. Section 12C – Machinery, plant, implements, utensils and articles used for qualifying activities and/or trades. Ships and aircraft. Section 14 – Ships. Section 14*bis* – Aircraft.	➔	Section 12B – Machinery, plant, implements, utensils and articles used for qualifying activities and/or trades. Section 12C – Machinery, plant, implements, utensils and articles used for qualifying activities and/or trades. Ships and aircraft.

The gain that has been held over is recognised in five equal annual instalments commencing on the date that the replacement asset is brought into use. Any portion of the gain that has not been recognised by way of these instalments is recognised when the taxpayer disposes of the replacement asset or ceases to use it for the purposes of trade.

Where the taxpayer concerned is not a resident of the Republic, the original asset would have been situated in the Republic for capital gains tax to be applicable in terms of para 2(1)(*b*). The replacement asset must therefore also be an asset situated in the Republic as contemplated by that paragraph.

The Commissioner may extend the periods mentioned above by a maximum of six months if all reasonable steps were taken to conclude a contract or bring the replacement asset into use.

Where the taxpayer does not meet the commitment to either conclude a contract or bring an asset into use within the specified period, the gain that has been held over is recognised at the end of the specified period. An additional amount equal to the interest on the gain at the prescribed rate from the date of disposal of the original asset to the end of the specified period is calculated and is also recognised as a capital gain. This additional amount compensates the *fiscus* for the deferral in the taxation of the gain and obviates the need to reopen past assessments.

Example 1 – Hold over and spread of gain resulting from disposal and replacement of assets qualifying for capital allowances

Facts: Bee (Pty) Ltd sold various assets on 14 September 2002 in order to make funds available to purchase an aircraft costing R10 million. It had ordered the aircraft and made an up-front payment of R1 million to secure the order on 1 March 2002.

Asset	**Acquired**	**Cost** **R**	**Market value on valuation date** **R**	**Selling price** **R**
Aircraft	3 October 1994	2 000 000	2 800 000	5 000 000
Press	9 October 1995	5 000 000	650 000	710 000
Truck	6 October 1997	3 000 000	No valuation	350 000

The original aircraft qualified for the capital allowances contemplated in s 14*bis,* the press qualified for the capital allowances contemplated in s 12C and the truck qualified for the capital deductions in terms of s 11(*e*). The new aircraft is to be used for the purposes of trade and will qualify for the s 12C capital allowance when it is brought into use on 1 November 2002. All assets had been fully written off for tax purposes by 30 September 2002.

Result: The disposal of the assets will have the following consequences in the year of assessment ending on 30 September 2002.

Aircraft

	R
Ordinary income	
Original cost	2 000 000
Less: allowances claimed	2 000 000
Tax value – 30 September 2002	Nil
Selling price	5 000 000
Recoupment	2 000 000

Eighth Schedule

Selling price	5 000 000
Less: recoupment	2 000 000
Proceeds	3 000 000

Determination of base cost

Market value

Since expenditure prior to valuation date = 0, market value = R2 800 000 and proceeds = R3 000 000, para 26 applies, and Bee (Pty) Ltd has freedom to choose market value, TAB or 20% of proceeds. The market value of R2 800 000 is not limited by para 26 or 27.

Time-apportionment base cost

TAB = B + [(P – B) x N/N+T
TAB = R0 + [(R3 000 000 – R0) x 7/8]
TAB = R3 000 000 x 7/8
TAB = R2 625 000

20% of proceeds

Proceeds = R3 000 000
20% x R3 000 000 = R600 000

The highest valuation date value yielded by the three available methods is market value of R2 800 000.

The capital gain is R3 000 000 – R2 800 000 = R200 000.

This capital gain may be held over and recognised in five equal annual instalments commencing on 1 November 2002 as

- an amount equal to the proceeds of R3 000 000 has been or will be used to acquire a replacement asset that qualifies for a capital allowance equivalent to the allowance granted in respect of the original aircraft,
- a contract has been concluded to acquire a replacement asset, and
- the replacement asset will be brought into use within a year of the disposal of the original asset.

In the year of assessment ending on 30 September 2003, Bee (Pty) Ltd will, therefore, reflect a capital allowance of R2 000 000 (R10 000 000 x 20%) in respect of the new aircraft and a capital gain of R40 000 (R200 000 / 5) in respect of the original aircraft.

Press

	R
Ordinary income	
Original cost	500 000
Less: allowances claimed	<u>500 000</u>
Tax value – 30 September 2002	Nil
Selling price	710 000
Recoupment	500 000

Eighth Schedule

Selling price	710 000
Less: recoupment	<u>500 000</u>
Proceeds	<u>210 000</u>

Determination of base cost

Market value

Since expenditure prior to valuation date = R0, market value = R650 000 and proceeds = R210 000, para 26(3) applies (market value loss, historical gain). The market value of R650 000 is limited to proceeds of R210 000. Bee (Pty) Ltd also has freedom to choose TAB or 20% of proceeds.

TAB

TAB = B + [(P – B) x N/N+T
TAB = R0 + [(R210 000 – R0) x 6/7]
TAB = R210 000 x 6/7
TAB = R180 000

20% of proceeds

Proceeds = R210 000
20% x R210 000 = R42 000

Once again, market value albeit limited by para 26(3) gives the highest valuation date value.

The capital gain is R210 000 – R210 000 = RNil. The hold over provisions are therefore not applicable.

Truck

	R
Ordinary income	
Original cost	300 000
Less: allowances claimed	300 000
Tax value – 30 September 2002	Nil
Selling price	350 000
Recoupment	300 000

Eighth Schedule

Selling price	350 000
Less: recoupment	300 000
Proceeds	50 000

Determination of base cost

Market value

A market value has not been determined, so this method is not an option.

TAB

TAB = B + [(P – B) x N/N+T
TAB = R0 + [(R50 000 – R0) x 4/5]
TAB = R50 000 x 4/5
TAB = R40 000

20% of proceeds

Proceeds = R50 000
20% x R50 000 = R10 000

In this case TAB gives the highest valuation date value.
The capital gain is R50 000 – R40 000 = R10 000.

The capital gain in respect of the truck may not be held over, as the capital deductions in respect of the truck, which were claimed in terms of s 11(*e*), are not equivalent to the capital allowances to be claimed in respect of the new aircraft in terms of s 12C.

The position on or after 22 December 2003

Table 1 – Summary of para 66

Paragraph 66	**Description**
(1)	Conditions under which an election to defer a capital gain may be made
(2)	Disregarding of capital gain in year of disposal
(3)	Allocation of capital gain over multiple replacement assets
(4)	Spreading of capital gain in proportion to capital allowances on replacement asset
(5)	Recognition of any remaining untaxed portion of a capital gain in year of disposal of replacement asset
(6)	Recognition of any remaining untaxed portion of a capital gain in year in which asset no longer used for purposes of trade.
(7)	Failure to conclude contract or bring replacement asset into use

Introduction

Paragraph 66 enables a person to elect to defer a capital gain arising on the disposal of qualifying depreciable assets where the proceeds are reinvested in qualifying depreciable assets. Section 8(4)(*e*) provides matching deferral relief in respect of any recoupment of capital allowances on such assets. The election must be made in the tax return reflecting the disposal of the old asset.

Conditions under which an election to defer a capital gain may be made (para 66 (1))

A person can elect that para 66 applies to the disposal of an asset (other than a financial instrument) under the following conditions:

- The asset must have qualified for a capital deduction or allowance in terms of s 11(*e*), 12B, 12C, 12E, 14 or 14*bis.*
- The proceeds must be equal to or exceed the base cost of the asset (i.e. a capital gain or break-even situation). Capital losses are unlikely to arise, as in most cases the person would claim a scrapping allowance under s 11(*o*). Even if a capital loss did arise, this provision does not apply, as most persons would want to claim the capital loss in the year of assessment in which it arises. This provision also applies where the proceeds are equal to the base cost of an asset. This is necessary because despite not having a capital gain, a person may have a recoupment under s 8(4), and one of the pre-requisites for the equivalent relief provided by s 8(4)(*e*) is an election under para 65 or 66. Where less than all the proceeds are expended in acquiring a replacement asset para 66 will not apply. It is possible, however, to acquire a replacement asset costing more than the proceeds realised upon the disposal of the old asset.
- The relief applies where an amount at least equal to the receipts and accruals from the asset disposed of 'has been' or 'will be' expended to acquire one or more replacement assets all of which will qualify for a capital deduction or allowance in terms of s 11(*e*),

12B, 12C or 12E. The use of the words 'has been' indicate that it is possible to acquire a replacement asset prior to disposing of the old asset, although if this is done too far in advance it will be questionable whether the asset so acquired is a 'replacement'. There is no requirement that the replacement asset must fulfil the same function as the old asset. The only requirement is that the replacement asset must qualify for an allowance under the specified sections of the Act. For example, a person could dispose of a machine qualifying for a deduction under s 12C, and use the proceeds to acquire a motor vehicle qualifying under s 11(*e*).

- All the replacement assets must be from a deemed SA source in terms of s 9(2)(*b*), namely, any asset (other than immovable property) of a
  - resident not forming part of a permanent establishment (PE) outside SA, and
  - non-resident that forms part of a PE in SA.

  Where a resident replaces the asset with one located in a PE outside SA, any capital gain on that asset may be placed outside the SA tax net and for this reason para 66 will not apply. This could happen, for example, where an offshore company that is a resident (a CFC) has a foreign branch that carries on a business establishment. The capital gains of such a branch would not be subject to CGT by virtue of s 9D(9)(*b*). Movable assets of a non-resident can only be subject to CGT if they form part of a PE in SA (para 2). Where the non-resident replaces such an asset with one that is not part of a PE in SA, the replacement asset will not fall within the SA tax net. For this reason the replacement asset must also form part of a PE in SA if the non-resident wishes to enjoy the deferral benefits of para 66 when disposing of the old asset.
- The relief applies where the contract for the replacement asset has been or will be concluded within 12 months of the disposal of the asset. The words 'has been' cover the situation where the replacement is acquired before the disposal of the old asset.
- All the replacement assets must be brought into use within three years of the disposal of the asset. A replacement asset may be acquired (contract concluded) and brought into use prior to the disposal of the asset being replaced.
- The Commissioner may extend the 12-month and three-year periods by no more than six months if all reasonable steps were taken to conclude those contracts or bring those assets into use.
- The asset must not have been deemed to have been disposed of and to have been reacquired by the person. For example, the relief will not apply in a 'degrouping' situation where a deemed disposal and immediate reacquisition is triggered.

Disregarding of capital gain (para 66(2))

A person who makes the election referred to above must disregard the capital gain in the year of disposal, subject to

- subpara (4) which spreads the capital gain in proportion to capital allowances on any depreciable replacement assets,
- subpara (5) which triggers any untaxed remaining portion of a capital gain when the replacement asset is disposed of, and
- subpara (6) which triggers any untaxed remaining portion of a capital gain when the person ceases to use the asset in the course of that person's trade.
- subpara (7) which triggers the capital gain if a contract for the replacement asset is not concluded or the replacement asset is not brought into use within the prescribed periods.

Allocation of capital gain over multiple replacement assets (para 66(3))

This paragraph applies where the amount received or accrued from the disposal of the old asset is used to acquire more than one replacement asset. The disregarded capital gain must be spread across the replacement assets in accordance with the following formula:

Capital gain attributable to a replacement asset =

$$\text{Disregarded capital gain} \times \frac{\text{Receipts and accruals expended on replacement asset}}{\text{Receipts and accruals expended on all replacement assets}}$$

This formula must be used when determining a capital gain under subpara (4) [spread of gain in proportion to allowances], (5) [gain arising on disposal of replacement asset] and (6) [gain on cessation of trade use].

Spreading of capital gain in proportion to capital allowances on replacement asset (para 66(4))

A person acquiring a qualifying replacement asset must account for the capital gain on disposal of the old asset as the allowances on the replacement asset are claimed. The portion of the capital gain allocated to the replacement asset that must be recognised in a year of assessment is determined in accordance with the following formula:

$$\text{Disregarded capital gain attributed to replacement asset} \times \frac{\text{Capital allowance claimed in year of assessment}}{\text{All qualifying capital allowances for all years of assessment based on cost or value of replacement asset at date of acquisition}}$$

Where improvements have been made to a qualifying replacement asset any allowances on those improvements must be taken into account in the numerator of this formula. This will have the effect of accelerating the recognition of the capital gain.

Recognition of any remaining untaxed portion of a capital gain in year of disposal (para 66(5))

This provision deals with the situation where a qualifying replacement asset has been disposed of and not all the capital gain has been recognised at the date of disposal. In other words, the asset has not been fully depreciated at that time. Where this happens any remaining untaxed portion of the capital gain must be recognised in the year of disposal.

Continuing relief for consecutive disposals and replacements

It is possible to make an election in terms of para 66 where the asset being disposed of is itself a replacement asset. Any capital gain arising from the disposal of an old asset is treated as a capital gain in respect of the replacement asset when the replacement asset is disposed of. This has the effect of providing an ongoing chain of relief in respect of qualifying replacement assets.

Cessation of trade (para 66(6))

Any untaxed portion of a capital gain must be recognised in the year of assessment in which a person ceases to use the asset in that person's trade

Failure to conclude contract or bring replacement asset into use (para 66(7))

This provision provides for the recognition of any disregarded capital gain where the person

- fails to conclude a contract within 12 months or
- fails to bring any replacement asset into use within three years.

In this event, the disregarded capital gain is brought to account in the year of assessment in which the 12-month or three-year period ends.

A further capital gain as compensation for the loss of interest to the fiscus

There is a sting in the tail awaiting a person who claimed deferral relief but failed to bring a replacement asset into use. A further capital gain must be brought to account in order to compensate the *fiscus* for the loss of interest it has suffered as a result of the unwarranted deferral benefit enjoyed by the person. This also obviates the need to revise the assessment relating to the year in which the old asset was disposed of. The capital gain is equal to the disregarded capital gain multiplied by the 'prescribed rate' of interest. The interest calculation will run from the date of disposal of the old asset until the expiry of the relevant 12-month or three-year period. The relevant prescribed rates that ruled during this period must be used. For a detailed discussion of the meaning of 'prescribed rate' see the commentary on para 65(6).

13.3 Transfer of asset between spouses

Paragraph 67

This rule provides for a deferral ('roll-over') of a capital gain or loss when an asset is transferred between spouses.

Scope and application

It applies where an asset is transferred to a person's spouse
- during that person's lifetime,
- as a result of that person's death,
- in consequence of a divorce order, or
- in the case of the termination of a permanent marital-like union, in consequence of an agreement of division of assets that has been made an order of court.

Note that the definition of spouse in s 1 has been widened and now reads as follows:

> '**"spouse"**, in relation to any person, means a person who is the partner of such person—
> (*a*) in a marriage or customary union recognised in terms of the laws of the Republic;
> (*b*) in a union recognised as a marriage in accordance with the tenets of any religion; or
> (*c*) in a same-sex or heterosexual union which the Commissioner is satisfied is intended to be permanent,
>
> and **"married"**, **"husband"** or **"wife"** shall be construed accordingly: Provided that a marriage or union contemplated in paragraph (*b*) or (*c*) shall, in the absence of proof to the contrary, be deemed to be a marriage or union without community of property'.

Treatment in the hands of the spouses

The transferor (disposing) spouse

Subparagraph (1)(*a*) provides that the disposing spouse must disregard any capital gain or loss when disposing of an asset to his or her spouse.

The transferee (acquiring) spouse

Subparagraph 1(*b*) ensures that the spouse to whom an asset is disposed of takes over all aspects of the history of the asset from that person's spouse, namely,
- the dates of acquisition and improvement
- the expenditure incurred,

- the currency in which the expenditure was incurred,[203] and
- the usage.

The dates and amounts of expenditure need to be taken over by the acquiring spouse for the purposes of determining the time-apportionment base cost of the asset. The usage of the asset needs to be taken over to ensure, for example, that any business usage of an otherwise exempt asset is taxed.

In terms of para 67(1)(*b*)(ii) an asset is treated as having been acquired for an amount equal to the expenditure incurred by the disposing spouse. It follows that any amounts paid by the acquiring spouse to the disposing spouse for an asset must be disregarded.

Transfers of assets between spouses for the purpose of tax avoidance may result in the capital gain or loss arising in the hands of the transferee spouse being attributed to the transferring spouse in terms of para 68.

Death of a spouse

Subparagraph (2)(*a*) makes the above roll-over provisions applicable to the assets of a deceased person that are bequeathed to that person's spouse. Paragraph 40(1)(*a*), which deems the assets of a deceased person to have been disposed of on death, excludes such assets as disposals in the hands of the deceased. Thus the deceased is relieved of any CGT liability in respect of the relevant assets and the surviving spouse takes over any unrealised gains and losses that accrued to the deceased spouse at the date of death.

Divorce of spouses

Subparagraph (2)(*b*) makes the roll-over provisions applicable to spouses who are divorced or separated provided that certain legal formalities are complied with. These are summarised in the table below.

Table 1 – Legal formalities for divorce/separation

Type of marriage	**Legal formality required for tax-free roll-over**
Marriage or customary union recognised in terms of the laws of the Republic	Divorce order
Religious marriages	Agreement of division of assets which has been made an order of court
Permanent same sex or heterosexual unions	

Example 1 – Transfer of assets to surviving spouse by deceased estate

Facts: Irvine dies and leaves assets to the value of R750 000 that he acquired at a cost of R80 000, to his wife Janice. The remainder of his assets were acquired by him at a cost of R450 000 and are valued at R1 200 000 at the time of his death. All the assets were acquired after valuation date.

Result: Irvine is treated in terms of para 40 as having disposed of assets to the value of R1 200 000 as at the date of death. The transfer to Janice of the assets bequeathed to her is treated as a disposal by Irvine for no gain or loss. The base cost to Irvine of those assets, namely, R80 000, is transferred to Janice along with those assets. Janice will therefore have

[203] Paragraph 67(*b*)(iii) was amended by Act 45 of 2003 with effect from 22 December 2003 to deem the acquiring spouse to have incurred the expenditure in the same currency in which it was incurred by the disposing spouse.

to determine any capital gain or loss in respect of the disposal of any of those assets with reference to the base cost of those assets in Irvine's hands.

Example 2 – Business use of asset prior to transfer to spouse

Facts: John used 10% of his primary residence as an office from valuation date up until transferring the residence to his wife.

Result: When his wife ultimately disposes of the primary residence 10% of the capital gain in respect of the period prior to her acquiring it will be taxable in her hands.

Non-resident spouses and anti-avoidance

Paragraph 67(3) is an anti-avoidance measure that prevents a tax-free roll-over to a non-resident spouse except in the case of

- immovable property situated in the Republic, or
- the assets of a permanent establishment through which a trade is carried on in the Republic.

Since the latter assets fall within the tax jurisdiction of the Republic even for non-residents, there is no need to preclude them from the roll-over relief conferred by subpara (1).

Example 3 – Transfer of assets to non-resident spouse

Facts: Bruce and Sheila plan to emigrate to Australia. Sheila has no CGT assets and is the first to emigrate so as to set up their new home in Perth. After she has left Bruce transfers the following assets to Sheila:

	Base cost	Market Value
	R	R
Holiday home at Plettenberg Bay	1 000 000	2 000 000
Listed shares	2 500 000	5 000 000

Result: Bruce will be subject to CGT on the capital gain of R2 500 000 on the transfer of the shares in terms of para 38, whilst Sheila will only be liable for CGT when she disposes of the Plettenberg Bay property.

13.4 Interests in collective investment schemes in property

Paragraph 67A

This paragraph deals with holders of a participatory interest in a portfolio comprised in any collective investment scheme in property shares (CISP). For this purpose a CISP is one managed or carried on by any company registered as a manager under s 42 of the Collective Investment Schemes Control Act 45 of 2002 for the purposes of Part V of that Act.

An interest in a CISP must be distinguished from one in a collective investment scheme in securities (CISS). The latter is a company whilst a CISP is actually a trust in which the holders of the shares have vested rights. Actions by the trustees are actions on the part of the beneficiaries and the CISP trust itself is not liable to CGT, since the capital gains and losses arising on the transactions it carries out do not accrue to it, but rather to its beneficiaries. The conduit pipe principle is, however, overridden by para 67A.

A holder of such an interest must determine a capital gain or loss in respect of any participatory interest in that portfolio only upon the disposal of that interest and with reference to the proceeds from the disposal of the participatory interest and its base cost.

Capital distributions treated as proceeds (para 67A(3))

[Effective 22 December 2003]

In terms of the Collective Investment Schemes Control Act, 2002 it is possible for a CISP to make a capital distribution to a holder on a going concern basis while the portfolio remains in force. Under the previous Act such capital distributions were specifically debarred except on winding-up.

The amount of cash or assets received from a CISP before disposal of the holder's interest must be treated as proceeds on disposal of that interest.

Proceeds comprise
- the amount of any cash received,
- the market value of any assets received on the date of acquisition, and
- to the extent that it does not constitute gross income in the hands of the holder.

Base cost of assets acquired from a CISP (para 67A(4))

[Effective 22 December 2003]

Any asset acquired by a holder of a participatory interest in terms of para 67A(3) must be treated as having been acquired for expenditure equal to the market value of that asset on the date of acquisition. The expenditure is treated as an amount of expenditure actually incurred and paid for the purposes of para 20(1)(*a*).

What would the position have been in the absence of para 67A?

Were it not for para 67A gains and losses determined in respect of disposals by a CISP trust would vest in the holders of participatory interests in that CISP trust in the tax year in which those gains and losses arise. Holders of participatory interests in a CISP trust would, therefore, have had to take gains and losses arising in that CISP trust into account as they arose. Their capital gains and losses would therefore not be deferred, as in the case of a CISS, to the date of disposal of their participatory interests. Paragraph 67A is aimed at obviating this result. Note that a CISS is exempt from CGT in terms of para 61.

13.5 Transfer of a unit by a share block company to its member

Paragraph 67B

A company which operates a share block scheme in relation to immovable property which wishes to open a sectional titles register so that it can allow share block holders the right to take transfer of the property for which they hold the right of use, must follow the procedures prescribed in the First Schedule to the Share Blocks Control Act 59 of 1980. In terms of item 8 of this Schedule the share block holder who wishes to take transfer of the property must surrender his or her share certificate and right of use of the property in return for transfer of the property. Although seen from the point of view of the share block holder this is merely a change in the form of ownership of the immovable property, this is a disposal that can give rise to a capital gain or capital loss.

Disregarding of capital gains and losses

In order not to create cash flow difficulties the recognition of the capital gain or loss is disregarded in the hands of the company and the person who acquires the sectional title unit.

Roll-over rules for person acquiring the unit

The capital gain or loss made by the person acquiring the unit is deferred until the person actually disposes of the immovable property. This is achieved by carrying across the details set out in the table below in respect of the shares and property improvements to the sectional title unit

Table 1 – Carry over of details from share block unit to sectional title unit

Paragraph 67B(2)	**Details in respect of the share block unit**	**Treated as details in respect of the sectional title unit**
(*a*)	Cost ito para 20 of acquiring shares	Cost of acquisition.
(*b*)	Cost ito para 20 of improvements made by shareholder to unit	Cost of improvements.
(*c*)	Date of acquisition of share	Date of acquisition.
(*d*)	Date of incurral of expenditure in respect of share and improvements	Date of incurral of expenditure in respect of acquisition of unit and improvements.
(*e*)	Use of immovable property in respect of which person held shares conferring right of use.	Use of unit.
(*f*)	Market value adopted or determined in terms of para 29(4) in respect of share	Market value adopted or determined in terms of para 29(4) in respect of unit.

The carry over of the relevant costs and dates of acquisition and incurral from the shares to the unit enables the person to use TAB in establishing the valuation date value of the unit. The carry over of the use of the immovable property while the person was a shareholder in the share block company enables the period of ordinary residence to be recognised for the purpose of the R1 million primary residence exclusion. Paragraph 67B is effective from 1 October 2001.

13.6 Mineral rights conversions and renewals

Paragraph 67C [Effective 1 May 2004]

This provision deals with mineral, mining, prospecting, exploration and production rights held before the introduction of the Mineral and Petroleum Resources Development Act 28 of 2002 and mining rights issued in terms of that Act. It provides that there is no disposal in terms of para 11 where existing rights are converted wholly or partially to new rights. The table below summarises the types of rights and relief granted. Since the old and new rights are deemed to be one and the same asset, it follows that any valuation in terms of para 29(4), dates of incurral and acquisition and costs will simply be carried across to the new rights. This is important for the purpose of determining the valuation date value of pre-valuation date mineral rights.

Table 1 – Roll-over relief in respect of mineral right conversions and renewals

<table>
<tr><th>Paragraph 67C</th><th>Type of old right</th><th>Type of disposal to be disregarded</th><th>Roll-over relief</th></tr>
<tr><td>(a)</td><td>• Old order right, or
• OP26 right
as defined in Schedule II of the Mineral and Petroleum Resources Development Act 28 of 2002.</td><td>Where old order right or OP26 right wholly or partially
• continues in force, or
• is converted into a new right ito the same Schedule.</td><td rowspan="2">The continued, converted or renewed right or permit is treated as one and the same asset as the right before continuation, conversion or renewal for purposes of the Income Tax Act.</td></tr>
<tr><td>(b)</td><td>Any
• prospecting right,
• mining right,
• exploration right,
• production right,
• mining permit,
• retention permit, or
• reconnaissance permit
as defined in s 1 of the Mineral and Petroleum Resources Development Act 28 of 2002.</td><td>Where existing right Is wholly or partially renewed in terms of that Act,</td></tr>
</table>

Effective date

Paragraph 67C came into operation on the date that the Mineral and Petroleum Resources Development Act 28 of 2002 came into operation, namely, 1 May 2004.

Chapter 14 - Trusts and trust beneficiaries

PART XII: TRUSTS, TRUST BENEFICIARIES AND INSOLVENT ESTATES

14.1 Summary

The CGT consequences of trusts can be rather confusing for the uninitiated because of the number of permutations. In an effort to clear up this confusion the position is summarised below.

The trustee can
- *vest* an unconditional right to the asset,
- *sell* the asset,
- *distribute* the asset, or
- *distribute* the gain
- in the current year
- in a future year.

The beneficiary can
- *sell* his or her vested or contingent right in the trust,
- *acquire* a vested or contingent right in the trust, or
- *acquire* the asset from the trust.

Non-resident beneficiaries are treated differently to resident beneficiaries.

In terms of the rules discussed in this chapter a capital gain will either be taxed in the hands of the trust or the beneficiary. However, these basic rules can be overridden by special attribution rules contained in paras 68 to 72, which provide for the whole or part of a trust capital gain to be taxed in the hands of the trust donor. These special rules are discussed in the next chapter,

Finally there are special rules dealing with resident beneficiaries of non-resident trusts (para 80(3) and the death of a beneficiary of a special trust (para 82).

The CGT consequences of trusts are summarised in the table below.

Table 1 – CGT consequences of trusts (excluding attribution of capital gains to donors under para 68 – 72)

Event	**Paragraph**	**CGT Consequence**
RESIDENT TRUSTS **Vesting, distribution and sale of asset – resident beneficiary**		
Trustee vests unconditional right to asset in resident beneficiary	80(1) 38(1)(*b*)	Capital gain ignored in trust and taxed in beneficiary's hands at time of vesting. Base cost of vested right in beneficiary's hands = market value of right at date of vesting. [Subject to attribution to donor in terms of paras 68, 69, 71 and 72]
Trustee distributes asset to resident beneficiary who has a vested interest in that asset	11(2)(*e*) 11(1)(*a*) 35, 13(1)(*a*)(ix)	Trust not taxed - not a disposal Gain or loss triggered in beneficiary's hands due to exchange of right to delivery of trust asset for the actual asset. Proceeds of right disposed of = market value of asset at date of distribution

	38(1)(*b*) 20	Base cost of right disposed of = market value at time of vesting Base cost of asset acquired = market value at time of exchange
Resident beneficiary sells asset after acquisition	Normal rules	Further gain or loss triggered on disposal
Vesting, distribution and sale of asset – non-resident beneficiary		
Trustee vests asset in non-resident beneficiary	Normal rules 11(1)(*d*)	If para 72 does not apply, will be taxed in trust (para 72 = attribution back to donor).
Trustee distributes asset to non-resident beneficiary who has a vested interest in asset	11(2)(*e*) /2(1)(*b*)	Trust not taxed - not a disposal by trust. If the vested right is an 'interest' contemplated in para 2(1)(*b*), the beneficiary will be taxed on the exchange of that vested right for the real right in the asset. Gain or loss determined in same way as resident beneficiary Otherwise, non-resident not taxed
Non-resident beneficiary sells asset after acquiring it from trust	Normal rules, 2(1)(*b*)	If para 2(1)(*b*) asset - further gain taxed. Otherwise, non-resident not taxed
Retention of gain or loss in trust		
Trustee sells asset and does not distribute gain	Normal rules	Gain taxed in trust at following rates: • Normal trust - at 20% (50% x 40%). • Special trust - at 10% or less (25% x marginal rate which is a max of 40%) Only special trusts for persons suffering from a mental illness or serious physical disability qualify for exclusions applicable to individuals (e.g. annual exclusion, primary residence exclusion). [Subject to attribution to donor in terms of para 70]
Trustee sells asset at a loss	Normal rules	Loss retained in trust – cannot be distributed
Distribution of gain		
Trustee sells asset and distributes gain to resident beneficiary not having a prior vested interest in the asset in the same year	80(2)	Capital gain ignored in trust and taxed in beneficiary's hands in that year. [Subject to attribution to donor in terms of paras 68, 69, 71 and 72]
Trustee sells asset and distributes gain to non-resident beneficiary not having a prior vested interest in the asset in the same year	Normal rules	Gain taxed in trust [Subject to attribution to resident donor in terms of para 72]
Trustee sells asset and distributes gain in a future year to resident beneficiary not having a prior vested interest in the asset.	Normal rules	Gain taxed in trust in year asset disposed of. Subsequent distribution of cash not taxed in trust as cash is not an 'asset'. The receipt of the cash in the beneficiary's hands does not arise from the disposal of an asset. There are therefore no CGT consequences for the beneficiary.

Sale of vested and contingent rights by beneficiaries		
Resident beneficiary sells contingent right	81	Beneficiary taxed on proceeds with zero base cost. The base cost is deemed to be nil even if the beneficiary paid something for the contingent right.
Resident beneficiary sells vested right	Normal rules	Beneficiary is taxed on proceeds less base cost. Base cost could be acquisition cost or market value at date of vesting.
Non-resident sells vested right	Normal rules	Non-resident beneficiary will be taxed on proceeds less base cost if para 2(1)(*b*) asset. Otherwise not taxed.
NON-RESIDENT TRUSTS **Beneficiary acquires vested right in trust capital in which he/she previously held contingent right**		
Amount vested represents prior year capital gains	80(3)	Capital gains taxed in beneficiary's hands in year of vesting
Amount vested represents current year capital gain arising from sale of asset or vesting of asset	80(3)	Capital gain taxed in beneficiary's hands in year of vesting

14.2 Historical background

The trust was unknown to Roman or Roman Dutch law. Trusts were introduced into England shortly after the Norman conquest. The trust was developed by the English Court of Chancery from the Germanic Salman or Treuhand institution. The trust of English law forms an integral part of all common law legal systems, including American law. In South Africa the trust was introduced during the 19th century by usage without the intervention of the Legislature. The English conception of an equitable ownership distinct from, but co-existing with, the legal ownership is foreign to our law. Our courts have evolved and are still in the process of evolving our own law of trusts by adapting the trust idea to the principles of our own law.[204]

In the 1915 Appellate Division case of *Estate Kemp and Others v McDonald's Trustee,* Solomon JA said the following:[205]

> '[T]he constitution of trusts and the appointment of trustees are matters of common occurrence in South Africa at the present day. Thus it is a recognised practice to convey property to trustees under antenuptial contracts; trustees are appointed by deed of gift or by will to hold and administer property for charitable or ecclesiastical or other purposes; the property of limited companies and other corporate bodies is vested in trustees and the term is used in a variety of other cases, as e.g. in connection with assigned or insolvent estates. The underlying conception in these and other cases is that while the legal dominium of property is vested in the trustees, they have no beneficial interest in it but are bound to hold and apply it for the benefit of some person or persons or for the accomplishment of some special purpose. The idea is now so firmly rooted in our practice, that it would be quite impossible to eradicate it or to seek to abolish the use of the expression trustee, nor indeed is there anything in our law which is inconsistent with the conception.'

See also *Estate Munro v CIR.*[206]

[204] *Braun v Blann and Botha NNO and Another* 1984 (2) SA 850 (A) at 859.
[205] *Estate Kemp and Others v McDonald's Trustee* 1915 AD 491 at 507.
[206] 1925 TPD 693, 1 SATC 163.

14.3 Trusts under the Income Tax Act

A **'trust'** as defined in s 1 means

> 'any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person'.

Two definitions of 'special trust' are contained in the Income Tax Act, one in s 1 and the other more restrictive definition, in para 1 of the Eighth Schedule. See **14.13.**

The definition of person in s 1 of the Income Tax Act includes 'any trust'. This definition was inserted following the decision in *CIR v Friedman and Others NNO*[207] that held that a trust is not a person. The trust is therefore a taxable entity for CGT purposes in its own right.

14.4 Trusts under South African common law

Under South African law there are three types of trust:

- Founder transfers ownership of assets to a trustee for benefit of beneficiaries ('ownership trust').
- Founder transfers ownership of assets to beneficiaries but control rests with the trustees ('bewind trust').
- Trustee administers affairs of another e.g. a mental patient, in the capacity of a curator.

The Trust Property Control Act 57 of 1988, which also defines a trust, draws no distinction between the ownership trust and the bewind trust, and recognises both types of trust.

This chapter is primarily concerned with the first type of trust.

14.5 Types of trusts

Trusts can be described in various ways, for example, in relation to
- their method of formation (*inter vivos* and testamentary trusts);
- the rights they confer on beneficiaries (vesting and discretionary trusts); or
- their purpose (trading trusts, asset protection trusts, special trusts, charitable trusts).

These descriptions are not mutually exclusive. For example, an *inter vivos* trust can be both a trading trust and a discretionary trust.

14.5.1 The bewind trust

In a bewind trust the founder makes a gift or bequest to the beneficiary and vests the administration of the assets in the administrator or trustee. This is known as a bewind in Dutch law and a bewindhebber in Roman-Dutch law. In a bewind trust the ownership of the assets of the trust vests in the beneficiary, but the administration of the trust vests in the trustee or bewindhebber.[208]

For CGT purposes the bewind trust can be ignored for the purpose of this chapter since the beneficiaries have full beneficial ownership of the trust assets. Since they have real rights in

[207] 1993 (1) SA 353 (A), 55 SATC 39.

[208] *Bafokeng Tribe v Impala Platinum Ltd and Others* 1999 (3) SA 517 (BH); *C:SARS v Dyefin Textiles (Pty) Ltd* 2002 (4) SA 606 (N) at 611.

the trust assets they will have to account for any CGT consequences in their personal capacities upon disposal thereof.

14.5.2 Inter vivos and testamentary trusts

- *Inter vivos trusts* – trusts created during the lifetime of an individual; and
- *Testamentary trusts* – trusts created upon the death of an individual in terms of the last will and testament.

14.5.3 Vesting and discretionary trusts

Vesting trust – A vesting trust is one where the assets and income of the trust have been vested in the beneficiaries. The beneficiaries have vested rights to the income and or capital.

Discretionary trust – A discretionary trust is one where the trustees have the discretion as to whether and how much of the income or capital to distribute to the beneficiaries. In these circumstances the beneficiaries merely have contingent rights to the trust income or capital.

Whilst the above terms are in common usage, they can be somewhat misleading, in that one will often not find a pure discretionary or vesting trust, but rather a hybrid entity. For instance, a discretionary trust may become a vesting trust once the trustees have exercised their discretion and vested the assets and income in the beneficiaries.

Vesting and discretionary trusts are addressed in more detail below. Paragraphs 80 – 82 of Part XII of the Eighth Schedule address the CGT consequences of discretionary trusts and their beneficiaries. More specifically, paras 80 and 81 deal with the CGT consequences at the moment of vesting.

The CGT consequences for beneficiaries who have already acquired their vested rights are dealt with in terms of the core rules, and the attribution rules in paras 68 – 73 in Part X. Once a trust's assets or gains have been vested in a beneficiary, the vesting trust virtually ceases to have CGT consequences in its own right, these having been passed on to the beneficiaries or the donors at the time of vesting.

14.5.4 Special trusts

Under the definition of 'special trust' in s 1, special trusts fall into two categories – those for mentally or physically disabled persons (para (*a*)), and testamentary trusts for minors (para (*b*)). The para (*a*) type of special trust is generally treated as a natural person for CGT purposes, and therefore receives far more favourable treatment. Special trusts are dealt with in detail under **14.13**.

14.5.5 Charitable trusts

A charitable trust can qualify for exemption from income tax in terms of s 10(1)(*c*N), and hence CGT under para 63 if it is approved by the Commissioner as a public benefit organisation (PBO) under s 30. To qualify for exemption a trust of this nature also has to carry on an approved public benefit activity as set out in Part I of the Ninth Schedule. Any capital gain or loss arising from the donation or bequest of an asset to an approved PBO must be disregarded in terms of para 62.

14.5.6 Offshore trusts

With many residents having invested funds offshore, it is useful to mention some common trust terms found in offshore jurisdictions. Offshore trusts tend to be formed in tax haven countries that impose no or low rates of tax on trusts and embrace the English common law of trusts.

Blind trust (also known as a limping trust or black hole trust) – This is a highly secretive vehicle typically formed for the purpose of concealing assets from revenue or exchange control authorities. It is not possible to identify the settlor, the purpose of the trust or true beneficiaries from the trust deed. A dummy settlor establishes the trust by donating a nominal sum to a trustee. The trust deed contains the name of a discretionary beneficiary (e.g. the Red Cross) but that beneficiary is usually not informed of its status as beneficiary. The trustees have the discretion to add or change the beneficiaries. The true beneficiaries are named in a 'letter of wishes' provided to the trustee. Once the trust is established assets can be added to the trust and additional beneficiaries added. A recent UK criminal case should serve as a warning to persons making use of such trusts to conceal assets.[209]

Bare trust (or simple trust) – A bare trust (found in the United Kingdom especially) is one where the beneficiaries have immediate and absolute entitlement to the income and capital of the trust, and have the right to take actual possession of trust property. A bare trustee has no active duties to perform, and is essentially a nominee.[210]

The Protector – A protector is someone appointed by the settler to supervise the trustees and to ensure that they administer the trust in accordance with the letter of wishes.

Letter of wishes – A document in which the settlor indicates his or her wishes for the administration of the trust assets, both during his or her lifetime and thereafter. It is merely a guide and whilst not binding on the trustees, they will in practice give effect thereto. It can be amended at any time.

14.6 The trustee

The word 'trustee' is defined in s 1 as follows:

> '**"trustee"**, in addition to every person appointed or constituted as such by act of parties, by will, by order or declaration of court or by operation of law, includes an executor or administrator, tutor or curator, and any person having the administration or control of any property subject to a trust, usufruct, fideicommissum or other limited interest or acting in any fiduciary capacity or having, either in a private or in an official capacity, the possession, direction, control or management of any property of any person under legal disability'.

The trustee is the representative taxpayer of a trust.[211]

Although legal ownership of the trust assets vests in the trustee, a trustee does not enjoy beneficial ownership of the trust assets.[212] In this regard Joubert JA said the following in *Braun v Blann and Botha NNO and Another*: [213]

> 'The trustee is the owner of the trust property for purposes of administration of the trust but qua trustee he has no beneficial interest therein.'

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[209] See P Webb 'Cold Stone Jug' (Nov/Dec 2003) *Accountancy SA* 29, also available online at <http://www.accountancysa.org.za/archives/2003nov/index.htm> (accessed 22 March 2005).
[210] See <http://www.inlandrevenue.gov.uk/manuals/cg2manual/html/1CGCON05/03_0021_CGCONT5D.htm> (accessed: 22 March 2005).
[211] In terms of para (*c*) of the definition of 'representative taxpayer' in s 1.
[212] *Estate Kemp and Others v McDonald's Trustee* 1915 AD 491.
[213] 1984 (2) SA 850 (A) at 859.

In *Crookes NO and Another v Watson and Others* Steyn JA stated the following:[214]

> 'It is merely pro forma, and by way of more or less technical legal abstraction that he is recognised as the holder of the *dominium*, denuded of all benefit to himself.'

And in *CIR v MacNeillie's Estate* Steyn CJ stated that[215]

> '[I]t is trite law that the assets and liabilities in a trust vest in the trustee.'

A trustee has a fiduciary duty to administer the trust assets for the benefit of the beneficiaries.[216]

14.7 Rights of beneficiaries

To appreciate the CGT consequences of trusts, and more particularly, beneficiaries, it is essential to have an understanding of the legal rights enjoyed by beneficiaries. These rights may be divided into two categories:

- Vested and contingent rights
- Personal and real rights

14.7.1 Vested rights

The term 'vested right' can have different meanings depending on the context in which it is used. This was highlighted in the case of *Jewish Colonial Trust Ltd v Estate Nathan*[217] where Watermeyer JA stated the following:

> 'Unfortunately the word "vest" bears different meanings according to its context. When it is said that a right is vested in a person, what is usually meant is that such person is the owner of that right – that he has all rights of ownership in such right including the right of enjoyment. If the word "vested" were used always in that sense, then to say that a man owned a vested right would mean no more than a man owned a right. But the word is also used in another sense, to draw a distinction between what is certain and what is conditional; a vested right as distinguished from a contingent or conditional right. When the word "vested" is used in this sense Austin (Jurisprudence, vol 2, lect 53), points out that in reality a right of one class is not being distinguished from a right of another class but that a right is being distinguished from a chance or a possibility of a right, but it is convenient to use the well-known expressions vested right and conditional or contingent right.'

In referring to the *Jewish Colonial Trust* case, Milne J stated the following in ITC 1328: [218]

> 'It is clear also from this case that a vested right may nevertheless be vested even though in some instances enjoyment of the right may be postponed. See also *Estate Dempers v SIR*,1977 (3) SA 410 (AD) at 425G-H (39 SATC 95).[219] Here it is quite clear that each of the beneficiaries acquires an immediate right to the income although enjoyment of it is postponed until the exercise of discretion by the trustee in favour of that beneficiary or the death of the beneficiary. It is not a necessary consequence of vesting that the beneficiary has a legal right to claim payment. See *Jewish Colonial Trust* case (*supra*) at 177 to the foot of p 181.'

[214] 1956 (1) SA 277 (A) at 305.
[215] 1961 (3) SA 833 (A) at 840G – H.
[216] Section 9(1) of the Trust Property Control Act 57 of 1988; *Sackville West v Nourse and Another* 1925 AD 516; *Administrators, Estate Richards v Nichol and Another* 1999 (1) SA 551 (SCA).
[217] 1940 AD 163 at 175-6.
[218] (1980) 43 SATC 56 (N) at 60.
[219] At SATC 112.

The principles set out above and in a number of other cases are summarized in the table below.

Table 2 - Characteristics of a vested right

Case Law	**Characteristic**
Jewish Colonial Trust Ltd v Estate Nathan[220].	A vested right Is certain as opposed to a contingent right which is conditional.
In re Allen Trust ;[221] *Estate Dempers v SIR* 1977 (3) SA 410 (A), 39 SATC 95[222] and ITC 1328.[223]	Enjoyment of a vested right may be postponed.
ITC 76[224] and *CIR v Polonsky*.[225]	A vested right is an accrued right.
ITC 1328 *supra*.	It is not a necessary consequence of vesting that the beneficiary has a legal right to claim payment.
CIR and Others v Sive's Estate.[226]	Property may be vested in a trustee purely for the purpose of administration.
Greenberg and Others v Estate Greenberg.[227]	A legatee does not acquire *dominium* in the property of an estate immediately upon the death of the testator. All the legatee acquires is a vested right to claim from the executors at some future date delivery of the legacy, i.e. after confirmation of the liquidation and distribution account.
Hiddingh v CIR;[228] *Hansen's Estate v CIR*;[229] ITC 1656 (1998) 61 SATC 195 (C).[230]	The right of an income beneficiary of a trust is a personal right of action against a trustee to receive the whole or part of the income produced by the trust assets and does not constitute a real right in respect thereof.
Estate Kemp and Others v McDonald's Trustee;[231] *Braun v Blann and Botha NNO and Another*.[232]	Whilst legal ownership of trust property is vested in the trustees, they do not have beneficial ownership thereof.

Vesting is not the same as ownership. Legal ownership can be given to a trustee whilst the income or capital in the trust property can be vested in a beneficiary. A vested right is a personal right.[233]

Once an asset has been vested in a beneficiary, actions by the trustee are actions on behalf of the beneficiary. This flows from the conduit pipe principle laid down in the *Armstrong*[234]

[220] 1940 AD 163 at 175-6.
[221] 1941 NPD 156.
[222] 1977 (3) SA 410 (A), 39 SATC 95 at 112.
[223] (1980) 43 SATC 56 (N) at 59–60.
[224] (1927) 3 SATC 68 (U).
[225] 1942 TPD 249, 12 SATC 11.
[226] 1955 (1) SA 249 (A) at 269.
[227] 1955 (3) SA 361 (A).
[228] 1940 AD, 11 SATC 54 at 211.
[229] 1956 (1) SA 398 (A), 20 SATC 254.
[230] (1998) 61 SATC 195 (C) at 200.
[231] 1915 AD 491.
[232] 1984 (2) SA 850 (A) at 860A.
[233] *SIR v Rosen* 1971 (1) SA 172 (A), 32 SATC 249 at 189,; *CIR v Lazarus' Estate* 1958 (1) SA 311 (A) at 320, 21 SATC 379; *Estate Kemp and Others v McDonald's Trustee* 1915 AD 491 at 503 506 510; *Levin v Gutkin, Fisher & Schneier* 1997 (3) SA 267 (W) at 284D.
[234] *Armstrong v CIR* 1938 AD 343, 10 SATC 1 at 6.

and *Rosen*[235] cases. The position can be compared to an agent acting on behalf of a principal, although a trustee is not an agent.[236] A beneficiary who has a vested right of this nature has an interest in the underlying assets. In *Hansen's Estate v CIR*[237] Hoexter JA confirmed that such a right was an interest for the purposes of the Estate Duty Act when he stated that

> '[t]he net income of the trust fund is derived from all the assets of the fund, and the holder of the right to receive the net income therefore has a financial interest in each and all of those assets. That financial interest is protected by law to this extent that the holder is entitled to prevent, by legal action, any maladministration of any asset by the trustee. In my opinion a financial interest in any property which is of such a nature that the holder has l*ocus standi* to prevent the maladministration of that property is an interest within the meaning of section 10(*b*).'

In Roman law the time of vesting is referred to as *dies cedit*, whilst the time of enjoyment is referred to as *dies venit*.[238]

14.7.2 Contingent rights

A contingent right is merely a *spes* – an expectation which might never be realized (see *Jewish Colonial Trust* case *supra* and ITC 76.[239]
For example, a beneficiary will have a contingent right where a trustee has a discretion as to

- whether to pay capital or income, or
- how much to pay or distribute,

to a beneficiary.

A beneficiary who has a contingent right merely has a right against the trustees to administer the trust in accordance with the trust deed,

14.7.3 Personal rights

A personal right (*jus in personam* or *jus ad rem*) is a right in or against a person or a thing. A beneficiary's vested or contingent right in a trust asset is a personal right. Both vested and contingent beneficiaries share the following personal right in common – they both have the right to expect the trustee to administer the trust assets in accordance with the trust deed.

A beneficiary who has a *jus in personam* can in due course acquire an additional personal right, being a right to claim payment, delivery or transfer of an asset.[240] This is referred to as a *jus in personam ad rem acquirendam*.

14.7.4 Real rights

A real right *(jus in rem or jus in re)* is a right that is enforceable against all persons. It is the badge of ownership. This must be distinguished from a *jus ad rem*, which is merely a personal right to oblige a person to give or to refrain from doing something. For example, assume that a beneficiary becomes entitled to possession of a particular asset on a certain date. At that time the beneficiary will have a *jus ad rem* against the trustee to effect transfer. Once transfer has been effected the beneficiary will have a real right – a *jus in rem*.

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[235] *SIR v Rosen* 1971 (1) SA 172 (A), 32 SATC 249 at 267.
[236] *Hoosen and Others NNO v Deedat and Others* 1999 (4) SA 425 (SCA) at 431G – H.
[237] 1956 (1) SA 398 (A), 20 SATC 246 at 255.
[238] Per Heher J in *Jowell v Bramwell-Jones and Others 1* 998 (1) SA 836 (W) 872G - H.
[239] (1927) 3 SATC 68 (U) at 70.
[240] *De Leef Family Trust NNO v CIR* 1993 (3) SA 345 (A), 55 SATC 207 at 216.

14.7.5 Exchange of rights

The definition of asset in para 1 is framed in wide terms and embraces both personal and real rights. A trust beneficiary who has a vested (personal) right in an asset will eventually exchange that personal right for a real right. An exchange of this nature will trigger a disposal in that beneficiary's hands in terms of para 11(1)(*a*).

Example – Exchange of personal right for real right

Facts: The John Smith Will Trust was created in terms of the last will and testament of John's grandfather who passed away on 1 July 2002. The will provided that John was to inherit the family farm when he turned 25. Should John have died before turning 25, the farm would, in terms of the will, have gone to his estate. The market value of the farm at the date of the grandfather's death was R1 000 000. At that time John was 20 years old. Upon reaching the age of 25 the trustee transferred the farm into John's name. The market value of the farm at the date of transfer was R1 200 000. After farming for 10 years John decided to sell the farm, and realized proceeds of R1 800 000.

Result: When his grandfather died John acquired a personal right (*jus in personam ad rem acquirendam)* against the trustee of the John Smith Will Trust to claim delivery of the farm when he turned 25.

Base cost of the personal right to claim delivery

The base cost of the personal right is determined in terms of para 38 because
- John is a connected person in relation to the trust, being a beneficiary,[241] and
- the trust disposed of the farm to John for a consideration that is not an arm's length consideration (John paid nothing for the farm).

In terms of para 38(1)(*b*) John is treated as having acquired the farm at market value of R1 000 000.

Exchange of personal right for real right

When John took transfer of the farm his personal right to claim delivery was extinguished in exchange for a real right (*jus in rem*), being the farm itself. The exchange constitutes a disposal in terms of para 11(1)(*a*). The proceeds are equal to the market value of the asset acquired (R1 200 000), since this constitutes an 'amount' for the purposes of para 35. See 'exchange of an asset' in **6.1** – Disposals. John therefore has a capital gain of R200 000 (R1 200 000 (proceeds) – R1 000 000 (base cost)).

