SOUTH AFRICAN REVENUE SERVICE

COMPREHENSIVE GUIDE TO CAPITAL GAINS TAX

(Issue 4)

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Preface

The purpose of this guide is to assist the public and SARS's personnel in gaining a more in-depth understanding of capital gains tax (CGT). While this guide reflects SARS's 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. These initial explanations have been completely revised, with the addition of many more explanations, examples and illustrations. Much of the additional material was inspired by the many e-mail and written queries submitted by the public.

This guide is not a binding ruling under Part IA of Chapter III of the Income Tax Act, 1962. Should an advance tax ruling be required, visit the SARS website for details of the application procedure.

This work reflects the law as at 2 November 2010 as amended by the Taxation Laws Amendment Act 7 of 2010. The 2011 tax rates have been used in this guide. These rates apply to companies with years of assessment ending between 1 April 2010 and 31 March 2011 and to persons other than companies with years of assessment commencing on 1 March 2010.

For more information you may

- visit the SARS website at
- **www.sars.gov.za**,
- visit your nearest SARS branch,
- contact your own tax advisor/tax practitioner,
- if calling locally, contact the SARS Contact Centre on 0800 00 7277, or
- if calling from abroad, contact the SARS Contact Centre on +27 11 602 2093.

Comments on this guide are always welcome and may be sent to
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ABBREVIATIONS

In this guide unless the context indicates otherwise,

- **'non-resident'** means a person that is not a 'resident' as defined in s 1;
- '**paragraph'** means a paragraph of the Eighth Schedule to the Act;
- **'Schedule'** means a Schedule to the Act;
- **'section'** means a section of the Act;
- **'tax treaty'** means an agreement for the avoidance of double taxation;
- **'tax year'** means in the case of a company, the year of assessment ending during the period of 12 months ending the last day of March;
- **'the Act'** means the Income Tax Act 58 of 1962; and
- a reference to any word or expression bears the meaning ascribed to it in the Act.

References to statutory provisions

para	Paragraph
paras	Paragraphs
s	Section
ss	Sections

Acronyms

BESA	Bond Exchange of South Africa
CDE	Capital development expenditure
CFC	Controlled foreign company as defined in s 9D(1)
CGT	Capital gains tax
CIPC	Companies and Intellectual Property Commission established under s 185 of the Companies Act 71 of 2008
CISS	Portfolio of a collective investment scheme in securities
CISP	Portfolio of a collective investment scheme in property shares
CTC	Contributed tax capital as defined in s 1
FEC	Forward exchange contract
FIFO	First-in-first-out
GG	*Government Gazette*
GN	Government Notice
IAS	International accounting standard
JSE	The securities exchange operated by JSE Ltd
LIFO	Last-in-first-out
MV	Market value
ODA	Official development assistance

OECD	Organisation for Economic Co-operation and Development
PBA	Public benefit activity contemplated in the Ninth Schedule
PBO	Public benefit organisation
PE	Permanent establishment
PV	Present value
SA	Republic of South Africa
SPID	Specific identification
STC	Secondary Tax on Companies
TAB	Time-apportionment base cost
VAT	Value-added tax
VDV	Valuation date value

Tax Court

C	Cape Tax Court (formerly Cape Income Tax Special Court)
EC	Eastern Cape Special Court
F	Federation of Rhodesia and Nyasaland Income Tax Special Court (from 1957 to 1964)
G	Gauteng Tax Court
K	Kimberley Tax Court
N	Natal Income Tax Special Court
SEC	South Eastern Cape Tax Court
SR	Southern Rhodesia Income Tax Special Court
SW	South West Africa 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 legal references

(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
All SA	All South African Law Reports
ALR	Australian Law Reports (1973 to date)
ATR	Australian Tax Reports
BCA	Court of Appeal, Botswana
BCLR	Butterworths Constitutional Law Reports
BH	Bophuthatswana High Court
(C)	Cape Provincial Division of the Supreme Court of South Africa
(CC)	Constitutional Court
ChD	Law Reports, Chancery Division (1876 – 1890)
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)
HC of A	High Court of Australia
IRC	Inland Revenue Commissioners
JTLR	Juta's Tax Law Reports

KB	Law Reports, King's Bench Division
LAWSA	*The Law of South Africa*, LexisNexis Butterworths
(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
SA Merc LJ	*South African Mercantile Law Journal*, Juta & Company Ltd
SATC	South African Tax Cases Reports
SC	Reports of the Supreme Court of the Cape of Good Hope from 1880
SC	Court of Session Cases (Scotland)
(SCA)	Supreme Court of Appeal
(SCD)	Special Commissioners' Decisions
Sc LR	Scottish Law Reporter 1965 – 1925
SIR	Secretary for Inland Revenue
SpC	Special Commissioners
STC	Simon's Tax Cases
(T)	Transvaal Provincial Division of the Supreme Court of South Africa
TC	Reports of Tax Cases, England
TC	United States Tax Court Reports
TPD	Reports of the Transvaal Provincial Division of the Supreme Court of South Africa
TS	Transvaal Supreme Court Reports
TSH	*Tax Shock, Horror*
UKHL	House of Lords (United Kingdom)
US Tax Ct LEXIS	United States Tax Court
(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 – Introduction

1.1 Reasons for the introduction of CGT

For a more comprehensive discussion of the reasons for the introduction of CGT see the Briefing by the National Treasury's Tax Policy Chief Directorate to the Portfolio and Select Committees on Finance Wednesday, 24 January 2001.[1] Briefly the reasons for the introduction of CGT are as follows:

1.1.1 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,[2] in Canada in 1971[3] and in Australia in 1985.[4] 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.

1.1.2 Horizontal equity

Haig-Simons[5] 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'.

Under 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% a year 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 while 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.

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[1] 'Capital Gains Tax In South Africa' (24 January 2001) available at <http://www.ftomasek.com/NationalTreasury.pdf> [Accessed 8 December 2011].

[2] Introduced under the Finance Act, 1965 on 6 April 1965. The CGT applied to disposals of assets from that date. Gains and losses accruing before that date were excluded by using time apportionment rules, or the taxpayer could elect to determine a 'Budget Day' valuation on that date.

[3] The tax became effective in 1972 with 'valuation day' or V-day as it is known, being 31 December 1971.

[4] Applies to assets acquired after 19 September 1985.

[5] 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.

1.1.3 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.

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.

1.1.4 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 before the amendment of the Income Tax Act in 2000[6] 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 from which 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.

1.1.5 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

[6] Paragraph (*c*A) inserted in 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.

form of capital gains (for example, property), rather than income producing assets (for example, 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.

1.1.6 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[7] and Brooks[8] to the Portfolio Committee on Finance.

1.2 Historical development of CGT in South Africa

1.2.1 Previous Commissions of Enquiry

The idea of taxing capital gains is not new in South Africa. In 1969, the Franzsen Commission[9] proposed a limited form of capital gains tax on immovable property and marketable securities, while the Margo Commission[10] in 1986 recommended that capital gains should not be taxed. Most recently, the Katz Commission in its third report[11] considered the merits and demerits of a capital gains tax in South Africa. It declined to make firm recommendations because 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. This implementation date was later extended to 1 October 2001.

1.2.2 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, while it makes interesting reading, it should not be relied upon as an authoritative summary of the present law.

1.2.3 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

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[7] R A Krever 'A Capital Gains Tax for South Africa' [online], (25 January 2001). Available from: <http://www.ftomasek.com/RickKreverDraft.html> [Accessed 8 December 2011].
[8] N Brooks 'Taxing Capital Gains is Good for the Tax System, the Economy and Tax Administration' [online], (26 January 2001). Available from: <http://www.ftomasek.com/NeilBrooksRevised.pdf> [Accessed 8 December 2011].
[9] 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.
[10] 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.
[11] Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, 1995, The Government Printer, Pretoria.

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.

1.2.4 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, when 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 everyone for their contributions.

1.2.5 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 South African 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 **1.2.6**.

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.

1.2.6 Table of amendments to CGT legislation

Table 1 – Amendments to CGT legislation

Act	**Bill no. and date tabled**	**Volume 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 of 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 of 27.7.2001	Amends paras 2, 20, 23, 32, 45, 46, 55, 60, 66, 84 and 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 of 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 and 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	B 26—2002	Vol 446, GN	Amends paras 29, 32 and 84 of the

Amendment Act 30 of 2002	Tabled 20.6.2002	1047, *GG* 23709 of 5.8.2002	Eighth Schedule.
Revenue Laws Amendment Act 74 of 2002	B 67—2002 Tabled 6.11.2002	Vol 450, GN 1581, *GG* 24181 of 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 and 86 of the Eighth Schedule. Substitutes paras 25, 43, 61, 63, 67A, 81 and Part XIII (now comprising paras 84 to 97) of the Eighth Schedule and Part III of Chapter II (now comprising ss 41 to 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 of 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 under s 30 of the Exchange Control and Amendment of Taxation Laws Act		*GG* 25511 of 29.09.2003 Notice No. R.1368	Regulation 4 (base cost of asset in respect of which election has been made; deemed disposal events pertaining to such asset). Regulation 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 of 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 and 96 of the Eighth Schedule. Inserts paras 20A, 67B and 67C. Substitutes paras 63, 65 and 66 Amends ss 41 to 47.
Taxation Laws Amendment Act 16 of 2004	B 8—2004 Tabled 18.06.2004	*GG* 26612 of 27.07.2004	Amends paras 1, 39, 65, 67C, 75, 76 and 78.
Revenue Laws Amendment Act 32 of 2004	B 24—2004 Tabled 09.11.2004	*GG* 27188 of 24.01.2005	Amends paras 1, 2, 3, 4, 11, 12, 13, 20, 20A, 25, 33, 38 and 56. Inserts paras 35A and 39A. Amends ss 41, 43, 45, 46 and 47. Inserts ss 24B, 24M, 24N and 35A.
Revenue Laws Amendment Act 31 of 2005	B 40—2005 Tabled 08.11.2005	*GG* 28450 of 01.02.2006	Amends paras 1, 2, 8, 11, 12, 20, 24, 30, 33, 38, 39, 42, 43, 55, 56, 64 64B, 72, and 76.
Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006	B 14—2006 Tabled 13.06.2006	*GG* 29068 of 25.07.2006	Amends paras 5, 45, 57 and 64B.
Revenue Laws Amendment Act 20 of 2006	B 33—2006 Tabled 02.11.2006	*GG* 29603 of 07.02.2007	Amends paras 11, 20, 24, 29, 30, 31, 40, 43, 62, 64, 64A, 67, 80 and 92. Inserts paras 63A and 65B.

Taxation Laws Amendment Act 8 of 2007	B 18—2007 Tabled 07.06.2007	*GG* 30157 of 08.08.2007	Amends paras 20, 29, 31, 39, 63. A, 64B, 65B, 66 and 84.
Revenue Laws Amendment Act 35 of 2007	B 42—2007 Tabled 30.10.2007	*GG* 30656 of 08.01.2008	Amends paras 12, 19, 20, 42, 43, 64B, 65, 66, 67, 67A, 74 and 76. Inserts paras 42A, 67AB and 76A. Repeals para 79.
Taxation Laws Amendment Act 3 of 2008	B 13—2008 Tabled 19.03.2008	*GG* 31267 of 22.07.2008	Amends paras 1, 12, 13, 20, 24, 40, 42, 54, 55, 64B, 74, 76, 76A, 80.
Revenue Laws Amendment Act 60 of 2008	B 80—2008 Tabled 21.10.2008	*GG* 31781 of 08.01.2009	Amends paras 11, 12, 13, 20, 24, 40, 64B, 67A, 67AB, 76, 78 and 80. Inserts para 57A.
Taxation Laws Amendment Act 17 of 2009	B 10—2009 Tabled 01.09.2009	*GG* 32610 of 30.09.2009	Amends paras 5, 13, 19, 25, 40, 45, 61, 64, 74, 75 and 80. Inserts paras 43A and 67D. Substitutes para 51.
Taxation Laws Amendment Act 7 of 2010	B 28—2010 Tabled 24.08.2010	*GG* 33726 of 2 November 2010	Amends paras 2, 12, 20, 29, 31, 38, 42, 43, 43B, 45, 51, 61, 62, 64B, 67A, 74, 78 and 96. Inserts paras 43B and 51A.
Taxation Laws Amendment Bill, 2011	B 19—2011 Tabled 25.10.2011		Amends paras 5, 12, 19, 20, 43, 51A, 55, 57, 64B, 74, 75, 76, 76A, 77 and 78. Inserts para 76B. Substitutes para 43A. Repeals Part XIII (paras 84 to 96).

1.2.7 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 on the interpretation of the legislation by correcting errors and omissions.

There is a general presumption against a statute being construed as having retroactive effect.[12] However, subject to the Constitution of the Republic of South Africa, 1996, Parliament has an unfettered discretion to change the law retrospectively to a date in the past.[13] There is an exception to this rule for cases on appeal to the High Court or SCA. In *Corium (Pty) Ltd & others v Myburgh Park Langebaan (Pty) Ltd & others*[14] the court summed up the rule as follows:

> 'There is a long accepted rule that a statute, even where it is expressly stated to be retrospective in its operation, is not to be treated as affecting matters which are the subject of pending litigation in the Supreme Court in the absence of a clear contrary intention appearing from the Act.'

In *Robertson & another v City of Cape Town & another; Truman-Baker v City of Cape Town*[15] the court considered whether retrospective legislation was unconstitutional. It concluded as follows:

[12] *National Director of Public Prosecutions v Carolus & others* 2000 (1) SA 1127 (SCA).
[13] See D Clegg and R Stretch *Income Tax in South Africa* [CD-ROM] (*My LexisNexis*: October 2008) LexisNexis Butterworths, Durban in para 2.16.2.
[14] 1995 (3) SA 51 (C) at 64A–B.
[15] 2004 (5) SA 412 (C).

- Apart from certain provisions pertaining to criminal law, the Constitution of the Republic of South Africa, 1996 does not contain any express provisions barring retrospective legislation.
- The passing of retrospective legislation in other constitutional democracies (India, the United States and Canada) has not been found to be unconstitutional.
- Retrospective legislation may be unconstitutional to the extent that it contravenes the rule of law[16] when it unreasonably or unfairly impairs the ability of those bound by the law to regulate their conduct in accordance therewith.

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

[16] Section 1(*c*) of the Constitution.

Chapter 2 – Capital v revenue

2.1 The words 'of a capital nature'

The words 'of a capital nature' are to be found in several sections of the Act, and are relevant not only for determining what is taxed on income account under sections of the Act and on capital account under the Eighth Schedule, but also in the context of determining a company's liability for STC.

Some examples in which the words are used for income tax purposes include the following:

- Section 1, definition of the term 'gross income' – which excludes 'receipts or accruals of a capital nature', but includes certain amounts 'whether of a capital nature or not'.
- Section 9C – which deems the amount received or accrued from the disposal of qualifying equity shares held for at least three years to be of a capital nature.
- Section 11(*a*) (general deduction formula) – which permits a deduction for expenditure and losses actually incurred in the production of income in carrying on a trade 'provided such expenditure and losses are not of a capital nature'.
- Section 11(*c*) (deduction for certain legal expenses) – which limits the deduction to so much thereof as 'is not of a capital nature.
- Section 24J(3) includes in gross income the amount of any interest determined under that section 'whether or not that amount constitutes a receipt or accrual of a capital nature'.

2.2 Allocating receipts and accruals and expenditure between sections of the Act and the Eighth Schedule

The distinction between income and capital is important because of the lower rate of tax attributable to capital gains. Furthermore, losses of a revenue nature can usually be set off against both income and capital gains, while capital losses may only be set off against capital gains.

As a rule, sections of the Act take precedence over the Eighth Schedule (see **4.4**), so whatever is excluded from gross income on the grounds of being of a capital nature should fall to be dealt with under the Eighth Schedule.

The table below gives an indication of what is taxed as, or allowed against, income under sections of the Act and what falls under the Eighth Schedule to be taxed as capital gains or allowed as capital losses. This table is merely illustrative and is not intended to be exhaustive.

Table 1 – Amounts falling under sections of the Act v amounts falling in Eighth Schedule

Sections of the Act	Eighth Schedule
RECEIPTS AND ACCRUALS	
General rule: Any amount received or accrued of a revenue nature (s 1 – definition of the term 'gross income').	Receipts or accruals of a capital nature excluded from the definition of the term gross income in s 1 which relate to the disposal of assets or waiver of debt.
Receipts or accruals of a capital nature specifically included in the definition of the term 'gross income'.	Amounts of a revenue nature deemed to be of a capital nature under s 9C (three-year rule for qualifying equity shares).

Any discount arising on the acquisition of a debt is deemed to be gross income under s 24J(3), regardless of whether it is of a capital nature (see **24.4**).	Pre-1 October 2001 capital profits distributed in anticipation of liquidation or deregistration to a shareholder (including a share-dealer).
REALISED AND UNREALISED GAINS	
Gains arising under certain employee share incentive arrangements under ss 8A (when option exercised), 8B (when shares disposed of within five years) and 8C (on date of vesting).	Certain unrealised receipts or accruals of a revenue nature, e.g. difference between standard value and market value of livestock on date of death.
	Certain unrealised receipts or accruals of a capital nature, e.g. deemed proceeds equal to market value on date of ceasing to be a resident.
	Section 8B gains when shares held for at least five years.
EXPENDITURE AND LOSSES	
General rule: Expenditure and losses actually incurred of a revenue nature incurred in carrying on trade and which are in the production of income [s 11(*a*)].	Expenditure and losses of a capital nature excluded from sections of the Act by s 11 and which qualify under para 20. The qualifying para 20 expenditure generally relates to the acquisition or disposal of assets.
Amounts of a capital nature that are specifically allowed as a deduction (e.g. repairs [s 11(*d*)], leasehold improvements [s 11(*g*)], capital allowances (e.g. s 11(*e*), 12B, 12C etc).	Certain amounts of a revenue nature allowed under para 20 that do not qualify under s 11 (e.g. one-third of interest paid in acquiring listed shares).
Certain capital expenditure incurred by farmers (para 12 of First Schedule and s 17A).	
Losses arising on vesting of equity instruments under s 8C.	

Capital expenditure not qualifying under the Eighth Schedule

Since the Eighth Schedule is concerned with capital gains and losses on the disposal of assets or waiver of debts, there will be some expenses of a capital nature that will not fall into either sections of the Act or the Eighth Schedule. This is likely to be the case with expenditure of a capital nature that is not incurred for the purpose of creating or improving an asset and which is not otherwise provided for (for example, bond registration costs).

2.3 Double deductions and double taxation

Although the Eighth Schedule applies to both capital assets and trading stock,[17] double deductions and double taxation are generally prevented by para 20(3)(*a*) in the case of expenditure and para 35(3)(*a*) in the case of receipts or accruals. To the extent that the double taxation issue is not addressed specifically, there is[18]

> 'a "necessary implication" that the same amount shall not be taxed twice in the hands of the same taxpayer . . .'.

[17] See the wide definition of an 'asset' in para 1.
[18] Per De Villiers JA in *CIR v Delfos* 1933 AD 242, 6 SATC 92 at 112.

2.4 Common law principles

The Income Tax Act does not define the words 'of a capital nature'. The line between income and capital has often been blurred and the source of much litigation between taxpayers and the *fiscus* over many decades. In deciding these disputes South African courts have over the years developed a number of tests or guidelines for distinguishing between the two concepts. However, there is[19]

> 'no single infallible test of invariable application'.

Many of these principles find their origins in decisions of the courts of the United Kingdom and other commonwealth countries such as Australia and New Zealand. Some of the better-known principles are summarised below.

The onus of proving that an amount is of a capital or income nature rests on the taxpayer under s 82 of the Income Tax Act. In *CIR v Middelman*[20] the court stated that in order to discharge the onus a taxpayer must

> 'establish his case on a balance or a preponderance of probabilities'.

In capital v revenue disputes the legal principles are well established, and the vast majority of cases are won or lost on the facts. The importance of establishing the true facts by gathering sufficient evidence cannot be over-emphasised. This is particularly important in presenting a case before the tax court, for once that court has made a finding of fact it cannot, except on certain limited grounds, be overturned on appeal. As was pointed out by Innes CJ in *CIR v George Forest Timber Co Ltd*,[21]

> '[i]t is dangerous in income tax cases to depart from the actual facts; the true course is to take the facts as they stand and apply the provisions of the statute'.

2.4.1 Receipts and accruals

2.4.1.1 Intention

2.4.1.1.1 Introduction

The most important test for determining the capital or revenue nature of a particular receipt or accrual is the taxpayer's intention in acquiring the asset (ITC 1185[22]).

In *CIR v Stott* Wessels JA stated the following:[23]

> 'The primary intention with which property is acquired is conclusive as to the nature of the receipt arising from the realisation of that property unless other factors intervene which show that it was sold in pursuance of a scheme of profit-making.'

The determination of a person's intention requires more than a superficial assessment, as was emphasised by Erasmus J in ITC 1719[24] when he said that the intention of a taxpayer must

> 'be determined not on the bare bones of the relevant transactions, but on the conspectus of all the relevant facts and attendant circumstances'.

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[19] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271 at 279.
[20] 1991 (1) SA 200 (C), 52 SATC 323.
[21] 1924 AD 516, 1 SATC 20 at 23.
[22] (1972) 35 SATC 122 (N).
[23] 1928 AD 252, 3 SATC 253 at 254.
[24] (2001) 64 SATC 73 (SEC) at 76.

2.4.1.1.2 Change of intention

In *John Bell & Co (Pty) Ltd v SIR*[25] Wessels JA stated that

> 'the mere change of intention to dispose of an asset hitherto held as capital does not *per se* subject the resultant profit to tax. Something more is required in order to metamorphose the character of the asset and so render its proceeds gross income. For example, the taxpayer must already be trading in the same or similar kinds of assets, or he then and there starts some trade or business or embarks on some scheme for selling such assets for profit, and, in either case, the asset in question is taken into or used as his stock-in-trade.'

2.4.1.1.3 Intention of a company

Wessels JA stated in *Elandsheuwel Farming (Edms) Bpk v SBI* that[26]

> ''it must be remembered that the dealings of a juristic person are controlled by human beings, and that they are the brain and ten fingers thereof'.

(Translated from original Afrikaans text.)

In *Tati Company Limited v Collector of Income Tax, Botswana* Smit JA stated the following:[27]

> 'A company being an artificial entity, its intentions must be determined from its formal acts.'

The above was cited from *Wilson v CIR.*[28]

Intention of directors

In *CIR v Richmond Estates (Pty) Ltd* Centlivres CJ stated the following:[29]

> 'A company is an artificial person "with no body to kick and no soul to damn" and the only way of ascertaining its intention is to find out what its directors acting as such intended. Their formal acts in the form of resolutions constitute evidence as to the intentions of the company of which they are directors but where a company has only one director, who is also the managing director and the sole beneficial owner of all its shares, I can see no reason in principle why it should be incompetent for him to give evidence as to what was the intention of the company at any given time. In such a case it is, perhaps, not going too far to say that his mind is also the mind of the company.'

Intention of sole shareholder

If a single individual is the sole beneficial holder of the shares of a company, the intention of that individual as to the policy of the company can be accepted as that of the company (*Yates Investments (Pty) Ltd v CIR*[30]).

Changes in shareholders

In the *Elandsheuwel Farming* case above the court took account of changes in shareholding that caused control of the company to pass into new hands. The advent of new controllers was held to bring about a change in the intentions of the company.

[25] 1976 (4) SA 415 (A), 38 SATC 87 at 103.
[26] 1978 (1) SA 101 (A), 39 SATC 163 at 175.
[27] 1974 (BCA), 37 SATC 68 at 75.
[28] 1926 CPD 63, 2 SATC 12 at 14.
[29] 1956 (1) SA 602 (A), 20 SATC 355 at 361.
[30] 1956 (1) SA 612 (A), 20 SATC 368.

Intention of controllers

In *SIR v Trust Bank of Africa Ltd* a management committee controlled the appellant company. Botha JA stated that he could[31]

> 'see no reason in principle why the persons who are in effective control of a company cannot give evidence as to what was the intention or purpose of the company in relation to any matter at any given time'.

Memorandum of association

In *SIR v Rile Investments (Pty) Ltd* Corbett JA stated the following:[32]

> 'Another consideration of some importance in the case of a taxpayer which is a company is the objects of the company as formulated in its memorandum of association, although the well-known practice in South Africa of framing objects in very wide terms may, in a particular case, reduce the significance of this factor (*Natal Estates* case (above) at 197F-H).'

The mere fact that the memorandum of a company prohibits the dealing or trafficking in shares is not decisive as to whether the profits on sale of shares are of a capital nature. Such provisions while being of importance cannot be considered *in vacuo* and the court must consider all the circumstances of the case (*African Life Investment Corporation (Pty) Ltd v SIR*).[33]

2.4.1.1.4 Mixed purposes and the dominant purpose

If a taxpayer has mixed purposes, the court will try to establish and give effect to the main or dominant purpose (*COT v Levy*).[34]

In *SIR v The Trust Bank of Africa Ltd* Botha JA stated that in order for a profit to be regarded as being of a capital nature[35]

> 'a taxpayer is not obliged to exclude the slightest contemplation of a profitable resale'.

2.4.1.1.5 Alternative methods

If a person has two alternative methods of turning an asset to account, that is, selling it or using it to produce income, the profit on sale will be of a revenue nature (*Durban North Traders Ltd v CIR*).[36]

2.4.1.1.6 Taxpayer's testimony

In ITC 1185[37] Miller J stated in regard to determining a taxpayer's intention at the time of acquiring a property that,

> 'the *ipse dixit*[38] of the taxpayer as to his intent and purpose should not lightly be regarded as decisive. It is the function of the court to determine on an objective review of all the relevant facts and circumstances what the motive, purpose and intention of the taxpayer were. Not the least important of the facts will be the course of conduct of the taxpayer in relation to the transactions in issue, the nature of his business or occupation and the frequency or otherwise of his past involvement or participation in similar transactions'.

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[31] 1975 (2) SA 652 (A), 37 SATC 87 at 106.
[32] 1978 (3) SA 732 (A), 40 SATC 135 at 141.
[33] 1969 (4) SA 259 (A), 31 SATC 163 at 176.
[34] 1952 (2) SA 413 (A), 18 SATC 127 at 136.
[35] *SIR v The Trust Bank of Africa Ltd* 1975 (2) SA 652 (A), 37 SATC 87 at 102.
[36] 1956 (4) SA 594 (A), 21 SATC 85.
[37] (1972) 35 SATC 122 (N) at 123/4.
[38] The taxpayer's testimony, meaning literally 'he himself said it'.

Corbett JA (as he then was) expressed similar sentiments in *Elandsheuwel Farming (Edms) Bpk v SBI.*[39]

> 'In the determination of the question into which of these two classes a particular transaction falls, the intention of the taxpayer, both at the time of acquiring the asset and at the time of its sale, is of great, and sometimes decisive, importance. Other significant factors include, *inter alia*, the actual activities of the taxpayer in relation to the asset in question, the manner of its realization, the taxpayer's other business operations (if any) and, in the case of a company, its objects as laid down in its memorandum of association . . .'

2.4.1.1.7 Insufficient funds

If a company purports to have acquired land for the purpose of development as an investment, but has insufficient funds to implement that intention, this may indicate that the company's true intention was to acquire the property for the purpose of resale at a profit with the result that the proceeds will constitute income (*CIR v Lydenburg Platinum Ltd*,[40] *Yates Investments (Pty) Ltd v CIR*,[41] *Ropty (Edms) Bpk v SBI*[42]).

2.4.1.1.8 No return or low return on investment

A property yielding a meagre return may be indicative of an intention to resell at a profit, in which case the profit will be on income account (*Yates Investments (Pty) Ltd v CIR*)[43].

The same applies to assets that do not produce an income, such as undeveloped land,[44] Krugerrands (see **2.4.3.2**) or diamonds.[45] But the taxpayer's intention and the surrounding circumstances must be taken into account. For example, in ITC 1283[46] a former Angolan resident converted his Angolan assets into coffee beans, which he imported into South West Africa from where he exported them overseas and obtained the proceeds in rands. The proceeds were held to be of a capital nature as the taxpayer's intention was merely to salvage his capital and he was not engaged in carrying on a business.

2.4.1.2 Realisation of capital at enhanced value v scheme of profit-making

In the landmark case of *Californian Copper Syndicate (Limited and Reduced) v Harris (Surveyor of Taxes)*[47] Clerk LJ stated the following:

> 'Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?'

The above was cited with approval in *Overseas Trust Corporation Ltd v CIR*.[48]

2.4.1.3 Fortuitous nature of the receipt or accrual

The receipts or accruals bear the imprint of revenue if they are not fortuitous, but designedly sought for and worked for (*CIR v Pick 'n Pay Employee Share Purchase Trust*).[49]

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[39] 1978 (1) SA 101 (A), 39 SATC 163 at 181.
[40] 1929 AD 137, 4 SATC 8.
[41] 1956 (1) SA 612 (A), 20 SATC 368.
[42] 1981 (A), 43 SATC 141.
[43] 1956 (1) SA 612 (A), 20 SATC 368 at 371/2.
[44] ITC 862 (1958) 22 SATC 301 (F).
[45] ITC 1608 (1993) 59 SATC 63 (T).
[46] (1978) 41 SATC 36 (SW).
[47] *Californian Copper Syndicate (Limited & Reduced) v Harris (Surveyor of Taxes)* 41 Sc LR 694, 5 TC 159.
[48] 1926 AD 444, 2 SATC 71 at *75.*
[49] 1992 (4) SA 39 (A), 54 SATC 271 at 280.

2.4.1.4 The 'tree and fruit' analogy

In *CIR v Visser* Maritz J stated the following:[50]

> 'If we take the economic meaning of "capital" and "income" the one excludes the other. "Income" is what "capital" produces, or is something in the nature of interest or fruit as opposed to principal or tree.'

2.4.1.5 Continuity in carrying on business

In *CIR v Stott*[51] it was said that as a general rule, one or two isolated transactions do not constitute the carrying on of a business. In that case it was pointed out that while a company could be regarded as carrying on a business with a single transaction, this would usually not be the case with an individual. Citing *Smith v Anderson*,[52] Wessels JA stated the following:

> 'Before it could be said that an individual was carrying on a business there must be some proof of continuity.'

But there are exceptions to this rule, one example being *Stephan v CIR*[53] in which an individual who salvaged a single ship's cargo was held to be carrying on business.

2.4.1.6 The 'filling a hole' test

When the receipt or accrual represents compensation, a test which is sometimes applied is to ask whether the compensation was designed to fill a hole in the taxpayer's profits, or whether it was intended to fill a hole in his assets *(Burmah Steamship Co Ltd v IRC*).[54]

If the compensation is in respect of filling a hole in assets, it will in addition be necessary to determine whether the asset is of a capital or revenue nature.

Compensation received in respect of the loss or sterilisation of a fixed capital asset is of a capital nature.[55]

In *CIR v Illovo Sugar Estates Ltd*[56] compensation received from the military for destruction of sugar cane plants which produced crops every two years over 14 to 16 years was held to be of a capital nature, while the compensation for growing crops was held to be of a revenue nature.

In *Estate A G Bourke v CIR*[57] a taxpayer received compensation for the destruction by fire of pine trees. It was held that the compensation was of a revenue nature. Pine trees do not renew themselves once felled. In the circumstances they represented the crop while the soil represented the income-earning structure. The loss of the pine trees was akin to the loss of the apples from an apple tree rather than to the loss of the apple tree itself.

In *Taeuber and Corssen (Pty) Ltd v SIR*[58] a payment in restraint of trade was held to be of a capital nature.

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[50] 1937 TPD 77, 8 SATC 271 at 276.
[51] 1928 AD 252, 3 SATC 253 at 260.
[52] *Smith v Anderson* (1880) 15 ChD 247.
[53] *Stephan v CIR* 1919 WLD 1, 32 SATC 54.
[54] 1931 SC 156, 16 TC 67.
[55] See *The Glenboig Union Fireclay Co Ltd v Commissioner of Revenue* 12 TC 427.
[56] 1951 (1) SA 306 (N), 17 SATC 387.
[57] 1991 (1) SA 661 (A), 53 SATC 86.
[58] 1975 (3) SA 649 (A), 37 SATC 129.

2.4.1.7 No halfway house

In *Pyott Ltd v CIR* Davis AJA stated the following:[59]

> 'I do not understand how this £9,000 could be, to cite from counsel's Heads of Argument, "non-capital", and yet "not income". This is a half-way house of which I have no knowledge.'

Despite the above comment, South African courts have applied apportionment to a single sum received when it was partly in respect of a restraint of trade and partly for services rendered. In *Tuck v CIR* Corbett JA stated that[60]

> 'it seems to me that in a proper case apportionment provides a sensible and practical solution to the problem which arises when a taxpayer receives a single receipt and the *quid pro quo* contains two or more separate elements, one or more of which would characterize it as capital'.

2.4.1.8 Revenue derived from capital productively employed

In *COT v Booysens Estates Ltd* Wessels J stated that[61]

> 'Income is, as a rule, revenue derived from capital productively employed.'

2.4.1.9 Fixed v floating capital

In *CIR v George Forest Timber Co Ltd* Innes CJ stated the following:[62]

> 'Capital, it should be remembered, might be either fixed or floating. The substantial difference was that floating capital was consumed and disappeared in the very process of production, while fixed capital did not; though it produced fresh wealth it remained intact. The distinction was relative, for even fixed capital, such as machinery, did gradually wear away and required to be renewed.'

Receipts and accruals from the disposal of fixed capital assets are in the nature of a realisation and will fall on capital account. Receipts and accruals from the disposal of floating capital assets form part of the ordinary revenue of the business.

2.4.1.10 Capital is held with an element of permanency

Vos J stated in *Bloch v SIR* that[63]

> 'capital is that which is held with an element of permanency and with the object that it should produce an economic utility for the holder'.

2.4.1.11 Length of holding period

The length of time that an asset is held is generally an unreliable indicator of whether the proceeds from its disposal will be of a capital or revenue nature. While a lengthy holding period may be indicative of a capital intent, the period of holding is far less important than other factors such as the taxpayer's intention in buying and selling the asset, and the manner in which the asset is dealt with. For example, in the *Natal Estates* case[64] farmland that had been held for more than 50 years was held to have been disposed of on revenue account because it was converted to trading stock. And at the other extreme, in ITC 1185[65]

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[59] 1945 AD 128, 13 SATC 121 at 126.
[60] 1988 (3) SA 819 (A), 50 SATC 98 at 114.
[61] 1918 AD 576, 32 SATC 10 at 15.
[62] 1924 AD 516, 1 SATC 20 at 23.
[63] 1980 (2) SA 401 (C), 42 SATC 7 at 18.
[64] *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A), 37 SATC 193.
[65] (1972) 35 SATC 122 (N).

the proceeds on disposal of a property that was held for only seven months were held to be of a capital nature as a result of a new intervening factor (see below).

2.4.1.12 Realisation soon after acquisition as a result of a new intervening factor

In ITC 1185[66] the appellant had acquired three properties as a long-term investment in 1968. In 1969 an industrial organisation announced that it would be relocating to the area, which caused a sharp rise in the value of the properties. Shortly after the announcement the appellant received a substantial offer and sold one of the properties at a substantial profit. In finding that the profit was of a capital nature, Miller J stated the following:[67]

> 'The fact that a property is sold for a substantial profit very soon after it has been acquired is, in most cases, an important one in considering whether an inference adverse to the taxpayer should be drawn, but it loses a great deal of its importance when there has been a *nova causa interveniens*.'[68]

2.4.1.13 Exchange of asset for shares

If a person exchanges an asset for shares, and the person's intention in making the original investment is unclear, the court will be less ready to infer that the transaction was a scheme of profit-making than if the consideration was in the form of cash (*SIR v Rile Investments (Pty) Ltd*).[69]

2.4.1.14 Conversion of trading stock to capital asset

In *CIR v Richmond Estates (Pty) Ltd* Centlivres CJ stated that[70]

> '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)'.

2.4.1.15 Realisation to best advantage

In *CIR v Stott*, a case dealing with the sale of land held as a capital asset by cutting it up into lots, the court stated the following:[71]

> 'Every person who invested his surplus funds in land or stock or any other asset was entitled to realise such asset to the best advantage and to accommodate the asset to the exigencies of the market in which he was selling. The fact that he did so could not alter what was an investment of capital into a trade or business for earning profits.'

The case has been applied in the context of converting blocks of flats to sectional title. See *Berea Park Avenue Properties (Pty) Ltd v CIR*[72] and ITC 1348.[73]

2.4.1.16 Conversion of capital asset to trading stock

While a person is entitled to realise a capital asset to best advantage, there are limits. This was revealed in the landmark case of *Natal Estates Ltd v SIR*. In that case the company disposed of farmland that it had held for many years by developing a township. In holding that the profits were of a revenue nature Holmes JA stated the following:[74]

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[66] Above.
[67] Above at 128.
[68] New intervening cause.
[69] 1978 (3) SA 732 (A), 40 SATC 135 at 152.
[70] 1956 (1) SA 602 (A), 20 SATC 355 at 361.
[71] 1928 AD 252, 3 SATC 253 at 261.
[72] 1995 (2) SA 411 (A), 57 SATC 167.
[73] (1981) 44 SATC 46 (EC).
[74] 1975 (4) SA 177 (A), 37 SATC 193 at 220.

> 'In deciding whether a case is one of realizing a capital asset or of carrying on a business or embarking upon a scheme of selling land for profit, one must think one's way through all of the particular facts of each case. Important considerations include, *inter alia*, the intention of the owner, both at the time of buying the land and when selling it (for his intention may have changed in the interim); the objects of the owner, if a company; the activities of the owner in relation to his land up to the time of deciding to sell it in whole or in part; the light which such activities throw on the owner's *ipse dixit* as to intention; where the owner subdivides the land, the planning, extent, duration, nature, degree, organization and marketing operations of the enterprise; and the relationship of all this to the ordinary commercial concept of carrying on a business or embarking on a scheme for profit. Those considerations are not individually decisive and the list is not exhaustive. From the totality of the facts one enquires whether it can be said that the owner had crossed the Rubicon and gone over to the business, or embarked upon a scheme, of selling such land for profit, using the land as his stock-in-trade.'

2.4.1.17 Sale of surplus land

A profit derived by a person who acquired land for investment purposes and subsequently disposed of a portion of it because it was surplus to his requirements was held to be of a capital nature (*CIR v Paul*).[75]

2.4.1.18 Realisation period

In *Berea West Estates (Pty) Ltd v SIR,*[76] Holmes JA indicated that the process of realising a capital asset to best advantage might in certain circumstances need 'the hand of time'. Thus, a deliberate delay in the disposal of a property in order to realise a better price will not on its own convert a capital asset to trading stock.

2.4.1.19 Realisation companies and trusts

The concept of a realisation company is an important exception to the rule that a company that buys an asset for the purposes of resale at a profit will be taxed on revenue account.
Typically a realisation company is formed for the express purpose of realising to best advantage capital assets previously owned by its shareholders. Provided that it simply realises those assets and does not embark on a scheme of profit-making, any profits realised will be of a capital nature. A trust can also be used as a realisation vehicle. See *Realization Company v COT,*[77] *Berea West Estates (Pty) Ltd v SIR,*[78] and *J M Malone Trust v SIR*.[79] But a distinction must be drawn between a realisation company and one which acquires land as trading stock for the purpose of developing and selling it at a profit. In the latter case the company is carrying on an operation of business in carrying out a scheme for profit-making and the amounts realised will be revenue derived from capital productively employed (*C: SARS v Founders Hill (Pty) Ltd*).[80]

2.4.1.20 Selling price based on future profits

The proceeds from the sale of a capital asset that are expressed as a fixed sum payable in instalments are of a capital nature. But the receipts will take on the character of income if a capital asset is sold by reference to future profits. This was confirmed by Rowlatt J in *William John Jones v The Commissioners of Inland Revenue* when he said that[81]

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[75] 1956 (3) SA 335 (A), 21 SATC 1.
[76] 1976 (2) SA 614 (A), 38 SATC 43 at 63.
[77] 1951 (1) SA 177 (SR), 17 SATC 139.
[78] 1976 (2) SA 614 (A), 38 SATC 43.
[79] 1977 (2) SA 819 (A), 39 SATC 83.
[80] 2011 (5) SA 112 (SCA), 73 SATC 183.
[81] *William John Jones v The Commissioners of Inland Revenue* [1920] 1 KB 711, 7 TC 310 at 315.

> 'a man may sell his property nakedly upon the share of the profits of the business and if he does that I think that the share of the profits of the business would be undoubtedly the price paid for his property; but still that would be the share of the profits of the business and would bear the character of income in his hands, because that is the nature of it'.

(Cited with approval in *Deary v Deputy Commissioner of Inland Revenue*.[82])

2.4.2 Expenditure

2.4.2.1 The 'once and for all' test

In *Vallambrosa Rubber Company v Farmer*[83] Lord Dunedin expressed the opinion that it was

> 'in a rough way not a bad criterion of what is capital expenditure as against what is income expenditure, to say that capital expenditure is a thing that is going to be spent once and for all, and that income expenditure is a thing which is going to recur every year'.

The above was cited in *New State Areas Ltd v CIR.*[84]

2.4.2.2 The 'enduring benefit' test

In *Atherton v British Insulated & Helsby Cables, Ltd*[85] Lord Cave said the following:

> 'But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable, not to revenue, but to capital.'

The above was cited in *New State Areas Ltd v CIR.*[86]

2.4.2.3 The true nature of the transaction

In *New State Areas Ltd v CIR* Watermeyer CJ, after reviewing a number of decisions of the courts in the United Kingdom said:[87]

> 'The conclusion to be drawn from all of these cases seems to be that the true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure even if it is paid in annual instalments; if, on the other hand it is in truth no more than part of the cost incidental to the performance of the income producing operations, as distinguished from the equipment of the income producing machine, then it is a revenue expenditure even if it is paid in a lump sum.'

In each case the correct inference must be drawn from all the circumstances.[88]

2.4.2.4 Income-earning structure v income-earning operations

In *SIR v Cadac Engineering Works (Pty) Ltd* Ogilvie Thompson JA stated the following:[89]

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[82] *Deary v Deputy Commissioner of Inland Revenue* 1920 CPD 541, 32 SATC 92 at 97.
[83] 1910 SC 519, 5 TC 529.
[84] 1946 AD 610, 14 SATC 155 at 165.
[85] 10 TC 155.
[86] 1946 AD 610, 14 SATC 155 at 168.
[87] 1946 AD 610, 14 SATC 155 at 170.
[88] *De Villiers v CIR* 1929 AD 227, 4 SATC 86 at 88.
[89] 1965 (2) SA 511 (A), 27 SATC 61 at 71.

> 'Upon the facts so decided, it must then be determined whether the payment in issue is
>
> (i) part of the income-producing operations (and therefore a revenue expense); or
>
> (ii) mere equipment of the income-producing machine or structure (and consequently of a capital nature).'

2.4.2.5 New asset need not be created

In *SIR v Cadac Engineering Works (Pty) Ltd* Ogilvie Thompson JA stated the following:[90]

> 'In my judgment, the mere circumstance that a payment has neither created a new asset nor made any addition to any existing asset is not necessarily conclusive in favour of such payment being a revenue expense.'

2.4.2.6 Protection of capital asset

Expenditure has been held to be of a capital nature when it is incurred for the purpose of the establishment or protection of a capital asset.

(*CIR v Hilewitz*,[91] ITC 849,[92] *Golby v SIR*[93])

2.4.3 Specific types of assets

2.4.3.1 Share transactions

2.4.3.1.1 The 'for keeps' test

The usual badge of a fixed, capital investment is that it is acquired for better or for worse, or, relatively speaking, for 'keeps', and will only be disposed of if some unusual, unexpected, or special circumstance, warranting or inducing disposal, supervened (*Barnato Holdings Ltd v SIR*[94]).

The sale of futures contracts is likely to be on revenue account, even if used as a hedge against losses on underlying shares held as capital assets (ITC 1756,[95] *Wisdom v Chamberlain (Inspector of Taxes)*[96]).

2.4.3.1.2 The transaction-by-transaction principle

Just as an occasional swallow does not make a summer, so an occasional sale of shares yielding a profit does not of itself make a seller of shares, a dealer therein (*CIR v Middelman*[97]).

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[90] 1965 (2) SA 511 (A), 27 SATC 61 at 75.
[91] *CIR v Hilewitz* 1996 (T), 60 SATC 86 at 99.
[92] (1957) 22 SATC 82 (C).
[93] 1968 (3) SA 432 (O), 30 SATC 107.
[94] 1978 (2) SA 440 (A), 40 SATC 75.
[95] ITC 1756 (1997) 65 SATC 375 (C). The court in this case did not have to decide on the merits of the case whether the profit on disposal of futures contracts held as a hedge was derived from a scheme of profit-making. The futures contracts in question had been held for about a year and the court noted that the appellant had failed to discharge the onus of proving that they had been held on capital account.
[96] (1969) 1 All ER 332 (CA).
[97] 1991 (1) SA 200 (C), 52 SATC 323.

2.4.3.1.3 Main purpose to derive dividend income

Shares bought for the dominant, main and overriding purpose of securing the highest dividend income possible will be of a capital nature when the profit motive is incidental (*CIR v Middelman*[98]).

2.4.3.1.4 Secondary purpose

In *African Life Investment Corporation (Pty) Ltd v SIR* the court distinguished between a case in which the dominant purpose of the taxpayer was to derive dividend income with the realisation of profits merely being incidental, and one in which the taxpayer had a main but secondary or subsidiary purpose to realise a profit on sale of shares. In the former case the 'absolving dominant purpose' would render the profits to be of a capital nature, while in the latter case they would be on revenue account. Steyn CJ stated the following:[99]

> 'Whether or not a purpose is dominant in the sense that another co-existing purpose may be effected at a profit without attracting liability for tax, is a matter of degree depending on the circumstances of the case.'

A profit will be of a revenue nature when realised by a taxpayer who has a secondary purpose of making a profit (*CIR v Nussbaum*[100]).

A taxpayer, who purchased shares cum div (that is, ripe with dividends), received the dividends and then sold the shares ex div, was held to be taxable on revenue account in respect of the resulting profits on the grounds that he had a co-existent intention to make a profit (*CIR v Tod*[101]).

2.4.3.1.5 Scope and frequency

The scale and frequency of a person's share transactions is of major importance, although not conclusive (*CIR v Nussbaum*[102]).

2.4.3.2 Krugerrands

Since Krugerrands by their nature do not provide the holder thereof with an income return, there is an inference in the absence of evidence to the contrary that they have been purchased for resale at a revenue profit. In some cases taxpayers have been able to prove that the proceeds realised on disposal of Krugerrands are of a capital nature. Typically this occurs when the coins are held as part of a collection, or when the taxpayer intends to bequeath them on death (that is, there is no intention to dispose of them at a profit).

The cases that have to date been heard by the courts in South Africa are summarised below.

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[98] Above.
[99] 1969 (4) SA 259 (A), 31 SATC 163 at 175.
[100] 1996 (4) SA 1156 (A), 58 SATC 283.
[101] 1983 (2) SA 364 (N), 45 SATC 1.
[102] 1996 (4) SA 1156 (A), 58 SATC 283.

Table 1 – Cases involving the disposal of Krugerrands

Case	Court's finding – capital or revenue	Period held	Intention in acquiring	Reason for selling
ITC 1355[103]	Capital	4 to 5 years	Bought as an investment to assist during bad times.	To assist family members (ill father, bedridden sister and provide dowry for sister).
ITC 1379[104]	Capital	1 to 13 years	Bought as an easily transportable investment that retained its value.	Sold all after repeated warnings that gold price was too high and would fall.
ITC 1525[105]	Revenue	12 years	To provide funds for a rainy day. Tendency to spend surplus cash on liquor.	Sold to inject capital into new business.
ITC 1526[106]	Revenue	8 months to 9 years	To provide a store of wealth for his children and protection from inflation.	Improvements to home and garden, buying two holiday apartments, a home for each of his daughters, repaying loan account, buying a car for his daughter, paying university fees and buying shares.
ITC 1543[107]	Capital	12 years	Bought by family company as hedge against inflation for benefit of children.	To finance reroofing of house, and to switch into shares because of a declining gold price.
CIR v Nel[108]		13 years	Long-term investment. Hedge against inflation. No intention to sell but rather to bequeath to children.	Urgent need by taxpayer to purchase a car for his wife.

2.4.3.3 Assets acquired by donation or inheritance

The proceeds on disposal of a property acquired by inheritance will be of a capital nature unless the realisation becomes embedded in the usual trading of the taxpayer (*CIR v Strathmore Exploration Ltd)*.[109]. Similarly a profit made on disposal of land acquired by donation was held to be of a capital nature (ITC 458).[110]

[103] (1981) 44 SATC 132 (C).
[104] (1983) 45 SATC 236 (C).
[105] (1991) 54 SATC 209 (C).
[106] (1991) 54 SATC 216 (T).
[107] (1992) 54 SATC 446 (C).
[108] [1997] 4 All SA 310 (T), 59 SATC 349.
[109] 1956 (1) SA 591 (A), 20 SATC 375 at 383.
[110] (1940) 11 SATC 178 (U).

2.4.3.4 Payments between lessor and lessee

2.4.3.4.1 Payments by lessee to lessor

Receipt by lessor

ITC 312[111] – In this case a lessor received an amount in respect of the premature cancellation of a lease. The court held that the amount represented compensation for the loss of rental income. The amount was therefore on income account.

Payment by lessee

Although *SIR v John Cullum Construction Co (Pty) Ltd*[112] did not involve a payment by a lessee to a lessor, the principle applied in this case may, depending on the circumstances, be relevant in such cases. It was held that a payment made to obtain a release from an onerous contract was deductible.

ITC 1600[113] – In this case a payment made by a lessee for the premature cancellation of various leases was held to be in the production of income and hence deductible.

2.4.3.4.2 Payment by lessor to lessee

Receipt by lessee

ITC 175[114] – In this case the lessee was approached by the lessor with a considerable offer to surrender the lease. The receipt was held to be of a capital nature.

ITC 355[115] – In this case an amount received by a lessee for the surrender of lease rights was held to be of a capital nature. The court followed the decision in ITC 175 although it expressed some doubt on the correctness of that decision.

ITC 354[116] – In this case the lessee agreed to accept compensation for cancellation of the lease in the form of a life annuity. The court held that the amount fell to be included in the lessee's gross income under the equivalent of para (*a*) of the definition of the term 'gross income'.

In *CIR v Illovo Sugar Estates Ltd*[117] the company's land was leased to the military authorities. Compensation received by the company in respect of standing crops was held to be of a revenue nature.

Payment by lessor

ITC 1267[118] – Payment by lessor to lessee to secure early termination of lease in order to obtain a higher rental. The court held that the amount was allowable, noting that the case was analogous to the *John Cullum Construction* case *(*above*)* and the *Palabora Mining*[119] case.

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[111] (1934) 8 SATC 154 (U).
[112] *SIR v John Cullum Construction Co (Pty) Ltd* 1965 (4) SA 697 (A), 27 SATC 155.
[113] (1995) 58 SATC 131 (EC).
[114] (1930) 5 SATC 180 (U).
[115] (1936) 9 SATC 91 (U).
[116] (1936) 9 SATC 85 (U).
[117] 1951 (1) SA 306 (N), 17 SATC 387.
[118] (1977) 39 SATC 146 (T).
[119] *Palabora Mining Co Ltd v SIR* 1973 (3) SA 819 (A), 35 SATC 159.

In *C: SARS v BP South Africa (Pty) Ltd*[120] the respondent company paid rent covering a lease period of 20 years as a lump sum up front in order to secure sites from which its petrol could be sold. The court held that the amounts were of a capital nature in that they created an enduring benefit and were paid once and for all.

[120] *C: SARS v BP South Africa (Pty) Ltd* 2006 (5) SA 559 (SCA), 68 SATC 229.

Chapter 3 – Design and overview of the core rules

3.1 Integration into the Income Tax Act

CGT has been incorporated into the Act as it is regarded as a tax on income. This approach has administrative advantages as the existing provisions and procedures of the 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 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 main body of the 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. While the move towards plain English drafting[121] 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. When 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.[122] A 'roll-over' is a deferral.

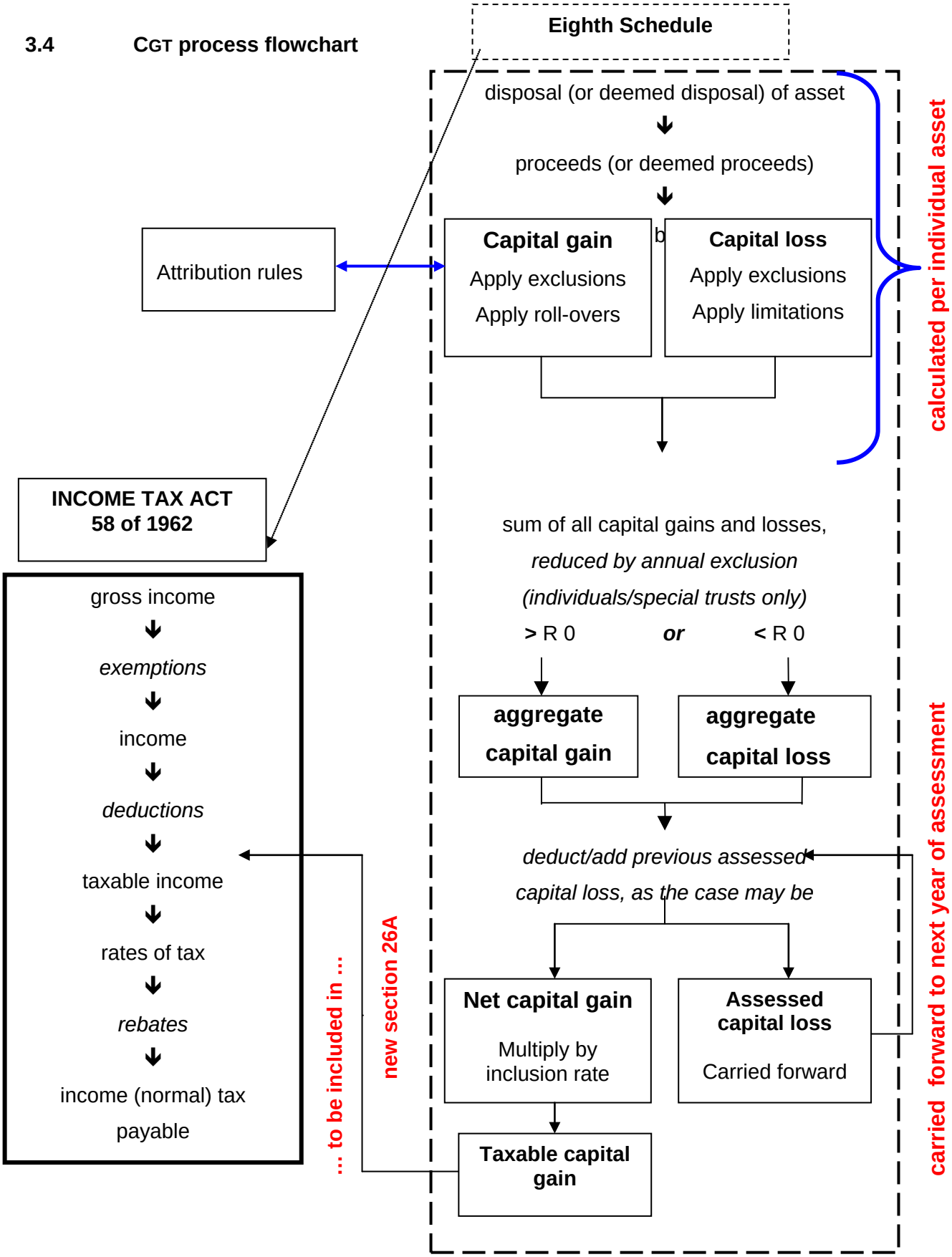
3.3 Use of other countries' tax legislation

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[123] is contained in a separate Act that spans more than 500 pages, while Australia's CGT[124] 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

[121] The Australian CGT legislation has been drafted in plain English.
[122] For example, the annual and primary residence exclusions prevent gains from being subjected to CGT, while at the same time preventing losses from being claimed within certain limits.
[123] The Taxation of Chargeable Gains Act, 1992.
[124] 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 8 December 2011].

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.

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 Basic steps in determining a taxable capital gain or assessed capital loss

The first step in calculating a person's taxable capital gain or assessed capital loss is to determine the person's capital gain or loss. In doing this, the Eighth Schedule provides for four key definitions that form the basic building blocks in determining that 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), regardless of whether the asset was acquired by the person before, on or after that date. However, only the capital gain accruing from 1 October 2001 is 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**). In the simplest case the amount received by or accruing to the seller of an asset is 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 fully dealt with in Part V of the Eighth Schedule (see **Chapter 8**).

The example below illustrates the calculation of a capital gain.

Example 1 – 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 2008 for R30 000.

Result:

Asset	100 shares	
Disposal event	Sale of the shares	
		R
Proceeds (sale price)		30 000
Less: Base cost (purchase price)		(10 000)
Capital gain		20 000

The same principles apply in calculating a capital loss, but in that 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 restructuring rules in ss 41 to 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**).

Aggregate capital gain or loss

Once all the capital gains and losses of a person have been calculated, the next step is to determine the 'aggregate capital gain' or 'aggregate capital loss. This is done by

- adding all capital gains and deducting all capital losses during the year of assessment to arrive at a net total, and
- in the case of a natural person or special trusts, reducing that net total (whether it be positive or negative) by the 'annual exclusion'. If the result is a positive figure it is an aggregate capital gain, and if it is negative, it is an aggregate capital loss.

Example 2 – Determination of aggregate capital gain

Facts:

The following gains and losses were derived during the 2010 year of assessment by an individual:

	R
Capital gain on sale of holiday house	57 500
Capital loss on sale of shares	(20 000)

Determine the aggregate capital gain or loss for the year of assessment ending 28 February 2011.

Result:

	R
Sum of capital gains and losses	37 500
Less: Annual exclusion	(17 500)
Aggregate capital gain	20 000

Annual exclusion

The annual exclusion is as follows:

	R
2012 (proposed)	20 000
2011	17 500
2010	17 500
2009	16 000
2008	15 000
2007	12 500
2006 and earlier years	10 000

The annual exclusion of a person who dies during a year of assessment is increased for that year as follows:

	R
2012 (proposed)	200 000
2008 to 2011	120 000
2007	60 000
2006 and earlier years	50 000

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 3 – Determination of net capital gain

	R
Aggregate capital gain for 2011	100 000
Less: Assessed capital loss for 2010	(60 000)
Net capital gain for 2011	40 000

Example 4 – Determination of assessed capital loss

	R
Aggregate capital loss for 2011	(50 000)
Assessed capital loss for 2010	(50 000)
Assessed capital loss for 2011	(100 000)

An assessed capital loss cannot be set off against a person's taxable income, nor can it be used to increase an assessed loss. It must be carried forward to the next year of assessment in which it will reduce an aggregate capital gain or increase an aggregate capital loss.

Taxable capital gain

A net capital gain for the current year of assessment is multiplied by the inclusion rate to arrive at the person's taxable capital gain which must be included in taxable income for the year of assessment.

Example 5 – Net capital gain

Facts:

During the year of assessment ending 28 February 2011, Gerhard sold 100 shares in ABC Ltd at a capital gain of R162 500. He also disposed of a rental property at a capital loss of R20 000. He had an assessed capital loss brought forward from the 2010 year of assessment of R25 000. Gerhard is in the highest tax bracket with a marginal tax rate of 40%. Determine his CGT liability for the 2011 year of assessment.

Result:

	R
Capital gain on sale of shares	162 500
Capital loss on sale of property	(20 000)
Sum of capital gains and losses	142 500
Less: Annual exclusion	(17 500)
Aggregate capital gain	125 000
Less: Assessed capital loss brought forward	(25 000)
Net capital gain	100 000
Inclusion rate	25%
Taxable capital gain (add to taxable income)	25 000

Normal tax on the amount included in taxable income is R25 000 x 40% = R10 000.