Base cost of the real right acquired (the farm)

The base cost of the *jus in rem* (the farm) is its market value of R1 200 000. See 'Assets acquired by barter or exchange' in **8.2.2**. Upon disposal of the farm John's capital gain is R600 000 (R1 800 000 (proceeds) – R1 200 000 (base cost)).

14.8 Impact of the core rules

The disposal of an asset to or by a trust, for example by vesting it in a beneficiary of the trust, is as a general rule subject to the general principles governing disposals, base cost and proceeds as well as to the general anti-avoidance and loss limitation rules. The disposal

[241] Paragraph (*b*)(ii) of the definition of 'connected person' in s 1.

of an asset to a beneficiary is, for example, subject to the connected person rule in para 38. In particular, regard must be had to paras (*a*) – (*b*A) of the definition of connected person in s 1 which read as follows:

> '**"connected person"** means—
> (*a*) in relation to a natural person—
> (i) any relative; and
> (ii) any trust of which such natural person or such relative is a beneficiary;
> (*b*) in relation to a trust—
> (i) any beneficiary of such trust; and
> (ii) any connected person in relation to such beneficiary;
> (*b*A) in relation to a connected person in relation to a trust (other than a collective investment scheme in property shares managed or carried on by any company registered as a manager under section 42 of the Collective Investment Schemes Control Act, 2002, for purposes of Part V of that Act), includes any other person who is a connected person in relation to such trust'.

Examples – Connected persons in relation to trusts and their beneficiaries

1. John is a beneficiary of the John Smith Trust.

From John's perspective, the John Smith Trust is a connected person to him (para (*a*)(ii)). From the John Smith Trust's perspective, John is a connected person to it (para (*b*)(i)).

2. Ruth is not a beneficiary of the John Smith Trust but she is John's sister.

From Ruth's perspective, the John Smith Trust is a connected person to her (para (*a*)(ii)) From the John Smith Trust's perspective, Ruth is a connected person to it (para (*b*)(ii))

3. Jane is unrelated to John but is also a member of the John Smith Trust.

In terms of para (*b*A) Jane is a connected person in relation to John, and John is a connected person in relation to Jane.

A disposal to a trust might be subject to the 'clogged loss' rule in para 39 (see **9.5** for more details).

Example – Clogged losses in relation to trusts and their beneficiaries

Facts: Abe bought an asset in 2002 at a cost of R2 000. He is a beneficiary of the Abe Trading Trust. In 2005 he sold the asset to the trust at its current market value of R1 500, realizing a capital loss of R500.

Result: In terms of para 39 he will not be able to use the capital loss of R500 against his other capital gains, but will only be able to utilise it against current or future capital gains arising from transactions with the Abe Trading Trust.

14.9 The CGT consequences of vesting trusts

A vesting trust can be described as one in which all the assets have been vested in the beneficiaries.

The position upon vesting

The vesting of a trust asset in a beneficiary triggers a disposal in the trust's hands (para 11(1)(*d*)). What happens to capital gains and losses arising in the trust as a result of the vesting of an asset or a capital gain in a beneficiary? The general rule is that gains will flow through to the beneficiary and be taxed in that beneficiary's hands (para 80(1) or (2)). In certain situations, however, capital gains may not be attributed to a beneficiary, and will either be taxed in the trust or be attributed to a donor in terms of para 68, 69 or 72. No flow through of capital gains is permitted where the beneficiary is

- a non-resident;
- a spouse and the asset was acquired by the trust from the person's spouse as part of a scheme to avoid tax (para 68); and
- a minor child and the trust asset was acquired by the trust by reason of a donation, settlement or other disposition by the child's parent (para 69).

Had a flow through of capital gains been allowed in these circumstances a loss of income to the fiscus would have resulted. Tax recovery from non-residents would have proved problematic, and in the case of tax-motivated donations between spouses and parent-minor child dispositions, income splitting would have resulted.

The attribution rules in paras 68 – 72 are addressed in Chapter 15.

Capital losses

No provision is made for capital losses to flow through to a beneficiary, or to be attributed to a donor. Capital losses arising from the vesting of an asset in a beneficiary may only be set off against capital gains arising from transactions with that same beneficiary (para 39).

The position after vesting

Once the right to claim a trust asset has been vested in a beneficiary, there will be no further CGT consequences for that trust, and the beneficiaries must account for any further capital gain or loss on disposal of their vested rights. The trustee holds the vested assets on behalf of the beneficiary, and actions by the trustee in respect of those assets are actions on behalf of that beneficiary (see comments above regarding vested rights).

Transfer of vested asset to beneficiary

What happens when the vested asset is transferred to the beneficiary? As mentioned earlier this triggers a disposal of a personal right and the acquisition of a real right in the asset from the beneficiary's perspective. However, from the trust's perspective there are no CGT consequences. This flows from para 11(2)(*e*), which provides that there is no disposal of an asset

> 'by a trustee in respect of the distribution of an asset of the trust to a beneficiary to the extent that the beneficiary has a vested interest in that asset'.

14.10 The CGT consequences of discretionary trusts

The assets of a discretionary trust are treated as those of the trust until an unconditional right to those assets is vested in a beneficiary. Such vesting will be treated as a disposal by the trust at market value (paras 11(1)(*d*) and 38). The capital gain determined in respect of that disposal will in terms of para 80 be taxed in the hands of the *resident* beneficiary in whom that right vests unless that gain is attributed to another person in terms of para 68, 69, 71 or 72.

14.11 Attribution of capital gain to resident beneficiary

Paragraph 80

14.11.1 Some general observations regarding para 80(1) and (2)

Paragraph 80(1) and (2) are subject to the special attribution rules in paras 68 – 72 which are described in the table below. What this means is that the flow through of a capital gain to a resident beneficiary is blocked when these other attribution rules apply. The relevant gain will instead be taxed in the hands of the person/s specified in these other attribution rules.

Table 3 – Attribution rules that override para 80(1) and 80(2)

Paragraph	Attribution rule
68	Capital gain attributed to spouse (donation motivated by tax avoidance)
69	Capital gain attributed to parent of minor child
71	Capital gain subject to revocable vesting
72	Capital gain vesting in non-resident

14.11.2 Application of para 80(1) and (2) to non-resident trusts

Paragraph 80(1) and (2) refer to a trust without indicating whether it is a resident or a non-resident trust. In terms of para 2(1)(*b*), the Eighth Schedule only applies to the following assets of a non-resident:

- immovable property in SA,
- Any right or interest in immovable property in SA,
- Shares in a company holding immovable property in SA (under certain conditions), and
- Assets of a permanent establishment in SA.

Only these specific SA source assets can give rise to capital gains in the hands of a non-resident trust. It follows that it is only capital gains of this nature in a non-resident trust that can be attributed to a resident beneficiary under para 80(1) and (2). Gains in respect of other assets held by a non-resident trust must be dealt with under para 80(3).

14.11.3 Types of disposal giving rise to attribution to a beneficiary

Capital gains arising from disposals set out in the table below are subject to attribution to a beneficiary.

Table 4 – Disposals giving rise to capital gains in a trust

Paragraph 80	Type of disposal by resident trust
(1)	Vesting of asset in resident beneficiary (para 11(1)(*d*))
(2)	Other disposals e.g. sale of asset by trust to third party (para 11 or 12).

14.11.4 Events not subject to attribution under para 80(1) and (2)

Paragraph 80 is important not only in respect of what it says, but also in relation to what it does not say. A trust is a separate legal entity taxable in its own right[242] and is subject to the core rules. If a capital gain has not been attributed out of a trust to a specific person then the

[242] The definition of 'person' in s 1 of the Act includes 'any trust'.

core rules must be applied and the trust must bear the CGT consequences. In other words, attribution is something that cannot be read in; it can only be applied when it is provided for.

For example, a capital gain that is not vested in a trust beneficiary in the year in which it arises will be taxed in the hands of the trust at the effective rate applicable to trusts unless the gain was derived by reason of a donation, settlement or other disposition and is subject to conditional vesting. In this case it might be taxable in terms of para 70 in the hands of the resident who made that donation, settlement or other disposition.

Examples of events that the attribution rules do not cover and their treatment are set out in the table below:

Table 5 – Events not subject to attribution

Event	**Treatment in terms of the core rules**	**Reason**
Assets or gains vested in non-resident beneficiaries.	A capital gain arising on the vesting of • an asset, or • a current year capital gain, in a non-resident beneficiary is taxed in the trust, unless attributed to a resident donor in terms of para 72.	In all of these scenarios no provision is made for the relevant capital gain or loss to be attributed to the beneficiary.
Capital losses arising in the trust, whether arising through the vesting of assets in beneficiaries or disposal of assets to third parties,	Capital losses remain in the trust.	
Capital gains that were subjected to CGT in a prior year that are vested in a subsequent year.	Capital gains arising in the trust in respect of a prior year that were not vested in that prior year are taxed in the trust unless attributed to a donor in terms of para 70. When subsequently vested they will not again be taxed in the beneficiary's hands.	
Waiver of loan to trust	A capital gain is deemed to arise in the trust's hands in terms of para 12(5) when the creditor waives the debt.	A beneficiary cannot acquire a vested right in a fictional capital gain under para 80(2).[243]

When a prior year capital gain is vested in a beneficiary, attribution does not apply. However, the vesting of a gain of this nature will invariably involve the vesting of an asset, which could conceivably give rise to an attributable capital gain in the trust. More often than not, though, the vesting of prior year capital gains should not give rise to a capital gain in the trust. For example, a distribution by way of a cheque payment is a part-disposal of an asset of the trust, namely, its bank account. In the case of a rand denominated bank account, no capital gain or loss should in the ordinary course of events arise.

[243] The principle that a trustee cannot vest deemed income was established in *Hulett v CIR* 1944 NPD 263, 13 SATC 58.

Where a beneficiary has lent an amount to a trust and later waives the right to claim the amount, a capital gain will be triggered in the trust (para 12(5)) and a capital loss in the hands of the beneficiary (para 56(2)). It is not possible for a beneficiary to acquire a vested right in the trust's deemed capital gain as it is merely notional and it will therefore remain taxable in the hands of the trust.

14.11.5 Vesting of asset (para 80(1))

The vesting of an interest in an asset of a trust in a resident beneficiary is a disposal by that trust (para 11(1)(*d*)).

A capital gain determined in respect of the disposal of a trust asset to a resident who is a trust beneficiary is ignored in the hands of the trust and treated as that beneficiary's gain.

14.11.6 Vesting of capital gain in same year of assessment (para 80(2))

A capital gain arising from the disposal of a trust asset will also be taxed in the hands of a resident beneficiary having no vested right to that asset if that gain is vested in that beneficiary in the year in which it arises.

14.11.7 The effect of attributing capital gains to beneficiaries

The taxable capital gain of a trust other than a special trust is taxed at an effective rate of 20% (previously between 16% and 21%). The attribution of a capital gain to a donor or beneficiary who is a natural person or a person other than a trust will therefore result in a lower effective tax rate in respect of that gain.

14.11.8 Capital gain attributed to resident beneficiary of non-resident trust (para 80(3))

Paragraph 80(3) deals with residents who have an interest in a trust that is not a resident. Where a resident acquires a vested interest to an amount representing the capital of a non-resident trust and

- the capital arose from
  - ➢ a capital gain of the trust in any previous year of assessment during which the resident had a contingent right to the capital; or
  - ➢ any amount which would have constituted a capital gain if the trust was a resident; and
- the capital gain has not been subject to tax in the Republic,

the amount must be taken into account for the purposes of determining the aggregate capital gain or aggregate capital loss of the resident.

The provision does not have retrospective effect as 'capital gain' is defined in the Act and refers only to capital gains arising on or after the valuation date.

Example 1 – Disposal by first beneficiary of vested right and subsequent disposal by trustee of asset on behalf of second beneficiary

Facts: Vernon invests R100 000 into a vesting trust. The trustee buys shares with the R100 000. The shares decline in value to R20 000 and Vernon sells his interest in the trust to Willem for R20 000, taking an R80 000 loss. The shares thereafter rebound in value to R100 000, at which point the trustee sells them for no gain or loss. The trustee then distributes R100 000 to Willem, saying it is a return of capital.

Result: Vernon's interest in the trust is acquired for a base cost of R100 000 and consists of a claim against the trustee in respect of the assets of the trust vested in Vernon. Any action by the trustee in respect of those assets will be an action on behalf of Vernon. Any sale of those shares will therefore be effected on behalf of Vernon while the proceeds from such sale will accrue to or be received by the trustee on behalf of Vernon. Vernon's interest in the trust, namely, the claim to the trust asset is, however, a separate asset that can be the subject of a separate disposal if Vernon is entitled to transfer that claim to another person. Vernon will therefore show a capital loss of R80 000 in respect of the disposal of the interest in the trust to Willem, while Willem will acquire the interest at a base cost of R20 000.

The subsequent sale of the shares by the trustee is a disposal on behalf of the person having a vested right to those shares, namely, Willem. The trust will therefore not determine a capital gain or a capital loss in respect of the disposal of those shares as they are disposed of on behalf of a specific beneficiary and not for the benefit of the trust. The proceeds from that disposal accrue to or in favour of Willem. The disposal of those shares by the trustee results in the extinction of Willem's claim to those shares (thus constituting a disposal of that claim in terms of para 11(1)) and the concurrent substitution of a new claim, namely, the claim for the proceeds that accrue to or in favour of Willem. The disposal of Willem's claim to the shares (acquired by Willem at a base cost of R20 000) in return for the new claim to the proceeds of R100 000 therefore results in a capital gain of R80 000 in Willem's hands.

Willem acquires a new asset (the claim to the proceeds on the sale of the shares) in return for the disposal of Willem's previous claim to the shares. The cost of acquisition of the new claim is therefore equal to the value of the previous claim at the time of its disposal in return for the new claim, that is, R100 000. The base cost to Willem of the new claim is therefore R100 000. The subsequent distribution of R100 000 to Willem will therefore amount to the extinction or disposal, in terms of para 11, of Willem's remaining interest in the trust for an amount equal to its base cost, thereby resulting in no capital gain or loss.

Example 2 - Disposal by first beneficiary of vested right and subsequent distribution by trustee of asset to second beneficiary

Facts: Xavier invests R100 000 into a vesting trust. The trustee buys shares with the R100 000. The shares decline in value to R20 000 and Xavier sells his interest to Yanga for R20 000, taking an R80 000 loss. The shares thereafter rebound in value to R100 000, at which point the trustee distributes them to Yanga.

Result: The distribution of the vested assets to Yanga will in terms of para 11(2)(*e*) not be a disposal of trust assets by the trustee but will amount to the disposal of Yanga's interest in the trust - the shares distributed to Yanga constitute a receipt in kind in Yanga's hands as a result of which Yanga's claim to the shares is extinguished. The shares are in effect exchanged for Yanga's interest in the trust. The value of those shares at the time of their distribution to Yanga, namely, R100 000, is taken into account as the proceeds from the disposal of Yanga's interest in the trust. Yanga will therefore realise a capital gain of R80 000 in respect of the disposal of the interest in the trust. The base cost to Yanga of the shares acquired as a result of that disposal will be equal to the value of Yanga's interest in the trust at the time of that disposal, namely, R100 000.

Example 3 – Part-disposal of vested right resulting from payment by trustee and subsequent disposal of remaining vested right

Facts: Zahir invests R100 000 into a vesting trust. The trustee buys shares with the R100 000. The shares rise in value to R200 000 at which point the trustee borrows

R150 000 from a bank. The shares are used as security for the loan. The trustee distributes the proceeds of the loan to Zahir as a non-refundable payment in respect of her interest in the trust. Zahir subsequently sells the interest in the trust to Ashok for R50 000.

Result: The distribution of R150 000 to Zahir represents a payment in satisfaction of part of Zahir's claim against the trustee for the vested asset. It therefore results in the extinction of part of Zahir's interest in the trust. The R150 000 in effect represents the proceeds from the part-disposal of Zahir's interest in the trust. Zahir's capital gain in respect of this part-disposal will be the following.

Portion of the base cost of entire interest (R100 000) attributable to the part disposed of as determined in terms of para 33:

$$= \frac{\text{Market value of part disposed of}}{\text{Market value of entire asset}} \times \text{Base cost of entire asset}$$

$$= \frac{\text{R150 000}}{\text{R200 000}} \times \text{R100 000}$$

$$= \text{R75 000}$$

	R
Proceeds from part-disposal of interest	150 000
Base cost of part disposed of	75 000
Capital gain	75 000

Zahir's capital gain in respect of the disposal of the remaining interest in the trust will be the following.

	R
Proceeds from the disposal of the remaining interest	50 000
Base cost of remaining interest (R100 000 minus R75 000)	25 000
Capital gain	25 000

Example 4 – Beneficiary with vested right to trust asset receiving loan from trust financed by third party; trustee thereafter surrendering asset to third party in settlement of loan

Facts: Bob invests R100 000 into a vesting trust. The trustee buys shares with the R100 000. The shares rise in value to R200 000 at which point the trustee borrows R150 000 from a bank by using the shares as security. The trustee advances the R150 000 to Bob as a loan. Bob is liable for the repayment of the bank loan as well as any interest payable in respect of it. The trustee is also empowered to sell the shares to repay any amount owing to the bank. The trustee subsequently surrenders the shares to the bank in full and final payment of the loan of R150 000 as well as of an amount of R30 000 payable as interest in respect of the loan.

Result: The transfer of the shares as security for the loan obtained by the trustee does not amount to the disposal, on behalf of Bob, of those shares to the bank (see para 11(2)(*a*)). There is also no disposal of an asset as a result of the loan advanced to Bob. No portion of the interest payable to the bank will qualify as part of the base cost of the shares as the loan was not used to finance the acquisition of the shares by the trust. The surrender of the shares to the bank in full and final settlement of the loan and finance charges owed to the bank will, however, amount to the disposal of the shares on behalf of Bob. The proceeds from that disposal will in terms of para 35(1)(*a*) be equal to the amount of the debt extinguished on behalf of Bob, namely, R180 000. This amount will accrue to or in favour of Bob and will therefore be taken into account as the proceeds from the extinction of Bob's interest in the trust. Bob's capital gain is therefore R180 000 – R100 000 = R80 000. No capital gain will be determined separately in the trust in respect of the disposal of the shares to the bank as this was done on behalf of Bob.

Example 5 – Beneficiary having vested right to trust asset; trustee using asset as security to borrow funds to purchase further asset on behalf of beneficiary; subsequent disposal of further asset and repayment of loan

Facts: Catherine invests R100 000 into a vesting trust. The trustee buys listed shares with the R100 000. The shares rise in value to R200 000 at which point the trustee borrows R150 000 by using the shares as security. The trustee uses the proceeds of the loan to buy further shares on behalf of Catherine. The trustee subsequently sells the new shares for R230 000, uses some of the proceeds to repay the loan of R150 000 as well as an amount of R30 000 payable as interest in respect of the loan and distributes the remaining amount of R50 000 to Catherine.

Result: Catherine has a vested right to the new shares bought on her behalf. The base cost of this right is R150 000, i.e. the liability incurred on her behalf in respect of the loan used to finance the acquisition of the shares and which is to be repaid from the proceeds of shares to which she has a vested right. The interest expense that is to be paid or eventually recovered from those proceeds also qualifies as an expense in her hands. A third of that interest of R30 000, namely, R10 000, qualifies in terms of para 20(1)(*g*) for inclusion in the base cost of her right to the new shares. The total base cost directly attributable in terms of para 33(2) to Catherine's right to the new shares therefore amounts to R160 000. The subsequent disposal on her behalf of the new shares results in an accrual of an amount of R230 000 to or in her favour. This represents proceeds from the disposal of her claim to those shares and results in a capital gain of R70 000 in her hands. The amount paid to Catherine of R50 000 has no CGT consequence, since it merely represents a return of her after-tax capital that was managed by the trustee on her behalf.

Example 6 – Discretionary trust - assets sold to trust via interest-free loan – trust and seller connected persons – transactions deemed to take place at market value – losses clogged – assets subject to revocable vesting – attribution of income and capital gain ito s 7(3) and para 73 - gain vested in non-resident beneficiary taxed in trust or attributed to resident donor ito para 72

Facts: Deborah set up a trust in the Republic. The trustees of the trust are Deborah, Eileen (an accountant in Guernsey) and Fish (a lawyer in Johannesburg).

Deborah sold the following assets to the trust at market value.

	Market value	Base cost	Capital gain (loss)
	R	R	R
Shares in Papa Ltd	800 000	200 000	600 000
Shares in Oscar Ltd	200 000	250 000	(50 000)
Undeveloped immovable property	500 000	100 000	400 000
Rent producing shopping complex	500 000	200 000	300 000
Deborah's residence	100 000	20 000	80 000
	2 100 000		

Result: Had the disposals not been at market value they would have been treated as having been made at market value in terms of para 38. The trust qualifies as a connected person in relation to Deborah as the trust beneficiaries include her spouse and children. The disposals by Deborah to the trust are therefore governed by the connected persons rules governing the amount of the proceeds of such disposals (para 38) and the clogging of capital losses determined in respect of such disposals (para 39).

The capital loss of R50 000 can, in terms of para 39, be deducted only from the capital gains determined in respect of the other disposals to the trust in the same or a subsequent tax year and not from gains from disposals to persons other than the trust. In this instance the capital loss is not clogged as it is exceeded by the capital gains arising from other disposals to the trust by Deborah. The capital gain of R80 000 in respect of the residence qualifies in Deborah's hands for the primary residence exclusion as she ordinarily resided in this residence.

The sales took place on credit and Deborah’s loan of R2 100 000 to the trust bears no interest and is payable on demand. The beneficiaries of the trust are Deborah’s children Gail and Harold (a minor), Deborah's spouse Ian and a list of charitable and educational institutions. The trustees have an unfettered discretion regarding the vesting, in a beneficiary, of any trust income or of any trust assets or of any gain from the disposal of any trust assets.

The following events occur in the first year of the trust’s existence.

- Gail emigrates.
- The trust earns rental income of R40 000 and dividend income of R12 500.
- The trustees exercise their discretionary powers at the end of that year by vesting the income of R52 500 in Harold.

	Market value	Base cost	Capital gain
	R	R	R
Deborah’s residence is vested in Ian	140 000	100 000	40 000
Undeveloped property is sold to a third party but the proceeds are not vested in any beneficiary	700 000	500 000	200 000
Shares are vested in Gail	610 000	500 000	110 000
			350 000

The failure to charge any interest on the loan of R2 100 000 is a donation, settlement or other disposition. The value of this benefit is equal to the interest expense saved by the trust as a result of this loan. Assuming that the trust would have been able to obtain a loan from a bank or other institution at an interest rate of 12.5% per annum, the trust saves an amount, during the first year, equal to the amount of interest that would have been payable at this rate, namely, R262 500. The trust would not have been able to distribute the full amount of any trust income and the full market value of any trust asset to the trust beneficiaries had it been obliged to pay R262 500 in interest.

The rental income of R40 000 and the dividends of R12 500 would have had to be applied to pay the interest charge and can therefore be treated as having arisen by reason of the donation made by Deborah. The income that was vested in Deborah's minor child can therefore be taxed in her hands in terms of s 7(3).

The amount of the income so deemed to be that of Deborah must in terms of para 73 be deducted from the total amount of interest saved by the trust as a result of the interest-free loan extended by Deborah. The remaining amount, namely, R210 000, represents the maximum amount of the capital gain that may be attributed to Deborah. It represents the portion of the gains that would have had to be applied by the trust to pay interest at a market-related rate.

The trust cannot claim the primary residence exclusion in respect of the capital gain from the disposal of the residence to Ian as the trust is not a natural person or a special trust as required by the definition of 'primary residence' in para 44. The gain of R40 000 must be taken into account in Ian's hands in terms of para 80(1) unless Deborah made the donation, settlement or other disposition mainly for purposes of tax avoidance (para 68). If this were the case, the gain would have to be taken into account in Deborah's hands.

The vesting in a trust beneficiary of a trust asset or of the capital gain determined in respect of the disposal of a trust asset is, in terms of the trust deed, clearly subject to a contingent event, namely, the exercise of the discretionary powers of the trustees. The capital gain of R200 000 in respect of the undeveloped property that was not vested in any beneficiary of the trust in the tax year in which it arose will therefore be subject to para 70 with the result that it will be taken into account in Deborah's hands.

Finally, the gain of R110 000 in respect of the shares vested in Gail will not be attributed to her in terms of para 80 as she is not a resident. R10 000 of the gain will be deemed back to Deborah in terms of para 72, whilst the remaining R100 000 will be taxed in the hands of the trust under the core rules. The R10 000 is the remaining amount of the interest that is available to be deemed to the donor (R262 500 (total interest) – R52 500 (s 7(3)) – R200 000 (para 70) = R10 000).

The above example may be summarised as follows:

	R
Rent	40 000
Interest	12 500
Total income	52 500
Distributed to Harold (minor)	(52 500)
	-
Deemed back to Deborah – s 7(3)	52 500

Interest-free loan
R2 100 000 x 12.5% = R262 500
Therefore interest available for deeming of capital gains back to Deborah (para 73):
= R262 500 – R52 500 = R210 000

	Capital gain	Deborah	Ian	Trust
	R	R	R	R
Residence vested in Ian	40 000	-	40 000	-
Undeveloped property not vested	200 000	200 000	-	-
Shares vested in Gail (non-resident)	110 000	10 000	-	100 000
Total gains realised	350 000	210 000	40 000	100 000

14.12 Base cost of interest in a discretionary trust

Paragraph 81

A beneficiary's contingent interest in a discretionary trust is treated as having a base cost of nil. This provision overrides para 38(1)(*b*) which provides that an asset acquired from a connected person must have a base cost equal to market value. The full proceeds from the disposal of the contingent interest will therefore be treated as a capital gain.

The above provision does not affect the 'connected person rule' in terms of para 38(1)(*b*) as regards the vesting of a right to an asset in a trust beneficiary. Once vesting takes place the beneficiary will acquire the asset at a base cost equal to its market value at the date of vesting. In other words there are two assets:

- the vested right to or in the *asset* – dealt with in terms of para 38(1)(*b*), and
- the discretionary interest in the *trust* – dealt with in terms of para 81.

Any expenditure incurred by a beneficiary in terms of para 20 in acquiring a contingent interest in a discretionary trust must be disregarded. This follows from the clear wording of para 81, which deems the base cost, whatever it may be in reality under para 20, to be nil.

Example 1 – Sale of discretionary interest in a trust

Facts: Johanna, Kim, Les and Marius are the beneficiaries of a discretionary trust the only asset of which is a holiday home that has a base cost of R360 000. The trustees of the trust vested one-fourth of the house in Marius. The market value of that portion at the time it was vested in Marius amounted to R300 000. This gave rise to a capital gain of R300 000 – (R360 000 x ¼) = R210 000 in the trust which was attributed to Marius in terms of para 80(1). The base cost of Marius' vested interest in the house is R300 000 in terms of para 38.

No rights to the house have been vested in any of the other beneficiaries. Johanna and Marius sell their interests in the trust for R150 000 and R350 000 respectively.

Result: The base cost of Johanna's interest in the trust is nil. Johanna's capital gain in respect of the disposal of her interest will therefore amount to R150 000 while that of Marius will amount to R50 000 (R350 000 (proceeds) – R300 000 (base cost))

14.13 Special trusts

Section 1 and para 1 – Definition of special trust, paras 5(1), 10(*a*), 82

The term 'special trust' is defined in both the Eighth Schedule under para 1 and in the principal Act in s 1.

The s 1 definition contains two categories of special trust.

14.13.1 Trusts for those suffering from a mental illness or physical disability (para (a))

The first category of special trust is one created solely for the benefit of a person who suffers from

- any mental illness as defined in s 1 of the Mental Health Act 18 of 1973, or
- any serious physical disability.

The mental illness or disability must incapacitate the person from

- earning sufficient income to maintain himself or herself, or
- managing his or her own financial affairs.

A trust loses its status as a special trust for years of assessment ending on or after the death of the beneficiary of that trust. It is therefore evident that a trust will only qualify as a special trust under this category if it has a single beneficiary.

This type of special trust is treated in the same manner as an individual for the purposes of the Eighth Schedule. In terms of para 1 a special trust means ‘a trust contemplated in paragraph (*a*) of the definition of ‘special trust’ in section 1’.[244]

The following provisions of the Schedule which apply to a natural person will apply equally to a para (*a*) special trust:

Table 1 – Provisions affecting special trusts

Paragraph	Provision
5(1)	Annual exclusion
10	Inclusion rate
45(1)	Primary residence exclusion
53(1)	Personal-use assets
59	Compensation for personal injury, illness or defamation

14.13.2 Testamentary trusts for relatives who are minors (para (b))

The second category covers trusts whose beneficiaries are nominated in terms of the will of a deceased person. To qualify as a special trust, the beneficiaries must satisfy the following requirements:

- They must be relatives of the deceased,
- They must be living on the date of death of the deceased (including a conceived but unborn child), and
- The youngest beneficiary must be under the age of 21 on the last day of the year of assessment of the trust.

It follows that as soon as there are no more beneficiaries under the age of 21, the special trust loses its status as a special trust.

In terms of para 10(*a*) this type of special trust also qualifies for the same 25% inclusion rate as an individual. However, for the purposes of the rest of the Eighth Schedule, this type of special trust is treated as a normal trust.

This means that it will not enjoy the annual exclusion of R10 000, the primary residence exclusion of R1 million, the personal use asset exclusion or the exclusion in respect of amounts received as compensation for personal injury, illness or defamation.

The tax rates applicable to special trusts are the same as those for individuals. By contrast, normal trusts are taxed at a flat rate of 40%.

14.13.3 Death of beneficiary of special trust

Paragraph 82

In terms of the definition of ‘special trust’ a trust loses its status as a special trust for years of assessment ending on or after the death of the beneficiary of that trust. The rates of tax to be applied to the taxable capital gain of the special trust after the death of the beneficiary will be the flat rate of 40% for trusts. Paragraph 82 is aimed at preserving, for purposes of the Eighth Schedule, the status of a trust as special trust in spite of the death of the beneficiary. The trust will continue to be treated as a special trust, except for the tax rate, until the earlier

[244] Inserted by Act 74 of 2002 and came into operation from the commencement of years of assessment ending on or after 1 January 2003.

of the disposal of all assets held by the trust or two years after the beneficiary's death. Thereafter the trust will pay CGT at the rate of 50% x 40% = 20% and will no longer enjoy the various exclusions such as the annual exclusion and primary residence exclusion.

Chapter 15 - Attribution of capital gains

PART X: ATTRIBUTION OF CAPITAL GAINS

15.1 Summary

This chapter explains the special attribution rules that override the core attribution rules that were discussed in the previous chapter. In terms of these special rules a capital gain is deemed back to the donor but the amount that can be deemed back may be restricted depending on the circumstances. Where the asset has been financed by a low or interest-free loan from the donor the amount that can be deemed back is limited to

- the interest saving enjoyed by the trust,
- less: any income deemed back to the donor in terms of s 7.

Where an asset is funded by means of a donation there is no limit on the extent of the attribution of a capital gain. Just as all the income generated by the asset will be deemed back to the donor in terms of s 7, so too will the entire capital gain be deemed back to the donor in terms of these rules. Where the donor no longer exists, for example, because he or she is deceased, no attribution can occur.

Part X deals with the attribution of a capital gain as defined in para 1. It follows that capital losses can never be attributed to a donor in terms of Part X, nor can they be set off against attributable capital gains prior to attribution, even if they arise in the same year of assessment from the same donation, settlement or other disposition. Capital losses will therefore always remain in the trust.

Table 1 – Summary of attribution rules: capital gain deemed back to donor (para 68 – 72)

Event	Paragraph	CGT Consequence
Gain vested in spouse for tax avoidance purposes	68	Taxed in hands of donor spouse. If not avoidance scheme gain will flow through to spouse beneficiary ito para 80
Gain vested in a minor by parent	69	Gain deemed back to donor – no flow through permitted
Gain not vested in beneficiary because subject to condition (e.g. exercise of trustee's discretion)	70	Taxed in hands of donor. Where gain has been vested this does not apply and gain will flow through to resident beneficiary
Vesting of gain can be revoked by donor	71	Taxed in hands of donor
Asset or gain vested in non-resident beneficiary	72	Taxed in hands of donor

15.2 The meaning of donation, settlement or other disposition

The term 'donation settlement or other disposition' is used throughout the attribution rules in paras 68 – 72. It has received extensive judicial consideration in relation to s 7, the leading case being *Ovenstone v SIR*.[245] A summary of the main principles that our courts have developed in interpreting this term are summarised below.

- A donation involves a gratuitous disposal of an asset out of liberality or generosity. The donee is enriched and the donor correspondingly impoverished. If the donee gives any

[245] 1980 (2) SA 721 (A), 42 SATC 55.

consideration it is not a donation (see *The Master v Thompson's Estate*[246]), (*Ovenstone* case *supra*).

- As long as the capital remains unpaid, the failure to charge interest on a loan is a continuing donation of the interest (*CIR v Berold*[247]).
- The phrase 'any donation, settlement or other disposition' excludes any disposal of property made for due consideration, but covers any disposal of property
  - made wholly gratuitously out of liberality or generosity; or
  - made under a settlement or other disposition for some consideration but in which there is an appreciable element of gratuitousness and liberality or generosity. (*Ovenstone* case *supra*)
- The expression 'donation, settlement or other disposition' must be read *ejusdem generis*[248] as 'donation, settlement or other *similar* disposition' (*Ovenstone* case *supra*). In other words, the word 'disposition' must be given a restrictive meaning.
- In *CIR v Woulidge*[249]assets were sold at market value on an interest-free loan. The loan itself was held not to be a donation as due consideration had been received in respect of the sale. This was evident from
  - the terms of the deed of sale,
  - the market-related purchase price, and
  - the subsequent repayment of the loan.
- Where the disposition contains both appreciable elements of gratuitousness and of proper consideration an apportionment may be made between the two elements for the purpose of determining the income deemed to have accrued to, or received by, the donor. The taxpayer bears the burden of proof to show that such an apportionment is possible and how a court should give effect to it (*Ovenstone's* case *supra* at 740D-F). See also *Joss v SIR.*[250]
- In determining the rate of interest that should be charged on a loan, regard must be had to what the trust would have paid had it borrowed the funds on normal commercial terms. The rate that the donor would have paid is irrelevant (*Ovenstone* case *supra*).
- The *in duplum* rule which restricts the amount of interest that can be charged on a loan to the outstanding capital balance, does not apply in determining the amount of interest to be attributed to a donor in terms of the attribution rules. It can only be applied in the real world of commerce and economic activity where it serves considerations of public policy in the protection of borrowers against exploitation by lenders (*Woulidge* case *supra*).

In deciding whether a capital gain is attributable to a donation, settlement or other disposition, the principle established in *CIR v Widan*[251] must be applied. In other words, there must be some close causal relation between the capital gain and the donation. In determining this one must have regard to the real efficient cause of the capital gain being generated. Where an asset has been directly financed by an interest-free or low interest loan this should be fairly easy to determine.

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[246] 1961 (2) SA 20 (FC) at 24F - 26C, 48F- 49C.
[247] 1962 (3) SA 748 (A) at 753F, 24 SATC 729 at 735 - 6.
[248] In terms of this rule of interpretation, when specific words are followed by general words, the general words must be restrictively interpreted to have the same sense or to refer to the same class as the specific words.
[249] 2002 (1) SA 68 (SCA), 63 SATC 483.
[250] 1980 (1) SA 674 (T), 41 SATC 206.
[251] *CIR v Widan* 1955 (1) SA 226 (A), 19 SATC 341.

15.3 Attribution of capital gain to spouse

Paragraph 68

The treatment of a person's capital gains that are derived directly or indirectly from that person's spouse mirrors that afforded to ordinary income in terms of s 7(2). That part of a person's capital gain as can be attributed to

- a donation, settlement or other disposition, or
- any transaction, operation or scheme made, entered into or carried out by that person's spouse

is in terms of this rule taken into account only in the hands of that spouse where the latter made, entered into or carried out that transaction mainly for purposes of the avoidance of any tax, duty or levy administered by the Commissioner. The Acts administered by the Commissioner involving tax, duties or levies are set out in Schedule 1 of the South African Revenue Service Act 34 of 1997. At the time of writing (July 2003) the Commissioner administered some 21 different Acts and various regulations, proclamations, and government notices. Some of the more well known Acts administered include the following:

- Marketable Securities Tax Act 32 of 1948
- Transfer Duty Act 40 of 1949
- Estate Duty Act 45 of 1955
- Income Tax Act 58 of 1962
- Customs and Excise Act, 91 of 1964
- Stamp Duties Act 77 of 1968
- Value-Added Tax Act 89 of 1991
- Tax on Retirement Funds Act, 38 of 1996
- Uncertificated Securities Tax Act, 31 of 1998
- Skills Development Levies Act 9 of 1999
- Unemployment Insurance Contributions Act 4 of 2002

This rule also applies where a person's capital gain is derived from a trade carried on by that person in association or in partnership with that person's spouse or where it is derived from that spouse or from a partnership or company at a time when that spouse was a member of that partnership or the sole, main or one of the principal shareholders of that company. The rule then applies in respect of so much of that person's gain as exceeds the amount of that person's reasonable entitlement to the gain. The latter amount is determined with regard to, *inter alia*, the nature of the relevant trade, the extent of that person's participation therein and the services rendered by that person.

A donation by a person to that person's spouse will as a general rule not result in a capital gain in that person's hands, as the base cost of that asset will be transferred to that spouse in terms of para 67. However, where the donation was made mainly for purposes of avoiding a tax, duty or levy administered by the Commissioner, the subsequent disposal of that asset by the spouse to whom it was donated might result in the inclusion of any resultant capital gain in the hands of the spouse who made that donation. Such donation, settlement or other disposition made by a person to a trust of which that person's spouse is a beneficiary, might also result in the application of this rule where a trust asset or the capital gain from the disposal of such asset is subsequently vested in that spouse.

Example – Attribution of capital gain to spouse

Facts: Barker and his wife Cherel operate a successful car rental business in partnership at Johannesburg International Airport. In view of the fact that Barker takes a leading role in the business, whilst his wife's involvement is minimal, they share profits in the ratio of 90:10. They had originally bought the car hire franchise for R100 000 in 2002, with Barker contributing R90 000 and his wife R10 000. Five years later with business booming, Barker decided it was time to retire. In order to avoid CGT, he transferred his share in the business to Cherel. In terms of para 67 Barker was treated as making no gain no loss on the transfer whilst Cherel was deemed to have acquired it for an expenditure of R90 000. Two weeks later she sold the business to a third party for R300 000 and they moved to Hermanus. She included the taxable capital gain of R200 000 x 25% = R50 000 in her tax return covering the year of disposal. Because she was over 65, she fell below the tax threshold and paid no tax.

Result: Harry, a tax auditor with SARS noticed the transaction, and after establishing the facts, and being satisfied that this was a scheme the sole purpose of which was to avoid CGT, subjected R45 000 of the R50 000 capital gain to tax in Barker's hands in terms of para 68.

See Example 6 in Chapter 14 for another example of the application of this rule.

15.4 Attribution of capital gain to parent of minor child

Paragraph 69

This rule mirrors the rule embodied in s 7(3) and (4) in terms of which income received by, accruing to or in favour of or expended for the benefit of a minor is in certain circumstances deemed to be that of a parent of that minor. Any amount of a minor child's capital gain or of a capital gain that has vested in or is treated as having vested in that child during the year in which it arose and that is attributable to a donation, settlement or other disposition made by a parent of that child, is treated as the capital gain of that parent. This rule also applies where the gain is attributable to a donation, settlement or other disposition made by another person in return for some donation, settlement or other disposition or some other consideration made or given by a parent of that child in favour, directly or indirectly, of that person or his or her family.

Example – Parent – minor child disposition

Facts: On 1 March 1999 Lorna lent R100 000 interest-free to the Lorna Family Trust. Had the trust borrowed the funds on overdraft to purchase the shares it would have paid interest at the annual rate of 15%. The discretionary beneficiaries of the trust are Lorna, and her two minor children, Conrad and Bronwyn. The trustee used the funds to purchase some listed shares in Mborna Ltd, a company listed on the JSE. On 29 February 2004 the trustee sold the shares at a capital gain of R205 000 and vested it in Conrad (16) and Bronwyn (14) in equal shares.

Result: There has been a donation, settlement or other disposition in that no interest has been charged on the loan. The following interest would have been payable on the loan had the funds been borrowed from the bank:

Year ended 28.02	R
2000	15 000
2001	15 000
2002	15 000
2003	15 000
2004	15 000
	75 000

In terms of para 69, R75 000 of the gain of R205 000 will be taxed in the hands of Lorna, whilst the balance (R130 000) will be taxed in the hands of Conrad (R65 000) and Bronwyn (R65 000). Note that for the purpose of determining the portion of the capital gain to be deemed back to Lorna, it is irrelevant that portion of the interest saved by the trust occurred prior to valuation date.

15.5 Attribution of capital gain that is subject to conditional vesting

Paragraph 70

In terms of this paragraph, in certain circumstances capital gains arising as a result of a conditional donation or similar transaction can be attributed to the donor.

The circumstances are

- where a person has made a donation, settlement or other disposition which is subject to a stipulation or condition that such person or any other person has imposed, to the effect that a capital gain or portion thereof shall not vest in the beneficiaries until the happening of some event,
- a capital gain that is attributable to the donation has arisen during the year of assessment but has not vested in any beneficiary, and
- the person who made the donation has been a resident throughout the same year of assessment.

A common form of conditional vesting occurs where the vesting of a trust asset or capital gain in a beneficiary is subject to the trustees' discretion.

In these circumstances the capital gain will be taken into account in determining the aggregate capital gain or loss of the person who made the donation, settlement or other disposition and disregarded in the determination of any other person's aggregate capital gain or loss.

This provision is similar to the provisions of s 7(5) of the Income Tax Act.

Example – Attribution of capital gain subject to conditional vesting

Facts: Frank (35) and Furter (37) are resident beneficiaries of the Frankfurter Family Trust, a resident discretionary trust formed by their grandfather. In terms of the trust deed, the trustee has an unfettered discretion as to whether or not to vest any of the income or capital of the trust in the beneficiaries. On 1 March 2001 their father, Trevor, lent R100 000 to the trust, which the trustee used to purchase listed shares on the JSE. Had the trust borrowed the funds from the bank, it would have paid interest at the annual rate of 15%. On 29 February 2004 the trustee sold the shares at a capital gain of R60 000. Of this amount he vested R10 000 in Frank, whilst the remaining R50 000 was retained in the trust.

Result: The trust saved interest of R100 000 x 15% x 3 = R45 000 over the three years that the shares were held. In terms of para 70, R45 000 of the capital gain left in the trust must be taxed in the hands of Trevor, whilst R5 000 will be taxed in the trust. Had the trustee vested the entire gain of R60 000 in Frank and Furter, it would have been taxed in their hands and there would have been no attribution to Trevor.

15.6 Attribution of capital gain that is subject to revocable vesting

Paragraph 71

In terms of this paragraph capital gains arising as a result of a revocable vesting can in certain circumstances be attributed to the donor.

The circumstances are

- where a donation, settlement or other disposition confers a right upon a beneficiary who is a resident to receive a capital gain attributable to that donation, settlement or other disposition,
- that right may be revoked or conferred upon another by the person who conferred it, and
- that capital gain has in terms of that right vested in that beneficiary during a year of assessment throughout which the person who conferred that right has been a resident and has retained the power to revoke that right.

In these circumstances the capital gain will be taken into account in determining the aggregate capital gain or loss of the person who retained the power of revocation and disregarded in the determination of the aggregate capital gain or loss of the beneficiary.

This provision is similar to the provisions of s 7(6) of the Income Tax Act.

Example – Revocable vesting

Facts: Scrooge Jnr, aged 25, is the sole beneficiary of the Scrooge Family Trust. In terms of the trust deed, the trustee has the right to vest the assets or income of the trust in Scrooge Jnr. during a year of assessment. However, he is also given the power to revoke the vesting of the income or assets in Scrooge Jnr. if in his view he is irresponsible in managing his financial affairs.

During the year ending 29 February 2004 the trustee vested a piece of land in Scrooge Jnr giving rise to a capital gain of R100 000 in the trust. In April 2004, after Scrooge Jnr had wasted R20 000 of his funds in an unsuccessful gambling spree at a casino, the trustee revoked the vested right that he had conferred on Scrooge Jnr.

Result: In terms of para 71 the capital gain of R100 000 will be taxed in the hands of the Scrooge Family Trust in the year of assessment ending 29 February 2004. Note it is irrelevant that the vesting was revoked in the subsequent tax year. Attribution occurs as a result of the fact that the trustee has the power to revoke the vested right. Whether or not that power is used is irrelevant.

15.7 Attribution of capital gain vesting in a person who is not a resident

Paragraph 72

Attribution rules apply when

- a donation, settlement or other disposition is made by a resident to any person (other than an entity that is not resident and which is similar to a public benefit organisation contemplated in s 30)[252] and

[252] Amended with effect from 22 December 2003 by s 112 of Act 45 of 2003. Previously the provision referred to a foreign entity as defined in s 9D of a similar nature.

- a capital gain attributable to that donation, settlement or other disposition has arisen during a year of assessment, and has during that year of assessment vested in or is treated as having vested in any person who is not a resident (other than a controlled foreign company, in relation to that resident).

In these circumstances, the capital gain must be disregarded in the hands of the person in whom it vests and be taken into account when determining the aggregate capital gain or loss of the person who made the donation, settlement or other disposition.

Example – Attribution of capital gain vesting in non-resident

Facts: On 1 March 2002 Millhouse sold an asset to the Millhouse Family Trust at market value of R100 000. The purchase price was credited to his loan account, and no interest was charged on the loan. Had the trust borrowed the funds from the bank to purchase the asset, it would have paid interest at the annual rate of 15%. The sole beneficiary of the trust is Richard, Millhouse's only son who resides in Brisbane, Australia. On 28 February 2005 the trustee vested the asset in Richard at a time when its market value was R150 000.

Result: The interest saved by the trust amounted to R45 000 (R100 000 x 15% x 3), In terms of para 11(1)(*d*) the vesting of an asset in Richard is a disposal. Since Richard is a connected person in relation to the trust, the transaction must be accounted for at market value in terms of para 38. Therefore the vesting of the asset gives rise to a capital gain of R150 000 – R100 000 = R50 000. Of this amount, R45 000 will be taxed in the hands of Millhouse in terms of para 72, and the remaining R5 000 will be taxed in the trust. Note that para 80 makes no provision for a flow through of a capital gain to a non-resident beneficiary.

The provisions of para 72 do not apply to a person who made a donation, settlement or similar disposition to a trust prior to that person becoming a resident. The donor must be a resident at the time of making the donation, settlement or similar disposition and it is irrelevant if that donor subsequently becomes a resident. In the United Kingdom case of *Inland Revenue Commissioners v Willoughby and related appeal*[253] the House of Lords held that an individual who had transferred assets abroad prior to becoming ordinarily resident in the United Kingdom, could not be brought within the relevant anti-avoidance provision because it required the avoider to be ordinarily resident at the time of the transfer.

15.8 Attribution of income as well as of capital gain

Paragraph 73

Where an amount of income as well as a capital gain has been derived from or is attributable to a donation, settlement or other disposition made by a person, the amount of that income as well as that capital gain might be subject to the attribution rules embodied in s 7 and paras 68 to 72, respectively. This might result in the taxation of both amounts in the hands of the person who made the donation, settlement or other disposition. Paragraph 73 limits the total amount of the income and gain that can be taxed in the hands of that person to the amount of the benefit derived from that donation, settlement or other disposition by the person to whom it was made. The quantified benefit to the latter person from, for example, an interest-free or low interest loan will therefore determine the extent to which any resulting income and capital gain can be attributed to the person who provided that benefit.

[253] [1997] 4 All ER 65.

Example 1 – Attribution of income and capital gain

Facts: On 1 July 1997 Wayne sold a residential building to the Wayne Family Trust for R1 000 000. The purchase price was funded by means of an interest free loan from Wayne. Had the trust funded the acquisition by obtaining a bond from a bank it would have paid interest at the rate of 15% per annum. The market value of the property on valuation date was R1 200 000, and this was adopted by the trust as the valuation date value. On 28 February 2003 the trust sold the property for R1 500 000 and reinvested the funds in another project. The trust did not distribute any portion of the capital gain to the beneficiaries of the trust.

The following is a summary of the net rental income derived by the trust, the amount deemed back to Wayne in terms of s 7(5) and the balance that could not be deemed back because the income was insufficient.

The maximum amount that can be attributed back each year is R1 000 000 x 15% = R150 000.

Year ended 28 February	Net rental income	Amount deemed back to Wayne in terms of s 7(5)	Shortfall (R150 000 – amount deemed back ito s 7(5))
1998	95 000	95 000	55 000
1999	100 000	100 000	50 000
2000	105 000	105 000	45 000
2001	110 000	110 000	40 000
2002	110 000	110 000	40 000
2003	120 000	120 000	30 000
			260 000

Result: The capital gain derived by the trust is:

	R
Proceeds	1 500 000
Base cost	1 200 000
Capital gain	300 000

The portion of this gain to be attributed to Wayne in terms of para 73 is R260 000. The remaining R40 000 will be taxed in the trust. The period before the introduction of CGT is only taken into account for the purpose of determining in whose hands the gain must be taxed. The gain itself, however, relates entirely to the post-CGT period and there is, therefore, no question of retrospective taxation.

See Example 6 in Chapter 14 for another example of the application of this rule.

15.9 Amnesty - attribution after disposal by electing party

Section 4(3)(*b*) of the Exchange Control Amnesty and Amendment of Taxation Laws Act, 2003; Regulations issued in terms of s 30 of the aforementioned Act.[254]

[254] GN R.1368, *Government Gazette* 25511 dated 29 September 2003.

In terms of s 4 of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003, a resident was entitled to elect to be the deemed owner of the assets of a non-resident discretionary trust. The electing party is deemed to have acquired the assets at market value on 1 March 2002 and to have disposed of them at market value when the trust disposes of them to any other person.

Suspension of attribution rules

Section 4(3)(*b*) of the Amnesty Act provides that

> 'the provisions of sections 7(5), 7(8) and 25B of the Income Tax Act, 1962, and paragraphs 70, 72 and 80 of the Eighth Schedule to that Act, shall not apply in respect of any income, expenditure or capital gain relating to that foreign asset, *while* it is so deemed to be held by that person.' [Emphasis added.]

Regulation 7 provides as follows:

> '7. For the purposes of section 4(3)(*b*) of the Act—
>
> (*a*) sections 7(5), 7(8) and 25B of the Income Tax Act, 1962, and paragraphs 70, 72 and 80 of the Eighth Schedule to the Income Tax Act, 1962, do not apply in respect of—
>
> (i) any income received or accrued or expenditure incurred by a trust relating to a foreign asset; or
>
> (ii) any capital gain determined by a trust in respect of the disposal of a foreign asset,
>
> during the period that the foreign asset is deemed to be held by the donor in terms of section 4(1) of the Act; and
>
> (*b*) any income received or accrued or expenditure incurred by a trust before 1 March 2002 in respect of a foreign asset is deemed to have been received or accrued or incurred, as the case may be, during the period that the foreign asset is so deemed to be held by that person.'

Attribution during the period of deemed ownership

The use of the word 'while' in s 4(3)(*b*) makes it clear that attribution in terms of the specified provisions is suspended during the period of deemed ownership. This is reinforced by Regulation 7(*a*), which more or less repeats in a slightly expanded form what is stated in the Act. It was necessary to suspend the attribution rules during this period in order to prevent the same amount from being taxed twice.

Attribution prior to the period of deemed ownership

Section 4(3)(*b*) only suspended attribution during the period of deemed ownership. It said nothing about the period prior to such deemed ownership which meant that potential amnesty applicants would not have been shielded from attribution in respect of this period. In order to prevent the taxation of such amounts, Regulation 7(*b*) was introduced. It deems income received or accrued and expenditure incurred by the trust prior to 1 March 2002 to have been received or accrued or incurred as the case may be, during the period of deemed ownership. This deeming is only for the purposes of s 4(3)(*b*) – in other words, for the purposes of suspending the attribution rules.

Attribution after the period of deemed ownership

The use of the word 'while' in s 4(3)(*b*) suggests that attribution under the specified provisions is only suspended while the electing party is the deemed owner. Once deemed ownership ends, there is by implication a return to reality, and attribution resumes in the normal way. There is a counter argument that the deemed sale at market value precludes any further attribution. It is submitted, however, that such an interpretation conflicts with the use of the word 'while' in s 4(3)(*b*). It also has the effect of extending the amnesty to the post-amnesty period which could never have been the intention of the amnesty legislature. The purpose of the deemed disposal at market value was to determine a capital gain or loss in the deemed owner's hands, and to prevent the imposition of donations tax on the deemed owner.

Example – Attribution of capital gain after cessation of deemed ownership under the amnesty legislation

Facts: In 1998 Michael took R1 000 000 offshore in contravention of the exchange control regulations and donated it to the Michael Family Trust, a non-resident discretionary trust established in Jersey. He did not declare the amount for donations tax purposes. The trustee purchased shares in Prop Co Ltd, a company registered in the Cayman Islands. Prop Co's sole asset consisted of a penthouse in Umhlanga Rocks. The market value of the shares on 1 March 2002 was R1 500 000. In October 2003 Michael applied for amnesty and made the s 4 election in respect of the Prop Co shares. On 1 March 2005 when the shares were valued at R2 100 000 the trustee vested the shares in the Michael 2 Trust, another Jersey-based trust. On 30 June 2007 the Michael 2 Trust sold the shares to a third party for R3 000 000.

Result: On 1 March 2002 Michael became the deemed owner of the Prop Co shares with a base cost of R1 500 000. On 1 March 2005 he was deemed to have disposed of them for R2 100 000 resulting in a capital gain in his hands of R600 000. In the 2008 tax year the capital gain arising in the Michael 2 Trust of R3 000 000 – R2 100 000 = R900 000 will be attributed to Michael in terms of para 72. This occurs because the shares were acquired out of proceeds that can be traced back to the donation Michael made to the Michael Trust. The attribution rules resume once Michael ceases to be the deemed owner.

Chapter 16 - Deceased estates

16.1 Disposal to and from deceased estate

Paragraph 40

16.1.1 Introduction

When a person dies there will be CGT consequences for the following persons:
- the deceased person in the year of death
- that person's deceased estate (a separate taxable entity)
- the heirs or legatees[255]

16.1.2 The deceased person

In terms of para 40(1) a deceased person is treated as having disposed of his or her assets at market value on the date of death. However, there are four exceptions to this rule, which do not trigger a disposal:
- Assets transferred to the surviving spouse as contemplated in para 67(2)(*a*).
- Assets bequeathed by the deceased to a public benefit organisation approved by the Commissioner in terms of s 30.
- A long-term insurance policy of the deceased which if the proceeds had been paid to the deceased, the capital gain or capital loss would have been disregarded in terms of para 55.
- An interest in South African pension, provident or retirement annuity funds or their foreign equivalents, where the capital gain or capital loss from the disposal of that interest would have been disregarded in terms of para 54,

Assets transferred to the surviving spouse qualify for roll-over relief in terms of para 67. This relief is similar to that granted to a deceased spouse for estate duty purposes in terms of s 4(*q*) of the Estate Duty Act. The surviving spouse inherits the base cost and all aspects of the history of the asset (date of acquisition and usage) from the deceased spouse and will have to account for any capital gains or losses when the asset is ultimately disposed of. The provision is not an exclusion from CGT but merely a deferral measure that has the effect of shifting the incidence of the tax from the deceased to his or her spouse. The surviving spouse will only pay CGT when he or she disposes of the asset. See **12.3 – Transfer of asset between spouses**.

In terms of para 40(1) assets left to a surviving spouse or approved PBO are not treated as a disposal on the date of death. Where the deceased bequeaths a portion of his or her primary residence to his or her surviving spouse or an approved PBO, and the balance to someone else, the primary residence exclusion of R1 million will have to be apportioned. See notes on para 45 in **11.4.4.**

16.1.2.1 Record keeping and valuation issues

Where the deceased holds pre-valuation date assets, the executor will have to select a valuation method. Where the deceased failed to determine the market value of an asset during the three years ending 30 September 2004, the executor will have to resort to either the TAB method (if he/she can find a record of costs) or 20% of proceeds method. Taxpayers should keep records of costs and valuations performed in order to enable their

[255] A legatee is a person entitled to a stated sum of money or a specified asset or collection of assets in terms of the last will and testament of the deceased.

executors to properly determine capital gains and losses. In the case of SA listed shares, participatory interests in portfolios of collective investment schemes and gold or platinum coins the executor will be bound by whatever asset identification method was adopted in terms of para 32 by the deceased (specific identification, FIFO or weighted average).

Trading stock and livestock must be brought to account at market value. In the case of livestock, farmers only include the standard value thereof in closing stock for normal tax purposes.[256] The result is that the difference between the market value and the standard value must be brought to account as proceeds. This is discussed in more detail below.

16.1.2.2 Livestock held and not disposed of at date of death

Livestock is an asset as defined in para 1 of the Eighth Schedule. When a farmer dies, para 5(1) of the First Schedule provides that the standard value of any livestock on hand must be included in closing stock.

By contrast, para 40 of the Eighth Schedule provides that upon death a person is treated as disposing of all his or her assets at market value. The result is that the difference between the standard value and market value constitutes proceeds for CGT purposes. In the case of livestock acquired after valuation date, where the cost of that livestock has been allowed as a deduction in terms of s 11(*a*), the base cost of that livestock will be zero by virtue of para 20(3)(*a*).

Example – Livestock on hand at date of death of taxpayer

Facts: Farmer Brown died on 28 February 2002 with the following livestock:

	Unit cost	Standard value	Market value at date of death
	R	R	R
1 Bull	5 000	50	9 000
10 Cows	3 000	40	50 000

Result: His capital gain will be determined as follows:

		R
Amount deemed to be received or accrued		59 000
Less: Standard values included in closing stock		
1 Bull	50	
10 Cows	400	(450)
Proceeds – para 35		58 550
Cost		
		35 000
Less: allowed in terms of s 11(*a*)		(35 000)
Base cost		Nil
Capital gain		58 550

16.1.2.3 Pre-valuation date livestock

The base cost of pre-valuation date livestock is calculated in the normal way, using TAB, market value or 20% of proceeds. Although livestock could in certain circumstances

256 Paragraph 5(1) of the First Schedule.

conceivably qualify as identical assets, the weighted average method may not be used for these assets as it is reserved for shares, participatory interests in collective investment schemes, gold and platinum coins and s 24J instruments (para 32(3A)). Livestock qualifying as identical assets must therefore be identified using the specific identification or first in, first out methods.

Where a taxpayer adopts market value as the valuation date value, the base cost will be the amount by which that market value exceeds the amount allowed under s 11(*a*) – this is in accordance with s 23B which prohibits double deductions. Where the market value is less than the amount allowed under s 11(*a*) the livestock will have a base cost of zero.

16.1.2.4 Executor carrying on farming operations

Where the executor carries on farming operations after the date of death, the deceased estate will acquire the livestock at a base cost equal to the market value of the livestock (para 40(1)). The same value is used for the purposes of the First Schedule (para 4(1)(*b*)(i)). At the end of the first year of assessment the executor will include the standard value in closing stock. The opening stock for the next year will be the same as the closing stock for the preceding year. The amount received on disposal of the livestock will be included in gross income and hence proceeds for CGT purposes will be zero. Since the market value would have been allowed as a deduction for normal tax purposes the base cost will also be zero. The result is neither a capital gain nor a loss.

16.1.2.5 Plantations and growing crops

In terms of common law, growing timber and crops accede to the land (*superficies solo cedit* - whatever is attached to the land forms part of it).

Plantations: When a farm is disposed of on a going concern basis, para 14 of the First Schedule requires that a portion of the proceeds on disposal of the farm be allocated to the value of the plantation, and that amount is deemed to be gross income. However, para 14 does not apply on death as there is no actual or deemed receipt or accrual of an amount under that provision when a farmer dies. The value of the growing timber must therefore be taken into account when determining the market value of the farm land on date of death. It will accordingly comprise part of the proceeds on the deemed disposal of the farm property in terms of para 40(1).
Growing crops: When a farm property is disposed of on a going concern basis, there is no requirement to include the value of any growing crops in gross income, except where the sale agreement specifies an amount in respect of those crops.[257] The result is that the value of the crops is simply treated as part and parcel of the value of the land and is an amount of a capital nature. The same treatment applies on death, and the value of the standing crops will simply be included in the market value of the farm land and will form part of the proceeds on disposal of the farm land on date of death in terms of para 40(1).

In the case of a farm acquired prior to the valuation date, the question arises as to whether growing timber and crops should be taken into account where the market value basis is adopted in determining the valuation date value of the farm. The view is held that whilst growing timber and crops do form part of the market value of the farm, the farmer may well have already claimed a deduction in respect of the cost of establishing and maintaining the plantation / crops. In order to prevent a double deduction it is submitted that the market value of the farm must be reduced in terms of s 23B by the amounts already allowed.

[257] See *Income Tax Practice Manual* ‘Farming – Growing crops, sale of’ at A – 290(1).

16.1.2.6 Assets subject to capital allowances

The Act makes no provision for the recoupment of capital allowances on death. As a result, the full market value of depreciable assets must be brought to account as proceeds (normally proceeds are reduced by the amount of any recoupments in terms of para 35(3)(*a*)). On the treatment of capital development expenditure of farmers, see **8.14**.

16.1.2.7 Usufructs created on death

Usufructs created on the death of a person must be valued in terms of para 31(1)(*d*). This involves determining the present value of the annual right of use at 12% per annum over the expected life of the person receiving the benefit, or where the right of enjoyment is a lesser period, over that lesser period. In terms of para 31(2) the Commissioner can determine a percentage other than 12% upon being satisfied that the usufruct could not reasonably be expected to produce an annual yield of 12%. Paragraph 31(2) prescribes the method for determining the market value of a usufruct. See **24.1** for a more detailed explanation and a number of examples.

16.1.2.8 Annual exclusion in year of death

The annual exclusion of the deceased person in the year of death is R50 000 (para 5(2)). The increased annual exclusion is designed to grant a measure of relief for the ‘bunching effect’ that occurs as a result of the simultaneous deemed disposal of all the assets of the deceased. The R50 000 is not subject to apportionment even where the period of assessment is less than a year. See **5.3 – Annual exclusion**.

16.1.2.9 Small business asset relief

In terms of para 57 a deceased person may qualify for relief from CGT on capital gains totalling up to R500 000 in respect of the disposal of small business assets. This is a once in a lifetime concession, and naturally if the deceased person had previously made use of the concession it will not be available on his or her death. See **11.6 – Disposal of small business assets on retirement**. To the extent that the R500 000 is not utilised by the deceased it will be available to the deceased estate should the executor dispose of any ‘active business assets’ to third parties. This follows from para 40(3), which provides that the disposal by the deceased estate of a natural person of an asset is treated in the same manner as if that natural person had disposed of that asset. Note that the estate is only entitled to the unutilised portion of the R500 000 and is not entitled to a further concession of R500 000.

The small business asset relief must be determined on an asset-by-asset basis. In terms of para 57(2) the asset must have been held for a continuous period of at least five years prior to disposal. In the case of livestock held and not disposed of at date of death, some of the animals may well have been held for a lesser period, and so will not qualify for the relief.

16.1.3 The deceased estate

16.1.3.1 Base cost of assets acquired by deceased estate

In terms of para 40(1) the deceased estate is treated as having acquired the assets from the deceased person at a cost equal to their market value on date of death. The amount is treated as expenditure actually incurred for the purposes of para 20(1)(*a*) (base cost). In some cases the executor may incur further costs in terms of para 20, and these will increase the base cost of the assets in the estate.

The CGT treatment of assets disposed of by the executor can be divided into two categories:

- Assets disposed of to heirs, legatees or a trustee of a trust.
- Assets disposed of to third parties.

16.1.3.2 Assets distributed to heirs, legatees or trustees (para 40(2))

Where the assets are finally distributed to the heirs, legatees or to a trustee of a trust the deceased estate is treated as having disposed of the assets for proceeds equal to the base cost of the deceased estate in respect of those assets. This does not apply to assets distributed to the surviving spouse or an approved public benefit organisation. The reason for this is that in terms of para 40(1) the deceased estate is treated as not having acquired those assets.

If the executor had, for example, incurred any expenditure contemplated in para 20 in improving any asset, this cost would be treated as part of the base cost to the heir or legatee.

The result is that the estate will make neither a gain nor a loss on disposal of assets of this nature. The above provision mirrors the treatment afforded to ordinary income where there are ascertainable heirs and legatees in terms of s 25 of the principal Act.

Paragraph 12(5) overrides para 40(2). As a result, where a debt owed to the deceased by an heir is cancelled in terms of the will of the deceased, a capital gain will arise in the heir's hands. The heir is deemed to have acquired the debt for a base cost of nil and to have disposed of it at market value. The deceased estate, however, will not be entitled to a capital loss in respect of the waiver of the debt. This is because para 40(2)(*a*) requires that the deceased estate be treated as having disposed of the debt for proceeds equal to the base cost of the debt to the deceased estate.

Where the will states that the assets of the deceased are to be sold and the proceeds distributed amongst a number of heirs, and one of those heirs agrees to take over a specific asset in part or full settlement of his/her share, the above provision will still apply. The estate will dispose of the asset at neither a gain nor a loss, and the heir will acquire the asset at an amount equal to its base cost in the deceased estate.

16.1.3.3 Assets disposed of by the executor (para 40(3))

Where the executor disposes of assets other than by distributing them to heirs, legatees or the trustee of a trust, the estate will be liable for the CGT on any capital gains or losses. Unlike ordinary income, which flows through to ascertainable heirs or legatees and is taxed in their hands in terms of s 25, gains and losses arising on the disposal of assets by an executor to a third party are trapped in the estate. Where those gains exceed the annual exclusion of R10 000, this could well necessitate the registration of the estate as a new taxpayer with its own tax reference number.

When disposing of an asset to third parties, para 40(3) provides that the deceased estate must be treated in the same manner as the deceased would have been treated, if the deceased had disposed of the asset. It is the intention that the estate be taxed at the same rate, and enjoy the same inclusion rate (25%) and exclusions (e.g. annual exclusion, primary residence exclusion) that the deceased would have enjoyed had the deceased disposed of the assets.

The estate will, in particular, be entitled to an annual exclusion of R10 000 in the year that it comes into existence – that is, in its first year of assessment that commences on the day after the date of death and ends on the last day of February (or date of finalisation of the estate if earlier). The R10 000 is not apportioned in the first or last year of assessment of the estate, even though the period of assessment may be less than a year.

In terms of para 48(*d*) a primary residence held by a deceased estate is treated as being ordinarily resided in by the deceased person for a maximum period of two years after the date of death. Should the executor take longer than two years to dispose of the residence, the period exceeding two years will not qualify as a primary residence, and the gain or loss must be apportioned. The R1 million exclusion may only be set off against the portion of the gain applicable to the first two years following the date of death.

Where the deceased leaves a specific sum of money to an approved public benefit organisation (PBO) and the executor sells an asset in order to effect payment to the PBO, that asset will not be excluded for CGT purposes in terms of para 40(1)(*b*). In addition CGT may also be payable by the estate if the asset has increased in value between the date of death and the date of sale. In order to qualify for the exclusion under para 62 the deceased must bequeath a specific asset to the PBO.

16.1.3.4 Pre-valuation date estates

Reading para 2 with para 40(1) it is evident that para 40(1) deals only with disposals occurring on or after the valuation date. The notion that valuations can be carried out retrospectively for an unlimited period also conflicts with the whole scheme of the Act. See in this regard the commentary in **9.4** on para 38, which also does not apply retrospectively. Where a person has died before the valuation date, the executor will be regarded as having acquired the assets for an expenditure of nil. In these circumstances the executor should have considered determining a market value as at 1 October 2001 in respect of the assets before 30 September 2004. This would, of course have been unnecessary in the case of SA listed shares, SA unit trusts, SA listed warrants, agricultural and financial futures. The prices of these assets were published in the *Government Gazette* and are therefore established. Where an executor has failed to value assets whose prices were not published in the *Gazette*, he or she will have to use the TAB or 20% of proceeds methods, both of which are likely to result in a lower base cost.

16.1.4 Assets acquired by heirs, legatees or the trustee of a trust (para 40(2)(b))

The heirs, legatees or the trustee of a trust are treated as acquiring assets from the deceased estate at the base cost of the deceased estate. The base cost would be the market value of the assets at date of death plus the cost of any improvements or other qualifying expenditure in terms of para 20 incurred by the estate. The amount is treated as expenditure actually incurred for the purposes of para 20(1)(*a*) (base cost).

As noted earlier, the spouse of the deceased person acquires the assets at the base cost of that deceased person, and not the deceased estate.

Assets acquired by inheritance prior to the valuation date are regarded as having been acquired by the heir for an expenditure of zero. This is of significance when determining the time-apportionment base cost of a pre-valuation date asset acquired by inheritance.
The provisions of para 40(2), which treat the heir as having acquired the asset at market value on the date of death only apply to disposals by the estate and acquisitions by the heir on or after the valuation date. An heir would, however, have the option of adopting the market value on valuation date in respect of such an asset.

Where a person has died before the valuation date, and the heir acquires the asset from the estate after the valuation date, the heir will acquire the asset at the base cost of the estate. As noted earlier under these circumstances the executor will be regarded as having acquired the assets for an expenditure of zero, and unless that executor determines a market value, the heir may be faced with the prospect of taking over a zero base cost or, where the executor has incurred some post-valuation date expenditure, a low base cost from the estate.

Example 2 – Determination of taxable capital gain of natural person in year of death

Facts: Richard Spectre died on 31 August 2002 leaving the following assets:

	Base Cost R	Market value R
Primary residence	1 000 000	2 100 000
Holiday home	250 000	350 000
Household furniture and effects	500 000	800 000
Yacht (11 metres in length)	300 000	200 000
Endowment policy	100 000	150 000
Second-hand endowment policy	200 000	300 000
Listed shares	600 000	900 000

In his will he stipulated that

- the holiday home was to be left to his surviving spouse,
- the endowment policy was to be left to his son,
- the second-hand endowment policy was to be left to Retina South Africa, a registered public benefit organization, and
- the remaining assets were to be sold and the proceeds split equally between his wife and son.

Result: The taxable capital gain or loss of Richard Spectre will be determined as follows:

Asset	Base cost	Market value	Capital gain / (loss)	Exclusions / roll-overs	Total	Paragraph conferring exclusion / roll-over
Primary residence	1 000 000	2 100 000	1 100 000	(1 000 000)	100 000	45(1)
Holiday home	250 000	350 000	100 000	(100 000)	-	40(1)(*a*) read with 67(2)(*a*)
Household furniture and effects	500 000	800 000	300 000	(300 000)	-	53(1)
Yacht	300 000	200 000	(100 000)	100 000	-	15
Endowment policy	100 000	150 000	50 000	(50 000)	-	40(1)(*c*) read with 55(1)(*a*)(i)
Second-hand endowment policy	200 000	300 000	100 000	(100 000)	-	40(1)(*b*) read with 62
Listed shares	600 000	900 000	300 000	-	300 000	
					400 000	

Sum of capital gains and losses	R400 000
Less: annual exclusion	(50 000)
Aggregate capital gain	350 000
Taxable capital gain (25% x R350 000)	87 500

Example 3 – Determination of taxable capital gain of deceased estate

Facts: The saga continues. After Richard had passed away his executor, Argie Bargie, proceeded to realise the assets that had not been bequeathed to specific persons. These assets realised the following proceeds:

	Proceeds	
	2003	2004
	R	R
Primary residence		2 300 000
Household furniture and effects	850 000	
Yacht		220 000
Listed shares	960 000	

In order to realise a better price for the yacht Argie Bargie had the navigation equipment upgraded at a cost of R5 000.

Result: The taxable capital gain of Richard's estate will be determined as follows:

2003

	Proceeds	Base cost	Capital gain
	R	R	R
Household furniture and effects	850 000	800 000	50 000
Listed shares	960 000	900 000	60 000

Since the household furniture and effects are personal use assets that would have been exempt in Richard's hands, the gain in his estate will also be disregarded.
The estate will be liable for CGT on the listed shares, calculated as follows:

	R
Capital gain	60 000
Less: annual exclusion	(10 000)
Aggregate capital gain	50 000
Inclusion rate	25%
Taxable capital gain	12 500

2004	Proceeds	Base cost	Capital gain
	R	R	R
Primary residence	2 300 000	2 100 000	200 000
Yacht	220 000	205 000	15 000

The gain on the disposal of the primary residence must be disregarded as it is covered by the primary residence exclusion of R1 million.

The base cost of the yacht is its market value on Richard's death (R200 000) plus the R5 000 spent on upgrading it. The taxable capital gain on disposal of the yacht is calculated as follows:

	R
Capital gain	15 000
Less: annual exclusion	(10 000)
Aggregate capital gain	5 000

Inclusion rate	25%
Taxable capital gain	R1 250

16.2 Tax payable by heir of a deceased estate

Paragraph 41

For capital gains tax purposes, a natural person is treated as disposing of all of his or her assets on the day before death. Capital gains tax will, therefore, be levied on the growth in the value of assets while estate duty will be levied on the net value of the deceased estate. There may be cases where a significant capital gains tax charge arises due to the growth in the value of the assets although the deceased estate is heavily indebted and would not be liable for estate duty.

This may have an impact on the liquidity of the deceased estate resulting in the assets having to be sold to meet the CGT liability. This paragraph provides an opportunity for the heir to acquire an asset from the estate provided that he or she accepts a part of the CGT liability. This would, for example, allow a family farm to be retained by the descendants of the deceased.

Where

- the CGT relating to the taxable capital gain of the deceased person exceeds 50% of the net value of the deceased estate, as determined for the purposes of the Estate Duty Act 45 of 1955, before taking into account that tax; and
- the executor of the deceased estate is required to dispose of an asset to pay that tax,

an heir or legatee who would have been entitled to the asset may accept both the asset and the liability on condition that the portion of the capital gains tax exceeding 50% of the net asset value described above is paid by him or her. This liability would have to be paid within three years of the executor obtaining permission to distribute the asset and would bear interest at the rate prescribed by the Minister.[258] 50% of the net value of the estate must be used to settle the remaining CGT liability.

The net value of an estate is determined in terms of s 4 of the Estate Duty Act before deducting the R1 500 000 allowance in terms of s 4A. The amount remaining after deducting the allowance is referred to as the 'dutiable amount', and is not relevant for the purposes of para 41.

Example 1 - Tax liability of estate taken over by heir

Facts: After Luke had passed away the net value of his estate before any CGT liability was as follows:

Assets	R
Share portfolio (base cost: R200 000)	3 000 000
Private motor vehicle	100 000
Cash at bank	50 000
Liabilities	
Bank loan secured over share portfolio	(2 500 000)
Sundry creditors	(350 000)
Net value of estate before CGT liability	300 000

[258] The definition of 'prescribed rate' is contained in s 1 of the Act. See **12.1** for a table of prescribed rates of interest.

The sole heir of Luke's estate, Luke Jnr, informed the executor that he would like to take over the share portfolio of his late father's estate. In order to facilitate this he was, if possible, also prepared to take over any remaining liabilities of the estate, and meet the costs of winding-up. Luke's father was paying tax at the maximum marginal rate at the time of his death. Luke indicated that as he was a bit cash strapped, he would like to take maximum advantage of para 41 of the Eighth Schedule.

Result: The CGT payable by the estate and the portion thereof that can be taken over by Luke Jnr is determined as follows:

Step 1 - Determine CGT liability attributable to asset to be taken over

	R
Deemed proceeds on disposal of share portfolio	3 000 000
Less: base cost	(200 000)
Capital gain	2 800 000
Less: Annual exclusion	(50 000)
Aggregate capital gain	2 750 000
Taxable capital gain 25% x R2 750 000	687 500
Tax thereon @ 40%	275 000

Step 2 – Determine 50% of net value of estate before CGT liability

Net value of estate before CGT liability	300 000
50% thereof	150 000

Step 3 – Allocate CGT liability between estate and heir

Total CGT liability – as above	275 000
Less: portion to be paid by estate – 50% of net value of estate	(150 000)
Portion to be taken over by Luke Jnr	125 000

The executor thereafter sold the motor vehicle and paid SARS R150 000. Luke Jnr arranged with his local SARS office to settle his portion of the CGT liability of R125 000 in monthly instalments over three years commencing from the time the Master authorized the distribution of the assets of the estate. He was obliged to pay interest at the prescribed rate on the amount outstanding.

Chapter 17 - Insolvent estates and companies in liquidation

Sections 1, 25C, 66(13)(*a*), 79B and para 83

The first two parts of this chapter (**17.1** and **17.2**) cover the insolvent estates of natural persons (individuals). Companies are dealt with in **17.3**.

17.1 Application of the principal Act

17.1.1 Recent amendments

Act 45 of 2003 introduced a number of amendments affecting individuals and their insolvent estates, namely,

- the introduction of a definition of 'date of sequestration' in s 1,
- the substitution of s 25C,
- the addition of a proviso to s 66(13)(*a*), and
- the insertion of s 79B(1A).

These amendments took effect on 22 December 2003 but for all practical purposes they have not changed the way in which these persons are taxed. The purpose of these amendments was merely to clarify the existing law and practice. The notes hereunder reflect these changes.

17.1.2 The three entities

When an individual's estate is sequestrated three distinct taxable entities arise, namely,

- the individual prior to date of sequestration,
- the insolvent estate, and
- the individual on or after date of sequestration.

These three entities must each be taken on register as separate taxpayers with their own tax reference numbers. In practice SARS will bring an insolvent estate on register as a special trust. This ensures that the insolvent estate will be taxed at the same rates of tax applicable to natural persons, and will not be granted the primary rebate in terms of s 6(2)(*a*) or interest exemption in terms of s 10(1)*(*i)(xv).
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17.1.3 Date of sequestration

Section 1

The term 'date of sequestration' is defined in s 1 and is summarised in the table below.

Table 1 – Date of sequestration

Type of sequestration	**Date of sequestration**
Voluntary surrender	Date of voluntary surrender if accepted by the court.
Application for provisional sequestration	If the court grants a final order of sequestration, the date of provisional sequestration of an estate.

17.1.4 Submission of returns (proviso to s 66(13)(a))

Section 66 prescribes the returns of income that must be submitted by the three entities mentioned above. The insolvent estate will have to be brought on register as a separate taxpayer and its first period of assessment will commence on the date of sequestration and end on the last day of February.

The second and subsequent years of assessment will commence on 1 March and end on the last day of February, or on the date on which the estate is finally wound up. In the case of the individual, separate returns must be submitted for the periods prior to and after the date of sequestration. The above is summarized in the table below.

Table 2 – Returns required to be submitted in the year of sequestration

Section 66(13)	**Taxable entity**	**Period begins on**	**Period ends on**
(*a*), proviso (*b*)(i)	Individual prior to sequestration	First day of year of assessment	Day preceding date of sequestration
(*a*) proviso (*b*)(ii)	Individual on or after date of sequestration	Date of sequestration	Last day of year of assessment
(*a*)	Insolvent estate	Date of sequestration	Last day of year of assessment

17.1.5 Person prior to sequestration and insolvent estate – the one and the same person rule

Section 25C

For the purposes of the Act (which includes the Eighth Schedule), and subject to any adjustments as may be necessary, s 25C deems the

- estate of a person prior to sequestration, and
- that person's insolvent estate,

to be one and the same person for the purpose of determining

- the amount of any allowance, deduction or set off to which the insolvent estate may be entitled,
- any amount which is recovered or recouped by or otherwise required to be included in the income of the insolvent estate, and
- any taxable capital gain or assessed capital loss of the insolvent estate.

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On sequestration a person's assets pass to that person's insolvent estate and this change of ownership would normally trigger a disposal in terms of para 11. However, the 'one and the same person' principle prescribed in s 25C brings the two entities together, and since a person cannot dispose of something to himself, there is no disposal of the individual's assets on the date of sequestration. Capital gains and losses are therefore determined in the hands of the insolvent estate when the assets are disposed of to third parties. Section 25C also has the effect of permitting an assessed loss or assessed capital loss to be carried forward from the person prior to sequestration into his or her insolvent estate.

17.1.6 Treatment of person where order of sequestration is set aside

Section 79B(1A)

In terms of s 79B(1A) where an order of sequestration is set aside, the Commissioner must withdraw any assessment issued in respect of

- the estate of a person for the period prior to the date of sequestration, and
- the insolvent estate of that person.

The Commissioner will then have to issue a fresh assessment in respect of the person concerned as if the sequestration never took place.

The effect of the setting aside of the order of sequestration is to terminate the existence of the insolvent estate *ab initio.* It follows that any transactions that took place in the insolvent estate while it was in existence must be accounted for in the hands of the individual who has been released from sequestration.

17.1.7 Rehabilitation

Section 79B(1A) refers to the situation where a provisional order of sequestration has been set aside or where, on appeal, a final order of sequestration has been set aside. It does not apply to a person who has become rehabilitated through an application for rehabilitation (s 124 of the Insolvency Act 24 of 1936) or through the effluxion of time (s 127A of that Act). Although in the latter cases the sequestration comes to an end in terms of s 129 of the Insolvency Act, the original order remains a *fait accompli* and is not set aside.

17.2 Treatment of assets and assessed capital losses

Paragraph 83

The purpose of para 83 is to provide for

- the treatment of assets in the hands of the insolvent estate of a natural person, and
- the forfeiture of an assessed capital loss by an insolvent.

In terms of para 83(1) the disposal of an asset by an insolvent estate is treated in the same manner as if that natural person had disposed of that asset. This ensures that the insolvent estate will be entitled to disregard and exclude the same amounts that the insolvent would have been entitled to disregard or exclude had he or she disposed of the assets of the insolvent estate. The purpose of this provision is to ensure that the insolvent estate will not be taxed on the disposal of personal use assets of the insolvent, such as

- a primary residence (where gain is less than R1 million),
- furniture and effects, and
- private motor vehicles.

It also confers the same 25% inclusion rate on the insolvent estate.

The provisions of para 83(2) effectively mirror the treatment of assessed losses in terms of s 20(1)(*a*)(i). It makes it clear that any assessed capital loss in the hands of the insolvent prior to sequestration is forfeited. In other words it may not be carried forward by the insolvent after date of sequestration. Note, however, that in terms of s 25C an assessed capital loss may be carried forward to the insolvent estate on the basis that the person's estate prior to sequestration and the insolvent estate are treated as one and the same person for the purpose of determining an assessed capital loss. However, any assessed capital loss remaining in the insolvent estate at the time it is finally terminated will be lost.

As noted earlier, where the order of sequestration is set aside the assessments that were raised on the individual and the insolvent estate in the year of sequestration must be withdrawn and a new assessment must be raised as if the sequestration never took place. In that case any assessed capital loss must be determined *de novo*.

As regards the effect of a compromise benefit on an assessed capital loss, see para 12(5). A release from an obligation gives rise to a capital gain.

The practical effect of s 25C and para 83

As noted above, the insolvent estate is a new taxable entity that comes into existence from the date of sequestration and it is quite separate and distinct from the insolvent person prior to that date. Although s 25C deems the insolvent person prior to sequestration and that person's insolvent estate to be 'one and the same person', this is only for the limited purposes of determining deductions, allowances, set offs, recoupments, a taxable capital gain or an assessed capital loss of the insolvent estate. For other purposes the insolvent estate and the person prior to sequestration remain separate entities. The intention of s 25C is, therefore, not to interfere with the separate identity of the estate as a tax paying entity in its own right, but rather to ensure, *inter alia*, that

- assessed losses can flow into the insolvent estate,
- assessed capital losses can flow into the insolvent estate,
- allowances claimed by the insolvent person prior to sequestration can be recouped in the estate, and
- debts included in the income of the person prior to sequestration can be claimed as bad debts in terms of s 11(*i*) by the insolvent estate.

The table below summarises some of the more important tax consequences affecting the three entities:

Table 1 - Tax consequences affecting the three entities on sequestration

Entity	**Type and period of assessment in year of sequestration**	**Consequence**
Person prior to sequestration	Original from beginning of year of assessment to day preceding date of sequestration.	Section 6 rebates apportioned in year of assessment preceding sequestration - s 6(4). Annual exclusion – R10 000. Primary residence exclusion – R1 million.
Insolvent estate	Original from date of sequestration to end of year of assessment	No s 6 rebate – applicable to natural persons only (s 6(1) and (2)). Assessed loss and assessed capital loss b/f from insolvent person prior to sequestration (s 25C). Annual exclusion must be reduced by portion utilised by person prior to sequestration (para 83(1) read with s 25C). 25% inclusion rate (para 83(1)). Primary residence exclusion – R1 million (para 83(1)) Gains and losses on personal use assets are excluded (para 83(1)).
Person after sequestration	Original from date of sequestration to end of year of assessment	The following may not be brought forward from the pre-sequestration period: • assessed loss (s 20(1)(*a*)(i)) • assessed capital loss (para 83(2)). Section 6 rebates apportioned for periods of less than a year – s 6(4). Annual exclusion – R10 000. Primary residence exclusion – R1 million.

The annual exclusion

The estate and the person prior to sequestration will have to share the annual exclusion. To the extent that the insolvent person has not used it prior to sequestration, any excess will be available for set off against gains and losses arising in the estate. This is consistent with the one and the same person concept prescribed by s 25C.

The person after date of sequestration will be registered as a new taxpayer. However, that person remains the same natural person as before and the annual exclusion in the year of sequestration must be shared between the person prior to sequestration, the insolvent estate and the person after sequestration.

Example 1 - Treatment of person prior to sequestration and insolvent estate

Facts: Cecil ran a small garage as a sole proprietorship under the style of Cecil's Motor Mania. After he had lost most of his customers as a result of the passing trade being diverted by the erection of a new freeway, he was unable to pay his debts and his creditors applied to court for his sequestration. The court granted a provisional order of sequestration on 31 August 2003 and this was made final on 31 October 2003. The Master appointed his trustee, Bob Brinkman, who immediately set about winding up the estate. He summarised the position as follows:

	R
Net loss from trade 1.3.2003 – 31.8.2003	(100 000)
Assessed loss brought forward	(250 000)
Capital gain on listed shares – sold 31.7.2003	150 000
Assessed capital loss brought forward	(50 000)
Interest income (after exempt portion) 1.9.2003 – 28.2.2004	15 000
Net loss from trade 1.9.2003 – 28.2.2004	(5 000)
Capital gain on sale of garage property (sold 31.10.2003)	1 800 000
Capital gain on sale of primary residence (sold 31.01.2004)	1 100 000

Result:

Cecil

Taxable income to date of sequestration (1.3.03 – 31.8.03)	
Capital gain – listed shares	150 000
Less: annual exclusion	(10 000)
Less: assessed capital loss brought forward	(50 000)
Net capital gain	90 000
Taxable capital gain 25% x R90 000	22 500
Net loss from trade	(100 000)
Assessed loss brought forward	(250 000)
Assessed loss carried forward	(327 500)

Cecil will be issued with an original assessment up to and including the day before the date of sequestration.

Cecil's insolvent estate

	R
Capital gain on disposal of garage	1 800 000
Disposal of primary residence:	1 100 000
Primary residence exclusion	(1 000 000)
Annual exclusion	-
Net capital gain	1 900 000

	R
Taxable capital gain 25% x R1 900 000	475 000
Taxable interest income	15 000
Net loss from trade	(5 000)
Assessed loss brought forward	(327 500)
Taxable income	157 500

Had Cecil been liable for tax at date of sequestration, his primary rebate would have been apportioned (halved), as his year of assessment ended on 31.8.2003. Cecil's estate is not entitled to the annual exclusion during the year ended 28.2.2004 as the full exclusion of R10 000 had been utilised by Cecil in the period up to date of sequestration. Since Cecil and his insolvent estate are treated as one and the same person for the purpose of determining a taxable capital gain or assessed capital loss, the annual exclusion may not exceed R10 000 in the year of sequestration. Since Cecil had utilised the full exclusion there was nothing left over for his estate.
Paragraph 83 also ensures that Cecil's estate qualifies for the primary residence exclusion.

Example 2 – Treatment of the person after date of sequestration

Facts: With effect from 1.9.2003 Cecil was taken on register by SARS as a new taxpayer and received his new tax number. Using funds borrowed from his father he purchased some listed shares at a cost of R100 000 on 31 October 2003 as a long-term investment. On 29 February 2004 he was forced to sell the shares, as he needed the funds to pay medical bills after his son had become seriously ill. He realised proceeds of R135 000. The only other income derived by Cecil was a salary of R60 000 (R10 000 per month).

Result: Cecil's taxable income will be:

	R
Capital gain on disposal of listed shares	35 000
Less: annual exclusion	-
Net capital gain	35 000
Inclusion rate	25%
Taxable capital gain	8 750
Salary	60 000
Taxable income	68 750

Note that Cecil's rebates must be halved in terms of s 6(4). His annual exclusion is nil because it was utilised by him prior to sequestration.

17.3 Companies in liquidation

A company in liquidation remains the same taxable entity[259] until it is finally dissolved. No special measures are therefore needed to deal with capital gains and losses arising in such companies. Any income tax payable in respect of the post-liquidation period by a company in liquidation (for example, as a result of capital gains arising during that period) qualifies as a cost of administration in terms of s 97(2)(*c*) of the Insolvency Act 24 of 1936.[260] There is no procedure for proving such claims,[261] which enjoy a higher degree of preference than claims for income tax in respect of the pre-liquidation period in terms of s 101. The liquidator in his

[259] *Van Zyl NO v CIR* [1997] 1 All SA 340 (C), 59 SATC 105.
[260] See the *van Zyl* case *supra* at SATC 113/114.
[261] E de la Rey *Mars, The Law of Insolvency in South Africa* 8 ed (1988) Juta & Co Ltd, Wetton in § 21.5 at 400.

capacity as public officer[262] must simply lodge the relevant returns of income and settle the taxes owing before distributing any surplus to the preferent and concurrent creditors.

Distributions of assets *in specie* by a company in liquidation are deemed to be made at market value in terms of para 75(1). An exception to this rule is, however, provided in terms of s 47 to qualifying subsidiary companies that distribute assets to their holding companies. Such assets are deemed to be disposed of to the holding company at their base cost, resulting in neither a gain nor a loss. Any unrealised gain or loss is rolled over into the holding company and is effectively deferred.

[262] Section 101(2) of the Income Tax Act.

Chapter 18 - Company distributions

PART XI: COMPANY DISTRIBUTIONS

Part XI of the Eighth Schedule incorporates the special rules that apply when a company distributes cash or other assets with respect to previously existing shares. Paragraph 75 addresses the impact of distributions at the distributing company level. Paragraphs 76 to 78 address the impact of distributions or issue of shares at the shareholder level.

18.1 Company distributions - definitions

Paragraph 74

This paragraph contains a number of definitions that are discussed below:

Definition – 'distribution'

> '**"distribution"** means any transfer of cash or assets by a company to a shareholder in relation to a share held by that shareholder, including any issue of shares or debt in that company (or any option thereto), regardless of whether that transfer constitutes a dividend'.

This definition is extremely wide and includes the issue of capitalisation shares, rights issues, debenture issues, dividends and distributions of capital profits during liquidation or winding-up. From a CGT point of view the more important definition is that of a capital distribution, discussed next.

Definition – 'capital distribution'

> '**"capital distribution"** means any distribution (or portion thereof) by a company that—
> (*a*) does not constitute a dividend; or
> (*b*) that constitutes a dividend which is exempt from secondary tax on companies by reason of s 64B(5)(*c*)'

A capital distribution is a 'distribution' as defined earlier, excluding a dividend as defined in s 1, but including a dividend distributed in the course or in anticipation of the liquidation or winding up or deregistration of a company that is exempt from STC in terms of s 64B(5)(*c*). As can be seen, this definition attempts to embrace those amounts that have not been subjected to STC. The reason for this is discussed below. The definition does not, however, embrace all STC-exempt dividends. For example, it does not include dividends exempt under the old rationalization and unbundling legislation that was effective prior to 1 October 2001.[263] One of the consequences of the amendment of s 64B(5)(*c*) with effect from 1 January 2003 is that capital profits relating to the period after 1 October 2001 are now subject to STC, and hence will not constitute capital distributions.

The table below illustrates the types of dividends that are exempt from STC in terms of s 64B(5)(*c*) and which constitute capital distributions, as well as those that do not comprise capital distributions.

A consequence of moving more dividends into the STC net is that these same dividends are moved out of the CGT net. Capital profits on disposal of shares in liquidated or deregistered companies will therefore be reduced. In fact, if the profits concerned were present at the time

[263] The old rationalization provisions are contained in s 39(2)(*a*) of the Taxation Laws Amendment Act 20 of 1994, whilst the old unbundling provisions are contained in s 60(5)(*a*) of the Income Tax Act 113 of 1993. In both cases, the distribution of assets or shares are deemed not to be a dividend for the purposes of Part VII of Chapter II, which deals *inter alia* with STC.

the shares were acquired (so-called pre-acquisition profits), capital losses could result on disposal of the shares. This flows from the fact that those capital profits would be included in base cost but excluded from proceeds on disposal.

Table 1 – Dividends exempt/not exempt ito s 64B(5)(*c*)

Section 64B(5)(*c*)	***Capital distributions*** **Dividends exempt from STC ito s 64B(5)(*c*) if declared out of**	***Amounts that are not capital distributions*** **Dividends not exempt ito s 64B(5)(*c*) if declared out of**
(i)	Pre-31.3.93 revenue profits.	• Pre-31.3.1993 revenue profits on revaluation of trading stock, and • Post-31.3.1993 revenue profits.
(ii)	Capital profits on assets disposed of prior to 1 October 2001.	Capital profits on assets acquired and disposed of on or after 1 October 2001.
(ii)	Portion of capital profits on assets acquired prior to and disposed of on or after 1 October 2001 that accrued prior to that date.	Portion of capital profits on assets acquired prior to and disposed of on or after 1 October 2001 that accrued on or after that date.
(ii)[264]	*Company becoming resident on or after 1 October 2001* Portion of capital profits on assets acquired prior to and disposed of on or after the date on which the company became a resident that accrued prior to that date.	*Company becoming resident on or after 1 October 2001* Portion of capital profits on assets acquired prior to and disposed of on or after the date on which the company became a resident that accrued after that date.
(iii)[265]	Profits distributed by a company before becoming a resident	Profits distributed by a company after becoming a resident
	Capital profits arising other than in respect of the disposal of an asset (e.g. a profit arising from a liability).	

Some examples of capital distributions

A capital distribution would include, for example:

- repayments of ‘pure’ share capital or share premium
- distributions of pre-valuation date capital profits and pre-31 March 1993 revenue profits in anticipation of or during liquidation or deregistration
- capitalisation shares that are not a ‘dividend’ as defined in s 1. Typically these consist of ordinary capitalisation shares with unrestricted dividend and capital participation rights. A capital distribution would not include capitalisation shares that constitute a ‘dividend’ – these include shares that are not part of the ‘equity share capital’ of a company. That term is defined in s 1 as follows:

[264] The proviso to s 64B(5)(*c*)(ii) that deals with companies becoming resident after 1 October 2001 was added by s 58(1)(*i*) of Act 45 of 2003 and was deemed to come into operation as from the commencement of years of assessment ending on or after 1 January 2004.
[265] Section 64B(5)(*c*)(iii) added by s 58(1)(*j*) of Act 45 of 2003 deemed to have come into operation on 26 February 2003 and applicable in respect of any dividend declared on or after that date.

'**"equity share capital"** means, in relation to any company, its issued share capital excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution, and the expression **"equity shares"** shall be construed accordingly'

It follows that preference shares carrying a right to a fixed dividend and a fixed repayment of capital in a liquidation do not form part of 'equity share capital', and would therefore not constitute a capital distribution.

The inverse CGT – STC relationship

In determining a capital gain or loss a 'capital distribution' can be likened to proceeds in terms of para 35, though the methodology for dealing with such distributions is not quite the same. For example, in para 76 the base cost of a share is reduced by capital distributions received or accrued prior to valuation date, whilst capital distributions received or accrued on or after valuation date are treated as proceeds on disposal of a share.

Why are certain STC-exempt dividends subject to CGT?

The reason is that there is a direct inverse relationship between CGT and STC that the definition of a capital distribution attempts to recognise. When a company distributes a dividend its net assets are reduced which in turn reduces the value of its shares. The company will pay STC on the dividend but the shareholder will pay less CGT on a disposal of the shares, as their value will have been reduced. On liquidation or deregistration, for example, the definition of capital distribution seeks to achieve the same result that would have been obtained had the shares in the company been sold. In theory it should make no difference whether shareholders sell their shares or realise them by liquidating or deregistering the company. The tax take should be approximately the same, and the treatment of the two realisation methods should be tax neutral. In practice, however, there will be slight differences between selling and distributing because the STC rate (12,5%) differs from the marginal CGT rate for individuals (10%) and companies (15%).

Definition – 'company' [Deleted with effect from 22 December 2003]

'**"company'** means any 'company' as defined in section 1, except for any portfolio in a collective investment scheme contemplated in paragraph (*e*) of that definition'

Paragraph (*e*) of the definition of 'company' in s 1 includes

'(i) portfolio comprised in any collective investment scheme in securities contemplated in Part IV of the Collective Investment Schemes Control Act, 2002, managed or carried on by any company registered as a manager under section 42 of that Act for purposes of that Part; or

(ii) arrangement or scheme carried on outside the Republic in pursuance of which members of the public are invited or permitted to invest in a portfolio of a collective investment scheme, where two or more investors contribute to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest'.

The amended definition came into operation on the same date as the Collective Investment Schemes Control Act 45 of 2002, namely, 3 March 2003.[266]

[266] The Collective Investment Schemes Control Act 45 of 2002 was promulgated in *Government Gazette* 24182 dated 13 December 2002 and came into operation on 3 March 2003 by proclamation by the State President in GN R18, 2003, GG 25007 dated 3 March 2003.

Paragraph (*e*) of the definition of 'company' therefore includes

- local collective investment schemes in securities (CISS), and
- foreign collective investment schemes.

The local CISS excludes a collective investment scheme in property shares (CISP) (which is actually a trust).

Equity unit trusts (now known as CISS's) were excluded from the para 74 definition of 'company' because as a general rule they were not permitted to distribute capital but had to reinvest it in other securities.[267]

This position changed with the introduction of the Collective Investment Schemes Control Act, which does not debar a CISS or CISP from making a capital distribution on a going concern basis. The exclusion of CISS's by means of the above definition and the failure to address capital distributions by CISP's meant that prior to 22 December 2003 it was not possible to subject the holder of a participatory interest to CGT on a capital distribution under Part XI.

The position on or after 22 December 2003

The deletion of the para 74 definition of 'company' with effect from 22 December 2003 means that the general definition of 'company' in s 1 applies which includes a CISS. It follows that capital distributions by CISS's will be treated as proceeds on disposal of a participatory interest by the holder in terms of para 76. Capital distributions by CISP's are treated in the same manner from the same date in terms of para 67A(3).

Definition – 'date of distribution' [effective from 22 December 2003]

> '**"date of distribution"** in relation to any distribution, means the date of approval of the distribution by the directors or by some other person or body of persons with comparable authority conferred under the memorandum and articles of association of the company making the distribution or under a law, regulation or rule to which that company is subject, except where the distribution is made—
>
> (*a*) by a company subject to the condition that it be payable to a shareholder of the company registered in that company's share register on a specified date, in which case it must be that date;
>
> (*b*) by a company to a shareholder of that company otherwise than by way of a formal declaration of a dividend, in which case it must be the date on which the shareholder became entitled to that distribution; or
>
> (*c*) by the liquidator of a company to a shareholder of that company in the course of the winding up or liquidation of that company, in which case it must be the date on which the shareholder became entitled to that distribution'.

Act 45 of 2003 introduced the definition of 'date of distribution' with effect from 22 December 2003. Consequential amendments were made by that Act to paras 75, 76(1), 78(1) and (3)(*b*) and by Act 16 of 2004 to paras 75(1), 76(3) and 78(1).

It is used, for example, in determining dates of acquisition and disposal of assets distributed *in specie*, and for determining the date on which such assets must be valued for purposes of establishing proceeds in the company's hands and base cost in the shareholder's hands. This definition mirrors the rules found in s 64B(4).

Definition – 'share' [Item (*b*) effective 22 December 2003]

> '**"share"** in relation to a company means—

[267] Section 18 of Unit Trusts Control Act 54 of 1981.

(*a*) any share capital of, or member's interest in, that company and any right or interest in or to such share capital or member's interest, whether or not that share capital or member's interest carries a right to participate in dividends or a capital distribution; or

(*b*) a participatory interest in a portfolio of a collective investment scheme referred to in paragraph (*e*) of the definition of "company"'.