Example 6 – Assessed capital loss

Facts:

During the year of assessment ending 28 February 2011 Moira sold her 11-metre yacht at a capital gain of R30 000 and her shares in XYZ Ltd at a capital loss of R147 500. She had an assessed capital loss of R25 000 brought forward from the 2010 year of assessment. Determine her assessed capital loss for the 2011 year of assessment.

Result:

	R
Capital gain on sale of yacht	30 000
Capital loss on sale of XYZ Ltd shares	(147 500)
Sum of capital gains and losses	(117 500)
Less: Annual exclusion	17 500
Aggregate capital loss	(100 000)
Assessed capital loss brought forward	(25 000)
Assessed capital loss	(125 000)

3.6 Inclusion, statutory and effective CGT rates for the 2011 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.

Table 1 – Inclusion, statutory and effective CGT rates for the 2011 year of assessment

Type of Taxpayer	Inclusion rate %	Statutory Rate %	Effective CGT rate %
Individuals	25	0 – 40	0 – 10
Public benefit organisations	50	28	14
Recreational clubs	50	28	14
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	28	14
• Corporate fund	50	28	14
• Untaxed policyholder fund	0	0	0
Companies	50	28	14
Small business corporations	50	0 – 10 – 28	0 – 5 – 14
Personal service providers			
• Companies	50	33	16,5
• Trusts	50	40	20
Companies which are not resident (e.g. a company having a PE in South Africa)	50	33	16,5
Tax holiday companies	50	0	0
Micro business[125]	50	0 – 1 – 3 – 5 – 7	0 – 0,5 – 1,5 – 2,5 – 3,5

The statutory rates in the above table are for the 2011 year of assessment (companies with years of assessment falling between 1 April 2010 and 31 March 2011; individuals and trusts with years of assessment ending on 28 February 2011). 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 40% x 25% = 10%. In the case of a company the effective rate of CGT is 50% x 28% = 14%. However, taking into account the STC on any capital profit distributed, the effective rate is 14% + 7,82% = 21,82%. This is arrived at as follows:

	1 April 2010 to 31 March 2011 R
Capital gain	100
Taxable capital gain R100 x 50%	50

[125] Under para 57A micro business's assets are not subject to CGT. However, under para 6 of the Sixth Schedule 50% of the receipts of a capital nature from the disposal of micro business assets are included in taxable turnover.

CGT R50 x 28%	14,00
Capital profit available for distribution R100 – R14	86,00
STC R86 x 10/110	7,82
Total effective rate of tax on capital gain R14 + R7,82	21,82

The above calculation is based on two assumptions.

- First, it is assumed 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.
- Secondly, it is assumed that the entire capital profit was distributed on or after 1 January 2011 and is subject to STC. Before this date s 64B(5)(*c*) exempted the pre-1 October 2001 portion of a capital profit distributed in anticipation or in the course of the liquidation or deregistration of a company from STC.

Chapter 4 – The Eighth Schedule – Scope and definitions

PART I: GENERAL

Paragraphs 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. Words or phrases defined in the Eighth Schedule that are used in the rest of the Act are also defined in s 1. With the exception of the definition of a 'special trust', the terms 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 in which amounts are determined. The table below sets out the terms that are defined in the Eighth Schedule and indicates whether they are also defined in s 1. Cross-references to the sections of the guide in which these definitions are dealt with are also provided.

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

Definition	Paragraph/Part/Section in which comprehensively defined	Defined in para 1?	Defined in s 1?	Reference in guide
Aggregate capital gain	Paragraph 6	No[126]	Yes	**5.4**
Aggregate capital loss	Paragraph 7	No[127]	Yes	**5.4**
Assessed capital loss	Paragraph 9	No	Yes	**5.6**
Asset	N/A – see below	Yes	No	See below
Base cost	Part V	Yes	No	**8**
Boat	N/A – see below	Yes	No	See below
Capital gain	Paragraph 3	Yes	Yes	**5.1**
Capital loss	Paragraph 4	Yes	Yes	**5.2**
Disposal; dispose	11 and amounts treated as disposals under Schedule	Yes	No	**6**
Individual policyholder fund	Section 29A(4)(*b*)	Yes	No	
Insurer	Section 29A(1)	Yes	No	
Net capital gain	Paragraph 8	Yes	No	**5.5**
Personal-use asset	Paragraph 53	Yes	No	**12.2**

[126] Deleted from para 1 by s 49(*a*) of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

[127] Deleted from para 1 by s 49(*b*) of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

Pre-valuation date asset	N/A – see below	Yes	No	See below
Primary residence	Paragraph 44	Yes	No	**11.1.2**
Proceeds	Part VI	Yes	No	**9.1**
Recognised exchange	N/A – see below	Yes	No	See below
Residence	Paragraph 44	Yes	No	**11.1.3**
Ruling price	N/A – see below	Yes	No	See below
Special trust	N/A – see below	Yes	Yes, but wider than para 1 definition	**14.13**
Taxable capital gain	Paragraph 10	No[128]	Yes	**5.7**
Valuation date	N/A – see below	Yes	No	See below
Value shifting arrangement	N/A – see below	Yes	No	See below and **21.3**

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

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

4.1.2 Definition – 'asset'

> '"**[A]sset"** 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 an 'asset' is of importance, as CGT is, with few exceptions,[129] not triggered until an asset is disposed of. A wide definition has been ascribed to the term, 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;

[128] Deleted from para 1 by s 49(*c*) of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

[129] Paragraph 12(5) triggers a capital gain upon the reduction or discharge of a liability under specified circumstances, although the mechanism for achieving this is based on the disposal of a deemed asset (the debt). Paragraph 93 triggers a capital gain or loss on settlement of a foreign currency liability.

- 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 (see **24.4**);
- a bank account, whether local or foreign; and
- trading stock.

In *CIR v Estate C P Crewe & another* in relation to the determination of estate duties, Watermeyer CJ said the following:[130]

> 'One would expect that when the estate of a person is described as consisting of property, what is meant by property is all rights vested in him which have a pecuniary or economic value. Such rights can conveniently be referred to as proprietary rights and they include *jura in rem*, real rights such as rights of ownership in both immovable and movable property, and also *jura in personam* such as debts and rights of action.'

It is therefore submitted that the word 'property' refers to anything that can be disposed of and turned into money. Things that are incapable of private ownership are excluded, that is, *res extra commercium,* which include *res communes* (things common to all inhabitants such as the sea and air) and *res publicae* (state property held for the benefit of inhabitants).[131] Furthermore, according to *LAWSA*,[132]

> 'under Roman law, rights arising in the sphere of the law of persons, such as personal liberty, parental authority and rights flowing from the marital relationship, were considered of such a personal nature that they were incapable of pecuniary evaluation and thus not things.'

Such rights would therefore not constitute 'property' for CGT purposes.

The competence to accept an inheritance is not a right and hence not property – see **6.1.3.8**.

The definition of an 'asset' is not concerned with the capital or revenue nature of property. Trading stock is thus an asset for CGT purposes. In a going concern situation a disposal of trading stock will usually not give rise to a capital gain or loss because double deductions and double taxation are prevented in determining base cost and proceeds by paras 20(3)(*a*) and 35(3)(*a*) respectively. But a capital gain can arise when trading stock is deemed to be disposed of at market value under the Eighth Schedule, for example, on death or upon a person ceasing to be a resident.

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[130] 1943 AD 656, 12 SATC 344 at 352.
[131] F du Bois *Wille's Principles of South African Law* 9 ed (2007) Juta & Company Limited at 417.
[132] C G van der Merwe under Things / Definition, Classification And Components / Definition / 'Impersonal Nature'
27 (First Reissue Volume) *LAWSA* [CD-ROM] (*My LexisNexis*: 31 October 2001) LexisNexis Butterworths, Durban in para 207.

The unissued share capital of a company is not property of the company. In *FCT v St Helens Farm (ACT) Pty Ltd* Barwick CJ stated the following:[133]

> `Until allotment and issue, which includes the entry of the allottee's name on the share register in respect of the allotted share or shares, there is no property in the unissued shares; and, in particular, there is not then, or for that matter at any other time, any property or proprietorial right in or of the company in the unissued shares in its capital. The company has the capacity to allot and issue shares in its capital up to the amount of that capital, its nominal capital. But that capital is not property of the company. Indeed when allotted and issued the nominal amount of the issued share or shares constitutes in accounting terms a liability of the company.[134] But it is not property which comes to the allottee from, or by transfer from, the company. It is property which comes into existence by the allotment and issue, or more precisely, which is the consequence of such allotment and issue.'

In *Burman v CIR*[135] the taxpayer, a property speculator, held shares and a loan account in a property company. When the company failed the taxpayer sought to claim a revenue loss in respect of the loan account. The court refused to allow the deduction on the basis that he was not a money-lender. The court rejected the argument that the shares and loan were a single economic unit even though it was intended that they be sold together. It was held by a majority that such a view ignored the commercial reality and legal consequences of the loans. It follows that when property loan stock companies issue linked units comprising shares and debentures, the shares and debentures must be regarded as separate assets for CGT purposes. The implication of this is that in some cases the two components will receive differing treatment for CGT purposes. For example, only the shares will qualify for roll-over relief under para 78(2) in the case of a share split or consolidation. Similarly, only the equity share component can be considered for roll-over relief under s 42 (asset-for-share transactions).

Deferred tax assets

For accounting purposes a deferred tax asset can arise, for example, when income that will be recognised for accounting purposes in a later financial year is subject to tax in the current financial year. The tax paid is recognised as an asset in the current year's financial statements and only expensed in the year when the related income is recognised for accounting purposes. See in this regard statement of generally accepted accounting practice IAS 12 (AC 102) 'Income Taxes' (revised March 2004) which requires that deferred tax assets should be recognised when it is probable that taxable profits will be available against which the deferred tax asset can be utilised. See also AC 501 'Accounting for "Secondary Tax on Companies (STC)' which provides for the creation of a deferred tax asset in respect of unutilised STC credits when it is probable that they will be utilised against future dividends declared.

A deferred tax asset is merely an accounting creation and not an asset as defined in para 1. It follows that a deferred tax asset cannot be disposed of or acquired for CGT purposes, This is of importance in the context of the corporate restructuring rules in ss 41 to 47, as s 41 uses the para 1 definition of an 'asset'. For example, a deferred tax 'asset' must not be taken into account when determining whether a company is a 'domestic financial instrument holding company' or 'foreign financial instrument holding company' as defined in s 41.

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[133] (1981) 146 CLR 337 (HC of A).

[134] With respect, the share capital of a company is not a debt of the company. In *CIR v Datakor Engineering (Pty) Ltd* 1998 (4) SA 1050 (SCA), 60 SATC 503 at 510 Harms JA held that redeemable preference shares were not debt of a company.

[135] 1991 (1) SA 533 (A), 53 SATC 63.

Unbilled work in progress

For accounting purposes taxpayers in the services sector (for example, in the accounting and legal professions) sometimes treat unbilled work in progress as an asset on the balance sheet.[136] Such work in progress is, however, merely an accounting creation and is not an asset for CGT purposes. In the tax computation the net profit before tax is increased by opening work in progress and decreased by closing work in progress. The effect of this reversal is simply to allow the current year's salaries and wages and other overheads as a deduction under section 11(*a*). Those amounts are an expense of a revenue nature because they do not create an enduring benefit and cannot be described as 'property' for the purposes of the definition of an 'asset'. In addition the work in progress does not represent a personal right against the client for whom the service is rendered as it is not enforceable until the service is billed and there is agreement with the client on the amount of the fee.[137] If an amount is stipulated for work in progress in the sale agreement, the amount received by the seller (for example, a retiring partner) is likely to be on revenue account.[138] If not separately stipulated the amount would probably form part of goodwill.

4.1.2.1 Corporeal property

Wille describes corporeal property as follows:[139]

> 'Corporeal property is perceptible to the external organs of sense, primarily in having the capacity to be handled or touched.'

LAWSA describes the modern concept of corporeality as follows:[140]

> '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 property

Incorporeal things are things that cannot be seen, heard, touched, smelled or tasted. They are imaginary conceptions, such as real and personal rights.[141]

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 for example, a pledge. The right to trade has also been held to constitute incorporeal property – see **24.5**.[142]

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[136] See IAS 2 'Inventories' in para 19 which requires work in progress of service providers to be accounted for at cost (profit margins and non-attributable overheads are excluded).
[137] See ITC 1824 (2007) 70 SATC 27 (P) in which it was held that there was no accrual in respect of a fee that had been billed but not accepted by the client.
[138] In ITC 1358 (1981) 44 SATC 155 (T) a retiring partner was held to be taxable on income account on receipt of a payment for unbilled work in progress. Similar results ensued in the Australian cases of *Stapleton v FCT* 89 ATC 4818 and *FCT v Grant* 91 ATC 4608. In *Grant's* case Jenkinson J followed Sheppard J's reasoning in *Stapleton* and concluded that work in progress in professional firms constituted an affair of revenue that represented what would in time become income when the work in question was complete.
[139] Above at 419.
[140] C G van der Merwe under Things / Definition, Classification And Components / Definition / 'Corporeality' 27 (First Reissue Volume) *LAWSA* [CD-ROM] (*My LexisNexis*: 31 October 2001) in para 206.
[141] *Wille* above at 165.
[142] ITC 1338 (1980) 43 SATC 171 (T) at 174.

4.1.2.3 Immovable property

According to *LAWSA* immovable things[143]

> 'are things which cannot be moved from one place to another without damage or change of form[8]'.

[8] Grotius 2 1 11–13; Voet 1 8 11; Van der Keessel 2 1 12; Goudsmit Pandecten-systeem vol 1 82.

Examples: Land, buildings with foundations in the soil, trees, growing crops, real rights over immovable property (for example, a usufruct or a registered lease of not less than ten years[144]).

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

Incorporeal immovable property includes real rights over immovable property: a registered usufruct over immovable property, old and new order mineral rights, a registered *praedial* servitude and building restrictions.[145]

The view is held that new order rights under the Mineral and Petroleum Resources Development Act 28 of 2002 comprise immovable property. Section 5(1) of that Act reads as follows:

> '**5. Legal nature of prospecting right, mining right, exploration right or production right, and rights of holders thereof.—**(1) A prospecting right, mining right, exploration right or production right granted in terms of this Act is *a limited real right in respect of the mineral or petroleum and the land to which such right relates*.'

(Emphasis added.)

The holder of such a right is entitled to access the land [s 5(3)(*a*)], prospect, mine, explore or produce [s 5(3)(*b*)], and remove and dispose of any minerals found [s 5(3)(*c*)].

A new order right shares many of the characteristics of other types of immovable property, namely,

- it is a real right (albeit limited),
- it is 'in respect of' the mineral and the related land (these words imply a close causal connection with the mineral and the land),
- the subject matter of the right can only be removed by causing damage to the land (the land has to be excavated to extract the mineral), and
- it is not dissimilar to a long-term lease, a usufruct or a servitude, all of which are rights of enjoyment of immovable property.

[143] C G van der Merwe under Things / Definition, Classification And Components / Classification / 'Movables and Immovables' 27 (First Reissue Volume) *LAWSA* [CD-ROM] (*My LexisNexis*: 31 October 2001) in para 224.
[144] See para (*b*) of the definition of 'immovable property' in s 102(1) of the Deeds Registries Act 47 of 1937
[145] C G van der Merwe under Things / Definition, Classification and Components / Classification / 'Incorporeal Movables and Immovables' 27 (First Reissue Volume) *LAWSA* [CD-ROM] (*My LexisNexis*: 31 October 2001) in para 225, and *Wille* above at 167.

4.1.2.4 Movable property

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.

Under Roman-Dutch law, corporeal and incorporeal things can also be classified as movable or immovable. Examples of movable incorporeal things include real rights over movable property, a usufruct over a movable asset and all personal rights. A member's interest in a close corporation is deemed to be movable property under s 30 of the Close Corporations Act 69 of 1984. Section 35(1) of the Companies Act 71 of 2008 confirms that a share issued by a company is movable property.

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 or group of persons. The parties to a contract have rights against each other. Personal rights are of two types, namely,

- a jus in personam ad rem acquirendam, being a right to claim delivery of a thing, and
- a *jus in personam ad faciendum*, being a right to claim performance or an act.

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.[146]
- 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*.

[146] *CIR v MacNeillie's Estate* 1961 (3) SA 833 (A), 24 SATC 282 at 840F–G.

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.

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 Brenda made payment of the award, 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 under 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.

Is the right to claim payment an asset?

While the right to claim payment is a personal right, it will not always be recognised as an asset for CGT purposes, particularly when 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*[147] in which 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 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 and 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 under 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' excludes foreign currency. However, gains and losses on foreign currency are determined separately under 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

[147] (1984) 58 TC 371 at 392F–G.

the purposes of s 108-5 when it is used as legal tender.[148] 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*[149] in which Hill J observed that[150]

> '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'.

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

While currency is excluded from the definition of an '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.

While 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. Under 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 an '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 a 'financial instrument' in s 1, which includes a deposit with a financial institution. The definition of a '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.

[148] See ATO Tax Determination TD 2002/25 dated 20 November 2002.
[149] 1990 22 FCR 42, 21 ATR 13.
[150] At ATR 31.

4.1.3 Definition – 'boat'

'**"[B]oat"** 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 metres in length are disallowed to the extent that they are not used for trade [para 15(*b*)].
- A boat can constitute a primary residence (para 44).
- A boat exceeding 10 metres in length is excluded from being a personal-use asset [para 53(3)(*d*)].

4.1.4 Definition – 'pre-valuation date asset'

'**"[P]re-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 before the valuation date. The term 'pre-valuation date asset' can be found in paras 25 to 27 and 30.

4.1.5 Definition – 'recognised exchange'

'**"[R]ecognised exchange"** means—

(*a*) an exchange licensed under the Securities Services Act, 2004; or

(*b*) . . . . . .

(*c*) an exchange in a country other than the Republic which is similar to an exchange contemplated in paragraph (*a*) and which has been recognised by the Minister for purposes of this Schedule by notice in the Gazette'[151]

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

The list of recognised exchanges in countries outside the Republic was published in the *Government Gazette* and is also available on the SARS website.[152]

4.1.6 Definition – 'ruling price'

'**"[R]uling 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

[151] Some minor textual amendments were made to the definition by s 63 of the Revenue Laws Amendment Act 31 of 2005.

[152] GN R 997 in *GG* 22723 of 2 October 2001. Available from: <http://www.sars.gov.za/home.asp?pid=3498> [Accessed 8 December 2011].

> 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. Paragraph (*a*) deals with local listed instruments while para (*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. 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

Example 1 – Higher bid by buyer

Facts:

The last sale of a share listed on the JSE takes place at 4pm on 1 July at a price of R100 a share. Just before the close of the market on that day, a buyer makes a bid for 100 shares at R102 a share.

Result:

The ruling price of the share will be R102 as the bid is higher than the last sale price.

Example 2 – Lower offer by seller

Facts:

The last sale of a share listed on the JSE takes place at 4pm on 1 July at a price of R100 a share. Just before the close of the market on that day, a seller offers 100 shares for sale at R99 a share.

Result:

The ruling price of the share will be R99 as the offer is lower than the last sale price.

Example 3 – Lower bid or higher offer

Facts:

The last sale of a share listed on the JSE takes place at 4pm on 1 July at a price of R100 a share. Determine the ruling price assuming that just before the close of the market on that day

- a buyer makes a bid of R99, or
- a seller makes an offer of R101.

Result:

In both cases the ruling price will be R100 as the bid is lower and the offer is higher than the last sale price.

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

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'

> '**"[S]pecial trust**" means a trust contemplated in paragraph (*a*) of the definition of 'special trust' in section 1.'[153]

The above definition of a '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'

> '**"[V]aluation 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

Before its amendment by the Taxation Laws Amendment Act 16 of 2004, para (*a*) read as follows:[154]

> '[I]n 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 . . ..'

Under 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 under s 10(1)(*c*A) must also disregard any capital gain or loss under para 63. The valuation date of a body that ceases to be exempt under s 10(1)(*c*A) and para 63 is the date on which it ceases 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 wording of para (*a*) applies to all exempt persons who become taxable, and not merely those who were previously exempt under 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. Since all PBOs fall outside para 63 with effect from the introduction of partial taxation for PBOs, it follows that their valuation date will be the first day of the first year of assessment commencing on or after 1 April 2006. For example, a PBO with a March year end will have a valuation date of 1 April 2006, since this is the commencement date of the 2007 year of assessment.

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[153] Inserted by Act 74 of 2002 and came into operation from the commencement of years of assessment ending on or after 1 January 2003.

[154] 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'

> '**"[V]alue 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. For there to be a 'value shifting arrangement' the parties must be connected persons before the transaction. 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 term in s 1, and a person who is not a resident.

- A resident is subject to CGT on the disposal of any asset whether in or outside the Republic,
- A non-resident is subject to CGT on the disposal of
  - any immovable property or any interest or right of whatever nature to or 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 **4.1.2** on the definition of an 'asset'.

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

> '**"[P]ermanent 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.'

Indirect interests in SA Immovable property [para 2(2)]

The term 'an interest in immovable property situated in the Republic' is defined broadly in para 2(2).

Before 1 February 2006

Before 1 February 2006 para 2(2) read as follows:

> '(2) For purposes of subparagraph (1)(*b*)(i), an interest in immovable property situated in the Republic includes a direct or indirect interest of at least 20 per cent held by a person (alone or together with any connected person in relation to that person) in the equity share capital of a company or in any other entity, where 80 per cent or more of the value of the net assets of that company or other entity, determined on the market value basis, is, at the time of disposal of shares in that company or interest in that other entity, attributable directly or indirectly to immovable property situated in the Republic, other than immovable property held by that company or other entity as trading stock.'

Under the above wording, the determination of the proportion of immovable property to other assets must be determined based on the market value of the net assets. The view is held that the liabilities must be allocated against the assets that they finance. For example, if South African immovable property was bonded to purchase plant, the liability must be allocated against the plant. A liability that cannot be linked to a specific asset must be allocated proportionately against the assets to which it is likely to relate. For example, unless the facts indicate otherwise, current liabilities would normally finance current assets and should be allocated accordingly.

Example 1 – Indirect interest of non-resident in immovable property in South Africa (pre-1 February 2006 position)

Facts:

Aaron, a non-resident, owns a 25% interest in XYZ (Pty) Ltd ('XYZ') the balance sheet of which appears as follows as at 28 February 2005:

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

Aaron disposes of his shares on 1 March 2005. Determine whether he will be liable for CGT on the disposal of his shares in XYZ if the long-term loan financed the acquisition of

- the land and buildings, or
- 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

Assuming that the long-term loan financed land and buildings

	R
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 total 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 Aaron will not be subject to CGT on the disposal of his shares.

Assuming that the 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 Aaron owns 20% or more of the shares in XYZ, and 80% or more of the market value of XYZ's net assets constitute immovable property, Aaron will be liable for CGT when he disposes of his shares.

Example 2 – Indirect interest in immovable property through multi-tier structure (pre-1 February 2006 position)

Facts:

Colin, a non-resident owns 100% of Seaco a South African resident company. Seaco's only assets consist of shares in two wholly owned South African subsidiaries, Subco and Tubco. Subco's net assets consist of plant and machinery, debtors and cash in bank less liabilities, the net market value of which is R100 000. Tubco's sole asset comprises land and buildings in Durban with a market value of R600 000 less a bond of R100 000. Colin disposes of his shares in Seaco. Will he be subject to CGT on the disposal?

Result:

The market value of Seaco's net assets consist indirectly of immovable property of R500 000 and other property of R100 000. The immovable property comprises 83% of Seaco's indirect net assets (R500 000/R600 000 x 100). Under para 2(2) Colin's shares in Seaco are deemed to be immovable property and he will be subject to CGT on the disposal thereof.

The position on or after 1 February 2006

Paragraph 2(2) was amended by s 64(1) of the Revenue Laws Amendment Act 31 of 2005. The amendment came into operation on 1 February 2006 and applies to any disposal on or after that date. The main impact of the change is as follows:

- In the case of multi-tier structures the 80%+ test has been moved to the top of the chain.

- The gross market value of assets of the entity must now be analysed instead of the market value of its net assets.
- Vested rights in a trust are now included.

The types of interest comprising immovable property in South Africa are summarised in the table below.

Table 1 – Interests that comprise immovable property in SA

<table>
<tr><th>Type of interest</th><th>Requirement 1</th><th>Requirement 2</th></tr>
<tr><td>Any equity shares held by a person in a company</td><td rowspan="3">80% or more of the market value of the
• equity shares,
• ownership or right to ownership, or
• vested interest,
• at the time of their disposal,
• is attributable directly or indirectly,
• to immovable property [in South Africa],
• held otherwise than as trading stock.</td><td>The person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20% of the equity shares[155] of that company.</td></tr>
<tr><td>Ownership or the right to ownership of a person in any other entity</td><td>The person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20% of the ownership or right to ownership of the other entity.</td></tr>
<tr><td>A vested interest of a person in any assets of any trust.</td><td>Any percentage interest.</td></tr>
</table>

The 80% requirement excludes immovable property held as trading stock as this is a CGT anti-avoidance measure.

A non-resident holding an interest of at least 20% of the equity shares in a company in which 80% or more of the market value of its assets comprise leasehold property in South Africa will be subject to CGT on disposal of those shares. This follows because 80% of the value of the shares is indirectly attributable to immovable property in South Africa. In other words, the lease derives its value from the immovable property of the lessor. The leasehold property may itself comprise immovable property if the lease is for not less than ten years and is registered in the deeds registry (see **4.1.2.3**).

In determining whether 80% or more of the value of shares in a company are directly or indirectly attributable to immovable property in South Africa, any liabilities in the company must be disregarded. This is in line with the OECD's interpretation[156] of article 13(4) of the OECD model treaty, which provides as follows:

> '4. Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.'

[155] The term 'equity share capital' was substituted with 'equity shares' with effect from 1 January 2011 by s 93(1) of the Taxation Laws Amendment Act 7 of 2010.
[156] The commentary on the OECD's 'Model Tax Convention on Income and on Capital' 8 ed (22 July 2010) condensed version in para 28.4.

For accounting purposes self-generated goodwill is not reflected in the financial statements of an entity.[157] However, it is an asset forming part of the market value of the interest in an entity and should not be lost sight of when determining whether or not 80% or more of an entity's assets comprise immovable property.

The reference to ownership or a right to ownership in any other entity is designed to bring within the ambit of the provision interests in foreign entities such as the Liechtenstein *stiftung* and *anstalt*.

No exception is made for the holding of shares in listed South African companies. Thus a non-resident holding shares in a South African-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 tax treaty must be considered before deciding whether the sale of shares by a non-resident in a company holding South African immovable property can be subject to CGT. For example, Article 13(2) of South Africa's tax treaty 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 South Africa on the disposal of shares in an unlisted company holding South African immovable property. On the other hand, if the company were listed, the disposal of the shares would not attract CGT in South Africa. Treaties such as those with Luxembourg, Mauritius and the Netherlands[158] provide that sales of assets other than immovable property are only taxable in the country of residence. Since shares are not 'immovable property' under South Africa's domestic law it follows that the provisions of these tax treaties will override para 2(1)(*b*).

Example 3 – Indirect interest of non-resident in immovable property in South Africa (on or after 1 February 2006 position)

Facts:

The facts are the same as in Example 1 except that XYZ's balance sheet is drawn up as at 28 February 2007 and Aaron disposed of his shares on 1 March 2007.

Result:

The market value of the shares in XYZ is attributable to the following assets:

[157] IAS 38 (AC 129) in para 48.
[158] Article 13(4) of the treaties with Luxembourg and Mauritius and Article 14(4) of the treaty with the Netherlands.

	R	
Land and buildings	180 000	(67,9%)
Plant and machinery	85 000	(32,1%)
Market value of assets	265 000	

Only 67,9% (R180 000/R265 000 x 100) of the value of Aaron's shares is attributable to immovable property. Aaron's shares are therefore not regarded as an 'interest in immovable property' and will not attract CGT upon disposal. As the disposal of Aaron's shares took place on or after 1 February 2006, any liabilities in XYZ must be disregarded in the determination of attributable value.

Example 4 – Indirect interest in immovable property through multi-tier structure (position on or after 1 February 2006)

Facts:

Roger, a non-resident, owns 25% of the shares in H. H holds a 100% interest in S and S owns 100% of T and U. H and S have no other assets except their investments in their respective subsidiaries.

The market value of S's interests in T and U is as follows:

	T	U
	R	R
Land	900	-
Plant	-	100
Bond	(800)	-
Net assets	100	100

Roger disposes of his shares in H. Is he subject to CGT?

Result:

90% of the value of the shares in H is indirectly attributable to immovable property (R900/R1 000 x 100). In making this determination any liabilities in T and U are disregarded. Roger will therefore be subject to CGT on the disposal of his shares in H.

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 rebate under s 6*quat*. In addition, non-residents remain subject to South African tax only to the extent that their income is from a source within or deemed to be within South Africa.

Under para 2, the CGT provisions apply to all assets of residents and the following assets of non-residents that are situated in South Africa:

- 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 South Africa 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)]

Under 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.

For the purpose of s 9(2)[159] an interest in immovable property held by a person includes

- any equity shares in a company,
- ownership or the right to ownership of any other entity, or
- a vested interest in any assets of any trust,

if

- 80% or more of the market value of those equity shares, ownership or right to ownership or vested interest, as the case may be, at the time of disposal thereof, is attributable directly or indirectly to immovable property held otherwise than as trading stock, and
- in the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person) directly or indirectly, holds at least 20% of the equity shares in that company or ownership or right to ownership of that other entity.

The use of the words 'directly or indirectly' is intended to prevent the shareholder placing South African immovable property outside the definition by placing it in a subsidiary. See **4.2**.

Source – movable property [s 9(2)(b)]

Resident

A capital gain or loss on disposal of movable property by a resident will have its source in South Africa if

- the asset is not attributable to a PE outside South Africa, and
- the proceeds from the disposal of the asset are not subject to any taxes on income payable to any sphere of government of any country other than South Africa.

Non-resident

A capital gain or loss on disposal of movable property by a non-resident will have its source in South Africa if the asset is attributable to a PE in South Africa.

These rules do not conflict with the approach adopted in the OECD Model Convention on the right of taxation of capital gains.

4.4 Precedence of sections of the Act over the Eighth Schedule

There are a number of situations in which both the Eighth Schedule and sections of the Act apply to the same amount, and the question then arises as to which takes precedence. The

[159] The definition of an interest in immovable property in s 9(2) was amended by s 13(1)(*b*) of Act 31 of 2005 with effect from 1 February 2006 and applies in respect of any disposal on or after that date.

rule of interpretation when a section of the Act and a Schedule are in conflict was summed up as follows by Kotze JA in *African & European Investment Co Ltd v Warren & others*:[160]

> '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.'

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

[160] 1924 AD 308 at 360. See also *R v Kok* 1955 (4) SA 370 (T) at 374F–G and *Executive Council of the Western Cape Legislature v President of the RSA* 1995 (10) BCLR 1289 (CC) para 33, 1995 (4) SA 877 (CC).

Chapter 5 – Taxable capital gain and assessed capital loss

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 on the disposal exceed the base cost of the asset.

The words 'in respect of'' make it clear that amounts received or accrued before 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 an earlier 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)]

The receipt or accrual of further proceeds in the current year of assessment from the disposal of an asset in an earlier year 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 under 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 (for example, when the additional amount was contingent on a future event at the time of the initial disposal).

The second exception applies when further proceeds are received from the disposal of a pre-valuation date asset in an earlier 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 *de novo* 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
Less: 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 when 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.[161]

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 for the cost of the vehicle in her 2003 return of income. She was unable to claim a scrapping allowance under s 11(*o*) as it then read, as the vehicle had not been 'scrapped'. During the 2005 year of assessment the

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

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 under para 3(*b*)(ii).

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 returns 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)]

Under 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 **8.27.2** occur in a year subsequent to the year of disposal. In essence, these events cover situations in which

- 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). A capital loss previously determined or redetermined under para 25 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 **8.27.2**.

5.1.3 Assets disposed of before valuation date

Proceeds received or accrued on or after the valuation date from the disposal of an asset before that date do not result in a capital gain under para 3. Under para 2 the Eighth Schedule only applies to disposals of assets on or after the valuation date. Similarly, when any expenditure is recovered or recouped in respect of an asset disposed of before 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 when 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 before 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 an earlier 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 earlier year's capital gain

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

Under 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.

If similar events to those described above occur in the case of an asset disposed of in the current year, para 4(*b*)(i) does not apply and the proceeds must be reduced under para 35(3)(*b*) or (*c*).

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 an earlier 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 under 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)]

Under 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 **8.27.2** occur in a year subsequent to the year of disposal. In essence, these events cover situations in which

- 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*). A capital gain previously determined or redetermined under para 25 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 **8.27.2**.

5.2.3 Assets disposed of before valuation date

A portion of the expenditure incurred on or after the valuation date in respect of an asset disposed of before that date will not result in a capital loss under para 3(*b*). Under 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 when applicable.

5.2.4 Disregarding of capital losses under other provisions

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

5.3 Annual exclusion

Paragraph 5

Although capital 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 for a year of assessment**				**Comment**
	2010 and 2011[162] **R**	**2009**[163] **R**	**2008**[164] **R**	**2007**[165] **R**	**2006 and earlier years of assessment R**	
Natural person	17 500	16 000	15 000	12 500	10 000	

[162] The annual exclusion was increased to R17 500 by s 67 of the Taxation Laws Amendment Act 17 of 2009. The revised amount is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2010.
[163] The annual exclusion was increased to R16 000 by s 1(2)(*c*) of the Taxation Laws Amendment Act 3 of 2008. The revised amount is deemed to have come into operation on 1 March 2008 and applies in respect of a year of assessment commencing on or after that date.
[164] The annual exclusion was increased to R15 000 and R120 000 (year of death) by s 2(2)(*b*) of the Taxation Laws Amendment Act 8 of 2007. The revised amounts are deemed to have come into operation on 1 March 2007 and apply in respect of any year of assessment commencing on or after that date.
[165] The annual exclusion was increased by s 32 of the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

Natural person – in year of death	120 000	120 000	120 000	60 000	50 000	Not subject to apportionment.
Special trust	17 500	16 000	15 000	12 500	10 000	The annual exclusion only remains available to a special trust until the earlier of • the date when all the assets have been disposed of, or • two years after the death of the beneficiary (para 82).
Deceased estate	17 500	16 000	15 000	12 500	10 000	The annual exclusion of R17 500 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	17 500	16 000	15 000	12 500	10 000	In the year of sequestration the annual exclusion for the person before sequestration and his/her estate may not together exceed R17 500. Thereafter the insolvent estate will enjoy an annual exclusion of R17 500

						[para 83(1)].

Some points to note on 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 purposes 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 when 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 R120 000 (2007: R60 000; 2006 and earlier years of assessment: 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 eight 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

Paragraph 8

A person's net capital gain for the year of assessment is the sum of

- the amount by which the person's aggregate capital gain for that year exceeds the assessed capital loss for the previous year of assessment [para 8(*a*)], and
- when para 64B(3) applies, the amount of any capital gain disregarded under para 64B(2) during the current or any previous year of assessment [para 8(*b*)].[166]

Paragraph 8(*b*) has the effect of ring-fencing the capital gain determined under para 64B(3) – in other words, such a capital gain may not be offset against capital losses arising in the current year or against an assessed capital loss from the previous year. This is an anti-

[166] Paragraph 8(*b*) was inserted by the Revenue Laws Amendment Act 31 of 2005. It is evident from the context of the amendment that it comes into operation on the same date as para 64B(3) and (4), namely, 8 November 2005.

avoidance measure aimed at certain schemes involving the participation exclusion in para 64B. A capital gain disregarded by a company under para 64B(2) is reinstated as a ring-fenced net capital gain if the company falls under para 64B(3). For more on para 64B see **12.18**.

5.6 Assessed capital loss

Paragraph 9

A person's assessed capital loss is determined in accordance with the table below.

Table 1 – Determination of assessed capital loss

Paragraph 9	**Aggregate capital gain or loss?**	**Assessed capital loss**
(*a*)	Aggregate capital gain	Amount by which assessed capital loss for previous year exceeds aggregate capital gain
(*b*)	Aggregate capital loss	Assessed capital loss for previous year + aggregate capital loss
(*c*)	Neither aggregate capital gain or loss	Assessed capital loss for previous year

An assessed capital loss brought forward from the previous year of assessment is taken into account in arriving at the net capital gain (para 8) or assessed capital loss (para 9) for the current year of assessment. An assessed capital loss for the current year of assessment is carried forward to the next year of assessment. There is no mechanism in the Act for setting off an assessed capital loss against ordinary income. Nor can it be used to increase an assessed loss contemplated in s 20. An assessed capital loss is therefore confined to the Eighth Schedule and can in effect only be utilised or set off against capital gains or losses respectively.

5.7 Taxable capital gain

Paragraph 10

A net capital gain for the current year of assessment is multiplied by the inclusion rate applicable to the person to arrive at the taxable capital gain. The inclusion rates are set out in the table below. See also **3.6** 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 under 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 • close corporation • company policyholder fund of an insurer • company which is not a resident deriving taxable income as defined in s 1 • corporate fund of an insurer • public benefit organisation • recreational club • trust (normal)	(*c*)	50

5.8 Inclusion in taxable income

Once a taxable capital gain has been determined, it is included in taxable income under s 26A, 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 taxable income to determine the normal income tax liability.

5.9 Set-off of gains and losses

5.9.1 Set-off of taxable capital gain against assessed loss

A taxable capital gain reduces a locally-derived assessed loss. This not-so-obvious fact follows from the definition of the term 'taxable income' which is defined in s 1 of the Act as follows:

> '"**[T]axable 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 under 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 impossible in the first place.

5.9.2 Set-off of foreign assessed loss against taxable capital gain

A taxable capital gain may not be set off against a foreign assessed loss or balance of a foreign assessed loss brought forward from the preceding year of assessment. This follows from the definition of the term 'taxable income' read with para (*b*) of the proviso to s 20(1).

'Taxable income' is defined in s 1 as follows:

> '"**[T]axable 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;'

Any assessed loss or balance of assessed loss ranking for set-off is determined under s 20, which falls within Part 1 of Chapter II. A taxable capital gain is included in para (*b*) by s 26A.

It follows that if an amount is not allowed to be set off against income under Part I of Chapter II it will not be brought within para (*a*) of the definition of the term 'taxable income' and will not qualify to be aggregated with any taxable capital gain included under para (*b*).

Paragraph (*b*) of the proviso to s 20(1) prevents the set-off of a foreign assessed loss or balance of a foreign assessed loss incurred in any previous year of assessment against any amount derived from carrying on any trade in South Africa. As a result, the amount of any foreign assessed loss or balance of a foreign assessed loss may only be set off against foreign income, and to the extent that the foreign assessed loss or balance of foreign assessed loss is not absorbed by such foreign income it is carried forward to the succeeding year of assessment and will not be taken into account under para (*a*) of the definition of the term 'taxable income'. Because of its exclusion from para (*a*) a foreign assessed loss or balance of a foreign assessed loss will not be available for aggregation with any taxable capital gain included under para (*b*), whether that taxable capital gain is derived in South Africa or abroad.

In applying the proviso to s 20(1) to an individual or a trust, s 20(2A) must be given effect. This means that any reference to 'trade' in the proviso must be read as including a reference to 'non-trade'. It follows that an individual or trust cannot set off a foreign assessed loss or balance of a foreign assessed loss against an amount of locally-derived non-trade income. As a result of the way in which taxable income is determined, it will not be possible to set off either a local or foreign taxable capital gain against a foreign assessed loss.

Example – Application of para (*b*) of the proviso to s 20(1)

Facts:

During the year ended 28 February 2006 Jackie derived the following amounts:

	R
Loss on rental of flat in London	(600 000)
Income from employment in South Africa	500 000
Taxable capital gain arising from sale of London flat	1 000 000

Determine Jackie's taxable income

Result:

Jackie's taxable income is determined as follows:

Step 1 – Determine the amount to be included in para (a) of the definition of the term 'taxable income'

Under para (*b*) of the proviso to s 20(1) Jackie is not permitted to set off the foreign rental loss against her South African employment income. The foreign assessed loss of R600 000 is therefore carried forward to 2007. The amount included in para (*a*) of the definition of the term 'taxable income' is therefore R500 000.

Step 2 – Determine the amount to be included in para (b) of the definition of the term 'taxable income'

The taxable capital gain of R1 000 000 is included in para (*b*).

Step 3 – Determine taxable income by aggregating the amounts determined under paras (a) and (b)

Taxable income = R500 000 + R1 000 000 = R1 500 000.

5.9.3 Set-off of foreign capital loss against local capital gain

For CGT purposes capital gains and losses can arise in respect of foreign assets under para 43 or Part XIII. Paragraph (*b*) of the proviso to s 20(1) prevents the set-off of a foreign assessed loss against domestic trade income (see **5.9.2**). The Eighth Schedule, in contrast, contains no restriction on the set-off of foreign capital losses against domestic capital gains. Nor does it restrict the set-off of domestic capital losses against foreign capital gains. Thus, subject to the clogged loss rule in para 39 and the anti-avoidance provisions of s 103/Part IIA, there is nothing to prevent the set-off of a foreign capital loss against a local capital gain. Similarly, apart from capital gains of CFCs (see below), there is no bar on the set-off of a foreign capital gain against a local capital loss. While para 43 is silent on this issue, para 86(3) confirms that a foreign currency capital gain or loss is treated as a capital gain or loss respectively.

Despite it generally being possible to set off a foreign capital gain against a local capital loss, there is an exception in relation to CFCs. Section 9D(2) requires that there shall be included in the income of a resident shareholder 'an amount equal to' the proportional amount of the 'net income' of a CFC. Section 9D(2A) defines 'net income' as 'an amount equal to' the taxable income of the CFC. A capital gain or loss of a CFC is determined as if the CFC had been a resident, and for this purpose the opening words of s 9D(2A) make paras 2(1)(*a*), 24, 70, 71, 72 and 80 of the Eighth Schedule applicable in determining the CFC's taxable income. The inclusion rate in determining a taxable capital gain is reduced to 25% when the resident shareholder is an individual, special trust or insurer's individual policyholder fund [s 9D(2A)(*f*)]. The effect of the words 'an amount equal to' mean that what is included in the resident's income is not a taxable capital gain but an amount equal to such a taxable capital gain. The separate character of a CFC's capital gains is thus lost with the result that any local capital loss cannot be set off against the amount included in the resident's income. There can be no question of the income inclusion retaining its component parts under a conduit-pipe principle in order to achieve a set-off.

5.9.4 Set-off of taxable capital gain against ring-fenced assessed loss

Section 20A provides for the ring-fencing of an assessed loss arising from certain 'suspect' trades. The question arises as to whether a ring-fenced assessed loss can be set off against a taxable capital gain arising from the disposal of an asset used in the course of the 'suspect' trade. The answer depends on whether the asset is disposed of during the course of or after cessation of the trade. No set-off is permitted if an asset is disposed of during the course of the trade. But once trade has ceased and an asset that was used in carrying on

the suspect trade is disposed of, s 20A(6)(*b*) permits a set-off of the ring-fenced assessed loss. It provides as follows:

> '(6) For the purposes of this section and section 20, the income derived from any trade referred to in subsections (1) or (5), includes any amount—
>
> (*a*) [not relevant – deals with recoupments]; or
>
> (*b*) derived from the disposal after cessation of that trade of any assets used in carrying on that trade.'

The references to 'any amount derived' and 'any assets' would seem to indicate that s 20A(6)(*b*) applies to a taxable capital gain. The amount of any taxable capital gain included in para (*b*) of the definition of the term 'taxable income' must be reduced by any amount thereof that has been set off under s 20A(6)(*b*).

Example – Set-off of taxable capital gain after cessation of suspect trade

Facts:

Roland owns a flat in Umhlanga that he bought for the stated purpose of letting to foreign tourists. However, he and his family occasionally used the flat as a holiday home when it was not let. As a result of the large bond used to finance the acquisition of the flat, it generated losses over three consecutive years at which point SARS informed Roland that his losses were to be ring-fenced. After a further three years of losses, Roland had accumulated a ring-fenced assessed loss of R100 000. He informed the letting agent that the flat was no longer available for letting, and he thereafter sold it for an amount that gave rise to a taxable capital gain of R500 000.

Result:

Roland is permitted to set off the ring-fenced assessed loss of R100 000 against the taxable capital gain of R500 000.

5.9.5 Set-off of assessed capital loss against taxable income

If a person sustains an assessed capital loss for a year of assessment, 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.

A balance of assessed loss of a company may not be carried forward to a year of assessment in which no trade is carried on. However, no similar provision exists in the case of an assessed capital loss and in theory it can be carried forward indefinitely. Section 103(2) should act as a deterrent to prospective traffickers in such losses.

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 term 'disposal'.[167]

A *disposal* is any

- event
- act
- forbearance,[168] 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* 3 ed 'forbearance' means

[167] 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.
[168] The term was borrowed from the Value-Added Tax Act 89 of 1991.

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

6.1.1.2 Conversion

6.1.1.2.1 Meaning of 'conversion'

The word 'conversion' is not defined in the Act. It has a number of dictionary meanings, many of which are inapplicable in the context of a disposal. The following meaning seems to be appropriate:[169]

> 'The exchange of one type of security or currency for another.'

It is submitted that a conversion involves a substantive change in the rights attaching to an asset. Some examples include the conversion of

- a company to a share block company and *vice versa*,
- a preference share to an ordinary share and *vice versa* (except when the rights are acquired up front),
- a dollar-denominated bank account to a euro-denominated bank account.

6.1.1.2.2 No gain or 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* under s 40A or the conversion of a co-operative to a company under s 40B will not give rise to a capital gain or loss in the shareholders' hands under 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 under 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 under para 67C (roll-over relief is granted).

Conversion of par value shares to no par value shares

Under s 35(2) of the Companies Act 71 of 2008 a share does not have a par value, subject to item 6 of Schedule 5 of that Act, which deals with transitional arrangements in respect of pre-existing companies. It is therefore not possible for a company formed after 1 May 2011 to issue par value shares,

Item 6(3) of Schedule 5 requires the Minister to issue regulations providing for the optional conversion and transitional status of par value shares of any pre-existing company. Any such regulations

> 'must preserve the rights of shareholders associated with such shares, as at the effective date, to the extent doing so is compatible with the purposes of this item'.

The regulations affecting the conversion of the nominal or par value of shares are contained in reg 31 of Part D of the regulations issued under GNR 351 of 26 April 2011 in *GG* 34239.

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[169] *American Heritage® Dictionary of the English Language* 4 ed (2004) Houghton Mifflin Company, available online at <http://dictionary.reference.com/browse/conversion> [Accessed 8 December 2011].

Under reg 31(3) it is not possible for a company to issue par value shares if no shares in that class have been issued out of the authorised shares in that class, or if they have been issued, they were all bought back. A pre-existing company that has par value shares in issue immediately before 1 May 2011 may issue further par value shares of the same class as those issued par valued shares up to the limit of its authorised par value shares, but may not increase the number of authorised par value shares [reg 31(5)]. The company may apply to convert the class of shares to shares of no par value. Such a proposal must not be designed substantially or predominantly to evade the requirements of any applicable tax legislation [reg 31(6)(*a*)]. Under reg 31(7) the board of directors is required to prepare a report describing amongst other things

- the material effects that the proposed conversion will have on the rights of the holders of the company's securities affected by the proposed conversion, and
- an evaluation of any material adverse effects of the proposed arrangement against the compensation that any of those persons will receive in terms of the arrangement.

The company must file a copy of the proposed resolution dealing with the conversion and report described above with the CIPC and with SARS, at the same time that the proposal is published to the shareholders [reg 31(8)(*b)*]. At any time before the shareholders' meeting called to consider the conversion SARS may apply to court for a declaratory order that the proposal contravenes reg 31(6)(*a*).

Given that a share is a bundle of rights,[170] there will be no disposal if those rights remain unchanged following a conversion from shares of par value to shares of no par value. However, if some of those rights are lost or diminished there will clearly be a disposal or part-disposal. Whether the reduction in rights will trigger a full or a part-disposal is a question of degree and will depend on the facts of the particular case. A part-disposal is more likely to be triggered when the loss of rights is limited and clearly identifiable. The compensation received by a shareholder who has been adversely affected by such a conversion would usually comprise the proceeds for the disposal, although para 38 will substitute a market value consideration between connected persons.

6.1.1.2.3 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*)].

6.1.1.2.4 Convertible preference shares

The view is held that no disposal will occur at the time of conversion of a convertible preference share if its time and terms of conversion are fixed up front. The details pertaining to the preference share (date of acquisition and cost) will simply be carried over to the ordinary share.[171]

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[170] *Standard Bank of South Africa Ltd & another v Ocean Commodities Inc & others* 1983 (1) SA 276 (A).

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

But if the option to convert is left to the whim of the shareholder or company, or 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. Under 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:

Under 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 proceeds are determined as an exchange transaction under the core rules. See the notes below and under **8.5** on barter or exchange transactions and para 20.

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.

Example 3 – Option to convert or redeem at a fixed future date

Facts:

Mientjie acquired a preference share on 1 March 2005 at a cost of R100. The preference share was redeemable on 28 February 2015 with an option granted to the holder to convert the share to an ordinary share on that date.

Result:

Should Mientjie exercise the option to convert to an ordinary share there will be a disposal on the date of conversion. The conversion is not under the original instrument in the sense of the flowering of rights originally acquired. The option gives rise to a new and independent transaction triggered by the voluntary act of the holder. An option is nothing more than an offer which has been left open for a period for acceptance. The agreement to convert is entered into at a future date in circumstances in which conversion need never otherwise have taken place.

6.1.1.2.5 Convertible debentures

A debenture is included in para (*a*) of the definition of an 'instrument' in s 24J(1). Section 24J(1) contains definitions of an 'adjusted gain on transfer or redemption of an instrument' and an 'adjusted loss on transfer or redemption of an instrument'.

Section 24J(4)(*a*) deems the 'adjusted gain' to accrue in the year of transfer or redemption, while s 24J(4)(*b*) deems an 'adjusted loss' to be incurred in the year of transfer or redemption. It follows that even if the right to convert a debenture into a share is acquired up front, a capital gain or loss will have to be determined at the time of conversion.

6.1.1.3 Creation

How does the creation of an asset result in a disposal? The concept sounds counter-intuitive but is valid[172] 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. The following are examples of the creation of assets that give rise to disposals:

- The granting of
  - a lease,
  - a servitude,
  - mineral rights,
  - a licence, 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**.

These creation events will usually trigger a part-disposal rather than a full disposal. In such event it becomes necessary to allocate part of the base cost of the main asset to the part disposed of under para 33 - see **8.37**.

6.1.1.4 Variation

The word 'variation' must be interpreted in the context of the disposal of an asset. The principle underlying para 11 is that a person must have disposed of an asset in the sense of having parted with the whole or a portion of it. This principle is reflected in the events listed in items (*a*) to (*g*) of para 11(1). A variation could, of course, involve the establishment of legal title to an asset or the improvement or enhancement of an asset. However, such events are not disposals for the following reasons:

- First, nothing has been disposed of – in fact, something additional has been acquired.

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

- Secondly, costs associated with such variations are included in the base cost of an asset under para 20, it follows that the legislature did not intend them to be disposals.

In the case of shares, the issue arises as to whether the variation of rights results in a full or a part-disposal. In *Standard Bank of South Africa Ltd & another v Ocean Commodities Inc & others* Corbett JA stated the following:[173]

> '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.'

Paragraph (*b*) of the definition of an 'asset' in para 1 includes

> 'a right or interest of whatever nature to or in such property'.

Based on the above it is submitted that the variation of one or more rights in a share may well result in a part-disposal of a share rather than a full disposal. Whether a full disposal has taken place will depend on whether the old shares were cancelled or redeemed under the Companies Act 61 of 1973, and whether a new share has come into existence. This is a question to be decided on the facts and circumstances of the particular case.

Example 1 – Variation that is not a disposal

Facts:

John holds 100 non-redeemable preference shares in Listco. Listco unilaterally agreed to make the shares redeemable at John's discretion. All other rights in the shares remained unchanged.

Result:

The variation of John's right of redemption is an improvement, not a disposal. He has not parted with any rights.

Example 2 – Disposal by variation of rights

Facts:

Jill owns 100 redeemable preference shares in Listco. In return for a payment of R1 a share, Jill agrees to give up her right of redemption and the shares are converted to non-redeemable preference shares.

Result:

Jill has disposed of her right of redemption in exchange for proceeds of R1 a share.

6.1.1.5 Exchange

Under para 11(1)(*a*) an exchange of an asset also constitutes a disposal. On the determination of the base cost of an asset acquired under an exchange transaction, see **8.5**. When proceeds are determined 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 restructuring rules in ss 41 to 47 provide roll-over relief for barter transactions. For example, in an asset-for-share transaction, a person disposes of an asset to a company in exchange for shares in that company. The transferor is given roll-over relief provided the requirements of s 42 are met.

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

[173] 1983 (1) SA 276 (A) at 288.

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 2008 Lammie sold the holiday home for R170 000.

Result:

The CGT consequences for Lammie are as follows:

Land

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

As a result of the 'exchange' with Barry, there has been a disposal of the land under para 11(1)(*a*). In a barter transaction, the proceeds are equal to the market value[174] 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 under 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 2008 Lammie will have a capital gain of R10 000 (R170 000 (proceeds) – R160 000 (base cost).

6.1.1.6 Vesting of shares by an employee share incentive trust

Under para 11(1)(*d*) the vesting of an interest in an asset of a trust in a beneficiary is a disposal. The word 'vesting' is used in para 11(1)(*d*) in the common law sense of unconditional entitlement. It does not mean a vesting as contemplated in s 8C which occurs when all restrictions on the disposal of the share are lifted. If the common law vesting in an employee of a share by a share incentive trust precedes the vesting under s 8C, para 11(2)(*j*) prevents a disposal at the time of the common law vesting. When all restrictions are lifted on the share it vests under s 8C but this event is not a disposal. It will therefore be observed that from the trust's perspective, there is no disposal of the share either at the time of the common law vesting or at the time of the s 8C vesting. Paragraph 11(2)(*j*) thus prevents any capital gain from arising in the trust and being attributed to the employee under para 80(1). Such a capital gain if allowed to arise would result in double taxation since the employee would be taxed on a capital gain which is already reflected in the s 8C income gain.

The employee thus acquires the share at the time of the common law vesting and its base cost is equal to its market value when all restrictions on disposal are lifted [para 20(1)(*h*)(i)].

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

Example – Vesting of shares by an employee share incentive trust

Facts:

The VHF Employee Share Incentive Trust holds shares in VHF Ltd, which the trustees vest in employees of that company under the terms of the trust deed. Under the arrangement, a right to acquire shares is granted to employees on day 1. The shares vest in three equal tranches at the end of years 5, 6 and 7, provided the employee is still in service on those dates. Even once vesting takes place, the shares remain restricted for a further three years as to rights of disposal. At the end of years 8, 9 and 10 respectively all restrictions are lifted.

Result:

On day 1 the employees merely acquire contingent rights to take delivery of a certain number of shares at the end of years 5, 6 and 7. There is no disposal by the trust at this point.

At the end of years 5, 6 and 7 a common law vesting takes place in three equal tranches. Although such a vesting is a disposal by the trust under para 11(1)(*d*), it is deemed not to be a disposal under para 11(2)(*j*). The latter provision states that there is no disposal of an asset

> 'which constitutes an equity instrument contemplated in section 8C, which has not yet vested as contemplated in that section;'

Since each tranche of shares is restricted for a further three years, vesting under s 8C will only occur at the end of years 8, 9 and 10 respectively. The market value of the shares will be included in the employees' income at those times, and the employees will acquire the shares for a base cost equal to the same market value under para 20(1)(*h*)(i).

6.1.2 Non-disposal events [para 11(2)]

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 issue or cancellation by a company of its shares or member's interest and the granting of an option by that company to acquire a share, member's interest[175] or debenture in that company. See commentary below.
(*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.[176]
(*d*)	The issue of any bond, debenture, note or other borrowing of money or obtaining of credit.

[175] The reference to a member's interest was inserted by s 44 of the Revenue Laws Amendment Act 20 of 2006 and is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

[176] A collective investment scheme in securities (CISS) must in any event disregard any capital gain or loss under para 61. Paragraph 11(2)(*c*) therefore seems to be aimed at preventing a disposal by a collective investment scheme in property shares (CISP).

(*e*)	Deleted.[177]
(*f*)	Deleted – see **6.1.3.1**.
(*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 under a 'lending arrangement' as defined in s 1 of the Securities Transfer Tax Act 25 of 2007 and the return of a similar security to the lender within the 12-month period contemplated in that definition.[178]
(*i*)	The vesting of the assets of the spouse of an insolvent in the Master of the High Court or in a trustee. Under s 21 of the Insolvency Act 24 of 1936, when 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.[179] This provision ensures that duplication of income and capital gains is avoided.
(*k*)	On the cession or release of a right to acquire a marketable security in whole or in part for a consideration which consists of or includes another right to acquire a marketable security in the circumstances contemplated in s 8A(5).[180]

Issue and cancellation by a company of its own shares [para 11(2)(b)]

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. Frequently the company would have paid nothing 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 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. A capital loss that results when a company buys back its own shares and cancels them in accordance with s 85(8) of the Companies Act 61 of 1973 must be disregarded under para 11(2)(*b*). In some foreign jurisdictions a company acquires its own shares and holds them as treasury shares on its balance sheet and later either cancels or sells them. However, under South African law a company cannot hold rights against itself. When a company buys back its own shares (which comprise a bundle of rights), those shares are immediately disposed of by way of merger. Given that in determining its 'net income' under s 9D(2A) a CFC is treated as a resident for the purposes of the Eighth Schedule, the subsequent 'disposal' of treasury shares must be regarded as a reissue of shares under South African law, which will not give rise to a capital gain or loss. A similar

[177] Before its deletion by s 74 of the Revenue Laws Amendment Act 60 of 2008 para 11(2)(*e*) stated that there was 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 that beneficiary has a vested interest in that asset'. The deletion is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009, and was consequent on the introduction of para 13(1)(*a*)(iiA). The effect of the latter amendment is to backdate the distribution of the asset to the time of vesting. As a result, the distribution of the asset becomes a no gain or loss disposal and there is no need to treat it as a non-disposal.

[178] Paragraph 11(2)(*h*) was amended with effect from 22 December 2003. Previously the provision made reference to the definition of a 'lending arrangement' under the Stamp Duties Act 77 of 1968.

[179] Paragraph 12(2)(*j*) inserted by the 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.

[180] Paragraph 11(2)(*k*) was inserted by s 66(1) of the Revenue Laws Amendment Act 31 of 2005, came into operation on 1 February 2006 and applies in respect of any disposal on or after that date.

approach is followed in the United Kingdom where, under s 195 of the Finance Act, 2003, the acquisition by a company of its own shares is not recognised as an asset.

Exchange of share options under s 8A(5) before 1 February 2006

Paragraph 11(2)(*k*) was introduced with effect from 1 February 2006. It effectively provides roll-over relief by treating as a non-disposal the cession or release by an employee of one share option for another in the circumstances contemplated in s 8A(5). SARS takes the view that a similar position prevailed before the introduction of para 11(2)(*k*), though for different reasons. The view is held 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 under para 35(3)(*a*) of the Eighth Schedule. Any expenditure in respect of the first option would similarly have to be reduced under 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 that existed with s 8A(5) before the introduction of para 11(2)(*k*) 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 before vesting of an equity instrument contemplated in s 8C as a non-disposal. Under 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 in which 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 under para 11(2)(*j*).

Example – Substitution of one restricted share for another under 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 under s 8C(3)(*b*)(ii) read with s 8C(4)(*a*). Under para 11(2)(*j*) the exchange of shares is deemed not to be a disposal as it has occurred before vesting.