The above definition includes a person who is not the registered shareholder but who has a right to dividends or capital.

The definition of 'shareholder' in s 1 includes a person who has a right to

> 'all or part of the benefit of the rights of participation in the profits, income *or capital* attaching to the share so registered. . .'.

This ensures that a person who has a right to dividends only must treat a capital distribution as proceeds on disposal of a share in terms of para 76. This could occur, for example, where a dividend is declared in anticipation of liquidation or deregistration. Such a dividend may comprise a capital distribution even though it is a dividend and would flow to a dividend beneficiary.
In summary, the definition covers a person who has full ownership of a share, a bare dominium holder and a usufructuary.

Example 1 – Usufructuary receiving capital distribution

Facts: The ABC Trust holds shares in Tranz (Pty) Ltd. Kim has a vested right to the income of the trust, whilst Kim's son Duncan has a vested right in the shares. Tranz (Pty) Ltd decides to liquidate and declares a dividend of R100 000 in anticipation of liquidation in terms of s 64B(5)(*c*). The dividend is made up as follows:

	R
Pre-valuation date capital profits	65 000
Pre-1993 revenue profits	25 000
Revenue profits	10 000
	100 000

The base cost of Kim's right to the dividends is R80 000.

Result: Since a distribution of profits in anticipation of liquidation is not regarded as a return of capital ITC 101 (1927) 3 SATC 324 (U), the above distribution constitutes income for purposes of the trust deed and would flow through to Kim.

Since Kim holds a 'share' as defined she must treat the capital distribution as proceeds on disposal of her 'share' in terms of para 76 as follows:

	R
Capital distribution (R65 000 + R25 000)	90 000
Base cost	80 000
Capital gain	10 000

Upon dissolution of Tranz (Pty) Ltd there would be a disposal of her 'share' in terms of para 77(1)(*a*).

18.2 Distributions in specie by a company

Paragraph 75

As stated above, para 75 regulates the impact of distributions of assets *in specie* at the distributing company level. This paragraph applies regardless of whether the distribution occurs during the lifetime operations of the company, during liquidation, or otherwise.

If a distribution qualifies as a disposal of one or more assets, the distribution generates a capital gain or loss for the distributing company at market value as if the assets distributed were sold to the shareholder at market value. This rule exists as a matter of tax parity within the corporate tax system – a straight asset distribution should have the same tax impact as a company sale of the asset followed by a distribution of after-tax cash proceeds.

Any capital gain or loss on the distribution of an asset to a shareholder occurs on the 'date of distribution' as defined in para 74.[268] The distribution of an asset *in specie* also includes a distribution by way of an interim dividend.[269] The company is treated as having disposed of the asset on the 'date of distribution' for an amount received or accrued equal to the market value of the asset on that date. Where a company disposes of an asset such as trading stock or a depreciable asset subject to recoupment, the provisions of para 35(3)(*a*) will operate to reduce the 'amount received or accrued'.[270]

Paragraph 75 does not apply to the issue of shares (or options thereto) in the company making the distribution. These forms of distribution do not constitute a disposal by virtue of para 11(2)(*b*).

Example 1 – Company level consequences of distributions of assets *in specie*

Facts: Ay (Pty) Ltd has 100 issued ordinary shares of which Kevin owns 90 and Leoni owns 10. Among other assets, Ay (Pty) Ltd owns shares in Zulu (Pty) Ltd, an unconnected company, as well as land. The Zulu (Pty) Ltd shares have a market value of R180 000 and a base cost of R200 000. The land has a market value of R20 000 and a base cost of R7 000. Ay (Pty) Ltd distributes the shares in Zulu (Pty) Ltd to Kevin and the land to Leoni. Both distributions come partly from profits and partly from share capital.

Result: The distributions of shares and land qualify as disposals at market value. Ay (Pty) Ltd realises a capital loss of R20 000 from the disposal of the shares and a capital gain of R13 000 from the disposal of the land. As Kevin is a connected person[271] in relation to Ay (Pty) Ltd, Ay (Pty) Ltd may only set off the capital loss of R20 000 against capital gains arising from transactions with him (para 39(2)).

Paragraphs 76 to 78: Shareholder Level Consequences

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[268] Prior to 22 December 2003 para 75(2) referred to 'the date the distribution is approved by the directors or by some other person with comparable authority conferred under the memorandum and articles of association of the company making the distribution'.

[269] The reference to 'interim dividend' was inserted by Act 45 of 2003.

[270] Prior to 22 December 2003 the provision simply deemed the amount to be 'proceeds'. However, proceeds is the amount arrived at after applying para 35 and reliance therefore had to be placed on the general presumption against double taxation to overcome the fact that no provision was made to exclude amounts that had already been taxed as ordinary income.

[271] See the definition of 'connected person' in s 1. Paragraph (*d*))(iv) of that definition includes 'any person, other than a company as defined in s 1 of the Companies Act, 1973 (Act No. 61 of 1973), who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20% of the company's equity share capital or voting rights'.

Paragraphs 76 to 78 address the shareholder-level consequences of various distributions. Paragraph 76 provides rules for distributions of cash or assets in specie. Paragraph 77 contains time of disposal rules regarding distributions in liquidation. The issue by a company of its own shares is covered under para 78.

18.3 Distributions of cash or assets in specie received by a shareholder

Paragraph 76

The purpose of this paragraph is to address the shareholder consequences of certain distributions of cash or assets *in specie,* including amounts received in anticipation of or during liquidation or deregistration.

Paragraph 76 does not deal with situations where a shareholder

- surrenders previously held shares in exchange for cash or assets - a share buy-back (this is dealt with under the core disposal rules) or
- receives a capital distribution after being deemed to have disposed of his or her shares in terms of para 77 (which deals with deregistered or liquidated companies).

A capital distribution of cash or the market value of an asset i*n specie* that is received by or accrues to a shareholder must be dealt with in the manner described in the table below.

Table 1 – Treatment of capital distributions of cash or assets *in specie*

Date of distribution[272]	Paragraph 76	Treatment of capital distribution
Prior to the valuation date	(1)(*a*)	Reduce para 20 expenditure incurred before valuation date. Where the expenditure is exhausted, the excess is disregarded.
On or after the valuation date	(1)(*b*)	Treat as proceeds on disposal of the share, except where the weighted average method is adopted.
	(2)	Where the weighted average method is adopted, the capital distribution is deducted from the base cost of the group of identical assets of which the share in question forms a part. This is dealt with in more detail below.

Issue of shares and granting of options by company

The issue by a company of its own shares to its shareholders or the granting of an option to take up such shares does not constitute a capital distribution. These actions do not amount to the distribution of an 'asset *in specie*' by the company – a requirement of para 76(1) and (2).

The meaning of 'shareholder'

Prior to 22 December 2003 the word 'shareholder' as used in para 76 was intended to be used in the sense of a holder of a 'share' as defined in para 74. On or after that date the word 'shareholder' must be given its defined meaning as per s 1 of the Act. See in this regard the commentary on the definition of 'share' in para 74.

[272] The term 'date of distribution' is defined in para 74 and was introduced with effect from 22 December 2003.

Market value of capital distribution of assets in specie

A capital distribution of assets *in specie* must be determined on the basis of the market value of the assets and not their nominal value.

Example 1 – Market value of assets *in specie*

Facts: A company in liquidation distributes an asset with a cost of R50 and a market value of R100. The company has revenue reserves of R10 and pre-valuation date capital reserves of R40 from which the dividend is declared.

Result: The market value of the capital distribution is arrived at as follows:

	R
Market value of distribution received	100
Less: Portion of distribution that constitutes a dividend subject to STC	10
Market value of capital distribution	90

Pre-CGT capital distributions cannot result in negative expenditure

Paragraph 76(1)(*a*) requires that the expenditure incurred in terms of para 20 before valuation date be reduced. The use of the word 'reduced' means that, where pre-valuation date capital distributions exceed the expenditure incurred prior to valuation date, the excess must be disregarded in the absence of any provisions to the contrary. The view is held that that expenditure cannot be 'reduced' below zero. The purpose of this treatment is to prevent the taxing of pre-CGT capital gains.

Persons who adopt TAB need to bear in mind that if the pre-CGT expenditure is reduced to zero, and they have any post-CGT expenses (e.g. selling expenses), the proceeds formula in para 30 will result in the entire gain being thrown into the post-CGT period. See Example 3 below.

Post-CGT capital distributions

The treatment of post-valuation date capital distributions as proceeds is consistent with the method used for determining capital gains and losses on assets generally, where the proceeds received prior to disposal of an asset are gathered up and accounted for on disposal.

Deferral approach v part-disposal approach

An alternative approach – followed by the United Kingdom[273] - of triggering a part-disposal each time a capital distribution takes place – though theoretically more correct, is beset with practical difficulties and is complex to administer. It would have entailed valuing the shares immediately before each capital distribution in order to determine the portion of the base cost disposed of. The Australian approach is similar to that adopted by South Africa, though the Australian legislation triggers a gain when the base cost turns negative.[274]

[273] See s 122 of the Taxation of Chargeable Gains Tax Act, 1992. The United Kingdom does, however, permit small capital distributions to be credited against base cost.
[274] See CGT event G1 - s 104-135(4) of the Income Tax Assessment Act, 1997.

Record keeping

The South African treatment of capital distributions results in a deferral of a capital gain or loss until the share is disposed of. A disposal will occur when one of the events listed in para 11 or 12 occurs – for example, sale, donation, cessation of residence, dissolution, deregistration, or the issue of a certificate by a liquidator in terms of para 77(1)(*b*). As a result of this deferral, para 79 contains an anti-avoidance measure that addresses disposals disguised as capital distributions.

An important consequence of the deferral approach is that shareholders are required to maintain detailed records of all capital distributions received or accrued from the date of acquisition until the date of disposal of a share. Even if market value is adopted, a shareholder will still need to have a record of pre-CGT capital distributions for the purposes of applying the kink tests.

The relationship between para 76 and the kink tests

The variables used in the kink tests in paras 26 and 27 will be determined by para 76. For example, where paras 26 and 27 refer to the expenditure incurred before valuation date, that will be the expenditure so incurred reduced by any capital distribution in terms of para 76(1)(*a*). Similarly, the proceeds on disposal used in the kink tests will include any post-CGT capital distributions in terms of para 76(1)(*b*).

The weighted average method (para 76(2))

Where the weighted average method is adopted, para 76(2) dictates that the base cost must be reduced by the amount of any capital distributions received or accrued. The base cost reduction method has been retained for the weighted average method in order to simplify record keeping. Had capital distributions been treated as proceeds on disposal, the result would have been the same as the base cost reduction method. However, taxpayers would have had to retain a separate pool of capital distributions, which would have had to be proportionately reduced each time a disposal of an identical asset took place. This would have added unnecessary complexity and would not have matched the way in which capital distributions are usually accounted for in practice.

Subparagraph (2)(*a*) states that the weighted average base cost must be determined by 'deducting' the capital distribution from the base cost. The use of the word 'deducting' is intended to permit the base cost to become a negative amount when capital distributions exceed the previous base cost of the shares on hand.

Example 2 – Shareholder receiving distribution out of retained income and share capital

Facts: Martin owns all the shares in Yankee (Pty) Ltd. Among other assets, Yankee (Pty) Ltd holds land with a R120 000 value and R50 000 in cash. The base cost of Martin's shares is R100 000. After valuation date Yankee (Pty) Ltd distributes the land and the cash to Martin. R90 000 of the distribution comes from retained income and the remaining R80 000 comes from share capital. The amount of R90 000 is subject to STC.

Result: Paragraph 76 does not apply to R90 000 of the distribution because this portion constitutes a dividend. The remaining R80 000 is treated as proceeds on disposal of the shares held by Martin.

Example 3 – Pre-CGT capital distribution exceeding expenditure before valuation date

Facts: Ten years prior to valuation date Martin acquired the entire share capital of Yankee Ltd at a cost of R100 000. In 1998 the company distributed an amount of R125 000 to Martin, made up as follows:

	R
Cash (ex retained income)	15 000
Assets (ex share capital and share premium)	110 000
	125 000

The market value of the shares on valuation date was R30 000.

Five years after valuation date Martin disposed of his shares for proceeds of R50 000. He incurred selling expenses of R3 000.

Determine Martin's capital gain or loss using TAB and market value.

Result:

TAB

Step 1 – Determine pre-CGT expenditure

	R
Acquisition cost	100 000
Less: Pre-CGT capital distribution (para 76(1)(*a*))	(110 000)
	(10 000)
Limited to	Nil

Paragraph 76(1)(*a*) does not permit the expenditure incurred before valuation date to become negative, and it is therefore limited to nil.

Step 2 – Determine post-CGT expenditure

The post-CGT expenditure comprises the selling expenses of R3 000.

Step 3 – Apply the proceeds formula

Exp before / total exp x proceeds
= R0/3 000 x R50 000
= R0

Step 4 – Apply TAB formula

TAB = B + [(P – B) x N/N + T]
TAB = R0 + [(R0 – R0) x 10/15]
TAB = R0

Step 5 – Determine gain or loss

Capital gain = Proceeds – [VDV + post-CGT expenditure]
= R50 000 – [R0 + R3 000]
= R47 000

Market value

Capital gain = Proceeds – [VDV + post-CGT expenditure]
= R50 000 – [R30 000 + R3 000]
= R17 000

Applying the kink tests:

Expenditure before valuation date = R0
Expenditure after valuation date = R3 000
Market value on valuation date = R30 000
Proceeds = R50 000
There is an overall historical gain of R47 000. Paragraph 26 therefore applies. Since there is a gain on market value, Martin has a choice of TAB, market value or 20% of proceeds in terms of para 26(1). Market value gives the most tax efficient result.

Example 4 – Pre- and post-valuation date capital distributions

Facts: Ten years prior to valuation date Maria acquired the entire share capital of Yankee Ltd at a cost of R100 000. In 1998 she received a distribution out of pure share capital of R15 000. The market value of the shares on valuation date was R80 000.

In 2002 Maria received a further capital distribution of R5 000.

Five years after valuation date Maria disposed of her shares for proceeds of R150 000. She incurred selling expenses of R7 000.

Determine Maria's capital gain or loss using TAB and market value.

Result:

TAB

Step 1 – Determine pre-CGT expenditure

	R
Acquisition cost	100 000
Less: Pre-CGT capital distribution (para 76(1)(*a*))	(15 000)
Pre-CGT expenditure	85 000

Step 2 – Determine post-CGT expenditure

The post-CGT expenditure comprises the selling expenses of R7 000.

Step 3 – Apply the proceeds formula

Proceeds = Amount realised (R150 000) + post-CGT capital distributions (R5000) = R155 000
Exp before / total exp x proceeds
= R85 000/(R85 000 + R7 000) x 155 000
= R85 000/R92 000 x R155 000
= R143 206,50

Step 4 – Apply TAB formula

TAB = B + [(P – B) x N/N + T]
TAB = R85 000 + [(R143 206,50 – R85 000) x 10/15]
TAB = R85 000 + [R58 206,50 x 10/15]
TAB = R85 000 + R38 804,33
TAB = R123 804,33

Step 5 – Determine gain or loss

Capital gain = Proceeds – [VDV + post-CGT expenditure]
= R155 000 – [R123 804,33 + R7 000]
= R155 000 – R130 804,33
= R24 195,67

Market value

Capital gain = Proceeds – [VDV + post-CGT expenditure]
= R155 000 – [R80 000 + R7 000]
= R68 000

Applying the kink tests:

Expenditure before valuation date = R85 000
Expenditure after valuation date = R7 000
Market value on valuation date = R80 000
Proceeds = R155 000
There is an overall historical gain of R155 000 – R92 000 = R63 000. Paragraph 26 therefore applies. Since there is a gain on market value, Maria has a choice of TAB, market value or 20% of proceeds in terms of para 26(1). TAB gives the most tax efficient result.

Example 5 – Weighted average method

Facts:

Date	Shares	Base cost
		R
Valuation date	100	220
2002 Acquisitions	150	300
Capital distribution received		(300)
2003 Acquisitions	110	200
Capital distribution received		(600)
Total	360	(180)

Average base cost per share = -R180/360 = -R0.50
Assume that 100 shares are disposed of in 2004 at R3 per share.

Result:

Proceeds = R300
Base cost of shares disposed of = 100 x -R0.50 = -R50
Capital gain = proceeds – base cost
Capital gain = R300 – (-R50)
= R300 + R50

= R350

Example 6 – Dividend exempt from STC in terms of s 64B(5)(*f*)

Facts: The facts are the same as Example 2, except that all the shares of Yankee (Pty) Ltd are owned by X-Ray Ltd. X-Ray Ltd has elected that the R90 000 be exempt from STC in terms of s 64B(5)(*f*).

Result: The result is the same as Example 1. The R90 000 dividend amount does not constitute a capital distribution. The STC-free nature of the dividend has no impact on this analysis, unless exempt by virtue of s 64B(5)(*c*). Note that the incoming dividend of R90 000 will be subject to STC when X-Ray Ltd distributes the relevant reserves to its shareholders. Because it was previously exempt from STC the incoming dividend may not be set off against any outgoing dividends distributed by X-Ray Ltd in arriving at its 'net amount' for STC purposes (s 64B(3)).

Example 7 – Multiple capital distributions received prior to dissolution

Facts: ABC (Pty) Ltd was formed 10 years prior to valuation date with a share capital of R10 000. Mr Fender has held all the shares since date of formation. Some years after the valuation date he decided to place the company into voluntary liquidation. ABC (Pty) Ltd's balance sheet appeared as follows before any final dividend distributions:

Capital employed

	R
Share capital	10 000
Capital profits arising on assets disposed of	
- before valuation date	50 000
- after valuation date (note 1)	60 000
Revenue profits – pre-1993	10 000
- post-1993	20 000
	150 000

Employment of capital

Cash	150 000

Note 1

The capital profits of R60 000 that arose in respect of disposals after valuation date were determined as follows:

Asset	Date of acquisition	Date of disposal	Cost R	Proceeds R	Capital profit R
Land	30.09.1996	30.09.2006	100 000	125 000	25 000
Plant	31.12.2001	28.02.2006	50 000	85 000	35 000

The market value of the land on valuation date was R115 000.

The company makes the following distributions:
Year ended 28 February 2010

	R
Dividend	140 000

Year ended 28 February 2011

Share capital	10 000

The company was placed in liquidation on 31 March 2010 and finally dissolved on 28 February 2011. The dividend is declared in anticipation of liquidation and all the requirements of s 64B(5)(*c*) read with s 41(4) have been met.

Mr Fender adopts the time-apportionment base cost (TAB) method to determine the valuation date value of his shares.

Result: The capital gain or loss on disposal of Mr Fender's shares will be determined as follows:

Year ended 28 February 2010

Although no disposal has taken place in this year of assessment, it is nevertheless necessary to determine the amount of the capital distributions received by or accrued to Mr Fender as he will need this information in the year of disposal.

Pre-CGT disposals

The capital profit of R50 000 arising from a pre-CGT disposal is fully exempt from STC in terms of s 64B(5)(*c*).

Post-CGT disposals

Land

The portion of the capital profit on disposal of the land that is subject to STC is determined as follows:

	R
Proceeds	125 000
Market value on 1 October 2001	115 000
Capital profit subject to STC	10 000

Capital profit exempt from STC in terms of s 64B(5)(*c*) = R25 000 – R10 000 = R15 000.

Plant

The entire profit on sale of the plant (R35 000) is subject to STC.

Total capital distributions as defined in para 74 are therefore as follows:

	R
Capital profit on pre-CGT disposal	50 000
Portion of capital profit on sale of land	15 000
Pre-1993 revenue profits	10 000
	75 000

In terms of para 76(1)(*b*) the capital distribution of R75 000 must be treated as proceeds on disposal of the shares.

The portion of the dividend that is subject to STC is made up as follows and is not a capital distribution:

	R
Portion of capital profit on sale of land	10 000
Capital profit on sale of plant	35 000
Post-1993 revenue profits	20 000
Total – non-capital distribution	65 000

Reconciliation:	R
Capital distributions	75 000
Non-capital distributions	65 000
Total distribution	140 000

Year ended 28 February 2011

Capital distribution (return of share capital) 10 000

In terms of para 77 the shares are deemed to be disposed of on date of dissolution (28 February 2011).

Proceeds = R75 000 + R10 000
= R85 000

TAB = R10 000 + [(R85 000 – R10 000) x 10/20]
= R10 000 + R37 500
= R47 500
Capital gain = Proceeds – TAB – post-CGT expenditure
= R85 000 – R47 500 – R0
= R37 500

Base cost of asset acquired by a shareholder as a result of a distribution (para 76(3))

Where an asset *in specie* is received by or accrues to a shareholder

- the shareholder is treated as having acquired the asset on the 'date of distribution' at an expenditure equal to its market value on that date,[275]
- the expenditure is treated as an amount of expenditure actually incurred and paid for the purposes of para 20(1)(*a*), and

The term 'date of distribution' is defined in para 74.

This rule applies regardless of whether the distribution constitutes a capital distribution or a dividend.

It also includes assets acquired prior to the valuation date. This is important for the purpose of determining the time-apportionment base cost of such assets.

Pre-CGT unbundlings
The unbundled company shares

A shareholder who received shares in terms of an unbundling transaction prior to the valuation date is deemed to have acquired them at market value in terms of para 76(3).

[275] The term 'date of distribution' was inserted in para 76(3) by s 30 of Act 16 of 2004. The amendment came into operation as from the commencement of years of assessment ending on or after 1 January 2005.

Where the shareholder elects to use TAB to determine the base cost of the unbundled company shares, the expenditure before valuation date ('B' in the TAB formula) will be the market value determined under para 76(3). The date of acquisition for the purposes of determining 'N' (period before valuation date) in the formula will be the 'date of distribution' as defined in para 74.[276] By not retaining the date of acquisition of the old shares, the value of 'N' in the TAB formula (period before valuation date) will be lower. This means that a higher proportion of any capital gain or loss will be subject to CGT when the new shares are disposed of.

The unbundling company shares

Despite the fact that a pre-CGT unbundling distribution would have been exempt from STC in terms of the old unbundling legislation,[277] it nevertheless falls outside the definition of a capital distribution.[278] It follows that there is no means to reduce the expenditure in respect of the unbundling company shares in terms of para 76(1)(*a*).[279] From the *fiscus*' point of view this is a somewhat perverse situation, since by rights a portion of the expenditure in respect of the unbundling company's shares should be allocated to the unbundled company's shares. The problem only arises where TAB is used in respect of the unbundling company shares. If market value were used, the price of the shares on valuation date would reflect the fact that the unbundling company no longer held an interest in the unbundled company. Shareholders may adopt market value or TAB for the unbundling company shares.

In the case of post-CGT unbundlings s 46(3) makes provision for a pro-rata reduction in the base cost of the unbundling company shares and also enables the date of acquisition of the old shares to be carried across to the new shares.

18.4 Distributions in liquidation or on deregistration received by a shareholder

Paragraph 77

The purpose of this paragraph is to provide the following rules for shareholders of companies that are being liquidated or deregistered:

- a disposal rule;
- a time of disposal rule;
- a rule dealing with capital distributions received or accrued after the date of disposal of a shareholder's shares.

Capital distributions prior to disposal

As mentioned, shareholders of companies that are to be liquidated or deregistered who receive capital distributions before disposal of their shares must reduce the base cost of their shares in terms of para 76.

Disposal and time of disposal – para 77(1)

Shareholders of a company that is being wound up or deregistered are deemed to have disposed of their shares at the earlier of

[276] Section 60(5)(*b*)(iv) only allows the date of acquisition of the old shares to be carried across to the new shares for the purposes of ss 9B and 24A where the old shares were held as trading stock.
[277] Section 60(5)(*a*)(i) of the Income Tax Act 113 of 1993 deems the distribution not to be a dividend for the purposes of Part VII of Chapter II. STC falls under Part VII.
[278] Only dividends that are exempt from STC in terms of s 64B(5)(*c*) are brought within the definition of 'capital distribution'.
[279] Section 60(5)(*b*) only permits the allocation of a part of the cost of the old shares to the new shares where the old shares were held as trading stock.

- the date of dissolution or deregistration; or
- in the case of liquidation or winding-up, the date when the liquidator declares in writing that no reasonable grounds exist to believe that the shareholder of the company (or shareholders holding the same class of shares) will receive any further distributions in the course of the liquidation or winding-up of that company.

This provision enables shareholders of companies that are being liquidated or deregistered to crystallise a capital gain or loss in respect of those shares.

Date of dissolution

The term dissolution applies to companies that are compulsorily or voluntarily wound up or liquidated – it does not apply to deregistration. The corporate state of the company finally terminates upon dissolution, which is dealt with in s 419 of the Companies Act 61 of 1973. In terms of that section, the Master issues a certificate of dissolution, a copy of which is sent to the Registrar of Companies for recording and publishing in the *Gazette*. The date of dissolution is the date of recording by the Registrar.[280] The same provisions of the Companies Act apply equally to close corporations.[281]

Date of deregistration

The date of deregistration of a company occurs on the date of publication in the *Government Gazette* by the Registrar of Companies in terms of s 73(5) of the Companies Act, or in the case of an external company in terms of s 332(4) of that Act. In the case of a close corporation it is the date of publication in the *Government Gazette* by the Registrar of Close Corporations in terms of s 26(3) of the Close Corporations Act.
Note that the dates of dissolution and deregistration mentioned above apply to companies registered in South Africa. In the case of a company registered in another country the law of the relevant country would determine the date of dissolution or deregistration.

Certificate issued by liquidator

The issue of a certificate by the liquidator allows a shareholder to crystallise a loss without having to wait until the liquidation process is finalised.[282]

Distributions after date of disposal – para 77(2)

If a shareholder receives any further capital distributions after the date of disposal determined in subpara (1), the distributions are treated as a capital gain without any base cost offset.

Example 1 - Capital distributions by company in liquidation

Facts: Ophelia owns 20 shares in Uniform Ltd with an aggregate base cost of R500. The company ran into financial difficulty and the directors placed the company into liquidation on 1 June 2002. On 20 October 2002 the liquidator distributed R100 in cash to Ophelia. At the same time he declared that all remaining proceeds would go to creditors and that

[280] Section 419(3).
[281] In terms of s 66 of the Close Corporations Act 69 of 1984.
[282] The Australian legislation contains a similar provision. In terms of s 104-145 of the Income Tax Assessment Act, 1997 the liquidator can make a declaration that the shares are worthless (CGT event (G3) and the taxpayer can elect to take a loss. The United Kingdom also has a worthless share provision enabling a loss to be crystallized where the shares are of negligible value – s 24(2) of the Taxation of Chargeable Gains Tax Act, 1992.

shareholders should not expect any further distributions. Following some investigation the liquidator came across some hidden assets belonging to the company and was able to make a final distribution to Ophelia of R30 in cash. The company was finally dissolved on 10 April 2003. None of the distributions described constitute dividends.

Result: In terms of para 77(1) Ophelia is deemed to have disposed of her shares on 20 October 2002. In the 2003 tax year she will have a capital loss of R400 (R100 proceeds in terms of para 76(1)(*b*) less R500 base cost). In terms of para 77(2) she will have a capital gain of R30 in the 2004 tax year.

When determining the impact of distributions occurring in anticipation of a winding up, liquidation or deregistration, it is noted that a capital distribution includes dividends exempt from STC by reason of s 64B(5)(*c*).

The purpose of this inclusion is to achieve the same result that would have been obtained had a shareholder of a company in liquidation or deregistration disposed of his or her shares, prior to such a distribution. It should also be noted, for example, that the pre-1993 profits would be included in the base cost of any shares held on 1 October 2001. Failure to reduce base cost by these distributions or to include them in proceeds would therefore result in a fictitious loss. It is emphasised that these reserves are neither subject to STC nor CGT.

The purpose of including STC exempt dividends in this manner is to ensure that company distributions have either a capital gain/loss impact or an STC impact. The legislation recognises the direct relationship between the value of a company's shares and the size of its dividend distributions. For example, assume a company is formed on 1 October 2001 with R1 share capital. Five years later it has post-acquisition reserves of R50 000. If its shares were sold for R50 001, a capital gain of R50 000 would result. Alternatively, if the company declared a dividend of R50 000 and thereafter disposed of its shares, there would be no gain or loss as the company would be reduced to a worthless shell. In the former case CGT would be payable whilst in the latter STC would be payable.

No such anti-avoidance rule exists for intra-group dividends exempt from STC because the clogged loss rule limits the usefulness of artificial losses between connected persons and because intra-group dividends are eventually subject to tax when the dividend leaves the group.

18.5 Share buy-backs

Paragraphs 11(1)(*b*) and 35, s 1 definition of gross income

The shareholder level consequences of share buy-backs are fully taken into account under the basic disposal rules and are accordingly not covered by Part XI. Under the basic disposal rules, any shareholder who receives a distribution in redemption of a share is treated as having disposed of that share solely for the portion of the distribution (if any) constituting 'pure' share capital or share premium (i.e. the capital distribution portion).

This arises from:
Disposal – para 11(1)(*b*) includes as a disposal event the redemption, cancellation or surrender of an asset;
Proceeds – para 35. Since dividends are included in the definition of gross income by virtue of para (*k*) of that definition, they will be excluded from proceeds in terms of para 35(3)(*a*). What remains in proceeds is the non-dividend portion of the consideration received in respect of the buy-back.

Example 1 – Buy-back of shares

Facts: Phoebe and Quintillian respectively own 80% and 20% of all Tango Ltd's shares. The base cost of Phoebe's shares is R3 000 000. Phoebe surrenders all of her shares in Tango Ltd for a R4 500 000 distribution. Of this amount, R1 200 000 represents share capital and R3 300 000 qualifies as a dividend.

Result: Tango Ltd is subject to STC on the R3 300 000 dividend. Phoebe realises a capital loss of R1 800 000 upon disposal of her shares (R1 200 000 capital distribution less the R3 000 000 base cost in the shares redeemed). The use of this artificial capital loss is limited by the clogged loss rule of para 39.

18.6 Share distributions received by a shareholder

Paragraph 78

Paragraph 78 addresses the shareholder level impact of a distribution when that distribution consists of the issue of shares by the company making the distribution. Share distributions of this kind fall into two classes:

- the issue of additional shares without the surrender of previously existing shares (i.e. the issue of capitalisation shares), and
- the issue of shares in substitution for shares previously held in the same company (for example, share substitutions). Issues of capitalisation shares and share substitutions do not generate any capital gain or loss.

Capitalisation shares (para 78(1))

Capitalisation share issues tend to fall into two categories

- 'scrip dividends', where the shareholder is given the choice of accepting capitalisation shares in lieu of a dividend, and
- ordinary capitalization issues, which are simply the capitalisation of existing reserves by transferring an amount from retained income to share capital.

In both cases the tax treatment for STC and CGT purposes is identical. Scrip dividends enable a company to retain cash for future investment and also have the benefit that no STC will be payable provided the shares comprise 'equity share capital' as defined in s 1. STC will only be payable when and if the company subsequently reduces its share capital.

Issues of capitalisation shares have no base cost impact on previously held shares that carry the rights to participate in the capitalisation shares.

Capitalisation shares that do not constitute a dividend

Capitalisation shares that do not constitute a dividend are treated as having been acquired on the 'date of distribution'[283] as defined in para 74 for expenditure incurred and paid of nil.

In the case of capitalisation shares acquired prior to the valuation date, a shareholder will still have the option of adopting market value, TAB or 20% of proceeds in respect of such shares. This will prevent the shareholder from being subjected to CGT on a pre-CGT gain.

[283] The reference to the date of distribution was inserted by the Taxation Laws Amendment Act 16 of 2004, effective from 27 July 2004. Prior to this date para 78(1) was silent regarding the date of acquisition of capitalisation shares where those shares do not constitute a dividend. In the absence of a specific rule, the date on which the shareholder becomes unconditionally entitled to the shares should be used.

Under the weighted average method capitalisation shares must be added to the pool with an expenditure of nil. The shares will thereafter 'acquire' a negative or positive base cost from the pool.

Shareholders wishing to adopt TAB in respect of capitalisation shares need to exercise caution, since any selling expenses incurred will result in the proceeds formula in para 30 having to be applied. Since there would be nil expenditure before valuation date and the selling expenses after valuation date, the effect will be to throw the entire gain into the post-CGT period.

Example 1 – Base cost of pre-valuation date capitalisation shares

Facts: John acquired 10 capitalisation shares in lieu of dividends from MVK Limited five years prior to the valuation date. He sold them five years after valuation date for R100 per share, and incurred selling expenses of R5 per share. The market value of the shares on valuation date was R60 per share.

Result: The effect of adopting the three valuation date value methods is shown below.

Market value

Capital gain = proceeds – VDV – post-CGT expenditure
= R1 000 – R600 – R50
= R350

TAB

P = R0 / (R50+R0) x R1 000 = 0
TAB = B + [(P – B) x N/N + T]
TAB = R0 + [(R0 – R0) x 5/10
TAB = R0
Capital gain = proceeds – VDV – post-CGT expenditure
= R1 000 – R0 – R50
= R950

20% of proceeds

Proceeds = R1 000
Post-CGT expenditure = R50
Proceeds less post-CGT expenditure = R950
VDV = 20% x 950 = R190
Capital gain = proceeds – VDV – post-CGT expenditure
= R1 000 – R190 – R50
= R760

Capitalisation shares that constitute a dividend

Capitalisation shares that constitute dividends (e.g. non-participating preference shares) are rare, since unlike normal capitalisation shares, they will be subject to STC. For a more detailed discussion on the nature of such shares see the commentary on para 74 in **18.1**. Shares of this nature are treated as having been acquired on the 'date of distribution' as defined in para 74[284] for an expenditure incurred and paid equal to the amount of the dividend. The intention is not to trigger CGT as well as STC in respect of such shares.

Example 2 – Base cost of capitalisation shares constituting a dividend

Facts: Ronen (Pty) Ltd issues 100 000 7% redeemable preference shares of R1 each to its existing ordinary shareholders on the basis of 1 preference share for each ordinary share held. The preference shares are issued out of retained income. Christine holds 1 000 ordinary shares and receives 1 000 preference shares.

Result: Her preference shares will have a base cost of R1 000. Ronen (Pty) Ltd will pay STC of 12,5% x R100 000 = R12 500 in respect of the preference share issue as it constitutes a dividend. Christine immediately disposes of her preference shares at the market value of R1/share, making neither a capital gain nor a loss.

Share substitution (para 78(2))

A share substitution contemplated in para 78(2) covers

- a share split (subdivision) e.g. 10 new shares for each old share
- a consolidation e.g. 1 new share for every 10 old shares
- a conversion of a company, close corporation or co-operative referred to in ss 40A and 40B of the Income Tax Act.

An equal share-for–share exchange e.g. 1 new share for 1 old share is not covered by para 78(2). An exchange of share certificates as a result of, say, a change of name will not trigger a disposal since the underlying rights in the shares will have remained unchanged. Where one share is substituted for another and the rights in the new share differ from the old share, a disposal may well be triggered. See in this regard the commentary on convertible preference shares in **6.1.1.2**.

The provisions of para 78 are subject to the value-shifting provisions in paras 11(1)(*g*), 23 and 35(2), which means that the latter provisions take precedence.

The shareholder must disregard any capital gain or loss arising from the substitution (para 78(2)(*a*)).

The following details are carried over from the old shares to the newly issued shares (para 78(2)(*b*)):

- any expenditure allowable in terms of para 20,
- the date that expenditure was incurred,
- the date of acquisition, and
- any market value adopted or determined in terms of para 29(4).[285]

The aggregate expenditure or market value of the old shares is allocated among the newly issued shares according to the relative market values of the new shares.

[284] Paragraph 78(1) was amended by s 116 of Act 45 of 2003 to include the reference to the 'date of distribution'. This amendment took effect on or after 22 December 2003.

[285] Section 78(2) and (3) was amended by Act 45 of 2003 to replace the reference to base cost with a reference to expenditure and market value. To the extent the amendment replaced the words 'base cost' with 'expenditure allowable in terms of paragraph 20 in respect of' it was deemed to come into operation on 1 October 2001. However, the insertion of the references to the date of incurral of the expenditure and any market value adopted or determined in terms of para 29(4) were not backdated and therefore came into operation on 22 December 2003.

The carry over of these details

- enables a person to use the time-apportionment base cost method when determining the valuation date value of pre-valuation date shares, and
- ensures that the kink tests in paras 26 and 27 can be applied to the new shares.

Conversion

As noted above, a capital gain or loss will not be triggered by a conversion in terms of ss 40A and 40B of the Income Tax Act. The table below provides more detail of qualifying conversions.

Table 1 – Corporate conversions qualifying for tax-free treatment

Income Tax Act section	**Type of conversion**	**Act governing conversion**
40A	From a company to a close corporation	Section 77 of the Close Corporations Act 69 of 1984.
	From a close corporation to a company	Section 29C of the Companies Act 61 of 1973.
40B	From a co-operative to a company	Section 161A or 161C of the Co-operatives Act 91 of 1981.

Example 3 – Issue of capitalisation shares

Facts: Sierra (Pty) Ltd has 100 000 issued ordinary shares, each of which has a market value of R60. Rae holds a single Sierra (Pty) Ltd share with a base cost of R50. Sierra (Pty) Ltd distributes one new ordinary share to its shareholders for each ordinary share held.

Result: The distribution of the additional ordinary share falls under subpara (1) because no previously held shares are surrendered in substitution. Rae retains the R50 base cost in the previously existing ordinary share and receives a zero base cost in the new share. (Note that the capital gain or loss on disposal of either share depends on whether Rae disposes of the share under the first-in first-out method, weighted average method, or specific identification method as prescribed under para 32.)

Example 4 – Share split

Facts: The facts are the same as Example 1, except Sierra (Pty) Ltd announces a share split with Sierra (Pty) Ltd shareholders surrendering each of their previously held ordinary shares for two new ordinary shares.
Result: The share split qualifies as a share distribution in substitution because previously held shares are being surrendered in exchange. Rae realises no capital gain or loss from the disposal of his or her previously existing share. Rae has the same aggregate R50 base cost in the two new shares with each new share receiving a base cost of R25 (i.e. R50 divided in equal value between the two shares).

Distribution of shares with cash or assets in specie (para 78(3))

Special rules apply when a company distributes both shares and cash or assets *in specie* in exchange for previously held shares. Under this circumstance, the distribution must be divided into share and non-share elements as if both elements were separate yet simultaneous transactions. The share-for-share element falls under para 78(2), and the non-share portion is subject to CGT. A portion of the expenditure allowable in terms of para 20 and any market value adopted or determined in terms of para 29(4) in respect of the old shares must be allocated to the non-share proceeds. The allocation is done on a pro rata basis in relation to the relative market value of the share and non-share portions.

Example 5 – Share substitution plus cash

Facts: Romeo Ltd has 100 000 issued ordinary shares and 50 000 issued preference shares. The ordinary shares each have a market value of R20 and the preference shares each have a market value of R50. Salomi owns 1 preference share with a base cost of R12. Romeo Ltd enters into a substitution whereby each preference share surrendered will be substituted for two ordinary shares and R15 in cash. Of the R15 cash amount, R5 of the cash distribution qualifies as a dividend, and the remainder comes from share capital.

Result: The receipt of the capital distribution of R10 will trigger a capital gain in Salomi's hands. In terms of para 78(3) the base cost of R12 must be allocated between the ordinary shares received and the capital distribution. The dividend of R5 is ignored since it does not constitute a capital distribution.

Salomi has received 2 ordinary shares with a combined market value of R40 and a capital distribution of cash of R10. The base cost of the preference share of R12 is allocated as follows:

		R
To ordinary shares	(40/50 x 12)	9,60
To capital distribution	(10/50 x 12)	2,40
		12,00

The ordinary shares will therefore have a base cost of R4,80 per share (R9,60 divided by 2).

Salomi will have a capital gain of R10 – R2,40 = R7,60 in respect of the capital distribution of cash.

18.7 Matching contributions and distributions

Paragraph 79

Paragraph 79 contains a special rule to prevent taxpayers from disguising gains on the disposal of shares through matching contributions and distributions. In transactions of this kind, the intended purchaser first purchases shares from the company as a contribution of capital. The company then distributes the recently contributed amount to a previously existing shareholder as a reduction in share capital. If form governs, the contribution is tax-free because the issue of company shares does not trigger a disposal, and a reduction in share capital only reduces the base cost of previously existing shares.

The matching contribution and distribution rule eliminates this result by treating any distribution as capital gain to the extent that the matching contributions and distributions are part of a scheme to avoid a capital gain on the disposal of shares by a shareholder and the shareholder receiving the distribution is a connected person in relation to the company making the distribution. (The connected person determination is made before the purchase of shares acquired through the matching contribution of capital.) Any shareholder generating capital gain under this rule cannot offset the gain with the base cost of previously held shares, and the base cost of previously held shares remains unaffected by the distribution.

Example 1 – Matching contribution and distribution

Facts: Tertia owns all the shares of Quebec (Pty) Ltd. The shares have an aggregate base cost of R100 000 and a market value of R500 000. Una is interested in purchasing the shares for R500 000, but Tertia does not want to generate a capital gain on the transfer. Pursuant to this aim, Una contributes R600 000 to Quebec (Pty) Ltd in exchange for a second class of ordinary shares that will possess majority voting control. Quebec (Pty) Ltd then distributes R500 000 to Tertia with respect to the previously held shares as a reduction in share capital.

Result: Without the matching contribution/distribution rule, no capital gain or loss would be generated on the issue of Quebec (Pty) Ltd shares nor would any capital gain result from the distribution to Tertia. Tertia would simply reduce the base cost in her shares to zero (with the excess R400 000 being added to proceeds upon eventual sale). Under the matching contribution/distribution rule Tertia is deemed to have a capital gain of R500 000 on the distribution (without any base cost offset in the shares previously held by Tertia).

Chapter 19 - Foreign currency gains and losses

19.1 Introduction

The provisions of the Act dealing with foreign currency gains and losses are set out in the table below. It is important to identify into which category an asset falls because this will determine its tax treatment.

Table 1 – Provisions of the Act dealing with different types of foreign currency gains and losses

Provision	Persons to whom applicable	Category of asset	Example
Paragraph 43(1) & (2)	All persons	CGT assets other than • foreign equity instruments, • immovable property in SA • movable assets of a resident (other than assets of a foreign PE of that resident) • assets of a PE in SA of a non-resident.	Immovable property outside SA. Loans, advances or debt owing in foreign currency (e.g. a foreign bank account or a euro bond). Assets of a foreign PE of a resident.
Paragraph 43(4)	All persons	• Foreign equity instruments • immovable property in SA • Movable assets of a resident (other than assets of a foreign PE of that resident) • Assets of a PE in SA of a non-resident	Listed shares, participatory interests in portfolios of collective investment schemes and gold and platinum coins. Land and buildings in SA. Unlisted shares, foreign endowment policies. Assets held by a SA branch of a non-resident company.
Part XIII (para 84 – 96)	Persons falling outside s 24I (see below)	Foreign currency assets: • Units of foreign currency • Loans, advances or debt in foreign currency	Foreign notes and coins, traveller's cheques, bank deposits, bonds, debentures, loans
		Foreign currency liabilities: • Loans, advances or debt owed in foreign currency	Mortgage bonds, bank loans, credit card debt and other loans.
Section 24I	• Companies • Trading trusts	Exchange items: • Foreign currency	

	• Individuals holding units of currency, loans, advances or debt in foreign currency as trading stock, and
	• Individuals or trusts in respect of
	  • forward exchange contracts owed by or to them, and
	  • rights or contingent obligations to buy or sell foreign currency option contracts.
		assets or liabilities (see above),
		• Forward exchange contracts owed by or to a person
		• Rights or contingent obligations under foreign currency option contracts.
			See above examples

Gains and losses falling under s 24I will be taxed as ordinary income. Gains and losses falling within the first three categories are subject to CGT. Assets enjoying the most favourable treatment in times of a depreciating rand are those falling within para 43(1) and (2).

19.2 Assets disposed of or acquired in foreign currency

Paragraph 43

The position prior to 22 December 2003

Paragraph 43 has undergone substantial revision since its introduction in 2001. Space does not permit a full discussion of the implications of each of these amendments, but two fundamental policy shifts deserve mention. The first was the introduction by Act 74 of 2002 of the concept of an average exchange rate for the translation of foreign currency expenditure and proceeds instead of the ruling exchange rate. The second was the removal by Act 45 of 2003 of movable assets such as foreign endowment policies and foreign unlisted shares from para 43(1) or (2) and their placement in para 43(4). These deemed SA source assets are now treated in the same way as foreign equity instruments and are exposed to full currency fluctuation.

To assist the reader, the table below sets out the Amending Acts and their effective dates. When dealing with a disposal prior to years of assessment commencing on or after 13 December 2002 or a disposal prior to 22 December 2003 it would be best to check the wording of the paragraph as it read at the applicable time.

Table 1 – Summary of amendments to para 43

Amended by	Amendment	Effective date
Section 38 of Taxation Laws Amendment Act 5 of 2001	Introduces para 43	1 October 2001
Section 91 of Second Revenue Laws Amendment Act 60 of 2001	Substitutes subpara (1), partly substitutes subpara (2) and inserts subpara (4).	1 October 2001
Section 84 of Revenue Laws Amendment Act 74 of 2002	Substitutes entire paragraph.	Applies in respect of the disposal of any

		asset during any year of assessment which commences on or after 13 December 2002.
Section 101 of Revenue Laws Amendment Act 45 of 2003	Substitutes subparas (1) and (2), partly substitutes subparas (4), (5) & (7) and inserts subpara (5A).	Applies to any disposal on or after 22 December 2003.

Table 2 - Overview of para 43

Paragraph 43	**Application to type of asset**	**Translation of**
(1)	Assets other than those in subpara (4)	Proceeds and expenditure in same foreign currency.
(2)		Proceeds or expenditure in different currencies
(3)	Deleted	
(4)	Foreign equity instruments, immovable property in SA, movable assets of a resident outside SA (except assets in a foreign PE of that resident) and assets of a PE in SA of a non-resident	Proceeds or expenditure in foreign currency.
(5)	All assets	Deemed proceeds and base cost
(5A)	Foreign debt of a resident	Base cost of waived foreign debt deemed to be acquired by debtor
(6)	All assets	Market value on valuation date
(7)	All assets	N/A – Definitions

Introduction

When dealing with assets acquired or disposed of in foreign currency, it is necessary to determine the capital gain or loss in rands. Paragraph 43 provides the rules for converting the various components making up the capital gain or loss into rands (expenditure, proceeds and where applicable, market value). It specifies when the conversion must take place and the appropriate exchange rate to be used. These rules also affect the manner in which pre-valuation date assets are to be treated; this includes the way in which the kink tests in paras 26 and 27 are to be applied.

Assets located inside South Africa could be acquired or disposed of in a foreign currency, and these are also addressed by para 43.

Definitions (s 1, para 43(7))

Paragraph 43 makes reference to a number of defined terms, some of which are defined in s 1 whilst others are defined in para 43(7).

Section 1 definitions

> '**"average exchange rate"** in relation to a year of assessment means—
> (*a*) the average determined by using the closing spot rates at the end of daily, weekly or monthly intervals during that year of assessment; or
> (*b*) the weighted average determined by using the closing spot rates at the end of daily, weekly or monthly intervals during that year of assessment during which income is received or accrued or expenditure is incurred, which average must be based on—
> (i) the net amount of receipts and accruals (excluding those of a capital nature) and deductible expenditure during each such period; and
> (ii) the net amount of capital gains or capital losses determined in respect of any disposal of assets during that period,
>
> which must be consistently applied within that year of assessment'.

Two methods are open to a taxpayer for the purpose of determining the average exchange rate.

The simple average method

The first method is a simple average of closing spot rates over the selected interval (365 days, 52 weeks or 12 months). For example, if a daily interval is selected, then the average exchange rate will be the total of the 365 daily closing spot rates during the year divided by 365 (assuming it is not a leap year).

Average rates of exchange supplied by the SA Reserve Bank are available on the SARS website under Income Tax / Average exchange rates for a year of assessment.[286]

The weighted average method

The second method is a weighted average of net amounts of

- receipts and accruals (other than those of a capital nature) and deductible expenditure, and
- capital gains and capital losses.

The term 'net amount' means that it is necessary to determine the 'profit' or 'loss' in respect of non-CGT transactions, and the sum of capital gains and losses in each period. This will yield two net amounts, one in respect of ordinary income and the other in respect of capital gains, which must in turn be added together to arrive at a total net amount. The net amount is an absolute value; in other words, losses are treated as positive figures.

Paragraph (*b*) seeks to arrive at a transaction based average rather than one based on amounts included in taxable income. In the case of capital gains and losses no regard is to be had to inclusion rates.

The example below illustrates the calculation of the weighted average exchange rate.

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[286] See <http://www.sars.gov.za/it/average_exchange_rates/Average%20exchange%20rates%20for%20purposes%20of%20the%20Income%20Tax%20Act1.pdf> (accessed 22 March 2005).

Example 1 – Determination of weighted average exchange rate

Month	Net Income	Net Loss	Net capital gains	Net capital Losses	Total net amount	Spot rate at end of month	Total
	$	$	$	$	$		R
1	100		1000		1100	10	11000
2		50			50	10.5	525
3	200				200	10.75	2150
4		100			100	11	1100
5	250			2000	2250	10.8	24300
6	300				300	10	3000
7		150			150	9.5	1425
8	400				400	8	3200
9	600				600	7.6	4560
10	100		500		600	8	4800
11	50				50	8.5	425
12		500			500	8.2	4100
					6300		60585
Weighted average exchange rate			60585 / 6300				9.616667

The above definition requires that the closing spot rate be used. Practice Note 4 dated 8 March 1999[287] gives some guidance on what constitutes an appropriate spot rate.[288]

> 'Various types of ruling exchange rates
>
> 'Spot rate' is defined in s 24I(1) of the Act as the appropriate quoted exchange rate for the delivery of currency within a period of two business days. The word 'appropriate' is used to provide for cases where more than one currency exists in a country, for example, financial rands or commercial rands (in South Africa until 13 March 1995). The rate applied on translation date must be the closing rate quoted by the authorised foreign currency dealer used by the taxpayer for the relevant day for a similar amount of foreign currency. The quoted selling rate must be applied in the case of an exchange item which is a liability and the quoted buying rate where the exchange item is an asset.'

Thus in the context of a CGT asset it is the bank's buying rate at the close of business on the relevant date that must be used. The buying rate is the rate that the bank will purchase a given quantity of foreign currency from the seller thereof. The table below shows some of the different rates quoted by foreign exchange dealers, depending on the medium being used.