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

Paragraph 11(2)(*f*) used to deal with this topic, but it was deleted because it was considered unnecessary, merely stating the obvious.

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 the term 'gross income' or alternatively be a payment for the disposal of an asset.[181]

6.1.3.2 Company conversions under ss 40A and 40B

If 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 Income Tax Act.[182] The same applies to a co-operative that converts to a company.[183] The Companies and Close Corporations Acts similarly provide that the company's corporate existence and rights remain unchanged.[184] 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 in the hands of the shareholder under 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 (for example, agricultural to a trading co-operative), and
- 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 when 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 under 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

[181] ITC 746 (1952) 16 SATC 312 (C).
[182] Section 40A of the Income Tax Act.
[183] Section 40B of the Income Tax Act.
[184] See ss 29(1) and 29D of the Companies Act 61 of 1973 and s 27(5) of the Close Corporations Act 69 of 1984.

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 under 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 **8.35**).

6.1.3.4 Consolidation or subdivision of land and conversion from freehold to sectional title

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 before an actual disposal. A similar situation prevails when freehold property is converted to sectional title (for example, when a person converts a block of flats to sectional title). In essence the rights of beneficial ownership are not disposed of but are simply subdivided. Provided the sectional title units continue to be held as capital assets, a disposal will only occur when the units are actually disposed of. In some situations, however, the subdivision of land or conversion to sectional title may be an indicator that a person has gone over to a scheme of profit-making. In such event the conversion of a capital asset to trading stock will trigger a deemed disposal under para 12(2)(*c*).

6.1.3.5 Acquisition of shares upon conversion of a non-proprietary exchange

This rule is contained in s 26 of the Taxation Laws Amendment Act 9 of 2005 which is deemed to have come into operation on 1 July 2005.[185] It is aimed at enabling non-proprietary exchanges such as the former JSE Securities Exchange SA (now JSE Ltd)[186] and the Bond Exchange of South Africa, to convert to companies without adverse tax consequences for their members. Under a conversion of this nature, the rights previously held and the shares acquired in the company are deemed to be one and the same asset for the purposes of the Act. This has the effect of a roll-over for CGT purposes.

The roll-over applies when

- a person acquires shares in a company that has assumed all the functions of a non-proprietary exchange,
- that exchange was exempt from tax under s 10(1)(*d*) before 1 July 2005, and
- the shares are issued by 1 January 2008[187] in exchange for any right in the non-proprietary exchange before the conversion.

[185] As per s 26A which was inserted by s 97(*b*) of the Revenue Laws Amendment Act 20 of 2006.
[186] The JSE Securities Exchange South Africa was incorporated as a public company on 1 July 2005.
[187] The date was changed from 1 January 2007 to 1 January 2008 by s 97(*a*) of the Revenue Laws Amendment Act 20 of 2006.

6.1.3.6 Switching from one class of a portfolio of a collective investment scheme to another

Some unit portfolios split their portfolios into different classes.[188] The purpose of this administrative arrangement is to enable the fund manager to charge different management fees for each class. The investors in the various classes, however, have an equal undivided share per unit in the fund assets and income. In these circumstances the switch by an investor from one class to another within the same portfolio is not regarded as a disposal.

Example – Switching from one class to another in the same fund

Facts:

The ABC Investors Fund (a portfolio of a collective investment scheme in securities) operates three fund classes, A, B and C. The A class is open to institutional investors that invest a minimum of R50 million. The B Class applies to persons investing between R500 000 and R49 999 999. The C Class applies to small investors. The manager of the fund charges the following fees: A: 0,75%, B 0,90% and C 1%. The assets of the fund comprise shares listed on the JSE, and all classes of investor (A, B and C) share in the same assets and income. Sampkor currently owns units in Class C to the value of R100 000. After acquiring further units in Class C its total investment was valued at R550 000 and it requested to switch to Class B to take advantage of the lower fee structure.

Result:

The exchange of the Class C units for Class B units in the ABC Investors Fund is not regarded as a disposal.

6.1.3.7 Appointment of new contingent beneficiaries by a discretionary trust

The appointment of new contingent beneficiaries by the trustee of a discretionary trust will not normally give rise to a disposal by the trust or the beneficiaries. The trust continues to hold the trust assets until the time of vesting. An existing beneficiary will continue to merely hold a *spes*. While it could be argued that the value of an existing beneficiary's contingent right could be diluted by the introduction of new beneficiaries, this is by no means certain and would only be known when the assets of the trust are finally vested in the beneficiaries. At the time of appointment of a new beneficiary it would not be possible to quantify the dilution. Accordingly the appointment of a new contingent beneficiary is unlikely to give rise to a 'value shifting arrangement'. However, in some cases the appointment of new contingent beneficiaries can result in a complete change in the purpose for which the trust was formed. In such a case a new trust comes into existence, and the old trust ceases to exist.[189] This will result in a disposal of the assets from the old trust to the new trust, and in this regard para 38 must be considered. There are also likely to be simultaneous tax consequences for the old beneficiaries or trustees, particularly if they relinquish their rights in exchange for consideration. Provisions to bear in mind include para (*d*) of the definition of the term 'gross income' (relevant to a trustee relinquishing his or her office) and para 81 which stipulates that the base cost of a beneficiary's interest in a discretionary trust is nil.

[188] In the late 1990's fees were deregulated, resulting in different fee classes. The Regulated Fee Class (R Class) applies to investors at the time of deregulation who have a right not to be charged more than 1% + VAT unless they agreed to pay more. Investors in other classes can be charged whatever fee they agree to pay (for example, a flat fee or one based on performance).
[189] ITC 1828 (2007) 70 SATC 91 (G).

6.1.3.8 Repudiation of inheritance

In *Wessels NO v De Jager & another NNO*[190] an insolvent and his wife had been married out of community of property. After his sequestration but before his rehabilitation his wife had taken out a policy on her life, nominating the insolvent as the beneficiary. Subsequently the insolvent's wife died intestate. The insolvent refused to accept the benefits of the policy and also renounced his inheritance as intestate heir. The issue was whether the right to accept the policy proceeds vested in his trustee. The court held that the insolvent did not acquire a right to the policy proceeds until he accepted the offer arising from the contract between his wife and the insurer. In the case of the inheritance the court stated that only the competence of acquiring the inheritance had accrued to the insolvent. The right to acquire the inheritance would only accrue to him if he accepted the benefit. As a result the insolvent acquired no right to property which vested in his trustee.

Based on the above principles, it is accepted that the repudiation of an inheritance will not give rise to the disposal of an 'asset' for CGT purposes.[191]

6.1.3.9 Listing of a company

Does the listing of a private or public company result in a disposal of shares in the hands of pre-existing shareholders? A disposal will only occur if there is a variation in the rights attaching to the shares or if the shares have undergone a conversion into another type of share. If the rights remain unchanged, the listing will merely improve the marketability of the share which should not result in a disposal.

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 under para 20(1)(*a*), the market value so established must be treated as expenditure actually incurred.

Proceeds are arrived at by reducing the amount received or accrued in respect of the deemed disposal to the extent it has been included in gross income [para 35(3)(*a*)].

The deemed disposal and reacquisition rule in para 12(1) does not apply when para 12(4) applies, and it is also subject to para 24.[192] Paragraph 12(4) contains special rules that deal

[190] 2000 (4) SA 924 (SCA).
[191] See 'Renunciation and Adiation on Inheritances; Insolvency of Beneficiary' (October 2002) 51 *The Taxpayer* 181 at 184.
[192] These conditions were inserted by s 50(1)(*a*) of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation on 21 February 2008 and apply in respect of an asset disposed of on or after that date, unless that disposal is the subject of an application for an advance tax ruling accepted by the Commissioner before that date.

with the situation in which a foreign company ceases to be a CFC because it has become a resident [cessation of CFC status for any other reason is dealt with under para 12(2)(*a*)]. Paragraph 24 contains special 'kink tests' which, when applicable, have the effect of substituting a different value for the market value base cost established under para 12(1) or (4) in order to prevent 'phantom' losses.

Under para 13(1)(*g*) the time of the events contemplated below (except in the case of transfers between the four funds of an insurer and para 12(4) which has its own timing rule) 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 – Reduction of amount received or accrued by amounts included in income

Facts:

On 1 March 2007 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 2008 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 John's 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) (ii)	A person commences[193] or ceases to be a • resident, or • cfc.[194] This applies to all assets, except • immovable property in South Africa or any right or interest in such property [para 2(1)(*b*)(i)]; • any asset attributable to a permanent establishment (PE) in South Africa [para 2(1)(*b*)(ii)]	The term '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'. *Companies* cease to be resident when

[193] The word 'commences' was inserted in the opening words of para 12(2)(*a*) by s 50(1)(*b*) of the Taxation Laws Amendment Act 3 of 2008, and deemed to have come into operation on 21 February 2008 and apply in respect of an asset disposed of on or after that date, unless that disposal is the subject of an application for an advance tax ruling accepted by the Commissioner before that date.
[194] The reference to a CFC was inserted by the Revenue Laws Amendment Act 31 of 2005, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2006.

(iii) (iv)	• any qualifying equity share contemplated in s 8B, which was granted to that person less than five 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.[195] • any right to acquire any marketable security contemplated in s 8A.[196]	• they are not incorporated, established or formed in South Africa, and • their place of effective management changes to a country outside South Africa. Tax treaties have rules on residence, which in certain circumstances override domestic law. A person may therefore be resident under domestic law but non-resident for tax treaty purposes.[197] When a company ceases to be a CFC because it has become a resident, this provision does not apply, and the matter must be dealt with under para 12(4). In the case of ss 8B and 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 South African taxation after exit on any s 8A or 8C gain that arises at the date of vesting as the revenue gain relates to South African-source services.
(*b*)	An asset of a person who is not a resident that • becomes an asset of the person's PE in South Africa other than by acquisition, or • ceases to be an asset of the person's PE in South Africa other than by a disposal under para 11.	For example, a person's asset in another country is brought to South Africa for use by the PE. For example, the person withdraws the asset from the PE for personal or other use.

[195] Paragraph 12(2)(*a*)(ii) and (iii) were inserted by the Revenue Laws Amendment Act 32 of 2004 and apply in respect of any person who ceases to be a resident on or after 26 October 2004.
[196] Paragraph 12(2)(*a*)(iv) inserted by s 67 of the Revenue Laws Amendment Act 31 of 2005, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2006.
[197] 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.

(*c*)	Non-trading stock that becomes trading stock.[198]	Under 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 under 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 under 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.

In ITC 1848[199] the appellant, a listed company, changed its place of effective management from South Africa to Luxembourg on 2 July 2002. As a result, the company was deemed for the purposes of the tax treaty to be exclusively a resident of Luxembourg from that date. A director of the company remained in South Africa until 29 January 2003 at which point he relocated to Europe and any permanent establishment which may have existed in South Africa up to that time ceased to exist. At the time of the change of effective management para 12(2)(*a*) read as follows:

> '(*a*) a person who ceases to be a resident, or a resident who is as a result of the application of any agreement entered into by the Republic for the avoidance of double taxation treated as not being a resident, in respect of all assets of that person other than assets in the Republic listed in paragraph 2(1)(*b*)(i) and (ii);'

The above provision was amended to delete the reference to a person ceasing to be a resident as a result of the application of a tax treaty with effect from years of assessment ending on or after 1 January 2004. In the appellant's case the amendment took effect on 1 March 2003 which was subsequent to the change of effective management on 2 July 2002. The definition of a 'resident' was simultaneously amended with effect from 26 February 2003 to exclude a person who ceases to be a resident as a result of the application of a tax treaty. Again this occurred after the date of the change of effective management.

Article 13(4) of the tax treaty with Luxembourg reads as follows:

> '4. Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3, shall be taxable only in the Contracting State of which the alienator is a resident.'

At issue was whether the appellant was liable to CGT on a deemed disposal of its sole asset (being shares in its subsidiary) under para 12(2)(*a*) as a result of its change of residence under the tax treaty on 2 July 2002.

The court found in favour of the taxpayer on the basis that any deemed disposal under para 12(2)(*a*) was prevented by article 13(4) of the treaty. The judgment, however, leaves

[198] See, for example, *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A), 37 SATC 193.
[199] ITC 1848 (2010) 73 SATC 170 (C).

several questions unanswered,[200] among them why para 13(1)(*g*)(i) was not considered (this provision deems the disposal to occur on the day before the change of effective management thus placing the deemed disposal beyond the reach of the treaty), why the court found it necessary to consider non-retrospective amendments to the Act which occurred after the change in effective management, whether the company's shares in its subsidiary were indeed attributable to a permanent establishment in South Africa from 2 July 2002 until 29 January 2003, and if so why para 12(2)(*b*)(ii) read with article 13(2) of the treaty did not apply (the article confers a taxing right on South Africa for movable assets of a permanent establishment in South Africa). SARS has appealed against the decision.

Persons becoming resident before valuation date

Paragraph 12(2)(*a*) only applies to persons who became residents of South Africa on or after 1 October 2001. The reasons for this are as follows:

- Under para 2, the Eighth Schedule only applies to disposals on or after the valuation date.
- The implication of allowing the backdating of valuations for an unlimited period is contrary to the legislative intent, as evidenced by para 29(4).

It follows that those persons who became residents of South Africa before valuation date must determine the base cost of their assets in accordance with the same rules that apply to persons who have always been residents. The cost of such a person's assets for the purposes of TAB and the kink tests in paras 26 and 27 will be the amount actually incurred under para 20 and not the market value of those assets at the time the person became resident.

Asset transferred to a foreign PE

Paragraph 12(1) does not apply when a resident transfers an asset to a PE outside South Africa. Any capital gain or loss on disposal of such an asset must be taken into account by the resident, and there is thus no need to trigger a deemed disposal of the asset at the time of its transfer to the foreign PE.

Example – Company ceasing to be a CFC

Facts:

South African Company owns all 100 ordinary shares of CFC. CFC's sole assets consist of a portfolio of listed shares in companies, none of which hold significant levels of South African immovable property. These shares have a market value of R5 million and a base cost of R1 million. CFC issues an additional 100 ordinary shares to Foreign Company. Foreign Company's shares are held by foreign individuals.

Result:

The issue of ordinary shares eliminates CFC status because South African Company no longer holds more than 50% of the ordinary shares. This loss of CFC status triggers para 12(2) with the exit charge applying to all the portfolio shares, thereby generating a capital gain of R4 million (R5 million proceeds less R1 million base cost).

[200] See E Mazansky 'Exit Charges and Double Tax Agreements' (7 June 2011) available at <http://moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page259?oid=59156&sn=Detail&pid=1> [Accessed 8 December 2011].

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

Paragraph 12(3) deals with the situation in which trading stock of a person ceases to be trading stock of that person, otherwise than by way of disposal under 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 under s 22(8), and
- immediately reacquired those assets for a cost equal to that amount.

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

- Conventional disposals envisaged in para 11.
- Changes in usage dealt with under para 12(3).

Conventional disposals of trading stock

Since the conventional disposals are catered for under 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 under s 22(8)**	**Base cost of acquirer**
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 under s 85 of the Companies Act 61 of 1973	Market value	Market value – para 38 or 76(3)

Changes in usage of trading stock

Trading stock may cease to be trading stock without a conventional disposal under 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.

Under para 12(3) when trading stock ceases to be held as trading stock, the person is treated as

- having disposed of the assets for a consideration equal to the amount included in that person's income under s 22(8), and
- to have immediately reacquired those assets for a cost equal to that amount. The cost is treated as an amount of expenditure actually incurred and paid for the purposes of para 20(1)(*a*).

The table below sets out how the base cost of the assets formerly held as trading stock is determined based on the various types of disposal contemplated in s 22(8).

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

Type of use	**Amount to be included in income under s 22(8) / Amount treated as base cost in hands of acquirer**
Private or domestic use or consumption	• Cost, less any provision for obsolescence, or • if 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

Paragraph 12(3) does not apply to trading stock which is used as a capital asset in the circumstances contemplated in para (*j*A) of the definition of the term 'gross income' in s 1. This would apply, for example, to a motor vehicle manufacturer that manufactures a vehicle as trading stock and subsequently uses it as a demonstration vehicle. Such assets remain trading stock as defined in s 1, since the proceeds from their ultimate disposal are included in 'gross income' under para (*j*A) of the definition of that term.

Sight should, of course, not be lost of the following dictum of Centlivres CJ in *CIR v Richmond Estates (Pty) Ltd*:[201]

> '[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).'

Shares which become affected shares under s 9B

Section 9B applies to JSE-listed shares disposed of before 1 October 2007.

Under s 9B(2) a taxpayer can elect that

> 'any amount received by or accrued to or in favour of him *as a result of the disposal* on or after 14 March 1990 of an affected share, be deemed to be of a capital nature for the purposes of the definition of "gross income" in section 1 . . .'.

(Emphasis added.)

[201] 1956 (1) SA 602 (A), 20 SATC 355 at 361.

For s 9B to apply the shares must be held for at least five years. The section applies regardless of whether the shares were acquired as trading stock. The election is binding on the person's entire portfolio of JSE-listed shares.[202]

The term 'affected share' is defined in s 9B(1) and means

> 'a listed share in a company as contemplated in paragraph (*a*) of the definition of "listed company", *which has been disposed of* before 1 October 2007 by the taxpayer who immediately prior to such disposal had been the owner of such share as a listed share for a continuous period of at least five years: Provided that— . . .'.

(Emphasis added.)

A share can accordingly only become an 'affected share' on a disposal in the ordinary sense of the word. Furthermore, shares do not automatically cease to be trading stock after they have been held for at least five years. It follows that there is no deemed disposal under para 12(3) after shares have been held for at least five years. For more on s 9B see *SARS* Interpretation Note 43 (Issue 2) 'Circumstances in which Amounts Received or Accrued on Disposal of Listed Shares are Deemed to be of a Capital Nature' (31 August 2010).

Shares which become qualifying shares under s 9C

Section 9C replaced s 9B and applies to the disposal of any 'qualifying share' on or after 1 October 2007.[203]

Section 9C(2) provides as follows:

> '(2) Any amount other than a dividend received by or accrued to a taxpayer in respect of a qualifying share shall be deemed to be of a capital nature.'

A 'qualifying share' is defined in s 9C(1) as follows:

> '**"[Q]ualifying share"**, in relation to any taxpayer, means an equity share contemplated in section 41, which has been disposed of by the taxpayer or which is treated as having been disposed of by the taxpayer in terms of paragraph 12 of the Eighth Schedule, if the taxpayer immediately prior to such disposal had been the owner of that share for a continuous period of at least three years excluding a share which at any time during that period was—
>
> (*a*) a share in a share block company as defined in section 1 of the Share Blocks Control Act, 1980 (Act No. 59 of 1980);
>
> (*b*) a share in a company which was not a resident, other than a company contemplated in paragraph (*a*) of the definition of "listed company"; or
>
> (*c*) a hybrid equity instrument as defined in section 8E.'

A share thus only becomes a 'qualifying share' to which s 9C applies when disposed of under the common law or upon a deemed disposal under para 12. Thus, shares held as trading stock do not automatically cease to be held as trading stock after three years and for this reason para 12(3) does not trigger a deemed disposal at the end of the three-year period. For more on s 9C see SARS Interpretation Note 43 (Issue 3) 'Circumstances in which Certain Amounts Received or Accrued from the Disposal of Shares are Deemed to be of a Capital Nature' (30 September 2011).

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[202] See SARS Interpretation Note 43 'Circumstances in which Amounts Received or Accrued on Disposal of Listed Shares are Deemed to be of a Capital Nature' [online], (10 August 2007) available at <http://www.sars.gov.za/home.asp?pid=55887> [Accessed 8 December 2011].

[203] See SARS Interpretation Note 43 (Issue 3) 'Circumstances in which Certain Amounts Received or Accrued from the Disposal of Shares are Deemed to be of a Capital Nature' [online] (30 September 2011).

6.2.4 Controlled foreign company becoming a resident [para 12(4)]

A foreign company that ceases to be a CFC because it becomes a resident is, subject to para 24, deemed to acquire each of its assets (except the assets described below) at an expenditure equal to their market value immediately before the disposal. The deemed expenditure is treated as an amount of expenditure actually incurred and paid for the purposes of para 20(1)(*a*). This rule does not apply to

- any immovable property or an interest or right in immovable property situated in South Africa, and
- an asset of a permanent establishment through which the CFC carried on a trade in South Africa during the year of assessment, and
- assets held by the CFC if any amount received or accrued from their disposal would have been taken into account for purposes of determining the net income of that CFC under s 9D.

In other words, for these excluded assets the expenditure incurred by the CFC will remain the expenditure of the resident company. Since these assets fell within the South African tax net while the foreign company was a CFC, there is no need to trigger a deemed disposal and reacquisition.

Paragraph 12(4) is aimed at assets of a CFC which qualify for the 'foreign business establishment' exemption under s 9D(9)(*b*). Since these assets did not fall within the South African tax net while the company was a CFC, it is appropriate that any pre-residence unrealised capital gains and losses be excluded from the South African tax system by the 'deemed acquisition at market value' rule.[204]

The time of disposal is the date immediately before the day on which the foreign company ceases to be a CFC [para 13(1)(*g*)(i)].

Example – CFC becoming a resident [para 12(4)]

Facts:

Holdco, a South African-resident company owns all the shares of CFC 1. CFC 1 has active foreign business establishment assets falling outside s 9D and portfolio passive assets falling within s 9D, including all the shares of CFC 2. CFC 1 shifts its effective management to South Africa, thereby triggering South African residence status (and the loss of s 9D CFC status).

Result:

The conversion of CFC 1 to South African residence status is a para 12(4) event. Paragraph 12(4) triggers a deemed sale of the foreign business establishment assets, none of which is taxable by virtue of the foreign business establishment exemption in s 9D(9)(*b*). However, the deemed sale results in a market value base cost step-up of the foreign business establishment assets. The portfolio passive assets and the shares of CFC 2 are not subject to deemed sale treatment, meaning that those assets retain their historical base cost.

[204] Paragraph 12(4) was substituted by s 75(1) of the Revenue Laws Amendment Act 60 of 2008 deemed to have come into operation on 21 February 2008 and applies in respect of an asset disposed of on or after that date, unless that disposal is the subject of an application for an advance tax ruling accepted by the Commissioner before that date.

Paragraph 24 overrides para 12(4) if the actual pre-residence expenditure and proceeds on disposal are each lower than the market value of the asset on the day immediately before the day on which the person became a resident (see **8.26**).

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

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

Paragraph 12(5) deals with the situation in which 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.

The purpose of para 12(5) is to ensure that a debtor who is relieved of the obligation to pay any portion of the amount owing will be subject to CGT on a capital gain equal to the amount discharged. Such reductions may result from a waiver of debt (whether or not gratuitous or otherwise) donations, bequests 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 capital gains and losses. In the absence of para 12(5), creditors would be able to claim losses, while 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. Redeemable preference shares are not regarded as debt.[205] Thus para 12(5) will not be triggered if such shares are redeemed at a discount.

In determining the portion of an interest debt that has been incurred, regard must be had to s 24J(2). Under 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*[206] in which 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 – 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 under s 24J(2).

[205] *CIR v Datakor Engineering (Pty) Ltd* 1998 (4) SA 1050 (SCA), 60 SATC 503 at 510.
[206] *Cactus Investments (Pty) Ltd v CIR* 1999 (1) SA 315 (SCA), 61 SATC 43.

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 under 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 rule in para 56(1) is that a capital loss on a claim owed by a connected person must be disregarded. However, when the debtor is subject to CGT on the corresponding capital gain under para 12(5), the creditor will be entitled to the capital loss [para 56(2)(*a*)]. Under para 39 a capital loss between connected persons would normally be ring-fenced ('clogged'). However, since para 56(2) overrides para 39 a capital loss allowable under para 56(2) is not clogged. (para 56(2) applies 'despite' para 39). If the capital loss arises from the waiver of a loan to a trust, and the capital gain in the trust is attributed back to the 'donor' under (say) para 70 or to a resident beneficiary under para 80(2), the creditor will not be able to claim the capital loss, since the capital gain will have been removed from the trust, and hence para 56(2)(*a*) cannot provide relief.

See **24.4** on the determination of the capital loss on disposal of a loan. For a pre-valuation date loan it will be necessary to determine the valuation date value of the loan under para 27 (loan that is not a s 24J instrument) or para 28 (loan that is a s 24J instrument). It follows that only the portion of the overall loss relating 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 when the market value method applies and the market value of the loan was equal to its face value on valuation date.

The waiver by an executor of a debt owed to a deceased person in accordance with the deceased's last will and testament results in the disposal of the debt by the deceased estate at its base cost under para 40(2)(*a*) – see **16.1.3.2**. This means that despite the debtor being subject to tax on a capital gain under para 12(5), the deceased estate will not be entitled to a corresponding capital loss.

6.2.5.4 Treatment of the debtor when 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 the following 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.

Time of disposal

Under para 13(1)(*g*)(ii) the time of disposal when an event under para 12(5) occurs is the date that the event occurs. In other words it is the date on which the debt is reduced or discharged by the creditor. When a person has bequeathed a debt to a debtor under his or her last will and testament, see **6.2.5.13**.

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, when 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

Paragraph 12(5) applies when a debt owed by a person to a creditor has been reduced or discharged by that creditor for a consideration that 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 if 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.[207]

Issue of shares in discharge of debt

When, 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 execution of the transaction by book entry does not alter this fact, although it may well result in a recoupment in the company's hands under s 8(4)(*m*) or 20(1)(*a*)(ii).[208]

Waiver of debts owed to SARS

The issue of a reduced assessment does not give rise to a capital gain under para 12(5) because the due date of the reduced assessment is the same as the previous original or additional assessment. The effect is thus to expunge the debt *ab initio*. But the waiver of a tax debt under s 91A is a discharge of a debt for no consideration that will trigger para 12(5).

[207] *Ogus v SIR* 1978 (3) SA 67 (T), 40 SATC 100 at 109.
[208] CIR v *Datakor Engineering (Pty) Ltd* 1998 (4) SA 1050 (SCA), 60 SATC 503.

Repayment of shareholder's debit loan through payment of a dividend

The reduction of a shareholder's debit loan account by set-off as a result of the declaration of a *bona fide* dividend should not give rise to the application of para 12(5). The company will have received consideration under para 35(1)(*a*) in that its liability to pay the dividend will have been discharged through set-off against the debit loan.

Example 1 – Discounting of debt

Facts:

Andrew owes Duncan R100 payable in five years' time. Duncan agrees to accept R70 on condition that Andrew settles the debt after one 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 under 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 2 – Debt cancellation

Facts:

Ecks Ltd borrows R10 million from its non-resident controlling shareholder, Expert Ltd to finance non-deductible expenditure. Before 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.

Example 3 – Discharge from obligation for consideration less than face value of debt

Facts:

On 1 March 2005 Ecks Ltd issues 10 000 debentures of R10 000 each, bearing interest at 12% a year, expiring in 10 years' time. In 2008 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 related commentary in **19.2.10.**

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[209] and ITC 1448[210] it was held that the act of adiation was a donation even though what followed was by operation of law under s 37 of the Administration of Estates Act.

6.2.5.9 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.

The write back by a company for accounting purposes of unclaimed dividends which have prescribed is unlikely to give rise to a capital gain under para 12(5). Typically the prescription of such amounts does not result from an intent on the part of the creditor to allow the amounts to prescribe. Rather prescription results from a failure by a debtor to notify the company of a change of address or banking details.

6.2.5.10 Gains otherwise accounted for [para 12(5)(a)]

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

Table 1 – 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*)[211]	Recoupment
Section 20(1)(*a*)(ii)	Reduction of assessed loss by compromise benefit
Paragraph 2(*h*) of the Seventh Schedule[212]	Release of employee from obligation to pay any amount owed to the employer
Paragraph 20(3)	Reduction of base cost

Under para 20(3), when an asset has been purchased on credit, 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 disposal. If the decrease in the liability were also to be treated as a capital gain, double taxation would result.

[209] (1984) 46 SATC 121 (T).
[210] (1988) 51 SATC 58 (C).
[211] The reference to s 8(4)(*m*) was inserted by the Revenue Laws Amendment Act 45 of 2003 with effect from 22 December 2003. Where cases involving s 8(4)(*m*) arise before this date, the provisions of the main body of the 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 main body of the 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.
[212] Inserted by s 94 of the Taxation Laws Amendment Act 7 of 2010 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2011.

Example 1 – Reduction in base cost as a result of purchase price reduction [para 20(3)]

Facts:

Duncan sells Andrew his 10,4-metre 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 under para 20(3)(*b*). Andrew will not again be subjected to CGT on the capital gain arising from the discharge of his debt under para 12(5).

Example 2 – Reduction in purchase price after disposal [para 3(*b*)(ii)]

Facts:

Duncan sells Andrew his 10,4-metre yacht for R500 000. Andrew agrees to pay the purchase price in five equal annual instalments. After five years Andrew has paid nothing to Duncan and sells the yacht for R400 000 which he pays to Duncan. In the sixth year Duncan gives him a discount on the purchase price of R50 000, leaving Duncan with an outstanding debt of R50 000.

Result:

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

Example 3 – 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 under 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) under s 20(1)(*a*)(ii).

Result:

The amount of R15 000 will not constitute a capital gain under para 12(5).

6.2.5.11 Disposal of assets between spouses

Paragraph 67 (transfer between spouses) takes precedence over para 12(5).

Example – 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 tells Gordon that he need not repay her.

Result:

Under para 67(1)(*a*) Jean is deemed to have disposed of the loan at no gain/no loss. Gordon is deemed under 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. Under 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 summarised 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 under 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 under para 35(1)(*a*) – amount by which
Gordon's liability has been discharged R100 000
No gain/no loss.

6.2.5.12 Loans to trusts discharged by donation

Taxpayers have for many years taken advantage of the annual donations tax exemption[213] to donate amounts to their trusts. In this way estate duty is avoided on the death of the donor. Such annual donations can have CGT consequences if the trust is indebted to the donor. The issue is discussed in some depth in the example below.

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

Facts:

Some years ago Bob contributed cash of R600 000 on loan account to The Bob Family Trust which the trust subsequently used to purchase various growth assets. 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 an amount equal to the annual donations tax exemption limit each year to his trust, which in turn uses the donation to repay his loan account. Under para 12(5) the cancellation of debt triggers a capital gain. Will the annual 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? For the purposes of this example ignore the attribution rules in paras 68 to 73 and 80(2).

[213] The exemption is granted under s 56(2)(*b*). The amount of R100 000 applies to donations on or after 1 March 2007. The earlier limits were R50 000 (1 March 2006 to 28 February 2007); R30 000 (1 March 2002 to 28 February 2006); R25 000 (1 March 1996 to 28 February 2002).

Result:

The cancellation of part of the trust debt will give rise to a capital gain in the trust under 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 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. South African courts have not always taken kindly to cheque-swapping antics as the taxpayer in ITC 1583[214] 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 1690,[215] 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*[216] and the Australian case of *Richard Walter (Pty) Limited v FCT*.[217] 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 swapping 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 capital 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 R100 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 R100 000 (an asset) and a credit loan of R600 000 (a liability). The two loans can be set off and this would not give rise to a capital gain.

A donation under which 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.'

Thus, if 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. Under 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.

[214] (1993) 57 SATC 58 (C).
[215] (1999) 62 SATC 497 (G).
[216] [2001] UKHL 6; [2001] 1 All ER 865.
[217] (1996) 33 ATR 97 at 107.

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*,[218] *Erf 3183/1 Ladysmith (Pty) Ltd & another v CIR*[219], in which South African courts have looked at the true intention of the parties.

6.2.5.13 Loan bequests

A popular estate planning ploy is to dispose of growth assets to a family trust during a person's lifetime. Upon death, more often than not, the testator will simply bequeath the debt to the family trust and the debt will be cancelled. Before the Revenue Laws Amendment Act 74 of 2002, some commentators expressed doubts as to whether the action on the part of the deceased person 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 the inherited 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 at a base cost of nil. In order to remove any doubt in this regard, para 40(2) was made subject to para 12(5), which means that para 12(5) takes precedence. The discharge of a debt in this manner will therefore trigger a capital gain in the heir's hands under para 12(5). This issue came before the Gauteng Tax Court in ITC 1793.[220] In that case the deceased had sold some shares to her family trust on loan account. On 15 March 2002 she passed away with her last will and testament providing that the loan be bequeathed to the trust. The Commissioner applied para 12(5) and taxed the resulting capital gain in the trust's hands on the basis that the loan had been discharged for no consideration. The assessment in dispute related to the 2003 year of assessment. One of the issues before the court was whether the amendment making para 40(2) subject to para 12(5) applied to the appellant. Under s 130(2) of Act 74 of 2002 the amendment came into operation with effect from the commencement of years of assessment ending on or after 1 January 2003. It was argued by counsel for the appellant that the amendment did not apply because the deceased's last year of assessment ended on her date of death. Bertelsmann J rejected this argument, pointing out that it was the trust's year of assessment that was relevant. The creditor (the deceased) had discharged the debt for no consideration by operation of law when her last will and testament became effective upon her death. The appeal was accordingly dismissed. An issue not addressed by the court was the exact time of disposal under para 12(5). In other words, does it occur on the date of death or at some later stage, such as after the liquidation and distribution account has lain open for inspection for the prescribed period and no objection has been lodged to it?[221] It is submitted that while the discharge process begins with the coming into force of the last will and testament, the time of disposal can only occur once it is clear that the debtor is unconditionally relieved of the debt. For example, if the estate's assets are insufficient to pay estate duty, the debtor may be called upon to repay all or a portion of the loan, notwithstanding that the last will and testament provides that the loan should be bequeathed to the debtor.

In ITC 1835[222] a different result ensued. On 16 March 1992 the testatrix executed a joint will with her husband. She died on 10 June 2003, and under the joint will bequeathed the free residue of her estate to a family trust, which owed her R539 189 at the date of her death. In winding up the estate the executor did not collect the amount owing by the trust, but instead awarded it to the trust. The Commissioner applied para 12(5) to the trust on the basis that the loan had been discharged for no consideration. As a result the trust was subjected to

[218] 1997 (5) JTLR 119 (SCA), 60 SATC 1.
[219] 1996 (3) SA 942 (A), 58 SATC 229.
[220] (2005) 67 SATC 256 (G).
[221] See s 35(12) of the Administration of Estates Act 66 of 1965.
[222] (2008) 71 SATC 105 (K)

CGT on a capital gain of R539 189. In dealing with the crux of the matter Lacock J stated the following:[223]

> 'What is required in terms of this paragraph is an act by a creditor whereby he/she consciously intended to discharge a debt for no consideration. The determining factor is the intention of the creditor whereby he/she disposed of a debt or an asset, and not the subsequent manner in which that creditor's estate may be administered.'

The court distinguished the case from ITC 1793[224] in which the testatrix had specifically awarded a loan to a family trust as a legacy. After considering the evidence the court concluded that the testatrix did not intend to bequeath the loan to the trust and upheld the appeal.

It has been suggested that the problem encountered in ITC 1793 can be circumvented by the deceased leaving cash or other assets to the heir, which can 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 concerning repayment of the debt 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.

Another argument that has been raised is that para 20(3)(*b*) should take precedence over para 12(5). In other words, the base cost of an asset acquired with the proceeds from the loan should be reduced. This would not eliminate the gain but would defer it until the asset is sold. In this regard, para 12(5)(*a*)(*aa*)(B) provides that para 12(5) does not apply if para 20(3) applies. But this argument ignores para 40(2). In essence para 40(2)(*b*) provides a general rule under which an heir acquires an asset from the deceased estate at the base cost of the deceased estate. Had this rule applied to a loan, the loan would be acquired by the heir at market value on date of death and would immediately be disposed of by merger with the amount owing by the heir. In other words, the loan would not be discharged by waiver, but by set off. However, since para 40(2) is subject to para 12(5) that provision must take precedence. The debtor is not afforded an opportunity to elect out of para 40(2) and can therefore not choose to apply para 20(3)(*b*).

6.2.5.14 Amounts owing between group companies [para 12(5)(a)(bb)]

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[225] as defined in section 41.

The exclusion does not, however, address the situation in which 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 consequences. This results in additional cost to groups of companies. It also unnecessarily increases the number of companies on register.

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[223] In para 13.3.
[224] (2005) 67 SATC 256 (G).
[225] This amendment came into operation on 22 December 2003 and applies in respect of any reduction or discharge on or after that date.

The relief for group companies

In order to alleviate the problem described above para 12(5) does not apply when the debtor and creditor are part of the same 'group of companies' as defined in s 41.[226] The s 41 definition modifies the definition of the same term in s 1 which reads as follows:

> '**"[G]roup of companies"** means two or more companies in which one company (hereinafter referred to as the "controlling group company") directly or indirectly holds shares in at least one other company (hereinafter referred to as the "controlled group company"), to the extent that—
>
> (*a*) at least 70[227]
>
> per cent of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
>
> (*b*) the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company;'

In determining the 'more than 70%' requirement a simple summation of direct holdings of controlling and controlled group company holdings in the company in question must be made. The calculation is not based on the determination of an effective percentage interest. For example, if A owns 60% of B and B owns 60% of C, A will have an effective interest in C of 60% x 60% = 36%, but this is irrelevant in determining whether A, B and C form part of the same group of companies. It is only A's 60% interest in B and B's 60% interest in C that will determine whether the companies are part of the same group of companies. Although the opening words of the definition of a "group of companies" refer to a controlling group company's indirect holding of shares this is merely a linking mechanism (that is, C is linked to A through this reference).

With effect from 1 October 2007 the exclusion in para 12(5) uses the narrower definition of a 'group of companies' in s 41. The narrower definition excludes any group company which is

- a company contemplated in para (*c*), (*d*) or (*e*) of the definition of a 'company' (see below),
- a non-profit company as defined in s 1 of the Companies Act, 71 of 2008,
- a company that derives any amount constituting gross income of whatever nature that would be exempt from tax under s 10 were it to be received by or to accrue to that company,
- that company is a PBO or recreational club that has been approved by the Commissioner under s 30 or 30A, or
- that company is a company contemplated in para (*b*) of the definition of a 'company', unless it has its place of effective management in South Africa (that is, a company incorporated under foreign law).

The companies excluded under the first bullet point are as follows:

- Paragraph (*c*) – any co-operative.

[226] The reference to a group of companies *as defined in s 41* was inserted by s 71 of the Revenue Laws Amendment Act 35 of 2007 and deemed to have come into operation on 1 October 2007 and applies in respect of any disposal on or after that date.
[227] '70 per cent' substituted for '75 per cent' in the definition of 'group of companies' by s 3(1)(*h*) of the Revenue Laws Second Amendment Act 32 of 2005 and deemed to have come into operation on 8 November 2005.

- Paragraph (*d*) – company formed to serve a specified purpose beneficial to the public or section of the public.
- Paragraph (*e*) – collective investment scheme.

The exclusion of these companies as part of a 'group of companies' limits the relief to situations in which both debtor and creditor are fully within the tax system. In other words, the elimination of a capital gain for a taxable debtor is matched by the elimination of a capital loss for a taxable creditor.

The impact on the creditor

Under 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 under 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.

The relief provided under para 12(5)(*a*)(*bb*) is compulsory. It follows that debtor and creditor group companies cannot elect out of the relief, even when it would be more advantageous to do so. This could happen, for example, when the debtor has an assessed loss that would otherwise have absorbed any para 12(5) capital gain, thereby enabling the creditor to claim a capital loss.

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 been imposed by virtue of the Act. [228]

The two circumstances are as follows:

Debt acquired from non-member of group [para 12(5)(a)(bb)(A)]

Paragraph 12(5) applies if

- the discharge of the debt (or substituted debt) was acquired directly or indirectly from a person who is not a member of the same group of companies, and
- the transaction was part of a scheme to avoid any tax otherwise imposed by virtue of the Act.

Example 1 – 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.

[228] The word 'Act' was substituted for the word 'subparagraph' by s 50(1)(*e*) of the Taxation Laws Amendment Act 3 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009. The purpose of the amendment was to extend the application of the anti-avoidance measure.

Result:

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

The company becomes a member of the group of companies after the debt arose [para 12(5)(a)(bb)(B)]

Paragraph 12(5) applies if

- the debt discharged (or substituted debt) arose before the debtor or another person became members of the same group of companies, and
- the transaction was part of a scheme to avoid any tax otherwise imposed by virtue of the Act.

Example 2 – 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 have a capital gain of R100 000 under para 12(5).

Example 3 – 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 waiver of the loan would have had adverse CGT consequences for Subco as it would have resulted in it having a capital gain of R100 000. 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.

6.2.5.15 Waiver of debt upon winding-up, liquidation, deregistration or termination of company [para 12(5)(a)(cc)]

Introduction

Before a company can be deregistered its directors must submit a request to the Companies and Intellectual Property Commission in the prescribed manner and form (section 82(3)(*b*)(ii) of the Companies Act 71 of 2008). Upon receipt of the form the commission must be satisfied that the company has ceased to carry on business and has no assets, or, because

of the inadequacy of its assets, there is no reasonable probability of the company being liquidated.

In the case of a voluntary liquidation, the company must settle all its debts within 12 months.[229] Typically in such cases, the shareholders will waive their right to repayment of their loans in order that the deregistration or voluntary liquidation process can proceed, with attendant potential para 12(5) consequences for the company.

Paragraph 12(5) contains two exclusions that may prevent a capital gain from arising in a company upon its liquidation, deregistration or final termination. These exclusions are set out in the table below.

Table 1 – Exclusions which may assist with waiver of loans upon liquidation or deregistration of company

Paragraph 12(5)(*a*)	**Description**	**Inserted by**	**Applicable to any reduction or discharge on or after**
(*bb*)	Debt waived between members of a group of companies (see **6.2.5.14**)	Section 93(1)(*c*) of the Revenue Laws Amendment Act 45 of 2003	22 December 2003
(*cc*)	Debt waived in anticipation or during course of liquidation, winding-up, deregistration or final termination when debtor company and creditor are connected persons (see below)	Section 67(1)(*e*) of the Revenue Laws Amendment Act 31 of 2005	1 February 2006

These exclusions do not cover all situations or situations before the effective date of their introduction. They also do not cover loans owed by a trust that is unable to pay its debts.

The position assuming that para 12(5)(a)(bb) and (cc) do not apply

Assuming para 12(5)(*a*)(*bb*) and (*cc*) do not apply, there is no obvious way of preventing the application of para 12(5) upon waiver by a shareholder of a debt owed by a company that is to be liquidated or deregistered. 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 company will simply be a disguised waiver of debt. Both these ploys are likely to fall foul of Part IIA (impermissible tax avoidance arrangements under ss 80A to 80L) or be regarded as sham transactions.

There is, however, some consolation for the shareholder who 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 before valuation date. In that case the shareholder would have to determine the valuation date value of the loan using the TAB, market value or 20% of proceeds methods.

Example 1 – Dormant company owing an amount to its shareholder before deregistration

[**Note:** This example illustrates the position before 1 February 2006. After that date the exclusion in para 12(5)(*a*)(*cc*) applies.]

[229] Section 80(3)(*a*) of the Companies Act 71 of 2008.

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

Before deregistration which took place on 28 February 2005 Marisa waived the debt owed to her by Burnout. Under para 12(5) the waiver of the loan triggered CGT in Burnout of R100 000 x 15% = R15 000 under 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 tax consequences for the purchaser when the loan acquired at a discount is repaid – either a capital gain will arise or the discount will be treated as interest received under s 24J(3).[230]

Some advisors have suggested that the problems outlined in this 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. Apart from being open to attack under the general anti-avoidance provisions or as a sham transaction, the scheme in any event does not succeed 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.

The exclusion in para 12(5)(a)(cc)

This exclusion applies to disposals on or after 1 February 2006.[231]

A debtor company must disregard a capital gain under para 12(5) when

- it is a connected person in relation to the creditor, and

[230] Section 24J(3) was amended by s 24(1)(*i*) of the Revenue Laws Amendment Act 32 of 2004 with effect from 1 January 2005 and applies in respect of any instrument issued, acquired or transferred on or after that date.

[231] Inserted by s 67 of the Revenue Laws Amendment Act 31 of 2005.

- the reduction or discharge was made in the course or in anticipation of the liquidation, winding-up, deregistration or final termination of the corporate existence of the debtor company.

The relief applies *to the extent* that the amount of the reduction or discharge did not exceed the amount of the creditor's expenditure contemplated in para 20 of the debt at the time of the reduction or discharge.

Example 2 – Waiver of loan when creditor pays less than face value for loan

Facts:

Katie owns all the shares in Rescue (Pty) Ltd. The company is dormant, owes her R100 000 on loan account and has an accumulated loss of R100 000. Katie acquired her shares and the loan under a scheme of arrangement under s 311 of the Companies Act 61 of 1973, Katie had acquired the loan from the former shareholders at 10% of its face value (R10 000). What are the implications under para 12(5) should Katie waive the loan in order to facilitate the deregistration of Rescue (Pty) Ltd?

Result:

Rescue (Pty) Ltd will have a capital gain of R90 000, since the relief under para 12(5)(*a*)(*cc*) is limited to Katie's para 20 expenditure.

Circumstances under which para 12(5)(a)(cc) does not apply

The connected person and para 12(5) avoidance rule

The relief will not apply if

- the debtor company became a connected person in relation to the creditor after the debt (or any substituted debt) arose [para 12(5)(*a*)(*cc*)(A)], and
- these transactions are part of a scheme to avoid any tax otherwise imposed by virtue of the Act[232] [para 12(5)(*a*)(*cc*)(*B*)].

Example 3 – Debtor company and creditors becoming connected persons after debt incurred in order to avoid para 12(5)

Facts:

Crafty (Pty) Ltd has 10 shareholders, all individuals, each owning 10% of its shares. Each shareholder is owed R10 000 by the company, which is dormant. The company has no assets and an accumulated loss of R100 000. The directors wish to deregister the company, but in order to do so the shareholders must waive their loans to the company. However, this will give rise to a capital gain of R100 000 in the company which the directors wish to avoid. The company cannot use para 12(5)(*a*)(*cc*) because the shareholders are not connected persons in relation to the company.[233] In order to overcome this problem the directors

[232] The word 'Act' was substituted for the word 'subparagraph' by s 50(1)(*f*) of the Taxation Laws Amendment Act 3 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009. The purpose of the amendment was to extend the application of the anti-avoidance measure.

[233] Under para (*d*)(iv) of the definition of 'connected person' in s 1 an individual will be a connected person in relation to a company if he or she holds together with any connected persons in relation to himself or herself, directly or indirectly, at least 20% of the company's equity share capital or voting rights.

convert the company to a close corporation, since under para (*d*)(vi) of the definition of a 'connected person' in s 1, every member of a close corporation is a connected person in relation to the close corporation.

Result:

The relief provided by para 12(5)(*a*)(*cc*) will not apply because

- the debt was incurred before the creditors and Crafty (Pty) Ltd became connected persons, and
- the conversion of Crafty (Pty) Ltd to Crafty CC was part of a scheme to avoid the tax that would otherwise have arisen under para 12(5).

The steps to terminate rule [para 12(5)(c)]

The exclusion under para 12(5)(*a*)(*cc*) does not apply when the debtor company

- has not within 18 months of the reduction or discharge or such further period as the Commissioner may allow taken the steps in s 41(4) to liquidate, wind up, deregister or finally terminate its corporate existence,[234]
- has at any stage withdrawn any step taken to liquidate, wind up, deregister or finally terminate its corporate existence, or
- does anything to invalidate any such step so taken with the result that the company is or will not be liquidated, wound up, deregistered or finally terminate its corporate existence.

Recovery of tax [para 12(5)(d)]

Any tax that becomes payable as a result of para 12(5)(*c*) in respect of a debtor company, must be recovered from that company and the creditor who shall be jointly and severally liable for the tax.

Impact on creditor

Since the debtor company and creditor must be connected persons for the exclusion in para 12(5)(*a*)(*cc*) to apply, para 56(1) will apply to the creditor. It follows that to the extent that the debtor company does not have to account for the capital gain on waiver of the loan [see para 56(2)(*a*)], the creditor will not be entitled to a capital loss.

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

[234] Paragraph 12(5)(*c*)(i) was amended by s 50(1)(*g*) of the Taxation Laws Amendment Act 3 of 2008 and deemed to have come into operation on 1 January 2008. Previously the provision allowed the company a period of six months in which to take the steps contemplated in s 41(4).

- 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) to (ix)],
- disposals arising from specific events [para 13(1)(*b*) to (*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.
(iiA)[235]	The distribution of an asset of a trust by a trustee to a beneficiary to the extent that the beneficiary has a vested interest in the asset	Date on which the interest vests.
(iii)	Donation of an asset	Date of compliance with all legal requirements for a valid donation – see **6.3.7**.
(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 a company to a person to acquire a share, participatory interest[236] or debenture of that company	Date on which that option terminates
(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

[235] Paragraph 13(1)(*a*)(iiA) inserted by s 76(*a*)of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

[236] The previous reference to a unit was substituted by a reference to a participatory interest by the Revenue Laws Amendment 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.

(*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*)	Deleted[237]	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 that commences or ceases to be a resident or a CFC in respect of all assets of that person other than • assets in the Republic listed in para 2(1)(*b*)(i) and (ii) (South African immovable property or assets of a PE in South Africa), • any qualifying equity share under s 8B granted to a person less than five years before the date on which that person so ceases to be a resident, • any equity instrument under s 8C, which had not yet vested as contemplated in that section at the time that the person so ceases to be a resident, • any right to acquire any marketable security	Date immediately before the day that the event occurs

[237] Paragraph 13(1)(*d*) was deleted by s 76(*b*) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009. The provision stated that the time of disposal in the case of 'the vesting of an interest in an asset of a trust in a beneficiary is the date on which that interest vests'. Although the vesting of an interest in an asset of a trust in a beneficiary remains a disposal event under para 11(1)(*d*), the time of such a disposal must now be inferred from para 13(1)(*a*)(iiA) as being the date on which the interest vests. This would in any event be the date under general principles, since the date on which the beneficiary becomes unconditionally entitled to the asset is the date of vesting.

	contemplated in s 8A. (*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)[238] person ceasing to be a CFC as a result of becoming a resident	
(*g*)(ii)	Paragraph • 12(2)(*f*) transfer of assets between funds of an insurer • 12(5) reduction or discharge of debt without full consideration. See **6.2.5.13** on the time of disposal of debts waived on death.	Date that that event occurs

Application of para 13 to pre-CGT disposals

Although not specifically stated, the time of disposal and acquisition rules in para 13 also apply to assets acquired before the valuation date. This can be seen from the definition of 'pre-valuation date asset' in para 1 which reads as follows:

> '**"[P]re-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.'

The above definition was amended by s 65(1)(*a*) of the Second Revenue Laws Amendment Act 60 of 2001 to clarify the position when an asset is sold before valuation date but delivery takes place after that date. The related Explanatory Memorandum states that

> '[t]he date an asset is "acquired" or "disposed of" is set out in paragraph 13(1) and (2) and using these prescribed rules will add certainty.'.

The application of the time of disposal rules to pre-valuation date assets is thus necessary to identify what constitutes a pre-valuation date asset and to fix the time of acquisition of such assets.

Beneficial ownership of immovable property

It sometimes happens that a person (A) will register immovable property in the name of another person (B), for example, a relative, boyfriend or girlfriend, on the understanding that A will remain the true owner despite registration in B's name. This ill-advised arrangement

[238] The reference to para 12(4) was inserted by s 68(1) of the Taxation Laws Amendment Act 17 of 2009 and deemed to have come into operation on 21 February 2008 and applies in respect of an asset disposed of on or after that date, unless that disposal is the subject of an application for an advance tax ruling accepted by the Commissioner for SARS before that date.

may be done in an effort to conceal assets from creditors or to obtain bond finance from a bank because A is not creditworthy. For CGT purposes however, registration of immovable property in a person's name is evidence of a transfer of ownership and any private arrangement between the parties would not prevent that transfer of ownership. This follows from s 16 of the Deeds Registries Act 47 of 1937, which reads as follows:

> '**16. How real rights shall be transferred.**—Save as otherwise provided in this Act or in any other law the ownership of land may be conveyed from one person to another only by means of a deed of transfer executed or attested by the registrar, and other real rights in land may be conveyed from one person to another only by means of a deed of cession attested by a notary public and registered by the registrar: Provided that . . ..'

Should the property ever have to be transferred to the party alleging to be the true owner (A) a disposal will occur at that point and B will have to account for the disposal and its attendant CGT consequences. The position with an asset such as a share is different as in that case it is possible for a person to act as a nominee of a beneficial owner (see **12.4.3.6**).

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. If 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 vesting of an interest in an asset of a trust in a beneficiary is the date on which the asset vests. This would under general principles also be the date on which the beneficiary became unconditionally entitled to the asset. The date can also be inferred from para 13(1)(*a*)(iiA) which takes the time of distribution of an asset back to the time of vesting.

The time of disposal of shares held by a shareholder in a company that is being liquidated or deregistered is determined under para 77(1).

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 when a change of ownership has been effected or is to be effected. While 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 five kilometre radius of Agatha's business for two 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.[239] 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 & Planning Service v Kruger*[240] 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, but no action will lie to compel the performance of a condition (*Scott & another v Poupard & 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 2008, subject to Kevin being able to obtain a bond. On 30 June 2008 Kevin obtained the bond, and on 15 August 2008 the property was transferred into his name.

Result:

The date of disposal is 30 June 2008 when the suspensive condition is fulfilled.

A resolutive condition on the other hand is one in which 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 2008 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 2010.

Result:

The date of disposal is 15 January 2008.

[239] A D J van Rensburg, J G Lotz, T A R van Rhijn (updated by R D Sharrock) under Contract / Terms / Conditions / 'General' 5(1) (Second Edition Volume) *LAWSA* [CD-ROM] (*My LexisNexis*: 30 November 2003) in 192.
[240] 1974 (1) SA 689 (T) at 695.

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. The courts have laid down some general rules for determining the date of conclusion of a contract, and these are as follows:[241]

- 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.[242]
- The general rule can be varied by the offeror stipulating the method of acceptance.[243]

Effective dates

It is a common practice for parties to insert an 'effective date' in an agreement of sale which differs from the date on which the agreement is concluded. The insertion of an effective date in a contract does not have any bearing on the time of disposal laid down by para 13. In the case of a contract not subject to a suspensive condition, the time of disposal is the date on which the agreement is concluded, not any effective date agreed to by the parties.

6.3.5 Impact of time of disposal on time of accrual or incurral

Under para 13(1)(*a*)(ii) the time of disposal of an asset by a change of ownership ˆeffected or to be effected is in the case of an agreement which is not subject to a suspensive agreement the date on which the agreement is concluded. The effect of this rule is to create a legal fiction that the asset has been transferred or delivered on the date on which the agreement is concluded. Prof Gerrie Swart comments on this rule as follows:[244]

> 'A legal fiction is created, in other words, that the asset involved is transferred or delivered to the person entitled thereto on the date on which the unconditional right to claim such transfer or delivery arises, even though the actual transfer or delivery may be effected only at a later date (including a date falling in a later tax year, or which might, due to unforeseen circumstances, never occur). This artificial rule is of profound importance. By treating the transfer or change of ownership of an asset as having taken place on the date on which and during the tax year in which the contract is concluded or becomes unconditional, the fictional change of ownership precedes the actual change of ownership. The rule therefore operates prospectively, with the result that the change of ownership is drawn back and recognized in the tax year in which the initial contractual

[241] R H Christie *Christie – Law of Contract in South Africa* 5 ed [CD-ROM] (*My LexisNexis*: 28 February 2006) LexisNexis Butterworths, Durban in Chapter 2 – Agreement / Acceptance./ Necessity for Acceptance.
[242] *Dunlop v Higgins* (1848) 9 ER 805; *Cape Explosives Works Ltd v SA Oil & Fat Industries Ltd* 1921 CPD 244 and *Kergeulen Sealing & Whaling Co Ltd v CIR* 1939 AD 487, 10 SATC 363.
[243] *Driftwood Properties (Pty) Ltd v McLean* 1971 (3) SA 591 (A) and *Laws v Rutherfurd* 1924 AD 261.
[244] Gerard Swart 'The Taxation of Trusts – Superimposing New Rules on Old Principles' (July 2002) 17 *Acta Juridica* 102 at 128.

> right arises. The actual transfer or delivery of the asset in a later tax year is ignored as it does not qualify as a disposal in that year.'

Under the common law it has been held that there is no accrual until delivery.[245] But since para 13(1)(*a*)(ii) deems delivery to have occurred on conclusion of the agreement, any delay in actual delivery will not delay an accrual of proceeds or the incurral of expenditure.

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.[246]

Example – Time of accrual of proceeds under a deferred delivery arrangement

Facts:

On 21 February 2010 Ipeleng concluded an agreement with Johannes under which she disposed of her holiday flat to him for R800 000. The sale was not subject to any suspensive conditions. Under a term of the agreement Johannes was required to pay R800 000 into the trust account of Ipeleng's attorney after which the attorney would effect transfer and make payment to Ipeleng. Johannes duly transferred the funds on 11 March 2010 and Ipeleng's attorney effected transfer of ownership in the deeds registry on 22 March 2010. He paid the funds over to Ipeleng on 2 April 2010. The base cost of the property in Ipeleng's hands was R200 000.

Result:

Ipeleng is deemed to have disposed of the property on 21 February 2010 and Johannes is deemed to have acquired it on the same date. The proceeds of R800 000 accrue to Ipeleng on 21 February 2010 because she is deemed under para 13(1)(*a*)(ii) to have transferred ownership on 21 February 2010 even though the actual transfer of ownership took place on 22 March 2010.

In the 2010 year of assessment Ipeleng will have a capital gain of R800 000 – R200 000 = R600 000. Johannes is deemed to have incurred expenditure of R800 000 for the purposes of para 20(1)(*a*) on 21 February 2010.

6.3.6 Cancellation of contract as a result of a resolutive condition

An interesting question arises as to whether the accrual of proceeds is prevented in a contract subject to cancellation as a result of a resolutive condition. For example, it might be provided that the contract will be cancelled should payment not take place by a certain date. The view is held that at the time of disposal the contract is *perfecta*, and the seller is entitled to either the return of the asset (money's worth) or payment (money). In either case the proceeds can be unconditionally determined and the seller has a definite right *in praesenti*.

6.3.6.1 Impact on disposal

In the case of a contract subject to a resolutive condition, the disposal takes place when the agreement is concluded [para 13(1)(*a*)(ii)]. The question arises as to how the CGT consequences of such a contract should be dealt with in the event of the fulfillment of a

[245] *W H Lategan v CIR* 1926 CPD 203, 2 SATC 16; ITC 424 (1938) 10 SATC 338 (U). See also A P de Koker *Silke on South African Income Tax* [CD-ROM] (*My LexisNexis:* June 2008) in § 2.8, and ITC 316 (1934) 8 SATC 166 (U).
[246] *R v Katz* 1959 (3) SA 408 (C) at 417.

resolutive condition which results in the contract being cancelled. The common law position was described by Coetzee J in *Amoretti v Tuckers Land & Development Corporation (Pty) Ltd*[247] in which he cited with approval the following extract from *Wessels on Contract*:[248]

> 'If the resolutive condition is fulfilled, the law regards the whole transaction *inter partes* as if the absolute contract had never existed and the parties must therefore be restored to their former position. *Obligatio resolvitur nunc ex tunc*. Thus, in the case of a sale subject to a resolutive condition, the Romans said that, when the condition was fulfilled, the subject-matter of the sale was to be regarded *as if it had never been bought or sold*. The resolutive condition therefore has a retrospective effect.'

(Emphasis added by Coetzee J.)

But from a tax perspective the matter cannot be dealt with retrospectively.[249] Tax is an annual event and assessments cannot be held open indefinitely for conditions to be fulfilled; nor can they be reopened to give effect to subsequent events (unless this is explicitly provided for).

6.3.6.2 Effect of the cancellation

The Eighth Schedule deals with two scenarios, namely,

- cancellation in the same year of assessment, and
- cancellation in a subsequent year of assessment.