[287] Income Tax: The Treatment of Gains and Losses on Foreign Exchange Transactions in terms of Section 24I of the Income Tax Act, 1962 (the Act).
[288] In para 4.4.1.

Table 3 – Types of exchange rate

Abbreviation	Description
TT buy	Bank receiving electronic transfer from abroad (telegraphic transfer)
SM buy	Surface mail (bank buying foreign notes)
Airmail buy	Foreign cheques and travellers' cheques deposited with the bank

For the majority of CGT assets the TT buy rate would be acceptable.
Banks also have different rates depending on the quantity of currency being purchased.

> '**"foreign equity instrument"** means—
> (*a*) a share or depository receipt in respect of a share listed on any—
> (i) stock exchange contemplated in paragraph (*b*) of the definition of "listed company";
> (ii) any national, regional or local exchange outside the Republic which is comparable to a stock exchange contemplated in subparagraph (i); or
> (iii) any interdealer quotation system outside the Republic that regularly publishes or releases firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise;
> (*b*) a participatory interest in an arrangement or scheme contemplated in paragraph (*e*) (ii) of the definition of "company" in section 1;
> (*c*) any other contractual right or obligation which derives its value from any specified index outside the Republic; or
> (*d*) any coin made mainly from gold or platinum, and any option, future or contract relating to such share, participatory interest, investment or contractual right or obligation or coin'.

A depository receipt is a negotiable certificate usually issued by a depository bank in a local country, which represents a specific number of shares issued by a foreign company in a foreign country. The depository receipts are traded on the local exchange. In the United States these are known as ADR's (American Depository Receipts).

Example – Depository receipts

John, a resident, purchased 100 ADR's in Dracula Ltd, a Transylvanian company for $12 each via the New York Stock Exchange. The ADR's were issued by the Bank of New York in respect of the 100 underlying shares, which were held by the Bank of Transylvania.

In para (*a*)(i) of the above definition, reference is made to a stock exchange contemplated in para (*b*) of the definition of **'listed company'** in s 1, namely,

> 'a stock exchange in a country other than the Republic which has been recognised by the Minister as contemplated in paragraph (*c*) of the definition of **"recognised exchange"** in paragraph 1 of the Eighth Schedule'.

The list of recognised exchanges in countries outside the Republic was published in GN R997 *Government Gazette* 22723 of 2 October 2001.[289]

Paragraph (*a*)(ii) of the above definition is intended to cover exchanges that are not on the list of recognised exchanges.

[289] See <http://www.sars.gov.za/cgt/information/recognised_exchange_no_3.pdf> (accessed 22 March 2005).

Currency gains and losses on foreign equity instruments that constitute trading stock are fully taxable in terms of s 9G. Where such instruments are held as capital assets the currency gain or loss is determined in terms of para 43(4).

> '**"permanent establishment"** means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development'.

Article 5 of the OECD Model Tax Convention reads as follows:[290]

'1. For the purposes of this Convention, the term »permanent establishment« means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term »permanent establishment« includes especially:
   - a) a place of management;
   - b) a branch;
   - c) an office;
   - d) a factory;
   - e) a workshop, and
   - f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term »permanent establishment« shall be deemed not to include:
   - a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
   - b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
   - c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
   - d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
   - e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
   - f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7 The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or

[290] The definition as it read on 9 April 2003. (See: <http://213.133.111.71/allgemein/divers/oecd_tax_2003/node10.php> (accessed 22 March 2005).

> otherwise), shall not of itself constitute either company a permanent establishment of the other.'

In terms of Article 3 the term 'enterprise' applies to the carrying on of any business. One of the most common examples of a permanent establishment (PE) is a branch of a company. A foreign company could have a PE in South Africa, and a South African company could have a PE in a foreign country.

The following terms are defined in para 43(7):

> '**"foreign currency"** means currency other than local currency', and
>
> **"local currency"** means—
> (*a*) in relation to a permanent establishment of a person, the currency used by that permanent establishment for purposes of financial reporting (other than the currency of any country in the common monetary area);
> (*b*) in any other case, the currency of the Republic'.

In terms of item (*a*), the term 'local currency' could comprise a currency other than rands. However, the currencies of counties in the common monetary area are excluded because of concern that these currencies could be used to escape taxation on foreign currency fluctuations. These countries have their own currencies, but they are on par with the SA Rand (for example, one Namibian dollar = one rand). The currencies falling within this category are the Lesotho maloti, Namibian dollar and Swaziland emalangeni.

Example 2 – Local currency

1. *Facts:* A resident has a branch in London, and that branch reports its profits or losses in sterling.

   Result: The local currency is sterling.

2. *Facts:* A non-resident has a branch in South Africa and that branch reports its financial results to that non-resident in sterling.

   Result: The local currency is sterling.

3. *Facts:* A resident has a branch in Botswana. The branch reports its results in both pula and US dollars.

   Result: The resident can elect which of the currencies (pula or USD) will comprise the local currency.

4. *Facts:* A resident has a branch in Namibia. The branch reports its results in Namibian dollars.

   Result: The local currency of the PE will be regarded as rands.

Categories of asset

Paragraph 43 deals with two broad categories of asset
- Foreign equity instruments and certain SA source assets (subpara (4))
- Immovable property held outside SA by a resident, assets of a foreign PE of a resident and loans, advances or debt owing to a person in foreign currency (subpara (1) and (2)

The table below provides an overview of the different categories with examples.

Table 4 – Categories of asset dealt with in para 43

Paragraph 43	**Type of asset**	**Example**
(1) and (2)	Any other asset not covered by para 43(4).	The following assets of a resident: • Assets attributable to a PE outside SA. • Immovable property outside SA. • Loans, advances or debt owing to the person in a foreign currency.
(4)	*Foreign equity instruments* *Deemed SA source assets:* • Immovable property in SA • Any interest or right in or to immovable property in SA • Assets (other than immovable property outside SA) of a resident • Assets of a PE in SA of a non-resident excluding • Assets in the form of loans, advances or debt in foreign currency dealt with ito Part XIII (para 84 – 96) Overall exclusion • Exchange items falling within s 24I.	• Foreign listed shares • Participatory interests in foreign collective investment schemes • Land and buildings in SA owned by a non-resident • Any movable asset of a resident held outside SA other than in a PE (e.g. foreign endowment policy, foreign unlisted shares) • Assets of a SA branch of a foreign company Exclusions: The following assets of a PE in SA of a non-resident • Overseas bank deposits • Dollar denominated loans Overall exclusions: • ESKOM stock held as trading stock by an individual. • ESKOM stock held by a company or trading trust.

Immovable property held outside SA by a resident and assets of a foreign PE of a resident (para 43(1) and (2))

The proceeds and expenditure in respect of the assets covered by para 43(1) and (2) can be denominated in various currencies. The purpose of these subparagraphs is to lay down the rules for converting the various currency permutations into the local currency. As noted earlier, the term 'local currency' can include currency other than rand in the context of a foreign PE of a resident.

Paragraph 43(1) and (2) deal with the situations where

- both expenditure and proceeds are denominated in the same foreign currency (para 43(1), and
- expenditure and proceeds are denominated in different currencies (para 43(2).

Proceeds and expenditure in same foreign currency (para 43(1))

Paragraph 43(1) applies where both proceeds and expenditure are denominated in the same foreign currency. The method of translation is set out in the table below.

Table 5 – Translation of proceeds and or expenditure into local currency: para 43(1) assets

Paragraph 43	HOW PROCEEDS DERIVED AND EXPENDITURE INCURRED	How capital gain or loss determined and translated into local currency
(1)	In same foreign currency. [Excluding para 43(4) assets]	• Determine capital gain or loss on disposal in foreign currency, and • Translate that capital gain or loss into rand ito s 25D(2) using the average exchange rate in the year of disposal.

It follows that no account is taken of the currency fluctuation between the date of incurral of the expenditure and the date of disposal. Where the rand has declined over the years against the foreign currency, this will be to the taxpayer's benefit. The reason for this is that the base cost is translated at the lower exchange rate ruling at the date of disposal thereby giving more rands, instead of the higher rate at the date of incurral of the expenditure. The higher the base cost, the lower the capital gain. The treatment of these assets is similar to the treatment of CFC's under s 9D where the foreign taxable income is brought back to rands at the average exchange rate during the relevant year of assessment.

Example 3 – Disposal of foreign asset that is not a foreign equity instrument (proceeds and expenditure in foreign currency – para 43(1))

Facts: In 1998 Neil purchased a flat in Sydney for R400 000 or AU$135 000 in order to derive rental income. The market value of the property on 1 October 2001 was AU$220 000. In 2007 the property is sold for AU$270 000 when the average AU$/R exchange rate is AU$1 / R4. Neil elected to use the market value of the property as the valuation date value.

Result: The capital gain on disposal of the asset is determined as follows:

	AU$
Proceeds	270 000
Base cost	220 000
Capital gain before translation	50 000
Capital gain translated to rand (AU$50 000 X 4)	R200 000

Example 4 – Foreign bank accounts

Facts: In 2000 Carolyn invested $100 in the Caribbean Islands Shady Bank Inc. All went well until the 2005 year of assessment when the bank manager began speculating in the futures market. As a result, the bank was placed in liquidation, and in February 2006 Carolyn received $40 in full and final settlement of her claim against the bank. The market value of her investment was $100 on valuation date.

Result: Carolyn has a capital loss of $60 in terms of para 43(1) which must be translated into rands at the average exchange rate in 2006. Carolyn will also have to determine a capital gain or loss under Part XIII in respect of the bank account.

Note: Usually foreign bank accounts will not give rise to a capital gain or loss under para 43(1), since the amount invested will simply be repaid in the same foreign currency.

Proceeds and expenditure in different currencies (para 43(2))

Paragraph 43(2) deals with the situation where the currency of expenditure and the currency of disposal differ. For this purpose the two terms have the following meanings:
The 'currency of disposal' is the proceeds that have been

- received or accrued, or
- denominated for purposes of financial reporting of a PE,

in any currency.
The 'currency of expenditure' is the expenditure

- actually incurred, or
- denominated for purposes of financial reporting,

in another currency (that is, one that differs from the currency of disposal).

Application to non-resident permanent establishments

The intention of para 43(2) is that where a foreign PE's asset is either acquired or disposed of in a currency other than the reporting currency of the PE (local currency) para 43(2)(*a*), (*b*) or (*c*) will apply. This treatment matches the rules that govern a local PE where all exchange differences in relation to rand are taken into account for tax purposes. The provision would not be applicable where, for example, the reporting currency of a UK PE of a resident is £ and the PE acquires and disposes of an asset in £.
Even though reporting takes place in a single currency, as soon as

- the currency of accrual differs from the currency of reporting of the expenditure, or
- the currency of reporting of the receipt or accrual differs from the currency of incurral of the expenditure,

para 43(2) will apply.

Example – Application of para 43(2) to a foreign PE

Facts: A South African company has a branch in London. The branch reports all its transactions in sterling. It has acquired and disposed of assets in various currencies as per the table below. None of the assets comprise foreign equity instruments or deemed SA source assets. Determine in each instance whether para 43(2) applies.

Result:

Currency in which expenditure incurred	**Currency in which proceeds derived**	**Does para 43(2) apply?**	**Reason**
US dollars	Sterling	Yes – (*b*)	Currency of expenditure differs from currency of disposal.
US dollars	US dollars	Yes – (*c*)	Currencies of expenditure and disposal differ from reporting currency.
US dollars	Euros	Yes – (*c*)	Currency of expenditure differs from currency of disposal.

US dollars	Rand	Yes – (*c*)	Currency of expenditure differs from currency of disposal.
Sterling	Sterling	No	Currency of expenditure and disposal are the same as the reporting currency.
Sterling	US dollars	Yes – (*b*)	Currency of disposal differs from currency of expenditure.
Sterling	Rand	Yes – (*b*)	Currency of disposal differs from currency of expenditure.
Rand	Rand	Yes – (*c*)	Currencies of expenditure and disposal differ from reporting currency.

Application to immovable property held outside SA by residents

Apart from assets of a foreign PE, the only other type of asset covered by para 43(2) is immovable property of a resident held outside SA. In the case of such immovable property, a comparison is made between the currency in which the expenditure was incurred and the currency in which the proceeds are received or accrue. If the two currencies differ, para 43(2) applies.

Table 6 – Translation of proceeds and or expenditure into local currency: para 43(2) assets

Paragraph 43(2)	**How proceeds and expenditure denominated**	**Translation method**
(*a*)	Expenditure actually incurred or denominated in local currency, proceeds in another currency.	Translate proceeds into local currency at average exchange rate in year of disposal.
(*b*)	Proceeds received or accrued or denominated in local currency, expenditure in another currency	Translate para 20 expenditure into local currency at average exchange rate in year expenditure incurred or treated as being incurred. If local currency did not exist at time of expenditure, use first available exchange rate for that currency.
(*c*)	Neither proceeds nor expenditure in local currency.	• Translate para 20 expenditure to currency of disposal at average exchange rate in year in which expenditure incurred or treated as being incurred. If currency of disposal did not exist at time of expenditure, use first available exchange rate for that currency of disposal); and • Translate foreign currency capital gain or loss to local currency at average exchange rate in year of disposal. • Translate the local currency capital gain or loss arrived at above into rand in accordance with s 25D.

It will be observed that where an asset is acquired in a foreign currency and disposed of in rands, the base cost of the asset is exposed to the full currency fluctuation.

Where an asset is acquired in one foreign currency and disposed of in another foreign currency, only the currency gain or loss determined between the two foreign currencies is taken into account and the rand currency gain or loss with regard to the asset is ignored (para 43(2)(*c*)).

Currency of disposal not in existence at time of expenditure

Items (*b*) and (*c*) of para 43(2) deal with the situation where a currency of disposal did not exist at the time of expenditure. This provision was inserted primarily to deal with the introduction of the euro which replaced currencies such as the Austrian schilling, Belgian franc, Finnish markka, French franc, German mark, Irish punt, Italian lira, Luxembourg franc, Netherlands guilder, Portuguese escudo and Spanish peseta. In these cases the currency of expenditure (say French francs) must be converted to the currency of disposal (say euros) using the first available exchange rate. For example, when the euro was introduced, rates of exchange were set for conversion of the member countries' existing currencies, and these are the rates that must be used.

Example 4 – Expenditure in local currency, proceeds in foreign currency (para 43(2)(*a*))

Facts: In 2004 John, a resident, purchased a holiday home in London for R5 000 000. In 2007 he sold the home to a German businessman for €900 000 when the average rate for that tax year was €1 = R 10.

Result: His capital gain will be determined as follows:

		R
Proceeds	€900 000 x R10 =	9 000 000
Base cost		5 000 000
Capital gain		4 000 000

Example 5 – Proceeds in local currency, expenditure in foreign currency (para 43(2)(*b*))

Facts: Moyra, a resident, purchased a holiday home on the Isle of Wight in February 2004 for £400 000 using funds in her London bank account. Assume that the average exchange rate for 2004 was £1 = R12. In 2007 she disposed of it to a Belgian who had business interests in SA for R9 000 000. He settled the purchase price by transferring the funds to her from his SA bank account.

Result: Her capital gain will be determined as follows:

		R
Proceeds		9 000 000
Base cost	£400 000 x R12 =	4 800 000
Capital gain		4 200 000

Example 6 – Neither expenditure nor proceeds in local currency and currency of expenditure no longer in existence (para 43(2)(*c*))

Facts: Renaud, a SA resident, purchased a chateau in the south of France for 5 000 000 French francs (FRF) on 1 October 1995 at a time when FRF 1 = R1. On 1 July 2005 he sold it to Debbie for 800 000 euros (€). On the date of implementation of the euro the exchange rate was FRF 100 = €15.24. In the year of disposal the average rand/euro exchange rate was €1 = R7.90513.

Assuming that Renaud chose TAB as the valuation date value of the chateau, determine his capital gain or loss.

Result: The chateau was acquired in FRF and disposed of in euros, so para 43(2)(*c*) applies.
Step 1: Translate currency of expenditure to currency of disposal at average exchange rate in year of incurral

The first step is to translate FRF to euros. Since the currency of disposal did not exist at the time the expenditure was incurred, the first available exchange rate must be used (FRF 100 = €15.24).
FRF 5 000 000 x 15.24/100 = € 762 000.
TAB = B + [(P – B) x N/N+T]
TAB = €762 000 + [(€800 000 – €762 000) x 6/6+4]
TAB = €762 000 + [€38 000 x 6/10]
TAB = €762 000 + €22 800
TAB = €784 800

Step 2: Determine capital gain in currency of disposal

Determine the capital gain in euros.

	€
Proceeds	800 000
Base cost	784 800
Capital gain	15 200

Step 3: Translate capital gain to local currency at average exchange rate in year of disposal

€15 200 x R7.90513 = R120 157,98

Application of para 43(2) to loans, advances or debts

As a rule, where a debt is denominated in a foreign currency, the debtor will repay the debt in the same currency. This would happen, for example, where a person invests in a foreign bank account. Where the investor asks the bank to pay an amount standing to the credit of the account in another currency, the original debt will still be discharged in the currency in which the funds were invested, and the conversion of the foreign currency proceeds into another currency will be a separate ‘cash’ transaction. Since cash is not an asset as defined in para 1 the second leg of the transaction will not result in para 43(2) being applicable.
However, where the debt is disposed of to a third party, the proceeds may well be in a different currency to the expenditure, and this will trigger para 43(2). An example would be a euro bond acquired in euros and sold in rands.

Foreign equity instruments and assets sourced in the Republic para 43(4))

Application

Subparagraph (4) applies to

- foreign equity instruments, and
- the following deemed SA source assets:
    - Immovable property in SA or any interest or right in or to immovable property in SA.
    - Assets other than immovable property of
        - a resident (but excluding assets attributable to a PE outside SA), or
        - a non-resident attributable to a PE in SA.

excluding

- assets in the form of loans, advances or debt in foreign currency (dealt with in para 43(1) or (2) and Part XIII (para 84 – 96)

And excluding from both categories

- any exchange item to which s 24I applies.

When any of the above assets are bought or sold in foreign currency, para 43(4) will apply.

Foreign equity instruments

The term ‘foreign equity instrument’ is defined in s 1 – see above where the complete definition is cited. For ease of reference a summary of the instruments covered by the definition is contained in the table below.

Table 7 – Summary of foreign equity instruments

Paragraph	Instrument description
(*a*)(i)	Listed shares on a recognised stock exchange outside SA.
(*a*)(i)	Listed shares on a stock exchange outside SA that is comparable to a recognised exchange.
(*a*)(iii)	Listed shares on an inter-dealer quotation system outside SA
(*b*)	Participatory interest in a collective investment scheme carried on outside SA.
(*c*)	Index-linked investments outside SA
(*d*)	Coins made mainly from gold or platinum
	Options, futures or contracts in respect of any of the above investments

Unlisted shares are not foreign equity instruments. However, in the case of a resident they are deemed to be SA source assets – see below.

Deemed SA source assets

Paragraph 43(4) specifically includes any asset

- the capital gain or loss from the disposal of which is derived or deemed to have been derived from a SA source ito s 9(2).

Excluded are assets contemplated in

- para (*b*) of the definition of ‘foreign currency asset’ in para 84,

Deemed SA source assets ito s 9(2)

The s 9(2) assets that are included are comprised of two categories:

Immovable property in SA

- Immovable property situated in SA, whether held by a resident or a non-resident (s 9(2)(*a*)),
- Any interest or right of whatever nature to or in immovable property in SA, whether held by a resident or a non-resident (s 9(2)(*a*)),

Assets other than immovable property in SA

- Assets of a resident not attributable to a PE outside SA (s 9(2)(*b*)(i)), and
- Assets of a non-resident attributable to a PE in SA (s 9(2)(*b*)(ii))

The term ‘an interest in immovable property’ includes any equity shares in a company or other entity where

- 80% or more of the value of the net assets of that company or other entity, determined on the market value basis, is attributable directly or indirectly to immovable property, (other than immovable property held by that company or entity as trading stock); and
- that person (whether alone or together with any connected person in relation to that person) holds at least 20% in the equity share capital of that company or other entity.

Indirect interest in immovable property

Resident or non-resident shareholder
(including connected persons)
↓ 20%
Company
↓
Immovable property in SA
(80% of MV of net assets)

For an example illustrating the determination of an indirect interest in immovable property, see the end of Chapter 4.

Exclusion of assets of a CFC from para 43(4)(b)

In terms of s 9D(2A) a controlled foreign company (CFC) is deemed to be a resident for the purposes of

> 'the definition of "gross income", sections 7(8), 10(1)(*h*), 10(1)(*h*A), 25B and paragraphs 2(1)(*a*), 12, 24, 70, 71, 72 and 80 of the Eighth Schedule'.

Paragraph 2(1)(*a*) provides that the Eighth Schedule applies to 'any asset of a resident'. It follows that the Eighth Schedule applies to the assets of a CFC. However, a CFC is not deemed to be a resident for the purposes of s 9(2). It follows that the provisions of para 43(4)(*b*) do not apply to a CFC. This means that such assets must be dealt with in terms of para 43(1) or (2). For example, if a CFC disposes of any of the assets listed below in the same foreign currency in which it was acquired, the disposal will fall within para 43(1):

- a foreign endowment policy,
- an unlisted share,
- a machine, or
- a debt asset

If the currencies of acquisition and disposal differ, the disposal must be dealt with in terms of para 43(2).

Exclusion of foreign currency assets (para (b) of definition of foreign currency asset in para 84)

Excluded from deemed SA source assets are any 'foreign currency assets' described in para (*b*) of the definition of that term in para 84, Part XIII. That definition reads as follows:

> '**"foreign currency asset"** in relation to a person means any amount in foreign currency—
> (*a*) which constitutes a unit of foreign currency of that person; or
> (*b*) owing to that person in respect of any loan, advance or debt payable to that person'.

Examples of para (*b*) foreign currency assets include

- bank accounts of individuals, and
- foreign stocks and bonds held by individuals as capital assets.

(Note: In terms of para 85 Part XIII does not apply to any foreign currency asset covered by s 24I)

These are excluded because their CGT consequences are addressed in Part XIII (paras 84 – 96). It was not necessary to exclude the assets described in para (*a*) as these are not assets as defined in para 1, and are also dealt with in Part XIII.

Overall exclusion of exchange items to which s 24I applies

Excluded from both foreign equity instruments and deemed SA source assets is any exchange item to which the provisions of s 24I are applicable. The term 'exchange item' is defined in s 24I(1) as follows:

> '**"exchange item"** of or in relation to a person means an amount in a foreign currency—
> (*a*) which constitutes any unit of currency acquired and not disposed of by that person;
> (*b*) owing by or to that person in respect of a loan or advance or a debt incurred by or payable to such person;
> (*c*) owed by or to that person in respect of a forward exchange contract; or
> (*d*) where that person has the right or contingent obligation to buy or sell that amount in terms of a foreign currency option contract'.

Section 24I applies[291] to any

- company,
- trust carrying on any trade,
- Individual who holds any amount contemplated in para (*a*) or (*b*) of the definition of 'exchange item' as trading stock, and
- Individual or trust in respect of any amount contemplated in para (*c*) or (*d*) of the definition of 'exchange item', In the context of CGT assets this includes
  - forward exchange contracts, and
  - foreign currency option contracts.

Although foreign currency is an exchange item it is not a CGT asset as defined in para 1 (i.e. it is already excluded from para 43). However, the following exchange items comprise CGT assets and are therefore excluded from para 43(4):

- Loans, advances or debt held by
  - companies and trading trusts as capital assets or trading stock, or
  - Individuals as trading stock.
- Forward exchange contracts held as capital assets or trading stock by companies, trusts or individuals
- Foreign currency option contracts held as capital assets or trading stock by companies, trusts, or Individuals.

Translation of proceeds and expenditure into rands

When para 43(4) applies the capital gain or loss must be determined by translating

- the proceeds into rands at the average exchange rate in the year of disposal, and
- the expenditure incurred *in respect of that foreign equity instrument* into rands at the average exchange rate in the year of incurral.

As regards expenditure it will be observed that the provision makes specific reference to foreign equity instruments (see italics) but omits to mention the deemed SA source assets. These assets should be translated in the same manner as foreign equity instruments.

[291] Section 24I(2).

The rationale behind the translation method

The full currency gain or loss determined on disposal is taxable in respect of para 43(4) assets.

This has the effect that the rand-based currency gain or loss between the date on which the expenditure was incurred and the tax year of disposal, is taken into account.

Had the currency gains in these foreign liquid investments not been taxed it would have created an easy mechanism to artificially shift funds offshore to the detriment of the capital account and ultimately the external value of the rand. Furthermore, it would also have created an artificial incentive to buy shares in SA blue chip companies on foreign exchanges.

The old para 43(4)

The comments below apply to disposals of foreign equity instruments that took place prior to years of assessment commencing on or after 13 December 2002. In other words, for individuals this refers to the 2003 and prior tax years.

Prior to its amendment by Act 74 of 2002 para 43(4)(*b*) provided that the 'valuation date value' of a foreign equity instrument should be translated into rands at the ruling exchange rate on valuation date. In order to avoid anomalous results the term 'valuation date value' must be taken in this context as a reference to market value on valuation date. For the purposes of applying TAB and the kink tests in paras 26 and 27, expenditure must be translated into rands at the rate ruling at the time the relevant amount was incurred. Neither TAB nor the kink tests must be applied in foreign currency. As will be seen below, para 43(4) was amended to exclude the reference to valuation date value, and expenditure is now translated at the average exchange rate.

Example 7 – Foreign equity instruments

Facts: Stella, who lives in Durban, purchased 1000 shares in Royal PLC, a company listed on the London Stock Exchange on 1 December 2003 at a cost of £1 000 when the average exchange rate was R16 = £1. She sold the shares for £1200 on 28 February 2008 when the average rate in that year was R18 = £1.

Result: Her capital gain will be determined as follows:

	R
Proceeds £1 200 x R18 =	21 600
Base cost £1 000 x R16 =	16 000
Capital gain	5 600

It will be seen that both the gain in pounds (£200 x R18 = R3 600 and the exchange rate growth on the original investment are subject to CGT (£1 000 x R2 = R2 000 (R18-R16). Had Stella purchased the shares before valuation date, the market value of the shares would have been converted at the rate ruling on 1 October 2001 (para 43(6)). If this asset were not a foreign equity instrument, for example, a house in London, the exchange rate growth on the original investment (R2 000) would not have been taxed.

Example 8 – Determination of TAB on disposal of deemed SA source asset under para 43(4)

Facts: Marisa bought a foreign endowment policy from the Jersey Assurance Company at a cost of £100 000 on 1 December 1996. On 1 December 2005 she contributed a further sum of £10 000 to the policy.
The policy paid out £150 000 on maturity on 1 December 2010. Assume that the average exchange rates during the various years of assessment were as follows:
1997 R7 = £1
2006 R12 = £1
2011 R15 = £1
Determine Marisa's capital gain or loss using TAB.

Result:

Step 1: Determine the rand value of TAB components

Expenditure before valuation date = £100 000 x R7 = R700 000
Expenditure on or after valuation date = £10 000 x R12 = R120 000
Proceeds = £150 000 x R15 = R2 250 000

Step 2: Apply the proceeds formula

P = R x B/[A + B]
P = R2 250 000 x R700 000/[R120 000 + R700 000]
P = R2 250 000 x R700 000/R820 000
P = R1 920 732

Step 3: Apply the TAB formula

TAB = B + [(P – B) x N/(N + T)]
TAB = R700 000 + [(R1 920 732 – R700 000) x 5/15
TAB = R700 000 + [R1 220 732 x 5/15]
TAB = R700 000 + R406 911
TAB = R1 106 911

Step 4: Determine capital gain or loss

Capital gain = Proceeds – TAB – post-valuation date expenditure

Capital gain = R2 250 000 - R1 106 911 – R120 000
= R1 023 089

Translation of deemed proceeds and base cost (para 43(5))

This provision applies where

- a person is treated as having received an amount of proceeds from the disposal of an asset, and
- the base cost of that asset has been determined in foreign currency.

When this happens the person

- *disposing of the asset* must treat the proceeds as being denominated in the currency of the base cost, and

- *acquiring the asset* must for the purposes of paras 12, 38 and 40 treat the asset as being denominated in the currency of the base cost of the person who disposed of the asset.

Table 8 – Provisions providing for deemed proceeds and base cost

Paragraph	Disposal event
12	Events treated as disposals and acquisitions e.g. • Cessation of residence • Non-trading stock that becomes trading stock • Asset ceasing to be personal use asset otherwise than by disposal etc
38	• Donation • Consideration not measurable in money • Connected person disposal at non-arm's length price
40	Death

Example 9 – Deemed proceeds where base cost denominated in foreign currency (para 43(5))

Facts: John, a resident passed away in 2007 leaving behind a flat in London that he had acquired in 2003 for £100 000. The market value of the flat on date of death was £120 000.

Result: In terms of para 40(1) read with para 43(5)(*a*) John is treated as having disposed of the flat for proceeds of £120 000. The resulting capital gain of £20 000 must be translated at the average exchange rate in the year of disposal in terms of para 43(1). John's estate is treated as having acquired the property at a base cost of £120 000 in terms of para 40(1) read with para 43(5)(*b*).

Base cost of claim acquired by debtor under para 12(5) (para 43(5A))

The purpose of this provision is to facilitate the application of para 43(5) where para 12(5) applies to a debt denominated in a foreign currency.

In terms of para 12(5) where a creditor discharges the debt owed by a person for less than its face value, the debtor is treated as having

- acquired the creditor's discharged claim for a base cost of nil, and
- immediately disposed of it for proceeds equal to the amount discharged.

In terms of para 43(5)(*a*) a person who derives deemed proceeds under para 12 must treat the amount of those proceeds as being denominated in the currency of the base cost. Paragraph 43(5A) establishes the currency of the base cost. It provides that where para 12(5) applies in respect of any debt owed by a person in any foreign currency, the base cost of the claim must be treated as being denominated in that foreign currency.

Example 10 – Base cost of para 12(5) debt acquired by debtor

Facts: Mary, a resident, owed Jack, a non-resident, £100. As a result of Mary's inability to repay the debt, Jack waived his right to claim the amount.

Result: In terms of para 12(5)(*b*)(i) Mary is deemed to have acquired the debt at a base cost of nil. Paragraph 43(5A) makes it clear that the base cost is equal to £0. In terms of para 12(5) Mary is deemed to have disposed of the debt acquired for proceeds equal to the amount of the debt that has been waived for no consideration. In terms of para 43(5)(*a*) the amount of those proceeds will be deemed to be denominated in the currency of the base cost (pounds). Mary will therefore have proceeds of £100, which must be translated into rand at the average exchange rate in the year of disposal

Market value on valuation date (para 43(6))

Where a person has adopted market value as the valuation date value of an asset, that market value must be determined in the currency of expenditure of that asset. In other words, if an asset was bought in pounds, it must be valued in pounds.

The table below sets out the currencies into which the market value must be translated on valuation date at the ruling exchange rate. The term 'ruling exchange rate' must be given its ordinary meaning. In this regard it is considered that the authorised dealer's closing spot 'buy' rate on 1 October 2001 would be appropriate (see notes above under definition of weighted average exchange rate).

Table 9 – Translation of market value into currency of expenditure

Paragraph 43	**How proceeds and expenditure denominated**	**Translate market value using ruling exchange rate on 1 October 2001 into**
(2)(*b*)	Proceeds in local currency, expenditure in another currency.	Rands
(4)	Proceeds and / or expenditure in foreign currency.	Rands
(2)(*c*)	Proceeds and expenditure in different foreign currencies.	Currency of disposal

Example 10 – Application of the kink tests to foreign equity instruments

Facts: Peter bought 100 shares in Wilson PLC, a share listed on the London Stock Exchange at a cost of £100 in 1995. On 1 October 2001 they had a market value of £150, and in 2007 he sold them for £120. The average exchange rate in 1995 was R7 = £1 and in 2007 was R15 = £1. The closing spot rate on valuation date was R10 = £1. Determine Peter's capital gain or loss taking cognizance of paras 26(3), 43(4) and 43(6).

Result: Paragraph 43(6) states that the market value must be determined in the currency of expenditure (pounds).
Expenditure = £100 x 7 = R700
Market value = £150 x 10 = R1 500
Proceeds = £120 x 12 = R1 440
This gives a capital loss before applying para 26(3) of R1 500 – R1 440 = R60.

Applying para 26(3), the valuation date value is equal to proceeds less expenditure on or after valuation date, that is, R1 440. Peter will therefore make no gain, no loss on disposal of his shares. Note that the decline in market value of R60 after 1 October 2001 has two components:

- The decline in the pound value of the shares £150 – 120 = £30 x R10 = R300, and
- The decline in the value of the rand (a benefit for Peter) of R12 – R10 = R2 x 120 = R240.

Peter's market value loss of R60 comprises the difference between these two components, namely, R300 – 240 = R60, and this is restricted to nil in terms of para 26(3). It is appropriate that the kink tests be applied in rands and not in foreign currency. The reason is that a person in Peter's position would otherwise be denied the pound loss of R300 whilst being subject to CGT on a currency gain of R240, which would be unfair.

19.3 Individuals holding trading stock, companies, and trading trusts

Section 24I

The development of capital gains tax provisions to deal with the foreign currency gain and loss element of the disposal of foreign currency assets and other foreign assets required a review of the provisions of section 24I. The scope of the provisions has been extended to include all foreign currency gains and losses of:

- companies
- trusts which are carrying on any trade and
- any natural person who holds any exchange item as trading stock.

This results in a clear distinction between the provisions of section 24I and the Eighth Schedule based on the type of taxpayer.

As a result, certain exchange items that were not dealt with under section 24I are now subject to the provisions of that section. These exchange items are deemed to have been acquired on 1 October 2001 at the ruling exchange rate on that date.

19.4 The use of foreign debt to finance assets

Section 24I(11)

The comments below apply to companies, trading trusts and individuals holding exchange items as trading stock.

In terms of para 43(1) or (2), the exchange gain or loss element attributable to the period of ownership of certain foreign assets is not subject to tax on disposal of those assets. Where a foreign loan, advance or debt is used to finance the foreign asset, exchange differences may arise on that loan, advance or debt. This results in a mismatch for tax purposes in that the exchange differences on the liability are accounted for as part of ordinary income under s 24I, whilst the corresponding currency gain or loss is not accounted for under the Eighth Schedule. In order to create parity in the tax treatment of the exchange differences in respect of the asset and the financing of the asset, exchange differences on such a loan, advance or debt are not allowable for tax purposes.[292] Any exchange difference in respect of a forward exchange contract or foreign currency option contract entered into to hedge the above loan, advance or debt is for the same reason not taken into account for tax purposes.[293]

Through a process of elimination, s 24I(11) only applies to foreign loans used to acquire the assets set out below, where the purchase consideration is denominated in foreign currency :

- immovable property situated outside South Africa,
- movable assets of a resident attributable to a permanent establishment situated outside South Africa,
- movable assets of a non-resident not attributable to a permanent establishment situated inside South Africa,

[292] Section 24I(11)(*a*).
[293] Section 24I(11)(*b*).

unless in the circumstances the proceeds on disposal of such assets would be from a true South African source. It is unlikely that a true South African source will arise in respect of any of the above transactions other than the sale of a non-residents' movable assets.

Chapter 20 - Foreign currency assets and liabilities

PART XIII

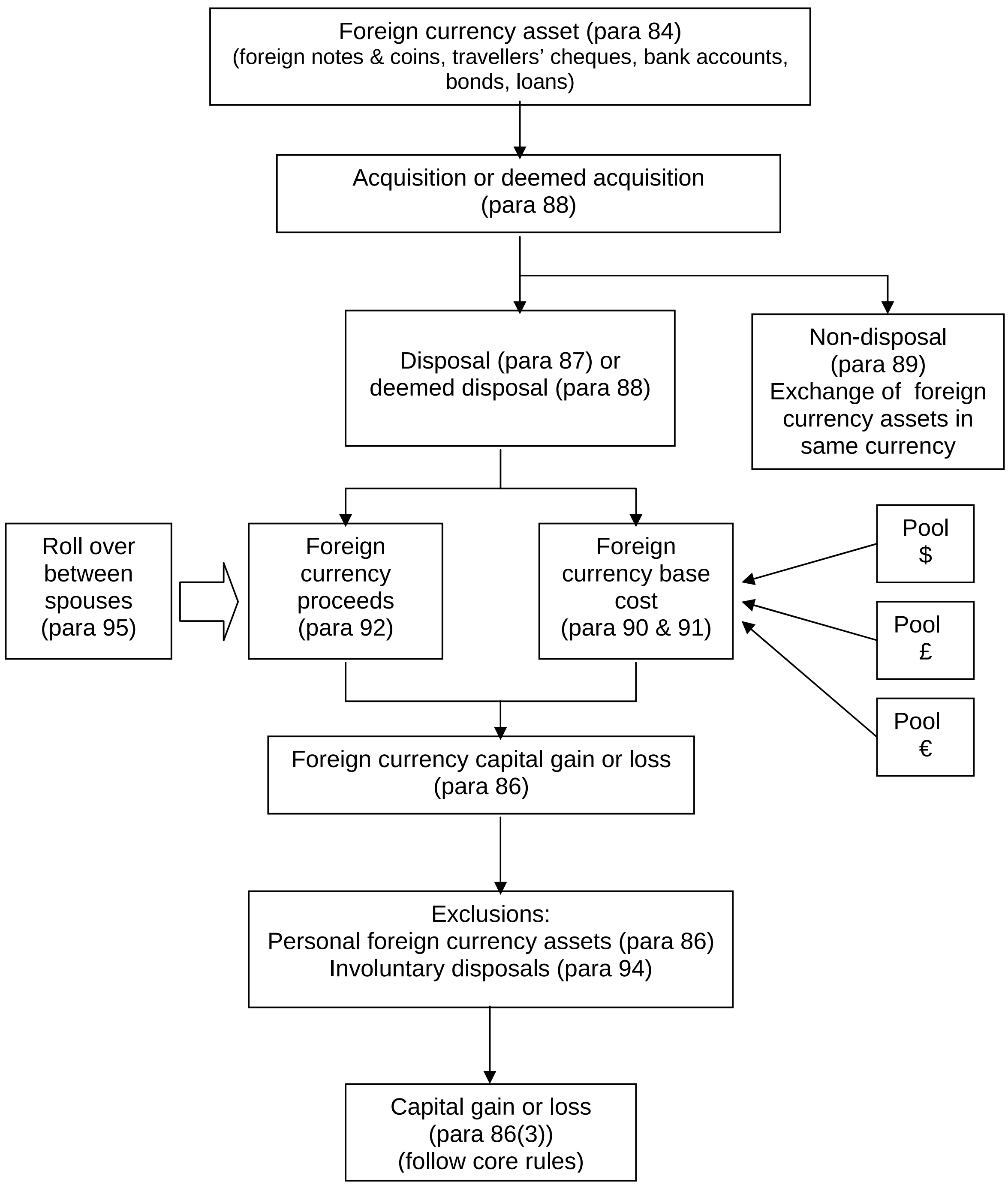
Part XIII of the Eighth Schedule contains separate rules for determining capital gains or losses arising from currency transactions. These rules are in addition to the rules for determining capital gains or losses on the disposition of assets within a foreign currency as contemplated under para 43.

Table 1 – Quick reference guide to foreign currency

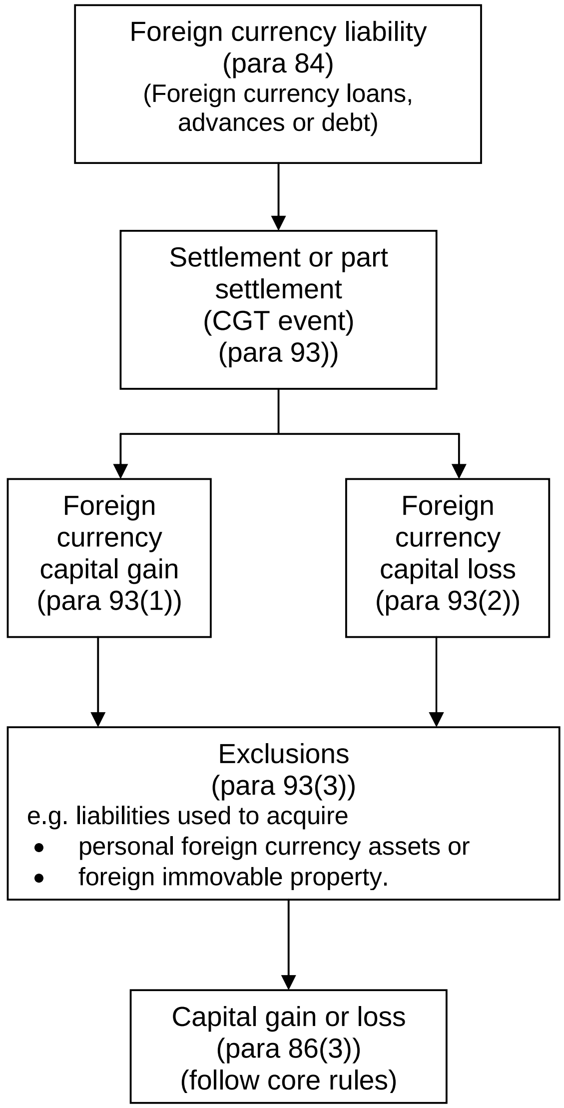
Para-graph	**Topic**	**Summary**
84	Definitions	• Foreign currency • Foreign currency asset • Foreign currency base cost • Foreign currency liability • Foreign currency proceeds • Personal expenses • Personal foreign currency asset • Valuation date
85	Application	Part XIII applies to disposal of foreign currency assets and settlement of foreign currency liabilities. It is not applicable where s 24I applies.
86	Foreign currency capital gain and foreign currency capital loss	Defines foreign currency capital gain and loss in relation to asset disposals and settlement of liabilities. Personal foreign currency asset gains and losses are excluded.
87	Disposal of foreign currency asset	Lists events that trigger a disposal of a foreign currency asset (e.g. sale, donation, vesting, etc)
88	Events treated as acquisition or disposal of foreign currency asset	*Deemed disposals* • Cessation of residence • S 24I becomes applicable to person • Foreign currency asset becomes personal foreign currency asset *Deemed acquisitions* • Pre-valuation date assets (1.3.2003/residence) • Part XIII becomes applicable to a person (not personal foreign currency assets) • Personal foreign currency asset becomes foreign currency asset
89	Exchange of foreign currency assets denominated in same foreign currency	No disposal or acquisition to extent one foreign currency asset exchanged for another in same foreign currency. N/A to personal foreign currency assets.
90	Foreign currency asset pool	Separate pools must be kept for each foreign currency. Personal foreign currency assets are excluded. Additions are translated into rands at the average exchange rate in the year of acquisition.
91	Foreign currency base cost of foreign currency asset	Base cost of disposals is equal to weighted average rand value of pool.
92	Foreign currency proceeds	Proceeds are translated to rands at the average exchange rate in the year of disposal. Amounts taxed

		outside Part XIII are excluded from proceeds.
93	Settlement of foreign currency liability	• Defines how a foreign currency capital gain or loss is determined upon settlement or part settlement of a foreign currency liability. • Specifies disregarded foreign currency capital gains and losses.
94	Involuntary disposal of foreign currency asset	Foreign currency capital gains and losses arising from expropriation, theft or physical loss are excluded.
95	Transfer of foreign currency assets between spouses	Provides roll-over relief for transfers between spouses
96	Application of provisions of Eighth Schedule	• Identifies paragraphs in the rest of the Eighth Schedule that apply to Part XIII. • Ascribes specific meanings to ‘market value’ and ‘base cost’.

Determination of foreign currency capital gain or loss in respect of disposal of foreign currency assets



Overview of foreign currency liabilities



20.1 Definitions

Paragraph 84

The following definitions apply for the purposes Part XIII, unless the context otherwise indicates:

> '**"foreign currency"** means any currency other than the currency of the Republic'.[294]

The word 'currency' refers to money in current circulation. Foreign currency therefore means foreign notes and coins in current circulation.

[294] The definition was amended by Act 45 of 2003 with effect from 22 December 2003. It previously referred to 'any currency which is not legal tender in the Republic'.

Excluded, for example, would be an old Roman gold coin. See in this regard the commentary on the definition of 'asset' in **4.1.2**.

> '**"foreign currency asset"** in relation to a person means any amount in foreign currency—
> (*a*) which constitutes a unit of foreign currency of that person; or
> (*b*) owing to that person in respect of any loan, advance or debt payable to that person'.

Examples of foreign currency assets:

- Foreign bank notes or coins e.g. US$ 100 in cash
- Any amount in a foreign bank account denominated in foreign currency (this is actually a loan to the bank and is not foreign currency)
- Travellers' cheques denominated in a foreign currency
- A dollar denominated loan owed to a person

Redeemable preference shares are not foreign currency assets as they have 'a completely different nature' to debt.[295]

> '**"foreign currency base cost"** means the base cost in respect of a foreign currency asset, as determined in accordance with paragraph 91'.

> '**"foreign currency liability"** means an amount in foreign currency owing by that person in respect of any loan, advance or debt incurred by that person'.

The Part XIII provisions also embrace foreign currency gains and losses arising from liabilities. This goes further than the normal CGT rules which impose the tax on assets only, with the exception of para 12(5). These rules are consistent with s 24I

> '**"foreign currency proceeds"** means the proceeds from the disposal of a foreign currency asset, as determined in accordance with paragraph 92'.

> '**"personal expenses"** of a person means any—
> (*a*) domestic or private expenses incurred outside the Republic in respect of foreign accommodation (excluding the acquisition of any immovable property) or foreign personal-use assets; or
> (*b*) traveling or maintenance expenses'.

Examples of (*a*) include hotel costs and rent incurred during the course of an overseas vacation. Excluded is the cost of acquiring a holiday home in a foreign country.

Also included in para (*a*) are foreign personal-use assets. This term is not defined, but the term 'personal-use asset' is defined in para 53(2) as

> 'an asset of a natural person or a special trust that is used mainly for purposes other than the carrying on of a trade'.

A number of assets used for non-trade purposes are, however, excluded as personal-use assets in terms of para 53(3), for example, gold or platinum coins (other than collectors' items), immovable property, certain large boats and aircraft, financial instruments, usufructs and long-term policies.

It is submitted that the term 'foreign personal-use asset' refers to personal-use assets acquired in a foreign country. Examples include the acquisition of a digital camera in Singapore, jewellery in Dubai, or the importation of a sports car from Italy. However, the importation of a 30-metre luxury yacht would be excluded.

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[295] Per Harms JA in *CIR v Datakor Engineering (Pty) Ltd* [1998] 4 All SA 414 (A), 60 SATC 503 at 509.

Examples of (*b*) include the cost of

- air, bus, taxi, rail or ship fares
- food, clothing, medicines, hospitalization, and maintenance payments in terms of a divorce settlement.

> '**"personal foreign currency asset"** means any foreign currency asset of a person which constitutes—
>
> (*a*) an amount which constitutes a unit of foreign currency in cash or cash equivalent, held primarily for the regular payment of personal expenses; or
>
> (*b*) any one account held in the relevant foreign currency with a banking institution from which funds can be immediately withdrawn, which account is used primarily for the regular payment of personal expenses'.

Purpose

The purpose of this provision is to prevent the triggering of disposals each time small amounts of a personal nature are expended. This provision was inserted mainly to reduce compliance costs for taxpayers. Having a qualifying bank account or cash and travellers' cheques means that the holder will not be subject to CGT on any currency gains or losses made in respect thereof.

Cash equivalent

The term 'cash equivalent' used in (*a*) would include travellers' cheques.

Regular payment of personal expenses

A question arises as to the meaning of the phrase 'regular payment of personal expenses' which appears in both (*a*) and (*b*). How regularly must the personal expenses be paid before the cash, cash equivalent or bank account will qualify as a personal foreign currency asset? In this regard 'regular' must be distinguished from 'occasional'. The *Shorter Oxford English Dictionary* contains various meanings for the word 'regular', but the most appropriate meaning, it is submitted, is the following:

> '3. Characterized by the presence or operation of a definite principle; marked by steadiness or uniformity of action, procedure, or occurrence 1594. b. Recurring or repeated at fixed times or uniform intervals 1756. c. Habitually or customarily used, received, observed, etc.; habitual, constant 1797.'

An example of a regular payment would be the monthly payment of rates and electricity in respect of a home in a foreign country.

Any qualifying bank account would probably have to be a current account because it must be possible to withdraw the funds without notice on a regular basis.

One bank account per currency

As regards (*b*), a person is allowed to select one bank account per foreign currency as a personal foreign currency asset. It is therefore possible that a person could hold two or more foreign currency bank accounts (e.g. a dollar account and a euro account) as personal foreign currency assets provided the requirements are met.

Primarily used for personal payments

The account must be used *primarily* for the payment of personal expenses. An account that is used primarily for business or investment transactions will not qualify as a personal foreign currency asset.

In deciding whether an account qualifies, regard must be had to the predominant usage of the account, which will entail an examination of both the volume and value of transactions. For example, an account that is used to make 10 payments of $10 each for personal purposes and 2 payments of $5 000 each for business purposes could hardly be said to be used primarily for the payment of personal expenses.

Example – Personal foreign currency asset

1. *Facts:* Shaun has two bank accounts with a London bank, a deposit account and a current account. The deposit account is not used except for the purpose of making occasional transfers to the current account. He only uses the current account to pay his annual subscription to a British cycling magazine of £40 and to buy the odd gift.

   Result: Neither bank account is a personal foreign currency asset since they are not used for the regular payment of personal expenses. Although the cycling magazine may be purchased on a regular annual basis, the view is held that the account must be regularly used during a year of assessment.

2. *Facts:* Shania also has two bank accounts in London, a deposit account and a current account. She uses the deposit account to transfer funds to her current account as and when required. The current account is used mainly to pay the monthly rent of her holiday home in Knightsbridge.

   Result: Since the deposit account is not used for the regular payment of personal expenses it is not a personal foreign currency asset. The current account is a personal foreign currency asset as it is used for the regular payment of personal expenses.

'**"valuation date"**' means—

(*a*) 1 March 2003; or

(*b*) where a person becomes a resident of the Republic after 1 March 2003, the date that such person becomes a resident'.

The importance of the valuation date is that currency gains and losses in respect of the period prior to 1 March 2003 are disregarded, despite the fact that CGT was introduced with effect from 1 October 2001. The reason for this is that Part XIII was only brought into law with effect from 13 December 2002, and it would not have been proper to impose CGT retrospectively on currency gains and losses while the law was not in place. In terms of para 88 a person is deemed to have acquired all their pre-valuation date assets on 1 March 2003.