6.3.6.2.1 Cancellation in the same year of assessment in which the agreement is entered into

Under para 35(3)(*c*), upon cancellation of a contract in the same year of assessment, the proceeds received or accrued must be reduced by

> 'any reduction, as the 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'.

And the base cost taken into account under para 20(1)(*a*) to (*g*) must be reduced under para 20(3)(*b*) by any amount which

> 'has for any reason been reduced or recovered or become recoverable from or has been paid by any other person (whether prior to or after the incurral of the expense to which it relates), to the extent which such amount is not taken into account as a recoupment in terms of section 8(4)(*a*) or paragraph (*j*) of the definition of "gross income" of an amount contemplated in item (*a*)'.

The above provisions would have the effect of reducing the proceeds and base cost to nil. Going forward, the base cost of the asset in the seller's hands would be restored to its original pre-sale position.

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[247] 1980 (2) SA 330 (W) at 332.

[248] J W Wessels (edited by A A Roberts) Vol 1 *The Law of Contract in South Africa* 2 ed (1951) Butterworth & Company (Africa) Ltd, Durban in paras 1409–1411. See also A J Kerr 'Resolutively Conditional Sales' 24 (First Release Volume) *LAWSA* [CD-ROM] (*My LexisNexis*: 31 July 2000) LexisNexis Butterworths, Durban in para 125.

[249] See, for example, ITC 1346 (1981) 44 SATC 31 (C) where a lecturer who received a salary while on study leave was required to repay it if he did not resume his post at the conclusion of his leave. The court held that the amount had to be included in gross income despite being subject to a contingency.

6.3.6.2.2 Cancellation in a subsequent year of assessment in which the agreement is entered into

The cancellation of a sale in a subsequent year of assessment must be dealt with under paras 3(*b*)(ii) and 4(*b*)(i)(*aa*).

Under those provisions the proceeds taken into account in the year of disposal are treated as a capital loss in the year of cancellation, while the base cost taken into account in the year of disposal is treated as a capital gain in the year of cancellation. The effect is to reverse an earlier year capital gain as an aggregate capital loss in the year of cancellation or an earlier year capital loss as an aggregate capital gain in the year of cancellation. The Act does not make provision for the reopening of the earlier year's assessment. This can obviously have cash flow consequences for a seller when a capital gain arises in the year of disposal. Going forward, the base cost of the asset in the seller's hands is restored to its pre-sale position. Some relief may be available to a seller under s 24N in the case of a disposal of equity shares under certain conditions. That provision replaces the normal accrual principle with the due and payable principle when the purchaser is obliged to return the shares in the event of non-payment (see **10.3**).

Example 1 – Cancellation of contract subject to resolutive condition in same year of assessment

Facts:

Ernest owns an asset with a base cost of R100 000. He enters into an unconditional contract with Paul on 1 March of year 1 under which Paul must pay the purchase price of R500 000 on signature of the agreement. The contract is, however, subject to cancellation in the event of the fulfillment of a resolutive condition, namely, that the purchase price must be settled within three months. Paul fails to pay by 31 May of year 1 with the result that the condition is fulfilled and the contract cancelled. Paul returns the asset to Ernest and is relieved from paying the purchase price of R500 000.

Result:

There is no capital gain or loss on the sale of the asset by Ernest. The proceeds of R500 000 that accrued to him must be reduced by R500 000 under para 35(3)(*c*) while his base cost of R100 000 is reduced by R100 000 under para 20(3)(*b*). Paul's cost of acquisition of R500 000 is reduced by R500 000 under para 20(3)(*b*) and he has neither a capital gain nor a capital loss. Alternatively, Paul has proceeds of R500 000 under para 35(1)(*a*) less a base cost of R500 000 which also gives no gain or loss.

Example 2 – Cancellation of contract subject to resolutive condition in a subsequent year of assessment

Facts:

The facts are the same as in Example 1 except that the resolutive condition requires the purchase price to be settled by 31 May of year 2.

Result:

Ernest will have a capital gain of R400 000 (proceeds of R500 000 less base cost of R100 000) in year 1. The base cost of the asset in Paul's hands in year 1 is R500 000. In year 2 Ernest will have a capital gain of R100 000 [reversal of base cost accounted for in year 1 under para 3(*b*)(ii)] and a capital loss of R500 000 [reversal of proceeds accounted for in year 1 under para 4(*b*)(i)(*aa*)]. The net result for Ernest is an aggregate capital loss of R400 000. Paul's cost of acquisition of R500 000 is reduced by R500 000 under

para 20(3)(*b*) and he has neither a capital gain nor a capital loss. Alternatively, Paul has proceeds of R500 000 under para 35(1)(*a*) less a base cost of R500 000 which also gives no gain or loss.

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) occurs when 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.
Donatio mortis causa	Date of death (see below)
Section 56(1)(*d*) donation	Date of acceptance by donee.

In *Law of Contract in South Africa* the following is stated on the need for acceptance:[250]

> '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.[197]
>
> 'The general rule applies to donations in the same way as to other contracts.[198] 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.[251] This has never been our law, as is made clear by Paul D 50 17 69: *"Invito beneficium non datur"*.'[199]

[250] R H Christie *Christie – Law of Contract in South Africa* 5 ed [CD-ROM] (*My LexisNexis*: 28 February 2006) LexisNexis Butterworths, Durban in Chapter 2 – Agreement / Acceptance./ Necessity for Acceptance.

[251] 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.

[197] *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.

[198] *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).

[199] A benefit is not conferred on anyone against his will. Cf Pothier s 578.

Donatio mortis causa

A *donatio mortis causa* is a donation made in contemplation of death. In order to be valid it must be executed with the formalities required for a will.[252] It vests only on the donor's death and may be revoked by the donor at any time before that date even if it has been delivered to the donee.[253]

Given the revocable nature of a *donatio mortis causa* no binding rights are created in favour of the donee before death and the donor cannot be regarded as having parted with anything before that date. There is no certainty that a transfer of ownership will be effected at a future date as required by para 13(1)(*a*) and for these reasons the time of disposal is regarded as the date of death.

Section 56(1)(d) donations

Section 56(1)(*d*) contemplates a donation in which vesting takes place before the death of the donor, while delivery of the subject matter takes place after date of death.

The application of s 56(1)(*d*) was considered in ITC 1192[254] and more recently in *C: SARS v Marx NO*.[255] According to the *Marx* case the executory contract of donation comes into force upon acceptance by the donee. The act of donation and the delivery of the asset are two separate legal events. It is therefore submitted that the donation comes into effect when the donee accepts the terms of the donation.

6.3.8 Time of disposal = day before the specified event

Under 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 term 'resident' is defined in s 1. An individual will become a resident upon becoming 'ordinarily resident'[256] or when satisfying the physical- presence test.[257] The latter test is satisfied when the individual has been physically present in South Africa for more than

[252] Voet 39.6.4.
[253] *Meyer & others v Rudolph's Executors* 1918 AD 70 at 84.
[254] ITC 1192 (1965) 35 SATC 213 (T) at 219.
[255] *C: SARS v Marx NO* (2006 (4) SA 195 (C), 68 SATC 219.
[256] See SARS Interpretation Note 3 'Resident: Definition in Relation to a Natural Person – Ordinarily Resident' [online], (4 February 2002), available at <http://www.sars.gov.za/home.asp?pid=54958> [Accessed 8 December 2011].
[257] See SARS Interpretation Note 4 (Issue 3) 'Resident: Definition in Relation to a Natural Person – Physical Presence Test' [online], (8 February 2006) available at <http://www.sars.gov.za/home.asp?pid=54958> [Accessed 8 December 2011].

- 91 days in the current year of assessment,
- 91 days in each of the immediately preceding five[258] years of assessment, and
- 915[259] days in total during the immediately preceding five[260] years of assessment.

A company or trust will become resident when it has its place of effective management in South Africa. Companies or trusts that are incorporated, established or formed in South Africa are automatically regarded as resident in South Africa 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).

The provisions of any applicable tax treaty may override the above rules by deeming a person to be exclusively a resident of another country.

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

Paragraph 13(2) provides that when an asset is disposed of, the acquirer is treated as having acquired it at the time of disposal contemplated in para 13(1). This time of acquisition rule only applies when an asset has been disposed of. Under 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 restructuring rules in ss 41 to 47, and this overrides the core rule in para 13(2).

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

Each spouse is entitled to the full annual exclusion. But the primary residence exclusion is apportioned between the spouses (see **11.2.2**)

[258] Five years substituted for three years by s 3(1)(*i*) of the Revenue Laws Second Amendment Act 32 of 2005 and shall
(i) in respect of any person who by virtue of para (*a*)(ii) of the definition of 'resident' was a resident on 28 February 2005, come into operation on 1 March 2006 and applies in respect of any year of assessment commencing on or after that date; and
(ii) in respect of any other person, is deemed to have come into operation on 1 March 2005 and applies in respect of any year of assessment commencing on or after that date.
[259] 915 days substituted for 549 days by s 3(1)(*i*) of the Revenue Laws Second Amendment Act 32 of 2005. See previous footnote for commencement date of the amendment.
[260] Five years substituted for three years by the Revenue Laws Second Amendment Act 32 of 2005 (see previous footnote).

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 a 'spouse' in s 1).

6.5 The accrual system and marriage out of community of property

The Matrimonial Property Act 88 of 1984 makes the accrual system automatically applicable to a marriage out of community of property unless its application is specifically excluded in the antenuptial contract.[261] Under the accrual system a claim will arise on death or divorce in the hands of one spouse against the other for the difference in growth of the estates of the spouses,[262] For example, if the growth in value of spouse A's estate during the marriage is R100, and the growth in value of spouse B's estate is R50, spouse B will have a claim of R25 against spouse A on dissolution of the marriage.

The accrual system does not result in a splitting of capital gains and losses between spouses. A capital gain or loss on disposal of an asset by a person married out of community of property must be accounted for by the spouse that owns the asset. A claim under the accrual system only arises on death or divorce of a spouse[263] or under an order of court.[264] It does not affect the tax treatment of the spouses during the subsistence of the marriage or even on its termination. This is a claim for a sum of money, not a pre-existing entitlement to specific assets or income of the other spouse. The accrual claim is thus contingent on death or divorce and its quantum also depends on the value of the estates of the spouses at the time of those events. It might happen, for example, that gains accumulated earlier in a marriage are later lost or expended. It does not therefore have any impact on the incidence of an accrual of an amount of gross income or proceeds on disposal of an asset.

[261] Section 2 of the Matrimonial Property Act 88 of 1984.
[262] Section 3 of the Matrimonial Property Act 88 of 1984.
[263] Section 3 of the Matrimonial Property Act 88 of 1984.
[264] Under s 8 of the Matrimonial Property Act 88 of 1984 the court can order the division of the accrual of the estate of a spouse if that spouse's conduct is seriously prejudicial to the other spouse's ultimate accrual claim on dissolution of the marriage (s 8(1)). The court can also exclude the accrual system completely (s 8(2)).

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 under para 53. However, certain assets used mainly for non-trade purposes that are likely to generate substantial capital gains as a result of market forces are included, namely

- certain specified assets whose reduction in value is most likely attributable to the personal-use and consumption of the asset, and
- certain specified 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. However, 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 microlight 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 a ‘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.
- Fiduciary, usufructuary or 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 under 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

An apportionment on a fair and reasonable basis will be required if an asset of this nature is used for trade and private purposes. Only the trade portion of any capital loss will be 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
Less: Base cost	(1 000 000)
Loss	(100 000)
Disregarded capital loss	-

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

Example 2 – Disregarding of capital loss – business and private usage

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 R	Allowed R
Cost	1 000 000	
Less: Section 12C allowances	(400 000)	200 000
Tax value	600 000	
Less: Proceeds	(100 000)	
Section 11(*o*) allowance	(500 000)	(250 000)

Note: The section 11(*o*) allowance is determined with reference to the original cost and total wear-and-tear allowances ignoring any private element. Once the section 11(*o*) allowance has been established, it is apportioned to disallow the portion relating to private use.[265]

Base cost	Total R	Business R	Private 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

[265] See *Silke on South African Income Tax* in § 8.106; 'Scrapping Allowance' *Income Tax Practice Manual* in 2.(2) at [A:S18]; ITC 322 (1935) 8 SATC 243 (U).

Capital gain or loss

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

7.2 Intangible assets acquired before 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. 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.

A person must disregard any capital loss on disposal of an intangible asset acquired before the valuation date if it was

- acquired from a connected person, or
- associated with a business taken over by that person or any connected person in relation to that person.

This restriction does not affect self-developed intellectual property or intellectual property acquired on or after valuation date.

Example – Pre-1 October 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:

The capital loss of R90 million on disposal of the intellectual property is disregarded because

- 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.

7.3 Forfeited deposits

Paragraph 17

A capital loss must be disregarded

- if it results from the forfeiture of a deposit in respect of an asset, and
- that asset is not intended to be used wholly and exclusively for business purposes.

Capital losses arising from forfeited deposits on 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 (for example, Krugerrands).
- Immovable property, excluding a primary residence (for example, a holiday home).
- Financial instruments[266] (for example, 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

Paragraph 18 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 if the option was to

- acquire an asset intended for use wholly and exclusively for business purposes,
- 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 **21.4**.

[266] As defined in s 1.

Chapter 8 – Base cost

PART V: BASE COST

8.1 Base cost – allowable expenditure

Paragraph 20, s 23C

Paragraph 20 sets out what may and may not form part of the base cost of an asset. The determination of qualifying expenditure under para 20 is relevant for determining the base cost of both pre- and post-valuation date assets.

Paragraph 20 is the primary method for determining the base cost of post-valuation date assets, although there are exceptions when a method such as market value is prescribed (for example, person becoming a resident (para 12), assets acquired by donation or at a non-arm's length price from a connected person (para 38) and assets acquired by heirs and legatees (para 40).

Paragraph 20 is also relevant in determining elements making up the base cost of pre-valuation date assets. For example, para 20 determines

- the amounts included in the symbols 'B' and 'A' in the TAB formulae,
- the post-valuation date expenditure taken into account in applying the market value, 20% of proceeds and weighted-average methods, and
- the expenditure to be taken into account when applying the kink tests in paras 26 and 27.

8.2 Base cost – domestic and unproductive expenditure

Under s 23(*b*) and (*f*) domestic or private expenses and amounts incurred in the production of exempt income are not allowable as deductions against income. However, para 20 overrides these sections and expenditure of this nature may qualify to be added to the base cost of an asset under appropriate circumstances. An overriding measure is not required for s 23(*g*) as that provision is only concerned with the prohibition of a deduction from *income* for non-trade expenditure, something which is irrelevant for the purposes of determining a capital gain or loss.

8.3 Base cost – direct costs of acquisition and disposal [para 20(1)(*a*) to (*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*)	Expenditure actually incurred in respect of the cost of acquisition or creation of an asset. The cost of an option used to acquire a marketable security or equity instrument referred to in ss 8A and 8C respectively is excluded from this item by the proviso to para 20(1)(*h*). This is because the cost of the option would already have been allowed as a deduction in determining taxable income.

(*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.[267] In the case of immovable property, transfer costs include the cost of obtaining a certificate of compliance for electrical installation as required by the Electrical Installation Regulation under the Occupational Health and Safety Act 85 of 1993 and an entomologist's certificate (required in KwaZulu-Natal and the Cape) for the purposes of effecting transfer. However, repairs necessitated by such inspections will not qualify unless the property was used wholly and exclusively for business purposes [para 20(1)(*g*)(i)]. Since it is necessary to cancel a bond before transfer can take place, it is accepted that bond cancellation fees also qualify as a transfer cost.
(iii)	Stamp duty,[268] transfer duty or similar duty. The amnesty levies imposed under the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003 are not regarded as being similar to stamp duty or transfer duty. The latter are transaction taxes, usually imposed as a result of the transfer of ownership in an asset from one person to another. By contrast, the amnesty levies were imposed once-off by reason of an amnesty application relating to an underlying criminal offence, and are thus not directly related to the acquisition or disposal of an asset. In any event, to allow such levies to form part of base cost would be contrary to public policy, frustrate the legislative intent, and allow a punishment imposed to be diminished or lightened – see ITC 1490.[269] Securities transfer tax (STT) was introduced by the Securities Transfer Tax Act 25 of 2007 with effect from 1 July 2008. It replaced stamp duty and uncertificated securities tax on marketable securities. STT is levied on any transfer of a security (whether listed or unlisted) based on the taxable amount of the security. A "security" means any • share in a company, • member's interest in a close corporation, or • any right or entitlement to receive any distribution from a company or close corporation. STT is considered to be a 'similar duty' to stamp duty for the purposes of para 20(1)(*a*)(iii).
(iv)	Advertising costs to find a seller or to find a buyer
(v)	Cost of moving the asset from one location to another. The allowable costs relate only to those incurred in acquiring or disposing of an asset. This would,

[267] This inclusion is similar to that found in s 110–35(3) of the Australian Income Tax Assessment Act, 1997, which includes in the 'cost base' the 'costs of transfer'.
[268] The Stamp Duties Act 77 of 1968 was repealed by s 103(1) of the Revenue Laws Amendment Act 60 of 2008 with effect from 1 April 2009.
[269] (1990) 53 SATC 108 (T).

	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 under s 11(*e*)(v), 12C(6) or 12E(3). Any moving costs incurred by a seller will form part of the seller's base cost. This would not apply when 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. Installation costs borne by a seller under a sale that is not on revenue account 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 under para 22 (see Example 1 below). The donations tax may be added to base cost despite s 23(*d*).[270]
(viii)	A portion of the donations tax payable by a donee of an asset. 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. Under para 58 a person must disregard any gain or loss on the exercise of an option.

8.4 Base cost – composite acquisitions

Assets are sometimes acquired with other assets as part of a composite acquisition. For example, a single contract of purchase may be entered into at an inclusive price embracing multiple assets. In these circumstances the purchase price must be apportioned to the respective assets broadly by reference to their market values at the date of acquisition.[271] The onus rests on the taxpayer under s 82 to justify any allocation. The court will not accept a fictitious allocation of the purchase price. In ITC 1235[272] 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.

8.5 Base cost – 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[273] Goldblatt J stated the following on the meaning of the word 'expenditure':

> '"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.'

[270] Section 23(*d*) prohibits the deduction of any tax, duty, levy, interest or penalty imposed under the Act.
[271] 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.
[272] (1975) 37 SATC 233 (T) at 236.
[273] (2004) 66 SATC 373 (G) at 376.

The learned judge cited the following extract from *Silke*[274] 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.[41] 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.'

[41] *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.

Silke continues:[275]

> 'In accordance with the principle of the decision in *Caltex Oil (SA) Ltd v SIR*[299] 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.'

[299] 1975 (1) SA 665 (A), 37 SATC 1. See C Divaris 'The Caltex Case' (1975) 14 *Income Tax Reporter* 1 at 12–14.

In *C: SARS v Labat Africa Ltd*[276] the court stated that expenditure

> 'requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends'.

This confirms that the expenditure in a barter transaction is the amount by which each party's assets are diminished. For more on the *Labat* case see **8.40.2**.

If 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 **6.1.1.5**.

8.5A Assets acquired before valuation date by donation, inheritance or by distribution *in specie*

The issue arises as to whether any expenditure is actually incurred for the purposes of para 20(1)(*a*) in acquiring an asset before the valuation date by donation, inheritance or by distribution *in specie*.

This is relevant, amongst other things, in determining 'B' in the TAB formula and in applying the kink tests in paras 26 and 27. At first glance one might conclude that the expenditure is nil, since no consideration appears to be given for the asset.

But in the context of CGT, the definition of an 'asset' in para 1 is wide and includes personal rights such as

- an heir's vested right to claim delivery of an asset bequeathed under a last will and testament once the liquidation and distribution account has lain open for inspection and no objection to it has been lodged with the Master,
- a donee's right to claim delivery of a donated asset upon acceptance of the donation, and

[274] *Silke on South African Income Tax i*n § 7.4.
[275] In § 7.24.
[276] Case 669/10) [2011] ZASCA 157, 28 September 2011, unreported. The SCA judgment overturned the decisions in ITC 1801 (2006) 68 SATC 57 (G) and *C: SARS v Labat Africa Ltd* (2009) 72 SATC 75 (North Gauteng High Court).

- a shareholder's accrued right to claim delivery of an asset to be distributed as a dividend *in specie*.[277]

When the actual asset is acquired the personal rights referred to above are extinguished. The market value of the personal rights at the time of their extinction represents the 'expenditure' actually incurred in acquiring the asset.

Applying this principle to an asset acquired by donation, inheritance or distribution *in specie*, the sequence of events is as follows:

First, upon accrual, the person acquires a right to claim delivery of the asset for no consideration.

Next, the personal right to claim delivery of the asset is extinguished upon acquisition of the ultimate asset. The proceeds from the disposal of the personal right to claim delivery are equal to the market value of the ultimate asset, while the cost of the personal right is nil. This will give rise to a pre-CGT gain, but it is not relevant for purposes of the Eighth Schedule, since the disposal occurs before valuation date.

Finally, the expenditure actually incurred for the purposes of para 20(1)(*a*) on the acquisition of the ultimate asset is equal to the market value of the personal right to claim delivery immediately before it is disposed of through extinction.

The disposal of a personal right to claim delivery in return for the actual asset is well recognised in the time of disposal rules in para 13. For example, under para 13(1)(*a*)(iiA) the time of disposal of an asset distributed to a beneficiary who has a pre-existing vested interest in the asset is taken back to the time of vesting. This is done in order to prevent any capital gain or loss from arising at the time of transfer of ownership of the asset.

Example – Acquisition of asset by inheritance before the valuation date

Facts:

On 15 May 1996 Darryl passed away. In his last will and testament he bequeathed his holiday home to his daughter Leigh. On 10 June 1997 the estate became distributable after the liquidation and distribution account had lain for inspection for the prescribed period and no objection had been lodged against it. On 15 July 1997 the executor transferred the property into Leigh's name. The value of the property on 15 July 1997 was R100 000. Leigh sold the property for R700 000 on 31 December 2010. Determine Leigh's capital gain or loss on disposal of the property using TAB.

Result:

TAB = B + [(P – B) x N/(N + T)]
= R100 000 + [(R700 000 – R100 000) x 5/15]
= R300 000

Capital gain = Proceeds – base cost
= R700 000 – R300 000
= R400 000

[277] The time of accrual of a dividend depends on the terms specified in the resolution of the company dealing with the declaration of the dividend. For example, unconditional entitlement may arise on the date of declaration, or if payable to shareholders registered on a later date, on that date. See *Silke* in § 2.8.

8.5B Base cost of debt assets acquired through services rendered or as a result of interest received or accrued

The principles discussed in **8.5A** also apply to debt assets arising from services rendered and accrued interest. These principles apply both before and on or after the valuation date, except to the extent that they are dealt with explicitly in para 20(1)(*h*).

The pre-existing personal rights which are given up in exchange for the debt asset are

- a service provider's contractual right to claim payment once the service has been rendered to the satisfaction of the customer; and
- a right to claim payment of interest on a loan or bank deposit.
- The establishment of the base cost of a debt asset arising from services rendered has been specifically addressed in para 20(1)(*h*)(ii)(*dd*). That provision applies to any disposal on or after 8 November 2005, and thus covers debt assets arising before valuation date which are repaid on or after that date. The general principle illustrated in **Example 1** below applies to debt assets disposed of before 8 November 2005.

Example 1 – Base cost of debt arising from the rendering of a service

Facts:

Ernest called Joe the plumber to repair a water leak at his home. After inspecting the site Joe told Ernest that it would cost R1 000 to repair the broken pipe. Ernest agreed, and Joe proceeded to do the repair. Joe had to purchase some replacement pipes and other materials and claimed these costs under s 11(*a*). Once the job was complete Ernest expressed his satisfaction with the work and asked Joe if he could pay the amount of R1 000 in 10 days' time as he was experiencing a cash-flow problem. Joe agreed, and 10 days' later Ernest duly paid Joe the amount of R1 000. What is the base cost of the debt that arose when Joe completed the job?

Result:

Upon entering into the contract, Joe acquired a personal right against Ernest to undertake the repair work. That personal right is an asset, the base cost of which is nil, because all Joe's expenditure was claimed under s 11(*a*) and is hence excluded from base cost under para 20(3)(*a*). When the job was completed and Ernest was satisfied with it, an amount of R1 000 accrued to Joe which was included in his gross income. The amount of R1 000 was therefore excluded from proceeds under para 35(3)(*a*). The disposal of the personal contractual right through extinction in order to acquire a right to claim R1 000 (being the debt asset) accordingly gives rise to no capital gain or loss. The base cost of the debt asset is equal to the market value of the personal right given up, determined immediately before its disposal (R1 000). When Ernest settles the debt, Joe receives proceeds of R1 000 and there is also no gain or loss.

Example 2 – Interest accrued on bank account before valuation date

Facts:

Nathi invested R100 000 in a deposit account with the ABC bank on 1 September 2001. At the end of the first month the bank credited Nathi's account with R1 000. What is the base cost of the bank deposit on valuation date?

Result:

On 30 September 2001 Nathi acquired a right to claim accrued interest of R1 000 from the bank. When the bank deposited the amount of R1 000 into his bank account, Nathi gave up that right in return for the bank deposit of R1 000. The expenditure incurred on the amount deposited into his bank account is equal to the market value of the right to claim a cash payment which was extinguished on 30 September 2001, and which had a value of R1 000 at that time. This principle applies equally in establishing a base cost for accrued interest on or after the valuation date.

8.6 Base cost – 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 does the buyer incur expenditure? Under the common law the expenditure will usually only be incurred when delivery is taken (ITC 1444[278] and ITC 1725).[279] But for CGT purposes the common law position is varied by the time of disposal rule in para 13(1)(*a*)(ii) and the time of acquisition rule in para 13(2). See **6.3.5**.

8.7 Base cost – 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:

- 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). If 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 should an asset be 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.[280] In *Estate Welch v C: SARS*[281] it was confirmed by Marais JA that the common law test for a donation was as follows:

[278] (1987) 51 SATC 35 (T).
[279] (2000) 64 SATC 223 (C).
[280] *The Master v Thompson's Estate* 1961 (2) SA 20 (FC), 24 SATC 157 at 24F–26C, 48F–49C.
[281] 2005 (4) SA 173 (SCA), 66 SATC 303 at 183.

> '[T]he disposition [must] be motivated by pure liberality or disinterested benevolence and not by self-interest or the expectation of a *quid pro quo* of some kind from whatever source it may come.'

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 300 000. The base cost of the yacht before taking into account any donations tax paid is R750 000.

Gerrie paid donations tax of R240 000, calculated as follows.

	R
Market value of asset donated	1 300 000
Less: Section 56(2)(*b*) abatement	(100 000)
	1 200 000
Donations tax @ 20%	240 000

Result:

$$\text{Allowable addition to base cost} = \frac{\text{(Market value of asset – base cost)}}{\text{Market value of asset}} \times \text{Donations tax}$$

$$= \frac{\text{R1 300 000 – R750 000}}{\text{R1 300 000}} \times 240\,000$$

= R550 000/R1 300 000 x R240 000
= R101 538

Base cost of yacht = R750 000 + R101 538
= R851 538

The purpose of this provision is to achieve parity with the estate duty that would have become payable on the capital gain had the donor died on the date of donation. The formula ignores the effect of the R100 000 donations tax abatement, the R3,5 million[282] 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 R3,5 million estate duty abatement has been used against other assets.

	R
Value of yacht (includes gain of R550 000)	1 300 000
Less: CGT paid (R550 000 x 10%)	(55 000)
	1 245 000
Estate duty at 20%	R249 000

Estate duty levied on gain = (R550 000 – R55 000) x 20%
= R495 000 x 20%
= R99 000

[282] The abatement was increased from R2,5 million to R3,5 million by s 1(1) of the Taxation Laws Amendment Act 8 of 2007. The increased abatement came into operation on 1 March 2007 and applies in respect of the estate of any person who dies on or after that date. Earlier abatements: 1 March 2006 to 28 February 2007: R2,5 million; 1 March 2002 to 28 February 2006: R1,5 million; 16 March 1988 to 28 February 2002: R1 million.

Total tax collected on gain = R55 000 + R99 000 = R154 000

Comparing this with the donation of the yacht, and assuming that the R100 000 abatement has been used against other donations, the tax collected will be as follows:

Donations tax	=	R1 300 000 x 20%
	=	R260 000

(Includes donations tax on gain of R550 000 x 20% = R110 000)

Capital gain	=	R1 300 000 – (R750 000 + R110 000)
	=	R440 000
Capital gains tax	=	R440 000 x 10%
	=	R44 000

Total tax collected on gain = R110 000 + R44 000 = R154 000

8.8 Base cost – donations tax paid by donee [para 20(1)(*c*)(viii)]

When 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 under 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 (see **8.7**).[283] Donations tax may also not be added to the base cost of the donee's asset should the donor disposed of the asset at a capital loss.

Example – Donations tax paid by donee acquiring asset

Facts:

Hannalie acquires a yacht by donation from her father at a time when its market value is R1 300 000. The yacht had a base cost of R750 000 in her father's hands. The donations tax due by her father was R240 000, calculated as follows:

	R
Market value of asset donated	1 300 000
Less: Section 56(2)(*b*) abatement	(100 000)
	1 200 000
Donations tax @ 20%	240 000

As her father failed to pay the donations tax to SARS within the prescribed period, Hannalie was held liable for the sum of R240 000 under s 59 of the Income Tax Act.

[283] *The Master v Thompson's Estate* 1961 (2) SA 20 (FC), 24 SATC 157 at 24F–26C, 48F–49C and *Welch's Estate v C: SARS* 2005 (4) SA 173 (SCA), 66 SATC 303.

Result:

Hannalie's father was liable for CGT on a capital gain of R550 000 as a result of the donation (R1 300 000 – R750 000), Hannalie may add the following amount to the base cost of her yacht.

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

$$= \frac{\text{R550 000}}{\text{R1 300 000}} \times \text{R240 000}$$

$$= \text{R101 538}$$

8.9 Base cost – costs of establishing, maintaining or defending a legal title or right in an asset [para 20(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 in which legal expenses of this nature have been held to be of a capital nature:

- ITC 1677[284] – 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[285] – 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 nightclub in an up market area. The city council wishes to expropriate the nightclub's premises.

Result:

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

8.10 Cost of improvements or enhancements to value of asset [para 20(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

[284] (1999) 62 SATC 276 (N).
[285] (1998) 61 SATC 58 (C).

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.

Non-scrip capital contributions

In some foreign jurisdictions, shareholders are permitted to inject capital into a company without the issue of shares. If the value of the existing shares held by the shareholder is correspondingly enhanced, the amount expended can be added to the base cost of the shares. An issue arises as to whether the amount can still be added to base cost when the company has made subsequent losses, since one of the conditions of para 20(1)(*e*) is that the enhancement must be reflected in the state or nature of the asset at the time of disposal. The view is held that the incurral of subsequent losses will not disqualify the expenditure under para 20(1)(*e*).[286]

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. Jeannee would have had a part-disposal when she scrapped the jacuzzi and any capital loss should have been determined at that point.

8.11 Base cost – option acquired before, asset acquired or disposed of after valuation date [para 20(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 when 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.

Under 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.

[286] See *National Mutual Life Association of Australia Ltd v Commissioner of Taxation* [2009] FCAFC 96,76 ATR 608 in which it was held that a non-scrip capital contribution by a company to its subsidiary was reflected in the state or nature of the subsidiary's shares at the time of their disposal. Accordingly the amount formed part of the 'reduced cost base' of the shares.

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 (R100) would equal the market value of the share (R120).

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 he 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 – R300 000 = R80 000

TAB = B + [(P – B) x N/(N + T)]
= R10 000 + [R80 000 – R10 000) x ½]
= R10 000 + R35 000
= R45 000

Note: For the purpose of determining 'N' and 'T' a part of a year is treated as a full year [proviso to para 30(1)].

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
R80 000 x 20% = 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).

8.12 Base cost – holding costs incurred wholly and exclusively for business [para 20(1)(*g*)]

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 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.[287] Nevertheless, in exceptional cases isolated transactions can constitute a business in the hands of an individual, as in *Stephan's* case.[288] The frequency of transactions is not of the same importance in the case of a company formed for certain purposes in deciding whether

[287] *CIR v Stott* 1928 AD 252, 3 SATC 253 at 260. See S Wilson 'Carrying on Business' (2000) 14 *Tax Planning* 1 at 6.
[288] *Stephan v CIR* 1919 WLD 1, 32 SATC 54.

it is carrying on business.[289] Persons carrying on business would normally claim the relevant expenditure under the sections of the Act against ordinary income. In the case of vacant land not held as trading stock, it is difficult to see how expenses such as rates and interest can qualify under para 20(1)(*g*). Typically, vacant land is held, and not used. If it were used to generate rental income, any expenditure on rates and interest would usually qualify under s 11(*a*) and be excluded from base cost by para 20(3)(*a*). In addition, the passive holding of land as an investment, particularly by an individual, would be unlikely to comprise a business. 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*).

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'.

Should a share be delisted, only interest incurred up to the date of delisting will qualify.

Limitation on 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 when 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 under s 11(*a*) and hence excluded from base cost by para 20(3)(*a*).

Interest incurred in acquiring unlisted shares is not allowed as an addition to the base cost of those shares. In many instances current costs that do not qualify for a deduction against income tend to relate to private consumption. A deduction for such costs cannot be justified. It would be very easy to circumvent the business-usage requirements of para 20(1)(*g*) by acquiring shares using loan finance in a private company holding non-business assets. A secondary consideration is that the addition of interest to the base cost of an asset amounts to a disguised form of inflation indexing, a policy that has not been adopted in the Eighth Schedule.

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.

[289] *Platt v CIR* 1922 AD 42, 32 SATC 142 at 148.

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 through 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. Pre-production interest would not qualify under the Income Tax Act under s 11(*b*A) since that section does not include land – ITC 1619.[290]

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 with 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.)[291]

[290] (1995) 59 SATC 309 (C).
[291] (1962) 25 SATC 414 (T).

Example 6 – Interest incurred in financing the cost of shares

Facts:

Quintin acquires 2 000 shares in Ess Limited, a company listed on the JSE, at a cost of R100 000 which he finances with 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
Less: Non-allowable portion (R15 000 x 2/3)	(10 000)
Interest that may be added to base cost	5 000

8.13 Base cost – asset resulting in an inclusion in gross income upon acquisition [para 20(1)(*h*)(i) to (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 determined.

Table 2 – Base cost of assets that resulted in an inclusion in income when acquired

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 under s 8A or 8C.	The • market value of the marketable security or equity instrument, or • amount received or accrued from the disposal thereof, that was taken into account in determining the amount of the gain or loss (including when the gain and loss so determined was nil).[292] (Note 1)
(ii)(*aa*)	Assets acquired by a lessee from a lessor when there has been a recoupment under s 8(5)	Amount included in lessee's income under s 8(5), which reduced the purchase price of the asset. (Note 2)
(ii)(*bb*)	Assets the acquisition of which results in a taxable benefit under para (*i*) of the definition of the term '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. (Note 1)
(ii)(*cc*)	Obligatory improvements effected by a lessee under a lease which constitute gross income in the lessor's hands under para (*h*) of the definition of the term 'gross income'	Amount included in gross income *Less:* Amount of any allowance granted under s 11(*h*).

[292] The reference to an amount received or accrued was added by s 68(1) of the Revenue Laws Amendment Act 31 of 2005. The amendment came into operation on 8 November 2005 and applies in respect of any disposal on or after that date.

(ii)(*dd*)[293]	Assets the acquisition of which results in an amount being included in the person's gross income under para (*c*) of the definition of the term 'gross income' in s 1. This provision also establishes a base cost for any debt asset arising in the hands of the person rendering the service. For example, A renders a service to B for R100. A agrees to accept payment after 30 days. The base cost of A's debt asset is R100.	The value placed on the asset for the purposes of determining the amount so included in the person's gross income.
(iii)(*aa*)	Right in a controlled foreign company (CFC 1) held directly by a resident	The proportional amount of • the net income of CFC 1 included in the resident's income under s 9D during any tax year, and • the net income of any other CFC in which CFC 1 and the resident directly or indirectly have an interest that was included in the resident's income under s 9D during any tax year • *Less:* Foreign dividends distributed by CFC 1 that are exempt under s 10(1)(*k*)(ii)(*cc*).[294] **Note:** In determining the proportional amount of the net income of a CFC no regard must be had to the inclusion rate in para 10. (Note 3)
(iii)(*bb*)	A right in a CFC (CFC 2) held directly by another CFC (CFC 1)	An amount equal to • the proportional amount of the net income of ➢ CFC 2, and ➢ any other CFC in which both CFC 2 and CFC 1 directly or indirectly have an interest, which during any year of assessment would have been included in the income of CFC 1 under s 9D had it been a resident, *Less:*

[293] Sub-subitem (*dd*) added by s 68(1)(*c*) of the Revenue Laws Amendment Act 31 of 2005, and comes into operation on 8 November 2005 and applies in respect of any disposal on or after that date.

[294] The reference to s 10(1)(*k*)(ii)(*cc*) was inserted by the Revenue Laws Amendment Act 45 of 2003 with effect from 22 December 2003. Previously the provision referred to s 9E(7)(*e*)(i). Sub-subitem (*aa*) was amended by the Revenue Laws Amendment Act 31 of 2005 with effect from 8 November 2005. The purpose of the amendment was to simplify the provision by disregarding the inclusion rate.

		• The amount of any foreign dividend distributed by CFC 2 to CFC 1 if that dividend would have been exempt from tax under s 10(1)(*k*)(ii)(*cc*) had CFC 1 been a resident.[295] **Note:** In determining the proportional amount of the net income of a CFC no regard must be had to the inclusion rate in para 10. (Note 4)

The proviso to item (h)[296]

The purpose of this proviso is to prevent the effective duplication of expenditure forming part of the base cost of assets referred to in para 20(1)

- (*h*)(i) – marketable security or equity instrument acquired under s 8A or 8C,
- (*h*)(ii)(*bb*) – assets acquired by employees / directors that have been subject to fringe benefits tax under the Seventh Schedule, and
- (*h*)(ii)(*dd*) – assets acquired in exchange for services rendered (for example, by an independent contractor) that have been included in para (*c*) of the definition of the term 'gross income'.

In these cases, any expenditure actually incurred by that person in respect of the asset must be disregarded when it is incurred before the date

- on which the market value or value placed on the asset under the Seventh Schedule was determined, or
- on which the asset was disposed of, when the amount received or accrued from the disposal is taken into account in determining the gain or loss under s 8C (see note 1).[297]

Examples of the type of expenditure excluded by this proviso are

- the cost of an option contemplated under para 20(1)(*c*)(ix) when that option is to be used to acquire a s 8A marketable security or s 8C equity instrument, and

[295] Paragraph 0(1)(*h*)(iii) was amended by s 52 of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009. The amendment to subitem (iii)(*aa*) was merely textual, while the amendment to subitem (iii)(*bb*) ensured that the correct proportion of the net income of CFC 2 was added to the base cost of CFC 1's shares in CFC 2. Assuming resident held 80% of CFC 1 and CFC 1 held 80% of CFC 2, the provision previously appeared to erroneously add 80% x 80% = 64% of CFC 2's net income to the base cost of CFC 1's shares in CFC 2, instead of 80%.

[296] The proviso was inserted by the Revenue Laws Amendment Act 31 of 2005, came into operation on 8 November 2005 and applies in respect of any disposal on or after that date. As regards disposals before this date, the view is held that the actual acquisition costs would in any event have been eliminated by para 20(3)(*a*) since they were allowed in determining the income gain or loss. Alternatively, the specific provisions of para 20(1)(*h*)(i) and (ii)(*bb*) take precedence over the general provisions of para 20.

[297] Paragraph (*b*) of the proviso to para 20(1)(*h*) was inserted by the Revenue Laws Amendment Act 20 of 2006 and is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

- the strike price paid for that marketable security or equity instrument that would otherwise have been allowable under para 20(1)(*a*) when the option is exercised.

These costs are excluded because they are effectively reflected in the value of the asset included under para 20(1)(*h*).

Note:

1. The reference to an amount received or accrued was inserted following an amendment to s 8C. In certain circumstances the market value of the instruments is not used to determine the s 8C gain or loss, but rather the amount actually received or accrued from the disposal. For example, an employee who resigns may be obliged to sell the equity instruments back to the employer at cost. In these cases the s 8C gain or loss is determined using the actual amount received or accrued [see s 8C(2)(*a*)(i)].

2. A lessee who acquires an asset from a lessor at less than market value must include the difference between the market value and the amount paid for the asset in gross income under 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.

4. This adjustment applies when a lower-tier CFC is disposed of by a higher-tier CFC. When this happens it is necessary to determine the base cost of the shares in that lower-tier CFC so that the capital gain or loss arising in the higher-tier CFC can be determined and imputed to the resident under s 9D. As in note 3 above this provision prevents double taxation.

Base cost of restricted equity instruments disposed of to connected persons

In some cases an employee will dispose of shares to a connected person such as a relative or family trust while the shares are restricted under s 8C. When the equity instrument 'vests' (that is, the restriction is lifted), s 8C(5) deems the income gain or loss to arise in the hands of the employee. From a CGT perspective the wording of para 20(1)(*h*)(i) is wide enough to ensure that the connected person will receive a step-up in base cost equal to the market value of the share on which the employee was subjected to normal tax. The opening words of para 20(1) refer to an asset acquired by 'a person' – which would apply to the employee's trust or relative, while the base cost step-up under para 20(1)(*h*)(i) is granted if the gain or loss is taxed in the hands of '*any* person' (that is, the employee). Therefore the person acquiring the asset can add an amount to base cost under para 20(1)(*h*)(i) as long as some other person (the employee) is taxed under s 8A or 8C In this way economic double taxation of the employee and the family trust ore relative is averted.

Base cost of assets subject to fringe benefits tax

Under para 16(1)(*b*) of the Seventh Schedule an employee will be liable to income tax on the value of an asset transferred to say, a relative of the employee or the employee's family trust. With effect from the commencement of years of assessment ending on or after 1 January 2008, the relative or family trust will be able to secure a step-up in base cost under para 20(1)(*h*)(ii) for the asset acquired.[298] Before this date no step-up under this provision was possible because the provision only covered the situation in which the employee acquired the asset.

[298] The reference in para 20(1)(*h*)(ii)(*bb*) to 'that' person's gross income was replaced by a reference to 'any' person's gross income by s 73(*a*) of the Revenue Laws Amendment Act 35 of 2007.

Example 1 – Base cost of shares acquired under s 8A

Facts:

On 1 October 2001, Trevor is granted an option to acquire 1 000 shares in his employer, ComWorld Ltd at a price of R1 a share when the market price is R1,50 a share. He pays 10 cents a share for the options. On 28 February 2003 he exercises the options when the market price is R5 a share, and on 30 June 2006 he sells his shares at R8 a share.

Result:

The following gains will arise in Trevor's hands:

- 2003 year of assessment – an ordinary income gain under s 8A
- 2007 year of assessment – a capital gain.

These gains will be determined as follows:

Section 8A gain

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

Capital gain

	R
Proceeds 1 000 x R8	8 000
Less: Base cost 1 000 x R5	(5 000)
Capital gain	3 000

Note: The actual cost of the shares comprises the option cost of R100 and the purchase price of the shares of R1 000. These amounts are excluded from base cost by para 20(3)(*a*) since they would have been allowed as a deduction in determining the s 8A gain. 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 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 all the 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 before 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 resigns 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. The Trust subsequently sells the share for R150 with all parties settling their related loans.

Result:

The share vests in 2008 when the restriction lifts, triggering R100 of ordinary income for Jeremy. Under para 20(1)(*h*)(i) the Trust's base cost of the shares is R100 because the 'vesting . . . resulted in the determination of any gain or loss to be included in or deducted from . . . any person's income in terms of section . . . 8C'. The Trust has a capital gain of R50 on the sale (R150 proceeds less R100 base cost). The disposal by Jeremy to Anne and by Anne to the Trust must be disregarded under para 11(2)(*j*).

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

Facts:

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

Year of assessment ended	R
28 February 2001	10 000
28 February 2002	10 000
28 February 2003	10 000
29 February 2004	10 000
28 February 2005	10 000
	50 000

At the end of the 2005 year of assessment, 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. Under s 8(5) an amount of R48 000 (R50 000 – R2 000) was included in Andrew's income for the 2005 year of assessment. In 2010 Andrew sold the property for R65 000.

Result:

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

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

Andrew's capital gain is therefore R65 000 – R50 000 = R15 000

Example 5 – Determination of base cost of CFC [para 20(1)(*h*)(iii)(*aa*)]

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 000 on 19 December 2001. The receipts and accruals of the foreign company consist of the following:

	R
Foreign dividends	200 000
Capital gain on disposal of shares	400 000
Capital loss on disposal of shares	(100 000)

Result:

The net income of the CFC (disregarding the inclusion rate applicable to individuals) as contemplated in s 9D is R200 000 + R400 000 – R100 000 = R500 000. The base cost of the shares is determined as follows:

	R
Cost of shares [para 20(1)(*a*)]	200 000
Net income as above [para 20(1)(*h*)(iii)(*aa*)]	500 000
Base cost	700 000

Example 6 – Base cost of shares in multi-tier CFC structure [para 20(1)(*h*)(iii)(*bb*)]

Facts:

Sam, a resident, owns all the shares in CFC 1 which owns all the shares in CFC 2 which owns all the shares in CFC 3. Sam acquired all the shares in CFC 1 at a cost of R300 000 on 1 March 2007. At that date each CFC owned a portfolio of foreign listed shares valued at R100 000. On 29 February 2008 CFC 3 sold its portfolio of shares for R150 000 and reinvested the proceeds in other foreign listed shares. On 30 June 2008 CFC 3 declared a dividend of R25 000 to CFC 2 which on-declared it to CFC 1 which on-declared it to Sam. On 31 December 2008 CFC 1 disposed of its interest in CFC 2 for R275 000.

Result:

The disposal of listed shares by CFC 3 gives rise to a capital gain of R50 000 which is taxed in Sam's hands under s 9D (that is, R50 000 x 25% = R12 500 was included in Sam's taxable income). The base cost of CFC 1's shares in CFC 2 is determined as follows:

	R
Market value of shares on date CFC 2 became a CFC [para 12(2)]	200 000
Net income of CFC 3 (disregarding inclusion rate)	50 000
Less: Exempt dividend [s 10(1)(*k*)(ii)(*cc*)]	(25 000)
	225 000

Capital gain = R275 000 – R225 000
= R50 000

Check: The value of the listed investments in CFC 2 and CFC 3 increased by R100 000 from the date CFC 1 became a CFC until it disposed of CFC 2. Of this, R50 000 was taxed in Sam's hands on 29 February 2008. The remaining R50 000 capital gain arises on 31 December 2008 when CFC 1 disposes of the shares in CFC 2.

8.14 Base cost – asset acquired as a result of a 'value shifting arrangement' [para 20(1)(*h*)(iv)]

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

8.15 Base cost – asset acquired by heirs or legatees from non-resident estate [para 20(1)(*h*)(v)]

The base cost of an asset inherited by a person from a non-resident estate is determined as follows:

8.15.1 Paragraph 2(1)(b) assets [proviso to para 20(1)(h)(v)]

This category applies to

- immovable property in South Africa or any interest or right of whatever nature to or in such property, and
- assets of a permanent establishment in South Africa.

The base cost of these assets must be determined by both residents and non-residents under para 40(2)(*b*). Under that provision, the heir, legatee or trustee acquires the asset at the base cost to the deceased estate (market value on date of death plus any further para 20 expenditure incurred by the executor).

8.15.2 All other assets [para 20(1)(h)(v)][299]

The base cost of all other assets (for example, listed shares) is determined under para 20(1)(*h*)(v) which follows the same treatment as in para 40(2)(*b*). The asset is deemed to be acquired for an amount equal to

- the market value determined immediately before the death of the deceased person, and
- any further expenditure incurred by the executor of the estate under para 20 in the process of winding up the estate.

8.15A Base cost – asset acquired from a non-resident by way of donation, consideration not measurable in money or connected person transaction at a non-arm's length price [para 20(1)(*h*)(vi)]

An asset is deemed to be acquired at market value on the date of acquisition when

- it is acquired on or after the valuation date,
- from a person who at the time of that acquisition was not a resident,
- by way of donation, consideration not measurable in money, or transaction between a connected person not at an arm's length price.[300]

[299] Under s 107(2) of the Revenue Laws Amendment Act 20 of 2006 para 20(1)(*h*)(v) comes into operation as from the commencement of years of assessment ending on or after 1 January 2007. Before that date such assets will have a base cost of nil.

[300] Paragraph 20(1)(*h*)(vi) was introduced by s 77(1)(*c*) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

This provision was introduced because of concern that para 38(1) did not apply to disposals of non-South African source assets by non-residents. As with para 38, it does not apply to assets acquired before the valuation date. Except when the transitional rules in para 97 apply, the actual cost of acquisition (if any) of assets acquired under these circumstances must be used for pre-valuation date assets when TAB is adopted. Paragraph 12(5) overrides this provision, with the result, for example, that if a non-resident waives a debt owed by a resident, the resident will have a capital gain equal to the amount discharged. In other words, the debt will be deemed to be acquired at a base cost of nil under para 12(5) instead of at a base cost equal to market value under this provision.

Amounts excluded from base cost

Paragraph 20(2) and (3)

8.16 Exclusions – certain current costs [para 20(2)]

Except to the extent permitted under para 20(1)(*g*) (see **8.12**) 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 under 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.

Reductions in base cost

Paragraph 20(3)

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

8.17 Reduction – expenditure already allowed [para 20(3)(*a*)]

The expenditure in para 20(1)(*a*) to (*g*) must be reduced by any amount that

- is or was allowable or is deemed to have been allowed in determining taxable income [para 20(3)(*a*)(i)], and

- is not included in the taxable income of that person under s 9C(5) [para 20(3)(*a*)(ii)],[301]

before the inclusion of any taxable capital gain.

This provision prevents the double deduction of expenditure.

The words 'or is deemed to have been allowed' were inserted to deal with assets of a micro business referred to in the Sixth Schedule.[302] Under ss 11(*e*)(ix), 12C(4A), 12D(3A), 12DA(4), 12F(3A) and 37B(4) a taxpayer is deemed to have been allowed the applicable capital allowances granted under those sections during years of assessment when the asset has been used in the taxpayer's trade but the receipts or accruals from that trade were not included in the taxpayer's income during those years of assessment. This will be relevant in determining the base cost of an asset that was used in a micro business but is subsequently moved out of such a business, say, because the person's turnover exceeds the threshold required in order to remain within the presumptive turnover tax regime.

Section 9C(5) provides for a recoupment of expenditure claimed under section 11 by a share-dealer when qualifying equity shares are disposed of after having been owned by the seller for a continuous period of at least three years. Were it not for para 20(3)(*a*)(ii) the recouped expenditure could not be added to the base cost of the shares because it was originally 'allowable' notwithstanding that it was later recouped. Nevertheless, in order to qualify as part of the base cost of the shares, such recouped expenditure must still satisfy the requirements of para 20. Not all such expenditure will qualify under para 20; for example, only one-third of the interest incurred on funds borrowed to acquire listed shares or participatory interests in collective investment schemes will qualify as part of base cost, while no portion of interest on funds borrowed to acquire unlisted shares will qualify [para 20(1)(*g*)].

Paragraph 20(3)(*a*) does not apply to amounts included in base cost by para 20(1)(*h*). However, the proviso to para 20(1)(*h*) prevents any double deduction of expenditure.

Example – Application of para 20(3)(*a*)

Facts:

Hazel bought a bakkie at a cost of R100 000 on 1 March 2004. At the time of its disposal on 28 February 2007 she had claimed wear-and-tear allowances of R60 000 under s 11(*e*).

Result:

Under para 20(3)(*a*) the base cost of Hazel's bakkie is R100 000 – R60 000 = R40 000.

[301] Paragraph 20(3)(*a*)(ii) inserted by s 95 of the Taxation Laws Amendment Act 7 of 2010 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2011.

[302] Introduced by s 77(1)(*d*) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

8.18 Reduction – expenditure recovered or recouped [para 20(3)(*b*)]

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

The expenditure contemplated in para 20(1)(*a*) to (*g*) must be reduced when an expense has for any reason been

- reduced,
- recovered,
- become recoverable from any other person, or
- been paid by any other person.

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

In *C: SARS v Pinestone Properties CC*[303] the court held that the onus was on SARS to show that an amount previously allowed to be deducted had been recovered or recouped by the taxpayer.

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

- section 8(4)(*a*), or
- para (*j*) of the definition of the term 'gross income' (which deals with the recoupment of certain mining capital expenditure).

Under the proviso to para 20(3), para 20(3)(*b*) also does not apply in respect of a government grant or government scrapping payment that is provided in respect of programmes or schemes that the Minister has identified by notice in the *Gazette* for purposes of para 20(3).

Under para 12(5)(*a*)(*aa*)(B), para 12(5) does not apply to the extent that para 20(3) applies (see **6.2.5.10**). In other words, para 20(3)(*b*) takes precedence over para 12(5). Paragraph 20(3)(*b*) will apply when A buys an asset from B on credit, and B later waives all or a part of the debt while A still holds the asset. If A has disposed of the asset at the time of the waiver, A will have a capital gain under para 3. But if A borrows money from C to pay B for the asset, and C later waives part of the debt para 20(3)(*b*) will not apply since there has been no recovery of the expenditure incurred by A on the asset. Instead, A will have a capital gain under para 12(5) while C will have a capital loss, subject to para 56.

Example – Reduction in expenditure

Facts:

Uriah buys an asset from Vlok for R50 000 in five equal annual instalments of R10 000. After seven years Uriah has still not paid the last instalment. Vlok agrees to accept R6 000 in full and final settlement.

[303] 2002 (4) SA 202 (N), 63 SATC 421 at 426.

Result:

The expenditure in respect of Uriah's asset has been reduced by R4 000 (R10 000 – R6 000), and its base cost will therefore be R50 000 – R4 000 = R46 000.

Shares acquired cum div

A dividend received shortly after the acquisition of a share the price of which includes the value of the dividend is not regarded as a recovery of cost under para 20(3)(*b*). There is no guarantee that the price of a share will drop after the declaration of a dividend (see *Tod's* case).[304] Also, given that the major part of the value of a share usually comprises the right to receive dividends, there does not seem to be any justification for treating a dividend received soon after acquisition of the share as a recovery of cost, while treating other dividends as receipts or accruals of gross income. Paragraph 19 addresses the disregarding of a capital loss arising on disposal of a share as a result of the receipt or accrual of a pre-acquisition dividend.

Purchased annuities under s 10A

The capital element of a purchased annuity referred to in s 10A is regarded as a return of the expenditure incurred under para 20 in acquiring the annuity.

Loan repayments

See **24.4** on the treatment of loan repayments as a cost recovery.

8.19 Reduction – para 20(3)(*c*)

Paragraph 20(3)(*c*) in its original form was deleted and later reinserted. The current version, however, fulfills an entirely different purpose to the initial version. The table below summarises the changes to para 20(3)(*c*) since it was first introduced into the Eighth Schedule. For the sake of completeness the commentary on the old version is retained in **8.19.1** below, while the current version is dealt with in **8.19.2**.

Table 1 – Amendments to para 20(3)(*c*)

Amending Act	Commencement date	Purpose
Taxation Laws Amendment Act 5 of 2001	Any disposal on or after 1 October 2001	Reduces base cost by any amount included therein by para 20(1) and (2) which has not been paid and is not due and payable in a year of assessment.
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.	Deletes para 20(3)(*c*)
Revenue Laws Amendment Act 20 of 2006	The reinsertion is deemed to have come into operation as from the commencement of years of assessment ending	Reduces expenditure in para 20(1)(*a*) to (*g*) in respect of any amount which is

[304] *CIR v Tod* 1983 (2) SA 364 (N), 45 SATC 1.

	on or after 1 January 2007.	• exempt from tax under s 10(1)(*y*) or (*y*A), • is granted or paid for purposes of the acquisition of an asset, and • not identified for exclusion from para 20(3)(*c*) by the Minister by notice in the Gazette. This provision relates to Government grants, scrapping payments and ODA assistance amounts.

8.19.1 Reduction – expenditure unpaid and not due and payable [old 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.

Before the deletion of para 20(3)(*c*), the expenditure in para 20(1)(*a*) to (*g*) incurred by a person had to be reduced by any amount

> 'which has not been paid and is not due and payable in a year of assessment'.

This was essentially an anti-avoidance measure. In order 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.[305] The more difficult question arises when the amount owed is replaced by a new loan. It is impossible 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.[306]

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

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 1 – 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 three years.

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 2 – 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 **8.40.5**.

8.19.2 Reduction – Government grants, scrapping payments and ODA assistance amounts [current para 20(3)(c)]

Paragraph 20(3)(*c*) was reinserted by the Revenue Laws Amendment Act 20 of 2006, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

The expenditure incurred by a person in respect of an asset in para 20(1)(*a*) to (*g*) must be reduced by any amount which is exempt from tax under s 10(1)(*y*) or (*y*A) and is granted or paid for purposes of the acquisition of an asset.

Section 10(1)(*y*) exempts from normal tax any government grant or government scrapping payment received or accrued under any programme or scheme which has been approved under the national annual budget process and has been identified by the Minister by notice in the *Gazette.*

Section 10(1)(*y*A) exempts from normal tax any amount received by or accrued to any person (for example, a foreign donor or multinational company) in respect of goods or services provided to beneficiaries under an official development assistance (ODA) agreement, and in respect of projects approved by the Minister and exempted by notice in the *Gazette*.

The purpose of this provision is to prevent so-called 'double-dipping'. Double-dipping occurs when a recipient of exempt income uses that exempt amount to purchase an asset, and then claims that amount as part of the base cost of the asset. The reduction in base cost will, however, not apply to government grants or scrapping payments relating to a project identified by the Minister by notice in the *Gazette* for purposes of para 20(3)(*c*). This relaxation could occur, for example, when the grant or scrapping payment takes into account the double dip. For example, assume that a company is given a tax-free grant of R100 in order to buy an asset. Assuming that para 20(3)(*c*) applies, the cost to the *fiscus* is R28. The *fiscus* would suffer the same cost if it reduced the tax-free grant to R66,67 and allowed the double dip [(R66,67 x 28% = R18,67) + (R66,67 x 50% x 28% = R9,33) = R28].

8.20 Base cost – adjustment for currency gain or loss exclusion under s 24I(11A) [para 20(4)][307]

This provision must be read with s 24I(11A). Section 24I(11A) deals with the situation in which a resident enters into a forward exchange contract or foreign currency option contract for the purpose of acquiring the equity shares in a foreign company. For s 24I(11A) to apply the resident

- must acquire at least 20% of the equity shares in the foreign company under the transaction,
- the acquired company must be a CFC after the transaction, and
- under IFRS the exchange gain or loss in respect of the hedge must not be reflected in the resident's income statement (IAS 39 refers).

In these circumstances the currency hedge gain or loss is excluded for normal tax purposes. However, the *quid pro quo* for this exclusion is that the base cost of the equity shares must, under para 20(4), be

- reduced by any excluded currency gain or premium received, or
- increased by any excluded currency loss or premium paid.[308]

[307] Paragraph 20(4) was inserted by s 45(1)(*e*) of the Revenue Laws Amendment Act 20 of 2006 and deemed to have come into operation on 31 December 2006 and applies in respect of any year of assessment ending on or after that date.

[308] The reference to a premium received or paid was inserted by s 60(1)(*b*) of the Taxation Laws Amendment Act 8 of 2007, and deemed to have come into operation on 31 December 2006 and applicable in respect of any year of assessment ending on or after that date.

Section 24I(11A) also applies when the shares in the foreign company are acquired by a member of a group of companies as defined in s 1, but the hedge is taken out by another member of the same group. In this scenario the hedge exchange gain or loss may only be excluded by the hedging company if it is not reflected in the consolidated income statement of the group for the purposes of IFRS (when both the acquiring company and the hedging company are part of that group). The acquiring company must reduce the base cost of the equity shares by the amount of any exchange gain and increase it by the amount of any exchange loss that was excluded in the hands of the hedging group company.