Persons becoming resident after 1 March 2003

Persons who become resident after 1 March 2003 will have to value their foreign currency assets on the day on which they become resident. The purpose is to exclude pre-entry currency gains and losses incurred prior to the person taking up residence. Interestingly, this differs from para 12(4) read with para 13(1)(*g*)(i) which requires that such persons be treated as disposing of and reacquiring their assets on the day before taking up residence. The reason for the inconsistency is unclear. A person must be treated as having acquired the assets at the commencement of the day of arrival (one second after midnight).

20.2 Application

Paragraph 85

Part XIII applies in respect of the
- acquisition and disposal of any foreign currency asset, and
- settlement or part settlement of any foreign currency liability,

of a resident.

However, Part XIII does not apply to a resident to whom the provisions of s 24I apply in respect of any foreign currency asset of that person in the relevant foreign currency.

Section 24I applies[296] to any
- company,
- trust carrying on any trade,
- individual holding any amount contemplated in para (*a*) or (*b*) of the definition of “exchange item” as trading stock, and
- individual or trust in respect of any amount contemplated in para (*c*) or (*d*) of the definition of “exchange item”.

Once an individual falls within s 24I as a result of holding a qualifying exchange item as trading stock, that person is brought within s 24I in respect of all exchange items. This includes liabilities and amounts not held as trading stock.

An **‘exchange item’** as defined in s 24I (1) means an amount in a foreign currency

> ‘(*a*) which constitutes any unit of currency acquired and not disposed of by that person;
> (*b*) owing by or to that person in respect of a loan or advance or a debt incurred by or payable to such person;
> (*c*) owed by or to that person in respect of a forward exchange contract; or
> (*d*) where that person has the right or contingent obligation to buy or sell that amount in terms of a foreign currency option contract’.

Since para (*a*) and (*b*) of the above definition include all foreign currency assets and liabilities as defined, it follows that Part XIII will not apply to
- any company or trading trust, or
- an individual holding a unit of foreign currency, or a loan, advance or debt as trading stock.

Or put positively, Part XIII is applicable to:

Individuals
- holding foreign currency assets exclusively as capital assets or personal use assets, and/or
- having foreign currency liabilities.

Non-trading trusts
- holding foreign currency assets as capital assets, and/or
- having foreign currency liabilities.

[296] Section 24I(2).

Examples – Application

1. *Facts:* Hangord (Pty) Ltd owns a fixed property in London from which it derives rental income that it pays into a bank in Jersey.

   Result: Currency gains and losses must be dealt with in terms of s 24I, and not Part XIII.

2. *Facts:* The trustees of the Tomahawk Trading Trust, which was formed in South Africa, borrowed £100 000 from Franz Tomahawk, a resident of Jersey for the purpose of erecting a beer factory in South Africa,

   Result: Any currency gains or losses must be dealt with in terms of s 24I and not Part XIII.

3. *Facts:* The trustees of the A Makhatini Family Trust invested £10 000 in a one-year fixed deposit with the DroogEast Bank PLC in Scotland.

   Result: Any currency gains and losses must be determined in accordance with Part XIII.

4. *Facts:* Mathenga, a resident, went on holiday to Thailand, taking 40 000 Baht in travellers' cheques. He holds no other foreign currency assets or liabilities.

   Result: The transaction must be dealt with in terms of Part XIII and not s 24I.

5. *Facts:* Wayne, a resident has a business bank account in New York and a foreign mortgage bond with a French bank. He has no other foreign currency assets or liabilities.

   Result: All foreign currency assets and liabilities must be dealt with in terms of Part XIII and not s 24I.

6. *Facts:* Same facts as in 5. but Wayne acquires some United States treasury bonds as trading stock.

   Result: All Wayne's foreign currency assets and liabilities must now be dealt with in terms of s 24I and not Part XIII.

20.3 Foreign currency capital gain and foreign currency capital loss

Paragraph 86

This paragraph defines the terms
- foreign currency capital gain, and
- foreign currency capital loss.

Each term is defined in relation to the disposal of a foreign currency asset and the settlement or part settlement of a foreign currency liability, as per the table below.

Table 2 - Definition of foreign currency capital gain or loss (para 86)

Paragraph 86	Term	Context	Definition
(1)	Foreign currency capital gain	Disposal of foreign currency asset (other than a personal foreign currency asset)	Amount by which foreign currency proceeds exceed foreign currency base cost.
		Settlement or part settlement of any foreign currency liability	As determined in para 93(1).
(2)	Foreign currency capital loss	Disposal of foreign currency asset (other than a personal foreign currency asset)	Amount by which foreign currency base cost exceeds foreign currency proceeds.
		Settlement or part settlement of any foreign currency liability due by the person	As determined in para 93(2).

Amounts already taken into account in determining taxable income

Any part of the foreign currency proceeds or foreign currency base cost that has otherwise been taken into account in determining the taxable income of

- the person, or
- that person's spouse where the asset was acquired under the inter-spouse roll-over provisions of para 95,

must be excluded from the determination of the foreign currency capital gain or loss.

This could occur where the expenditure has been allowed as a deduction against ordinary income or the proceeds have been included in income or have been taken into account in determining a capital gain or capital loss during the current or any previous year of assessment.

The exclusion of personal foreign currency assets

Personal foreign currency assets (see definitions – para 84) are excluded from the determination of a foreign currency capital gain or loss, and are therefore not subject to CGT.

Equivalent of capital gain or loss (para 86(3))

A foreign currency capital gain or loss is treated as a capital gain or loss for the purpose of determining a person's aggregate capital gain or loss. In other words, one simply follows the core rules for determining a taxable capital gain or assessed capital loss.

Example – Determination of taxable capital gain of person with foreign currency capital gains and losses

Facts: Muriel disposed of a number of assets and foreign currency assets during the year ending 28 February 2006.

Result: Her taxable capital gain for the year was determined as follows:

	R
Capital gain on disposal of shares	100 000
Capital loss on disposal of second-hand policy	(40 000)
Foreign currency capital gain on closure and repatriation of funds in UK bank account to SA	20 000
Foreign currency capital loss on utilisation of US bank account to purchase machine	(15 000)
Sum of capital gains and losses	65 000
Annual exclusion	(10 000)
Aggregate capital gain / net capital gain	55 000
Inclusion rate	25%
Taxable capital gain	13 750

As can be seen, the foreign currency capital gain and loss are treated in the same way as an ordinary capital gain or loss.

20.4 Disposal of foreign currency asset

Paragraph 87

This paragraph sets out the events that trigger a disposal of a foreign currency asset. It would seem that the list of events is intended to be exhaustive, even though the provision uses the word 'includes'.[297] These provisions are similar to the core disposal rules in para 11. Note that they do not cover the settlement in whole or in part of a foreign currency liability, which is dealt with in terms of para 93. Death is not included as a disposal event in para 87, but is brought in by para 96 which makes para 40 applicable in determining a foreign currency capital gain or loss.

Table 3 - Disposal events

Paragraph 87	Disposal event in relation to foreign currency asset
(*a*)	Conversion, sale, donation, expropriation, cession, exchange or any alienation or transfer.
(*b*)	Forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry, abandonment or loss.
(*c*)	Vesting of any foreign currency asset of a trust in a beneficiary of that trust.

20.5 Events treated as acquisition or disposal of foreign currency asset

Paragraph 88

This paragraph contains a number of deeming provisions that either trigger a disposal or an acquisition of a foreign currency asset. In the notes that follow, these disposal and acquisition events are examined separately. Although para 88 identifies the relevant events and their timing, it is silent as to the value at which the foreign currency asset is deemed to be disposed of or acquired. Assets must be regarded as having been disposed of or acquired at market value, which is consistent with the equivalent provision contained in para 12.

[297] See *Estate Brownstein v CIR*
1957 (3) SA 512 (A), 21 SATC 262 where it was held that the word 'includes' can also be used in an exhaustive sense.

Deemed disposals (para 88(2), (3) & (5))

The table below sets out the events that are treated as disposals of foreign currency assets (other than personal foreign currency assets).

Table 4 – Events treated as disposals – para 88

Paragraph 88	**Event treated as disposal of foreign currency asset**	**Date of deemed disposal**
(2)	Person ceases to be resident.	Immediately[298] before ceasing to be resident.
(3)	Section 24I becomes applicable to a person in respect of a foreign currency asset.	Immediately before s 24I becomes applicable
(5)	Foreign currency asset becomes a personal foreign currency asset.	Date foreign currency asset commences to be held as personal foreign currency asset

Persons ceasing to be resident (para 88(2))

The word ‘resident’ is defined in s 1.
Individuals cease to be resident when they

- cease to be ordinarily resident, or
- are not ordinarily resident, and cease to be physically present in South Africa for the number of days specified in the definition of a resident’.

Trusts cease to be resident when

- they are not established or formed in SA, and
- their place of effective management changes to a country outside South Africa.

DTA’s have rules on residence which in certain circumstances override domestic law. A person may therefore be resident under domestic law but non-resident for DTA purposes. The definition of ‘resident’ therefore excludes

> ‘any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation’.

A person will therefore cease to be a resident when the DTA determines that that person is no longer a resident. This could result in an earlier cessation of residence than would otherwise have been the case.

Example – Individual ceasing to be resident as a result of the application of a double tax treaty

Facts: On 1 March 2003 Jim, a resident, placed $100 000 on interest-bearing deposit with the Bank of New York. Some years earlier Jim had won a green card in a US green card lottery and had applied for US citizenship. On 30 June 2005 Jim became a US citizen. He proceeded to purchase a house in Sparta, Tennessee and his family left South Africa and moved into the house. Because of his business interests Jim continued to spend more than 91 days a year in South Africa.

[298] The word ‘immediately’ was inserted by s 119 of Act 45 of 2003, effective 22 December 2003.

Result: In terms of the physical presence test in the definition of 'resident' in s 1 he therefore remained a South African resident, despite the fact that he had ceased to be ordinarily resident. Since the US taxes its citizens on their worldwide income, Jim also became a US resident under US tax law. The dual residence conflict is, however, resolved by Article 4(1)(*b*) of the US-SA double tax treaty. It defines a resident of SA as one who is ordinarily resident' in SA. Since SA's physical presence test is ignored for the purpose of the DTA, SA lost its right to tax Jim on any foreign currency capital gains or losses on or after the date on which he ceased to be ordinarily resident, and not on the later date when he ceased to be physically present. His New York bank account will therefore be deemed to be disposed of in terms of para 88(2) when he ceased to be ordinarily resident.

Section 24I becomes applicable to a person (para 88(3))

Once an individual falls into s 24I by, for example, holding a foreign currency asset as trading stock, that person falls outside Part XIII in respect of all foreign currency assets and liabilities and is subject to tax on foreign currency gains and losses as ordinary income. Any unrealized foreign currency capital gains and losses up to and including the day before s 24I becomes effective are taxed under Part XIII.

Example – Section 24I becoming applicable to a person

Facts: Wendy held US treasury stock as a long-term investment up to 30 September 2005. On 1 October 2005 she converted the investment to trading stock by commencing business as a bond trader.

Result: Any unrealized foreign currency capital gain or loss on her investment up to 30 September 2005 will be subject to CGT under Part XIII. Thereafter any foreign currency gains and losses will be taxed as ordinary income under s 24I.

Foreign currency asset becomes a personal foreign currency asset (para 88(5))

When a foreign currency asset becomes a personal foreign currency asset it is necessary to trigger a disposal, otherwise any unrealized foreign currency capital gain or loss up to the date of change in usage would escape CGT. The reason for this is that foreign currency capital gains and losses on personal foreign currency assets are excluded from CGT since they fall outside the definitions of foreign currency capital gain or loss in para 86.

Example – Foreign currency asset becoming personal foreign currency asset

Facts: Up to 31 January 2005 Jed had used his foreign bank account exclusively for business purposes. However, on that date his offshore business closed and he began using the account for private purposes on 1 February 2005.

Result: Jed will be subject to CGT on any unrealized foreign currency capital gain or loss on the account one second after midnight on 31 January 2005.

Deemed acquisitions (para 88(1), (4) and (6))

Table 5 – Events treated as acquisitions

Paragraph 88	**Event treated as acquisition**	**Date of deemed acquisition**
(1)	All foreign currency assets not disposed of before valuation date (other than personal foreign currency assets)	• 1 March 2003 - foreign currency assets held and not disposed of on that date.[299] • After 1 March 2003, date person becomes a resident.
(4)	Part XIII becomes applicable to a person (other than personal foreign currency assets)	Immediately before Part XIII became applicable.
(6)	A personal foreign currency asset becomes a foreign currency asset	Date person ceases to hold a foreign currency asset as a personal foreign currency asset.

Deemed acquisition of pre-valuation date foreign currency assets (para 88(1))

In terms of para 88(1) a person is treated as having acquired all his or her pre-valuation date foreign currency assets (other than personal foreign currency assets) on valuation date (1 March 2003). The term 'valuation date' is defined in para 84 and has a dual meaning. In the case of a person who

- was a resident on 1 March 2003, it means that date, and
- becomes a resident after 1 March 2003, it means the date that person became a resident.

The purpose of para 88(1) is to exclude unrealized currency gains and losses that arose prior to the commencement of Part XIII, or in the case of a person who becomes a resident, to exclude unrealized currency gains and losses that arose whilst the person was resident abroad.

Personal foreign currency assets are excluded from the deemed acquisition rule on valuation date because currency gains and losses in respect of these assets are excluded from CGT.

The deemed acquisition rule is intended only to apply for the purpose of determining the base cost of the foreign currency asset pool (see para 90) and not for the purpose of the Act as a whole. The rule must be read in the context of Part XIII.

Deemed acquisition on Part XIII becoming applicable (para 88(4))

An example of a deemed acquisition under para 88(4) would be where an individual holding a loan as trading stock converts it to a long-term investment. This may be a somewhat unlikely scenario, for as noted by Centlivres CJ in *CIR v Richmond Estates (Pty) Ltd*[300]

> 'it may be as difficult to change from a trader to an investor for taxation purposes "as it is for a rope to pass through the eye of a needle" (*Gunn's Commonwealth Income Tax*, 4th ed., sec 583).'

[299] Paragraph 88(1) amended with effect from 22 December 2003 by Act 45 of 2003. The amendment was of a textual nature.
[300] 1956 (1) SA 602 (A), 20 SATC 355 at 361.

Immediately prior to this deemed acquisition an amount would have been included in the individual's income in terms of s 22(8)(*b*)(v) (deemed disposal of trading stock at market value) and in terms of s 24I(12)(*b*) (deemed realization of exchange item).

Deemed acquisition when personal foreign currency asset becomes foreign currency asset (para 88(6))

An example of an acquisition under para 88(6) would be where a foreign bank account that was previously used for private purposes commences to be used for business purposes. In this situation there is no preceding disposal because the asset would have previously fallen outside the CGT net. It is therefore only necessary to establish a base cost for the foreign currency asset.

20.6 Exchange of foreign currency assets denominated in same foreign currency

Paragraph 89

Where one foreign currency asset is exchanged for another, there is no disposal or acquisition provided that

- both assets are denominated in the same foreign currency,
- in the case of a disposal, the value in foreign currency surrendered does not exceed the value in foreign currency acquired, and
- in the case of an acquisition, the value in foreign currency acquired does not exceed the value in foreign currency surrendered.

To the extent that the values are exceeded, a disposal or acquisition will occur.

In effect this amounts to a tax-free roll-over. Were it not for this provision, simple transactions such as the transfer of an amount from a foreign current account to a call account within the same bank in the same currency would have triggered disposals and acquisitions. This would have been administratively burdensome.

Example – Exchange of one foreign currency asset for another: amount surrendered equal to amount acquired

Facts: Debbie withdrew £100 from her business current account with the Natwest PLC bank and placed it with the Midlands PLC bank on 32-day call.

Result: The withdrawal will not constitute a disposal and the deposit will not constitute an acquisition.

Example – Value of foreign currency asset surrendered exceeds value of foreign currency asset acquired

Facts: Janette withdrew $1 000 from her Wells Fargo bank account. She used $700 to purchase a US treasury bond, $200 to acquire 100 shares in Jumping Juniper Inc, a company listed on the NYSE, and $100 to purchase a Bank of England bond for £70.

Result: The withdrawal of $700 is not a disposal since the same amount was used to purchase a foreign currency asset denominated in the same foreign currency. However, the withdrawal of $300 will constitute a disposal of her US bank account because

- $200 was used to purchase an asset that does not constitute a foreign currency asset, and
- the Bank of England bond was not denominated in the same foreign currency.

The treasury bond of $700 is treated as not having been acquired, whilst the purchase of the shares and Bank of England bond will constitute acquisitions.

Example – Value of foreign currency asset acquired exceeds value of foreign currency asset surrendered

Facts: Dheveni withdrew £100 from her business account with the Abbey National Building Society, which she used towards the purchase of a Bank of England bond costing £120. The remaining £20 was financed by a loan from the Natwest Bank.

Result: The withdrawal of the £100 will not constitute a disposal of her Abbey National account, and £100 of the purchase price of the bond will not constitute an acquisition of that bond. However, the remaining £20 of the purchase price of the bond will constitute an acquisition of that bond.

The tax-free roll-over treatment does not apply where either the asset surrendered or the asset acquired are personal foreign currency assets (para 89(2)).

Example – Exchange of foreign currency assets where one asset is a personal foreign currency asset (para 89(2))

1. *Facts:* Shanitha withdrew £100 from her personal use current account in the Isle of Man and placed it on fixed deposit for five years with the same bank.

   Result: The withdrawal constitutes a disposal under para 87, although it does not give rise to a foreign currency capital gain or loss in terms of para 86. The placing of the £100 on fixed deposit is an acquisition for the purposes of Part XIII.

2. *Facts:* Assume the same facts as in 1. above. When Shanitha's fixed deposit matured, she used the proceeds to acquire travellers' cheques that she used during her holiday to England.

   Result: The exchange of the fixed deposit for the travellers' cheques is a disposal, since the travellers' cheques are a personal foreign currency asset. The purchase of the travellers' cheques constitutes an acquisition, though any foreign currency capital gain or loss arising from their disposal will be excluded by para 86.

20.7 Foreign currency asset pool

Paragraph 90

In terms of para 90(1) a separate currency pool must be maintained for each currency in which a person's foreign currency assets are denominated. For example, assets acquired in dollars must be added to the dollar pool, whilst assets acquired in pounds must be added to the pound pool.

Additions to a pool

Assets acquired that must be added to the pool consist of
- Pre-1 March 2003 foreign currency assets
- Foreign currency assets acquired on or after 1 March 2003
- Interest deemed to have accrued on a foreign currency asset under the Act (e.g. s 24J).

It would appear that the reference to deemed accrued interest only applies to interest that has accrued on or after the valuation date. Interest accrued prior to that date would be reflected in the market value of the asset. Interest received that is accumulated, for example, in a bank account, must be added at face value. The amount so accumulated represents the acquisition of an asset, namely, the right to claim payment of the amount from the bank.

Personal foreign currency assets held on 1 March 2003 or acquired thereafter are not added to the pool, since gains and losses on these assets are excluded from CGT under para 86.

Pre-valuation date assets must be added to the pool at market value (see commentary on para 88(1) above).

Disposals from a pool

The foreign currency amounts in the pool must be reduced by disposals of foreign currency assets that take place on or after 1 March 2003.

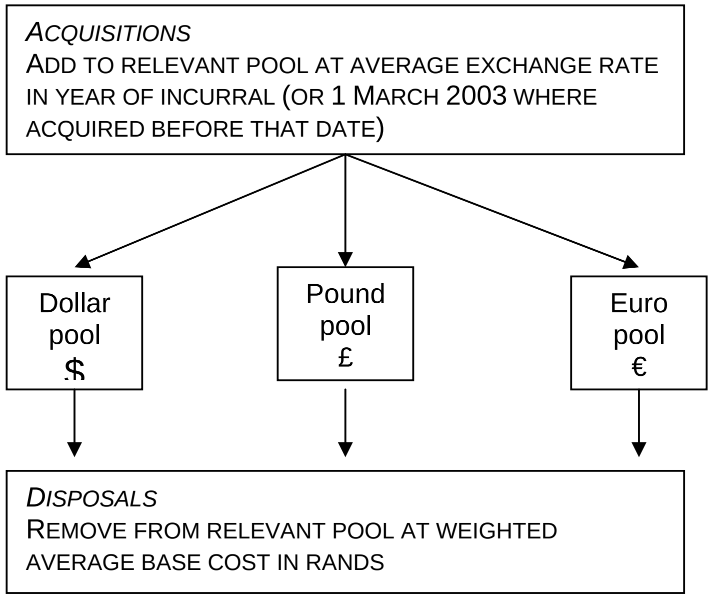
Determination of total asset pool base cost

Foreign currency amounts added to the pool must be converted into rands at the average exchange rate prevailing in the year of acquisition. The identification of the applicable average exchange rate is subject to para 95 (roll-over between spouses) and para 96 (application of core provisions to Part XIII). For example, under para 95 the transferee spouse takes over the date of acquisition from the transferor spouse.
Two separate totals are then determined, namely, the

- foreign currency total, and
- rand total.

When an asset is disposed of these two totals must be reduced. The foreign currency total is reduced by the amount in foreign currency disposed of. The rand total is reduced by the weighted average base cost of the asset disposed of as determined under para 91.

Foreign currency asset pools



Example – Maintenance of separate foreign currency asset pools

Facts: George held the following foreign currency assets on 1 March 2003:

	$	£
Business current account	100 000	
Personal current account	10 000	
US Treasury bonds	15 000*	
Fixed deposit		20 000
Loan to UK company		12 000

* Market value on 1 March 2003.

Result: George must maintain two separate asset pools, one in US dollars and the other in sterling. The dollar denominated personal current account will not form part of the dollar asset pool, since it is a personal foreign currency asset (excluded by para 90(1)(*a*)).

In terms of para 88(1) George is treated as having acquired all his pre-1 March 2003 foreign currency assets (other than personal foreign currency assets) on 1 March 2003. This means that a total of $115 000 must be added to the dollar pool and £32 000 to the pound pool on 1 March 2003. Acquisitions during the year of assessment ending 29 February 2004 must be translated to rand at the average exchange rate applicable during that year (para 90(2)).

It is assumed that the average exchange rates for the years ending 29 February 2004 and 28 February 2005 were as follows

2004	2005
R8 = $1	R9 = $1
R12 = £1	R13 = £1

During the years ending 29 February 2004 and 28 February 2005 the following transactions took place in the dollar pool:

2004	2005

	$	$
Interest earned on treasury bonds	150	160
Amount withdrawn to pay business rent	1 000	-
Purchase of treasury bonds	-	130 000

Determine the weighted average rand value of the dollar asset pool for each of the 2004 and 2005 years of assessment.

Date	Transaction	$	Average exchange rate	R
01.03.03	Business current account	100 000	8	800 000
01.03.03	Treasury bonds	15 000	8	120 000
28.02.04	Interest	150	8	1 200
28.02.04	Rent paid	-1 000	8	-8 000
28.02.04	Total	114 150	8	913 200
28.02.05	Interest	160	9	1 440
28.02.05	Treasury bonds	130 000	9	1 170 000
28.02.05	Total asset pool base cost	244 310	8.532766	2 084 640

20.8 Foreign currency base cost of foreign currency asset

Paragraph 91

This paragraph sets how to determine the base cost in rands of a foreign currency asset disposed of by a person. Expressed as a formula the base cost of a foreign currency asset is equal to

$$\text{Total asset pool base cost in rands before disposal (para 90(2))} \times \frac{\text{Value in foreign currency of foreign currency asset disposed of}}{\text{Total value in foreign currency of relevant foreign currency asset pool (para 90(1))}}$$

In the case of non-growth assets such as bank accounts, it is unlikely that any foreign currency capital gains or losses will emerge during the year ending 29 February 2004. The reason for this is that the base cost and the proceeds from any disposals during this first year of implementation of Part XIII will be translated at the same average rate of exchange.

Example – Determination of weighted average base cost

Facts: Assume the same facts as in the example under para 90. In the 2006 tax year George disposes of the treasury bonds that he held on valuation date for proceeds of $16 000. Determine the base cost of these bonds.

Result: The bonds were added to the pool at market value on 1 March 2003 of $15 000. Therefore the base cost is 15 000/244 310 x 2 084 640 = R127 991. Or put differently, $15 000 x 8.532766 = R127 991.

20.9 Foreign currency proceeds

Paragraph 92

Proceeds in respect of the disposal of a foreign currency asset are determined by translating the value in foreign currency of the asset into rands at the average exchange rate in the year of disposal. The amount so arrived at must then be

- reduced by any capital gain that was included therein, and
- increased by any capital loss,

determined outside Part XIII and relating to the disposal of that foreign currency asset.

The term 'value in foreign currency' refers to the currency of disposal. Where the currency of disposal is rands, the rand amount must be translated back to the foreign currency of expenditure at the spot rate, and then that foreign currency amount must be retranslated into rands at the average exchange rate.

The adjustment of the proceeds by the amount of any capital gain or loss determined outside Part XIII refers, for example, to a euro bond purchased in euros

The term 'average exchange rate' is defined in s 1 and discussed at length under the commentary on para 43.

The above rules are subject to para 95 (roll-over between spouses) and 96 (application of core CGT provisions to Part XIII)

Example – Determination of proceeds

Facts: Rhoda acquired a US treasury bond at a price of $83.33 on 1 January 2004 when the face value was $100 with a coupon rate of 5%. The prevailing interest rate at the time was 6%. Interest is payable annually on 31 December.

The average exchange rate when the bond was purchased was R8 = $1.

On 1 January 2007 she disposed of the bond for a consideration of $125. The increased price was due to the fact that prevailing interest rates had fallen to 4% at the time.

The average exchange rate in the year of disposal was R12 = $1.
Determine the proceeds on disposal in terms of para 92.

Result: The bond was acquired for $83.33 when the interest rate was 6%. Interest of $5 (6% x $83,33) was received on 31 December 2004, 2005, 2006 and 2007 and was included in income under the gross income definition read with s 24J. In terms of para 35(3)(*a*) the interest is excluded from proceeds in determining the dollar gain under para 43(1). The bond was sold for $125. In terms of para 43(1) the capital gain is $125 – 83.33 = 41.67 x R12 = R500,04.

The treasury bond is a foreign currency capital asset. The proceeds for purposes of para 92 are determined as follows:

		R
Amount received	$125 x R12	1 500,00
Less: capital gain determined under para 43(1)		500,04
Proceeds – para 92		999,96

Note

1. The overall return on a foreign bond consists of three components:

- Interest determined under s 24J,
- The dollar gain determined under para 43(1) and Part XIII,

- The currency gain on the original investment, determined under Part XIII.

Paragraph 92 removes the double taxation in respect of the dollar gain.

2 This example has been simplified by ensuring that the interest was taken out of the purchase price and selling price. If the instrument had been purchased, say on 30 June 2004 the yield to maturity method under s 24J would have had to be applied to determine the accrued interest.

20.10 Settlement of foreign currency liability

Paragraph 93

This paragraph sets out the rules for determining the foreign currency capital gain or loss where a foreign currency liability has been settled or part settled. These rules operate independently from those relating to the disposal of foreign currency assets. Whether or not a foreign currency capital gain or loss arising from settlement or part settlement of a liability must be disregarded depends on the type of asset that was funded by that liability. As will be seen, the scope of this provision goes beyond liabilities used to fund foreign currency assets as defined in para 84. It also addresses para 43 assets.

The table below summarises in formula form the lengthier verbal definitions in para 93(1) and (2) of 'foreign currency capital gain' and 'foreign currency capital loss' in the context of the settlement or part settlement of a foreign currency liability.

Table 6 – Settlement or part settlement of foreign currency liability - determination of foreign currency capital gain and loss

Paragraph 93	**Term**	**How determined**
(1)	Foreign currency capital gain	F x (Ri - Rs) where Ri > Rs
(2)	Foreign currency capital loss	F x (Rs - Ri) where Rs > Ri
Where F = Foreign currency amount settled or part settled. Ri = Average exchange rate in rands in year liability incurred. Rs = Average exchange rate in rands in year liability settled.		

Example – Determination of foreign currency capital gain or loss when foreign currency liability settled or part settled

Facts: Steve borrowed £100 000 from the Northlands Bank PLC to purchase a Bank of England bond when the average exchange rate was R10 = £1. After two years he repaid £10 000 when the average exchange rate was R15 = £1.

Result: His foreign currency capital loss on the part settlement of the loan is £10 000 x (R15 – 10) = R50 000.

Disregarded foreign currency capital gains and losses arising from settlement or part settlement of foreign currency liabilities (para 93(3))

Paragraph 93(3) sets out those foreign currency gains and losses that must be disregarded. It does this by exception by listing those foreign currency capital gains and losses that must be accounted for (see table below). Anything not on that list must be disregarded.

Table 7 – Foreign currency capital gains and losses that must be accounted for

Paragraph 93(3)	**How foreign currency liability used**
(*a*)	To acquire any right in terms of a • forward exchange contract, or • foreign currency option contract.
(*b*)	To acquire any foreign currency asset other than a personal foreign currency asset.
(*c*)	To acquire any • foreign equity instrument, or • any asset in local currency ito para 43(4).
(*d*)	To refinance any foreign currency liability which was utilised to acquire any asset in item (*a*), (*b*) or (*c*), which was not disposed of during any previous year of assessment.

Foreign currency capital gains or losses arising from a liability incurred for a purpose other than those listed above must be disregarded. These include, for example, foreign currency capital gains and losses arising from the

- settlement of a liability used to acquire a personal foreign currency asset, or
- settlement of a liability used to acquire an immovable property in a foreign country,
- refinancing of a liability used to purchase any asset in item (*a*), (*b*) or (*c*) where the asset was disposed of in a previous year.

The purpose of taking account of gains and losses on liabilities used to finance the acquisition of assets such as foreign equity instruments is to ensure symmetry with the treatment of the currency gain or loss derived from the asset. For example, in the case of a foreign equity instrument, the full currency gain is subject to CGT (proceeds translated at average rate in year of disposal and base cost at average rate in year of incurral). If the instrument is funded by a foreign liability, any currency gains on the asset side are mirrored by losses on the liability side.

Example – Reason for accounting for currency gain and loss in respect of asset and its related liability

Facts: Susan purchased a foreign share for \$100 when the average exchange rate was R5 = \$1 and sold it for \$100 when the average exchange rate was R10 = \$1. The share was purchased with a \$100 loan that was repaid when the share was sold.

Result:

Currency gain on asset: \$100 x R10 – 5 = R500 (para 43(4))
Currency loss on liability: \$100 x R5 – 10 = - R500 (para 93)
Overall currency gain / loss = RNil.
By recognising the currency gain and loss from both the asset and the liability Susan is left in a tax neutral position.

The reason for excluding assets such as those in para 43(1) and (2) and personal foreign currency assets is that the currency gain or loss on the base cost is not brought to account.

Example – Reason for not accounting for foreign currency capital gain or loss on settlement of liabilities used to finance certain assets

Facts: Lorna purchased an apartment in New York for $100 000 when the average exchange rate was R5 = $1 and sold it for $100 000 when the average exchange rate was R10 = $1. The apartment was purchased with a $100 000 bond which was repaid when the apartment was sold.

Result: There is no gain or loss under para 43(1) ($100 000 - $100 000) x R10 = RNil. It would therefore make no sense to allow a loss on settlement of the liability.

Time of incurral rule in respect of pre-valuation date foreign currency liabilities (para 93(4))

Pre-valuation date foreign currency liabilities are deemed for the purposes of para 93 to have been incurred on valuation date as defined in para 84. This ensures that unrealized foreign currency gains and losses incurred before the valuation date are not subject to CGT.[301]

20.11 Involuntary disposal of foreign currency asset

Paragraph 94

A person must disregard any foreign currency capital gain or loss determined in respect of an involuntary disposal of any foreign currency asset by way of
- expropriation,
- theft or
- physical loss.

This provision differs markedly from the equivalent provision in the core rules (para 65). Unlike para 65 which grants deferral relief in respect of capital gains, this provision disregards both gains and losses. The provision protects the *fiscus* for example, against claims for the loss of foreign banknotes. This is consistent with the treatment of South African currency, which is excluded from the definition of 'asset' in para 1.

Example – Disregarding of loss of foreign currency asset

Facts: Andrew was on business in London and drew £100 from his business current account with the UK bank for the purpose of defraying certain business expenses. The base cost of the amount withdrawn when converted at the weighted average exchange rate of his asset pool was R10 = £1. A pickpocket stole his wallet in Soho resulting in the loss of the £100. The average exchange rate in the year of disposal was R11 = £1. Determine Andrew's gains and losses for CGT purposes.

Result: Foreign currency is not an asset under the core rules, so para 43(1) does not apply. Andrew has suffered a currency loss as follows:
Proceeds Nil
Base cost £100 x 10 = R1 000
However, in terms of para 94 Andrew must disregard the currency loss of R1 000.

[301] Paragraph 93(4) inserted by s 119 of Act 45 of 2003, effective 22 December 2003.

20.12 Transfer of foreign currency assets between spouses

Paragraph 95

This provision provides roll-over relief to spouses where a person disposes of a foreign currency asset to his or her spouse. The transferor spouse is treated as having disposed of the foreign currency asset for proceeds equal to the foreign currency base cost of the asset, resulting in no gain, no loss. The transferee spouse is treated as having acquired the asset at that same base cost in rands.

Example – Roll-over between spouses

Facts: Jack and Jill are married out of community of property. On 1 July 2005 Jack held $10 000 in a 32-day notice account with the Bank of New York. The weighted average rand value of his asset pool was R8 = $1 immediately before the transaction. On the same date he transferred $5 000 to his wife who placed the funds in a 12-month fixed deposit with the same bank. Interest of $100 accrued on maturity. On maturity Jill immediately transferred the capital back to South Africa when the average exchange rate was R10 = $1. She placed the accrued interest of $100 on 32-day call with the Bank of Chicago.

Result: The CGT consequences for Jack and Jill are as follows:

Jack

Jack is deemed to have disposed of the $5 000 at the base cost of R40 000. He will make no gain no loss.

Jill

Jill is treated as having acquired the $5 000 at Jack's base cost of R40 000. The $100 interest is added to her base cost pool at R10 = $1, namely, R1 000. The weighted average base cost of her asset pool is determined as follows:

$	R = $1	R
5 000	8	40 000
100	10	1 000
5 100	8.03922	41 000

Weighted average base cost = R41 000/$5 100 = R8,03922

On remitting the funds to South Africa, she will realize a capital gain as follows:

		R
Proceeds	$5 000 x 10	50 000
Base cost	$5 000 x R8.03922	40 196
Foreign currency capital gain		9 804

20.13 Application of provisions of Eighth Schedule

Paragraph 96

Core rules applicable to Part XIII (para 96(1)

Certain core rules, set out in the table below, apply equally in determining a foreign currency capital gain or loss from the disposal of a foreign currency asset.

Table 8 – Provisions of Eighth Schedule applicable to determining foreign currency capital gain or loss

Paragraph	Description
11(2)(*a*)	Non-disposal - transfer of asset as security for debt
11(2)(*e*)	Non-disposal – distribution of trust asset to beneficiary to extent he/she has vested right
11(2) (*i*)	Non-disposal – asset of person vesting in Master as a result of sequestration of spouse
12(1)	Events treated as disposals and acquisitions
12(2)(*a*)	Person ceasing to be resident
13	Time of disposal
14	Disposal by spouse married in COP
36	Disposal of partnership asset
38	Disposal by way of donation, consideration not measurable in money and transactions between connected persons not at an arm's length price
39	Capital losses determined in respect of disposals to certain connected persons
40	Disposal to and from deceased estate
56	Disposal by creditor of debt owed by connected person
62	Donations and bequests to public benefit organisations
63	Exempt persons
68	Attribution of capital gain to spouse
69	Attribution of capital gain to parent of minor child
70	Attribution of capital gain subject to conditional vesting
71	Attribution of capital gain subject to revocable vesting
72	Attribution of capital gain vesting in non-resident
73	Attribution of income and capital gain
80	Capital gain attributed to beneficiary
82	Death of beneficiary of special trust
83	Insolvent estate of person

Meanings assigned to certain words used in the core rules (para 96(2))

The following terms used in the above core rules have been assigned specific meanings in the context of Part XIII:

Table 9 – Core terms having special meaning in Part XIII

Term used in core rules	Meaning in Part XIII
Market value	The value in foreign currency translated to rand at the average exchange rate for the year of assessment
Base cost	Foreign currency base cost

Effective date

Part XIII came into operation on 1 March 2003 and applies in respect of years of assessment commencing on of after that date. For example, Part XIII will apply in the case of an individual or a non-trading trust, to the year ending 29 February 2004 and later years.

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Chapter 21 - Anti-avoidance measures

21.1 Section 103(1)

The provisions of s 103(1) may be applied to a capital gain where the requirements of the section are met.

21.2 Section 103(2)

The assessed loss anti-avoidance provisions of s 103(2) have been extended to deal with the utilisation of an assessed loss, capital loss or assessed capital loss against a 'tainted' capital gain. The section deals with such capital gains in much the same way as the existing law deals with tainted income that has been sought to be set off against an assessed loss. The set-off of the offending capital gain is disregarded, meaning in effect that the assessed loss, capital loss or assessed capital loss is ring-fenced and only available for set-off against untainted capital gains.

Example 1 – How a tainted capital gain can arise

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

Result: The company was informed by SARS that the gain was tainted in terms of s 103(2) as it was part of a scheme to utilise the assessed capital loss.

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

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

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

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

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

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

Result: Taxable capital gain = R100 000 + R150 000 = R250 000 x 50% = R125 000

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

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

$$= \frac{100\,000}{250\,000} \times 125\,000$$

$$= \text{R}50\,000$$

Therefore assessed loss = R200 000 – (125 000 – 50 000) = R125 000

Two assessments will be issued, one reflecting a taxable income of R50 000 and the other an assessed loss of R125 000.

Section 103(4), which imposes a presumption of a tax avoidance purpose on a taxpayer unless the contrary is proven, has been amended to include a reference to a capital loss or assessed capital loss.

21.3 Value shifting

Value shifting - relevant provisions

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

Table 1 – Value shifting provisions

Paragraph	Purpose
1	Defines a ***'****value shifting arrangement****'***
11(1)(*g*)	Deems there to be a disposal when there is a decrease in the interest of a person in a company, partnership or trust as a result of a value shifting arrangement.
13(1)(*f*)	Fixes the time of disposal as the date on which the value of the person's interest decreases.
20(1)(*h*)(iv)	Provides that the base cost of the asset must be determined in terms of para 23
23(*a*)	Specifies the formula to be used to determine ***base cost*** in the hands of the person whose interests have decreased.
23(*b*)	Provides how ***base cost*** is to be determined in the hands of the beneficiary of the value shifting arrangement.
35(2)	States how ***proceeds*** are to be determined.

These measures are restricted to arrangements between connected persons so as to exclude *bona fide* commercial transactions.

What is value shifting?

Value shifting involves the effective transfer of value from one entity to another without constituting an ordinary disposal for CGT purposes.

Why have value shifting legislation?

Without specific rules, entities could manipulate the value of assets in order to obtain a CGT benefit.

Do other countries have such legislation?

Value shifting anti-avoidance provisions are, for example, contained in the Australian[302] and United Kingdom[303] tax legislation. In both countries the primary focus is on shares, though land transactions are also addressed. The provisions in the Eighth Schedule are somewhat different from those found in other jurisdictions as the core rules and South African common law deal with certain cases that must be dealt with specifically in other jurisdictions. The donations tax and STC implications should not be lost sight of when considering a value shifting arrangement.

Where is value shifting most prevalent?

It is found typically between connected persons, for example:

- between parents and their children
- within groups of companies

What are some examples of value shifting?

- Issue of shares at a discount
- Variation of rights attaching to shares or interests in land (e.g. manipulating voting or dividend rights)
- Buying back of shares at below market value

Example – Value shifting by issuing shares at a discount

Facts: Bongo is the sole shareholder of Why (Pty) Ltd in which he holds 2 shares of R1 each. The retained income in the company amounts to R99 998. The market value of the shares on 1 October 2005 is R100 000. The base cost of Bongo's 2 shares on valuation date is R50 000. On 1 October 2005, Why (Pty) Ltd issues a further share of R1 to Bongo's daughter, Cynthia, at a cost of R1.

Result: The position may be summarised as follows:

	Before R	After R
Share Capital	2	3
Retained income	99 998	99 998
Market Value 1.10.2005	100 000	100 000
Market value per share	50 000	33 333

1. Determination of whether a value shifting arrangement has occurred

The issue of shares to Cynthia constitutes a 'value shifting arrangement' as defined in para 1 of the Eighth Schedule in that:

- There is an arrangement
- Bongo has retained an interest in Why (Pty) Ltd
- There has been a change in the rights or entitlements in the interests in Why (Pty) Ltd
- The change in interest occurred other than as a result of a disposal at market value
- The market value of Bongo's interest has decreased from R100 000 to R66 666

[302] The share value shifting provisions are contained in Part 3.3, Division 140 of the Income Tax Assessment Act 1997.
[303] Sections 29 to 34 of the Taxation of Chargeable Gains Act, 1992.

- **Cynthia has acquired an interest in Why (Pty) Ltd**

2. Calculation of Bongo's capital gain

2.1 Determination of proceeds – paras 11(1)(g) and 35(2)

Paragraph 11(1)(*g*) includes as a disposal

> 'the decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement'.

Paragraph 35(2) provides for the proceeds to be determined as follows:

> 'The amount of the proceeds from a disposal by way of a value shifting arrangement is determined as the market value of the person's interests to which subparagraph 11(1)(*g*) applies immediately prior to the disposal less the market value of the person's interests immediately after the disposal, which amount shall be treated as having been received or accrued to that person.'

	R
Market value of Bongo's interest before disposal	100 000
Market value of Bongo's interest after disposal	66 667
Decrease in market value (proceeds on disposal)	33 333

2.2 Determination of Bongo's base cost – para 23(a)

Applying the formula:

$$Y = \frac{\text{Market value of interest before disposal - market value of interest after disposal}}{\text{market value of interest before disposal}}$$

$$= \frac{\text{R100 000 – R66 667}}{\text{R100 000}}$$

$$= 33\%$$

Base cost attributable to disposal of Bongo's interest = R50 000 x 33% = R16 500

2.3 Determination of Bongo's capital gain

Capital gain = Proceeds – base cost
= R33 333 – R16 500
= R16 833

*3. Determination of Cynthia's base cost – para 23(*b*)*

Cost of Cynthia's share in Why (Pty) Ltd	= R1
Increase in value of Cynthia's interest	= R33 333 (see 2.1 above)
Revised base cost	= R33 334

21.4 Losses arising from dividend stripping

Paragraph 19

Paragraph 19 contains an anti-avoidance provision designed to prevent persons from generating artificial capital losses through dividend stripping. In a typical dividend stripping transaction, a person purchases a share that is expected to distribute a dividend, receives that dividend, and then generates a loss on the immediate resale of the underlying share. This temporary holder of the share incurs no economic loss as a result of the transaction because this temporary holder receives both a dividend along with the offsetting loss on resale. However, if form governs, the temporary holder of the share generates an artificial tax benefit because the dividend is tax-free at the shareholder level with a capital loss on resale. The capital loss is artificial because the base cost on purchase reflects pre-acquisition earnings to be distributed. Although the transaction generates an STC charge, this tax is not borne by the investor but by the company paying the dividend.

Dividend stripping can occur with respect to both short-term holdings as well as long-term holdings. Dividend stripping with long-term holdings typically requires that the dividend involved be of an extraordinary nature because only dividends of an extraordinary nature have a long-term negative impact on the value of underlying shares. The Eighth Schedule only targets dividend stripping of an extraordinary nature. Dividend stripping on a short-term basis has been ignored because such share transactions are most likely of an ordinary revenue nature. Moreover, any loss resulting from short-term dividend stripping will most likely be completely offset by either the Uncertificated Securities Tax or Stamp Duty.

In order for a capital loss on the sale of a share to be disregarded under this paragraph, the transaction must fall within two parameters. First, the share must not have been held for more than two years before resale. This two-year period will be extended (i.e. will not include days) for periods in which the risk on the shares is hedged with offsetting positions. Secondly, the shares must have carried the right to participate in one or more dividends that are extraordinary in the aggregate. Dividends are extraordinary to the extent those dividends exceed 15% of the proceeds received or accrued on disposal of that share.

Example 1 – Extraordinary dividends

Facts: Eleanor purchased a preference share on 1 January 2002 for R150. She received a dividend of R12 on 1 July 2002 and another dividend of R12 on 1 July 2003. She sold the preference share for R140 on 1 September 2003.

Result: Before taking into account para 19, Eleanor has a R10 loss on the sale of the preference share (R140 proceeds less R150 base cost). However, para 19 applies because the aggregate dividends received within the 2-year period exceed 15% of the proceeds on sale. The aggregate dividends over the 2-year period are R24 (2 x R12), and the 15% amount is R21 (15% of R140), resulting in a R3 extraordinary dividend. Therefore, after taking para 19 into account, Eleanor can claim only R7 of the R10 amount as a capital loss.

Example 2: Extraordinary dividends- share buy-back

Facts: Tea (Pty) Ltd has 100 000 issued ordinary shares. The ordinary shares each have a par value of R10 and a market value of R50. Franz purchases 100 ordinary shares on 1 April 2002 for R5 000, and on 1 June 2003 he surrenders the shares to Tea (Pty) Ltd for R5 000 in a share buy-back. Of the R5 000 received by Franz, R1 000 is out of share capital and R4 000 constitutes a dividend.

Result: Before taking into account para 19, Franz has a R4 000 loss on the sale (R1 000 proceeds less R5 000 base cost). However, para 19 applies because the dividend portion of the buy-back is extraordinary. The extraordinary portion equals R3 850 (the R4 000 dividend minus R150 (15% of the R1 000 proceeds)). Therefore, after taking para 19 into account, Franz can claim only R150 out of the R4 000 amount as a capital loss.

Exception for group company distributions (para 19(2))

The provisions of para 19(1) do not apply to the extent that

- dividends were declared by a company to a shareholder as defined in s 41,
- the shareholder and the company declaring the dividend form part of the same group of companies, and
- the controlling company and the company declaring the dividend are both residents.[304]

In terms of s 41(1) a 'shareholder' includes a registered shareholder except where a person is entitled to all or part of the profits or income from the company, in which case that person is regarded as the shareholder to the extent of that entitlement.

Exclusion of certain types of dividend (para 19(3)(b))

Paragraph 19 does not apply to the following types of dividend:

- any foreign dividend
  - ➢ that has been included in the income of the person disposing of the share, or
  - ➢ which is exempt from tax in terms of s 10(1)(*k*)(ii)(*cc*) by reason of the company being a CFC in terms of s 9D,[305]
- any dividend declared by a company contemplated in para (*e*) of the definition of company (that is, a portfolio comprised in any collective investment schemes in securities (CISS)), and
- any dividend contemplated in s 11(*s*). Section 11(*s*) allows a company to claim a dividend as a deduction where its shares are held by a CISP (collective investment scheme in property shares). Such dividends are taxable in the hands of the unit holders.

21.5 Transitional period measures

Paragraph 97

This rule applies in respect of assets acquired during the period from 23 February 2000 until and including the day before the valuation date. It is aimed at preventing persons from artificially inflating the base cost of an asset for purposes of determining its time-apportionment base cost in terms of para 30. The measure covers all assets acquired during this period

- under a transaction not effected at arm's length; or
- directly or indirectly from a person qualifying as a connected person (either at the time of that acquisition or at any time up to a subsequent disposal of that asset within a period of three years after that acquisition). The term 'connected person' is defined in the Income Tax Act and includes, *inter alia*, any relative of a person.

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[304] Paragraph 19(2) was amended by Act 45 of 2003 with effect from 22 December 2003. Previously the provision excluded a holding company or intermediary company as defined in s 64B.

[305] The reference to s 10(1)(*k*)(ii)(*cc*) was inserted by Act 45 of 2003, effective as from 22 December 2003. Previously the provision referred to an exempt dividend ito s 9E(7)(*e*)(i).

The base cost of the asset in the hands of the person from whom it was acquired, as well as the period for which that person held the asset prior to that transaction, will be attributed to the person who acquired it should the latter wish to determine and use the time-apportionment base cost of that asset as its valuation date value.
This anti-avoidance measure will also cover any asset which

- is reacquired within a period of ninety days of its disposal, during the transitional period, under a non-arm's length transaction or its disposal directly or indirectly to a connected person; or
- replaces a substantially identical asset that was disposed of during the transitional period either under a non-arm's length transaction or directly or indirectly to a connected person, if the replacement asset is acquired within a period of ninety days from the date of that disposal.

Paragraph 97 does not apply to any disposal of an asset by a fund contemplated in s 29A(4) to any other such fund in terms of s 29A(6) or (7).

South African long-term insurers are required for income tax purposes to create four funds to conduct their business. The funds are regarded as separate persons for income tax purposes and disposals of assets between the funds are regarded as disposals on which CGT is imposed. In terms of s 29A(6) and (7) of the Income Tax Act the insurers are required to transfer assets between the different funds if there is a change in policyholders or a balancing of assets and liabilities is required. In view of the fact that these disposals are involuntary, for the purposes of this paragraph the different funds of the insurers are not treated as connected persons and these provisions do not apply to transactions between the funds under these circumstances.

Example 1 – Acquisition of asset during transitional period under non-arm's length transaction

Facts: Jack and Jill are friends. Jack bought an aircraft for R100 000 on 1 March 1990. On 24 February 2000 he sold it to Jill for R200 000 at which stage the market value was R150 000. In 2004 Jill sold the aircraft to a third party for R180 000. Neither Jack nor Jill have claimed any capital allowances on the aircraft. Jill elects to use TAB for determining the valuation date value of the aircraft.

Result: In determining TAB, Jill is deemed to have acquired the aircraft on 1 March 1990 at a cost of R100 000.

Example 2 - Acquisition of asset during transitional period from a connected person

Facts: Andy and Mandy are friends. Andy bought a piece of land for R100 000 on 1 March 1990. On 30 September 2001 Andy sold the land to Mandy for R500 000 which was the market value of the land at the time. On 28 September 2004 Andy and Mandy were married. On 29 September 2004 Mandy sold the land to a third party for R750 000.

Result: In determining TAB, Mandy is deemed to have acquired the land on 1 March 1990 at a cost of R100 000. The fact that Mandy paid an arm's length price for the land is irrelevant.

Example 3 – Reacquisition of asset within 90 days during transitional period from connected person or in terms of non-arm's length transaction

Facts: Tim and Kim are husband and wife. Tim purchased a piece of land at a cost of R100 000 on 1 March 1990. On 1 March 2000 he sold it to Kim for R150 000, and on 30 May 2000 he repurchased it from her at a cost of R500 000. Tim sold the land in 2004 for R400 000 and elected to use TAB to determine the valuation date value of the land.

Result: Tim is deemed for the purpose of determining TAB to have acquired the land at a cost of R100 000 on 1 March 1990.

Example 4 - Reacquisition of substantially similar asset within 90 days during transitional period from connected person or in terms of non-arm's length transaction

Facts: Agnes and Zeb are married. They each bought 50 shares (each block of shares representing a 50% stake) in Matabane Catering (Pty) Ltd on 1 March 1990 at a cost of R50 000 (R1000/share). Agnes held share certificate numbers 1 – 50 and Zeb held 51 – 100.

On 1 March 2000 Agnes sold her shares to Zeb for R100 000, and on 29 May 2000 she reacquired share certificate numbers 51 – 100 from Zeb at a cost of R500 000.

Result: For the purpose of determining TAB, Agnes is deemed to have acquired her 50 shares at a cost of R50 000 on 1 March 1990.

Chapter 22 - Administrative provisions

22.1 Returns of income (IT12 / IT14)

Section 66(1)(*a*) of the Act provides that the Commissioner shall annually give public notice that all persons who are liable to taxation and are required to furnish returns for the assessment of tax, must furnish returns for the purposes of assessment. These annual notices can be found on SARS Online (<www.sars.gov.za>) under Legislation / Regulations and Government Notices / Income Tax.

Section 66(1)(*b*)(v) includes amongst the categories of persons having to submit returns

> 'any person whose aggregate capital gain or aggregate capital loss for the year of assessment exceeds an amount to be stated by the Commissioner in the notice referred to in paragraph (*a*)'.

The notice covering the 2004 year of assessment[306] requires a return to be submitted by

> 'every natural person who had any capital gain or capital loss exceeding R10 000'.

The figure of R10 000 is equal to the annual exclusion.

Interim measure

In cases where taxpayers have a year of assessment that ended in October, November, December 2001 or January 2002 and they have a CGT event, they must complete an interim return (CGT 1) and submit this with their normal income tax return. Persons affected include:

- deceased or insolvent estates
- persons emigrating overseas, or
- companies with a year end of October, November, December or January

The CGT 1 form can be downloaded from SARS Online <www.sars.gov.za> by clicking on CGT and then Forms.

Furnishing of information

22.2 Return of information by managers of collective investment schemes

Section 70A

In terms of s 70A, every portfolio of a collective investment scheme in securities[307] or property[308] must furnish to the Commissioner an annual return in such form and within such time and containing such information as the Commissioner may prescribe.

Information regarding the sale of financial instruments and participatory interests in collective investment schemes during the tax year must be submitted in the form of an IT3(c) return.

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[306] The 2004 notice was published in GN 767, G*overnment Gazette* 24840 dated 10 May 2004. See <http://www.sars.gov.za/legislation/regs_notices/NOTICE%20TO%20SUBMIT%202004%20RETURNS%20GG.pdf> (accessed 22 March 2005).

[307] As defined in para (*e*)(i) of the definition of 'company' in s 1, namely, a portfolio in securities contemplated in Part IV of the Collective Investment Schemes Control Act, 2002, managed or carried on by any company registered as a manager under s 42 of that Act for purposes of that Part.

[308] A portfolio contemplated in Part V of the Collective Investment Schemes Control Act, 2002, managed or carried on by a company registered under s 42 of that Act for the purposes of Part V of that Act.

This return can be submitted manually or electronically – for details of the system specifications see SARS Online under Income Tax / New IT System / Specifications. Collective investment scheme portfolio managers wishing to make a manual submission must ensure that the same information required for electronic submission is supplied. The information must be submitted annually, either to the local SARS office or to SARS Head Office PO Box 402 Pretoria 0001. Apart from the personal details of the taxpayer, including identity number, the following details must be supplied:

- The source code indicating nature of the capital gain or loss
- Description of the financial instrument
- Number of instruments/ units sold
- Total value of units purchased based on weighted average
- The proceeds of the instruments/ units sold
- The net gain or loss value of the units sold
- The balance of the number of instruments/ units as at the last day of February
- The weighted average value of the instruments/ units as at the last day of February

The Commissioner has prescribed the weighted average method in terms of para 32(3A) for reporting purposes. The use of the weighted average basis for these returns does not prevent unit holders from using one of the other permissible bases[309] for determining the base cost of identical assets and capital gains or losses, provided that they have retained sufficient records to do so.

22.3 Return of information by portfolio administrators

Section 70B

Section 70B of the Act makes provision for returns of information by portfolio administrators. In terms of the section every person (other than a pension fund, provident fund, retirement annuity fund or an insurance company in respect of financial instruments held for policy holders) who

- administers a portfolio of financial instruments, as contemplated in the Eighth Schedule, on behalf of any other person; and
- has the mandate of that other person to buy and sell such financial instruments on that other person's behalf,

must furnish to the Commissioner an annual return in such form and within such time and containing such information as the Commissioner may prescribe.

The information must be submitted on an IT3(c) return. See in this regard the comments under the section of this Guide dealing with section 70A.

It will be observed that the weighted average method in terms of para 32(3A) has been prescribed for reporting purposes. See in this regard the comments under the section of this Guide dealing with section 70A.

22.4 Retention of records

Section 73B of the Act contains new record keeping requirements to ensure compliance with the provisions of the Eighth Schedule. Unlike s 73A, which is targeted at persons earning income other than remuneration, all persons in possession of assets that can give rise to capital gains or losses are required to retain the relevant records.

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[309] TAB, market value or 20% of [proceeds less post-valuation date expenditure]. With TAB and market value the assets that have been disposed of would have to be identified using specific identification or FIFO.

The relevant records must be retained for a period of four years from the date of submission of the return of income in which a capital gain or capital loss is reflected.
Persons not required to render returns of income who have capital gains or capital losses in excess of R10 000 are required to retain all records pertaining thereto for a period of five years from the date of disposal of the assets concerned.

22.5 Onus of proof

In terms of s 82 of the Act the burden of proving that-

- a capital gain is not taxable
- an amount is to be disregarded or excluded in terms of the Eighth Schedule

rests upon the taxpayer.

22.6 Appeals to the Tax Board

Taxpayers whose objections to assessments have been disallowed by SARS may lodge an appeal against the decision if they are dissatisfied therewith using the prescribed form ADR – 2. They have three avenues open to them: They can

- agree with SARS to settle the matter outside court via the ADR (alternative dispute resolution) process,
- take the matter to the Tax Board, provided the tax in dispute does not exceed R100 000, or
- take the matter to the Tax Court.

In terms of s 83A(1)(*a*), where the tax in dispute exceeds R200 000,[310] an appeal would normally be referred directly to the Tax Court.

How is the R200 000 threshold determined where an assessed capital loss is in dispute? In such a case one must have regard to the tax that could become payable in the future.

Assuming

- a marginal tax rate of 40%, and
- no other capital gains during the current year of assessment,

an assessed capital loss would have to exceed R2 000 000 before the appeal needs to be referred to the Tax Court:

Future aggregate capital gain	R2 000 000
Inclusion rate	25%
Future taxable capital gain	R500 000
Tax saving thereon at 40%	R200 000

In other words, R200 000 in tax would be saved by utilising the assessed capital loss of R2 000 000 against a future aggregate capital gain of the same amount.

22.7 Discretionary powers

The Eighth Schedule confers a number of discretionary powers on the Commissioner that are set out below. These are subject to objection and appeal in terms of s 3(4) of the Act.

[310] The limit of R200 000 was published in GN 1429 in *Government Gazette* 27070 dated 10 December 2004, applicable to any appeal noted on or after 1 January 2005. The previous limit was R100 000 (GG 21733 dated 17 November 2000, effective 1 December 2000.

Table 1 – Discretionary powers of Commissioner under the Eighth Schedule

Paragraph	**Description**
29(2A)	This provision gives the Commissioner the power to determine the market value of shares listed on the JSE in certain circumstances.
29(7)	This provision gives the Commissioner the power to adjust the market value of an asset.
31(2)	A usufruct must be valued at a yield of 12%. The Commissioner can amend this percentage where he is satisfied that the property could not reasonably be expected to yield 12%.
65(1)(*d*)	This provision relates to the deferral of a capital gain where a person's asset has, for example, been expropriated, stolen or destroyed. The person must conclude a contract for the acquisition of a replacement asset within a year and bring that asset into use within three years. The Commissioner has the power to extend these periods by six months.
66(1)(*e*)	This provision relates to the deferral and spread of a capital gain arising on the disposal of assets subject to certain capital allowances. The person must conclude a contract for the replacement of the asset within a year and bring that asset into use within three years. The Commissioner has the power to extend these periods by six months.

22.8 Additional tax

Section 76 of the Act provides for additional tax to be levied in the event of a default or an omission.

In terms of s 76(5), where a taxpayer disregards or excludes an amount that should not have been disregarded or excluded in terms of the Eighth Schedule, that taxpayer is deemed to have omitted that amount from his return of income.

22.9 Definition of an 'assessment'

The definition of an 'assessment' in s 1 of the Act includes a reference to an assessed capital loss determined in terms of the Eighth Schedule.

22.10 Estimated and additional assessments

Estimated assessments

Section 78 provides for estimated and agreed assessments. An 'aggregate capital gain or aggregate capital loss' can be estimated by or agreed with the Commissioner in qualifying circumstances.

Additional assessments

Section 79 provides for the issuing of additional assessments. The provisions cover the situation where an assessed capital loss is reduced.

22.11 Withholding tax on payments to non-resident sellers of immovable property

Section 35A

Commencement date

Section 35A comes into operation on a date to be determined by the President by proclamation in the *Gazette*.

In terms of para 2, non-residents are subject to CGT on capital gains made on the disposal of

- immovable property in SA,
- any right or interest in immovable property in SA, and
- assets of a PE in SA.

The term 'immovable property' includes an interest of at least 20% in a company where 80% or more of its net value consists of SA immovable property. For more on this, see the commentary on para 2.

Collection of the CGT on capital gains made by non-residents on the disposal of immovable property can be problematic because they frequently do not have other assets in SA that could be attached and their ties to SA are often tenuous. The introduction of a withholding tax for CGT purposes on disposals of immovable property in SA is designed to facilitate tax collection.

Table 1 – Summary of CGT withholding tax provisions

Section 35A	**Subject**	**Description**
(1)	Rate of withholding tax	Purchaser of immovable property in SA must withhold tax at following rates from amount payable to non-resident seller: *% Type of seller* 5 Natural person 7,5 Company 10 Trust
(2)	Tax directives	Seller may apply to Commissioner in prescribed form for nil or reduced rate of withholding tax. The Commissioner may only consider these factors: • Security furnished e.g. a bank guarantee. • Other assets in SA. • Whether the seller is subject to tax on the disposal. For example, the disposal may qualify for roll-over relief ito ss 41 -47, be exempt in terms of a DTA, or in the case of a foreign embassy, exempt ito s 10(1)(*a*). • Whether actual liability is less than the prescribed withholding rate. For example, where the seller can show that the property has been sold at a capital loss or where an individual is below the tax threshold.
(3)	Advance payment	The tax withheld is an advance payment in respect of seller's normal tax liability.
(4)	Payment of tax	Purchaser must pay tax withheld to SARS within • 14 days (resident) • 28 days (non-resident)
(5)	Translation of	If purchase price payable in foreign currency, amount

	amounts payable in foreign currency	withheld must be translated into rand at spot rate on date paid over to SARS.
(6)	Submission of declaration by purchaser	Purchaser must submit declaration in prescribed form when paying tax over to SARS.
(7)	Personal liability of purchaser	If purchaser knows or should reasonably have known that seller was a non-resident and fails to withhold the tax, that purchaser • will be personally liable for tax not withheld, and • must pay the tax to SARS within the time the amount should have been paid.
(8)	Non-liability of purchaser if not notified of seller's status	A purchaser who is assisted by an estate agent or conveyancer will not be held personally liable when not notified of seller's non-resident status by that estate agent / conveyancer.
(9)	Interest and penalties	A purchaser who fails to pay the withholding tax to SARS within the prescribed period is liable for • interest at the prescribed rate, calculated from the day following the date for payment to the date the amount is received by SARS, • a penalty of 10%, plus • any other penalties or charges under the Act.
(10)	Waiver of penalty	The Commissioner can waive the whole or part of the late payment penalty having regard to the circumstances of the case. No provision has been made for the waiver of interest.
(11)	Notification by estate agent and conveyancer	Both the estate agent and the conveyancer must notify the purchaser that the seller is a non-resident and that s 35A may apply. This requirement only applies to an agent/conveyancer receiving remuneration in connection with the disposal.
(12)	Personal liability of estate agent / conveyancer	An estate agent or conveyancer will be held personally liable for the tax not withheld, limited to the amount of his/her remuneration where he or she • knows or should reasonably have known that the seller is a non-resident, and • fails to notify the purchaser.
(13)	Right of recourse against seller	The purchaser, estate agent and conveyancer can recover any amount for which they have been held personally liable under s 35A(7) or (12) from the seller. This does not include any interest or penalty.
(14)	Exemptions	Section 35A does not apply • where the total amounts payable do not exceed R2 million, or • to any deposit paid to secure the disposal before the agreement is entered into. The withholding tax on the deposit must be recovered from the first following payments made by the purchaser. Where the value of the property exceeds R2 million, the tax applies to the full purchase price without regard to the R2 million limit.
(15)	Definitions	'Conveyancer' – means one defined in s 102 of the Deeds Registries Act 47 of 1937. 'Estate agent' – means one defined in s 1 of the Estate

		Agency Affairs Act 112 of 1976. 'Foreign currency' – means currency other than that of the Republic. 'Immovable property' – as contemplated in para 2(1)(*b*)(i) and (2).

Example 1 – Withholding of tax from non-resident individual

Facts: Manuel, a non-resident, sells a South African residential property to Madeleine, a SA resident, for R10 million. The closing date of the sale is 10 June 2006 with the funds flowing at that date. Madeleine pays the R10 million using R800 000 of her cash savings and R9,2 million by means of a mortgage bond.

Result: Madeleine must withhold R500 000 (5% of R10 million) from the amount paid to Manuel. Madeleine must pay over this R500 000 to SARS 14 days later (s 35A(4)(*a*)).

Example 2 - Withholding of tax from non-resident company

Facts: Shop Co PLC, a United Kingdom resident company, sells a South African shopping centre to Reddy Cash Ltd, a resident company. The closing date of the sale is 15 September 2006. Under the agreement, the local company must pay

- R20 million by 15 September 2006,
- R20 million by 15 September 2007, and
- R10 million on 15 September 2008.

All amounts are paid using bank borrowings.

Result: Even though all the proceeds accrue on 15 September 2006, Reddy Cash Ltd must withhold solely based on its actual payments. It must therefore withhold

- R1,5 million (7,5% of R20 million) on 15 September 2006,
- R1,5 million (7,5% of R20 million) on 15 September 2007, and
- R750 000 (7,5% of R10 million) on 15 September 2008.

It must pay over the withheld amounts to SARS 14 days after each withholding date.

Example 3 – Purchase price R2 million or less

Facts: Cassius, a non-resident, sells a SA commercial property to Jackie, a SA resident, for R800 000.

Result: No withholding obligation applies under s 35A because the total amount does not exceed R2 million.

Example 4 –Purchase price exceeding R2 million

Facts: The facts are the same as Example 3, except that the contract price is R2,1 million.

Result: The withholding obligation of s 35A applies to the full R2,1 million. Jackie must withhold R105 000 (5% of R2,1 million).

Example 5 – Withholding of tax from deposits

Facts: Michael, a non-resident, enters into a contract for the sale of his Cape Town holiday home to Costa, a SA resident for R5 million. On 25 June 2006, Costa must pay a R25 000 deposit to secure the property, pending financing approval. The financing is subsequently approved and the remaining R4 975 000 amount is to be paid on the closing date, on 12 September 2006.

Result: Costa has no obligation to pay any withholding tax on the deposit until the closing date. On that date, he must withhold 5% based on the full R5 million (the R25 000 deposit plus the R4 975 000 balance).

Example 6 – Withholding from non-refundable deposits

Facts: The facts are the same as Example 5, except that the deposit is non-refundable and the transaction is never closed.

Result: No withholding obligation applies because the underlying agreement for the disposal of the property never occurs.

Chapter 23 - Impact of CGT on the rest of the Act

23.1 Provisional tax - capital gains excluded from the basic amount

For the purposes of making an estimate of taxable income in respect of the first and second periods, a taxpayer is permitted to use the 'basic amount' (the taxable income per the year last assessed). In determining the basic amount a taxpayer must exclude all taxable capital gains derived during the relevant year of assessment (para 19(1)((*d*) of the Fourth Schedule refers). As capital gains tend to be irregular the intention of this amendment is to prevent a taxpayer's estimate of taxable income from being distorted by a non-recurring capital gain in the previous year.

23.2 Provisional tax - capital gains and the third provisional tax payment

For the purpose of the third provisional tax payment, a taxpayer is required to take into account all capital gains arising during the relevant year of assessment. Failure to do so will result in the levying of interest on any underpayment of provisional tax in terms of s 89*quat* of the Act.

In determining whether such interest may be waived, the normal rules will apply - that is, are there reasonable grounds for contending that the capital gain should not have been included in taxable income. Typically it will only be contentious capital gains that will need to be considered for the waiver of interest, that is, cases where the taxpayer is able to advance a cogent factual or legal argument in favour of exclusion of the gain. The interest may not be waived where the capital gain has been omitted or understated as a result of carelessness, ignorance or inadvertence.[311]

23.3 Provisional tax - can a capital gain make a person a provisional taxpayer?

The definition of provisional taxpayer contained in para 1 of the Fourth Schedule provides as follows:

> '**"Provisional taxpayer"** means—
> (*a*) any person (other than a company or a person referred to in subparagraph (1) of paragraph 18) who derives by way of *income* any amount which does not constitute remuneration in terms of the definition of that expression in this paragraph'. (Emphasis added.)

Since a taxable capital gain is included directly in taxable income, it does not constitute income as defined. Accordingly a capital gain cannot make a person a provisional taxpayer.

Example 1 – Capital gain does not make a person a provisional taxpayer

Facts: During the year ending 28 February 2006 Kim derives an annual salary of R51 000. She also made a capital profit of R20 000 on the sale of some listed shares on 31 January 2006.

Result: Kim will not be a provisional taxpayer since her sole source of 'income' is her salary which constitutes 'remuneration' as defined.

[311] See D S McAllister 'An Interesting Discretion' (2000) 14 *Tax Planning* 26 at 27, Butterworth Publishers (Pty) Ltd, Durban.

Example 2 – Capital gains and the third provisional tax payment

Facts: The facts are the same as Example 2, except that Kim also earned interest income of R25 001 during the year.

Result: Kim will be a provisional taxpayer by virtue of her interest income. The exemption in para 18(1)(*a*) of the Fourth Schedule only applies to a person earning remuneration where that person's other taxable income does not exceed R10 000. When calculating her third provisional tax payment due by 30 September 2006, she will have to take into account the capital gain:

	R
Salary	51 000
Interest	25 001
Less: exempt portion	(15 000)
Taxable capital gain (R20 000 - R10 000) x 25%	2 500
Taxable income	63 501

In other words, she will have to base her topping up payment on R63 501.

Since a taxable capital gain is included directly in taxable income in terms of s 26A it will have an impact on a number of the deductions that are based on a percentage of taxable income.

23.4 Impact of CGT on various deductions

Deductions expressed as a percentage of taxable income

Because certain deductions in the principal Act are based on a percentage of taxable income, they are affected in different ways by the inclusion of a taxable capital gain in taxable income. They include the following:

- Pension contributions – s 11(*k*)
- RAF contributions – s 11(*n*)
- Medical and dental expenses – s 18(2)(*c*)
- Donations to certain public benefit organisations – s 18A(1)(*b*)(ii)(*aa*)
- Entertainment – s 11(*u*)

The impact of a taxable capital gain on each of these deductions is discussed below:

Pension contributions

Section 11(*k*) provides as follows:

> '7,5 per cent of the remuneration (being the income or part thereof referred to in the definition of 'retirement-funding employment' in s 1) derived by such person during such year in respect of his retirement-funding employment'.

Since a taxable capital gain does not constitute income from retirement-funding employment, this deduction remains unaffected.

*RAF contributions - section 11(*n*)*

A taxpayer will not be able to claim 15% of a taxable capital gain for the purposes of determining the allowable portion of retirement annuity fund contributions. This follows from the wording of s 11(*n*)(*aa*)(A):

> '(A) 15 per cent of an amount equal to the amount remaining after deducting from, or setting off against, the *income* derived by the taxpayer during the year of assessment (excluding income derived from any retirement funding employment (being the income or part thereof referred to in the definition of **"retirement-funding employment"** in section 1)) the deductions or assessed losses admissible against such income under this Act (excluding this paragraph, sections 17A, 18, 18A and 19(3) of this Act and paragraph 12(1)(*c*) to (*i*), inclusive, of the First Schedule)'.

Since a taxable capital gain is not included in 'income' as defined but rather in taxable income, the 15% limitation may not be calculated on a taxable capital gain.

*Medical and dental expenses – s 18(2)(*c*)*

In terms of s 18(2)(*c*) medical deductions for persons under the age of 65 are restricted to

> 'so much of the sum of such amounts as exceeds 5 per cent of the taxpayer's taxable income as determined before granting an allowance under this section'.

This has the effect of restricting the amount that a taxpayer who is under the age of 65 can claim in respect of medical expenses, since the threshold will be boosted by 5% of any taxable capital gain.

*Donations to certain public benefit organisations – s 18A(1)(*b*)(ii)(*aa*)*

Section 18A(1)(*b*)(ii) provides that qualifying donations are restricted to

> '(*aa*) five per cent of the taxable income of the taxpayer as calculated before allowing any deduction under this section or section 18; or'
> (*bb*) R1 000.'

It follows that taxpayers will be able to claim 5% of any taxable capital gain in determining the allowable portion of any qualifying donations.

*Entertainment - section 11(*u*)*
[Repealed with effect from 1 January 2005]

Apart from an overall limit of R2 500 (s 11(*u*)(i)(*aa*)), s 11(*u*)(i)(*bb*) contains a percentage restriction on the deductibility of entertainment expenses of

> 'R300 plus 5 per cent of so much of the taxable income (as determined before any deduction is made under this paragraph) derived by the taxpayer from carrying on during the year of assessment any trade in connection with which such expenditure was incurred, as exceeds R6 000'.

It is unlikely that taxable capital gains will have much impact on s 11(*u*). There are two reasons for this:

- The taxable capital gain would have to arise from the same trade in respect of which the entertainment expenditure was incurred. For example, an employee receiving an entertainment allowance from his employer would not be able to use the taxable capital gain arising from the disposal of a second home.

- Most employees receiving entertainment allowances would be restricted by the R2 500 limit. The R300 plus 5% limit only becomes relevant up to a taxable income of R50 000 ([R50 000 – 6000] x 5% = R2 200 + R300 = R2 500).

Capital development expenditure

Paragraph 12(1)(*c*) to (*i*) of the First Schedule provides that capital development expenditure (CDE) may only be deducted from *taxable income* derived by a farmer from farming operations. It follows that any portion of taxable income that is comprised of capital gains that are unconnected to farming operations will not be available for set off against CDE. This would include, for example, capital gains arising from the disposal of any portion of farm land or houses on the farm used by non-employees.

Example – Effect of capital gains on deductions

Facts: The following details relate to an employee under the age of 65 in respect of the 2005 tax year:

	R
Salary - pensionable	80 000
Bonus - (non-pensionable)	50 000
Capital gain (gross)	100 000
Pension contributions	7 500
RAF contributions	10 000
Medical claim	12 000

Result: The taxable income will be determined as follows:

Step 1: Determine the taxable capital gain

Capital gain	100 000
Less: annual exclusion	(10 000)
Aggregate capital gain	90 000
Inclusion rate	25%
Taxable capital gain	22 500

Step 2: Determine the taxable income

Salary (pensionable)		80 000
Bonus (non-pensionable)		50 000
Less: Deductions		
Pension contributions		(6 000)
Actual	7 500	
Allowable: R80 000 x 7,5%	6 000	
Carried forward	1 500	
RAF contributions		(7 500)
Actual	10 000	
Allowable: R50 000 x 15%	7 500	
Carried forward	2 500	
Taxable capital gain – s 26A		22 500
Subtotal		139 000

Medical deduction	R	R
Actual expenses	12 000	
Non-allowable portion 5% x R139 000	6 950	
Allowable portion		(5 050)
Taxable income		133 950

The normal rebates and tax rates will apply to the taxable income of R133 950. It will be observed that the capital gain does not increase the allowable portion of pension and RAF contributions, but does reduce the medical deduction.

23.5 Rating formula

Section 5(10)

Section 5(10) makes provision that where the income of a taxpayer includes

- any special remuneration (an award paid to a member of a mine proto team);
- an amount received by or accrued to him or her upon or because of the termination or impending termination of his or her services (for example, a golden handshake award)
- a lump sum benefit from a pension, provident or retirement annuity fund; or
- an amount contemplated in para 15(3) or 17 or 19(1) of the First Schedule (for example, certain concessions to sugar cane, plantation and other farmers),

the tax rate to be applied in respect of the taxable income shall be determined as the rate applicable before taking into account any such special remuneration, amount in respect of termination of services, lump sum or First Schedule amounts.

Section 5(10) has been amended to provide that any amount of taxable capital gain included in the taxable income of a person must be excluded in determining the rate of tax to be applied in respect of any lump sum benefit or any amount received or accrued upon termination or impending termination of services. The formula now reads as follows:

$$R = \frac{A}{B + D - (C + L + G)}$$

where G represents the amount of the taxable capital gain included in taxable income in terms of s 26A.

23.6 Rebate in respect of foreign taxes

Section 6*quat*

Section 6*quat* prevents double taxation on capital gains of residents attributable to the disposal of assets situated outside the Republic.

It provides a credit against South African tax for foreign taxes levied on these gains.

Consistent with international norms for preventing double taxation and with South Africa's international tax treaties, the provision only applies to gains realised on assets outside the Republic.

International tax norms provide the source country with primary taxing rights over gains from the disposal of assets. The source country is the country in which the assets are situated.

Where a person is liable to both South African tax and foreign tax in respect of a capital gain realised on the disposal of an asset situated in the Republic, under the Republic's agreements for the avoidance of double taxation and international norms, it will be the responsibility of the foreign jurisdiction to provide a tax credit for South African tax levied in respect of the gain.

23.7 Controlled foreign companies

Section 9D, Paragraph 20

23.7.1 Introduction

Extracts from a document prepared by the National Treasury have been adapted in compiling this section of the Guide.[312] These notes focus mainly on those aspects of s 9D that impact on the determination of capital gains and losses, and do not represent a comprehensive analysis of all aspects of s 9D.

Section 22(1) of Act 45 of 2003 effected a number of amendments to s 9D. They came into operation on 1 June 2004 and apply in respect of the foreign tax year of a controlled foreign company (CFC) that ends during any year of assessment commencing on or after that date. These notes cover the position both before and after these amendments.

23.7.2 What is a controlled foreign company?

The term CFC is defined in s 9D(1) and means a foreign company in which more than 50% of the total participation rights are held by SA residents.

'Participation rights' means the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of that foreign company, whether or not of a capital nature.

In considering whether more than 50% of the shareholders of a foreign listed company or collective investment scheme are SA residents, no regard must be had to persons holding less than 5% of the participation rights. This exception does not apply to connected persons collectively holding more than 50% of the participation rights.

23.7.3 The minimum shareholding requirement

For the CFC provisions to apply to a resident, that resident, together with any connected persons, must hold at least 10% of the participation rights in the company (proviso (A) to s 9D(2)). The determination of the 10% threshold is made at the end of the foreign tax year, or where the company ceased to be a CFC, immediately before it ceased to be a CFC.

23.7.4 The need for CFC legislation

With the introduction of the worldwide system of taxation, South African residents became subject to tax on their worldwide income, including foreign capital gains. It would have been a fairly simple matter for SA residents to defer, perhaps indefinitely, taxation on foreign income and capital gains by placing assets in a foreign company. The income would only have been taxable when repatriated as a dividend (prior to 1 June 2004 in terms of s 9E, and on or after that date in terms of para (*k*) of the definition of gross income in s 1). This necessitated the introduction of CFC legislation in the form of s 9D.

[312] K Engel 'National Treasury's Detailed Explanation to Section 9D of the Income Tax Act' (June 2002), available online under Tax Policy at <http://www.treasury.gov.za> (accessed 22 March 2005).

23.7.5 Imputation of foreign capital gains of CFC's to SA residents

Section 9D of the Income Tax Act provides for the imputation of the net income of a CFC to the SA resident shareholders. It is a look-through measure that pierces the corporate veil and treats the income of the CFC as the income of the shareholder. In terms of s 9D(2) a portion of the net income of the CFC, which is proportionate to the shareholding or interest of that shareholder in the CFC, is taxed in the hands of the shareholder.

23.7.6 Determination of net income

The 'net income' of a CFC in respect of a foreign tax year is an amount equal to the taxable income of the CFC determined in accordance with the Income Tax Act as if the CFC had been a

- taxpayer, and
- a resident for purposes of the definition of 'gross income', ss 7(8), 9E,[313] 10(1)(*h*), 10(1)(*h*A), 25B and the following paragraphs of the Eighth Schedule:

Para-graph	**Description**
2(1)(*a*)	Application of Eighth Schedule to the disposal of any asset of a resident on or after the valuation date.
12	Events treated as disposals and acquisitions.
24	Base cost of assets of a person who becomes a resident on or after the valuation date.
70	Attribution of capital gain subject to conditional vesting.
71	Attribution of capital gain subject to revocable vesting.
72	Attribution of capital gain vesting in non-resident.
80	Capital gain attributed to beneficiary.

(Section 9D(2A).)

In terms of s 26A, taxable income includes a taxable capital gain. Section 9D makes specific provision for the way in which the taxable capital gain or assessed capital loss of the CFC is to be determined in calculating the net income of the CFC.

23.7.7 Valuation of assets on becoming a CFC

Where a company only becomes a CFC after 1 October 2001, the valuation date for purposes of the determination of any taxable capital gain or assessed capital loss of that CFC will be the date that it became a CFC (Section 9D(2A)(*e*).)

23.7.8 Base cost adjustments (para 20(1)(h)(iii))

South African residents with a share in a CFC must adjust their base cost of that interest for net income inclusions as well as certain dividends from that CFC. South African residents receive an upward base cost adjustment in their CFC shares to the extent of any net income inclusions. They also receive a full upward base cost adjustment for their net capital gains (even though those gains are only partially included in income). However, residents must reduce the base cost of their CFC shares to the extent they receive a tax-free dividend distribution that represents previously taxed s 9D income. CFC dividends are exempt in terms of s 10(1)(*k*)(ii)(*cc*) (prior to 1 June 2004 in terms of s 9E(7)(*e*)(i)).

[313] The reference to s 9E has been deleted with effect from 1 June 2004.

Example – Base cost adjustments to shares in CFC

Facts: South African Company owns all the shares of CFC with a R500 base cost. In 2001, CFC generates R100 of active income, R30 of passive interest income, and R40 of passive capital gains. The latter two items are included in South African Company's income by virtue of s 9D. In 2002, CFC distributes all R170 of the previously described profits.

Result: The base cost of the shares in the CFC is determined as follows:

	R
Opening base cost of shares in CFC	500
2001	
Active income (no adjustment)	-
Add: Passive interest income	30
Add: Passive capital gains	40
Revised base cost	570
2002	
Less: exempt foreign dividend	(70)
Closing base cost	500

Note the full credit for the passive capital gains despite the 50% inclusion rate.

23.7.9 Inclusion rate (s 9D(2A)(f))

Where the resident is a natural person, special trust or an insurer in respect of its individual policyholder fund, the taxable capital gain of the CFC is 25% of the CFC's net capital gain for the relevant year of assessment (s 9D(2A)(*f*)). The reason for this is that capital gains of companies are subject to CGT at an inclusion rate of 50%. Where the CFC's gain is being taxed in the hands of an individual, it is appropriate that it should be taxed at the inclusion rate applicable to individuals.

South African corporate shareholders with CFC capital gains include those gains at an inclusion rate of 50%.

23.7.10 Multi-tier CFC's (s 9D(2A)(j))

A foreign company in which a resident has an indirect qualifying interest will also constitute a CFC in relation to that resident (see definition of a CFC in s 9D(1)). In other words, not only is the proportional amount of the net income of the holding company imputed to the resident shareholder, but also the proportional amount of the net income of any CFC subsidiaries in which the resident has an indirect qualifying interest. A special rule exists to deal with the determination of a capital gain or loss on disposal of an interest in a subsidiary CFC by a holding company CFC.

Example – Disposal of subsidiary CFC in multi–tier CFC group

Facts: Mark, a resident, owns 80% of Holdco Ltd, a CFC in the Channel Islands. Holdco in turn owns 80% of Subco Ltd. All Subco's assets generate passive investment income.

Holdco acquired Subco some years before valuation date at a cost of £1 000. The market value of Subco on 1 October 2001 was £1 500. In the year ending 29 February 2004 Subco derived a taxable income of £300 and declared a dividend to Holdco of £100. On 31 March 2004 Holdco disposed of Subco for proceeds of £1 750. Subco did not earn any further income or declare any further dividends prior to the date of sale of its shares by Holdco The average exchange rate during the 2004 tax year was R12 = £1, and during 2005 was £13.

Result: Mark's indirect 64% effective interest in Subco (80% x 80%) makes Subco a CFC in relation to Mark.

In the 2004 tax year, an amount of 64% x £300 x 12 = R2 304 will be included in Mark's taxable income.

The base cost of Holdco's interest in Subco is determined as follows:

	£
Market value on 1.10.01	1 500
Net income £300 x 80%	240
Less: Dividend £100 x 80%	(80)
Base cost	1 660
Proceeds	1 750
Less: Base cost (as above)	1 660
Capital gain	90

Amount to be imputed to Mark
Inclusion rate = 25%
Taxable capital gain = £90 x 25% = £22,50
Mark's interest in this gain = 80% x £22,50 = £18
Average exchange rate in year of disposal £1 = R13
Therefore the taxable capital gain to be included in Mark's taxable income is £18 x R13 = R234

23.7.11 Definition of 'local currency' and para 43 (s 9D(2A)(k))

The term 'local currency' as used in para 43 means in relation to

- the permanent establishment (PE) of a CFC the currency used by that PE for purposes of financial reporting (s 43(7)(*a*)), and
- the CFC itself, the currency used by the CFC for purposes of financial reporting (s 9D(2A)(*k*)).

Example – Local currency

Facts: John is the sole shareholder of Johnco, a London-based investment company. Johnco reports its financial results in sterling. Johnco has a branch in Bermuda that operates a property rental business. The branch reports its financial results in US dollars.

Result: In applying para 43, the local currency of the branch is deemed to be US dollars, and the local currency of Johnco is deemed to be sterling.

23.7.12 Translation of capital gains and losses (s 9D(6))

23.7.12.1 The general rule

The net income of a CFC (which includes any taxable capital gain) must be determined in the currency used by the CFC for purposes of financial reporting. The relevant foreign currency amount to be included in the taxable income of the resident is then translated into rand at the average exchange rate for that year of assessment in terms of s 25D.

23.7.12.2 The special rule for para 43(4) assets

A special translation rule applies to para 43(4) assets of a CFC which comprise of the following:

- Foreign equity instruments
- Deemed SA source assets:
  - Immovable property in SA
  - Any interest or right in or to immovable property in SA
  - Assets of a PE in SA.

Overall exclusion

- Exchange items falling within s 24I

Capital gains and losses in respect of the disposal of the above para 43(4) assets must in the first instance be

- determined in the currency of the Republic, and thereafter
- translated
  - into the currency used by the CFC for the purposes of financial reporting,
  - using the average exchange rate contemplated in s 25D.

At first glance the translation of the rand capital gain or loss into the foreign currency of reporting seems to be an unnecessary step. If one has the capital gain or loss in rands why not simply stop there? The reason becomes apparent if the CFC has an assessed loss before taking into account any capital gain in terms of para 43(4). In terms of s 9D(2A)(*b*) the assessed loss of a CFC is carried forward by the CFC and cannot be offset against the other taxable income of the resident (in other words it is not imputed to the resident). The above procedure ensures that the CFC's para 43(4) capital gain is set off against its assessed loss. If the capital gain were not included in the net income of the CFC the resident would be taxed on it and the assessed loss of the CFC would be unavailable for set off.

Example – Disposal of foreign equity instrument by CFC

Facts: A SA resident holding company owns all the shares of a foreign subsidiary (CFC) incorporated and based in a tax haven in the Channel Islands. The CFC uses sterling for the purpose of financial reporting. The CFC sells a share listed on the NYSE during its financial year ended 30 June 2004 for proceeds of \$150. The share was purchased on 1 October 2001 for \$50. The relevant exchange rates are
On 1 October 2001 R9 = \$1 (ruling exchange rate)
Year ending 30 June 2004 R15 = £1 R10 = \$1 (average exchange rates)
The taxable income (all of a passive nature) of the CFC before inclusion of any capital gains is £1 000.

Result:

Step 1 – Determine capital gain in rands in terms of para 43(4)

	R
Proceeds $150 x R10 =	1 500
Base cost $50 x R9 =	450
Capital gain	1 050
Inclusion rate	50%
Taxable capital gain	525

Step 2 – Determine amount to be included in net income in currency used by CFC for financial reporting

Translate into £ using average exchange rate during the year ending 30 June 2004 = R525/£15 = £35

Step 3 – Determine amount to be included in income of resident company

Net income = £1 000 + £35 = £1 035 x R15 = R15 525.

23.7.13 Designated country exemption (s 9D(9)(a))

Section 9D(9)(*a*) was deleted by s 22(1)(*g*) of Act 45 of 2003 with effect from 1 June 2004 and the amendment applies in respect of the foreign tax year of a CFC which ends during any year of assessment commencing on or after that date.

23.7.13.1 Reason for the removal of the exemption

Under s 9D(9)(*a*) income from listed foreign countries was exempt if it was derived from a country with a similar tax system to South Africa's and subject to a statutory rate of at least 27% (capital gains = 13,5%). The underlying rationale was to eliminate high taxed foreign income, most of which would generate marginal additional revenue for the *fiscus* after offsetting foreign tax credits.

The system created an impression that South Africa's tax system favoured certain countries over others. The use of the list concept was also problematic because many countries have hidden incentives that do not simply eliminate statutory income or cannot be uncovered without a full understanding of the entire tax system involved. For these reasons the designated country exemption was removed. The notes hereunder therefore apply to the period prior to the amendment when the designated country exemption was still in force.

23.7.13.2 The position prior to 1 June 2004

The CFC provisions do not apply to the extent that the net income of a CFC is attributable to amounts that have been or will be subject to income tax in a *designated country* at a *qualifying statutory rate*. The latter term is defined in s 1, and means a qualifying statutory rate as defined in s 9E. In terms of the definition in s 9E(1), capital gains of any CFC are exempt where those capital gains have been or will be subject to tax in a *designated country* at a statutory rate of at least 13,5%. The term 'designated country' is also defined in s 1 and means a designated country contemplated in s 9E(8). In terms of the latter provision the Minister of Finance can publish in the *Gazette* the names of designated countries that meet the required criteria, such as those that determine their income tax on substantially the same basis as SA. See commentary on s 9E in **23.8**.

In determining the qualifying statutory rate

- the application of any double taxation agreement must be taken into account;
- there must be no right of recovery by any person of the tax (other than a right of recovery resulting from the carry back of an assessed loss to a prior tax year);
- the right to carry back foreign assessed losses must be ignored;
- where the designated country imposes tax on a progressive scale of statutory rates of tax, the statutory rate is deemed to be the highest rate on the scale.(s 9E(1)).

23.7.14 Business establishment (s 9D(9)(b))

The CFC rules do not apply where the CFC is a company and its net income is attributable to any business establishment in any country other than the Republic. The term 'business establishment' is defined in s 9D(1), and is very similar to the definition of a permanent establishment.

Since net income of a CFC includes capital gains, the exemption also applies to the disposal of capital gain assets attributable to a business establishment. Stated differently, if CFC factory income is exempt, so is any capital gain stemming from that CFC's sale of factory assets.

23.7.15 CFC Income of a passive nature (mobile foreign passive income) (s 9D(9)(b)(iii))

23.7.15.1 General Background

Besides satisfying the diversionary rules, CFC receipts and accruals attributable to a business establishment will not qualify for exemption if those receipts and accruals are of a passive nature.

Passive receipts and accruals consist of dividends, interest, royalties, rent, annuities, insurance premiums, and similar income of a passive nature.

Also included in passive receipts and accruals are capital gains derived from the disposal of assets that generate or could generate the categories of passive income just described (e.g. the sale of shares).

Lastly, passive receipts and accruals include all forms of currency gains (i.e. section 24I income, and currency gains in respect of foreign equity instruments).

Passive income and gains are fully subject to tax because no direct competitiveness concerns are at stake if no active business is involved. Assets generating passive income or gain, such as portfolio stocks and bonds, are also readily mobile. As such, these assets can easily be shifted abroad without economic consequence (e.g. to wholly owned CFCs). Immediate taxation of CFC passive income is consistent with international practice.

23.7.15.2 The position prior to 1 June 2004

No working capital exception exists for passive items. As a result, a CFC cannot claim that passive income or gains are eligible for the business establishment exemption merely on the grounds that the income or gain acts as working capital or will be used for future CFC business activity. Section 9D does not contain this form of exception because a CFC could always contend that passive income could ultimately be used for a business undertaking. However, certain exceptions exist for passive income, such as the *de minimis* exception and the exception for banking, insurance, financial service, and rental businesses.

23.7.16 The de minimis exception (s 9D(9)(b)(iii)(aa))

Passive income is subject to a *de minimis* rule for administrative convenience. This rule prevents s 9D from applying when a CFC earns trivial amounts of income from passive investments. This *de minimis* rule applies as long as CFC passive income does not exceed 5% of the sum of the amounts making up the CFC's net income. For this purpose the net income must be

- reduced by amounts of a capital nature (which would have been partially included because of the inclusion rate in respect of capital gains)
- increased by the full amount of capital gains and foreign currency gains.

The purpose of the above adjustment is to arrive at a gross amount. This rule is an 'all-or-nothing' rule.

Passive income either falls within or outside the 5% threshold. If passive income exceeds the 5% level, all passive income (not just the amounts exceeding 5%) are subject to s 9D.

Passive capital gains are part of the *de minimis* calculation. These gains are measured in terms of gains (not total proceeds) with capital losses ignored. Capital gains are measured for purposes of both the numerator and the denominator.

Example – *De minimis* exception for passive capital gains

Facts: South African Company owns all the shares of CFC. CFC earns income of R4 million from the sale of its trading stock. In addition, CFC sells Foreign Company X shares with a R600 000 base cost for R1 million cash, and CFC sells Foreign Company Y shares with a R1 300 000 base cost for R500 000 cash.

Result: The R400 000 of gains on the Foreign Company X shares do not qualify for the *de minimis* exception. These gains amount to 9% of the total (R400 000/R4 400 000). The losses on the Foreign Company Y shares are disregarded for purposes of the *de minimis* calculation.

23.7.16.1 The position on or after 1 June 2004

The previous *de minimis* passive exemption allows passive CFC income to be exempt if that income (gross income and gross capital gains) does not exceed 5% of the total. None of this passive income is exempt once the 5% threshold is exceeded. The amended position after 1 June 2004 shifts the policy of this exemption in favour of an objective working capital exemption. Most businesses have a small amount of working capital that is necessary for the proper functioning of that business. The previous all-or-nothing cut off has been abandoned and after 1 June 2004 the exemption is shifted to a 10% of active income threshold with amounts below that threshold remaining exempt even if the total passive amounts exceed the 10% threshold.

Example –The 10% *de minimis* exemption for passive income

Facts: South African Company owns all the shares of CFC. CFC generates R200 000 of gross income from the trading operations of its business establishment. CFC also maintains working capital that generates R23 000 of passive income.

Result. R20 000 of the passive income is exempt under s 9D(9)(*b*)(iii)(*aa*). The excess R3 000 falls within the CFC tax net.

Example – Non-application of *de minimis* rule where no business establishment

Facts: South African Company owns all the shares of CFC. CFC solely holds portfolio investments generating R200 000 of passive income. CFC does not have a business establishment.

Result. Section 9D(9)(*b*)(iii)(*aa*) does not apply under either pre- or post-1 June 2004 law. No active income is attributable to a business establishment. The post-1 June 2004 changes to s 9D(9)(*b*)(iii)(*aa*) also clarify the interaction of this exemption with other section 9D(9) exemptions. Under the post-1 June 2004 exemption, the 10% calculation is determined without reference to the exemptions contained in s 9D(9)(*e*) through (*f*B) or to amounts not included as income (such as dividends that are exempt by virtue of the participation exemption under s 10(1)(*k*)(ii).

23.7.17 The financial services exception (s 9D(9)(b)(iii)(bb))

A further exception to the passive net income rule exists for companies whose principal trading activity consists of banking or financial services, insurance or rental business. However, this exception does not apply to amounts derived from a

- foreign financial instrument holding company
- resident who is a connected person in relation to the CFC, or a resident holding 5% or more of the participation rights in the CFC.
- resident as part of a tax avoidance scheme.

23.7.18 SA source income subject to SA tax treaty benefits (s 9D(9)(e))

Also excluded from the CFC provisions is any *taxable income* derived by a CFC that is

- not exempt, nor
- taxed at a reduced rate in terms of a SA double tax agreement

A CFC is a non-resident and will only have a 'taxable income' in respect of amounts derived from a SA source. In the case of CGT this includes capital gains on immovable property or assets of a PE in SA. The purpose of this exclusion is to prevent the same amount from being taxed twice, i.e. once as taxable income in the hands of the non-resident CFC and again in the hands of the SA resident shareholder of the CFC.

Where taxable income of a CFC is taxed at a lower rate in terms of a DTA, it will be taken into account in full when determining s 9D taxable income in relation to the SA resident shareholder. The minimal tax payable by the CFC will not qualify as a s 6*quat* rebate as it is not tax imposed by a foreign government. The tax treaties do not give relief for s 9D income as it is not the CFC that is taxed but the resident shareholder. From a CGT perspective this does not seem to be of relevance as the lower rate of tax in DTA's tends to apply to passive income such as interest and royalties, and not capital gains.

23.7.19 Capital gains attributable to business establishment or subsidiary company of CFC (s 9D(9)(fB))

A capital gain of a CFC will be excluded from its net income where the asset disposed of was attributable to any business establishment

- of a CFC, or
- any other foreign company that forms part of the same group of companies as the CFC.

The exclusion does not apply to a financial instrument as defined in s 1 or an intangible asset defined in para 16. The term 'group of companies' is defined in s 1. To be part of the same group of companies the controlling company must hold at least 75% of the equity shares of the controlled company.

23.7.20 Disposal of interest in foreign company by CFC (s 9D(9)(h))
[Deleted with effect from 1 June 2004]

Section 9D(9)(*h*) contains a participation exemption for foreign dividends and the sale of shares by CFCs. Under this exemption, dividends from the foreign shares and the sale of foreign shares will be exempt if the CFC receiving the dividend or selling the shares has a more than 25% interest in the equity shares of a foreign company. With effect from 1 June 2004 the participation exemption for dividends has been moved to s 10(1)(*k*)(ii)*(dd*) and the exemption for selling shares to para 64B.
The position before 1 June 2004

Excluded from the CFC provisions are amounts received by or accrued to a CFC from

- the disposal of equity shares in any other foreign company, or
- dividends received from any other foreign company.

For this exclusion to apply the CFC must have held more than 25% of the equity shares in the foreign company for at least 18 months. The percentage shareholding is determined immediately before the date of disposal of the shares or declaration of the dividend.

The exclusion of capital gains on the disposal of the shares in another foreign company does not apply where the other company was a foreign financial instrument holding company immediately before the disposal of its shares. An extensive definition of the term 'foreign financial instrument holding company' is contained in s 9D(1). In essence it is a foreign company that holds more than 50% of the market value or two-thirds of the cost of its assets in the form of financial instruments. The assets include assets of controlled group companies. There are a number of exclusions relating to financial instruments consisting of trade debts, and *bona fide* licensed banks, insurers, dealers or brokers. In determining the 50% shares and loans in companies forming part of the same group of companies must be disregarded.

23.7.21 Election to apply s 9D to CFC net income excluded under s 9D(9) (s 9D(12)

Section 9D(12) enables a resident who, together with any connected person, holds at least 10% but not more than 25% of the participation rights in a CFC to elect that the provisions of s 9D(9) shall not apply to the net income of the CFC. In other words, instead of such net income only being taxed when declared as a foreign dividend, the resident can elect to apply imputation. The downside of being taxed on the dividend basis is that the resident only has access to the foreign dividend withholding taxes for the purpose of claiming a s 6*quat* rebate. By making the election the resident can drill down into the company and access the underlying corporate tax. Where an election has been made, any dividend subsequently distributed out of the relevant net income will be exempt in terms of s 10(1)(*k*)(ii)(*cc*).

This enables the resident to avoid the economic double taxation of profits distributed and taxed as a foreign dividend where no underlying foreign tax credits may be claimed. However, this elective provision should not be used to bring foreign tax credits in excess of the South African tax liability into the tax system, which would shield other sources of low taxed foreign income. Therefore, excess foreign tax credits will in these instances be forfeited. This election may be made on a year-by-year basis.

Example 1 – Election to apply imputation to s 9D(9) excluded net income

Facts: Carolyn owns 10% of a CFC that operates a business establishment in Hades, a high tax country. The CFC derived R1 000 in active net income and after paying the relevant taxes paid the remainder to its shareholders by way of dividend. Hades has a 30% corporate tax rate and imposes a 10% dividend withholding tax. Carolyn received a net dividend of R63 after tax. Her marginal tax rate is 40%.

Result: Under the dividend basis, Carolyn's tax liability would have been determined as follows:

	R
Gross dividend received (para (*k*) of gross income)	70
Tax thereon at 40%	28
Less: s 6*quat* rebate	(7)
Tax payable	21

If Carolyn makes an election in terms of s 9D(12) her tax liability will be determined as follows:

	R
Net income of CFC (s 9D)	100
Tax thereon at 40%	40
Less: s 6*quat* rebate (R30 + R7)	(37)
Tax payable	3

As can be seen, Carolyn has saved R21 – R3 = R18 by making the s 9D(12) election.