Example – Adjustment of base cost as a result of the application of s 24I(11A)

Facts:

On 1 March 2007 resident Holdco enters into negotiations to acquire 51% of the equity shares in foreign Subco at a price of $100 000. On the same date Holdco took out a forward exchange contract of $100 000 at R7,10 = $1 to cover the expected purchase. At the time the expected acquisition was considered to be a 'highly probable forecast transaction' that qualified as a 'cash flow hedge' under IAS 39.[309] On 31 July 2007 the contract for the acquisition of the shares was concluded and the purchase price was settled on the same date. Holdco elected to reduce the initial cost of the shares by the exchange gain on the FEC (that is, the gain was not reflected in its income statement).[310]

The spot rates were as follows:

1 March 2007	R7,09 = $1
31 July 2007	R7,20 = $1

Result:

Holdco has the following exchange gain in respect of the FEC:

	R
Proceeds $100 000 x R7,20	720 000
Less: Cost $100 000 x R7,10	(710 000)
Exchange gain	10 000

The exchange gain on the FEC is disregarded under s 24I(11A). The base cost of the Subco shares is determined as follows:

	R
Expenditure actually incurred [para 20(1)(*a*)][311]	720 000
Less: Exchange gain on FEC disregarded under s 24I(11A) [para 20(4)]	(10 000)
Base cost	710 000

8.21 Base cost – exclusion of value-added tax allowed as input tax deduction (s 23C)

Section 23C ensures that value-added tax cannot be claimed as a deduction under the Income Tax Act when it has been allowed as an input tax deduction under s 16(3) of the Value-Added Tax Act 89 of 1991. See also the remarks on VAT in the determination of market value under para 31.

[309] See definition of 'hedged item' in para 9 of IAS 39 'Financial Instruments: Recognition and Measurement'.
[310] Under para 98(*b*) of IAS 39.
[311] Incurred at the spot rate on 31 July 2007.

8.22 Base cost – farming development expenditure (para 20A)

Paragraph 20A

This paragraph was inserted by the Revenue Laws Amendment Act 45 of 2003 and applies to any disposal on or after 22 December 2003.

8.22.1 The position before 22 December 2003

Farmers are entitled to claim certain capital development expenditure (CDE) in the year of incurral under para 12(1)(*a*) to (*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, while expenditure on a movable dipping tank can be recouped in the special manner discussed below.

While recoupments of CDE in respect of movable assets may not be included in taxable income under s 8(4)(*a*), they are dealt with by first reducing any qualifying balance of CDE brought forward from the previous year under para 12(3B). To the extent that the qualifying balance is insufficient, the excess is included in farming income.

8.22.2 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 under the First Schedule.

The base cost of an asset must be reduced under para 20(3)(*a*) to the extent that the farmer has had a deduction against farming income in respect of CDE under para 12(1) of the First Schedule, 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 under para 35, except to the extent it has been recouped under para 12 of the First Schedule.

Under 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? Paragraph 35(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). A farmer who discontinues farming operations during a year of assessment and does not recommence those operations during the following year of assessment will forfeit any unutilised balance of CDE.[312] Before the introduction of para 20A the Act did not allow for any portion of this forfeited balance to be claimed as a capital loss.

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	
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 brought forward	(8 000)
Recoupment (restricted to qualifying balance)	8 000
Qualifying balance	Nil
Farming income before any CDE	30 000
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 brought forward from year 1, and R2 000 was included in income.

R

[312] This follows from s 26 of the Act. See 'Farming – Expenditure on Improvements – Cessation of Farming Operations' *Income Tax Practice Manual* at [A:F13].

Cost of movables	10 000
Less: Amount allowed as CDE under para 12(1)	(10 000)
Base cost (para 20)	Nil
Proceeds	2 000
Less: Base cost	-
Capital gain	2 000

Example 2 – Capital development expenditure and immovable assets

Facts:

In year 1 Mr Brown purchased some farmland 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 under 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 to 10.

Result:

Mr Brown's capital gain on disposal of the land will be as follows:

	R
Proceeds	800 000
Less: Base cost	(500 000)
Capital gain	300 000

Note: 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 under 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.

8.22.3 The position on or after 22 December 2003

Paragraph 20A was inserted by s 96 of the Revenue Laws Amendment Act 45 of 2003, came into operation on 22 December 2003 and applies to any disposal on or after that date.

8.22.3.1 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.

8.22.3.2 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 under 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.

Paragraph 12(1A) of the First Schedule deems expenditure contemplated in para 12(1)(*a*), (*b*), (*d*) or (*e*) of that Schedule on conserving and maintaining land to be incurred in carrying on farming operations. The work must be undertaken under an agreement entered into under s 44 of the National Environmental Management: Biodiversity Act 10 of 2004.

8.22.3.3 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 on which farming operations have ceased. This could happen upon the death of a farmer or when 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.

8.22.3.4 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 under para 20. CDE qualifying under para 12(1)(*c*) to (*i*) of the First Schedule is limited to income from farming operations. The result is that when 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. Under 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.

8.22.3.5 Why is CDE forfeited on cessation of farming operations?

As a 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. A person who ceases to carry on farming operations during a year of assessment may not carry forward any unutilised CDE to the next succeeding year of assessment if the person does not carry on farming operations in that succeeding year.[313] A fatal interruption occurs because the First Schedule ceases to be applicable and there is no other mechanism in the Act under which the CDE can be

[313] 'Farming – Expenditure on Improvements – Cessation of Farming Operations' *Income Tax Practice Manual* at [A:F13].

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.[314] 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.

8.22.3.6 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.

8.22.3.7 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

- the year of assessment in which the farm property is sold, and
- when 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 using 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 use 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 farming operations will be recommenced before the end of the succeeding year of assessment, and

[314] See *Silke on South African Income Tax* in §15.30.

- 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 when 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.

8.22.3.8 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. If a portion of CDE has been utilised against farming income on or after 1 October 2001, 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.

8.22.3.9 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 in respect of which election can be made

When immovable property acquired	CDE limited to
Before valuation date	Proceeds reduced by any other amount allowable under para 25, namely, the • valuation date value under 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 when 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 28 February 2008 he decided to discontinue farming operations and converted his farm into a tourist resort. At the end of the 2008 year of assessment, Frikkie had unutilised CDE of

R200 000, all incurred after the valuation date. On 28 February 2009 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 2009 year of assessment 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	R
Proceeds		1 000 000
Less: Valuation date value	800 000	
Post-1 October 2001 improvements	30 000	(830 000)
CDE qualifying to be added to base cost		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. He must make the election in his 2009 return of income. Should he make the election it will result in no capital gain or loss on disposal of the property, determined as follows:

	R	R
Proceeds		1 000 000
Less: Market value on 1 October 2001	800 000	
Unutilised CDE (limited)	170 000	
Improvements – 2009	30 000	(1 000 000)
Capital gain or loss		-

Example 2 – Limitation on CDE when 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:

	R
On or after valuation date	50 000
Before valuation date	20 000

TAB disregarding CDE [para 20A(2)]
TAB = B + [(P – B) x N/(N + T)]
= R100 000 + [(R150 000 – R100 000) x 5/10]
= 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
= R120 000

TAB = B + [(P – B) x N/(N + T)]
= R100 000 + [(R120 000 – R100 000) x 5/10]
= R100 000 + R10 000
= 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 = B + [(P – B) x N/(N + T)]
= R125 000 + [(R150 000 – R125 000) x 5/10]
= R125 000 + R12 500
= R137 500

Capital gain = R150 000 – R137 500
= R12 500

John would therefore use LIFO.

8.22.3.10 Restriction when 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 when 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 when 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 under para 12(1)(*c*) to (*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
Before 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 before the valuation date as the market value basis has been adopted.

8.23 Base cost – prevention of double deductions (para 21)

Paragraph 21

This paragraph embodies more or less the same principles contained in s 23B (prohibition of double deductions). Its purpose is twofold.

First, when 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-counting' provision.)

Secondly, no expenditure shall be allowed under para 20(1)(*a*) or (*e*) when it has in fact qualified under any other provision of the Eighth Schedule but has been limited under that other provision. (An 'anti-carry forward' provision.) As an example, in the case of a disposal of an asset by way of donation, when the donor pays donations tax, under para 20(1)(*c*)(vii), the donations tax allowable as expenditure for purposes of determining base cost is calculated under para 22. Any balance that is not allowable as expenditure under this paragraph may not then qualify as 'expenditure actually incurred' under para 20(1)(*a*).

8.24 Base cost – amount of donations tax to be included (para 22)

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 **8.7**.

8.25 Base cost – 'value shifting arrangement' (para 23)

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 **21.3**.

8.26 Base cost – asset of a person who becomes a resident (para 24)

Paragraph 24

This paragraph applies when

- a person becomes a resident on or after 1 October 2001, and
- disposes of an asset acquired before that person became a resident or CFC.

When the circumstances in para 24(2) and (3) are applicable, those provisions will substitute a different base cost for the market-value-based one determined under para 12(2)(*a*) or (4). In essence para 24 is a gain and loss limitation rule known as a 'kink test'.

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.

Under para 24(1) the base cost of such assets is equal to the sum of

- the value of that asset determined under para 24(2) or (3), and
- the expenditure allowable under para 20 incurred on or after that date in respect of that asset.

Certain assets are excluded from para 24, namely,

- immovable property in the Republic [para 2(1)(*b*)(i)],
- assets of a permanent establishment situated in the Republic [para 2(1)(*b*)(i)], and
- an asset held by a person if any amount received or accrued from the disposal of the asset would be taken into account for purposes of determining the net income as contemplated in s 9D of that person, acquired by a person before the date on which that person became a resident.[315]

The assets referred to in the first two bullet points above are taxed on a source basis and are not influenced by any change in the residence status of the owner. The s 9D passive assets referred to in the third bullet point are excluded from para 24 because under para 12(1) read with para 12(4) they are not subject to deemed disposal and reacquisition treatment when a CFC becomes a resident. The exclusion of these assets under para 24(1) seems superfluous, since they (together with other assets) are in any event excluded from para 12(2)(*a*) and (4).

[315] These words were inserted into para 24(1) by s 78(1)(*a*) of the Revenue Laws Amendment Act 60 of 2008, and deemed to have come into operation on 21 February 2008 and applicable in respect of an asset disposed of on or after that date, unless that disposal is the subject of an application for an advance tax ruling accepted by the Commissioner before that date.

This paragraph does not apply to persons who became residents before 1 October 2001 [para 24(4)]. Such residents will be subject to the normal rules and would have to determine the valuation date value of their assets under paras 25, 26, 27 and 28.

Under para 12(2)(*a*) read with para 13(1)(*g*) persons becoming resident in South Africa are deemed to have disposed of and re-acquired their assets (other than the South African-source assets listed below) at market value on the date immediately before the day on which they become resident. The South African-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 [para 12(2)(*a*)(i)],
- an asset of a permanent establishment through which that person carries on a trade in the Republic during the year of assessment [para 12(2)(*a*)(i)],
- any qualifying equity share contemplated in s 8B, which was granted to that person less than five years before the date on which that person ceased to be a resident [para 12(2)(*a*)(ii)],
- any equity instrument contemplated in s 8C, which had not yet vested as contemplated in that section at the time that the person ceased to be a resident [para 12(2)(*a*)(iii)], and
- any right to acquire any marketable security contemplated in s 8A [para 12(2)(*a*)(iv]).

Under para 12(4) a CFC that becomes a resident is deemed to dispose of and reacquire each of its assets at market value immediately before it ceases to be a CFC. This provision excludes immovable property in South Africa and assets of a PE in South Africa listed in para 2(1)(*b*)(i) and (ii) and any asset the capital gain or loss from the disposal of which would have been included in the net income of the CFC under s 9D. It follows that by a process of elimination, the deemed disposal and reacquisition rule under para 12(4) applies to foreign business establishment assets of the CFC which would have been exempt from CGT when disposed of.

There is no time limit for the determination of the market values established under para 12(2)(*a*) or (4) – see notes at the end of this paragraph.

This paragraph envisages two distinct cases.

Scenario 1 – Proceeds and pre-residence expenditure are each lower than market value on day before becoming resident [para 24(2)]

The first scenario deals with the situation in which both the proceeds and the allowable expenditure, as contemplated in para 20, incurred before becoming a resident are less than the market value determined on the day immediately before becoming resident. In this case the person who becomes a resident or CFC is treated as having acquired the pre-residence asset at a cost equal to the higher of

- the expenditure allowable under para 20 incurred in respect of that asset before the date of becoming a resident; or
- those proceeds less the expenditure allowable under para 20 incurred on or after that date in respect of that asset.

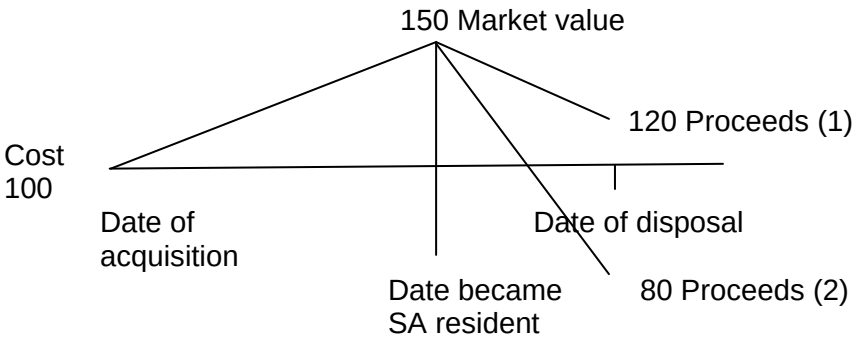
The expenditure allowable under para 20 actually incurred before becoming resident for the above purpose refers to the actual pre-residence expenditure. It is not the market value

determined under para 12(2)(*a*) or (4) on the day before becoming resident, which is deemed to be para 20 expenditure under para 12(2)(*a*)[316] or (4).

Two permutations are possible under the first scenario:

- Proceeds may be higher than expenditure before residence, or
- proceeds may be lower than expenditure before residence.

Example 1 – Proceeds and cost less than market value



In case (1) proceeds must be used thereby eliminating the loss of R30 (R150 – R120).
In case (2) historical cost must be used resulting in a loss of R20 rather than R70 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
Less: Base cost	(100 000)	(125 000)
Capital gain / (loss)	Nil	(50 000)

Note:

1. The base cost under permutation 1 is R75 000 + R25 000 and under permutation 2 is R100 000 + R25 000.

2. In both permutations, the market value is not considered and the actual capital gain or loss allowable is determined in relation to historic cost.

[316] This was clarified by amendments to s 24(2) and (3) effected by s 69 of the Revenue Laws Amendment Act 31 of 2005, which were deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2006.

Scenario 2 – Proceeds and market value on day before becoming resident are each lower than pre-residence expenditure [para 24(3)]

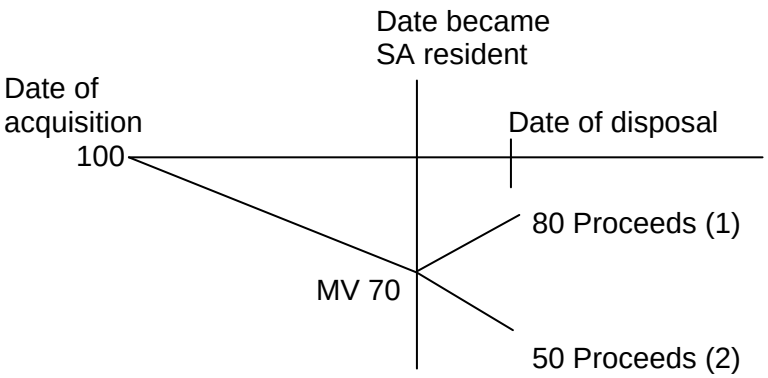
The second scenario occurs when both the proceeds and the market value on the day before becoming resident are lower than the allowable expenditure, as contemplated in para 20, incurred before becoming a resident. In this case the person who becomes a resident is treated as having acquired that asset at a cost equal to the higher of:

- the market value; or
- those proceeds less the expenditure allowable under para 20 incurred on or after that date in respect of that asset.

Again, two permutations are possible under the second scenario. The proceeds may be

- higher than market value, or
- lower than market value.

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 R10 that would have arisen had market value been used.
In case (2), market value must be used resulting in a loss of R20 (R50 – R70) compared to the loss of R50 that would have resulted had historical cost been used.

Example 4 – Proceeds and market value less than cost

	Permutation 1 R	Permutation 2 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
Less: Base cost	(100 000)	(125 000)
Capital gain / (loss)	Nil	(50 000)

Note: The base cost under permutation 1 is R75 000 + R25 000 and under permutation 2 is R100 000 + R25 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 when there is no record of expenditure. Despite this, the Commissioner may apply s 78 to estimate the amount of the expenditure using available information.

Time period for performing valuations

Under para 12(2)(*a*) a person that commences or ceases to be a resident or a CFC (except when para 12(4) applies) must be treated as having disposed of that person or company's 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*). A similar rule under para 12(4) applies to the foreign business establishment assets of a CFC that becomes a resident.

These persons are responsible for valuing their assets. If a person fails to value an asset, the Commissioner can estimate its value under s 78.

Unlike para 29(4) which requires that pre-valuation date assets be valued within three years of valuation date, para 12(2)(*a*) and (4) set 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 under s 82(*b*). Regardless of when the valuation is done, the fact remains that a valuation is mandatory.

8.27 Base cost – pre-valuation date assets (para 25)

Paragraph 25

8.27.1 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 under para 26, 27 or 28, and the expenditure allowable under 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

Paragraph 25 does not apply to a person who has adopted the weighted-average method for valuing certain categories of identical assets under para 32(3A). 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 could be one of the following:

- Market value on 1 October 2001
- Time-apportionment base cost (TAB)
- 20% x (Proceeds – post-valuation date expenditure)
- Proceeds – post-valuation date expenditure

8.27.2 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 years of assessment.

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 following table 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.
- If 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 under para 3(*b*)(iii)(*aa*) (capital gain) or para 4(*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 when 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, Under 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 when 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 year of assessment

During the 2005 year of assessment Ruzanne's capital loss of R30 000 was disregarded under para 26(3). Under that provision the valuation date value of the land was deemed to be R120 000.

2007 year of assessment

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 under para 25(2). The revised capital gain is determined as follows:

	R
Proceeds R120 000 + R35 000	155 000
Less: Base cost	(150 000)
Capital gain	5 000

Example 2 – Redetermination of capital gain upon accrual of further proceeds when 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 year of assessment

In 2005 Ruzanne had a capital gain of R5 000 (R155 000 proceeds less R150 000 base cost).

2007 year of assessment

In 2007 Ruzanne will have a redetermined capital gain of R40 000.

	R
Proceeds R155 000 + R35 000	190 000
Less: 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 under para 3(*b*)(iii)(*aa*). The earlier year capital gain of R5 000 is treated as a capital loss in the current year under 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 when 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 year of assessment

TAB = B + [(P – B) x N/(N + T)]
= R200 000 + [(R500 000 – R200 000) x 3/6]
= R200 000 + R150 000
= R350 000

	R
Proceeds	500 000
Less: Base cost	(350 000)
Capital gain	150 000

2006 year of assessment

P = R500 000 + R100 000
= R600 000

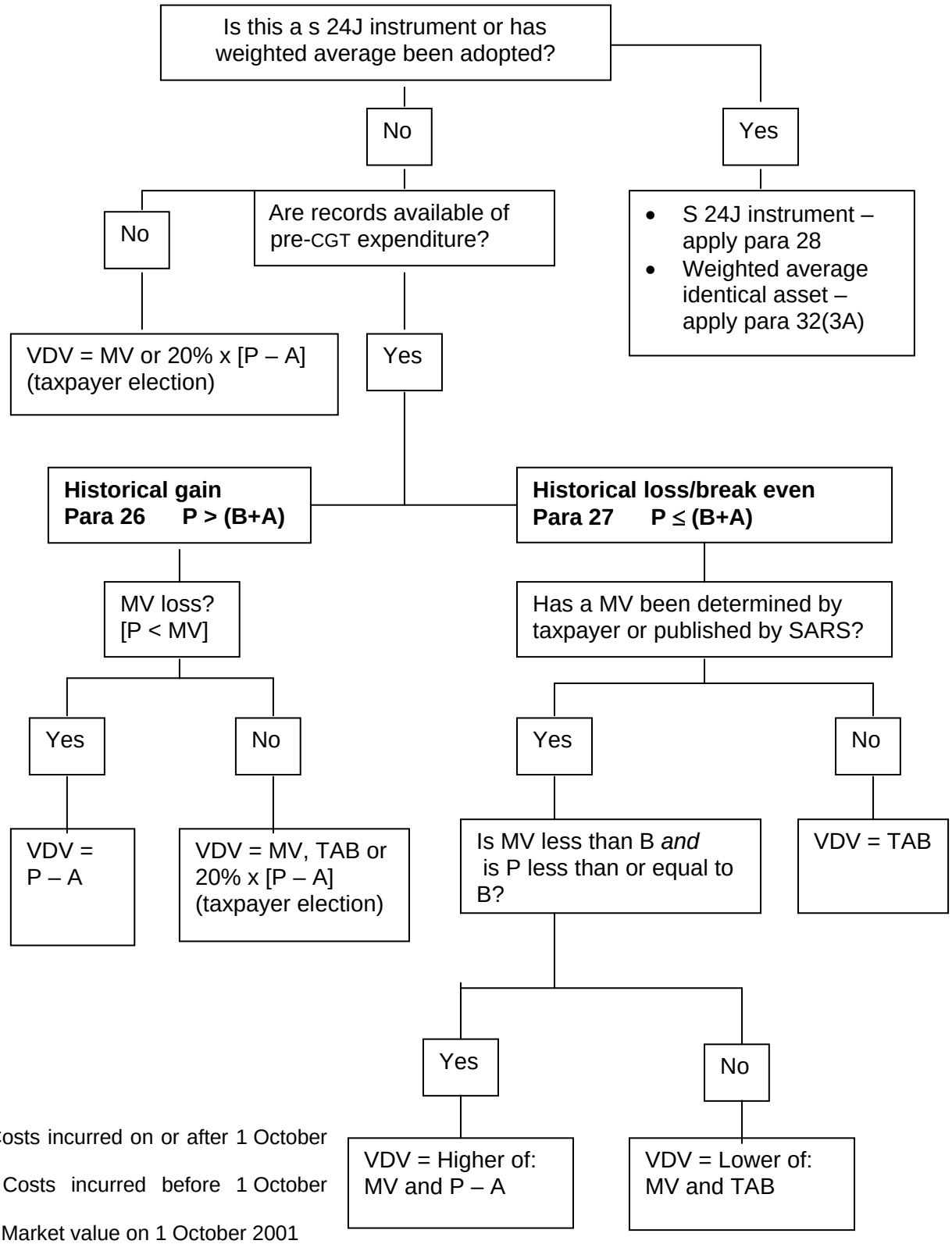
TAB = B + [(P – B) x N/(N + T)]
= R200 000 + [(R600 000 – R200 000) x 3/6]
= R200 000 + R200 000
= R400 000

	R
Proceeds	600 000
Less: Base cost	(400 000)
Capital gain	200 000

The earlier 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 under para 3(*b*)(iii)(*aa*). The net result is that an amount of R50 000 will be subject to CGT in 2006.

Note: The number of years after valuation date ('T' in the TAB formula) remains unchanged at three years despite the fact that the additional proceeds were received five years after valuation date.

Overview of paras 26 and 27



KEY:
A = Costs incurred on or after 1 October 2001
B = Costs incurred before 1 October 2001
MV = Market value on 1 October 2001
P = Proceeds
TAB = Time-apportionment base cost
VDV = Valuation date value

8.28 Valuation date value – when proceeds exceed expenditure or expenditure in respect of an asset cannot be determined (para 26)

Paragraph 26

8.28.1 Introduction

The base cost of a pre-valuation date asset is equal to its valuation date value plus any allowable para 20 expenditure incurred on or after the valuation date [para 25(1)]. The 'valuation date value' is therefore a key component making up the base cost of a pre-valuation date asset, its purpose being to provide a base cost starting point that will eliminate pre-CGT gains and losses when the asset is disposed of. The rules for determining the valuation date value of an asset are contained in paras 26 and 27. These provisions also contain anti-avoidance measures that limit losses under certain conditions. Two categories of asset fall outside these rules, namely, certain classes of identical asset in respect of which the weighted-average method has been adopted under para 32(3A), and s 24J instruments which are addressed under para 28.

Paragraph 26 determines the valuation date value of an asset for which

- the pre-valuation date expenditure is known, and the asset is disposed of at an historical gain, that is, the proceeds from its disposal exceed the allowable para 20 expenditure incurred before, on and after the valuation date [para 26(1)], and
- the pre-valuation date expenditure is unknown (para 26(2).

Paragraph 26(3) contains a loss limitation rule that applies when the market value method is adopted.

Paragraph 27 on the other hand deals with the situation when the pre-valuation date expenditure is known and the disposal of the asset results in an historical loss or break-even situation.

Unlike para 27 which is prescriptive in the methods that must be used in determining a valuation date value, a person disposing of an asset falling under para 26 has the freedom to choose the method that gives the most favourable result. This freedom of choice may, however, be restricted in two respects. First, para 26(3) will substitute a no gain or loss rule when the market value method is adopted under para 26(1)(*a*) and a capital loss results. Secondly, the option to adopt the market value method depends on compliance with para 29.

8.28.2 Valuation date value methods when proceeds exceed allowable para 20 expenditure [para 26(1)]

This paragraph sets out the method for determining the valuation date value of a pre-valuation date asset disposed of on or after the valuation date if

- the pre-valuation date expenditure in respect of the asset is known,
- proceeds exceed expenditure allowable under para 20 incurred before, on and after the valuation date (an historical gain);
- that asset is not an instrument as defined in s 24J of the Act (these assets are dealt with under para 28), and
- the asset is not part of a class of identical assets to which para 32(3A) applies. Under para 32(3A) a person can elect to determine the base cost of certain classes of identical assets using the weighted-average method. The classes of asset are listed

financial instruments, participatory interests in collective investment schemes, gold and platinum coins and listed interest-bearing instruments. A person who elects to use weighted-average for a class of identical assets is not permitted to use the TAB or 20% of proceeds methods for determining the valuation date value of an asset forming part of that class. However, the person will also not be subject to the loss limitation rule in para 26(3).

A person who meets the above criteria may, subject to the overriding loss limitation rule in para 26(3), determine the valuation date value of a pre-valuation date asset using

- 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 under para 20 incurred on or after the valuation date, or
- the time-apportionment base cost of the asset, as contemplated in para 30.

The choice of method is made in the return of income reflecting the disposal of the asset.

8.28.3 Limitation on 'phantom' losses [para 26(3)]

Paragraph 26(3) contains a loss-limitation rule known colloquially as a 'kink test'. The label originates from the United Kingdom and describes the shape of the graph that results when the pre-valuation date expenditure, market value on valuation date and proceeds are plotted. There are three prerequisites for the application of this rule:

First, the asset must be one contemplated in para 26(1). In other words, it must have been disposed of at an historical gain.

Secondly, the person disposing of the asset must adopt the market value of the asset as its valuation date value under para 26(1)(*a*). This adoption will usually take place in the year of assessment in which the asset is disposed of. Merely because a person has determined the market value of an asset does not mean that the person has adopted it. Before adoption is possible several requirements must be met.

- A person must have a record of pre-valuation date expenditure. This follows from para 26(1), which applies when the proceeds from the disposal of an asset exceed the expenditure allowable under para 20 incurred *before*, on and after the valuation date. A person who does not have a record of pre-valuation date expenditure would adopt market value under para 26(2)(*a*), not para 26(1)(*a*).
- The asset must have been valued within the time limit prescribed by para 29(4). For example, if the valuation date is 1 October 2001 the asset must have been valued by 30 September 2004 unless it was an asset such as a JSE-listed share whose price was published in the *Gazette*, in which case there is no time limit.
- The person must have complied with the valuation form submission requirements for certain high-value assets under para 29(5).
- Persons who have adopted the weighted-average method under para 32(3A) may not adopt market value under para 26 as they must apply that method consistently [para 32(6)]. The kink test also does not apply to pre-valuation date s 24J instruments. These are dealt with under para 28.

Thirdly, the asset must have been disposed of at a loss, that is, the proceeds must not exceed the market value of the asset on valuation date.

When the above conditions are met, the rule substitutes as the valuation date value an amount equal to the proceeds less the expenditure allowable under para 20 incurred on or after the valuation date in respect of the asset. This will result in no gain or loss.

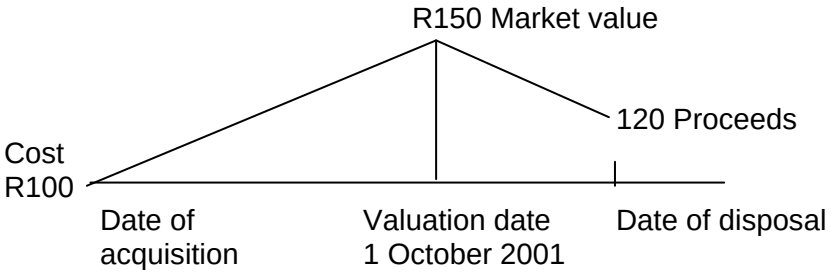
The rule thus eliminates 'phantom' capital losses when the market value has been adopted at valuation date but proceeds exceed actual or historic cost. Any capital gain with reference to the actual or historic cost is, however, also disregarded.

Example 1 – Paragraph 26(3) – Historical gain, market value loss ('kink test')

Facts:

Vicky acquired an asset before the valuation date at a cost of R100, which was allowable under para 20. She determined its market value on 1 October 2001 at R150 and adopted that value as the valuation date value. She sold the asset for R150 after the valuation date.

Result:



Step 1: Is there an historical gain? Yes, R120 – R100 = R20 and para 26 therefore applies.

Step 2: Is there a market value loss? Yes, R120 – R150 = -R30

Since both conditions are satisfied, the loss limitation rule in para 26(3) applies. Therefore,
VDV = Proceeds (R120) – post-1 October 2001 expenditure (RNil) = R120.
Capital gain / loss = Proceeds – base cost
Capital gain / loss = Proceeds – [VDV + post-1 October 2001 expenditure]
Capital gain / loss = R120 – [R120 + R0] = RNil

Example 2 – Paragraph 26 – Historical gain and market value loss with post-CGT expenditure

Facts:

Werner disposed of a pre-valuation date asset after the valuation date. Details of the asset are 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

Werner adopted the market value of the asset as its valuation date value.

Result:

Paragraph 26(3) applies because

- the asset has been disposed of at an historical gain (R150 000 – R100 000 – R25 000), and

- the proceeds do not exceed market value on valuation date (R150 000 < R200 000)

Valuation date value = Proceeds less expenditure on or after valuation date

	R
Proceeds	150 000
Less: Post-valuation date expenditure	(25 000)
Proceeds less post-valuation date expenditure	125 000
Valuation date value (as above)	125 000
Post-valuation date expenditure	25 000
Base cost	150 000
Proceeds	150 000
Less: Base cost	(150 000)
Capital gain / (loss)	Nil

What range of proceeds fall within para 26(3)?

It is important to realise that para 26(1) 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 (market value loss).

In Example 1 the loss limitation rule will apply when proceeds fall within the range 101 – 149 (ignoring cents). 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 either to a break-even situation (proceeds = market value) or a market value gain (proceeds > market value). In this situation the taxpayer would still fall within para 26(1), 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-valuation date expenditure] as the valuation date value.

What if proceeds were R80? The paragraph would not apply in its entirety because the person would have failed to pass the entry requirement, having an historical loss of R80 – R100 = R20. A key requirements for entry into para 26(1) is an historical gain. In this case the matter would be dealt with under para 27, which deals with the historical loss and break-even situations.

Understanding 'proceeds less post-1 October 2001 expenditure'

The loss-limiting formula 'proceeds less post-valuation date expenditure' will always result in a no gain or loss situation. This formula is applied elsewhere in the Eighth Schedule, such as in paras 24 and 27. In order to understand this formula it is necessary to begin with the core base cost formula in para 25:

Base cost = valuation date value (VDV) + post-valuation date expenditure
A no gain or loss situation arises when:
Base cost = Proceeds.
This can be restated as:
VDV + post-valuation date expenditure = Proceeds
And then rearranged as:
VDV = Proceeds – post-valuation date expenditure.

Essentially the 'proceeds less post-valuation date expenditure' formula works backwards to arrive at a VDV that will yield neither a gain nor a loss after the post-1 October 2001 expenditure is added to it.

8.28.4 Expenditure unknown [para 26(2)]

If 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 using

- 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 under para 20 incurred on or after the valuation date.

Persons who do not have a record of expenditure and failed to value their assets by 30 September 2004 as prescribed by para 29(4) will have no option but to resort to the '20% of proceeds' method. When adopting that method, post-valuation date expenditure must first be deducted from proceeds before multiplying the result by 20%.

A person who does not have a record of pre-valuation date expenditure may not adopt TAB by assuming that the pre-valuation date expenditure is 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.

8.29 Twenty per cent of proceeds method

One of the options available to a person for determining the valuation date value of a pre-valuation date asset is the so-called '20% of proceeds method'. This method is available when a person

- has a record of pre-valuation date expenditure and is in the historical gain situation [para 26(1)(*b*)], or
- does not have a record of pre-valuation date expenditure [para 26(2)(*b*)].

It is not available when the pre-valuation date expenditure is known and there is an historical loss or break-even situation under para 27. In most cases the method is likely to be one of last resort when the TAB and market value methods are unavailable. This could happen when the person does not have a record of pre-valuation date expenditure or a market value has not been determined within the time prescribed by para 29(4). Yet in some cases the method can yield a more favourable result than TAB or market value, as for example when the growth in value on or after the valuation date has been exponential, or when the asset has a nil or relatively low pre-CGT cost but has been improved on or after valuation date (the proceeds formula under para 30(2) can produce a less favourable result in these circumstances when TAB is adopted).

Errors in the application of the method are not uncommon, due in part to it being informally (and misleadingly) referred to as the '20% of proceeds method'. In fact, the method is not always applied by multiplying the proceeds by 20%. Any allowable para 20 expenditure incurred on or after the valuation date must first be deducted from the proceeds before multiplying the result by 20%. Once this has been done the base cost of the asset must be determined under para 25 by adding the post-valuation date expenditure to the valuation date value so determined. In some cases the valuation date value produced under this method can be a negative figure which will result in a capital loss. This would occur when the post-valuation date expenditure exceeds the proceeds.

Example 1 – 20% of proceeds method

Facts:

Waheeda acquired an asset many years before the valuation date and neither she nor the Commissioner could establish its original cost. 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 2007 for R115 000. Determine the capital gain using the '20% of proceeds' method.

Result:

	R
Proceeds	115 000
Less: Post-1 October 2001 expenditure	(15 000)
Subtotal	100 000
VDV R100 000 x 20%	20 000
Post-1 October 2001 expenditure	15 000
Base cost	35 000

	R
Proceeds	115 000
Less: Base cost	(35 000)
Capital gain	80 000

Example 2 – 20% of proceeds method resulting in capital loss

Facts:

Susan acquired an asset many years before the valuation date. Unfortunately she had lost all her records of the cost of the asset in a fire. In 2004 she improved the asset at a cost of R100 000, all of which qualified as allowable expenditure under para 20. In 2007 she disposed of it for proceeds of R60 000. She did not obtain a market value for the asset by 30 September 2004

Result:

Susan's only alternative is to use the 20% of proceeds method to determine its valuation date value. TAB is unavailable as she does not have a record of pre-valuation expenditure, and the market value method cannot be used because she failed to perform a valuation by 30 September 2004 as required by para 29(4).

	R
Proceeds	60 000
Less: Post-1 October 2001 expenditure	(100 000)
Subtotal	(40 000)
VDV R40 000 x 20%	(8 000)
Post-1 October 2001 expenditure	100 000
Base cost	92 000

	R
Proceeds	60 000
Less: Base cost	(92 000)
Capital loss	(32 000)

8.30 Valuation date value – when proceeds do not exceed expenditure (para 27)

Paragraph 27

8.30.1 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 when

- that asset was acquired before the valuation date,
- proceeds do not exceed expenditure, allowable under 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 under para 28), and
- the asset is not part of a class of identical assets to which para 32(3A) applies. Under para 32(3A) a person can elect to determine the base cost of certain classes of identical assets using the weighted-average method, namely, listed financial instruments, participatory interests in collective investment schemes, gold and platinum coins and listed interest-bearing instruments. The gain and loss limitation rules in para 27 will not apply to the identical assets falling within the particular class of asset in respect of which an election to use weighted average has been made.

The paragraph also does not apply to a person who does not have a record of expenditure. The valuation date value of such an asset must be determined under para 26(2).

Paragraph 27 deals with three separate scenarios. These rules – also known as 'kink tests'[317] – are designed to protect the *fiscus* from 'phantom' losses that would otherwise arise if taxpayers were given free rein to adopt either the time-apportionment base cost (TAB) or market value methods.

When a disposal falls within para 27 (that is, the proceeds do not exceed the expenditure) the valuation date value is fixed by para 27. In other words, a person has no freedom to choose another method for determining the valuation date value. This differs from the situation in which there is an historical gain. In that case para 26 applies and a person has freedom to choose the method that gives the highest base cost, subject to the para 26(3) kink test which eliminates a capital loss when the market value method is adopted.

8.30.2 Assets whose market value has been determined or published [para 27(3)]

The first two scenarios are contained in para 27(3) and apply when

- a person has determined the market value of an asset on the valuation date, as contemplated in para 29, or

[317] 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.

- the market value of an asset has been published under that paragraph.

Assets whose value has been determined under para 31 must also be included since para 29(1)(*c*) includes such assets.

8.30.2.1 Assets in respect of which a market value has been determined

There has been much confusion among taxpayers as to when they will be regarded as 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), while 'determined' refers to a factual situation when 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.

Before the amendment of para 27 by the Second Revenue Laws Amendment Act 60 of 2001, there was some uncertainty over 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 in which 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 of 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 assets 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 when para 26 applies.

8.30.2.2 Assets with published values

Paragraph 27(3) refers to assets whose market values have been published under para 29. These are assets whose prices were published by the Commissioner in the *Government Gazette*.[318] See commentary on para 29(4) in **8.33.8**.

8.30.2.3 The first scenario [para 27(3)(a)]

The first scenario arises when

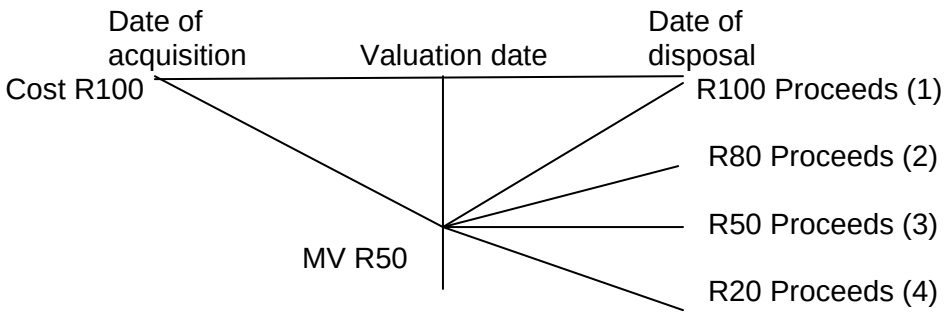
- proceeds are less than or equal to pre-1 October 2001 expenditure (in other words a loss or break-even situation), and
- market value is less than pre-1 October 2001 expenditure.

Under these circumstances 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 – Scenario 1: MV < B ≥ P



P = Proceeds, B = Pre-1 October 2001 costs, 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

[318] GN 65 *GG* 23037 of 25 January 2002. The prices are also available from the SARS website under CGT / Value of assets on 1 October 2001.

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? While 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 or 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.

8.30.2.4 The second scenario [para 27(3)(b)]

The second scenario also applies when a market value has been determined or published and deals with any situation not covered by the first scenario.

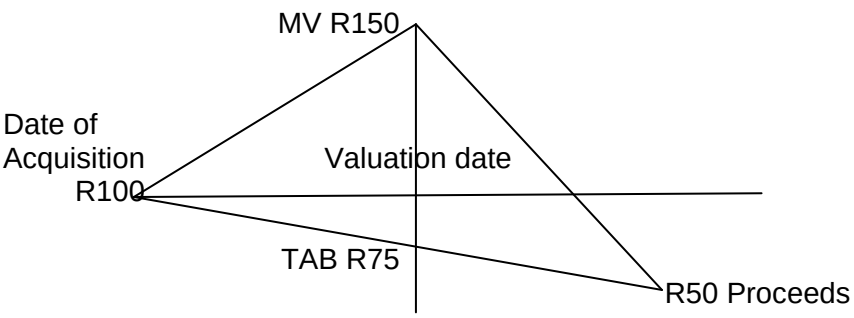
The valuation date value of an asset in these circumstances must be determined as the **lower** of

- market value
- TAB (time-apportionment base cost under 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 1 – Scenario 2: P ≤ B < mv



P = Proceeds, B = Pre-1 October 2001 costs, MV = Market value on valuation date

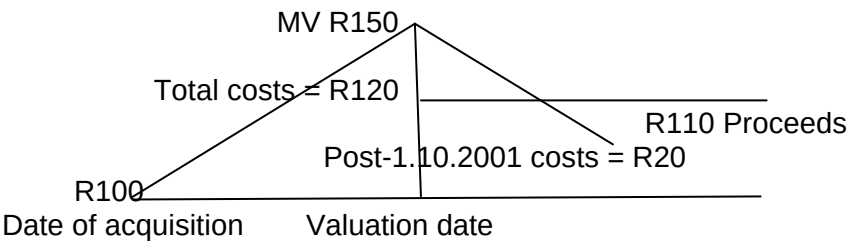
Assume that the asset in this case was purchased five years before valuation date and sold five years after.

TAB = B + [(P – B) x N/(N + T)] (see para 30(1) for details of the TAB formula)
= R100 + [(R50 – 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 2 – Scenario 2: P ≤ [A + B] < MV



P = Proceeds, A = Post-1 October 2001 costs, B = pre-1 October 2001 costs, MV = Market value on valuation date

Assuming an equal 5-year period before and after 1 October 2001, TAB would be calculated as follows:

P = R100/R120 x R110

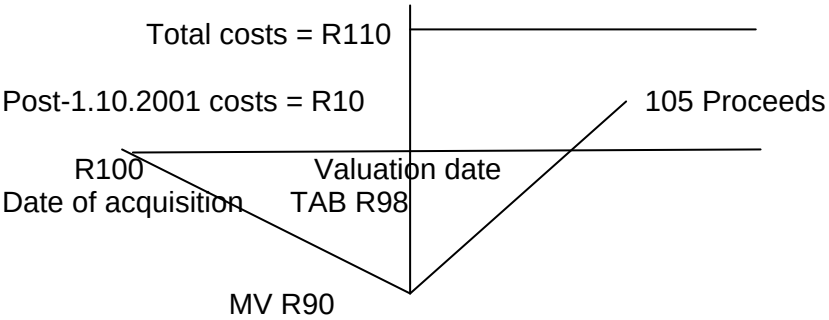
P = R92

TAB = B + [(P – B) x N/(N + T)]
= 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 3 – Scenario 2: MV < P ≤ [A + B]



P = Proceeds, A = Post-1 October 2001 costs, B = Pre-1 October 2001 costs, MV = Market value on valuation date

TAB:
Assume asset acquired two years before and disposed of two years after valuation date.
P = R100/R110 x R105 = R95,45
TAB = B + [(P – B) x N/(N + T)]
= R100 + [(R95,45 – R100) x 2/4]
= R100 – [R4,55 x 2/4]
= R100 – R2,28
= 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).

8.30.3 The third scenario [para 27(4)]

If the person has not determined a market value or the price of the asset is not one published in the *Government Gazette*, para 27(4) provides that the valuation date value of the asset is its time-apportionment base cost.

Example 1 – Scenario 3: P ≤ [A + B] and no MV determined or published

Facts:

An asset was acquired on 5 July 1997 at a cost of R200. On 30 June 2006 the asset was sold for R50. No market value was determined in respect of the asset and its price was not published in the *Government Gazette*.

Result:

The asset has been disposed of at an historical loss of R50 – R200 = -R150 and para 27 therefore applies. Since no market value on valuation date has been determined or published for the asset, the valuation date value must be determined using TAB under para 27(4).

TAB = B + [(P – B) x N/(N + T)]
= R200 + [(R50 – R200) x 5/10]
= R200 + [-R150 x 5/10]
= R200 – R75
= R125

Capital loss = R50 – R125
= -R75

Some further examples of the application of para 27 are set out below.

Example 2 – Historical loss and market value loss when MV > pre-1 October 2001 costs

Facts:

Xerxes acquired an asset 10 years before the valuation date for R100 000 and disposed of it five years after the valuation date for R80 000. The market value of the asset at valuation date had been determined as R120 000.

Result:

	R
Expenditure before valuation date	100 000
Market value at valuation date	120 000
Proceeds upon disposal	80 000

As a market value has been determined, the valuation date value of the asset is the lower of

- market value, or
- TAB,

of that asset.

Therefore, the lower of

- R120 000, or
- TAB = 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
Less: Base cost	(86 667)
Capital loss	(6 667)

In this example para 27 is applicable, as proceeds do not exceed expenditure allowable under para 20 incurred both before and after the valuation date. As the market value has been determined and it exceeds expenditure allowable under para 20 (para 27(3)(*a*) is therefore inapplicable) the lower of market value or TAB is the valuation date value to be used [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 3 – Historical loss and MV loss when MV < pre-1 October 2001 expenditure

Facts:

The facts are the same as in Example 2 but the expenditure allowable under para 20 incurred *before* the valuation also exceeds the market value (para 27(3)(*a*) is applicable). A 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 under para 20 incurred after the valuation date.

Therefore, the higher of

- R90 000, or
- R80 000 (R80 000 – R0),

equals R90 000.

	R
Proceeds	80 000
Less: Base cost	(90 000)
Capital loss	(10 000)

In this example para 27 is applicable, as proceeds do not exceed expenditure allowable under para 20 incurred both before and after the valuation date. As the market value has been determined and it does not exceed expenditure allowable under 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 used.

8.31 Valuation date value – instrument [para 28)]

Paragraph 28

8.31.1 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 (for example, 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 a 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 yielding 10% a year 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.

8.31.2 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).

8.31.3 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)'.

Since an interest-free loan is not an instrument as defined in s 24J, it follows that such loans must be dealt with under the core rules and not under para 28.

8.31.4 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

Method	**How determined**	
'Adjusted initial amount' on 1 October 2001	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.	
Market value on 1 October 2001	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.	
	Type of instrument	**Date market value determined**
	• Listed on a recognised exchange	Last trading day before 1 October 2001
	• Other instruments	Valuation date

The term '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 South Africa before 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 South Africa, 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 *Government Gazette* but are available on the SARS website.[319] SARS accepts BESA's T + 3 mark-to-market valuation on 28 September 2001 as the valuation date value of these instruments. In order to determine the market value of a s 24J instrument from the BESA prices on the SARS website, the following formula should be used:

$$\text{Nominal value of instrument} \times \frac{\text{All-in price}}{100}$$

Example 1 – Determination of market value of s 24J instrument on valuation date

Facts:

An RSA R150 bond has a nominal value of R14 000 000. Determine the market value on valuation date of the bond.

Result:

According to the BESA schedule, the All-in Price of an R150 bond is 106,84896. Therefore the market value of the bond is R14 000 000 x 106,84896/100 = R14 958 854,40.

Example 2 – 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 South Africa with a term of two years at a discount of R1,2 million to the face value of R10 million. Interest is receivable six-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:

[319] Available at <http://www.sars.gov.za/home.asp?pid=179> [Accessed 8 December 2011]. Select the MTM Excel worksheet at the bottom of the page.

	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 6.50308% for each accrual period. The method for determining the yield to maturity is explained in **8.32.3** below. The yield to maturity can be proved as follows:

Period	1	2	3	4	Total
Cash flow	300 000	300 000	300 000	10 300 000	
Factor	0,93894	0,88161	0,82778	0,777233	
PV	281 682	264 483	248 333	8 005 502	8 800 000

The present value (PV) discount factor is $1/(1 + r)^n$ in which r = percentage interest rate and n = period. The discount factor for the first period is $1/(1 + 0{,}0650308)^1$, for the second period 1/(1,0650308 x 1.0650308) etc.

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	867 260
Adjusted initial amount	9 367 260

Step 5 – Determine capital gain or loss

Period	Opening balance R	Interest at 0.0650308 R	Receipts R	Closing balance R
31.12.2000 to 30.06.2000	8 800 000	572 271	(300 000)	9 072 271
01.07.2001 to 31.12.2001	9 072 271	589 977	(300 000)	9 362 248
01.01.2002 to 30.06.2002	9 362 248	608 834	(300 000)	9 671 082
01.07.2002 to 31.12.2002	9 671 082	628 918	(10 300 000)	-
		2 400 000	(11 200 000)	

Interest earned before 1 October 2001 = R572 271 + (R589 977 x 3/6) = R862 260
Interest earned on or after 1 October 2001 = R2 400 000 – R862 260 = R1 532 740

	Total	Pre-1 October 2001	Post-1 October 2001
	R	R	R
Total receipts	11 200 000	300 000	10 900 000
Less: Interest accrued	(2 400 000)	(867 260)	(1 532 740)
	8 800 000	Disregard	9 367 260
Less: Base cost (adjusted initial amount)			(9 367 260)
Capital gain or loss			-

No capital gain or loss has arisen in this example as the adjusted initial amount has been adopted as the valuation date value of the instrument and it was held until maturity.

Impact of choice of method

A person who adopts the adjusted initial amount as the valuation date value and holds the instrument to maturity will not realise a capital gain or loss. However, if there has been a change in prevailing interest rates and the instrument is disposed of before maturity, a capital gain or loss might result.

Under the market value method, a capital gain or loss will arise if the prevailing interest rates differ

- at the date of acquisition and the valuation date, or
- at the valuation date and the date of disposal.

In the first case this would result in the market value on valuation date differing from the adjusted initial amount on that date. In the second case a capital gain or loss should arise even if the instrument is held to maturity.

8.31.5 Identification methods

A person will be entitled to use specific identification or FIFO for the purpose of identifying listed 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.

8.31.6 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 applicable to instruments that are not listed on a recognised exchange. It is considered that the potential for abuse exists mainly with unlisted instruments. The time-apportionment base cost must be substituted as the valuation date value of an instrument when

- a person has adopted the adjusted initial amount as its valuation date value, and
- the proceeds from its disposal are less than that amount.

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 before valuation date that is received on or after valuation date.

Example – Application of the 'kink' test to unlisted instruments

Facts:

On 31 December 2000 Bargh (Pty) Ltd, a company with a financial year end of 30 June, acquired an unsecured debenture in Shady Dealings (Pty) Ltd with a term of two years at a discount of R1,2 million to the face value of R10 million. Interest is receivable six-monthly, calculated at 3% of the face value of the instrument. At maturity date, 31 December 2002, the instrument will be redeemed at par.

On 12 September 2001 Shady Dealings informed Bargh 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 was placed in compulsory liquidation, and Bargh was informed that concurrent creditors would 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 = B + [(P – B) x N/(N + T)]
= R8 800 000 + ([R0 – R8 800 000] x 1/(1 + 1))
= R8 800 000 – R4 400 000
= R4 400 000

Capital loss = R0 (proceeds) – R4 400 000 (TAB) = R4 400 000

8.32 Base cost – instruments acquired on or after valuation date

8.32.1 Base cost

The determination of the base cost of an instrument 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 under para 31.

8.32.2 Proceeds

When an instrument is disposed of, the proceeds will comprise the total receipts over the period that the instrument was held, reduced under para 35(3)(*a*) by the accrued interest.

8.32.3 Determination of accrued interest

A common misconception exists that the regular coupons received, usually six-monthly, constitute 'interest'. This would, of course, be the case should the instrument be acquired at face value on date of issue. But when it is purchased on the bond exchange at a later date,

the chances are that its value will differ from the face value because of fluctuations in prevailing interest rates. The interest on such instruments must be determined using the 'yield to maturity' method set out in s 24J. The yield to maturity is determined by calculating the Internal Rate of Return (IRR) based on all cash flows up to the date of maturity (*not* date of disposal). The IRR is determined mathematically by an iterative (trial and error) process using a financial calculator or Excel spreadsheet. This is illustrated in the example in **8.32.4**.

8.32.4 Accrued interest included in acquisition price

The purchase price of a post-valuation date instrument may frequently include accrued interest. In these circumstances the initial accrual period will be shorter than the remaining accrual periods based on the regular intervals at which the coupons are received. In determining the IRR, s 24J requires that all accrual periods must be equal. In the example below this problem has been addressed by making all the accrual periods equal to the initial accrual period.

Any pre-acquisition interest will be reflected in the purchase price of the instrument. Upon receipt it will be accounted for as matching proceeds thereby giving rise to no gain or loss.

Example – Disposal of s 24J instrument acquired on or after valuation date

Facts:

On 1 April 2005 Johan purchased ESKOM stock for an amount of R9 100. The face value of the bond is R10 000 with a coupon rate of 5% payable every six months on 30 June and 31 December. The bond is redeemable at face value on 31 December 2010. Johan sells the bond on 28 February 2007 for R10 200. Determine Johan's capital gain or loss on disposal of the bond.

Result:

Step 1 – Determine the accrual period

For the purposes of this example an accrual period of three months has been elected [see para (*b*) of definition of an 'accrual period' in s 24J(1)]. This has been done to account for the three-month gap between the date of acquisition and the first receipt (1 April 2005 to 30 June 2005).

Step 2 – Determine yield to maturity

Cash flows to maturity:

	R
01.04.2005	(9 100)
30.06.2005	500
30.09.2005	0
31.12.2005	500
31.03.2006	0
30.06.2006	500
30.09.2006	0
31.12.2006	500
31.03.2007	0
30.06.2007	500
30.09.2007	0
31.12.2007	500
31.03.2008	0
30.06.2008	500
30.09.2008	0

31.12.2008	500
31.03.2009	0
30.06.2009	500
30.09.2009	0
31.12.2009	500
31.03.2010	0
30.06.2010	500
30.09.2010	0
31.12.2010	10 500
IRR	3,1704%

Using an Excel spreadsheet, the cash flows are listed in a column with the first cell (A1) containing -9100, second cell (A2) 500, third cell (A3) 0 etc and the last cell (A24) 10500. In cell A25 the following formula is entered:
=IRR(A1:A24)
This may give a rounded result of 3%, but the decimal point can be expanded using the increase/decrease button on the toolbar.

Step 3: Determine interest accrued using IRR

Period	Opening balance	Interest at 3,1704%	Receipts	Closing balance
01.04.2005 - 30.06.2005	9 100.00	288.51	-500	8 888.51
01.07.2005 - 30.09.2005	8 888.51	281.80	0	9 170.31
01.10.2005 - 31.12.2005	9 170.31	290.73	-500	8 961.04
01.01.2006 - 31.03.2006	8 961.04	284.10	0	9 245.14
01.04.2006 - 31.06.2006	9 245.14	293.11	-500	9 038.25
01.07.2006 - 30.09.2006	9 038.25	286.55	0	9 324.80
01.10.2006 - 31.12.2006	9 324.80	295.63	-500	9 120.43
01.01.2007 - 28.02.2007	9 120.43	192.77	-10 200	-886.80
		2213.20	-12 200	

Step 4 – Determine capital gain or loss

	R
Receipts	12 200
Less: Interest accrued [para 35(3)(*a*)]	(2 213)
Proceeds	9 987
Less: Base cost (para 20)	(9 100)
Capital gain	887

8.33 Market value on valuation date

Paragraph 29

8.33.1 Introduction

This is a transitional measure and deals with the requirements for the valuation of assets on valuation date. (Paragraph 31 contains the permanent market value rules.)

8.33.2 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 (that is, 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 the *Government Gazette*[320] and on the CGT page of the SARS website (Tax Types / Capital Gains Tax / Value of assets on 1 October 2001). These values must be used to determine the market value of these instruments.

Circumstances in which the Commissioner can determine the valuation date value of a financial instrument [para 29(2A)]

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 when

- 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.

In determining the market value, the Commissioner must have regard to

- the actual value of the instrument,
- if suspended, the reason for the suspension, and
- 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 former JSE Securities Exchange SA (now JSE Ltd), the Financial Services Board and SARS reviewed the prices and only one adjustment was made before the final prices were published in the *Government Gazette*[321] ('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.

The term 'ruling price' is defined in para 1. It is used in relation to listed financial instruments in a number of subparagraphs of para 29 instead of the phrase 'last price quoted'.

[320] GN 65 *GG* 23037 of 25 January 2002.
[321] GN 65 *GG* 23037 of 25 January 2002.

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* under a pre-valuation date unbundling transaction. SARS and Iscor have agreed on a price for Kumba at 1 October 2001 of R28,04,[322] and it is suggested that taxpayers use this figure. The price for Iscor is R25,22, as reflected in the *Gazette.* 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 a post-valuation date unbundling transaction, no adjustment is required for a pre-CGT unbundling transaction as the law stands at present. See commentary in **18.3.5**.

8.33.3 Financial instruments listed outside the Republic [para 29(1)(a)(ii)]

The valuation date values of financial instruments listed on a recognised exchange outside the Republic are determined on a different basis to financial instruments listed in the Republic for the following reasons:

- First, it would have been impractical for SARS to publish all the prices in the Gazette.
- Secondly, SARS did not have access to the data needed to determine a five-day volume weighted-average price.
- Thirdly, the risk of a South African resident being able to influence the price during the five days preceding 1 October 2001 was considered minimal.

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 **8.33.2** must be used.

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:

- If there is a higher bid or a lower offer on the 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.

For the meaning of 'bid' and 'offer' see **4.1.6**.

8.33.4 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.

[322] This agreement was advertised in *Business Day* of 29 January 2002.

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.

8.33.5 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 participatory interest could be sold to the management company of the scheme; or
- if 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 on valuation date.

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.

8.33.6 Other assets [para 29(1)(c)]

All other assets must be valued at market value under para 31.

8.33.7 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 is then applied to the base cost of the shares disposed of.

For para 29(3) to apply, the controlling interest must

- be held in a listed company,
- exceed 35% [para 29(3)],
- be disposed of in its entirety,

and the buyer and seller must not be connected persons.

The formula to be applied is set out in the example below:

Example – Valuation of controlling interest in listed shares

Facts:

Sweet Pea Ltd holds 51% of the issued shares of Pea Ltd, a company listed on the JSE for the past six 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 for each Pea Ltd share on 30 September 2002 (per JSE)	R1,95
Last selling price for each Pea Ltd share on 30 September 2002 (per JSE)	R2,05
Price for each share under sale agreement	R2,20
Average price for each Pea Ltd share under 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

$$\text{Base cost adjustment} = \frac{\text{Price per sale agreement – Last price quoted}}{\text{Last price quoted}}$$

$$= \frac{(R2,20 – R2,00)}{R2,00}$$

= 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
Less: Base cost	(4 950 000)
Capital gain	1 650 000

The market value of a controlling interest in an unlisted company must be determined in accordance with para 31(3), namely, the price a willing buyer would pay a willing seller with both parties dealing at arm's length in an open market, but disregarding any transferability restrictions or valuation method stipulations, and taking into account any preferential entitlement upon winding-up. For more information on valuation methods, see the SARS guide entitled *Valuation of Assets for Capital Gains Tax Purposes*.[323]

It is not a requirement for para 29(2) to apply that the shareholder must hold the controlling interest on valuation date. For example, a person may hold an interest of 25% on valuation date and acquire a further 11% interest after that date. In such event the adjustment to the valuation date market value must be applied to the pre-valuation date interest of 25%. The base cost of the post-valuation date interest of 11% remains unaffected by this adjustment, being determined under para 20 or 38.

[323] Available from: <http://www.sars.gov.za/home.asp?pid=4150&tid=65&s=pubs&show=889> [Accessed 8 December 2011].

8.33.8 Time limit on obtaining valuations [para 29(4)]

For the purposes of paras 26(1)(*a*) and 27(3), a person may only adopt or determine the market value basis for determining the base cost of an asset if the person satisfies the requirements set out below.

8.33.8.1 Valuation date – 1 October 2001

A person having a valuation date of 1 October 2001 may only adopt or determine a market value for the purposes of paras 26(1)(*a*) and 27(3) if

- that person has valued the asset on or before 30 September 2004,
- the price of that asset has been published by the Commissioner under para 29 in the Gazette, or
- the person has acquired that asset from that person's spouse under para 67 and the transferor spouse had adopted or determined a market value under 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.

Paragraph 29(4) originally provided that valuations had to be completed by 30 September 2003 (two years after 1 October 2001) but this period was extended by a year.[324]

There is no valuation time limit for assets whose prices were published in the *Government Gazette*,[325] namely,

- JSE-listed financial instruments
  - Equities
  - Warrants
  - Financial futures.
  - Agricultural futures
- South African unit trusts

The use of these prices is mandatory and taxpayers are accordingly relieved from having to value these assets. The prices are also available from the SARS website under Tax Types / Capital Gains Tax / Value of assets on 1 October 2001.

Although Krugerrand prices appear on the SARS website, they were not published in the *Government Gazette.* A person who uses the applicable Krugerrand prices on the SARS website will be regarded as having valued these assets within the prescribed period.

The prices of shares listed on a recognised exchange outside South Africa have not been published by SARS. Nevertheless, a person who uses the listed price in appropriate circumstances (for example, to value a minority holding) on valuation date will be regarded as having valued the relevant share within the prescribed period. As with Krugerrands the values of these assets were determined by the market on valuation date and it is not expected that independent valuations be performed.

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-

[324] The initial period of two years was extended to 30 September 2004 by the Minister. See GN 207 *GG* 26026 of 20 February 2004.
[325] GN 65 *GG* 23037 of 25 January 2002.

bearing instruments within the three-year limit. These assets are dealt with under para 28, which contains no time limit. The prices of listed s 24J instruments are nevertheless available on the SARS website under Tax Types / Capital Gains Tax / Value of assets on 1 October 2001.

The opening words of para 29(4) state that the subparagraph applies for the purposes of paras 26(1)(*a*) and 27(3). No reference is made to para 26(2)(*a*) which applies when neither the person nor the Commissioner can determine the expenditure in respect of the asset. It follows that there is no time limit for determining a market value on valuation date in such cases. However, persons falling into para 26(2)(*a*) will not be able to adopt the market value basis in respect of the high-value assets contemplated in para 29(5) unless they have complied with the submission deadline (that is, submitted the CGT 2L form with the first return after 30 September 2004).

Valuation of business v valuation of individual assets

In some cases taxpayers have valued the shares in a company but have neglected to value the assets within the company. They then seek to utilise the share valuation when the underlying business is disposed of as a going concern. In other cases taxpayers have simply valued the company's business as a whole. These practices are unacceptable for *inter alia* the following reasons:

- A company and its shareholders are separate taxpayers, each with their own tax obligations. If one taxpayer has performed a valuation, this cannot simply be imputed to another. The opening words of para 29(4) state that a person may only adopt or determine market value as the valuation date value 'if that person has valued that asset . . .'.
- The valuation of shares in a company may differ significantly from the valuation of the company's assets. For example, in valuing the shares on a net asset basis, the assets must be reduced by the liabilities, including the contingent liability for STC. Liabilities are not taken into account when valuing individual assets. Furthermore the method for valuing shares (for example, earnings yield or dividend yield) may be completely different to the method used to value individual assets in the company.
- Valuations must be performed for each asset. The business is not an asset, but rather a collection of assets. The fact that this was envisaged by the legislature can, for example, be seen in para 29(5)(*c*) in which it is recognised that a single share is an asset, but for the purposes of the submission requirement limit the value of all the shares held in the company must be taken into account.
- The kink tests in paras 26 and 27 must be applied to each asset. By grouping assets together for valuation purposes the kink tests will be averaged and this will not always give the same result that would ensue if the tests are applied on an asset by asset basis.

8.33.8.2 Valuation date after 1 October 2001

A person who ceases to be an exempt person under para 63 will have a valuation date after 1 October 2001.[326] In such a case the person's valuation date will be the date on which it ceases to be an exempt person. Currently this applies to PBOs and recreational clubs.

A person having a valuation date after 1 October 2001 may only adopt or determine a market value for the purposes of paras 26(1)(*a*) and 27(3) if

[326] See para (*a*) of the definition of 'valuation date' in para 1.

- that person has valued the asset within two years of the valuation date, or
- the asset is one contemplated in para 31(1)(*a*) or (*c*)(i) and the market value of that asset on valuation date is determined under one of those paragraphs.

Table 1 – Assets which do not have to be valued within two years by persons with a valuation date after 1 October 2001

Paragraph 31(1)	Description	Market value on valuation date
(*a*)	Financial instrument listed on a recognised exchange for which a price was quoted on that exchange	Ruling price on last business day before valuation date
(*c*)(i)	A participatory interest in a local collective investment scheme in • securities, or • property	Price at which a participatory interest can be sold to the management company of the scheme on valuation date.

Participatory interests in foreign collective investment schemes that are listed fall under para 31(1)(*a*) in the above table. However, when they are unlisted the person must establish their market value within two years of its valuation date under para 29(1)(*b*)(ii), namely,

- the last price published before valuation date at which a unit could be sold to the management company of the scheme, or
- when 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 on that date.

In the case of PBOs a capital gain or loss arising from the disposal of an unlisted participatory interest in a foreign collective investment scheme is likely to be excluded by para 63A(*a*). The failure by a PBO to value such an interest is therefore unlikely to have any adverse CGT consequences while the PBO remains approved by the Commissioner under s 30(3).

8.33.9 Early submission of valuation forms [para 29(5)]

In the case of the high-value assets summarised in the table below, the CGT 2L valuation form must be furnished to SARS with the first return of income submitted after 30 September 2004. A person who fails to meet this requirement may not adopt market value as the valuation date value of the asset and will be compelled to resort to the TAB or 20% of proceeds methods. If the form was not submitted with that return the Commissioner may allow an extended period for the lodging of the form. However, the person will have to provide SARS with proof that the valuation was performed on or before 30 September 2004.[327] That proof could take the form of

- a copy of a valuation by an independent third party signed and dated on or before 30 September 2004,
- a copy of the invoice from the valuer dated on or before 30 September 2004, or
- proof of payment of the valuer on or before 30 September 2004.

[327] This discretion was inserted in para 29(5) by s 47(1)(*c*) of the Revenue Laws Amendment Act 20 of 2006. The amendment did not carry a specific effective date. However, it is accepted that the amendment applies to any request submitted to the Commissioner on or after the date of promulgation of the Act, namely, 7 February 2007.

Paragraph 29(5) does not apply to persons having a valuation date after 1 October 2001, such as PBOs and recreational clubs [para 29(8)].

Table 1 – High-value assets in respect of which proof of valuation must be submitted

Type of asset	Applies	When market value exceeds
Any asset	Individual asset[328]	R10 million
Intangible asset	Individual asset	R 1 million
Unlisted shares	All shares held by the shareholder in the company	R10 million

'Intangible asset'

The words 'intangible asset' are not defined for the purposes of para 29(5) and must therefore be given their ordinary meaning. Intangible assets include goodwill, debts, patents, copyrights, trade marks, designs and mineral rights.

Partial interests in assets

A person owning a fractional interest in an asset must take the value of that interest and not the full value of the asset into account in determining whether the R1 million and R10 million limits have been exceeded. For example, if A owns one-third and B two-thirds of land with a market value of R18 million, A does not need to comply with para 29(5) since the value of A's interest is R6 million. However, B will have to submit a valuation form with the first return lodged after 30 September 2004 since the value of B's interest is R12 million.

Assets denominated in foreign currency

For the purpose of deciding whether the applicable R1 million and R10 million limits have been exceeded, it will be acceptable if the market value is translated into rands 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 under para 43(6) should be used in the return of income reflecting the disposal.

Non-residents

A non-resident who is not required to submit a tax return because of an absence of South African-source income, and who holds South African immovable property will only be required to submit a return (and the CGT 2 form) when the property is disposed of, and provided that the capital gain or loss exceeds the threshold set by the Commissioner in the annual notice to furnish returns.

Residents falling below the tax threshold

In a few cases a resident who holds high-value assets may not have to submit a return. This could happen if the resident's income is below the threshold set by the Commissioner. In such a case the valuation form must be lodged when the person has to lodge a return. That could occur when the person's income exceeds the submission threshold or when the asset is disposed of.

Adopt v determine

The earlier submission of the prescribed valuation form in the case of these high-value assets will not necessarily bind a person to using market value as a method in the year of

[328] In the case of listed shares, each share is a separate asset. It is therefore very unlikely that para 29(5)(*a*) will apply to listed shares.

disposal of an asset. In other words, in the historical gain situation of para 26, the TAB or 20% of proceeds methods remain alternatives for determining the valuation date value of an asset. However, by completing the form the person will have 'determined' a market value for the purposes of the kink tests in paras 26 and 27. More specifically, under para 27 a person's freedom to choose TAB may be precluded when 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.

Example – Submission date for valuation of high-value assets

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:

	R
Fixtures and fittings	10 000 000
Goodwill	2 500 000
Trade marks	1 700 000
Liquor licence	800 000

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	28 February 2004
Intangible assets • Goodwill • Trademark	 MV > R1 million MV > R1 million	 31 August 2004 31 August 2004

8.33.10 Submission of proof of valuation upon disposal [para 29(6)]

8.33.10.1 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 the following categories of assets:

- High-value assets referred to in para 29(5) that have been disposed of before the submission date provided for in para 29(5). For example, an individual sold all his shares in a private company in January 2003. The shares were valued at R11 million on 1 October 2001. The individual must submit the valuation form with his 2003 return of income.

- Any other asset that has been disposed of and has been valued.

Paragraph 29(6) requires that a person with assets falling in the above categories

> 'must submit proof of that valuation in a form prescribed by the Commissioner with the return for the year of assessment during which that asset was disposed of'.

Before 13 December 2002 para 29(6) did not stipulate in what form the proof of valuation had to be submitted. This was rectified retrospectively to 1 October 2001 by the Revenue Laws Amendment Act 74 of 2002. If a person disposed of an asset and submitted the actual valuation report instead of the prescribed form with a return of income before 13 December 2002, SARS will accept that para 29(6) has been complied with.

Three forms have been prescribed by the Commissioner since 1 October 2001. The first form was entitled 'Annexure' and was released before 1 October 2001. This was replaced by the CGT 2(*e*) [English] or CGT 2(*a*) [Afrikaans] form. The only difference between Annexure and CGT 2(*e*) or (*a*) was the number, which was inserted for ease of identification. Either of these forms will be acceptable to SARS if completed and signed by 30 September 2004. Persons who had completed and signed the Annexure form are not expected to have transcribed the information onto the CGT 2(*e*) or (*a*) form.

The meaning of the phrase 'in the form prescribed by' was considered in the United Kingdom case of *Osborne (deceased) v Dickinson (Inspector of Taxes)*.[329] In that case a taxpayer had completed certain capital gains tax pages, but had not completed the required return. The Special Commissioners held that the taxpayer had not submitted the information in the form prescribed.

The intention was that persons should complete and sign either Annexure or CGT 2(*e*) or (*a*) before 30 September 2004. There has been some uncertainty as to whether these forms 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 prescribed form must be used for this purpose. In the light of this uncertainty the CGT 2L form was introduced. A person who failed to complete and sign the Annexure or CGT 2(*e*) or (*a*) form on or before 30 September 2004 in respect of a valuation done by that date must complete the CGT 2L form. The person must declare that the valuation was performed by 30 September 2004 and that any third party valuation was accepted by that date.

The completion of the prescribed 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 purposes of para 27.

Taxpayers who backdate or inflate valuations expose themselves to the imposition of additional tax of up to 200% under s 76, interest under s 89*quat* and criminal prosecution. SARS reserves the right to call for valuations before the disposal of the relevant assets.

8.33.10.2 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. It will be acceptable if a person cross-references the CGT 2(*e*) form to a signed valuation report.

The CGT 2L form makes provision for the insertion of the date of the valuer's report.

The credibility of a valuation will be brought into question if the valuer refuses to sign either the CGT 2(*e*) form or the valuation report.

[329] SpC 393, [2004] STC (SCD) 104.

The CGT 2(*e*) form will also not be invalidated if a person has not inserted details of the original cost of the asset by the deadline date.

8.33.10.3 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.

When numerous assets have been valued, it will be acceptable if a single covering form is signed. 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.

8.33.10.4 Assets denominated in foreign currency

If an asset is denominated in foreign currency, the valuation must be done in the currency of expenditure under 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 rands using the applicable exchange rate under para 43(6).

8.33.10.5 Identical assets

In the case of identical assets such as unlisted shares or foreign listed shares, only one CGT 2 form need be completed for the particular group of identical assets. Thus if a person owned 100 shares in ABC (Pty) Ltd on valuation date, that person need only complete one form and not 100 forms.

8.33.10.6 CFCs and valuations

Under s 9D(2A) a CFC is treated as a resident for the purposes of para 2(1)(*a*). It follows that it must comply with para 29 should it wish to adopt the market value method for determining the base cost of its pre-valuation date assets. Any valuation would have to be completed by 30 September 2004 when it was a CFC on 1 October 2001.

A company that becomes a CFC after 1 October 2001 is deemed to have acquired all its assets at market value under para 12(2)(*a*) on the day before it becomes a CFC. Such a CFC falls within para 24 and is not subject to a time limit for determining a valuation. On the interaction between s 9D(2A)(*e*) and para 12(2)(*a*), see **23.7.8**.

A CFC will only be required to submit proof of the valuation in the form prescribed under para 29(5) or (6) when it is obliged to submit a return of income. This could occur, for example, when it has a branch in South Africa or disposes of immovable property in South Africa). But if it is not required to submit a return, the submission requirements in para 29(5) or (6) will not apply to it.

Although s 72A requires a resident shareholder of a CFC to submit a return, there is no requirement that the resident lodge the prescribed valuation form as a prerequisite to the CFC being permitted to adopt the market value method for determining the base cost of its assets.

8.33.11 The impact of para 29 on the determination of STC on liquidation or deregistration of a company

Before 1 January 2011 s 64B(5)(*c*) exempted a company that is being liquidated or deregistered from STC on the pre-1 October 2001 portion of any capital profit arising on the disposal of an asset on or after 1 October 2001 that was acquired before that date. For the purposes 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 the manner contemplated in para 29. The 'manner' includes not only the methodology for determining the valuation (for example, price per the *Government Gazette* for shares listed on the JSE), but also the period within which the valuation must be done as set out in para 29(4). 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 purposes of splitting the capital profit into exempt and non-exempt portions. Section 64B(5)(*c*)(ii) was amended by s 58(1)(*i*) of the Revenue Laws Amendment Act 45 of 2003 and now refers to

> 'the market value of that asset . . . *determined in the manner* contemplated in paragraph 29 . . .'.

(Emphasis added.)

The words in italics were inserted by the Revenue Laws Amendment Act 45 of 2003 to make it clear that para 29(4) had to be complied with. This is confirmed by the Explanatory Memorandum to the applicable clause in the underlying Bill, which stated the following:

> 'As part of the *quid pro quo* for the extension of the deadline for the preparation of valuations for CGT purposes, the proposal makes it clear that the deadline will also apply to valuations for the purposes of the exemption of the distribution of capital profits from STC.'

Note: The above is only relevant to distributions before 1 January 2011 because s 64B(5)(*c*) has been deleted with effect from 1 January 2011.

8.33.12 Right of Commissioner to amend valuation or call for further particulars [para 29(7)]

When 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. On the subject of erroneous valuations, see the articles cited in the footnote below.[330]

8.33.13 Period for performing valuations may be extended by Minister [old para 29(8)]

Before its amendment by s 47(1)(*b*) of the Revenue Laws Amendment Act 20 of 2006, para 29(8) provided the Minister of Finance with the power to extend the then two-year

[330] Charles Hattingh 'Deceit, Carelessness or Ignorance?' (November/December 2003) *Accountancy SA* 26 available online at <http://www.accountancysa.org.za/archives/2003/2003nov/columns/straight.htm> [Accessed 8 December 2011] and Charles Hattingh 'The Valuation Volcano is about to Erupt' (January 2005) *Accountancy SA* 38 available online at <http://www.accountancysa.org.za/resources/ShowItemArticle.asp?ArticleId=563&Issue=445> [Accessed 8 December 2011].

period within which valuations had to be performed (that is, by 30 September 2003) by notice in the *Government Gazette*. The period was extended to 30 September 2004.[331] That date has now been entrenched in para 29(4)(*a*)(i) and the Minister's power to extend the period has been removed.

8.33.14 Non-applicability of certain provisions to persons with a valuation date after 1 October 2001 [para 29(8)]

The provisions set out in the table below do not apply to a person whose valuation date is after 1 October 2001 (as in the case of PBOs and recreational clubs).

Table 1 – Provisions of para 29 that do not apply to persons with a valuation date after 1 October 2001

Paragraph 29	Description
(1)(*a*)	Prices of financial instruments listed on a recognised exchange in South Africa that were published in the *Gazette*. These prices were determined using the volume-weighted average price during the five business days before 1 October 2001.
(1)(*b*)(i)	Prices of units in South African equity or property unit trusts whose prices were published in the *Gazette*. These prices were based on the average price that a unit could be sold to the management company during the five trading days before 1 October 2001.
(2)	Determination of the market value of a controlling interest in a listed company.
(2A)	Listed financial instruments that • were not traded during the five business days preceding 1 October 2001, • were suspended during September 2001, or • when the market value exceeds the average of ruling price during first 14 days of September 2001 by 5% or more.
(3)	Definition of a 'controlling interest'.
(5)	Early submission requirements for certain high-value assets.
(6)(*a*)	Disposal of high-value assets before submission of proof with first return after 30 September 2004.

8.33.15 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 under s 11(*o*). A person may, however, not always qualify for an ordinary loss under s 11(*o*). This could happen, for example, in the case of an asset that was not 'scrapped' under s 11(*o*) before its amendment on 22 December 2003, or in the case of an asset disposed of on or after that date when that asset has a write-off period for tax purposes of 10 years or more.

For the purpose of determining the valuation date value of no gain or 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.

[331] GN 207 *GG* 26026 of 20 February 2004.

It does, however, sometimes happen that depreciable assets are sold above cost. This has been the case with some imported assets whose replacement cost has increased because of the depreciation in the value of the rand. It may also apply to certain buildings qualifying for capital allowances. The use of market value as the valuation date value of such assets then becomes worth considering for these 'gain' assets. No capital gain or loss should arise in the case of an asset sold below original cost, as the proceeds and the expenditure should be reduced to nil by any recoupments under para 35(3)(*a*) or capital allowances under para 20(3)(*a*).

A person who adopts market value must under para 35(3)(*a*) reduce any consideration received on disposal of the asset by any recoupment of capital allowances. However, the market value cannot be reduced under para 20(3)(*a*) by the capital allowances claimed, since that provision only applies to expenditure. Market value is not expenditure, but rather a 'valuation date value' under 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.

Example – Depreciable assets in respect of which 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.

8.34 Time-apportionment base cost

Paragraph 30

8.34.1 Introduction

The time-apportionment base cost method (TAB) is one of four methods that may be used for determining the valuation date values of assets acquired before valuation date, the other three being the market value method (paras 29 and 31), the weighted-average method [para 32(3A)] and the 20% of proceeds method (para 26). Under the TAB method the growth or decline that occurred before 1 October 2001 is added to or subtracted from the pre-CGT expenditure to arrive at the time-apportionment base cost, 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 under para 25.

The TAB method involves two types of apportionment, namely,

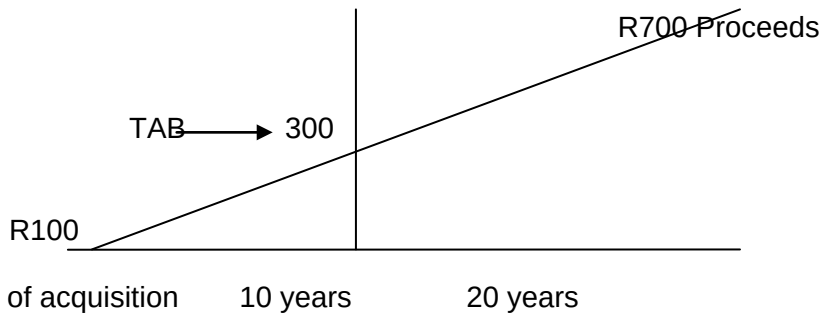
- time apportionment (applicable in all circumstances), and

- expenditure apportionment (applicable when expenditure incurred on or after valuation date).

Time apportionment

Time-apportionment involves a linear spread of the historical gain or loss between the pre- and post-CGT periods. The basic principle is illustrated in the simple example below.

Example 1 – Time-apportionment Base Cost (TAB)



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 = R400. 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 is then determined as follows:

	R
Proceeds	700
Less: Base cost (VDV)	(300)
Capital gain	400

Expenditure apportionment

As illustrated above, the TAB method involves apportionment of the overall gain or loss based on time. However, the TAB method also involves apportionment of the overall gain or loss by expenditure when expenditure is incurred on or after the valuation date. This is illustrated in the simple example below. In order to keep things simple, the period before and after valuation date has been made the same.

Example 2 – Time and expenditure apportionment

Facts:

An asset was acquired at a cost of R100 five years before valuation date and disposed of five years after valuation date for R900. A further amount of R200 was spent in improving the asset during 2003.

Result:

There is an overall gain of R900 (proceeds) – R300 (cost) = R600. The TAB method assumes that this gain was produced by both the pre- and post-valuation date expenditure on a proportional basis. Pre-CGT expenditure produces gain or loss both before and after valuation date, while post-valuation date expenditure can only produce gain or loss after the

valuation date. Since R200 of the total expenditure of R300 was incurred on or after valuation date, it follows that 2/3 of the overall gain of R600 will be subject to CGT (2/3 x R600 = R400).

One-third of the overall gain was produced by the pre-valuation date expenditure (R600 x 1/3 = R200). This gain was derived over the pre- and post-CGT periods and must be time-apportioned. In other words, R200 x 5/10 years = R100.

The total capital gain is therefore made up as follows:

	R
Gain produced by post-CGT expenditure	400
Time-apportioned gain produced by pre-CGT expenditure	100
Capital gain	500

The method for arriving at this capital gain under para 30 is different to that adopted in this example in that it involves the determination of TAB through the use of two formulae, but the result is the same. The example illustrates the principle that the higher the post-CGT expenditure, the greater the proportion of the overall gain or loss that will comprise a capital gain or loss.

8.34.2 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 before valuation date when expenditure is incurred in more than one year of assessment before 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 person falling within 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 when 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**.

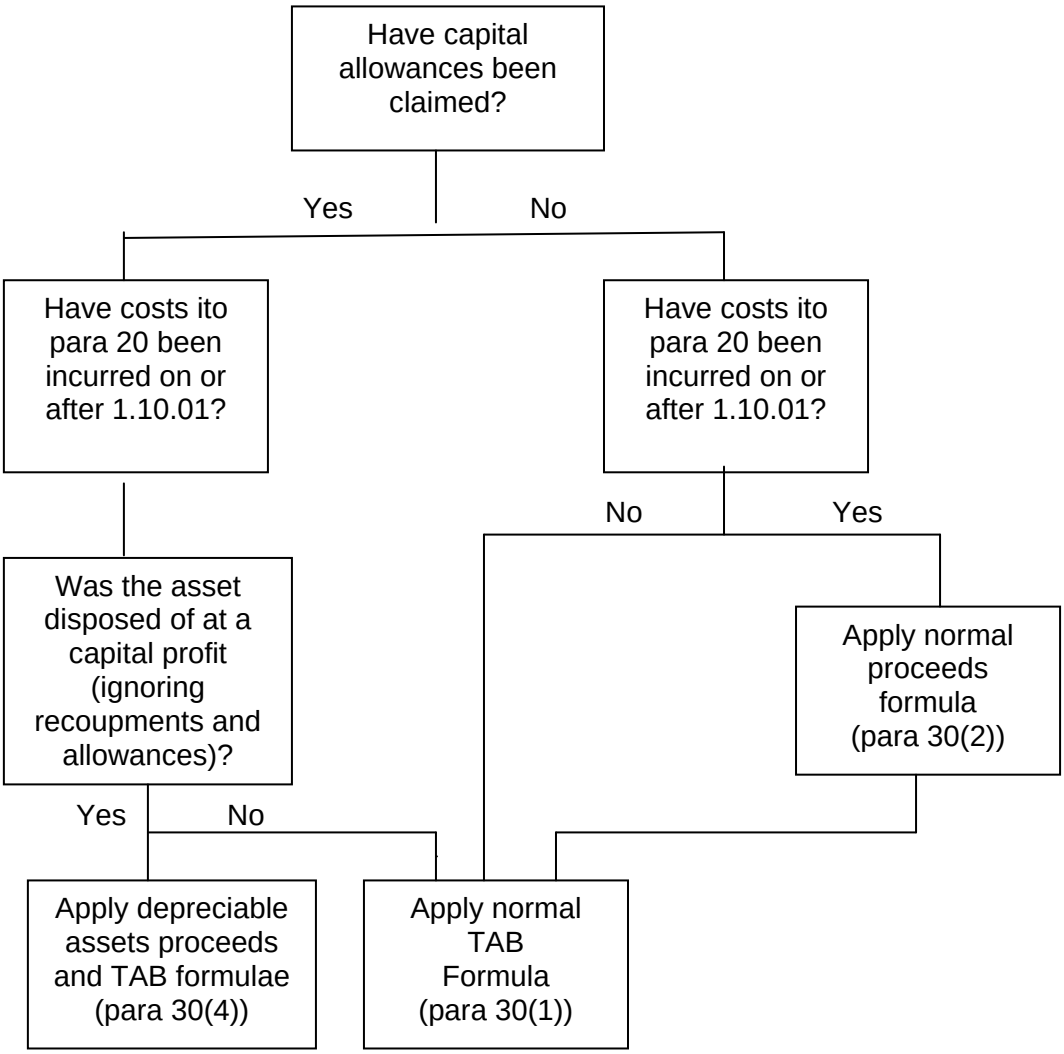
8.34.3 The formulae

Paragraph 30 contains two sets of formulae, namely,

- 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



8.34.4 The standard TAB formula [para 30(1)]

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

in which

'Y' = Time-apportionment base cost (TAB).

'B' = The amount of expenditure incurred before the valuation date in respect of the asset that is allowable before, on or after the valuation date under para 20. Pre-CGT expenditure must be reduced by capital allowances allowable as a deduction for income tax purposes in respect of that expenditure up to the date of disposal (para 20(3)(*a*) – see **8.34.4.1**).

'P' = Proceeds on disposal of the asset as determined in para 35.

Note:

- In the case of assets subject to capital allowances the amount received or accrued must be reduced by any recoupments included in gross income [para 35(3)(*a*)].
- 'P' must be determined in accordance with the proceeds formula in para 30(2) (see **8.34.5**) when allowable para 20 expenditure is incurred on or after the valuation date.
- 'P' must be reduced by selling expenses contemplated in para 30(5)(*c*) when the proceeds formula does not apply (see para 30(5)(*a*)(ii) and **8.34.10**).[332]

'N' = Number of years determined from the date that the asset was acquired to the day before valuation date.

Note:

- 'N' is limited to a maximum of 20 when expenditure has been incurred in more than one year of assessment before valuation date (see **8.34.4.2**).
- A part of a year is treated as a full year (see **8.34.4.3**).

'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.

8.34.4.1 Determining 'B' for depreciable assets not falling into para 30(3) and (4)

In determining pre-valuation date expenditure in respect of a depreciable asset, para 20(3)(*a*) must be applied so as to take into account all capital allowances up to the date of disposal, and not merely those allowable up to valuation date.[333]

Example – Determination of 'B' in the case of depreciable assets falling under para 30(1)

Facts:

Tony acquired an asset on 1 October 1998 at a cost of R100 000 and claimed capital allowances under s 11(*e*) at the rate of 10% a year on a straight line basis. On 30 September 2005 he sold the asset for R120 000. As at 1 October 2001 he had claimed capital allowances of R30 000 and by the date of sale he had claimed a further R40 000, making a total claim of R70 000.

Result:

'B' in the TAB formula is determined as follows:

[332] Applicable to disposals during years of assessment ending on or after 8 November 2005. Before that date selling expenses triggered the proceeds formula, since they were treated as post-CGT expenditure rather than as a reduction of proceeds.

[333] Clarified by the amendment of para 30(1)(*b*) by s 70(1)(*a*) of the Revenue Laws Amendment Act 31 of 2005.

	R
Cost of acquisition [para 20(1)(*a*)]	100 000
Less: Capital allowances R10 000 x 7 [para 20(3)(*a*)] (1 October 1998 – 30 September 2005)	(70 000)
Allowable expenditure under para 20 ('B')	30 000

All capital allowances up to date of disposal are taken into account and not only those allowable up to valuation date.

The proceeds are determined as follows:

	R
Consideration received or accrued	120 000
Less: Recoupment [para 35(3)(*a*)]	(70 000)
Proceeds	50 000

TAB = B + [(P – B) x N/(N + T)]
= R30 000 + [(R50 000 – R30 000) x 3/(3 + 4)]
= R30 000 + [R20 000 x 3/7]
= R30 000 + 8 571 = R38 571

Capital gain = Proceeds – TAB – A
= R50 000 – R38 571 – R0
= R11 429

8.34.4.2 The twenty-year limit

The number of years before valuation date ('N') is limited to 20 when expenditure has been incurred in more than one year of assessment before the valuation date.

Improvements to an asset before valuation date are 'thrown back' to the date of acquisition. This measure was introduced in preference to the slice method discussed earlier under 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 in which, say, a piece of land was acquired 100 years before valuation date, a shopping centre was erected on it shortly before valuation date, and then sold say five 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. There is no limit when all pre-valuation date expenditure is incurred in a single year. So if the 100-year-old land were sold five 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 when improvements take place after valuation date, though in this case the proceeds formula in para 30(2) will be triggered (see below) and will result in a greater proportion of the overall gain or loss becoming a capital gain or loss.

8.34.4.3 Parts of a year

As noted above, parts of a year are treated as a full year. For example, if an asset was acquired three years and one day before valuation date, 'N' will be treated as four years. Likewise if the asset was disposed of three years and one day after valuation date, 'T' will be treated as four years. This treatment is intended to eliminate the need for complex fractions, and assists when the exact day on which an asset was purchased is unknown (that is, only the month and year of acquisition or disposal need be known).

In determining whether expenditure has been incurred in more than one year for the purpose of limiting 'N' to 20, regard must be had to *years of assessment*. However, in determining the number of years before and after valuation date (N and T in the formula) the years are determined as follows:

- Pre-1 October 2001 – begin 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 – begin 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.

Example – Determination of 'N' and 'T'

The following examples illustrate the determination of 'N' and 'T':

Date of acquisition	'N'
1 October 1981	20
30 September 1981	21
30 June 1999	3
30 September 2000	2
30 September 2001	1
Date of disposal	'T'
1 October 2001	1
30 June 2002	1
30 September 2002	1
1 October 2002	2
30 June 2003	2

8.34.5 The standard proceeds formula [para 30(2)]

The symbol 'P' in the formula Y = B + [(P – B) x N/(N + T)] must be determined in accordance with the proceeds formula set out below when expenditure is incurred both before and on or after the valuation date: This formula was amended with effect from years of assessment ending on or after 8 November 2005 under the amendment 'R' and 'A' must be reduced by selling expenses contemplated in para 30(5) (see **8.34.10**).

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

in which

'P' = Proceeds to be used in the TAB formula.

'R '= Proceeds as determined under para 35, less any selling expenses contemplated in para 20(1)(*c*)(i) to (iv) [see para 30(5)(*a*)(i)], In arriving at proceeds under para 35 the amount received or accrued in respect of the disposal of the asset must be reduced by any recoupments (for example, of capital allowances) under para 35(3)(*a*).

'A' = Expenditure allowable under para 20 incurred on or after the valuation date, excluding any selling expenses referred to in para 20(1)(*c*)(i) to (iv) [see para 30(5)(*b*)].

'B' = The amount of expenditure incurred before the valuation date in respect of the asset that is allowable before, on or after the valuation date under para 20.

Note: In the case of depreciable assets not falling into para 30(3) and (4) the allowable expenditure under para 20 ('A' and 'B) is arrived at by reducing the relevant pre- or post-valuation date expenditure by any applicable capital allowances under para 20(3)(*a*). In the case of 'B' all capital allowances allowable up to the date of disposal in respect of the pre-

valuation date expenditure must be taken into account and not merely those allowable up to valuation date (see **8.34.4.1**).[334]

The proceeds formula is based on the premise that

- post-valuation date expenditure generates post-valuation date gain or loss, and
- pre-valuation date expenditure generates gain or loss both before and on or after valuation date.

In cases in which

- the expenditure before the valuation date is nil, and
- allowable para 20 expenditure has been incurred on or after the valuation date [excluding selling expenses – see para 30(5)],

the entire gain or loss will comprise a capital gain or loss as a result of the proceeds formula. Examples include capitalisation shares [particularly those disposed of during years of assessment ending before 8 November 2005 and the introduction of para 30(5)] and assets acquired by donation or inheritance before valuation date. When a capital gain results under these circumstances, one of the other valuation methods (market value, 20% of proceeds or weighted average) should be considered as an alternative to TAB.

8.34.5.1 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' under para 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 under s 73B of the Act. A person who fails to comply with this provision may be liable to a fine or imprisonment under 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 under ss 76 and 89*quat* respectively. A person who has lost records of post-valuation date expenditure can agree with the Commissioner under s 78(2) on the amount to be taken into account. The amount so agreed upon is not subject to objection and appeal.

[334] Clarified by the amendment of para 30(2)(*d*) by s 70(1)(*b*) of the Revenue Laws Amendment Act 31 of 2005.

8.34.5.2 Payment of commission by buyer

Before the introduction of para 30(5) which treats selling expenses as a reduction of proceeds, it was suggested by some tax practitioners 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 (as it then read) when they are carried out solely or mainly for the purposes of avoiding CGT. This could well be the case when the seller's original mandate to the agent was on the basis that the seller would pay the commission. For the purposes of transfer duty the commission must be added back to the consideration payable in determining the amount of the duty.[335]

8.34.6 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 October 2001	Use TAB formula. No limit on period before 1 October 2001
In more than one year of assessment before 1 October 2001	Use TAB formula. Period before 1 October 2001 limited to 20 years
Before, and on or after 1 October 2001	Use proceeds formula and thereafter TAB formula

8.34.7 Calculations must be made for each 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.

8.34.8 TAB calculator

The following TAB calculators are available on the SARS website:

- TAB Calculator. This applies to persons with a valuation date of 1 October 2001.
- TAB Calculator for PBOs and recreational clubs. This calculator makes provision for the valuation dates of PBOs and clubs which vary depending on their financial year-ends. It can also handle a valuation date of 1 October 2001.

Both calculators can be found on the SARS website under Tax Types / Capital Gains Tax.[336]

The calculators use an Excel worksheet and apply the standard TAB and proceeds formulae in para 30(1) and (2). They also apply the kink tests in paras 26(3) and 27(3), and in the historical gain situation inform the user whether there is an alternative method that provides a better result.

The calculators cannot be used to determine TAB under the special depreciable assets formulae in para 30(3) and (4).

[335] Section 6(*a*) of the Transfer Duty Act 40 of 1949.
[336] See <http://www.sars.gov.za/home.asp?pid=179> [Accessed 8 December 2011].

Example 1 – TAB: No improvements made before valuation date

Facts:

Barbara acquired a piece of land in Johannesburg on 1 October 1971 for R200 000 and disposed of it on 30 September 2011 for R2 000 000. Barbara incurred no other expenditure allowable under 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/(N + T)]
= 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
Less: Base cost (TAB)	(1 550 000)
Capital gain	450 000

Since Barbara did not incur expenditure in more than one year of assessment before the valuation date, 'N', in the above formula, is not limited to 20 years.

Example 2 – TAB: Improvements made in more than one year before 1 October 2001 and after that date

Facts:

The facts are the same as in Example 1, except that Barbara erected a shopping centre upon her piece of land, two 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 on 30 September 2011 for R12 000 000.

Result:

As a portion of the expenditure allowable under para 20 was incurred both before and on or after the valuation date, the proceeds formula in para 30(2) applies. Furthermore, since she incurred expenditure in more than one year before valuation date, 'N' must be limited to 20.

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:

B = R200 000 + R5 000 000 = R5 200 000
N = 20 (limited – see note below)
T = 10
Y = B + [(P – B) x N/(N + T)]
= R5 200 000 + [(R10 064 516 – (R5 200 000) 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
Base cost = TAB + post-CGT expenditure
= R8 443 011 + R1 000 000
= R9 443 011

	R
Proceeds	12 000 000
Less: Base cost	(9 443 011)
Capital gain	2 556 989

Note: 'N' in the above formula is limited to 20 years when expenditure is incurred in more than one year of assessment before the valuation date. In this example, N was limited from 30 to 20. Barbara loses 10 years in respect of her piece of land. However, a point in Barbara's favour is that the improvements effected only two years before valuation date will be treated as being incurred 20 years before valuation date.

Example 3 – Treatment of selling expenses as a reduction of proceeds for the purposes of determining TAB

Facts:

Zelda bought her holiday home on 1 June 1980 at a cost of R25 000. She sold it on 1 June 2006 for R850 000. She incurred the following selling expenses:

	R
Estate agent's commission	48 000
Cost of obtaining electrical compliance and entomologist's certificates	2 000
	50 000

Result:

Before introduction of para 30(5)

The proceeds formula is triggered because Zelda has incurred post-valuation date selling expenses.

P = R x [B/(A + B)]
= R850 000 x R25 000/(R50 000 + R25 000)
= R283 333

TAB = B + [(P – B) x N/(N + T)]
= R25 000 + [(R283 333 – R25 000) x 22/27]
= R25 000 + R210 494 = R235 494

Capital gain = Proceeds – valuation date value (TAB) – post-valuation date expenditure
= R850 000 – R235 494 – R50 000
= R564 506

After introduction of para 30(5)

The proceeds formula is no longer triggered because the selling expenses must be deducted from the proceeds as represented by the symbol 'P'.

P = R850 000 – R50 000 = R800 000

TAB = B + [(P – B) x N/(N + T)]
= R25 000 + [(R800 000 – R25 000) x 22/27]
= R25 000 + R631 481 = R656 481

Capital gain = Proceeds – valuation date value (TAB) – post-valuation date expenditure
= R850 000 – R656 481 – R50 000 = R143 519

Example 4 – Determination of TAB when selling expenses plus other post-valuation date expenditure incurred

Facts:

The facts are the same as in Example 3 except that Zelda spent R10 000 on 31 July 2003 on installing an electric fence around her property.

Result:

Before introduction of para 30(5)

P = R x B/(A + B)
= R850 000 x R25 000/(R60 000 + R25 000)
= R250 000

TAB = B + [(P – B) x N/(N + T)]
= R25 000 + [(R250 000 – R25 000) x 22/27]
= R208 333

Capital gain = Proceeds – valuation date value (TAB) – post-valuation date expenditure
= R850 000 – R208 333 – R60 000 = R581 667

After introduction of para 30(5)

R = R850 000 – R50 000 = R800 000
= R x B/(A + B)
= R800 000 x R25 000/(R10 000 + R25 000)
= R571 429

TAB = B + [(P – B) x N/(N + T)]
= R25 000 + [(R571 429 – R25 000) x 22/27]
= R25 000 + R445 238
= R470 238

Capital gain = Proceeds – valuation date value (TAB) – post-valuation date expenditure
= R850 000 – R470 238 – (R50 000 + R10 000)
= R319 762

8.34.9 The depreciable assets TAB and proceeds formulae [para 30(3) and (4)]

If 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, when 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. In order to rectify this problem an additional formula was introduced to cater for such circumstances.[337] Under 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.

8.34.9.1 Conditions under which the depreciable assets TAB and proceeds formulae apply [para 30(3)]

Three conditions must be met:[338]

- Expenditure under para 20(1)(*a*), (*c*) or (*e*) must have been incurred on or after the valuation date.
- A part of the expenditure referred to in para 20(1)(*a*), (*c*) or (*e*) incurred before, on or after the valuation date is or was allowable as a deduction in determining the taxable income of the person before the inclusion of any taxable capital gain (for example, the asset qualified for a capital allowance).
- The proceeds on disposal of the asset must exceed the allowable para 20 expenditure incurred before, on and after the valuation date in respect of the asset. In other words the asset must have been disposed of at an overall capital profit.

The expenditure referred to in para 20(1)(*a*), (*c*) and (*e*) is summarised in the table below.

Table 1 – Expenditure contemplated in para 20(1)(*a*), (*c*) and (*e*)

Paragraph 20(1)	Expenditure
(*a*)	Expenditure actually incurred in respect of the cost of acquisition or creation of the asset.
(*c*)(i) to (ix)	Various items of expenditure directly related to the acquisition or disposal of the asset (e.g. estate agent's commission, transfer duty, stamp duty, etc)
(*e*)	The expenditure actually incurred in effecting an improvement to or enhancement of the value of that asset, if that improvement or enhancement is still reflected in the state or nature of that asset at the time of its disposal.

8.34.9.2 The formulae

The formulae, which appear in para 30(4), are as follows:

$$Y = B + \frac{[(P_1 - B_1) \times N]}{T + N},$$

and

$$P_1 = \frac{R_1 \times B_1}{(A_1 + B_1)}$$

In which

[337] Introduced by the Revenue Laws Amendment Act 74 of 2002, effective as from 1 October 2001.
[338] Paragraph 30(3) was amended by s 70(1)(*c*) of the Revenue Laws Amendment Act 31 of 2005 with effect from years of assessment ending on or after 8 November 2005.

'P_1' = The proceeds attributable to the expenditure in B_1.

'A_1' = The sum of

- the expenditure allowable under para 20 in respect of the asset that is incurred on or after valuation date, and
- any amount of that expenditure that has been recovered or recouped as contemplated in para 35(3)(*a*),

less:

- any selling expenses contemplated in para 20(1)(*c*)(i) to (iv) [see para 30(5)(*b*)].

'B_1' = The sum of

- the expenditure allowable under para 20 in respect of the asset that is incurred before valuation date, and
- any amount of that expenditure that has been recovered or recouped as contemplated in para 35(3)(*a*).

'B', 'N' and 'T' = These symbols bear the same meanings ascribed to them in para 30(1).

'R_1' = The sum of

- the proceeds, and
- any amount contemplated in para 35(3)(*a*) in respect of the asset,

less:

- any selling expenses contemplated in para 20(1)(*c*)(i) to (iv).

The gain applicable to the pre-CGT period is determined by 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 'receipts' by the costs incurred before valuation date, divided by the total cost of the asset. 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, para 25 is 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 – 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 October 2001	Post-1 October 2001	Total
	R	R	R
Cost	100	200	300
Less: Capital allowances	(100)	(20)	(120)
Expenditure under para 20	-	180	180
Period (years)	10	5	15

	R
Received on disposal	321
Recouped under s 8(4)(*a*)	120
Proceeds under 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 October 2001 = R100; and on or after 1 October 2001 = R200;
- Capital allowances of R100 were claimed;
- There is an overall gain 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 October 2001)
= R201 – (R4,6667 + R180)
= R201 – R184,6667
= R16,3333

Note: 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.

8.34.10 TAB and selling expenses [para 30(5)]

8.34.10.1 Rationale

When a person has incurred expenditure on or after the valuation date, the proceeds formulae in para 30(2) and (4) will apply. The effect of these formulae is that the greater the expenditure incurred after the valuation date the greater the proportion of the overall gain or loss that will comprise a capital gain or loss. Since selling expenses comprise post-valuation date expenditure under para 20, they would, before the introduction of para 30(5), trigger the application of the proceeds formulae. In the absence of para 30(5) this could have a marked effect on the proportion of the gain or loss that is subject to CGT, especially when the historical cost of the asset is low in relation to the selling costs. This is particularly the case with immovable property which tends to be held for long periods of time and is associated with relatively high selling costs (for example, estate agent's commission). In other cases, such as the sale of shares, brokers often simply pay their clients a net amount of proceeds, and these taxpayers are not aware that the proceeds formula applies.

8.34.10.2 Exclusion of selling expenses from proceeds [para 30(5)(a)]

In order to assist taxpayers para 30(5) was introduced. It applies to disposals made during years of assessment ending on or after 8 November 2005. Under para 30(5) selling expenses must be deducted from

- when para 30(2) and (3) apply, the amounts represented by the symbols 'R' and 'R_1' respectively, and
- in any other case, the amount represented by the symbol 'P'.

The first bullet point applies when the person has incurred qualifying para 20 expenditure on or after the valuation date (for example, expenditure on improvements or in obtaining a CGT valuation). In such a case the proceeds formulae are triggered in the normal way by that expenditure (not by the selling expenses).

The second bullet point applies when there is no post-valuation date expenditure, and the proceeds formulae do not apply.

The reduction, when applicable, of the amounts represented by the symbols 'R', 'R_1' and 'P' by the selling expenses applies solely for the purposes of applying the TAB and proceeds formulae. Selling expenses remain post-valuation date expenditure for the purposes of the kink tests in paras 26 and 27, and for the purposes of determining a capital gain or loss under para 25.

8.34.10.3 Exclusion of selling expenses from allowable para 20 expenditure [para 30(5)(b)]

Except for para 30(3)(*c*) any reference in para 30 to expenditure allowable under para 20 must exclude selling expenses. This is to prevent the same amounts from being taken into account twice. For example, in the absence of para 30(5)(*b*), selling expenses would be deducted from proceeds and would also have been included in 'A' and 'A_1' in the proceeds formulae (expenditure on or after the valuation date).

However, para 30(3)(*c*) is an exception to the above rule. Paragraph 30(3) contains the entry requirements for the use of the special depreciable assets formulae. One of those requirements, contained in para 30(3)(*c*), is that there must be an overall gain. In making this determination, selling expenses must be taken into account, otherwise what appears to be an overall gain might in fact be an overall loss.

8.34.10.4 Definition – 'selling expenses' [para 30(5)(c)]

The term 'selling expenses' is defined in para 30(5)(*c*). It means qualifying expenditure referred to in para 20(1)(*c*)(i) to (iv) incurred directly for the purposes of disposing of an asset. Those expenses are

- the remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor, for services rendered,
- transfer costs,
- stamp duty, transfer duty or similar duty, and
- advertising costs to find a seller or to find a buyer.

'Selling expenses' do not include any expenditure described above that relates to the *acquisition* of an asset.

8.34.11 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 when the expenditure in question was incurred many years before the introduction of CGT. In such cases alternative forms of proof can be considered. It is impossible 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. If, 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 (for example, date of acquisition, description and cost) that should suffice as proof of expenditure.

8.34.12 Asset acquired for no consideration before valuation date

See **8.5A**.

8.34.13 Self-generated goodwill and TAB

In many cases, goodwill is not purchased, but is self-generated by the business.

The use of TAB for determining the valuation date value of self-generated goodwill may be possible in appropriate circumstances. Two issues, however, arise in this regard.

First, what costs should be allocated to self-generated goodwill for the purpose of determining 'A' and 'B' in the TAB and proceeds formulae? Much of the expenditure contributing to goodwill (for example, salaries and wages and advertising costs) will have been allowed against income and will be excluded from base cost under para 20(3)(*a*). Costs relating to other identifiable assets (for example, an advertising sign of a capital

nature[339] or the cost of a building) should be allocated to those assets, rather than to goodwill, While these other assets may contribute to the existence and value of goodwill, they are considered to be separate from goodwill which is taken as an asset in its own right. Furthermore, while goodwill may comprise different elements or arise from different sources, for example, a person, monopoly, site or name, it is treated as one asset inseparable from the business. However, a word of caution needs to be sounded in cases in which there is no pre-valuation date expenditure. The entire capital gain will be subject to CGT if there is even the slightest amount of qualifying post-valuation date expenditure because of the effect of the proceeds formula in para 30(2).

Secondly, at what point before the valuation date is the goodwill created? This information is needed to determine 'N' in the TAB formula (number of years or part thereof before valuation date). The following extract from the United Kingdom Inland Revenue and Customs *Capital Gains Manual* sets out when self-generated goodwill is acquired:[340]

> 'Where an asset was not acquired but was created by the person making the disposal, for example goodwill, the date of acquisition is the date the asset was created. The date the asset was created is determined as a question of fact on the basis of the evidence available.'

In the Australian case of *FCT v Murry*[341] it was said that the general rule is that only established businesses could have goodwill. But how long after establishment does goodwill arise? This issue has arisen in a number of United States tax cases dealing with the distinction between short-term and long-term capital gains. In *Erwin D Friedlaender v Commissioner of Internal Revenue*[342] the court noted that essentially, the goodwill of a business is the potential of that business to realise earnings in excess of the amount that might be considered a normal return from the investment in the tangible assets. Until such time as those excess earnings are produced, goodwill does not exist as an asset of the business. It is only in unusual circumstances that a value can be determined for goodwill after a relatively short period of operation.[343]

In the Australian case of *Hepples v FCT*[344] McHugh J stated the following:

> 'Although goodwill is commonly valued by capitalizing the expected future net profits or by estimating the worth of purchasing several years of the past profits of a business, it may exist even though the business has not made any profits and is unlikely to do so for some time.'

This would apply for example, when a person is operating an unprofitable business, and a new development is announced in the area that has the effect of substantially increasing the potential future turnover of the business.

In the case of site and monopoly goodwill it was pointed out in the *Murry* case above that goodwill may well be present at the time business operations commence.

The onus will be on the taxpayer to justify the values assigned to "A', 'B' and 'N'.

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[339] ITC 469 (1940) 11 SATC 261 (U).
[340] In CG17900.
[341] (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 8 December 2011].
[342] 26 TC 1005 1956 US Tax Ct LEXIS 97.
[343] In the US case of *Sidney v LeVine* 24 TC 147 the court found that goodwill existed in a partnership after a mere 28 months of operation as a result of having highly skilled employees who developed specially designed equipment.
[344] (1991) ALR 497.

8.34.14 Pre-CGT rationalisation schemes and TAB

Section 39 of the Taxation Laws Amendment Act 20 of 1994 provided roll-over relief for normal tax purposes in the case of certain rationalisation schemes. The type of scheme envisaged by s 39 was one in which

- on or after 4 November 1994,
- the whole or a part of any business undertaking of one company (the transferor company)
- was disposed of by way of sale, donation, cession, dividend or in any other form to any other company (the transferee company), and
- both such companies are at the time of that disposal members of the same group of companies.

Under s 39(6)(*c*) the Commissioner and the controlling company could agree that

> 'the transferor company and the transferee company shall, subject to such adjustments as may be necessary, be deemed to be one and the same company: Provided that [the proviso is not relevant for present purposes] . . .'.

The effect of s 39(6)(*c*) for the purposes of TAB is to ensure that the details (cost, date of acquisition and date of incurral of expenditure) are carried across from the transferor company to the transferee company. Although the 'one and the same person' principle was subject to agreement between the Commissioner and the controlling company, it is likely that it was a standard feature of most of the rationalisation schemes that were entered into. The final date by which an application could be submitted to the Commissioner under s 39 was 1 March 2002. These rules were replaced by the corporate restructuring rules in ss 41 to 47 of the Income Tax Act.

8.35 Market value

Paragraph 31, s 23C

8.35.1 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-arm's 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 when the vendor was entitled to an input tax credit under s 16(3) of the Value-Added Tax Act, 1991. A vendor who is not entitled to claim an input credit or a non-vendor may include VAT when determining market value. A vendor who was entitled to but failed to claim an input credit in any previous year must nevertheless exclude that amount from the market value of the asset. This follows from s 23C(1)(*b*) which is only concerned with entitlement and not the actual amount claimed.

8.35.2 Prescribed valuation methods

Table 1 – Prescribed methods for determining market value (para 31)

Paragraph 31	**Type of asset**	**Market value**
(1)(*a*)	Financial instrument listed on a recognised exchange for which a price is quoted	Ruling price[345] at close of business on last business day before the specified date.
(1)(*b*)	Long-term insurance policy with a South African insurer	Greater of: • Surrender value • Insurer's market value (assume policy runs to maturity).
(1)(*c*)(i)	Portfolio comprised in any collective investment scheme In securities[346] or property.[347]	Management company's repurchase price.
(1)(*c*)(ii)	Foreign collective investment scheme in shares, units or any other form of participatory interest.[348]	Management company's repurchase price or if not available, the selling price based on the price a willing buyer would pay a willing seller acting at arm's length in an open market.
(1)(*d*)	Fiduciary, usufructuary and other like interests	Present value of future benefits discounted at 12% a year 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.[349] • Other persons (e.g. companies or trusts) – 50 years.
(1)(*e*) and (2)	Asset subject to fiduciary, usufructuary or other like interest	Market value of full ownership, less value of *fideicommissum* or usufruct etc as determined above.
(1)(*f*) and (4)	Immovable farming property	• Market value less 30% (defined in Estate Duty Act) or • price based on a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market. On disposal by death, donation or non-

[345] As defined in para 1 of the Eighth Schedule.
[346] 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.
[347] As contemplated in Part V of the Collective Investment Schemes Control Act 45 of 2002.
[348] As defined in para (*e*)(ii) of the definition of 'company' in s 1.
[349] See regulations issued under s 29 of the Estate Duty Act 45 of 1955.

		arm's length transaction, the 'market value less 30%' may only be used if it is used in determining the base cost of the disposer on • valuation date, or, when applicable, • date acquired by inheritance, donation or non-arm's length transaction at market value less 30%. See **8.35.5**.
(1)(*g*)	Any other asset	Price based on willing buyer, willing seller at arm's length in an open market.
(3)	Unlisted shares	Price based on willing buyer, willing seller at arm's length in an open market, ignoring any: • Restrictions on transferability • Stipulated method of valuation.[350] 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.

8.35.3 What is '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, before 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.

[350] This provision is similar to that found in s 5(1)(*f*)*bis* of the Estate Duty Act 45 of 1955.

8.35.4 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 term 'insurer' as defined in para 1 and the related commentary on para 55 in **12.4.4.5**. Foreign policies must therefore be valued in accordance with the general rule in para 31(1)(*g*).

8.35.5 'Market value less 30%' and farming properties

Under para 31(1)(*f*), immovable property on which *bona fide* farming operations is carried on may be valued at

- the value contemplated in para (*b*) of the definition of the term 'fair market value' in s 1 of the Estate Duty Act 45 of 1955, or
- 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 [para 31(1)(*g*)].

Paragraph (*b*) of the definition of the term 'fair market value' in the Estate Duty Act was amended by s 1(1)(*a*) of the Revenue Laws Second Amendment Act 32 of 2005 with effect from the date of promulgation of that Act, 1 February 2006, and applicable in respect of the estate of any person who dies on or after that date. For the purposes of para 31(1)(*f*) the amendment should be regarded as applying to disposals or acquisitions on or after 1 February 2006.

Before 1 February 2006

Before 1 February 2006 the definition of the term 'fair market value' in s 1 of the Estate Duty Act read as follows:

> '**"[F]air market value",** means—
>
> (*a*) [not applicable]; or
>
> (*b*) an amount to be determined in accordance with the provisions of subsection (2) as representing the aggregate of the fair agricultural or pastoral value of the land and the value which any improvements situated thereon may be expected to add to such value of the land (which aggregate is hereinafter referred to as the surface value), together with the fair market value of any mineral rights attaching to the land, as at the date of the death of the deceased person.'

Subsection (2), which was deleted at the same time that para (*b*) of the above definition was substituted, read as follows:

> '(2)(*a*) In the case of any property in respect of which the executor elects the value determined in accordance with paragraph (*b*) of the definition of "fair market value" in subsection (1), the executor shall lodge an application in the prescribed form in duplicate for a determination of the surface value of that property with the magistrate of the district in which any such property is situate.
>
> (*b*)(i) Any magistrate with whom any such application has been lodged shall forward both copies thereof to any land hank valuator selected by him who has been appointed in terms of section seventy of the Land Bank Act, 1944 (Act No. 13 of 1944), with instructions to make a valuation of the surface value of the property in question.
>
> (ii) The provisions of the Land Bank Act, 1944, applicable to valuators appointed under the said Act, and any instructions issued from time to time by the Land Bank to such valuators in connection with the exercise of their duties, shall apply to any such valuator instructed to make a valuation of the surface value

of any such property as though he were making a valuation for land hank purposes.

(iii) Fees and travelling expenses shall be paid by the estate of the deceased to any such valuator in accordance with the tariffs applicable to the valuations of property by appraisers appointed under the Administration of Estates Act, 1965.

(*c*) Any land bank valuator to whom any such application in duplicate has been referred, shall cause the particulars of his valuation of the surface value of the property in question to be inserted on both copies of the application and shall within three days from the date on which his valuation was made forward one copy to the executor of the estate and the remaining copy to the magistrate for transmission to the Commissioner.

(*d*)(i)The Commissioner shall thereupon determine the surface value of the property in question, which determination shall be subject to the provisions of paragraph (*e*), or may refer the matter to the Board of the Land Bank as constituted under section four of the Land Bank Act, 1944 (in this section referred to as the Board), for its determination of such value.

(ii) The Commissioner shall at the same time determine the fair market value of the mineral rights attaching to the property in question and shall advise the executor of the values determined by him under this paragraph and shall indicate in such advice whether the determination of the surface value of the property was made by him or by the Board.

(*e*) If the executor considers himself aggrieved by the Commissioner's determination of the surface value of any property in terms of paragraph (*d*), he shall notify the Commissioner thereof in writing within twenty-one days or such further period as the Commissioner may allow from the date of the advice referred to in the said paragraph and the Commissioner shall thereupon cause the matter to be referred to the Board for review.'

The application of the above so-called Land Bank value is discussed below.

On or after 1 February 2006

On or after 1 February 2006 para (*b*) of the definition of the term 'fair market value' in the Estate Duty Act read as follows:

'**"[F]air market value",** means—

(*a*) [not relevant]; or

(*b*) in relation to immovable property on which a *bona fide* farming undertaking is being carried on in the Republic, the amount determined by reducing the price which could be obtained upon a sale of the property between a willing buyer and a willing seller dealing at arm's length in an open market by 30 per cent.'

Under para 31(4) the use of the alternative value under para (*b*) of the definition of the term 'fair market value' is restricted when the farming property is disposed of by way of death, donation, or non-arm's length transaction (that is, when the para (*b*) value is used to determine the proceeds on disposal). Under the restriction the para (*b*) method may not be used on disposal unless

- in the case of pre-valuation date farming property it is used to determine the valuation date value [para 31(4)(*a*)], or
- in the case of a farming property acquired on or after the valuation date by way of inheritance, donation or non-arm's length transaction, the property was acquired at a para (*b*) value [para 31(4)(*b*)].

The purpose of para 31(4) is to match like with like by ensuring that the method used for determining the consideration received or accrued on disposal under para 38 or 40 is the same as the method used in determining the base cost under para 26, 27, 38 or 40.

Pre-valuation date farming property [para 31(4)(a)]

Valuation date value: Market value less 30% cannot be used to determine the valuation date value of a farm property. Under para 29(4) all valuations had to be completed by 30 September 2004 and the amendment was not given retrospective effect. In other words, Land Bank value must be used as the valuation date value when para 31(1)(*f*)(i) is adopted.

Proceeds: The Land Bank value (disposal before 1 February 2006) or market value less 30% (disposal on or after 1 February 2006) can only be used for determining the consideration received or accrued on disposal by way of death, donation or non-arm's length transaction if Land Bank value is used in determining the valuation date value [para 31(4)(*a*)].