Example 2 – Election to apply imputation to s 9D(9) excluded net income

Facts: South African Company owns 25% of the ordinary shares of UK CFC. In 2005, UK Company generates £400 000 of active income attributable to a UK business establishment as well as £20 000 of passive income from related working capital. All this CFC income is subject to a 30% UK tax £420 000x 30% = £126 000). In 2006, UK Company distributes all remaining £294 000 (£420 000 - £126 000) to South African shareholders as a dividend.

Result. In 2005, South African Company can elect to treat an amount equal to its portion of CFC income as imputed amounts despite the exemptions of s 9D(9)(*b*) and the South African tax liability may be reduced by s 6*quat* rebates. South African Company can disregard the 2006 dividend because this dividend represents previously taxed income (see s 10(1)(*k*)(ii)(*cc*)).

23.7.22 Election to apply s 9D to a non-CFC (s 9D(13))

Section 9D(13) enables a resident who, together with any connected person, holds at least 10% but not more than 25% of the participation rights in a foreign company to elect that the company be treated as a CFC in respect of any foreign tax year of that company. This would apply to a foreign company in which residents hold less than 50% of the participation rights. Normally such companies fall outside s 9D and their resident shareholders only pay tax on the dividends they receive. The downside of being taxed on the dividend basis is that the resident only has access to any foreign withholding tax for the purpose of claiming a s 6*quat* rebate. By making the election the resident can drill down into the company and access the underlying corporate tax. Where an election has been made, any dividend subsequently distributed out of the relevant net income will be exempt in terms of s 10(1)(*k*)(ii)(*cc*).

This enables the resident to avoid the economic double taxation of profits distributed and taxed as a foreign dividend where no underlying foreign tax credits may be claimed. However, this elective provision should not be used to bring foreign tax credits in excess of the South African tax liability into the tax system, which would shield other sources of low taxed foreign income. Therefore, excess foreign tax credits will in these instances be forfeited. This election may be made on a year-by-year basis.

Example – Election to treat foreign company as CFC in terms of s 9D(13)

Facts: South African Company owns 20% of the ordinary shares of UK Company, the remainder of which is owned by an unconnected foreign individual. In 2005, UK Company generates £50 000 of passive net income subject to a 30% UK tax. In 2006, UK Company distributes all remaining £35 000 to its shareholders as a dividend on a pro rata basis.

Result. South African Company can elect to be subject to tax on its pro rata share of the £50 000 earned by UK Company as if UK Company were a CFC. Hence, South African Company is deemed to receive £10 000 of income along with £3 000 of s 6*quat* rebates (resulting in South African taxes of zero). South African Company can disregard all £7 000 of dividends received in the following year because all these dividends represent previously taxed income (see s 10(1)(*k*)(ii)(*cc*)).

23.8 Foreign dividends

Section 9E(1), (7)(*d*), (8)

Section 9E was repealed by s 23(1) of Act 45 of 2003 with effect from 1 June 2004 and applicable in respect of any foreign dividend received or accrued during any year of assessment commencing on or after that date. The position on or after 1 June 2004 is summarised in the table below.

Table 1 – Summary of provisions relating to s 9D and foreign dividends

<table>
<tr><td colspan="3"><u>Application of s 9D</u>
• A CFC is a foreign company in which more than 50% of the participation rights are held by residents.
• Section 9D applies to a shareholder who owns 10% or more of the participation rights in the CFC.</td></tr>
<tr><td>Type of foreign company</td><td>Percentage shareholding of</td><td>Treatment</td></tr>
</table>

	resident	
Any foreign company	0 – 100%	Dividends are exempt ito s 10(1)(*k*)(ii)(*aa*) if declared out of profits • subject to tax in SA (N/A where those profits subject to tax at a lower rate ito a DTA), or • derived from dividends declared by SA resident company.
CFC	10 – 25% inclusive	Normal rule: • Net income of CFC imputed to resident ito s 9D. • Dividends declared out of imputed income are exempt ito s 10(1)(*k*)(ii)(*cc*). • Income from business establishment not imputed (s 9D(9) exemption), but taxed in resident's hands when dividend declared (para (*k*) of definition of gross income). Section 9D(12) exception: • Resident can elect that s 9D applies to net income excluded by s 9D(9), thereby accessing s 6*quat* rebate on foreign tax on net income. Were it not for this election, only withholding taxes on foreign dividends would qualify for s 6*quat* rebate, not underlying taxes on company profits. • Dividends declared out of imputed net income are exempt ito s 10(1)(*k*)(ii)(*cc*).
Not a CFC	10 – 25% inclusive.	Normal rule: Section 9D not applicable as company not a CFC. • Dividends taxable in hands of resident when declared (para (*k*) of definition of gross income) • Capital gain / loss on disposal of shares in foreign company subject to CGT. Section 9D(13) exception: • Resident can elect that company be treated as a CFC, thereby accessing s 6*quat* rebate on foreign tax on net income. Were it not for this election, only withholding taxes on foreign dividends would qualify for s 6*quat* rebate, not underlying taxes on company profits. • Dividends declared out of imputed net income are exempt ito s 10(1)(*k*)(ii)(*cc*).

Any foreign company (CFC/non-CFC) except a foreign financial instrument holding company	More than 25%	• Dividends - exempt ito s 10(1)(*k*)(ii)(*dd*).
		• Capital gains or losses on disposal of shares in foreign company - exempt ito para 64B if
		  ➢ held for at least 18 months, and
		  ➢ disposed of to a non-resident.

Any foreign company	Less than 10%	• Dividends - taxable ito para (*k*) of definition of gross income. Exception: Dual listed shares – dividend exempt ito s 10(1)(*k*)(ii)(*bb*) [applies where > 10% of shares held by residents]. • Capital gain / loss on disposal of shares

		subject to CGT.

The position prior to 1 June 2004

As a general rule, foreign dividends are taxable in the hands of SA residents. However, a foreign dividend declared or deemed to be declared out of a capital profit, will not be subject to tax in the hands of a resident where the following two requirements are met:

The qualifying interest requirement

First, the dividend must be distributed directly or indirectly to a **resident**[314] holding a **qualifying interest** in the foreign company.

In terms of s 9E(1) a qualifying interest of any person means

> '(*a*) any direct interest of at least 10 per cent held by such person in the equity share capital of any company; and
>
> (*b*) any direct interest of at least 10 per cent held by any company contemplated in paragraph (*a*) in the equity share capital of any other company, which other company shall for the purposes of this definition be deemed to be a company contemplated in paragraph (*a*) in which such person holds a direct interest of at least 10 per cent'.

Examples – Qualifying interest

1. *Facts:* John owns 10% of Holdco, a foreign company based in the Cayman Islands.

   Result: John has a qualifying interest in Holdco.

2. *Facts:* Same facts as 1. above, but Holdco owns 15% of Subco.

   Result: Holdco has a qualifying interest in Subco. John is deemed to hold at least a 10% interest in Subco even though his actual interest is only 1,5% (10% x 15% = 1,5%).

The designated country / qualifying statutory rate requirement

Secondly, the exemption only applies to the extent that the profits out of which the dividend was declared constitute capital gains that are or will be subject to tax in a **designated country**[315] at a **qualifying statutory rate**[316] of at least 13,5% after taking into account the application of any double taxation agreement, if any;
In determining the statutory rate

- there must not be a right of recovery of the tax by any person (other than a right of recovery in terms of an entitlement to carry back losses arising during any year of assessment to a prior year of assessment), and
- when the designated country imposes tax on the company at a progressive scale of statutory rates, the statutory rate must for the purposes of the exemption be deemed to be the highest rate on the scale.

[314] As defined in s 1.
[315] See 'List of designated countries for the purposes of section 9E(8) of the Income Tax Act, 1962' GN 866 in *Government Gazette* 21526 of 1 September 2000.
[316] As defined in s 9E(1).

Example 1 – Foreign dividend distributed out of capital gain

Facts: Company B is a resident of country B and its sole asset is a piece of land. During the year ended 28 February 2003, company B sold the land at a profit of R100 000. Country B subjected the capital gain to its statutory rate of tax of 15% leaving R85 000 which was distributed as a dividend to Mr B, the sole shareholder who is a resident of South Africa. Country B is a designated country.

Result: The dividend will be exempt from normal tax in Mr B's hands because:

- Mr B holds a qualifying interest of at least 10% in company B
- Country B's statutory rate of tax on the capital gain is 13,5% or higher.

Example 2 – Foreign dividend subject to tax at progressive tax rates

Facts: The facts are the same as in Example 1, but country B taxes company profits as follows:

		R
On the first R90 000	10%	9 000
On the amount exceeding R90 000	15%	1 500
		10 500

Dividend declared to Mr B = R100 000 – R10 500 = R89 500

Average rate of tax	10,5%
Marginal rate of tax	15%

Result: The dividend will still not be subject to SA tax because account must only be taken of the marginal rate of tax, which exceeds 13,5%.

Example 3 – Carry back of losses

Facts: The facts are the same as in Example 1. During the year ended 29 February 2004 company B makes a loss of R50 000. Under the tax law of country B, company B is allowed to elect to 'claw back' the assessed loss against prior years' taxable income. It elects to carry back the loss to the previous year and to claim a refund of half the tax paid on the capital gain:

	R
Capital gain in 2003	100 000
Less: loss carried back	(50 000)
Revised taxable income	50 000
Revised tax payable (15%)	7 500
Tax previously paid	15 000
Refund claimed	7 500

Result: This right of recovery will not jeopardize the tax-free status of the foreign dividend in the SA resident's hands.

Chapter 24 - Treatment of specific types of assets

24.1 Usufructs

A *usufruct* is defined as

> 'the right to use the thing of another in such a way as to preserve its substantial character.'[317]

The *bare dominium* refers to the right of ownership in the underlying thing that is subject to a usufruct. Examples of CGT assets over which usufructs can be passed include

- land and buildings – the usufruct could be the right to live in the property or the rental income derived from letting the property
- shares – dividend income
- loans – interest income

A *usufructuary* is the person entitled to a usufruct.

The CGT treatment of usufructuary and bare dominium interests can be illustrated by the following examples:

Example 1 - Usufruct created on death

Facts: John Brown dies and bequeaths his holiday home to his family trust subject to a usufruct in favour of his spouse over her remaining life. His spouse has a life expectancy of 10 years. The base cost of the property in John's hands is R400 000 and the market value of the property at date of death is R1 000 000.

After 10 years John's wife passes away. The trust thereafter disposes of the property for R1 000 000. What are the CGT implications for

- John,
- John's deceased estate,
- John's wife, and
- The John Brown Family Trust?

Result:

John (the deceased)

The property is allocated between its component parts as follows:

	R
Market value	1 000 000
Usufruct (R1m x 12 % x 5.650)	678 000
Bare dominium	322 000

There will be a deemed disposal of the bare dominium in John's hands at market value at date of death in terms of para 40(1). Since the usufruct has been left to his spouse there is a roll-over in respect of that asset in terms of para 40(1)(*a*) read with para 67(2)(*a*). The capital gain on disposal of the bare dominium will be as follows:

[317] *Brunsdon's Estate v Brunsdon's Estate* 1920 CPD 159 at 174.

	R
Proceed	322 000
Base cost	
R400 000 x 322 000/1 000 000	128 800
Capital gain	193 200

Note that the base cost is apportioned in terms of the part-disposal rule in para 33. John will be entitled to the enhanced R50 000 annual exclusion in terms of para 5(2).

John's deceased estate

In terms of para 40(1) John's deceased estate will acquire the bare dominium at market value of R322 000. In terms of para 40(2)(*b*) the heir (in this case the trust) will in turn acquire the bare dominium at the market value to the deceased estate (R322 000). There is therefore no gain or loss in the hands of the deceased estate.

John's spouse (the usufructuary)

John's spouse (the usufructuary) acquires the usufruct at a rolled-over base cost of R271 200 (R400 000 – 128 800). When she passes away there is a disposal in terms of para 11(1)(*b*) (an expiry or termination) of the usufruct without any proceeds. She cannot, however, claim the loss of R271 200 if she used the property for non-trade purposes (para 15(*c*) read with para 53(3)(*f*)). Assuming that she let the property, she would be entitled to the loss on the grounds that the asset was used for the purpose of carrying on a trade. If she let the property and used it as a holiday home for say one month a year, she would be entitled to 11/12 of the loss. Paragraph 15(*c*) only limits the loss *to the extent* that the usufruct is not used for the purposes of carrying on a trade.

The John Brown Family Trust (the bare dominium holder)

The base cost of the property in the hands of the trust is R322 000 - the market value of the bare dominium at date of death. Assuming that property values remain constant, the property will grow in value each year as the usufruct heads towards expiry. On expiry the property will have regained its full value in the hands of the trust. When the trust subsequently disposes of the holiday home for R1 million it will therefore have a capital gain of R678 000 (R1 000 000 – 322 000). The base cost remains unchanged at R322 000 and is not affected by the expiry of the usufruct.

Some commentators have suggested that the bare dominium holder should be granted an uplift in base cost as a result of the enhancement in value caused by the expiry of the usufruct. There is no substance in this argument. At the date of acquisition the bare dominium was worth the 'low' value placed on it because of the encumbrance of the usufruct. Furthermore the enhanced value was obtained for no additional consideration. The reconciliation below proves that the overall tax burden (R600 000) is the same as if the full property had been disposed of by the deceased on the day before he died:

Reconciliation

	John	John's estate	John's spouse	John's Trust	Total
	R	R	R	R	R
Proceeds	322 000	322 000	-	1 000 000	1 644 000
Base cost	128 800	322 000	271 200	322 000	1 044 000
	193 200	-	(271 200)	678 000	600 000

Gain realised if property sold on day before death R1 000 000 – R400 000 = R600 000.

Example 2 – Usufruct created by trust after death

Facts: The facts are the same as Example 1 except that John bequeathed the entire property to his trust, which in turn created the usufruct in favour of his spouse.

Result:

John

John would have a capital gain of R600 000 (R1 000 000 – R400 000).

John's estate

The property simply flows in and out of the estate and no capital gain or loss arises.

The Trust

The trust's base cost is the same as the deceased estate, namely, R1 000 000. By passing the usufruct over the property the trust effects a part-disposal. The base cost of the bare dominium remaining in the trust is R322 000. The trust and its beneficiaries are connected persons in relation to each other (para (*b*) of the definition of 'connected person' in s 1). As a result, the trust is deemed to have disposed of the usufruct at market value of R678 000 in terms of para 38(1)(*a*) which is the same as the base cost. The granting of the usufruct therefore results in no gain or loss in the trust. Once the usufruct expires the value of the property returns to its full value of R1 000 000 (assuming no change in price levels) and if the trust sold the property it would realise a capital gain of R678 000.

John's spouse

John's spouse is a connected person in relation to the trust (para (*b*) of the definition of 'connected person' in s 1). The provisions of para 38(1)(*b*) dictate that she is deemed to have acquired the usufruct at a base cost equal to its market value (R678 000). When she passes away she will have a capital loss equal to the base cost. Whether that loss is allowable will depend on whether she used the property for trade purposes (para 15(*c*)).

Reconciliation

	John	John's estate	John's spouse	John's Trust	Total
	R	R	R	R	R
Proceeds	1 000 000	1 000 000	-	1 000 000	2 000 000
Base cost	400 000	1 000 000	678 000	322 000	2 000 000
	600 000	-	(678 000)	678 000	-

24.2 Leasehold improvements

The table below sets out the CGT consequences of improvements to leasehold property, principally in the context of land and buildings. The treatment of these improvements is dependent on the answers to the following questions:

- Were the improvements effected in terms of a lease agreement?
- Were they were effected before or after the valuation date?
- Was any compensation payable by the lessor?

The legal principle of *accessio* is relevant to leasehold improvements. It occurs when

- things belonging to different persons are mixed,
- the subordinate or less valuable thing accedes to or becomes part of the principal or more valuable thing, and
- as a consequence becomes the property of the owner of the principal thing.

In particular, this is a phenomenon that occurs when a thing is united with the ground - *superficies solo cedit* - whatever is attached to the land forms part of it. In ITC 1467[318] Conradie J stated the following:

> 'Permanent structures like buildings adhere to the soil upon which they are built. For this reason land and buildings cannot, leaving aside innovations like sectional title ownership, be separately owned. Legally there is only one *res* in existence – the property which comprises land and buildings.'

If a lessee builds on the ground of a lessor, the building belongs to the owner of the ground, the lessor, unless it is a building of a movable nature, such as a tent. When then does the timing of the disposal of those improvements by the lessee occur?

When a lessee attaches an asset to the land of a lessor there is an immediate disposal of the bare dominium in the assets concerned, while the right of use is retained until the end of the lease. In the absence of compensation, this has the effect of triggering an up-front capital loss. To prevent this, para 33(3)(*c*) was introduced with effect from 22 December 2003. It provided that there is no part-disposal of an asset by a lessee when that lessee improves or enhances the leased asset. The effect of this amendment was to defer the disposal of the bare dominium until the termination of the lease when the entire asset (comprising bare dominium and right of use) will be disposed of. However, for reasons which remain unclear, para 33(3)(*c*) was deleted by Act 32 of 2004. The amendment was deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2005. The effect is a fall back to the pre-22 December 2003 position meaning that a lessee is once again able to claim up-front losses in respect of the bare dominium disposed of.

Where improvements are undertaken in terms of a lease agreement, the question arises as to which deduction takes precedence – s 11(*g*) or the capital loss in terms of the Eighth Schedule. Section 11(*g*) grants an allowance in respect of the relevant expenditure but restricts the quantum that can be claimed in a single year of assessment. Paragraph 20(3)(*a*) provides that the relevant expenditure must be reduced by any amount which 'is or was *allowable* as a deduction in determining the taxable income of that person before the inclusion of any taxable capital gain'. It is submitted that the expenditure is 'allowable' in terms of s 11(*g*) in the sense that it is 'capable of being allowed' and that s 11(*g*) must therefore be applied in the first instance.

Table 1 – CGT consequences of leasehold improvements

Factor	**Effect on lessor**	**Effect on lessee**
Time of disposal	Disposal occurs when property upon which improvements were effected is disposed of.	The cost of effecting the improvements constitutes the price paid by the lessee for the right of occupation. *Period between 22.12.2003 and years of assessment*

[318] (1989) 52 SATC 28 (C) at 31.

		commencing on or after 24.1.2005 Any disposal of the bare dominium in the improvements is deferred until the end of the lease by para 33(3)(*c*). The time of disposal therefore occurs when the lease expires (para 13(1)(*b*)). *Period prior to 22.12.2003 and years of assessment commencing on or after 24.1.2005* The bare dominium in the improvements is disposed of at the time they are affixed to the land of the lessor. The right of use of the improvements is disposed of on expiry of the lease (para 13(1)(*b*)). Note: Paragraph 33(3)(*c*) was deleted by Act 32 of 2004.
Obligatory improvements effected ito lease agreement	Amount of improvements included in gross income (para (*h*) of gross income definition). An allowance is granted ito s 11(*h*) The above have no CGT consequence as they are in respect of the *acquisition*, not the disposal of an asset. The base cost of the improvements in terms of para 20(1)(*h*)(ii)(*cc*) is the amount included in gross income (by para (*h*) of the definition of gross income in s 1) less any allowance granted in terms of s 11(*h*).	Obligatory improvements are allowable under s 11(*g*). On disposal the amounts allowed in terms of s 11(*g*) must be excluded from base cost – para 20(3)(*a*).
Voluntary improvements effected before valuation date	No expenditure incurred in terms of para 20. Valuation date value (VDV) options include market value, 20% of [proceeds – post-1.10.2001 expenditure] or TAB. Note TAB would be based on the date the land was acquired, and the improvements would have a zero cost.	No normal tax deduction. Costs incurred form part of base cost. VDV options iro the right of use same as lessor. The market value would be influenced by the remaining period of the lease. The disposal of the bare dominium in pre-1.10.01 improvements represents a

		pre-valuation date disposal. The result is that no capital loss can be claimed iro that part of the asset.
Voluntary improvements effected after valuation date	No expenditure will be added to the base cost of the land since none was incurred.	Expenditure incurred ito para 20 = base cost
Compensation paid by lessor	Forms part of base cost in terms of para 20(1)(*e*). In the case of pre-1.10.2001 improvements, VDV determined using market value, TAB or 20% of proceeds.	Compensation included in proceeds ito para 35(1)(*b*). Any compensation in respect of bare dominium disposed of prior to 1.10.01 is not subject to CGT as it relates to a pre-CGT disposal.

24.3 Leasehold rights of lessees

A lessee's rights under a lease may give rise to an asset in the hands of the lessee. How would the value of this asset be determined on valuation date? One way would be to determine the extent to which the future rentals per the lease agreement are less than the projected market-related rental. For example, assuming no future increases in rentals, if the lease has 5 years to run at a rental of R5 000 per month and the current market related rental is R7 000 per month, then the 'asset' is the present value of R2 000 per month over 60 months. As the end of the lease approaches the lease becomes less valuable and when it terminates there would in most cases be no proceeds. It is unlikely that there would be much value in short-term leases, and the CGT implications are more likely to be apparent in a long-term lease such as a 99-year lease.

To summarise:
- On valuation date the market value of a lease could be determined (para 31(1)(*g*)).
- When the lease expires or the rights to the lease are sold there will be a disposal (para 11(1)(*b*)).
- Proceeds would usually be zero where the lease simply runs to the end of its term and expires. Proceeds could be received if the lessor paid an amount to the lessee in order to secure an early termination of the lease.[319]
- A capital loss would usually arise in such cases.
- Where the lease was taken out for a non-trade purpose para 15(*d*) would operate to disallow the loss.
- The question arises as to whether a market value loss of this nature arising in respect of a lease taken out for the purposes of trade would be allowable. In this regard the provisions of paras 26 and 27 need to be considered.

Example 1 – Disposal of lease rights on termination of lease

Facts: A lease terminates without proceeds.

Amount paid for lease rights	RNil
Market value of lease rights on 1 October 2001	R100 000
Proceeds on termination	RNil

[319] See ITC 175 (1930) 5 SATC 180 (U) where it was held that a payment by a lessor to a lessee to secure the early termination of a lease was of a capital nature.

Result: In this case para 27 applies and the lessee must use the lower of TAB and market value. TAB is zero resulting in no gain, no loss, and the market value loss would therefore not be allowable.

Example 2 – Proceeds received from lessor for early termination of lease

Facts: The landlord pays the lessee R20 000 to secure an early termination of the lease.

Expenditure before valuation date	RNil
Market value on valuation date	R100 000
Expenditure after valuation date	RNil
Proceeds	R20 000

Result: In this scenario para 26 applies. It dictates that the valuation date value (VDV) is equal to proceeds less post-CGT expenditure. Thus VDV = R20 000 - R0 = R20 000, proceeds = R20 000 resulting in no gain, no loss. The market value loss of R80 000 would not be allowable.

24.4 Loans

Asset

The definition of an ‘asset’ in para 1 is wide and includes ‘property of whatever nature, whether movable or immovable, corporeal or incorporeal …’. Upon making a loan the lender acquires a right to claim payment from the borrower which is an incorporeal asset.

Base cost

Paragraph 20(1)(*a*) includes in the base cost of an asset

> ‘the expenditure actually incurred in respect of the cost of acquisition or creation of that asset’.

The expenditure actually incurred in acquiring the right to claim payment is the amount advanced by the lender to the borrower plus any incidental costs such as the cost of drawing up the agreement.

Loan repayments

There is some controversy as to how loan repayments should be treated. At least two methods exist, namely,

- the cost recovery method (para 20(3)(*b*)), and
- the part-disposal method (para 33).

The cost recovery method

Where a loan is acquired at face value, and there is no intention to dispose of it to a third party, the cost recovery method will be appropriate for dealing with loan repayments. In these circumstances a capital gain would in the normal course of events not be anticipated, and the repayments can rightly be regarded as a recovery of cost. This is sanctioned by para 20(3)(*b*) which provides that the expenditure in acquiring an asset must be reduced by any amount recovered. This method has the advantage of simplicity, since a disposal is not triggered each time a loan repayment is received.

The part-disposal method

It can happen that a loan is acquired at less than face value, for example, under an offer of compromise. Alternatively, the creditor may intend to dispose of the loan before maturity. In such circumstances a capital gain will often be anticipated at the outset and it can no longer be argued that the loan repayments are a recovery of cost. In such cases the repayments will constitute proceeds arising from a part-disposal of the loan. Paragraph 33 contains two methods for determining the portion of the base cost disposed of:

- The market value formula method (para 33(1)).
- The specific identification method (para 33(2)).

A practical difficulty with the market value method is that it requires the market value of the loan to be determined immediately prior to each repayment. The market value of a loan, particularly one that is interest bearing, fluctuates constantly with prevailing interest rates and prospects of recovery. Where there are numerous repayments it would be administratively burdensome to apply this method.

An alternative would be to apply the specific identification method in para 33(2) to identify the portion of the base cost disposed of. The argument would be that since a loan is repaid at face value, all parts of a loan have equal cost, are indistinguishable and identifiable by nomination. For example, an interest-free loan of R120 is acquired at a cost of R100, and is repayable in 5 equal annual instalments. The base cost of each repayment is R20, and each year a capital gain of R24 – R20 = R4 will be realized.

Disposal

Under the cost recovery method, a disposal will occur upon a loan becoming fully repaid, since there will be a redemption or discharge of the debt in terms of para 11(1)(*b*).

When a loan becomes irrecoverable, there will also be a disposal of the right to claim payment. For example:

Event	**Para 11**	**Type of disposal**
• the debtor cannot pay	(1)(*c*)	Loss
• the debt prescribes	(1)	Extinction
• the debt is cancelled	(1)(*b*)	Cancellation

Bad debts

Once a loan becomes irrecoverable the balance of the loan (being the base cost) will give rise to a capital loss in terms of para 4(*a*). In order for this loss to be allowable, para 56 provides that:

- the debtor and creditor must not be connected persons, or
- if they are connected persons, the creditor will only be able to claim a loss to the extent that the debtor has accounted for the corresponding capital gain in the determination of his/her aggregate capital gain or loss.

Bad debts recovered

Should a creditor have claimed a loss from the disposal of a loan in a previous year, and an amount is subsequently recovered in the current year, that amount will be treated as a capital gain in terms of para 3(*b*)(ii).

The debtor

From the debtor's perspective the amount owed is a liability, so there is no CGT asset. However, where the debtor is relieved of any portion of that liability – whether through prescription or cancellation of the debt - para 12(5) effectively treats the amount so relieved as a capital gain. It achieves this result by treating:

- the debtor as having acquired the claim so reduced or discharged for no consideration
- the claim as having a base cost of zero;
- the claim as being disposed of for proceeds equal to the amount reduced or discharged.

For a detailed commentary on para 12(5) see **6.2.5.**

24.5 Restraint of trade payments

The courts in Australia and the United Kingdom have refused to accept that the right to trade is an asset for CGT purposes. In the Australian case of *Hepples v FCT*[320] Toohey J stated:

> 'The freedom of a person, in this case the appellant, to compete in the marketplace is not of itself an asset: *Forbes v NSW Trotting Club Ltd* (1979) 143 CLR 242, at 260-1. In *Kirby (Inspector of Taxes) v Thorn EMI Plc*. [1988] 1 WLR 445, at 458; [1988] 2 All ER 947, at 959, Purchas LJ observed of the capital gains tax provisions of the Finance Act 1965 (UK):
>
>> "The right to trade in the marketplace is a right which is common to all … To suggest that it is an incorporeal right … is wholly unjustifiable within the basic concept of an acquisition of an asset with its accretion in value owing to changes in economic circumstances, etc over a period of inflation followed by disposal with a realisation of a chargeable gain."'

But this view has not been accepted in South Africa. In ITC 1338[321] McEwan J said the following:

> 'The basic principle is that a company's or a person's right to trade freely is an incorporeal asset and, if he is paid for a restriction upon that right, whether partial or complete, he is being paid compensation for the loss or sterilization of the asset (or part of it as the case may be) and the payment therefore is a capital payment.'

The argument that a restraint of trade is not property was raised in *Taeuber and Corssen (Pty) Ltd v SIR.*[322] While the court did not comment directly on the contention, it clearly did not accept it, stating that

> 'the appellant had established an income-producing structure. The structure of appellant consisted not only of premises, personnel and the right to trade but also of certain specific contractual rights and duties . . .'.

The debate as to whether a right to trade is an asset may be academic because in many cases it will not be the right to trade that is being disposed of, but rather some other asset such as goodwill or know how.

The person agreeing to a restraint gives up the right to trade freely (an asset) in exchange for an amount of proceeds. By signing the agreement the restrained party creates an asset in the hands of the other party, thereby triggering a disposal in terms of para 11(1). The

[320] (1991) ALR 497 in para 16. The case is available online at <http://www.austlii.edu.au/au/cases/cth/HCA/1991/39.html> (accessed 22 March 2005).
[321] (1980) 43 SATC 171 (T) at 174.
[322] 1975 (3) SA 649 (A), 37 SATC 129 at 138.

asset so created is the right to expect the restrained party to abide by the terms of the restraint agreement. The time of disposal by the restrained party and the time of acquisition by the restraining party is the date on which the asset is created.[323] The right of the restraining party will be disposed of when the restraint ends, which will result in the extinction of the asset by termination (para 11(1)(*b*)). The time of disposal is the date of extinction (para 13(1)(*b*)).

Despite the common law position, restraint payments made on or after 23 February 2000 to the following persons must be included in their gross income in terms of para (*c*A) of the definition of gross income in s 1:

- individuals
- labour brokers without exemption certificates issued in terms of the Seventh Schedule
- personal service companies, and
- personal service trusts

As a result, restraint payments to the abovementioned persons will not be subject to CGT. Paragraph 35(3)(*a*) excludes from proceeds any amount included in the gross income of a person.

However, not all restraint payments are deemed in terms of para (*c*A) to be gross income. Payments to companies and trusts that are not personal service companies or trusts are excluded and will therefore be subject to CGT.

24.6 Non-refundable deposits

What happens when a person sells an asset subject to a non-refundable deposit and the sale falls through? Does the retention of the deposit result in a capital gain in the hands of the seller?

A capital gain will arise, but the methodology for its determination will vary depending on the terms of the sale agreement. If the agreement is subject to a suspensive condition, the time of disposal is when the condition is satisfied (para 13(1)(*a*)(i)). If the sale is unconditional, the sale takes place when the agreement is entered into (para 13(1)(*a*)(ii)). The taxation of a non-refundable deposit is illustrated in the two examples that follow.

Example 1 – Non-refundable deposit: Sale subject to resolutive condition

Facts: On 1 November 2004 Jane sold her holiday home for proceeds of R120 000. The base cost of the house was R100 000 resulting in a capital gain of R20 000 (R120 000 – R100 000). The buyer was obliged to make a non-refundable deposit of R10 000 and was required to pay the balance of R110 000 by 28 February 2005. The sale agreement provided that if any part of the purchase price was not paid within the stipulated time, the sale would be cancelled, the house returned to Jane and the deposit forfeited. The deposit simply forms part of the payment of the selling price. Jane had a debit loan of R110 000 and cash in the bank of R10 000. By 31 March 2005 the debtor had defaulted and the sale fell through. Jane reacquired the house when its value was R140 000.

Result: As the sale was cancelled, it must be unwound in Jane's hands during the year ended 28 February 2006 in terms of paras 3(*b*)(ii) and 4(*b*)(i)(*bb*). In terms of para 3(*b*)(ii) the base cost of R100 000 has been recovered by virtue of the repossession of the house. Jane therefore has a capital gain of R100 000. In terms of para 4(*b*)(i)(*bb*) R110 000 of the

[323] Paragraph 13 does not specify a time of disposal for the creation of an asset. However, it is not an exhaustive provision, and the time of disposal must therefore be deduced from the event itself.

R120 000 proceeds has become irrecoverable. She will therefore have a capital loss of R110 000. The sum of Jane's capital gains and losses in the second year is therefore a capital loss of R10 000. The overall result is a capital gain of R20 000 in year 1 and a capital loss of R10 000 in year 2, leaving an overall capital gain of R10 000 which is represented by the forfeited deposit.

Example 2 – Non-refundable deposit: Sale subject to suspensive condition

Facts: Assume the same facts as above, but the sale is contingent on the buyer obtaining a bond. In year 2 he fails to obtain the bond and the sale collapses.

Result: The moment that happens Jane acquires a right to claim the deposit from the buyer. The cost of that right is zero. She then disposes of the right for proceeds equal to the amount received of R10 000. Capital gain = R10 000 (proceeds) – R0 (base cost) = R10 000.

24.7 Exchange of equity instruments by employees under s 8A(5) and s 8C(4)

Exchange of share options under s 8A(5)

The view is held that the cession or release by an employee of one share option for another in the circumstances contemplated in s 8A(5) will not give rise to a capital gain or capital loss at the time of that cession or release. This is based on the view that any consideration received in respect of the cession or release of the first option 'must be' included in gross income upon exercise of the second option. In these circumstances the amount received or accrued must be reduced to nil in terms of para 35(3)(*a*) of the Eighth Schedule. Any expenditure in respect of the first option would similarly have to be reduced in terms of para 20(3)(*a*).

The above applies despite the fact that the second option may not be exercised because it is 'out of the money' at the relevant time. The intention is that s 8A should take precedence.

Exchange of restricted shares under s 8C

The problem described above does not arise under s 8C, which applies to equity instruments acquired by employees or directors on or after 26 October 2004. This follows from para 11(2)(*j*) which treats any disposal prior to vesting of an equity instrument contemplated in s 8C as a non-disposal. In terms of s 8C(3)(*b*)(ii), when a restricted equity instrument is disposed of, vesting normally occurs immediately before disposal. However, this rule does not apply to a disposal contemplated in s 8C(4). Section 8C(4)(*a*) deals with the situation where an employee acquires another restricted equity instrument from his or her employer in exchange for an existing restricted equity instrument. Thus no vesting occurs as a result of the exchange and there is no disposal in terms of para 11(2)(*j*).

Example – Substitution of one restricted share for another in terms of s 8C

Facts: Employee acquires a restricted equity share while being employed by Company X. Company X enters into an amalgamation with Company Y. Employee surrenders the restricted Company X share in exchange for a restricted Company Y share as part of the amalgamation.

Result. There are no CGT consequences. No vesting occurs as a result of the exchange of the restricted Company X and Y shares in terms of s 8C(3)(*b*)(ii) read with s 8C(4)(*a*). In terms of para 11(2)(*j*) the exchange of shares is deemed not to be a disposal as it has occurred prior to vesting.

24.8 Pre-valuation date depreciable assets and the market value method

A capital gain on a depreciable asset will only arise when the asset is disposed of for proceeds that exceed its original cost. In theory depreciable assets should not yield a capital gain because they deteriorate with use and as a result the proceeds on their disposal should be less than the original cost. Likewise their disposal should not give rise to a capital loss because any loss on disposal would normally be accounted for as an allowance in terms of s 11(*o*). A person may, however, not always qualify for an ordinary loss in terms of s 11(*o*). This could happen, for example in the case of an asset that was not 'scrapped' in terms of s 11(*o*) prior to its amendment on 22 December 2003, or in the case of an asset disposed of on or after that date where that asset has a tax write off period of 10 years or more.

For the purpose of determining the valuation date value of no gain no loss depreciable assets, TAB is likely to be the method of choice for most persons. TAB will usually be an option because apart from certain s 11(*e*) assets, the cost of the asset has to be known to qualify for the capital allowances.

It does, however, sometimes happen that depreciable assets are sold above cost. This has been the case with some imported assets where their replacement cost has increased because of the depreciation in the value of the rand. The use of market value as the valuation date value of such assets then becomes worth considering for these 'gain' assets. Where an asset is sold below original cost no capital gain or loss should arise, as the proceeds and the expenditure would be reduced to nil by any recoupments in terms of para 35(3)(*a*) or capital allowances in terms of para 20(3)(*a*).

Where a person adopts market value, any consideration received on disposal of the asset must be reduced by any recoupment of capital allowances in terms of para 35(3)(*a*). However, the market value cannot be reduced by the capital allowances claimed in terms of para 20(3)(*a*), as that provision only applies to expenditure. Market value is not expenditure, but rather a 'valuation date value' in terms of para 26 or 27. In the absence of any reduction to account for the capital allowances claimed, an artificial capital loss will invariably result. However, this should be limited to nil by the kink tests in paras 26 and 27.

The impact of s 23B

The rather lop sided effect of reducing proceeds by recoupments but not reducing market value by capital allowances ostensibly results in the fiscus being prevented from taxing most capital gains determined on an historical cost basis. The question, however, arises as to whether the valuation date value arrived at under para 26 or 27 should be reduced in terms of s 23B. Section 23B(1) provides as follows:

> '**23B. Prohibition of double deductions.—**(1) Where, but for the provisions of this subsection, an amount—
> (*a*) qualifies or has qualified for a deduction or an allowance; or
> (*b*) is otherwise taken into account in determining the taxable income of any person,
> under more than one provision of this Act, such amount or any portion thereof, shall not be allowed or taken into account more than once as a deduction or allowance in the determination of the taxable income of any person.'

In principle there does not seem to be any reason why s 23B should not be applied to reduce the valuation date value by capital allowances claimed. In fact, the failure to apply s 23B leads to the absurdity that there will be very few instances where the fiscus will be able to subject a capital gain to tax on the disposal of a depreciable asset. A gain would only arise where the proceeds plus the recoupment exceeds the market value.

Example – Depreciable assets where market value adopted as valuation date value

Facts: A machine cost R100 five years before valuation date and was fully written off for normal tax purposes by 1 October 2001. The market value of the asset was R100 on valuation date and it was disposed of for a consideration of R120. Determine the capital gain or loss using market value as the valuation date value.

Result:

Proceeds = R120 – R100 (recoupment) = R20
Expenditure = R100 – R100 (capital allowances) = R0
Market value = R100
Before applying para 26 a capital loss of R20 - R100 = R80 would have resulted. However, para 26(3) applies to limit the valuation date value (VDV) to the proceeds of R20, and this will give no gain or loss.

Applying s 23B, the VDV of R20 would be reduced to nil on the basis that the taxpayer had already enjoyed deductions in respect of the asset amounting to R100. This will result in a capital gain of R20. The person would therefore have to consider using TAB, as this would give a higher VDV.

24.9 The disposal of common property under a share block or sectional title scheme

It sometimes happens that the common property in a sectional title or share block scheme is surplus to the requirements of the shareholders / owners and is disposed of with attendant CGT consequences.

Share block schemes

Under a share block scheme, the shareholders enjoy an indefinite right of use and occupation in the common property, while the share block company holds the bare dominium. The bare dominium is virtually worthless given the indefinite right of use and occupation that has been granted to the shareholders. It follows that when common property is disposed of, this will normally involve a disposal by the shareholders of their right of use and occupation, and the proceeds will accrue to them and they must account for the CGT consequences.

Sectional title scheme

Section 16 of the Sectional Titles Act 95 of 1986 provides as follows:

> ‘**16. Ownership of common property.—**(1) The common property shall be owned by owners of sections jointly in undivided shares proportionate to the quotas of their respective sections as specified on the relevant sectional plan.’

It follows that it is the sectional title holders who must account for the CGT consequences of the disposal of common property, and not the body corporate.

Under both a share block and a sectional title scheme the part-disposal rules in para 33 will have to be applied so as to allocate a portion of the base cost to the common property disposed of. The primary residence exclusion will not be available because the residence itself has not been disposed of which is a requirement of para 45 read with para 46(*c*). However, to the extent that it has not been utilised against other capital gains and losses, the annual exclusion will be available. Whilst the levy income of a body corporate or share block company may be exempt in terms of s 10(1)(*e*), the exclusion provided by para 64 will not be applicable since the disposal is by the shareholders or owners, not by the share block company or body corporate.

Appendix A –Transfer of a residence out of a company or trust

A.1 Introduction

The Eighth Schedule to the Income Tax Act provides that only *natural persons* (individuals) are entitled to exclude the first R1 million of gains on disposal of their primary residences. This exclusion does not apply where the residence is owned by a company, close corporation or trust.

Many individuals have historically purchased their residences in companies or trusts for a variety of reasons, including protection from creditors, avoidance of transfer duty and estate duty and circumvention of the Group Areas Act. These persons now face a potential CGT liability when their company, close corporation or trust disposes of the residence.

In the notes that follow the term ‘company’ will also be used to refer to a close corporation.

Following representations the draft legislation was amended to allow individuals a window of opportunity to transfer their residences out of their companies or trusts into their own names without incurring any adverse tax consequences. Set out below are details of what is exempt and the conditions that need to be satisfied to secure a tax-free transfer.

A.2 Taxes qualifying for exemption

The relevant provisions offer exemption from:

- transfer duty on the transfer of the residence
- stamp duty on the registration of a mortgage bond and transfer of shares in a share block company
- secondary tax on companies in respect of any dividend arising in consequence of the transfer
- capital gains tax on any gain realised by the company or trust

A.3 The transfer duty exemption

The transfer duty exemption requirements are contained in s 9 of the Transfer Duty Act 40 of 1949. Section 9(16) deals with companies and s 9(17) with trusts.

The natural person requirement

An individual must acquire the residence.

The primary residence requirement after acquisition

After acquisition, the residence must constitute the individual’s ‘primary residence’ for CGT purposes.

When can the property be acquired?

Sections 9(16)(*a*) and 9(17)(*a*))

The acquisition must take place between-

- 20 June 2001 (date of promulgation of the Taxation Laws Amendment Act 5 of 2001 and
- 30 September 2002

Any disposal before 20 June 2001 will not qualify for the exemption.

The 100% direct shareholding requirement

Section 9(16)(*b*)

The individual alone or together with his or her spouse must directly hold all the share capital of the company or member's interest in the close corporation, between:

- 5 April 2001 and
- the date of registration in the deeds registry

The concession, therefore, does not apply where

- the residence is held by a subsidiary company;
- the shares in the company holding the residence are owned by a trust; or
- more than one person holds the shares and those persons are not spouses.

A residence held by a company cannot be transferred into the name of a spouse holding no shares. For example, if the husband holds all the shares, he cannot transfer the residence into his wife's name. But if they each hold some shares which together make up the total issued share capital, the residence can be transferred into either spouse's name or into their names jointly.

Assuming that there are two spouses, A and B who are married out of community of property, the table below shows into whose name the residence may be transferred:

Shareholders	**Residence may be transferred into the name of**
A owns 100%	A
A and B jointly own 100%	A, B or A and B jointly.

Trusts: The donation or financing requirement

Section 9(17)(*b*)

The individual must have either:

- disposed of the residence to the trust by way of donation, settlement or other disposition or
- financed *all* the expenditure actually incurred by the trust to acquire and to improve the residence.

Note that if only part of the expenditure was financed by the individual taking transfer, the exemption will not apply – as in the example, of a third party paying for the addition of a room to the residence. 'All the expenditure' means 100% of it.

Assuming that there are two spouses, A and B who are married out of community of property, the table below shows into whose name the residence may be transferred:

Spouses who donated the residence or financed all the expenditure	**Residence may be transferred into the name of**
A only	A, or A and B jointly
A and B jointly	A and B jointly

In the circumstances where a bond was obtained by the trust to finance the acquisition and improvement of the residence, the person who financed the interest on the bond and the repayment thereof will be regarded as having financed that expenditure.

It sometimes happens that taxpayers purchase their residences by taking over a trust. The person and or that person's spouse become the new trustees and beneficiaries. The validity of these schemes, which purport to avoid transfer duty, is not accepted by SARS. Taxpayers who have acquired their residences in this manner will not qualify for the exemption since they would not be the original financiers of the expenditure.

The residence and use requirement

Sections 9(16)(*c*) and 9(17)(*c*)

Between 5 April 2001 and the date of registration the individual or his or her spouse must have:

- ordinarily resided in the residence and
- used it mainly for domestic purposes

as his or her or their ordinary residence

Individuals acquiring their residences in a company or trust after 5 April 2001 will not qualify for the exemption.

Final date for registration in the Deeds Office

Sections 9(16)(*d*) and 9(17)(*d*)

The last day for registration in the Deeds Office is 31 March 2003.

Transfer of land with a residence

Provisos to s 9(16) and (17) read with para 46

The exemption applies in respect of the portion of the land on which the residence is situated and unconsolidated adjacent land that meets these requirements:

The 2-hectare limit

The exemption does not apply to land that exceeds 2 hectares.

The use requirement

Any land transferred must be used mainly for domestic or private purposes together with the residence from 5 April 2001 to the date of registration.

The simultaneous transfer requirement

Any land transferred must be disposed of at the same time and to the same person as the residence.

A.4 The stamp duty exemption

Schedule 1 to the Stamp Duties Act 77 of 1968 provides exemption for the following:

Mortgage bonds

Item 7(*e*)

No stamp duty will be payable where:
- a new bond is taken out by the individual acquiring the residence
- the individual takes over an existing bond from the company (substitution of a debtor)
- the bond is ceded from one lender to another (e.g. Bank A transfers the bond to Bank B)

Shares in a share block company

Item 15(*v*)

Where:
- the residence is held by a share block company and
- the shares in that share block company are held by a company or trust

the transfer of those shares from the company or trust to the individual will be exempt from stamp duty.

These stamp duty exemptions are subject to the same conditions as the transfer duty exemption and also came into effect on 20 June 2001.

A.5 The STC exemption

Methods of disposal qualifying for exemption

No STC will be payable where the interest in a residence is
- distributed as a dividend *in specie*; or
- sold, in which case any capital profit realised on sale may be distributed free of STC.

Applicable to transfer of shares in a share block company

The distribution of shares in a share block company will also qualify for the exemption.

Timing of distribution

The interest in the residence must have been distributed or disposed of on or before 30 September 2002

The distribution of the capital profits must be completed on or before 31 March 2003

Other requirements

The other requirements pertaining to the transfer duty exemption apply equally to the STC exemption. For example, the exemption will not apply to the portion of a property that exceeds 2 hectares. In such a case it may be necessary to liquidate or deregister the company in order to extract any capital profit STC-free (s 64B(5)(*c*) of the Income Tax Act).

Example 1 – The STC exemption (s 64B(5)(*k*))

Facts: Alton transferred his house into Zed Property (Pty) Ltd at a market value of R250 000 on 1 March 1995. The market value of the property on 1 October 2001 is R500 000. The balance sheet of Zed Property (Pty) Ltd on 1 October 2001 appears as follows:

	R
Share capital - 2 shares of R1 each	2
Non-distributable reserve	250 000
Shareholder's loan	249 998
	500 000
Property - at market value	500 000

The non-distributable reserve arose as a result of the revaluation of the property on 1 October 2001. Alton has indicated that he wishes to take advantage of the primary residence exclusion by transferring the property out of the company into his own name.

Result: The provisions of s 64B(5)(*k*) should be read and dealt with in terms of the following:

- Section 9(16) or (17) of the Transfer Duty Act 40 of 1949 - which enables a primary residence to be transferred from a company or trust free of transfer duty.
- Item 7(*e*) of the First Schedule to the Stamp Duties Act 77 of 1968 - which enables a stamp duty-free transfer of a mortgage bond.
- Paragraph 51 of the Eighth Schedule - which stipulates that the residence must be treated as having been disposed of at market value on 1 October 2001. Since the market value of the property on 1 October 2001 will constitute its base cost, no capital gain or capital loss will arise in the hands of the company.
- The provisions of the company's memorandum and articles of association - which will have to be examined to determine whether there are any restrictions on the distribution of capital surpluses.

Alternative 1: Distribute property *in specie* – s 64B(*k*)(i)

	R	R
Dr. Non-distributable reserve	250 000	
Cr. Distributable reserve		250 000
Dr. Dividend	250 000	
Dr. Shareholder's loan	250 000	
Cr. Property		500 000

In this case the dividend of R250 000 will be exempt from STC provided that the distribution of the residence takes place between the date of promulgation of the Bill and 30 September 2002.

Alternative 2: Sell property – s 64B(*k*)(ii)

Dr. Shareholder's loan	500 000	
Cr. Property		500 000
Dr. Non-distributable reserve	250 000	
Cr. Profit on sale of property		250 000
Dr. Dividend	250 000	
Cr. Shareholder's loan		250 000

It has been assumed that the size of the property does not exceed two hectares. Any capital profit attributable to the area exceeding two hectares would attract STC if distributed in the normal course of business. Such a distribution may, however, be exempt in terms of s 64B(5)(*c*) if made in anticipation of or during the course of winding-up or deregistration.

A.6 The CGT exemption

Paragraph 51

In subpara (1) where an interest in a residence has been transferred from a company or trust to a natural person

- the company or trust is treated as having disposed of that residence at market value on the valuation date; and
- that natural person is treated as having acquired that residence at market value on the valuation date.

The effect of this provision is that the capital gain or capital loss on the disposal of the residence will not be subject to CGT.

Any growth or reduction in the value of the property after 1 October 2001 must be accounted for in the hands of the individual/s taking transfer should the primary residence become subject to CGT

Subparagraph (2) provides that subpara (1) only applies where

- that natural person acquires that residence from that company or trust on or after the promulgation of the Taxation Laws Amendment Act 5 of 2001, but not later than 30 September 2002;
- that natural person alone or together with his or her spouse directly held all the equity share capital in that company from 5 April 2001 to the date of registration in the deeds registry of the residence in the name of that natural person or his or her spouse or in their names jointly; or
- that natural person disposed of that residence to the trust by way of donation, settlement or other disposition or made funds available that enabled that trust to acquire the residence;
- that natural person alone or together with his or her spouse ordinarily resided in that residence and used it mainly for domestic purposes as his or her or their ordinary residence from 5 April 2001 to the date of the registration.
- the registration of the residence in the name of the natural person or his or her spouse or in their names jointly, takes place not later than 31 March 2003.

This paragraph only applies in respect of that portion of the property on which the residence is situated and adjacent land as

- does not exceed two hectares;
- is used mainly for domestic or private purposes in association with that residence;
- is disposed of at the same time and to the same person as the residence.

A.7 Donations tax

The legislation does not provide for specific exemption from donations tax. In terms of s 58 of the Act the disposal of property for a consideration that is less than an adequate consideration, i.e. a sale of property at a consideration (value) less than its fair market value, is deemed to be a donation.

The section, however, provides that the Commissioner must determine that the consideration is inadequate. In the case where the following conditions are complied with it has been decided that the Commissioner will not seek to adjust the consideration where

- the transfer is exempt in terms of either s 9(16) or 9(17) of the Transfer Duty Act, and
- the transaction is not entered into for the purposes of tax avoidance, other than that specifically provided for.