Thus in the case of a farm acquired before valuation date and disposed of by way of death, donation or non-arm's length transaction on or after 1 February 2006, the Land Bank value on 1 October 2001 must be used as the valuation date value if the market value less 30% is used to determine the proceeds.

Under para 31(1)(*f*) a person has a choice of either market value or the para (*b*) value. It is accepted that a person who has determined both values by 30 September 2004 would be entitled to choose the value that gives the more favourable result in the circumstances. For example, if the property were sold to a third party market value may give a higher base cost than the para (*b*) value. On the other hand, if a farmer dies or donates the farm, the para (*b*) value may result in lower proceeds but Land Bank value will have to be adopted as the valuation date value.

Post-valuation date farming property [para 31(4)(b)]

Paragraph 31(4)(*b*) applies to farming property acquired on or after valuation date which is disposed of by way of death, donation or non-arm's length transaction. In such cases market value less 30% may only be used to determine the consideration received or accrued under para 38 or 40 if the property was acquired by way of inheritance, donation or non-arm's length transaction at a para (*b*) value (pre-1 February 2006: Land Bank value; on or after 1 February 2006: market value less 30%).

Sales to third parties

Under an arm's length sale to a third party the proceeds will be the actual amount received or accrued under para 35. In the case of pre-valuation date property, the valuation date value of the property will be either Land Bank value or market value, depending on which value the person has determined and adopted. In the case of post-valuation date farming property the base cost will be the actual cost under para 20, or when para 38 or 40 applies, the value determined under those provisions in accordance with para 31(1)(*f*). That could be market value, Land Bank value (pre-1 February 2006 acquisition) or market value less 30% (acquisition on or after 1 February 2006), depending on the method adopted by the person from whom the property was acquired.

Example 1 – Proceeds and base cost of pre-valuation date farming property

Facts:

Eddie acquired a farm in 1980 at no cost by inheritance from his late father. The Land Bank value of the property on 1 October 2001 was R1 million and the market value R1,3 million. Eddie complied fully with para 29(4).

On 30 June 2007 Eddie passed away. The market value of the property at that stage was R1,5 million. The executor determined the proceeds on death under para 40(1) using market value less 30% [para 31(1)(*f*)(i)].

Result:

Eddie will have a capital gain determined as follows:

	R
Proceeds R1 500 000 – R450 000 (30%)	1 050 000
Less: Base cost (Land Bank value)	(1 000 000)
Capital gain	50 000

The executor is not permitted to use market value on 1 October 2001 as the base cost because market value less 30% has been used to determine the proceeds on death [para 31(4)(*a*)].

Example 2 – Base cost of pre-valuation date farming property sold to third party

Facts:

The facts are the same as in Example 1 except that Eddie sold the property on 30 June 2007 to a third party for R1,5 million.

Result:

Eddie is entitled to use either Land Bank value or market value to determine the valuation date value of the property. Since market value gives the higher base cost he will choose that value (R1,2 million). He will therefore have a capital gain of R1,5 million less R1,2 million = R300 000. In these circumstances the actual proceeds of R1,5 million must be accounted for under para 35.

Example 3 – Post-valuation date farming property disposed of by way of donation (1)

Facts:

Rita acquired a farm by inheritance from her late father, Bob, in 2002. Bob's executor had adopted Land Bank value of R1 million for determining the proceeds on disposal of the farm under para 40(1)(*a*). On 30 September 2007 Rita donated the farm to her son Dirk when the market value of the farm was R1,5 million. Rita decided to determine her proceeds under para 38 using market value less 30%.

Result:

Rita will have proceeds of R1,5 million less 30% (R450 000) = R1 050 000. Her base cost will be equal to the base cost of Bob's deceased estate which was equal to Land Bank value [R1 million under para 40(2)(*b*)]. She will therefore have a capital gain of R50 000.

Example 4 – Post-valuation date farming property disposed of by way of donation (2)

Facts:

The facts are the same as in Example 3 except that Bob's executor adopted market value of R1,2 million in determining the proceeds on date of death under para 40(1).

Result:

Rita is not permitted to use market value less 30% in determining proceeds under para 38 in respect of her disposal to Dirk. She will therefore have proceeds equal to market value of R1,5 million. Her capital gain is R1,5 million (proceeds) less R1,2 million [base cost under para 40(2)(*b*)] = R300 000.

8.35.6 Market value – 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.[351] This raises the question as to how para 31(3)(*a*) is 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'[352]). 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.

8.35.7 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 the *Government Gazette*.[353]

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

[351] Section 81(1)(*a*) to (*f*) of the Co-operatives Act 91 of 1981.
[352] As defined in s 1 of the Co-operatives Act 91 of 1981.
[353] GNR 1942 *GG* 2533 of 23 September 1977.

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

*** NB** 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 year 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 a year for life	R8,130 12	R6,007 26
Therefore present value of R100 a year 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 a year, 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 a year for 10 years R5,650 2
Therefore present value of R100 a year for 10 years R565,02

Using Excel

The present value of an annuity can also be determined using a Microsoft Excel spreadsheet. For example, the formula for determining the present value of R100 per year for 10 years at 12% is
=PV(0.12,10,-100)
which gives a result of R565,02

8.36 Base cost – identical assets (para 32)

Paragraph 32

8.36.1 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 Krugerrands, 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 – 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
- all ordinary shares in Beta Ltd

Unique identifying numbers such as share certificate numbers must be ignored for the purpose of determining whether an asset is part of a holding of identical assets.

8.36.2 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:

8.36.2.1 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.

8.36.2.2 First-in-first-out (FIFO)

Under the FIFO method it is assumed that the oldest asset is sold first.

8.36.2.3 Weighted-average method

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 method 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 South Africa, whose price is regularly published in a national or international newspaper; *Subitem (ii)* • a collective investment scheme in securities or property whose price is 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 under s 65 of the Collective Investment Schemes Control Act 45 of 2002 to solicit investments from the public in South Africa.
(*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 organisations.

Assets in items (*a*) and (*d*) must remain in this class from the date of acquisition to the date of disposal. For example, if the weighted-average method had been used in respect of ABC Limited, a listed share, and that share became unlisted, the weighted-average method 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 (for example, private company shares and listed shares on an unrecognised exchange).
- Gold and platinum coins whose prices are not published in a newspaper for example, 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 under 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. The practical application of this is illustrated in the example below.

Example – Determination of weighted average after consecutive purchases and sales

Date	Description	Number of shares	Price per share	Base cost	Comment
			R	R	
01.10.01	Opening balance	100	5,0000	500,00	Market value according to *Gazette*
30.09.02	Purchase	300	5,5000	1 650,00	
		400	5,3750	2 150,00	R2 150/400
30.06.03	Sell	(50)	5,3750	(268,75)	
		350	5,3750	1 881,25	
28.02.04	Purchase	150	6,0000	900,00	
		500	5,5625	2 781,25	R2 781,25/500
30.06.05	Sell	(100)	5,5625	(556,25)	
		400	5,5625	2 225,00	

8.36.3 Consistency

Paragraph 32 contains two provisions aimed at ensuring the consistent use of the three asset identification methods (that is, FIFO, specific identification and weighted average). These rules are aimed at preventing base cost manipulation. The rules only apply to the four classes of identical assets referred to in para 32(3A), and do not cover groups of identical assets falling outside those classes, such as unlisted shares. It would, therefore, be possible to use specific identification for one group of unlisted shares, and FIFO for another such group. Under para 32(3A) it would not be possible to use the weighted-average method for unlisted shares.

8.36.3.1 The weighted average consistency rule [para 32(3A)]

A person using the weighted-average method for a group of identical assets falling into one of the four classes of assets referred to in para 32(3A) must use it for all other groups of identical assets falling into that class.

Example – 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 the weighted-average method 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.

If a group of identical assets falling into item (*a*) or (*d*), that is, listed shares or listed s 24J instruments, becomes unlisted, the weighted-average method can no longer be used for that group, and the specific identification or FIFO methods will have to be adopted for the unlisted assets. After delisting, the view is held that the base cost of the unlisted assets will continue to be their weighted-average base cost. However, if further identical assets are acquired they will have a base cost determined under para 20. Furthermore, the kink tests in paras 26 and 27 will not apply to any previously listed identical assets.

The removal of those assets from the particular class will have no impact on the use of the weighted-average method for any remaining listed shares or s 24J instruments falling in items (*a*) or (*d*).

8.36.3.2 The general consistency rule [para 32(6)]

Under para 32(6), once a person has adopted specific identification, FIFO or weighted average in respect of one of the four classes of identical assets referred to in para 32(3A), that person must continue to use that method until all the assets in the class have been disposed of. This rule is primarily aimed at the specific identification and FIFO methods, as consistency of use of the weighted-average method is assured in para 32(3A) as discussed in **8.36.3.1**.

It is implicit in para 32(6) that a person may adopt only one asset identification method (that is, specific identification, FIFO or weighted average) for each of the four classes of assets referred to in para 32(3A). Only once all the assets in that class have been disposed of can a different method be adopted in respect of that class.

Paragraph 32(6) states that 'once a person has adopted one of the methods . . . that method *must* be used . . .'. It follows that once a particular method has been adopted it is not open to a person to request a reopening of assessments in earlier years in order to achieve a more favourable result with hindsight using another method. This is so despite the fact that such a revision would result in a consistent application of a particular method. The evidence of adoption of a particular method can usually be deduced from the return of income reflecting the first disposal on or after valuation date of an identical asset falling within a particular class,

8.36.4 TAB and the kink tests

The weighted-average method may not be used when the base cost of an asset is determined using time-based apportionment (TAB) – para 25. This is because under time-based apportionment it is necessary to know the date of acquisition of each asset. This would not be an easy task if the assets were pooled. 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 inapplicable when the weighted-average method is adopted.

8.36.5 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**.

8.36.6 Relationship between the identification methods and valuation date value 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 – 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 R	Cost 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 R	Base Cost 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

8.37 Part-disposals

Paragraph 33

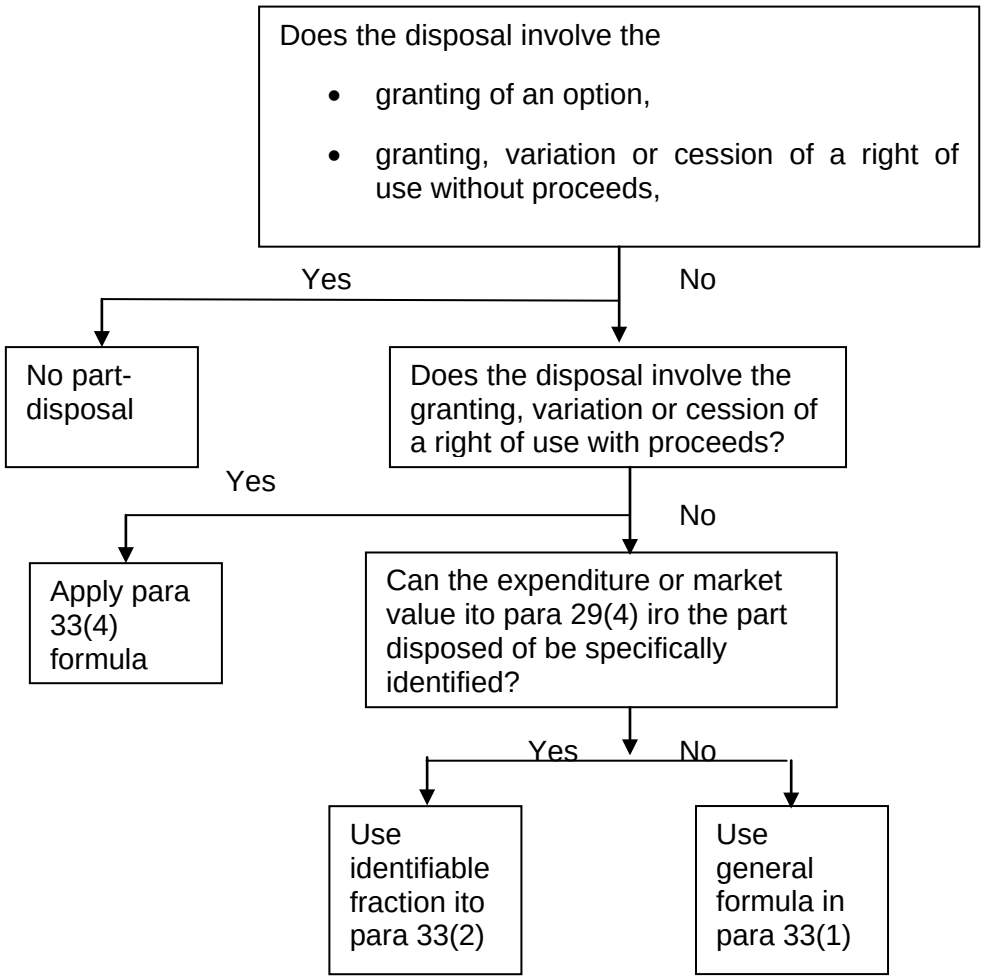
8.37.1 Purpose and application

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



8.37.2 The standard part-disposal formula [para 33(1)]

The portion of the expenditure allowable under para 20 and any valuation date market value adopted or determined under para 29(4) attributable to the part disposed of is determined in accordance with the following formula:

$$\frac{\text{Market value of part disposed of}}{\text{Market value of entire asset immediately before disposal}} \times \text{Expenditure under para 20 or market value under para 29(4) in respect of entire asset}$$[354]

The remainder of the expenditure or market value under para 29(4) would be allowable on a future disposal of the part retained.

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

$$\text{Base cost of part sold} = \frac{\text{R400 000}}{\text{R1 000 000}} \times \text{R700 000}$$

$$= \text{R280 000}$$

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-disposals and TAB

Facts:

Wayne paid R100 000 for a piece of vacant land five years before valuation date. He erected a fence around the property at a cost of R20 000 during the period after valuation date. Five 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 before 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%

[354] 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. Before 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.

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

8.37.3 Identifiable fraction method [para 33(2)]

The formula described above does not apply when a part of the allowable expenditure under para 20 or market value adopted or determined under 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.

Example – Part-disposal: Identifiable fraction

Facts:

Fiona purchased two adjoining pieces of land ten years before 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
Less: Expenditure (recognisable fraction)	(50 000)
Gain	120 000

The property was acquired 10 years before valuation date and sold five 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
Less: Time-apportionment base cost	(130 000)
Capital gain	40 000

Some practical issues are addressed below.

8.37.4 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.

8.37.5 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, it will 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.

8.37.6 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 under 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 when 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*)	Improvement or enhancement of immovable property which a lessee leases from a lessor (see Table 1 in **8.37.6.3** for effective dates)
(*d*)	Replacement of part of an asset if that replacement comprises a repair.

8.37.6.1 Granting of an option [para 33(3)(a)]

Under para 11(1)(*a*) the granting of an option is a disposal. It follows that proceeds received for the granting of an option will be subject to CGT with a nil base cost.[355] The base cost of the underlying asset in respect of which the option is granted will only be brought to account when the option is exercised and the asset itself is disposed of. An option created after the valuation date in respect of a pre-valuation date is not in itself a pre-valuation date asset, since it is 'created' on or after the valuation date.

8.37.6.2 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. The grant,

[355] The base cost of the option could, however, include expenses such as legal fees which are directly related to the cost of creating the option.

variation or cession of a right of use or occupation of an asset comprises the disposal of part of an asset, the base cost of which can be determined under para 33(1) and (2).The consideration the person receives for the use or occupation of the ass et 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 words 'use or occupation' contemplate a right of physical usage or occupation. A typical example is the granting of a lease over movable or immovable property. The granting of a right to the future dividend income from a share will not fall within para 33(3)(*b*) since it involves neither use nor occupation.

The sale of a future dividend stream (being a quasi-usufruct) results in a disposal of a portion of the bundle of rights attaching to the underlying shares. Such a sale must be accounted for as a part-disposal of the shares. The amount received or accrued from the part-disposal is not a 'dividend', but rather an amount of proceeds, assuming that the sale is on capital account. The amount paid by the buyer of the dividend stream is expenditure actually incurred for the purposes of para 20(1) in arriving at the buyer's base cost of the right to the future dividends. The dividends when received or accrued will comprise gross income in the buyer's hands under para (*k*) of the definition of the term 'gross income', which may be exempt under s 10(1)(*k*).

Example – Granting of a lease without proceeds

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 before signing the lease, the property had a market value of R120 000.

Determine the capital gain or loss assuming that XYZ (Pty) Ltd has a year-end of

- 30 November 2002
- 28 February 2003

Result:

Years of assessment ended before 1 January 2003

Under 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 under 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 as follows:

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 under 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.

8.37.6.3 Improvement or enhancement of immovable property by lessee [para 33(3)(c)]

After it was introduced by the Revenue Laws Amendment Act 45 of 2003 para 33(3)(*c*) was deleted in the following year[356] and then reinstated with more focused wording in the following year. The table below sets out the periods during which the rule applies and does not apply and the relevant wording of the provision.

Table 1 – Effective dates of amendments to para 33(3)(*c*)

Amending Act	Effective date		Effect	Wording '[T]here is no part-disposal of an asset in respect of—'
	From	To		
Section 38 of the Taxation Laws Amendment Act 5 of 2001 (inserts Eighth Schedule)	1 October 2001	Years of assessment ending on or before 31 December 2003	No rule (para 33(3)(*c*) not yet introduced).	
Section 99 of the Revenue Laws Amendment Act 45 of 2003 (substituted para 33)	Commencement of years of assessment ending on or after 1 January 2004	23 January 2005	Paragraph 33(3)(*c*) introduced.	'the improving or enhancing of that asset which is leased to that person'
Section 61(1)(*b*) of the Revenue Laws Amendment Act 32 of 2004	Paragraph 33(3)(*c*) deleted with effect from 24 January 2005	31 January 2006	No rule.	
Section 71(1)(*b*) of the Revenue Laws Amendment Act 31 of 2005	Applies in respect of any improvement or enhancement effected on or after 1 February 2006	To date	Rule reintroduced.	'the improvement or enhancement of immovable property which that person leases from a lessor'

Under the common law, improvements made to the property of a lessor by a lessee accede to the property. Although the lessee will continue to enjoy the use of the improvements until

[356] The deletion seems to have been made in error.

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.

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 1 February 2006 (and during the earlier period reflected in Table 1 above), 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 under para 20 and will be brought into account for capital gains tax purposes on the termination of the lease.

Example – Leasehold improvements by lessee

Facts:

Grocer (Pty) Ltd entered into a ten-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. Grocer (Pty) Ltd's year end is 31 March.

What is the CGT position of the lessee if the improvements were effected on

- 31 March 2005, or
- 31 March 2006?

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 2006

Under para 33(3)(*c*) the expenditure will form part of the base cost of the asset, that is, 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 will have 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.

8.37.6.4 Replacement of part of an asset comprising a repair [para 33(3)(d)]

[Effective as from the commencement of years of assessment ending on or after 1 January 2004]

A person who replaces part of an asset in the course of repairing it, disposes of part of the main asset by removing the worn out or damaged part. 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 when 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.

As to what comprises a repair, see the following extract from ITC 617[357]

> '(1) Repair is restoration by renewal or replacement of subsidiary parts of the whole. Renewal as distinguished from repair is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject matter under discussion.
>
> (2) In the case of repairs effected by renewal it is not necessary that the materials used should be identical with the materials replaced.
>
> (3) Repairs are to be distinguished from improvements. The test for this purpose is – has a new asset been created resulting in an increase in the income-earning capacity or does the work undertaken merely represent the cost of restoring the asset to a state in which it will continue to earn income as before?

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 replaced a rusty geyser at a cost of R6 000, which he claimed against rental income under s 11(*d*). He managed to sell the old geyser to a scrap metal merchant for R100.

Result:

When he removed the old geyser, John disposed of a part of the cottage. However, under para 33(3)(*d*) he does not have to determine the portion of the cost of the cottage attributable to the old geyser. The proceeds of R100 constitute a capital gain that must be recognised in the year of assessment in which the old geyser is disposed of.

8.37.6.5 Acquisition of shares cum div

No part-disposal is triggered when a shareholder acquires a share cum div and subsequently receives the dividend. The shareholder level consequences of dividend distributions are generally addressed in Part XI which does not make provision for a part-disposal in these circumstances.

8.37.7 Granting, variation or cession of a right of use or occupation when proceeds received or accrued [para 33(4)]

Despite para 33(3)(*b*), para 33(4) triggers a part-disposal when 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 the term 'gross income' (for example, rental income), while lease premiums will fall within para (*g*) of that definition. Deemed proceeds may also arise under para 38 when a lessor who is a connected person in relation to a lessee charges a rental or royalty that is not market related.

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:

[357] ITC 617 (1946) 14 SATC 474 (U) at 476.

Proceeds Market value of entire asset	x	Expenditure under para 20 or market value under para 29(4) in respect of entire asset immediately before 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 up-front 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 1 – Part-disposal when 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 a year for five years. Immediately before 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:

Under 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:

	R
Base cost	100 000
Proceeds (lease premium)	25 000
Market value of Speedy Boy	200 000

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*[358] 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*,[359] a landmark case that dealt with the meaning of the word 'plant'.

[358] (1887) 19 QBD 647 at 658.
[359] 1984 (2) SA 764 (A), 46 SATC 21.

A somewhat more restrictive view of the word 'plant' can be found in ITC 1046[360] in which 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'.

Example 2 – Part-disposal involving deemed proceeds under para 38

Facts:

Holdco owns all the shares in Subco 1 and Subco 2. Subco 1 owns a factory building, while Subco 2 carries on a manufacturing operation. Subco 1's property has a market value of R1 000 000 and a base cost of R200 000. Subco 1 enters into a ten-year lease with Subco 2 under which Subco 2 will pay an annual rental of R1. A fair rate of return on the property would be 12% a year. Determine Subco 1's capital gain or loss.

Result:

Subco 1 and Subco 2 are connected persons in relation to each other. Since the rental consideration of R1 a year is not market-related, para 38 applies. A fair rental would be R1 000 000 x 12% = R120 000 a year.

The present value of R120 000 a year for 10 years using an Excel spreadsheet is as follows:

=PV(0.12,10,-120000)
= R678 027

The present value of the actual rental is
=PV(0.12,10,-1)
= R6

The deemed proceeds under para 38 are R678 027 – R6 = R678 021.

Alternatively, this same result can be arrived at by discounting R119 999 (R120 000 – R1) a year at 12% over 10 years.

Under para 35(3)(*a*) the actual consideration of R1 a year is excluded from proceeds as it 'must be' included in gross income in future. Under para 33(4) the portion of the base cost disposed of is
Proceeds/market value x base cost
R678 021/R1 000 000 x R200 000
= R135 604

	R
Proceeds	678 021
Less: Base cost	(135 604)
Capital gain	542 417

Concern has been expressed that the outcome of Example 2 implies the imposition of transfer pricing on all connected-person leases, including informal leases between relatives of individuals. Most connected-person leases tend to be informal arrangements that are renewed on a day-to-day basis. Such arrangements arguably do not have a market value, since a third party would not be prepared to pay anything for the cession of a lease that can be cancelled at a moment's notice. These informal arrangements should accordingly not

[360] (1964) 26 SATC 217 (F).

result in deemed proceeds under para 38. The facts of Example 2 deal with a long-term lease which clearly creates a valuable leasehold right for the lessee.

8.37.8 Consistent adoption of the 20% of proceeds method [para 33(5)]

[Effective 22 December 2003]

A person who has adopted the 20% of proceeds method in respect of a part-disposal of an asset must continue to use that method for all subsequent disposals of that asset.

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 under 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 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:

Under 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.

8.37.9 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*[361] and the subsequent rulings issued by the Australian Tax Office.[362]

It follows that goodwill as a general rule cannot be partly disposed of. It is, however, accepted that it is possible to own and operate separate and distinct businesses, each with its own goodwill.

[361] (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 8 December 2011].

[362] Taxation Rulings TR 1999/16 and TR 1999/16A available at <http://law.ato.gov.au/atolaw/view.htm?Docid=TXR/TR199916/NAT/ATO/00001&PiT=99991231235958> and <http://law.ato.gov.au/atolaw/view.htm?locid='TXR/TR199916A/NAT/ATO'&PiT=99991231235958> [Accessed 8 December 2011].

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 a discrete business on 1 October 2001, even though the assets were assets of the business on that date.
- It follows 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. It is suggested that a list of discrete businesses in existence on valuation date be compiled and retained with the valuation of the goodwill of the whole business. This will assist the taxpayer in proving which of the businesses at the date of disposal existed at the valuation date.
- Expenditure incurred in developing pre-valuation date self-generated goodwill will invariably have been allowed against 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 before that disposal. This is done in order to determine the proportion of the goodwill to be allocated to the discrete business disposed of.

8.38 Debt substitution

Paragraph 34

Under 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 [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 when 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. Under 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 the asset.

Example – 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 capital gain = Proceeds [para 35(1)(*a*)] less base cost = R1 000 – R500 = R500.
Helen's capital loss = Base cost less proceeds = R1 000 – R900 = R100.

The base cost of Helen’s new asset is R900.

8.39 Exchange control and related tax amnesty assets

8.39.1 Introduction

Between 1 June 2003 and 29 February 2004 South African-resident individuals, deceased estates, trusts and close corporations were able to apply for amnesty in respect of certain exchange control and related tax offences. A pre-requisite for amnesty was that the applicant had to hold a foreign asset at 28 February 2003 which had been tainted by a tax or exchange control offence. The relevant legislation is contained in the Exchange Control

Amnesty and Amendment of Taxation Laws Act 12 of 2003 ('the Amnesty Act') and in Regulations issued under s 30 of that Act.[363]

A successful applicant is not liable to tax on any undeclared capital gain arising during any year of assessment ending on or before 28 February 2002 (s 15 of the Amnesty Act).

It follows that persons holding amnesty assets in their own names are required to make full disclosure of any capital gains and losses arising during the 2003 and subsequent years of assessment.

Section 4 of the Amnesty Act provided a special procedure under which a person (being a donor, deceased estate of a donor or beneficiary) could elect to treat foreign assets held by a non-resident discretionary trust as that person's own assets.

The base cost of assets held by persons in their own names is determined in the same way as non-amnesty assets. A successful applicant must use market value on 1 October 2001, TAB or 20% of proceeds to determine the valuation date value of pre-valuation date assets. The amnesty legislation did not make provision for the exclusion of any unrealised growth or decline in value of amnesty assets arising between 1 October 2001 and say, 1 March 2002. The base cost of foreign amnesty assets acquired on or after 1 October 2001 is determined under para 20 or, when applicable, para 38.

However, in the case of offshore trust assets in respect of which an election is made under s 4 of the Amnesty Act, any growth or decline in value before 1 March 2002 is disregarded. These special rules are addressed in **8.39.2**.

The table below summarises the rules applicable to amnesty assets.

Table 1 – Base cost of amnesty assets

Applicant	**Date of acquisition for CGT purposes**	**Base cost**
Person directly holding foreign assets in own name	*Direct assets* Normal rules determine date of acquisition (e.g. para 13(2) or general principles). ***Assets of CFC*** If foreign company was a CFC before 1 October 2001, the CFC will	Determined in accordance with the core rules: Pre-valuation date assets – under paras 25 to 28. Post-valuation date assets – under para 20 or 38. Foreign currency assets – under Part XIII of Eighth Schedule (valuation date = 1 March 2003 – para 84) Other foreign assets – para 43. If the person applied for exchange control amnesty in respect of the assets in question, whatever base cost is arrived at under the core rules is subject to the base cost limitation rule in s 28(2) of the Amnesty Act

[363] GN R 1368, *GG* 25511 of 29 September 2003.

	acquire its assets in the same way as any resident and its valuation date is 1 October 2001. If the foreign company became a CFC after 1 October 2001 its date of acquisition is the date it became a CFC[364]	Market value on valuation date, TAB or 20% of proceeds.
Donor, deceased estate of donor or beneficiary making an election in respect of foreign assets of a non-resident discretionary trust under s 4 of Amnesty Act	***General rule*** The first day of the last year of assessment ending on or before 28 February 2003.[365] *Assets of CFC* Under para 12(2)(*a*) read with para 12(1) the foreign company is deemed to have disposed of and reacquired its assets on the date it became a CFC. It became a CFC when its shares were deemed under s 4(3)(*a*)(ii) of the Amnesty Act to be acquired by the electing party, namely, on the first day of the last year of assessment ending on or before 28 February 2003.	Market value on 1 March 2002 plus subsequent expenditure incurred.[366] The market value of assets (other than Part XIII foreign currency assets) must be determined in foreign currency and translated to rands under para 43. If the person applied for exchange control amnesty in respect of the assets in question, this value is subject to the base cost limitation rule in s 28(2) of the Amnesty Act. Market value on date the foreign company became a CFC [para 12(2)(*a*)]. This rule is subject to the 'kink test' in para 24, which may substitute a different value.

8.39.2 Election in respect of assets held by foreign discretionary trust under amnesty provisions

The exchange control and related tax measures only apply to residents of South Africa. Since a foreign trust is unlikely to be a resident, such trusts would in the absence of s 4 of the Amnesty Act have been unable to apply for amnesty. Section 4 enables a donor, deceased estate of a donor or beneficiary to elect that the discretionary trust's assets be treated as being held by that electing party. For the purpose of the provision a donation includes a donation contemplated in s 58 of the Act.[367] 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

[364] Section 9D(2A)(*e*).
[365] Under s 4(3)(*a*)(ii) of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003.
[366] Regulation 4(*a*) of GN R 1368, *GG* 25511 of 29 September 2003.
[367] Regulation 2(*b*).

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.[368] This means that the election extends to assets acquired out of the proceeds of donated assets.

The electing party is treated as having

- 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.[369]

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 electing party 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 under s 22(8) and an acquisition under para 12(3) in the electing party's hands. Likewise, if the trust converts a capital asset in respect of which an election has been made into trading stock, a disposal at market value will be triggered for CGT purposes in the electing party's hands under para 12(2)(*c*) and an acquisition of trading stock at that same market value under s 22(3)(*a*)(ii).

For the purposes of determining the base cost of assets which are the subject of the s 4 election, the market value method is the only one open to an electing party. TAB and the '20% of proceeds' methods are not available options. There is no time limit for the determination of the market value.

The electing party is deemed to hold the asset until

- the foreign asset is disposed of by the trust to a person other than the electing party.[370]
- the electing party dies or ceases to be a resident,[371] 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 realisation of trust purpose and the dissolution of a close corporation as a result of liquidation.[372]

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 under s 4.[373] See in this regard the commentary under **15.9**.

When the trust becomes a South African resident after the election (for example, because new South African-based trustees are appointed to manage the trust), para 12(2)(*a*) will not trigger a disposal in the electing party's hands. This follows from the fact that while under

[368] Regulation 3.
[369] Regulation 4.
[370] Section 4(3)(*a*)(ii) of the Amnesty Act. Although Regulation 4(*c*)(i) states that the person must be deemed to hold the asset until it is disposed of by the trust (i.e. unlike s 4(3)(*a*) it does not exclude a disposal to the electing party), it is considered that s 4(3)(*a*) must prevail.
[371] Regulation 4(*c*)(ii).
[372] Regulation 4(*c*)(iii).
[373] Regulation 7.

para 12(2)(*a*) the trust is deemed to dispose of its assets at market value and to reacquire them at that same value upon the change of residence, the assets in question are deemed to be held by the electing party, and not the trust. Since the electing party would already be a South African resident, para 12(2)(*a*) cannot apply. Furthermore, s 4(3) refers to the disposal by the trust of the assets to 'any other person'. This wording envisages an actual disposal to a person, not a deemed disposal to no one in particular as is the case under para 12(2)(*a*).

When an election has been made in respect of a controlling interest in a foreign company (a CFC), s 9D will apply as if the resident electing shareholder held the shares directly. Thus the 'net income' (that is, the taxable income) of the CFC must be attributed to the electing party unless an exemption applies. Part XIII, which deals with foreign currency gains and losses, is not applicable to companies. The exchange gains and losses of the CFC must be determined under s 24I and will form part of the CFC's 'net income'.

8.39.3 Limitation of base cost of amnesty assets

Section 28(2) of the Amnesty Act

The Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003 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. In order 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 under s 28(2) of that Act.

Under 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 when 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. The normal rules apply in determining the base cost of an asset disposed of during the year preceding that date. For example, in the case of pre-valuation date assets the rules in paras 25, 26, 27, 28, 29 and 32 will apply. Section 28(2) also applies to the base cost of assets held by a foreign discretionary trust in respect of which an election has been made under s 4 of the Amnesty Act. Such assets are deemed to have been acquired by the electing party at market value on 1 March 2002.

Under 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 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 (for example, 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 February 2003 must be translated at the average rate in the year of incurral under 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 used 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)]
= £18 000 000 + [(£30 000 000 – £18 000 000) x 3/6
= £18 000 000 + £6 000 000
= £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 used 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 February 2003	€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

8.39.4 Disposal of shares at cost by trust to resident under Circular D 405

In a number of cases, residents placed shares in South African companies in offshore trusts for the purpose of exporting foreign currency illegally by way of dividends (the so-called '74/26' or 'loop' scheme).

The South African Reserve Bank established certain rules which are contained in Circular D 405 dated 30 September 2003[374] for the unwinding of these loop structures. One of the requirements of Circular D 405 is that the offshore trust must dispose of the shares in the South African company to a resident before 29 February 2004, and this sale must take place at original cost. Circular D 405 does not address the CGT consequences of unwinding loop structures. These must be deduced from s 4 of the Amnesty Act (when an election was made), or para 20 or 38 (when no election was made). The Amnesty Unit accepted that the shares in the South African company were a 'foreign asset' as defined in the Amnesty Act on the basis that the rights of ownership in the shares were transferred offshore. Without this acceptance it would not have been possible for an applicant to make an election in respect of the shares held by the trust. Clearly, the acquisition of the shares at a cost which is considerably less than market value will be of concern to persons in establishing the base cost to be taken into account in any future disposal of the shares.

If an election was made under s 4 and the electing party acquires the shares in the resident company at cost, the disposal by the trust and corresponding acquisition by the electing party must be disregarded under s 4(3)(*a*)(ii) of the Amnesty Act. Under that provision, the electing party is deemed to have held the shares

> 'from the first day of the last year of assessment ending on or before 28 February 2003 . . . until that foreign asset is disposed of by that discretionary trust to *any other person*'.

(Emphasis added.)

The italicised words make it clear that the electing party remains the deemed owner of the shares for CGT purposes, notwithstanding that that party may in reality have acquired the shares from the trust. Any amount paid by the party in acquiring the shares must accordingly be disregarded, since it does not relate to the cost of acquiring the asset (the asset was already deemed to be acquired). The resident must simply account for any capital gain or loss when the shares are disposed of to a third party (see example below).
If an election was not made, the base cost of the shares in the hands of the resident acquirer will have to be determined either under para 20 or 38. If the resident is not a connected person in relation to the trust, the price paid for the shares under Circular D 405 will constitute the expenditure actually incurred in acquiring the shares for the purposes of para 20(1)(*a*). Even though the price paid may be far less than the market value, para 38 would not apply as the price paid would not constitute a donation. For there to be a donation the transaction must be wholly gratuitous. A resident who is a connected person in relation to a trust will receive a step-up in base cost under para 38 equal to market value. This would be the case, for example, if the resident was a beneficiary of the trust. The facts and circumstances of structures unwound under Circular D 405 vary considerably and each case must be considered on its merits in determining the base cost of the shares.

Example – Shares in South African Company acquired at original cost by resident under Circular D 405

Facts:

Jurgen, a resident, set up a discretionary trust in Jersey. The trust acquired a 74% interest in his South African manufacturing company at cost of R740. Jurgen acquired the other 26% interest at a cost of R260 and funded the company's assets by way of a large interest-free loan. Under s 4 of the Amnesty Act, Jurgen made an election in respect of the trust's assets. The market value of the shares on 1 March 2002 was R1 000 000. He decided to take advantage of the Reserve Bank's offer to unwind the loop structure under Circular D 405, and purchased the shares from the trust at a cost of R740 on 29 February 2004. On

[374] Available at <http://www.ftomasek.com/archive/ExchangeControlD405.pdf> [Accessed 8 December 2011]. This circular must be read with circular D 417.

28 February 2006 he disposed of the shares to a third party for R1 150 000. The market value of the shares on 29 February 2004 was R1 100 000.

Result:

Under s 4(3) of the Amnesty Act, the acquisition of the shares by Jurgen must be disregarded since the trustees did not dispose of the shares to 'any other person'. The R740 paid by Jurgen for the shares must likewise be excluded from base cost. When he sells the shares to the third party he will make a capital gain of R1 150 000 – R1 000 000 = R150 000.

8.40 Assets acquired through the issue of shares

Section 24B

8.40.1 Purpose

Section 24B was introduced with retrospective effect to 1 October 2001.[375] It determines the expenditure incurred by a company that acquires an asset through the issue of its own shares. It also determines the expenditure incurred by the person in acquiring the shares in return for disposing of the asset. A number of anti-avoidance rules are also built into s 24B.

Several fundamental amendments were made to s 24B with effect from 21 October 2008[376] and subsequently still more amendments have been made by the Taxation Laws Amendment Act 17 of 2009 retrospective to that date.[377] These notes reflect the position after these amendments.

8.40.2 The position before s 24B

From a CGT perspective, the common law position set out below applies to assets acquired before 1 October 2001. For example, it will be relevant to a person adopting TAB.

In ITC 703[378] a company that paid a firm of technical consultants by the issue of shares was allowed to claim a deduction for a portion of the fees (the non-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[379] a company acquired a business licence through the issue of its own shares and sought to claim an allowance under s 11(*g*A) on the 'cost' of the licence. The court held that when a company issues its own shares in exchange for an asset, it has not incurred any

[375] 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.
[376] The amendments were effected by the Revenue Laws Amendment Act 60 of 2008, came into operation on 21 October 2008 and apply in respect of shares or debt instruments acquired or issued on or after that date.
[377] Section 37(1) of the Taxation Laws Amendment Act 17 of 2009 substituted s 24B(2), inserted s 24B(2C) and deleted s 24B(3). These amendments are deemed to have come into operation on 21 October 2008 and apply in respect of shares or debt instruments acquired, issued or disposed of on or after that date.
[378] (1950) 17 SATC 208 (N).
[379] (2004) 66 SATC 373 (G) at 376.

expenditure in respect of the acquisition of the asset, since it has not lost or expended anything.[380]

In *C: SARS v Labat Africa Ltd*[381] the taxpayer company had sought to claim a deduction under s 11(*g*A) for a trade mark which it had acquired in exchange for an issue of its shares. At issue was whether the company had incurred 'expenditure' in acquiring the trade mark. The court rejected the taxpayer's argument that it had incurred 'expenditure'. On the meaning of the word 'expenditure' Harms AP stated the following:[382]

> 'The term 'expenditure' is not defined in the Act and since it is an ordinary English word and, unless context indicates otherwise, this meaning must be attributed to it. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. The Afrikaans text, in using the term 'onkoste', endorses this reading. In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter- performance may be the same or even more than the value expended.'

The court noted that the words 'obligation' or 'liability' and 'expenditure' are not synonymous. The allotment of shares does not reduce the assets of the company and can therefore not comprise expenditure.

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 before the transaction.

In certain circumstances an acquiring company will be able to secure a deduction under the corporate restructuring rules, for example, under s 42(2) (asset-for-share transactions); and s 44(2) (amalgamation transactions).

8.40.3 General rule – Shares issued in exchange for asset [s 24B(1)]

A company that acquires an asset as defined in para 1 of the Eighth Schedule by issuing its own shares is deemed to have actually incurred an amount of expenditure on the asset equal to the lesser of

- the market value of the asset immediately after the acquisition, or
- the market value of the shares immediately after the acquisition [s 24B(1)(*a*)].

The seller is deemed to have disposed of the asset for an amount equal to the market value of the shares immediately after the acquisition [s 24B(1)(*b*)].

The above rules apply equally to trading stock and capital assets. Under s 41(2) the corporate rules in ss 41 to 47 override s 24B, except for s 24B(2) and (3) (the reference to s 24B(3) in s 41(2) is now superfluous because s 24B(3) has been deleted). The latter exceptions apply base cost limitation rules to the cross-issue of shares and debt.

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[380] See *Silke* in § 7.4 which was cited with approval in ITC 1783.
[381] Case 669/10) [2011] ZASCA 157, 28 September 2011, unreported. The SCA judgment overturned the decisions in ITC 1801 (2006) 68 SATC 57 (G) and *C: SARS v Labat Africa Ltd* (2009) 72 SATC 75 (North Gauteng High Court).
[382] In para 12 at 5.

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. Wendy and Newco elect out of s 42 under s 42(8A).

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 for 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 do not elect out of the roll-over relief under s 42.

Result:

Wendy does not have a 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*)].

Example 3 – Mismatch of asset and share values

Facts:

Naas owns an asset that has a market value of R100 000. He forms a trust that is not a resident of South Africa, and contributes R100 to that trust. Company B, also not a resident of South Africa, is formed and issues 100 000 shares (comprising 100% of its issued share capital) to the trust in exchange for the R100 cash contributed to the trust by Naas.

Naas then transfers the asset to Company B in exchange for the issue of 100 shares in Company B.

The balance sheets of the trust and Company B after the transactions are as follows:

Trust (non-resident)	R
Capital (from Naas)	100
100 000 shares in Company B	100

Company B (non-resident)

Share capital	No of shares	R
- Trust	100 000	100
- Naas	100	100 000
	100 100	100 100
Cash (from Trust)		100
Asset (from Naas)		100 000
		100 100

Result:

The trust is deemed to acquire the 100 000 shares for a base cost of R100, being the lesser of

- the market value of the asset immediately after the acquisition (R100), or
- the market value of the shares immediately after the acquisition (R100).

Company B is deemed to have acquired the asset for R100, being the lesser of

- the market value of the asset immediately after its acquisition (R100 000), or
- the market value of the shares immediately after their acquisition (R100).

Naas is deemed to dispose of the asset for an amount of R100, being the market value of the 100 shares acquired immediately after their acquisition.

Example 4 – Mismatch of asset and share values – company with accumulated loss

Facts:

Company B has share capital of R100 and an accumulated loss of R100 000. Darren owns an asset that has a market value of R100 100. Company B issues an additional 100 shares at a par value of R1 each and at a premium of R100 000 to Darren in exchange for the acquisition of Darren's asset (with a market value of R100 100).

Result

Before asset-for-share transaction

Share capital	R
100 shares of R1 each	100
Accumulated loss	(100 000)
Long-term liability	100 000
	100
Cash	100

After asset-for-share transaction

Share capital	R
200 shares of R1 each	200
Share premium	100 000
Accumulated loss	(100 000)
Long-term liability	100 000
	100 200
Cash	100
Asset	100 100
	100 200

Before the transaction each share in the company was worthless. After the transaction each share is worth R1 (R200/200). Thus Darren has exchanged an asset worth R100 100 for shares worth R100. Under s 24B(1)(*a*) the company is deemed to acquire the asset for R100, being the lower of

- its market value (R100 000), or
- the market value of the shares after the acquisition given as consideration (R100).

Under s 24B(1)(*b*) Darren is deemed to have disposed of the asset for an amount of R100, being the market value of the shares received as consideration.

Section 24B(1) does not deal with the base cost of Darren's shares. Under general 'barter or exchange' principles they have a base cost of R100 100, being the amount by which Darren was impoverished as a result of giving up an asset with a market value of R100 100.

8.40.4 Exception – Shares issued in exchange for issue of shares [s 24B(2)]

Section 24B(2) contains an exception to the deemed-expenditure rule in s 24B(1). Section 24B(2) applies when a company acquires any share which is issued to that company directly or indirectly in exchange for the issue of shares by that company or any connected person in relation to that company.

Under these circumstances the company is deemed not to have incurred any expenditure in respect of the acquisition of that share so acquired.

Example – 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 cross-issue of shares. Sub 1 receives a nil base cost in the Sub 2 shares received, and Sub 2 likewise receives a nil base cost in the Sub 1 shares.

8.40.5 Issue of preference shares in exchange for an issue of ordinary shares or convertible preference shares

Section 24B(2A) overrides the nil-expenditure rule in s 24B(2). It applies when

- a preference share was issued to a company in exchange for ordinary shares (or preference shares which are convertible into ordinary shares) issued by that company,
- the preference share was redeemed, and
- that company held that preference share for at least five years.

Under these circumstances the expenditure incurred by that company on the acquisition of the preference share is deemed for the purposes of the Act to be an amount equal to the lesser of

- the market value of the preference share as at the date of acquisition of the preference share, or
- the amount received or accrued from the redemption of the preference share.

The explanation below has been adapted from the Explanatory Memorandum.

The nil expenditure rule in s 24B(2) is sound. However, the rule can create some harsh results in a South African context, especially given the difficulties that certain parties have in obtaining third party financing. Because of these difficulties, certain cross-issue structures

have emerged that essentially allow certain investors to obtain financing to acquire a target company without resort to third party lending.

One such structure involves the issue of shares by an operating company in exchange for redeemable preference shares issued by an investor company.

The preference shares have a value equal to the value of the operating company shares issued in exchange (but the operating company shares have more growth potential). The investor company then obtains funds via dividends from the operating company or by selling the investor company shares after those shares have appreciated (partly due to the involvement of the investor company). Once the investor company has sufficient funds, the investor company redeems the preference shares, leaving the investor company as an unencumbered holder of operating company shares.

At issue is the redemption of the redeemable preference shares. Under current law, the operating company recognises as gain the full value of the redeemable preference shares. This result is seemingly problematic because the redemption of the preference shares is said to be economically akin to the return of principal on a loan (which should not, as a theoretical matter, give rise to tax). In other words, restoration of deemed lending finance is not an item that should be viewed as a taxable gain for the operating company.

Section 24B(2A) seeks to provide tax relief for operating companies that are essentially receiving repayment of principal on the self-financing of their shares.

However, the exception to the nil-expenditure rule is narrowly tailored because the cross-issue of shares can easily give rise to potential tax avoidance. Consequently, the exception will apply only if the following three conditions are met:

- First, the (operating) company must issue ordinary shares (or preference shares convertible into ordinary shares at the option of the holder) in exchange for the issue of redeemable preference shares by another (investor) company;
- Secondly, the preference shares must be held for a period of not less than five years.
- Thirdly, the triggering event is a redemption (as opposed to other forms of disposition).

If the exception applies, the (operating) company is deemed to have expenditure in the redeemable preference shares equal to the lesser of the market value of those preference shares on the date of initial issue or the amount received or accrued on redemption. The 'lesser of' test effectively limits the gain triggered on redemption without allowing for any loss.

Example 1 – Cross-issue of ordinary shares and redeemable preference shares

Facts:

Operating Company has an issued share capital of 4 million ordinary shares. Investor Company seeks to obtain a slightly greater than 25% interest in Operating Company. Operating Company accordingly
issues 1 000 001 ordinary shares to Investor Company. Investor Company issues redeemable preference shares in exchange. The ordinary shares and the preference shares are each worth roughly R2 million. Operating Company redeems the preference shares 10 years later for R2,5 million.

Result:

Operating Company is deemed to have expenditure of (roughly) R2 million under the arrangement. The gain on redemption is therefore limited to R500 000. Without the exception, Operating Company would have been taxable on the full amount of R2,5 million.

Example 2 – Redemption of redeemable preference shares at less than their initial market value

Facts:

The facts are the same as Example 1, except that the preference shares are redeemed for only R1,5 million.

Result:

No gain or loss results from the redemption because the expenditure is limited to R1,5 million (the amount received or accrued).

8.40.6 Disposal of preference share under intra-group transaction [s 24B(2B)]

Section 24B(2B) applies when the preference share referred to in s 24B(2A) is disposed of by that company to any other company under an 'intra-group transaction' as defined in s 45.

When that happens, that company and that other company must, during the period that that company and that other company form part of the same group of companies, be deemed to be one and the same person for purposes of s 24B(2A)(*c*).

Section 24B(2B) must be read with s 24B(2A). Thus, if a holder of the redeemable preference share (that is, the operating company) transfers the redeemable preference share to another group company under a s 45 intragroup roll-over, the recipient group company is viewed as one and the same as the transferor for purposes of this rule. Hence, the five-year rule can be satisfied by taking into account the holding periods of both the transferor and transferee group companies.

8.40.7 Asset moving down a chain of controlled companies by consecutive share issues [s 24B(2C)]

Section 24B(2C) overrides the nil-expenditure rule in s 24B(2). It applies when

- a company acquires any asset from a person (other than a share issued by that person) as consideration for shares issued by that company, and
- within 18 months after that issue, any controlled group company in relation to that company acquires the asset directly or indirectly as consideration for the issue of shares by the controlled group company to that company.

When this happens that company is deemed to have actually incurred an amount of expenditure in respect of those shares issued by the controlled group company which is equal to the lesser of

- the market value of the asset immediately after that acquisition, or
- the market value of the shares issued by the controlled group company immediately after that acquisition.

Thus, under s 24B(2C) the nil-expenditure rule in s 24B(2) for cross-issues expressly does not apply to transfers down a chain of multiple controlled group companies (that is, 70%-owned subsidiaries). This exception applies on condition that the consideration received by

the controlled group company is not used to acquire shares issued by a company other than a lower-tier controlled group company of the controlled group company. If this exception applies, the receipt of issued shares by a controlled group company in a chain of transfers will not give rise to a deemed nil expenditure.

Example – Disposal of asset down a chain of controlled companies

Facts:

Anne transfers land to Newco in exchange for shares issued by Newco. Newco then immediately transfers the land to wholly owned Newco Subsidiary in exchange for shares issued by Newco Subsidiary.

Result:

Even though the shares of Newco Subsidiary are arguably issued as a consequence of the first share issue by Newco, the exception to the nil-expenditure rule for cross-issues applies. Newco Subsidiary's shares held by Newco are deemed to have an expenditure equal to the lesser of the market value of the land received or the Newco Subsidiary shares issued (both of which are measured after the land-for-Newco Subsidiary transaction).

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 by a person are equal to

- the amount
- received by, or accrued to, or which is treated as having been received by or accrued to or in favour of, that person
- in respect of that disposal.

These words are explored in more detail below. The above is subject to

- para 35(2) – deemed proceeds under a 'value shifting arrangement',
- para 35(3) – certain reductions in proceeds, and
- para 35(4) – an anti-discounting to present value provision.

Paragraph 35(1) also includes two special inclusions.

9.1.1.1 'Amount'

The meaning of the word 'amount' was judicially considered in *Lategan v CIR*[383] in relation to its use in the definition of the term 'gross income' and the following dictum of Watermeyer J has been cited with approval in a number of other cases:[384]

> '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.)

In *Cactus Investments (Pty) Ltd v CIR*[385] the court held that in order to comprise an 'amount', rights of a non-capital nature must be 'capable of being valued in money'. Similarly in the *People's Stores* case[386] the court held that in order to be included in gross income an amount must be of such a nature that a value can be attached to it in money. In *Stander v CIR*[387] the court held that an amount must be capable of being turned into money or money's worth. But this view was soundly rejected in the landmark case of *C: SARS v Brummeria Renaissance (Pty) Ltd & others*.[388] In that case it was held that it did not follow that if a receipt or accrual cannot be turned into money, it had no money value. The 'turn into money' test was merely one of the tests for determining whether an accrual had a money value. The court confirmed that the test was objective, not subjective.

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[383] *W H Lategan v CIR* 1926 CPD 203 at 209, 2 SATC 16 at 19.
[384] See also *CIR v Butcher Bros (Pty) Ltd* 1945 AD 301, 13 SATC 21 at 34 and *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9 at 21.
[385] 1999 (1) SA 315 (SCA), 61 SATC 43.
[386] *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9.
[387] 1997 (3) SA 617 (C), 59 SATC 212 at 218/9.
[388] *C: SARS v Brummeria Renaissance (Pty) Ltd & others* 2007 (6) SA 601 (SCA), 69 SATC 205.

The word 'amount' bears the same meaning in relation to proceeds.

9.1.1.2 'Received by or accrued to'

The words 'received by or accrued to' have also received judicial consideration in relation to the gross income definition and bear a similar meaning in the context of para 35. The words 'received by' mean

> 'received by the taxpayer on his own behalf for his own benefit'.[389]

The word 'accrued' means

> 'to which he has become entitled'.[390]

As value-added tax does not accrue to or in favour of a vendor, it is not included in proceeds.

9.1.1.3 '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 or even been received or accrued in an earlier year of assessment. This could happen, for example, when an asset is expropriated, scrapped, lost or destroyed, as the time of disposal rules in para 13 provide in such cases that the disposal is delayed until the full compensation is determined.[391]

9.1.1.4 Specific inclusion – Reduction or discharge of debt [para 35(1)(a)]

The proceeds from the disposal of an asset include the amount by which any debt owed by that person has been reduced or discharged.

Example 1 – 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.

Result:

The amount of R100 paid by Jane to Jill will constitute part of the proceeds on disposal of Jack's asset.

Example 2 – Repurchase of own debt

Facts:

Listco issued 100 000 10% debentures of R1 each on the JSE at par. Following an increase in prevailing interest rates the listed price of the debentures dropped to 80c a debenture. Listco repurchased 20 000 debentures on the open market at 80 cents each.

Result:

After acquiring the debentures Listco has an asset (the debentures acquired) and a liability (the amount owing). The debentures acquired are disposed of by merger. The base cost of the debentures acquired is the amount paid for them, being 20 000 x R0,80 = R16 000.

[389] *Geldenhuys v CIR* 1947 (3) SA 256 (C), 14 SATC 419 at 430.
[390] *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9 at 19.
[391] See para 13(1)(*a*)(iv) (expropriation) and para 13(1)(*c*) (scrapping, loss or destruction).

Under para 35(1)(*a*) the proceeds are equal to the amount of the debt discharged, namely, R20 000. Listco will therefore have a capital gain of R20 000 – R16 000 = R4 000.

9.1.1.5 Specific inclusion – Compensation to lessee from lessor for improvements to property [para 35(1)(b)]

The proceeds from the disposal of an asset include any amount received by or accrued to a lessee from a lessor for improvements effected to the leased property.

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 have been repaid or have 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.

9.1.3.1 Amounts included in gross income / taxable income [para 35(3)(a)]

The use of the words 'must be' in para 35(3)(*a*) require a person to determine whether an amount will be taxed as income at some point in the future. This emphasises the point that as a general rule, sections of the Act will take precedence over the Eighth Schedule.

Recoupments

Any depreciation allowances recovered or recouped on disposal of an asset under s 8(4)(*a*) are included in gross income under para (*n*) of the definition of the term 'gross income'. The amount received or accrued on disposal of the asset must accordingly be reduced by the amount so recovered or recouped in order to arrive at the proceeds under para 35.

Dividends

Paragraph (*k*) of the definition of the term 'gross income' includes in the definition

> 'any amount received or accrued by way of a dividend'.

The amount received by or accrued to a shareholder upon a share buy-back must therefore be reduced by any portion thereof which constitutes a dividend – see **18.6**.

Sale of shares cum dividend

A sale of shares cum div occurs when shares are sold after the announcement of a dividend but before payment thereof, and the right to receive that dividend is given to the buyer. In these circumstances the amount received by the seller will effectively include compensation for the future dividend. In these circumstances the amount received or accrued from the sale of the share comprises the proceeds, which must not be reduced by the value of the future dividend.

Example – Sale of shares cum div

Facts:

On 31 January 2006 XYZ Ltd announced that it would be paying a dividend of R5 a share to shareholders registered in its share register on 5 February 2006. The dividend was payable on 28 February 2006.

On 1 February 2006 Gary sold a share in XYZ Ltd to Shaun cum div for R105.

Result:

Gary (seller)

Gary is regarded as having received proceeds of R105 in respect of the disposal. Although the selling price takes into account the forthcoming dividend, that portion (R5) is not a dividend in Gary's hands. Had it been a dividend it would have been excluded from proceeds under para 35(3)(*a*).

Shaun (buyer)

Shaun is regarded as having incurred para 20 expenditure of R105 in respect of the acquisition of the share. The dividend does not constitute proceeds in Shaun's hands as it is not received in respect of the disposal of the share. The receipt of the dividend is also not regarded as a recovery of expenditure in Shaun's hands under para 20(3)(*b*), as it has not been recovered and is merely the receipt of an amount of gross income (that is, it forms part of the income stream generated by the asset).

9.1.3.2 Proceeds repaid or repayable [para 35(3)(b)]

Proceeds must be reduced by any amount thereof that has been repaid or has become repayable to the person to whom an asset was disposed of. This rule only applies when the repayment takes place in the year of assessment in which the asset is disposed of or in a year of assessment before the year of disposal. An amount repaid in a year subsequent to the year of assessment in which an asset is disposed of is treated as a capital loss under para 4(*b*)(i)(*cc*) which contains an equivalent provision.

9.1.3.3 Amounts reduced as a result of cancellation, termination, variation, prescription, waiver or release from obligation [para 35(3)(c)]

Any accrued amount forming part of the proceeds from a disposal must be reduced when that amount is reduced as the result of the

- cancellation,

- termination, or
- variation of an agreement,
- or due to the
- prescription or waiver of a claim,
- release from an obligation, or
- any other event.

As with para 35(3)(*b*) this provision only applies when the reduction takes place in the year of assessment in which an asset is disposed of or in advance of that year of assessment. A reduction in a year of assessment subsequent to the year of assessment in which an asset is disposed of must be treated as a capital loss under para 4(*b*)(i)(*aa*), which contains an equivalent provision.

9.1.4 Disregarding of present value [para 35(4)]

An amount payable after the end of the year of assessment must be treated as having accrued to a person in the year of assessment in which that person becomes entitled to it, This provision mirrors the first proviso to the definition of the term 'gross income' in s 1 which was introduced following the *People's Stores* case[392] 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.

9.1.5 Proceeds – composite disposals

Assets are sometimes disposed of as part of the sale of a business as a going concern. A selling price expressed as a lump sum will have to be allocated across the various assets in accordance with their relative market values at the time of disposal.[393] Such an allocation is necessary because the 'business' is not an asset and CGT is imposed on an asset-by-asset basis. The onus rests on the taxpayer under s 82 to justify any allocation. The court will not accept a fictitious allocation of the selling price. In ITC 1235[394] 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.

In order to arrive at the total proceeds to be allocated among the assets, any lump sum which is net of liabilities taken over by the buyer must be increased by the amount of those liabilities, including contingent liabilities.

In the Canadian case of *Daishowa-Marubeni International Ltd v The Queen*[395] the appellant company owned certain timber rights which carried with them a reforestation obligation. The company disposed of its forestry business with the purchaser assuming the reforestation obligation. The business was valued at $180 million while the reforestation obligation was valued at $11 million by the parties. The sale agreement showed the purchase price as $169 million for the business and $11 million for the reforestation obligation. At issue was whether the proceeds on sale of the business were $169 million or $169 million plus the reforestation obligation.

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[392] *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9.
[393] 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.
[394] (1975) 37 SATC 233 (T) at 236.
[395] 2011 FCA 267.

The FCA held that the value of the reforestation obligation had to be included in the proceeds of disposition. The court noted that it was irrelevant whether the obligation was contingent or absolute – the issue was whether the obligation could be valued and in the instant case the parties had agreed upon the value of $11 million.

Example – Disposal of business

Facts:

Company A disposed of its business to Company B. The sale agreement provided that the purchase price was made up as follows:

	R
Market value of assets (itemised)	1 100 000
Less: Trade creditors	(300 000)
Contingent liabilities	(20 000)
Amount payable in cash	780 000

The contingent liabilities comprise obligations of Company A to meet the cost of

- post-retirement medical aid benefits for its employees;
- employee bonuses under a long-term bonus scheme; and
- repairs under property leases.

None of the assets disposed of comprise trading stock or depreciable assets.

Determine the proceeds on disposal of the assets

Result:

Company A is entitled to an amount of R1 100 000 for the disposal of the assets. Thus, R1 100 000 has accrued to Company A and comprises the proceeds under the opening words of para 35. This amount is settled by a cash payment of R780 000 and by the delegation of the trade creditors and contingent liabilities to Company B of R320 000.

Note: Under *Ackermans Ltd v C:SARS*[396] Company A is not entitled to a deduction under s 11(*a*) for the contingent liabilities since the amounts have not been actually incurred.

9.2 Disposal of partnership asset

Paragraph 36

9.2.1 Date of accrual of proceeds

Under 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.[397]

[396] (2010 (1) SA (1) SCA), 73 SATC 1.

[397] 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 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 issue of assessments.

A partnership[398] is not a separate legal entity[399] 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.[400] 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.[401]

9.2.2.1 Introduction of new partner

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 Withdrawal of partner

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.

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.

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[398] As to the requirements for a valid partnership see *Joubert v Tarry & Co Ltd* 1915 TPD 277.
[399] *Michalow, NO v Premier Milling Co Ltd* 1960 (2) SA 59 (W) at 61.
[400] *Executors of Paterson v Webster, Steel & Co* (1880 – 1882) 1 SC 350 at 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 and *Kirsh Industries Ltd v Vosloo & Lindeque* 1982 (3) SA 479 (W).
[401] This approach is followed by the United Kingdom and Australia. On the United Kingdom practice, see Partnerships: Statement of Practice D12 (17 January 1975) <http://www.hmrc.gov.uk/manuals/cgmanual/CG27170.htm> [Accessed 8 December 2011]. For the United Kingdom HM Revenue & Customs *Capital Gains Manual* on partnerships generally, see <http://www.hmrc.gov.uk/manuals/cgmanual/CG27000c.htm> [Accessed 8 December 2011]. For the Australian treatment see Chapter 3, Part 3-1, Division 106, Subdivision 106–A, s 106-5 of the Income Tax Assessment Act, 1997.

In *Isaacs v Isaacs*[402] 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.

Example 1 – Acquisition of interest in assets and liabilities of partnership

Facts:

Adele acquired a half share in a partnership made up as follows:

	R
Asset	100 000
Less: Creditor	(60 000)
Amount paid	40 000

Result:

Adele's CGT asset has a base cost of R100 000, not R40 000.

Table 1 – Consequences of change in partner's fractional interest

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

[402] 1949 (1) SA 952 (C) at 961, cited with approval in ITC 1721 (1999) 64 SATC 93 (G).

Example 2 – 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. Under their partnership agreement Jack has a 75% interest in the land and Jill 25%. The agreement states that profits must be shared evenly.

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 3 – 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. Five 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
Less: 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 4 – 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. Five 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 D (R22 500/3).

Result:

A, B and C each owned a one-third interest in the land before D joining. This was reduced to one-fourth resulting in a part-disposal.

	A	B	C	Total
	R	R	R	R
Proceeds	7 500	7 500	7 500	22 500
Less: 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 (1/12)
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
R7 500/R30 000 x R10 000 = R2 500

D will have a base cost of R22 500.

Example 5 – Admission of new partner who introduces an asset

Facts:

A and B enter into a partnership agreement under which they share profits 50/50. They each introduce cash of R50 which is used by the partnership to buy Asset 1 for R100. Some years later when Asset 1 is worth R200 they admit C to the partnership. C introduces an asset with a value of R100. A, B and C agree to share profits equally. The base cost of Asset 2 in C's hands before entry into the partnership was R60. Determine the CGT consequences for A, B and C in respect of the admission of C.

Result:

Upon the admission of C the partnership profit-sharing ratio changed as follows:

	A %	B %	C %
Before	50,00	50,00	-
Decrease/Increase	(16,67)	(16,66)	(33,33)
After	33,33	33,34	33,33

A and B each dispose of 16,67/50 (1/3) of their former interests.

Sale of fractional interest in Asset 1 by A and B to C

	A	B
Proceeds	33,33	33,33
Less: Base cost	(16,67)	(16,67)
Capital gain	16,66	16,66

The proceeds are equal to the market value of the fractional interest acquired by each partner in Asset 2 (R100 x 1/3).

A and B each disposed of 1/3 of their base cost in Asset 1, namely, 1/3 x R50 = R16,67.

Sale of fractional interest in Asset 2 by C to A and B

The base cost of Asset 2 in C's hands before admission was R60. Upon admission, C disposes of 2/3 of the interest in Asset 2 in exchange for a 1/3 stake in Asset 1. Thus C has a disposal of Asset 2 on entry as follows:

	R
Proceeds 1/3 x R200	66,67
Less: Base cost 2/3 x R60	(40,00)
Capital gain	26,67

C's remaining base cost in respect of Asset 2 is R60 – R40 = R20. C's base cost in respect of Asset 1 is the amount by which C has been impoverished as a result of the disposal of the 2/3 interest in Asset 2, namely, 2/3 x R100 = R66,67.

Summary – Base cost of A, B and C's interests after admission of C

	A	B	C
Asset 1	33,33	33,33	66,67
Asset 2	33,33	33,33	20,00

Example 6 – Change in profit-sharing ratio

Facts:

A and B enter into a partnership agreement under which they share profits 50/50. A introduces Asset X worth R5 000 and B introduces Asset Y worth R5 000. The base cost of each asset in the hands of A and B before entry into the partnership is R5 000.

Some years later Asset X is sold for R10 000. The amount realised is paid to the partners in equal shares and deposited into their personal bank accounts. A then reintroduces R5 000 and B R1 000 and they agree to change their profit-sharing ratios in accordance with their revised capital contributions. Asset Y is worth R10 000 at the time of the change in ratios.

What are the CGT implications for A and B of the change in profit-sharing ratios?

Result:

Step 1 – Introduce assets into partnership

	R
Capital account – A	5 000
Capital account – B	5 000
	10 000
Asset – X	5 000
Asset – Y	5 000
	10 000

Base cost after entry

	A R	B R
Asset X	2 500	2 500
Asset Y	2 500	2 500
	5 000	5 000

Upon entry A disposed of a 50% interest in Asset X in return for a 50% interest in Asset Y. Similarly, B disposed of a 50% interest in Asset Y in return for a 50% interest in Asset X. In this example these disposals resulted in no gain or loss because the value received was equal to the base cost of the part disposed of.

Step 2 – Sell Asset X

	R
Capital account – A (R5 000 + R2 500)	7 500
Capital account – B (R5 000 + R2 500)	7 500
	15 000
Bank account	10 000
Asset Y	5 000
	15 000

	A	B	Total
Proceeds	5 000	5 000	10 000
Less: Base cost	(2 500)	(2 500)	
Capital gain	2 500	2 500	

Step 3 – Distribute bank balance to A and B

	R
Capital account – A (R7 500 – R5 000)	2 500
Capital account – B (R7 500 – R5 000)	2 500
	5 000
Asset Y (MV = R10 000)	5 000

Step 4 – Revalue existing assets, reintroduce funds into partnership bank account and change ratios (A introduces R5 000, B R1 000)

	R
Capital account – A (62,5%)	10 000
(R2 500 + R2 500[403] + R5 000[404])	
Capital account – B (37,5%)	6 000
R2 500 + R2 500 + R1 000)	16 000
Asset Y (at MV)	10 000
Bank account (R5 000 + R1 000)	6 000
	16 000

A's position

A's interest in the partnership bank account

A has withdrawn an amount of R5 000 from his personal bank account thereby triggering a part-disposal of that bank account. The proceeds from this disposal are represented by the following partnership assets acquired in exchange:

Partnership bank account	R
Interest in amount introduced by A R5 000 x 62,5%	3 125
Interest in amount introduced by B R1 000 x 62,5%	625
Total interest in bank account (Check: R6 000 x 62,5%)	3 750
Additional interest in Asset Y R10 000 (MV) x 12,5%	1 250
	5 000

Since the base cost of the portion of A's personal bank account disposed of is equal to R5 000, the disposal will result in no gain or loss.

A's interest in Asset Y

As noted above, A acquires an additional 12,5% (62,5% less 50%) interest in Asset Y at a cost of R1 250. The revised base cost of A's interest in Asset Y is made up as follows:

	R
Initial cost	2 500
Cost of additional interest	1 250
Total base cost	3 750

[403] This is the revaluation surplus (50% x increase in market value of Asset Y).
[404] Additional contribution.

B's position

B has made two disposals. First, B disposed of a portion of his personal bank account by withdrawing R1 000 from it. Secondly, B disposed of a 12,5% interest in Asset Y which was worth R10 000 at the time of disposal. The amount given up by B is R10 000 x 12,5% = R1 250. In return for these two disposals B gained an increased interest in the partnership bank account. B acquired 37,5% of the amount introduced by A (37,5% x R5 000 = R1 875) and retained an interest of 37,5% of the amount he introduced (37,5% x R1 000 = R375). The position can be summarised as follows:

	Disposed of R	Acquired R
Decrease in value of interest in Asset Y	1 250	-
Withdrawal from personal bank account	1 000	-
Bank account – acquired from A	-	1 875
Bank account – own investment retained	-	375
	2 250	2 250

The part-disposal of B's personal bank account does not give rise to a capital gain or loss, since the base cost of R1 000 is equal to the proceeds of R1 000 (part of the amount acquired of R2 250).

The proceeds from the disposal of B's interest in Asset Y are equal to the interest acquired in the partnership bank account (R2 250 less R1 000 relating to the disposal of the personal bank account = R1 250).

B's base cost in respect of Asset Y comprises the following:

	R
Original base cost	2 500
Less: Revised base cost 37,5%/50% x R2 500	(1 875)
Part disposed of	625
Proceeds	1 250
Less: Base cost	(625)
Capital gain	625

Example 7 – Disposal of partnership asset

Facts:

The facts are the same as Example 3. Partners A and C sell the land for R120 000 two years later.

Result:

	A R	C R	Total R
Proceeds	80 000	40 000	120 000
Less: Base cost	(40 000)	(10 000)	
Capital gain	40 000	30 000	

Example 8 – Unequal initial contributions, equal profit sharing

Facts:

Duncan and Lorraine enter into a partnership agreement under 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 (R350 000 – 200 000)	150 000
Plant and machinery (R400 000 – 300 000)	100 000
Net income for the year	250 000

Distributed as follows:	R
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
Less: 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

	R
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:

	R
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

	R
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	R
- Plant and machinery	75 000
On dissolution	
- Land and buildings	75 000
- Plant and machinery	125 000
	275 000

Proof:	**R**
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 9 – 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 while 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 under 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, while 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 10 – Depreciable asset

Facts:

Five high-flying individuals purchase a helicopter in partnership at a cost of R5 000 000 during the 2002 year of assessment. They each contribute R1 000 000 to the partnership for this purpose and share in profits and losses equally. In their 2002 and 2003 returns of income they each claim a s 12C allowance of R200 000 a year (R1 000 000 x 20% = 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	(400 000)[405]
Proceeds	650 000

	R
Cost	1 000 000
Less: Section 12C allowances	(400 000)
Base cost	600 000

Capital gain R650 000 – R600 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 a 'connected person' in s 1 of the Act, which reads as follows:

> '**"[C]onnected 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 in these circumstances the partners 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. Paragraph 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 before valuation date from a connected person.

9.3 Assets of trust and company

Paragraph 37

Under the Eighth Schedule capital gains and losses determined in respect of most personal-use assets are disregarded. While 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 applies when a trust

[405] In *Chipkin (Natal) (Pty) Ltd v C: SARS* 2005 (5) SA 566 (SCA), 67 SATC 243 Cloete JA upheld the earlier decision in ITC 1784 (2004) 67 SATC 40 (G), namely, that a company that disposed of 99% of its interest in an aircraft partnership was subject to recoupment under s 8(4)(*a*) in respect of the s 14*bis* allowances it had claimed on its undivided share in the aircraft.

or company, the interest in which or shares of which, are owned directly or indirectly by a natural person, and

- 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, and
- the interest in the trust or company is thereafter disposed of by a person.

In this situation the 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 when 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 an arm's length price

Paragraph 38

9.4.1 Application

This provision applies when a person disposes of an asset

- by donation,
- for a consideration not measurable in money, or
- to a connected person[406] for a consideration which does not reflect an arm's length price.

9.4.2 'Not measurable in money'

The words 'not measurable in money' are not defined in the Act.[407] They would seem to refer to a consideration which does not have a pecuniary or economic value under Roman Dutch law being *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). Also falling into this category are rights arising in the sphere of the law of persons, such as personal liberty, parental authority and rights flowing from the marital relationship (see **4.1.2**).

Section 24M deals with the situation in which the consideration cannot be quantified in the current year of assessment (see **10.2.1**).

The words 'not measurable in money' do not include a barter transaction under which the value of the asset given can be determined.

[406] As defined in s 1.
[407] A similar term 'not measurable in terms of money' is used in s 22(4) in relation to the acquisition of trading stock.

Example – Consideration not measurable in money

Facts (with due acknowledgements to the TV series Isidingo on SABC 3):

Cherel has been charged with the murder of her husband's son Duncan. About two years previously she had shot him and dumped his body down a mineshaft. While in prison awaiting trial she approached Dumisani and asked him to provide her with an alibi, namely, that he was with her on the night of the murder. In exchange she would give him her shares in Deep Gold and ON-TV. He agreed. Assume that she duly transferred the shares to Dumisani upon him testifying at her trial

Result:

Under para 38 Cherel is deemed to have sold her Deep Gold and ON-TV shares for their market value as the consideration is not measurable in money. Dumisani is deemed to have acquired them for the same market value.

9.4.3 'Acting at arm's length'

The phrase 'acting at arm's length' was considered in *Hicklin v SIR*[408] in which 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.'

9.4.4 Substitution of market value for non-arm's length consideration

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[409] equal to the market value of the asset at the date of disposal. The acquirer 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.

When a person renders a service to a connected person under a service or management contract, and the parties agree to cancel the contract, the CGT consequences need to be considered. Such a contract may well be an asset, if it represents a source of profit. The 'cancellation' of a contract is a disposal event under para 11(1)(*b*). In determining whether the contract has a market value for the purposes of determining proceeds under para 38, regard must be had to the terms of the contract. For example, if the contract is subject to cancellation at the behest of either party at short notice, or if the contract is for a short period, it is unlikely to have much value. Since the *Brummeria* judgment, any clause in the contract preventing transfer of the contract would not prevent the establishment of an 'amount' of proceeds. And while the contract may be subject to reciprocal obligations, this does not mean that it does not have a market value. Any market value must be determined under para 31(1)(*g*), being the price a willing buyer would pay a willing seller for the asset, both parties acting at arm's length in an open market. Typically the market value would be determined by discounting the after-tax cash flows to present value over the remaining

[408] 1980 (1) SA 481 (A), 41 SATC 179 at 195.
[409] The term 'amount received or accrued' was substituted for the word 'proceeds' by the Revenue Laws Amendment Act 32 of 2004, effective 24 January 2005.

period of the contract.

9.4.5 Acquisition of asset by resident from non-resident

There is a view that for para 38(1)(*b*) to apply, para 38(1)(*a*) must apply. Since the Eighth Schedule does not apply to the disposal of assets by a non-resident [except for the deemed South African-source assets mentioned in para 2(1)(*b*)], it is contended that para 38(1)(*b*) cannot apply to the resident.

In order to enable the acquirer of the asset to establish an acquisition cost equal to market value, para 20(1)(*h*)(vi) was inserted.[410] See **8.15A**.

9.4.6 Asset acquired or disposed of between connected persons under option contract

The question arises as to whether para 38 should be applied when an option to acquire or dispose of an asset is exercised and the strike price differs from the market value of the asset at the time of exercise. In these cases the terms of the option contract cannot be ignored and para 38 should not be invoked merely because the strike price differs from the prevailing price. Paragraph 38 needs to be considered not at the time of exercise, but at the time when the option is granted. It is necessary to determine whether the price paid for the option is market-related. If not, para 38 will operate to substitute the market-related price for the actual option price.

Example 1 – Application of para 38 when asset acquired through exercise of option

Facts:

Patrick and Liesel own 25% and 30% respectively of the shares in Ger Ltd. In year 1 Liesel granted Patrick a call option which gave him the right (but not the obligation) to acquire one-sixth of her shares (that is, a further 5% stake in the company) at a strike price of R2 a share. The option had to be exercised before the end of year 5. He paid 50 cents for the option which was determined by an independent financial analyst as being an arm's length price. The base cost of Liesel's shares was 75 cents a share. In year 5 Patrick exercised the option when the shares were trading at R3 a share.

Result:

Patrick and Liesel are connected persons in relation to each other under para (*d*)(iv) read with para (*e*) of the definition of a 'connected person' in s 1. However, para 38 does not apply despite the fact that the price paid for the shares (R2 a share) is less than the price prevailing at the time of exercise of the option (R3 a share). Effect must be given to the option contract in determining whether the strike price was market-related. Since the price paid for the option was market-related there is no need to adjust it under para 38.

Year 1

Liesel will have a capital gain in respect of the granting of the option of 50 cents a share [proceeds of 50 cents a share less base cost of nil under para 33(3)(*a*)].

The base cost of Patrick's option is 50 cents a share.

[410] Paragraph 20(1)(*h*)(vi) was introduced by s 77(1)(*c*) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

Year 5

Liesel will have a capital gain of R2 (strike price proceeds) less base cost of 75 cents = R1,25 a share.

The base cost of Patrick's shares will be 50 cents (cost of option) plus R2 (strike price) = R2,50.

Example 2 – Non-arm's length option price

Facts:

The facts are the same as in the above example, except that Patrick only paid 25 cents a share for the option.

Result:

Under para 38

- the proceeds received by Liesel will be increased from 25 to 50 cents a share. In year 1 she will have a capital gain of 50 cents a share in respect of the granting of the option [proceeds 50 cents a share less base cost of nil under para 33(3)(*a*)], and
- the base cost of the option in Patrick's hands will be increased from 25 to 50 cents a share. The base cost of the shares acquired by Patrick in year 5 on exercise of the option will be 50 cents (option price adjusted under para 38) + R2 (strike price) = R2,50 a share.

9.4.7 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 under 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 under para 12(5).	Commencement of years of assessment ending on or after 1 January 2003.[411]
(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*)[412]	This provision was deleted because it was regarded as superfluous in view of para 11(2)(*j*), which provides that there is no disposal of a s 8C equity instrument before	

[411] Paragraph 38(1) was made subject to para 12(5) by s 81 of the Revenue Laws Amendment Act 74 of 2002.
[412] Deleted by s 98 of the Taxation Laws Amendment Act 7 of 2010 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2011.

	vesting as contemplated in that section.	
(2)(*e*)	Any asset in respect of which s 24B applies.	Assets acquired on or after 1 October 2001

Paragraphs 12(5) and 67 override para 38(1).[413]

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 and 8B 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 under 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, para 38 does 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.

9.4.8 Pre-valuation date disposals

Paragraph 38 only applies to disposals on or after the valuation date. This follows from para 2 which states that, subject to para 97, the Eighth Schedule applies to the disposal of an asset on or after the valuation date.

Nevertheless an asset acquired at a non-arm's length price before the valuation date may have a cost equal to market value at the time of its acquisition as a result of the extinction of personal rights leading up to its acquisition– see **8.5A**.

Example – Asset acquired for non-arm's length consideration before the valuation date

Facts:

On 10 June 1990 Albie's brother Morné offered to sell him 1 000 shares in ABC Ltd for R1 a share when the shares were valued at R10 a share. On 15 June 1990 Morné accepted Albie's offer, and at that stage the shares had increased in value to R11 a share. Morné finally took transfer of the shares on 31 July 1990 when the shares were valued at R12 each. He paid Albie R1 000 for the shares on the same date. What expenditure has Morné incurred in acquiring the shares for the purposes of para 20(1)(*a*)?

Result:

When Morné accepted Albie's offer he acquired a vested right to claim delivery of the shares at a price of R1 000. The cost of this right to Morné was R1 000. When Morné took transfer of the shares he gave up the right to claim delivery of the shares in return for the actual shares. The consideration he received for giving up that right is R12 000, being the market value of the actual shares (1 000 x R12 = R12 000). This gives rise to a pre-CGT gain of R12 000 – R1 000 = R11 000 which is irrelevant for CGT purposes.

[413] Paragraph 38(1) is 'subject to' paras 12(5) and 67.

Immediately before the acquisition of the actual shares the right to claim delivery was also worth R12 a share. Morné's expenditure in acquiring the shares is thus equal to the value of the right given up, being R12 000.

9.4.9 The receipt of a donation

The receipt of a donation is generally of a capital nature[414] unless it is a payment for services rendered or is in the form of an annuity. Does the receipt of such a donation gives rise to a capital gain in the hands of the donee? Upon acceptance of a donation, the donee acquires a personal right to claim payment of the donation from the donor for no consideration. 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 10 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.

[414] (1940) 11 SATC 178 (U).

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 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 (that is, 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:

Under 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 under para 20(3)(*a*)] = R0, giving a capital gain of R20.

Note: This example reflects the law on or after 24 January 2005. Before that date para 38 deemed the asset to be disposed of for 'proceeds' equal to market value. The term '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

9.5.1 The clogged loss rule

Under 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. In other words, the capital loss is ring-fenced and may only be set off against capital gains arising from disposals to the same connected person.

9.5.2 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*,[415] 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

[415] General provisions do not take from or reduce specific or special ones.

the transaction. This typically occurs, for example, in an asset-for-shares swap under which 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
(*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.	

Any capital loss arising on disposal of a subsidiary's shares as a result of its liquidation or deregistration is not ring-fenced under para 39, as the shares are not disposed of to a connected person. Paragraph 77(1) simply deems the shares to be disposed of and does not state to whom they are disposed of. The capital loss will, however, have to be disregarded when s 47(5) applies.

In the case of capital losses arising in respect of the disposal of claims owed by connected persons, see **9.5.6** below.

The position before commencement of years of assessment ending on or after 1 January 2004

Paragraph 39(1)(*b*) was introduced by the Revenue Laws Amendment Act 45 of 2003 with effect from the commencement of years of assessment ending on or after 1 January 2004. Before that date para 39(1) only dealt with disposals to connected persons and the relationship between the parties had to be determined before any disposal.

Example 1 – Timing of determination of connected person status

Facts:

Holdco owns all the shares in Targetco that it had acquired in 2003 at a cost of R100 000. On 28 February 2008 Holdco disposed of its shares in Targetco to Acquiringco in exchange for a 70% interest in Acquiringco. Before the transaction Holdco and Acquiringco were unrelated companies. The market value of the Acquiringco shares was R80 000. Determine whether or not Holdco's capital loss of R20 000 will be clogged under para 39.

Result:

The asset-for-share provisions in s 42 do not apply to the disposal by Holdco as the shares were disposed of at a capital loss (s 42 applies only to gain or break-even shares).

Before the disposal, Holdco and Acquiringco are unrelated parties. Immediately after the transaction, Holdco has a 70% interest in Acquiringco, which makes Holdco and Acquiringco 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 ABC Trust for R80 000. The trustees of the ABC Trust have the discretion to appoint any member of the Holdco group as a beneficiary. At the time the ABC Trust acquired the asset, the only nominated beneficiary was Oxfam. Immediately after the transaction, the trustees appointed Subco, a company in which Holdco has a 70% interest, as a beneficiary and awarded the asset to it.

Result:

Holdco's capital loss of R20 000 will be clogged under para 39(1)(*b*)(ii) because

- after the transaction Subco was a beneficiary of the ABC Trust, and
- Holdco owns 70% of the shares in Subco, which makes Holdco and Subco members of the same group of companies.

9.5.3 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 year of assessment 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.

9.5.4 Restricted meaning of 'connected person' [para 39(3)]

The definition of a 'connected person' will not extend, for purposes of para 39(1), to

- any relative of a natural person other than a parent, child, stepchild, brother, sister, grandchild or grandparent of that person, or
- disposals of assets between the four funds of an insurer contemplated in s 29A.

Transactions between spouses are dealt with under para 67 and for this reason they are not excluded from the definition of a 'connected person'.

South African long-term insurers are required for income tax purposes to create four funds to conduct their business, namely, the

- individual policyholder fund,
- company policyholder fund,
- untaxed policyholder fund and
- corporate fund.

Under s 29A(10) each of these funds is regarded as a separate taxpayer for the purposes of determining its taxable income. Thus disposals of assets between the funds are regarded as disposals in respect of which capital gains or losses must be determined. Section 29A(10) also provides that the four funds are deemed to be connected persons for the purposes of the Eighth Schedule. However, para 39(3)(*b*) provides that for the purposes of para 39(1) the

four funds of an insurer are not to be treated as connected persons. Consequently any capital losses arising on a disposal between the four funds of an insurer will not be clogged.

In the case of disposals before 1 February 2006, capital losses [except those arising under s 29A(6) or (7)] remain clogged.[416] As a result of a further amendment it is now clear that a pre-1 February 2006 clogged loss arising from a transaction with one fund of an insurer can be set off against a subsequent capital gain arising from a transaction with the same fund.[417]

9.5.5 Disposals to beneficiaries of share incentive trusts [para 39(4)]

[Applicable to disposals on or after 1 February 2006][418]

Any capital losses arising in an employee share incentive trust are not clogged if

- they relate to any right, marketable security or equity instrument contemplated in s 8A or 8C,
- the disposal is by virtue of the beneficiary's employment with an employer, directorship of a company or services rendered or to be rendered by that beneficiary as an employee to an employer, or
- as a result of the exercise, cession, release, conversion or exchange by that beneficiary of the right, marketable security or equity instrument, and
- that trust is an associated institution as contemplated in para 1 of the Seventh Schedule in relation to that employer or company.

Under the definition of a 'connected person' in s 1 a beneficiary of a trust is a connected person in relation to the trust. This means that in the absence of para 39(4) a share incentive trust would be unable to set off a capital loss arising upon the disposal of a share in one employee against a capital gain arising on the disposal of a share to another employee. Since the trust and the employee normally act at arm's length, it is appropriate that the losses in question not be clogged.

9.5.6 Losses on disposal of 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, when the debtor and creditor are connected persons, and the amount

- comprises a capital gain in the debtor's hands under 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 under s 20(1)(*a*)(ii), or

[416] Paragraph 39(3)(*b*) was widened to include all inter-fund disposals by s 73(1)(*a*) of the Revenue Laws Amendment Act 31 of 2005, effective 1 February 2006. Previously para 33(3)(*b*) only excluded disposals required as a result of a change of policyholders or to balance the assets and liabilities of the four funds under s 29A(6) and (7) on the basis that such transfers were involuntary. The exclusion now includes disposals under s 29A(6), (7) and (8).

[417] Under s 63 of the Taxation Laws Amendment Act 8 of 2007 the reference in the opening words of para 39(3) to 'this paragraph' were changed to refer to para 39(1). The amendment was backdated, and deemed to have come into operation on 1 February 2006 and applies in respect of any disposal on or after that date. The amendment ensures that the four funds remain connected for purposes of para 39(2) at the time of the subsequent capital gain, which is a pre-requisite for set-off.

[418] Paragraph 39(4) inserted by s 73(1)(*b*) of the Revenue Laws Amendment Act 31 of 2005, and applicable to any disposal on or after 1 February 2006.

- must be or was included as a capital gain in the hands of the acquirer of the claim.[419]

Example – 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:

Year	Asset	Market value 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 brought forward 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 as 'bed and breakfasting' and usually involves the disposal of listed shares in order to crystallise losses immediately before the end of the year of assessment followed by the repurchase of the same listed shares immediately thereafter.

[419] This provision came into operation as from the commencement of years of assessment ending on or after 1 January 2005.

Under para 42(1), if a person sells financial instruments (for example, listed shares) and replaces those financial instruments with ones of the same kind and of the same or equivalent quality within the 45-day period before or after the sale date, the loss cannot be immediately claimed for the purposes of CGT. The person disposing of the financial instruments need not be the person reacquiring them. This rule extends beyond the seller and includes connected persons. For the purposes of this paragraph, however, the term 'relative' is narrowed in scope. The definition of a '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
- disposals of assets between the four funds of an insurer contemplated in s 29A.[420]

Spouses are dealt with under para 67.

The expression 'financial instrument of the same kind and of the same or equivalent quality' refers to substantially identical shares in the same company (see **9.7** for more on this expression).

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 (that is, do not include days) for periods in which the risk on the shares is hedged with offsetting positions (for example, when the person has an option to sell).

A seller to whom the paragraph applies is treated as having received proceeds equal to the base cost of the financial instrument disposed of (that is, 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 under this rule. The deemed cost of the asset in the acquirer's hands is treated as expenditure actually incurred for the provisions dealing with base cost.

The purchaser is also deemed to acquire the financial instrument on the date on which the person who disposed of it acquired it. This deeming provision, which was inserted by the Revenue Laws Amendment Act 35 of 2007[421] has since been deleted by the Taxation Laws Amendment Act 3 of 2008 to prevent the acquirer taking advantage of the three-year safe-haven rule in s 9C.[422]

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.

[420] Paragraph 42(3)(*b*) previously only referred to disposals under s 29A(6) or (7). It was amended by s 74(1) of the Revenue Laws Amendment Act 31 of 2005 and now covers all inter-fund disposals – including those contemplated in s 29A(8). This was done to prevent the roll-over of unrealised capital losses from lower-taxed or non-taxed funds to higher-taxed funds. The amendment came into operation on 1 February 2006 and applies to any disposal on or after that date.

[421] Inserted by s 74 of that Act and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2008.

[422] Deleted by s 55 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

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 under para 42(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 if fewer shares are repurchased than were originally sold at a capital loss? Is the entire capital loss deferred? The answer is no. Only the portion of the loss attributable to the 'washed' sales is 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 under 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).

Example 3 – Wash sales and the various identification methods

Facts:

Craig holds the following shares in Lug Ltd, a company listed on a recognised exchange:

Date	Parcel	Number	R
1 October 2001	(A)	500	5 000
15 October 2004	(B)	500	4 500
20 February 2005	(C)	500	3 250
Subtotal		1 500	12 750

On 1 April 2005 he sold 500 Lug Ltd shares for R3 000. Determine whether para 42 applies to Craig if he adopts the following asset identification methods:

(*a*) Weighted average

(*b*) FIFO

(*c*) Specific identification (SPID)

Assume that

- when SPID is adopted, parcel C was disposed of,

- no connected person in relation to Craig acquired Lug Ltd shares within 45 days of either side of 1 April 2005,
- Craig purchased no other shares after 1 April 2005, and
- the disposal is on capital account regardless of the identification method adopted.

Result:

Step 1: Determine whether a capital loss has resulted from the disposal

Using the different identification methods the results are as follows:

Weighted average: The weighted-average base cost of the shares disposed of is R12 750/1500 = R8,50 a share. Therefore the base cost of the shares disposed of is 500 x R8,50 = R4 250. The capital loss is R3 000 (proceeds) – R4 250 (base cost) = -R1 250.

FIFO:

Under this method parcel A is deemed to be disposed of resulting in a capital loss of R3 000 – R5 000 = R2 000.

SPID: The disposal of parcel C gives rise to a capital loss of R3 000 – R3 250 = -R250.

Step 2: Determine whether financial instruments of the same kind and of the same or equivalent quality were purchased within 45 days of either side of the loss-making disposal

This is indeed the case, in that the shares purchased on 20 February 2005 were purchased within 45 days of the disposal on 1 April 2005.

Step 3: Disregard the capital loss and add it to the base cost of the shares acquired during the 45-day period

Weighted average:

The capital loss of R1 250 must be disregarded and added to the base cost pool as follows:

Date	**Parcel**	**Number**	**R**
1 October 2001	(A)	500	5 000
15 October 2004	(B)	500	4 500
20 February 2005	(C)	500	3 250
Subtotal		1 500	12 750
1 April 2005		(500)	(4 250)
Capital loss added back under para 42		-	1 250
		1 000	9 750

FIFO:

The capital loss of R2 000 must be disregarded and added to the base cost of parcel C which increases from R3 250 to R5 250.

SPID:

The shares acquired during the 45-day period must be ‘of the same kind and of the same or equivalent quality’. This does not include the same shares disposed of. Furthermore, since parcel C has been disposed of there are no shares acquired within the 45-day period to which the capital loss can be added.

In the circumstances the capital loss of R250 is allowable in full and para 42 does not apply.

9.7 Hold-over of capital gain on forced sale of listed shares

Paragraph 42A

Paragraph 42A applies in respect of any disposal on or after 1 March 2007.[423] It enables a person to defer a capital gain upon a forced sale of listed shares as a result of a court order under section 311 of the Companies Act 61 of 1973. This could occur, for example, because the company requires the shares in order to facilitate a Black Economic Empowerment deal.

With the introduction of the Companies Act 71 of 2008 s 311 has been repealed from 1 May 2011. The equivalent provision dealing with compulsory purchase of shares under the Companies Act 71 of 2008 is s 114. Under s 12(1) of the Interpretation Act 33 of 1957

> '[w]here a law repeals and re-enacts with or without modifications, any provision of a former law, references in any other law to the provision so repealed shall, unless the contrary intention appears, be construed as references to the provision so re-enacted'.

Until para 42A is amended to substitute the reference to s 311 with s 114 it is accepted that the reference to s 311 in para 42A should be taken as referring to s 114 for compulsory purchases of shares undertaken under the Companies Act 71 of 2008. To the extent that s 114 only requires a special resolution and not a court order it will be accepted that para 42A will nevertheless still apply.

The deferral relief only applies if the shares are replaced with shares of the same kind and of the same or equivalent quality within 90 days of the forced sale.

The expression 'share of the same kind and of the same or equivalent quality' refers to substantially identical shares in the same company.

Thus a shareholder who held a class A ordinary share in ABC Ltd (a listed company) that was forcibly acquired under s 311 of the Companies Act 61 of 1973, who wishes to take advantage of para 42A, must replace that share with a class A ordinary share in ABC Ltd. In the event that the particular class of share is no longer in issue, the share would have to be replaced with one bearing substantially identical rights.

The purpose of para 42A is to enable persons who have been forced to sell their listed shares under a s 311 scheme to replace those shares with substantially identical shares in order to restore their level of investment in the company concerned. The intention is not to grant relief to persons who replace their shares with shares in other companies.

The expression in question has been used to refer to identical assets in other legislative provisions such as para 42 and in the Securities Transfer Tax Act 25 of 2007 in relation to securities-lending arrangements.

The word 'kind' would include the nature of the share (for example, ordinary v preference) as well as the company in which the share is held. 'Quality', being an inherent or distinguishing characteristic, would include the underlying rights in the share.

While the original share must be listed, there is no requirement that the replacement share must be listed. Delisting before replacement will affect the marketability of the replacement share but should not affect the 'kind' or 'quality' of the share in the sense of changing the underlying rights in the share.

The relief is provided as follows:

- The person is treated as having disposed of the old shares at an amount equal to their base cost (that is, there will be no capital gain on the forced sale).

[423] Paragraph 42A was inserted by s 75 of the Revenue Laws Amendment Act 35 of 2007.

- The expenditure in respect of the replacement shares must be reduced by the amount of the capital gain that arose on the forced sale of the old shares (this is the base cost of the replacement shares).
- If the capital gain exceeds the expenditure in respect of the replacement shares, the excess is treated as a capital gain on disposal of the old shares and the replacement shares are treated as having a base cost of nil.
- The person is treated as having acquired the replacement shares on the same date as the old shares (this is relevant for the purposes of the s 9C three-year 'safe haven' rule).

Example 1 – Forced sale of listed shares followed by reacquisition of shares of the same kind

Facts:

Kate owns 2 000 ordinary shares in XYZ Ltd, a company listed on the JSE. Under a court order issued under section 311 of the Companies Act, Kate is forced to sell 25% (that is, 500) of those shares to XYZ Ltd in return for a cash payment of R110 000. The shares sold have a base cost of R90 000.

Within 40 days of the buy-back, Kate repurchases 500 of XYZ Ltd's ordinary shares for R135 000 on the open market.

Result:

Were it not for para 42A, Kate would have had a capital gain of R110 000 – R90 000 = R20 000 in respect of the 500 ordinary shares. However, under para 42A Kate is treated as having disposed of the 500 shares at their base cost of R90 000 and hence no capital gain arises on the disposal. This is because

- the sale occurred as a result of a section 311 court order,
- the shares are listed,
- the sale would have given rise to a capital gain, and
- the repurchase occurred within 90 days.

The base cost of the newly repurchased shares is only R115 000 (R135 000 cost less the R20 000 deferred gain on the buy-back).

Example 2 – Gain on old 'forced sale' shares exceeds expenditure on new shares

Facts:

The facts are the same as Example 1, except that Kate acquires the 500 ordinary shares in XYZ Ltd for R15 000.

Result:

The capital gain on disposal of the old shares (R20 000) exceeds the expenditure on the new shares (R15 000) by R5 000. As a result

- the base cost of Kate's new shares is reduced to nil, and
- the excess of R5 000 is treated as a capital gain.

9.8 Dividends treated as proceeds on disposal of certain shares

Paragraph 43A

This provision comes into operation when the dividends tax comes into operation.

9.9 Base cost of asset of controlled foreign company operating in a country which has abandoned a hyperinflationary currency

Paragraph 43B

The abandonment by a country of its currency will usually occur after a period of hyperinflation. During such a period there will invariably be a lack of reliable exchange rate information for the purpose of determining the tax cost of assets. This occurs because the official rate rarely reflects the true value of assets. The speed of the currency decline also makes it difficult to fix the exchange rate at a specified time.

Once a foreign currency is abandoned after a period of sharp decline in favour of a new, more stable currency, accounting rules often allow for the restatement of assets at market value. Paragraph 43B follows this approach because the continued use of historic costs is impractical.

Paragraph 43B applies when the functional currency of a CFC

- was the currency of a country which abandoned its currency, and had an official rate of inflation of 100% or more for the foreign tax year preceding that abandonment, and
- the CFC adopted a new functional currency as a consequence of that abandonment.

In the above circumstances the CFC must, for the purposes of determining the base cost of the asset, be deemed to have acquired the asset in the new currency

- on the first day of the foreign tax year of the CFC in which the new currency was adopted by the CFC, and
- for an amount equal to the market value of the asset on the date on which the new currency was adopted by the CFC.

Paragraph 43B is deemed to have come into operation on 1 January 2009 and applies in respect of foreign tax years of controlled foreign companies ending during years of assessment commencing on or after that date.

The Zimbabwe dollar is an historical example of a hyperinflation currency. The use of the Zimbabwe dollar as an official currency was effectively abandoned on 12 April 2009 as a result of the Reserve Bank of Zimbabwe legalising the use of the rand and the US dollar as standard currencies for exchange.

Example – Base cost of asset of CFC operating in a country which has abandoned a hyperinflationary currency

Facts:

SA Holdco owns all the shares of Z Co, a company which operates in Zimbabwe. SA Holdco's year of assessment ends on 31 December, while Z Co's tax year ends on 30 June. For its 2008 and earlier tax years, Z Co adopted the Zimbabwe dollar as its functional currency. With the abandonment of the Zimbabwe dollar on 12 April 2009 Z Co adopted the US dollar as its functional currency.

On 30 September 2004 Z Co acquired a machine for US$1 million, which it translated into its functional currency as Z$5 284 900 000. The market value of the machine on 12 April 2009 was US$800 000.

Result:

For the purposes of para 20, Z Co is deemed to have acquired the machine for US$800 000 on 1 July 2008.

Chapter 10 – Unquantified and unaccrued amounts

10.1 Overview

The treatment of unaccrued or unquantified amounts of proceeds and expenditure involves interplay between various sections of the 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 section 11(*o*) allowance
Section 23F(2) and (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
Section 24N	Incurral and accrual of amounts in respect of disposal or acquisition of equity shares
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 on the treatment of unquantified amounts receivable or payable,
- prevent revenue and capital losses from being claimed up front, 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 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 unquantified amounts not to be incurred until they are quantified.
(3)	Recovery or recoupment of amounts allowed as deductions	Recovery or recoupment under s 8(4) occurs as amounts are quantified.
(4)	Determination of deductions in respect of depreciable assets	Allowances that would have been granted in earlier 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 an asset acquired for a consideration based on future profits. The common law position with amounts receivable of such a nature is that while there may arguably be an accrual, there will be no 'amount'. Feetham *JA* stated in *CIR v Butcher Bros (Pty) Ltd*[424] that in the context of the gross income definition, the word 'amount' meant a consideration having an 'ascertainable money value' as opposed to mere 'conjectural value'.

South African courts have also considered the deductibility of unquantifiable expenditure. In *COT v 'A' Company*[425] the court allowed a merchant banker to claim a loss on a loan to a debtor who had been liquidated, despite the amount of the final liquidation dividend not having been quantified. Citing this case with approval, the court in *Edgars Stores Limited v CIR*[426] 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,[427] 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. In the latter case the normal common law principles apply and the accrual or incurral is deferred until the condition is fulfilled. Capital losses arising from amounts that have not accrued (whether by reason of s 24M or some other reason) are ring-fenced under para 39A until all unquantified amounts have been quantified. Revenue losses arising under s 11(*o*) on disposal of qualifying depreciable assets are similarly ring-fenced under 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. If 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 (see **2.4.1.20**).[428] 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 the term 'gross income'.[429] For these reasons it is likely that most unquantifiable transactions involving future receipts will be on revenue account.

The words 'cannot be quantified' are 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 amounts when the quantum of the amount is dependent on future events. This interpretation is consistent with the meaning of the word 'amount' in the *Butcher Bros* case

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[424] *CIR v Butcher Bros (Pty) Ltd* 1945 AD 301, 13 SATC 21 at 34.
[425] *COT v 'A' Company* 1979 (2) SA 409 (RAD), 41 SATC 59.
[426] 1988 (3) SA 876 (A), 50 SATC 81 at 90.
[427] (1995) 58 SATC 172 (C) at 179.
[428] *Deary v Deputy Commissioner of Inland Revenue* 1920 CPD 541, 32 SATC 92 and *William John Jones v The Commissioners of Inland Revenue* [1920] 1 KB 711, 7 TC 310.
[429] See *Silke* in § 4.3.

above, and the way in which the word 'quantified' was used in the *Edgars Stores* case and ITC 1601 above. Section 24M therefore essentially entrenches the common law position.

10.2.2 Disposal of asset for unquantifiable consideration [s 24M(1)]

Section 24M(1) applies when a person disposes of an asset for a consideration all or part of which cannot be quantified in that year of assessment. If 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 under para 3(*b*)(i). In the case of a pre-valuation date asset the capital gain or loss must be redetermined under para 25(2).

10.2.3 Acquisition of asset for unquantifiable consideration [s 24M(2)]

Section 24M(2) applies when a person acquires an asset for a consideration all or part of which cannot be quantified in that year of assessment. If 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. If the asset is disposed of before the amount is incurred the CGT consequences will be as follows:

- Post-valuation date asset – the amount incurred will be treated as a capital loss under para 4(*b*)(ii).
- Pre-valuation date asset – the capital gain or loss must be redetermined under para 25(2). The previous capital gain or loss will be reversed out, and the new capital gain or loss taken into account.

Example – Straight-forward gain on unquantified amounts

Facts:

In December 2001 Andrew acquired shares at a base cost of R250 000. In March 2005, he sold the shares to Bryan for a purchase consideration payable in instalments over five 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 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:

Section 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
Less: 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 five 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 when

- 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 under s 8(4) must be determined with reference to amounts that are deemed to accrue under 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). Under para 35(3)(*a*) any amount recovered or recouped under s 8(4) will reduce the proceeds.

10.2.5 Determination of deductions in respect of depreciable assets [s 24M(4)]

This subsection applies when

- 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. Should sufficient time have elapsed since the asset was brought into use, the person could qualify for a full deduction in respect of the additional expenditure. This could apply, for example, when the cost of an asset is allowed as a deduction over four years under s 12C. The immediate write-off is relevant from a CGT perspective in determining the amount to be allowed as a capital loss under para 4(*b*)(ii), since the relevant expenditure must be reduced by the amount of any capital allowances under 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 four 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 five 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 Incurral and accrual of amounts in respect of disposal or acquisition of equity shares (s 24N)

Section 24N

10.3.1 Application

This provision applies when

- a person during a year of assessment sells equity shares to another person, and
- a part of the purchase price is quantified or quantifiable but is due and payable by reference to future profits.

Under general principles the proceeds from such a sale would accrue to the seller in the year of sale and the purchase price would form part of the base cost of the purchaser in the same year. This provision is aimed at alleviating the cash flow difficulties that may be experienced by the seller under such an arrangement. It does this by deferring the accrual and incurral of the purchase price in the seller's and buyer's hands respectively to the extent and until the amounts become due and payable.

10.3.2 Conditions

Five conditions must be satisfied for the deferral to apply. These are as follows:

Significant deferred payment and link to future profits [s 24N(2)(a)]

More than 25% of the sales proceeds must be due and payable after the first year of assessment of the seller. Furthermore, the amount payable must be based on the future profits of the company in which the shares are held. This ensures that the deferred profit participation element is meaningful.

Sale of a meaningful company stake [s 24N(2)(b)]

One or more sellers must dispose of more than 25% of the total value of the equity shares in the same company during that year, and those sales must fall within s 24N. This rule assists the sale of a meaningful stake in a company. It is not intended to promote deferral for portfolio shares.

No connected persons [s 24N(2)(c)]

The sale must not occur between a seller and purchaser who are connected to each other after the disposal (for example, when buyer and seller are relatives or members of the same group of companies.

Resolutive condition [s 24N(2)(d)]

The sale must be subject to a performance requirement by the purchaser, namely, that the purchaser is obliged to return the equity shares to the seller in the event of failure by the purchaser to pay an amount when due. This resolutive condition means that the contingency 'profit participation' element is a core part of the transaction (as opposed to a standard deferred instalment agreement).

No cash equivalents [s 24N(2)(e)]

The amount payable to the seller cannot be payable under a financial instrument which is payable on demand or readily tradable in the open market. In other words, the claim cannot be a cash equivalent, thereby undermining the lack of cash-flow premise for relief.

10.3.3 Consequences for seller

In mechanical terms, the seller determines capital gains/losses during the initial year of disposal in the normal way, except that amounts due and payable in later years are ignored [s 24N(1)(*a*)(i)]. This calculation may trigger an initial capital gain or loss. Initial capital gains generate tax just like any other capital gain. However, initial capital losses are ring-fenced during that year [para 39A(1)]. The seller must then account for further consideration in later years as that consideration becomes due and payable [s 24N(1)(*b*)(i)]. This further consideration generates full capital gain during each year of instalment without any base cost deduction) [para 3(*b*)(i)] However, the seller reduces this gain to the extent of any remaining disregarded losses stemming from the initial year of transfer [para 39A(2)]. If any disregarded losses still exist after all instalments become due and payable, these remaining capital losses can be fully accounted for at that time [para 39A(3)].

10.3.4 Consequences for purchaser

If a purchaser acquires equity shares for consideration that wholly or partly includes amounts within s 24N, that purchaser's expenditure incurred (base cost) is accumulated over time. More specifically, the purchaser is initially viewed as having incurred expenditures to the extent of the consideration provided on transfer [s 24N(1)(*a*)(ii)]. Further expenditure is added to the asset acquired as further amounts become due and payable [s 24N(1)(*b*)(ii)]. If the transferee sells an equity share before all amounts are due and payable, the gain on the transfer is calculated without reference to these amounts. However, further amounts paid or

incurred by the transferee on the transferred asset will generate capital loss as those amounts are quantified [para 4(*b*)(ii)].

10.4 Disposal of asset for unaccrued amounts of proceeds

Paragraph 39A

10.4.1 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.[430]

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 can arise under s 24M when a portion of the proceeds cannot be quantified, in which case the accrual is deferred to the year of quantification. 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.

10.4.2 Disregarding of capital loss [para 39A(1)]

Under para 39A(1), a person must disregard a capital loss arising on disposal of an asset during a year of assessment when all the proceeds from that disposal will not accrue to that person during that year.

The primary source for making the determination as to whether all the proceeds have accrued will be the agreement of sale. Would capital losses continue to be ring-fenced if, for example, the sale agreement provides that the proceeds are equal to 10% of the profits for the next five years, and after four years the company has made consistent losses and is unlikely to turn a profit in the fifth year? Under these circumstances any capital loss will nevertheless still be ring-fenced until the end of the fifth year since there is still a possibility, no matter how remote, that a profit will be derived that will generate proceeds. However, if the purchaser were to be liquidated and finally wound up by the end of the fourth year, one could conclude with absolute certainty that no further proceeds will accrue, and the capital loss will be claimable in year four.

10.4.3 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 an earlier year under para 39A(1) may use 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 under s 24M(1)(*b*). Under 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 in respect of which the capital gain or loss is redetermined from scratch in the current year. In this 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.

[430] Inserted by s 64(1) of the Revenue Laws Amendment Act 32 of 2004.

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. Under the contract the purchase price was payable in annual instalments over the next five 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 of 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 under 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
Less: 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

Under para 20 Moira's base cost will be accumulated over the five 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 property index. The amounts ultimately received are R400 000, R200 000, R150 000, R0 and R250 000, Assume that these are on capital account and not an annuity.

Result:

Under 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 under para 39A(1). Subsequent years will trigger capital gains that will first be used against the suspended loss under 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
Less: 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

Under s 24M(2) read with para 20 the base cost of the office block acquired by Jules will be accumulated over the five 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. Under the contract, Lance must pay the following amounts over the next five years commencing on 28 February 2006:

- Fixed instalments of R20 000 a year, 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 Jody's hands 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 under 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
Less: 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

Under para 20 Lance's base cost is accumulated over the five 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 2008 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 (that is, 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.

10.4.4 Lifting of ring-fencing of capital loss [para 39A(3)]

If a person can prove that no further proceeds will accrue the remaining portion of any unused 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. The determination as to whether no further proceeds will accrue must be made taking into account the terms of the sale agreement and any subsequent events which would prevent further proceeds from accruing. When any possibility exists under the sale agreement that further proceeds could accrue, no matter how remote, the ring-fencing of the capital loss will not be lifted. See also **10.4.2**.

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 under para 39A(1). This suspended loss will be partly offset with successive gains under para 39A(2). However, the transaction will generate a net R400 000 capital loss in 2010 once all instalments have been received. Under para 39A(3) that capita loss may be set off 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
Less: 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)

Under para 20 and the common law principles governing the incurral of expenditure, Wolf' will have a base cost accumulated over the five 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.

10.5 Disposal of certain debt claims

Paragraph 35A

10.5.1 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.
- 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. The provision does not apply to a claim that is disposed of after all amounts have accrued to the seller of the asset.

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 under para 39A(3). This is more clearly explained in the example in **10.5.3**.

10.5.2 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 in 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.

10.5.3 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 acquirer of the claim must, under s 24M or normal common law principles, take the unaccrued portion of the claim into account when it accrues, either in determining gross income (for example, 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 2010 Jeremy sold plant having a base cost of R500 000 to Anne for a consideration of R1 200 000. The amount is payable on 1 May 2010 subject to the plant meeting certain performance criteria.

On the same day (28 February 2010) Jeremy disposed of his right to claim payment of the R1 200 000 amount due on 1 May 2010 to Debt Factors (Pty) Ltd for a cash consideration of R1 180 000. The market value of the plant on 28 February 2010 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,
- the right to claim payment from the disposal of the plant has been disposed of, and
- the claim disposed of had not accrued at the time of disposal.

Under para 35A(2) R1 180 000 is treated as proceeds on disposal of the plant. Therefore the capital gain or loss on disposal of the plant will be as follows:

	R
Proceeds	1 180 000
Less: 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
Less: Base cost	(1 200 000)
Capital loss	(20 000)

This capital loss on disposal of the unaccrued portion of the claim must be disregarded under para 35A(3).

Debt Factors (Pty) Ltd will have an income gain as follows:

	R
Gross income (received from Anne)	1 200 000
Less: Cost (paid to Jeremy)	(1 180 000)
Taxable income	20 000

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.

10.6 Limitation of section 11(*o*) 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 on disposal of depreciable assets under s 11(*o*). The section 11(*o*) allowance applies to certain depreciable assets with a useful life not exceeding 10 years. If 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 s 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% under 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 used, further accruals will generate recoupment of the amount claimed under s 12C of R200 000 [s 24M(3)]. Further amounts generate capital gains under 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
Less: 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

11.1 Definitions

Paragraph 44

This paragraph contains a number of definitions that apply for the purposes of Part VII unless the context indicates otherwise.

11.1.1 Definition – 'an interest'

> **'"[A]n 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 in which 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.

A lessee who rents a residence has an interest in that residence under the last item (a right of use or occupation) despite not owning that residence. The effect of this is that when 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.

11.1.2 Definition – 'primary residence'

'**"[P]rimary 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.'

11.1.2.1 General

Under 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 when one spouse resides in that residence and the other spouse who owns that residence does not reside in it, 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 in which

- 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.

The definition of a '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'.

11.1.2.2 Polygamous marriages

What is the position when a husband is married to more than one wife under 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 the primary residence exclusion in respect of more than one residence at a time.

11.1.2.3 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*[431] Botha JA held that the word 'mainly' prescribed a purely quantitative standard of more than 50%.

[431] 1966 (4) SA 444 (A), 28 SATC 233 at 245.

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, while 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.

11.1.2.4 Non-residents

11.1.2.4.1 The meaning of 'ordinarily resides'

Non-residents are potentially liable to CGT on the disposal of immovable property they hold in South Africa (para 2).

In certain circumstances a non-resident can have a primary residence in South Africa. A key requirement of the definition of a '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*[432] 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 in which a non-resident has no other primary residence, these tests do not seem appropriate.

11.1.2.4.2 No primary residence offshore

If a non-resident does not own a primary residence elsewhere and buys one for the purpose of residing in it 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' while in South Africa.

[432] 1946 AD 174, 13 SATC 362 at 371.

11.1.2.4.3 More than one primary residence

The South African home of a non-resident will not comprise a primary residence if the non-resident owns a primary residence in his or her home country. It would not be a residence in which the non-resident 'ordinarily resides' as his or her 'main' residence.[433]

A determination has to be made as to where a person ordinarily resides. This cannot be determined over a short period of a year unless there is clear evidence that the person has decided to permanently move his or her place of ordinary residence. The temporary letting of the overseas residence will not render the South African residence a primary residence, since the person does not ordinarily reside in the South African residence as his or her main residence. The letting of a residence could be an indicator of a change of primary residence but it is by no means a decisive factor.

11.1.3 Definition – 'residence'

> '**"[R]esidence"** 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 containing sufficient facilities to make it 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.[434] 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.

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.*[435] 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 in which 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 curtilage 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.

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[433] See also ITC 1807 (2006) 68 SATC 154 (C). In that case an employee of a UK Company was assigned to a SA company for 32 months. The issue under appeal was whether the employee was away from his 'usual place of residence' for purposes of determining whether residential accommodation supplied to him during his stay in SA was exempt from tax under para 9(7) of the Seventh Schedule. The court held that a person's ordinary place of residence is the place where he or she is ordinarily resident. The employee was accordingly held to be away from his usual place of residence, which was the UK.

[434] See ATO Tax Determination TD 92/158 dated 17 September 1992 which states that in most cases a tent will not be regarded as a substantial structure within the context of the equivalent Australian provision.

[435] *Lewis (Inspector of Taxes) v Lady Rook* [1992] 1 WLR 662, [1992] STC 171.

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.[436]

11.2 General principle

Paragraph 45

11.2.1 The primary residence exclusion [para 45(1)]

Subject to para 45(2) and (3), a natural person or a special trust must in determining an aggregate capital gain or loss on disposal of a primary residence disregard

- so much of the capital gain or loss to the extent that it does not exceed R1,5 million (2006 and earlier years of assessment: R1 million),[437] or
- subject to para 45(4), a capital gain if the proceeds on disposal do not exceed R2 million).[438]

These exclusions are overridden by para 45(2), (3) and (4). Under para 45(2) the amounts of R1,5 million and R2 million have to be apportioned when more than one person has an interest in the same primary residence. Paragraph 45(3) only allows a person one primary residence at a time. Paragraph 45(4) precludes the use of the R2 million threshold when a primary residence has not been ordinarily resided in on or after the valuation date or when it has been tainted by trade usage.

A taxpayer does not have a right of election between para 45(1)(*a*) and (*b*). In other words, a taxpayer who disposes of an 'untainted'[439] primary residence for R2 million or less must disregard the full amount of any capital gain even if it exceeds R1,5 million. However, capital losses are not affected by para 45(1)(*b*). Thus a taxpayer whose proceeds are R2 million or less can claim a capital loss to the extent that it exceeds R1,5 million.

Example 1 – Capital gain on disposal of primary residence

Facts:

On 1 October 2001 Obert purchased a residence to be used solely as his primary residence for a total cost of R1 250 000. During the 2011 year of assessment Obert sells this primary residence for R3 million in order to purchase another primary residence.

[436] The United Kingdom HM Revenue & Customs requires that the flats be contiguous. See the *Capital Gains Manual* in CG64305 available at <http://www.hmrc.gov.uk/manuals/cgmanual/CG64305.htm> [Accessed **8 December** 2011]. When flats are located on different floors or are separated by other flats the United Kingdom HM Revenue & Customs will only grant private residence relief in exceptional circumstances. Factors considered are the length of occupation and use.

[437] The primary residence exclusion was increased from R1 million to R1,5 million by s 33 of the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

[438] The R2 million threshold was introduced by s 73 of the Taxation Laws Amendment Act 17 of 2009 and deemed to have come into operation on 1 March 2009 and applies in respect of years of assessment commencing on or after that date. It was amended retrospectively to the same date by s 103(1) of the Taxation Laws Amendment Act 7 of 2010 to only apply to capital gains.

[439] See para 45(4).

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 2011 year of assessment, his additional income tax liability as a result of the capital gain realised is determined as follows.

	R
Proceeds	3 000 000
Less: Base cost	(1 250 000)
Subtotal	1 750 000
Disregarded under para 45(1)(*a*)	(1 500 000)
Balance subject to CGT	250 000
Less: Annual exclusion	(17 500)
Aggregate capital gain	232 500
Taxable capital gain (R232 500 x 25%)	58 125
Tax payable (R58 125 x 40%)	23 250

Example 2 – Proceeds not exceeding R2 million and capital gain would have arisen

Facts:

Lara acquired her primary residence at a base cost of R300 000 in 2002. During the 2011 year of assessment she sold it for R2 million.

Result:

Although the capital gain before applying para 45(1) is R1,7 million, Lara must disregard the entire amount because the proceeds on disposal of her primary residence are R2 million or less. There is, in fact, no need for her to determine the base cost of the residence.

Example 3 – Proceeds not exceeding R2 million and capital loss would have arisen

Facts:

Tineke bought her primary residence in 2004 for R3,5 million. She disposed of it during the 2011 year of assessment for R1,4 million.

Result:

Although the proceeds do not exceed R2 million, para 45(1)(*b*) does not apply to capital losses. Accordingly, Tineke's capital loss is determined as follows:

	R
Proceeds	1 400 000
Less: Base cost	(3 500 000)
Subtotal	(2 100 000)
Disregarded under para 45(1)(*a*)	(1 500 000)
Capital loss	(600 000)

11.2.2 Apportionment of the primary residence exclusion when more than one person has an interest in a primary residence [para 45(2)]

The R1,5 million exclusion (2006 and earlier years of assessment: R1 million) and the R2 million proceeds threshold operate on a 'per primary residence' basis and not on a 'per person holding an interest in the primary residence' basis. This means that when, for example, two individuals have an equal interest in the same primary residence, each of them will be entitled to a primary residence exclusion of a maximum of R750 000 (2006 and earlier

years of assessment: R500 000). In this example they would also disregard any capital gain or loss if the proceeds on disposal of each person's share was R1 million or less.

This would typically apply to spouses married in community of property.

When more than one person holds an interest in the same residence, the primary residence exclusion and the proceeds threshold are only split between those persons who occupy the residence as their *primary residence*. The interests of persons who do not reside in the residence as their primary residence are not taken into account.

Example 1 – Spouses married in community of property

Facts:

The facts are the same as in Example 1 in **11.2.1**, 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 2010 year of assessment, Obert and Portia's taxable capital gains are determined as follows.

	Total R	Obert R	Portia R
Capital gain apportioned under para 14	1 750 000	875 000	875 000
Less: Disregarded under para 45(2)	(1 500 000)	(750 000)	(750 000)
Balance subject to CGT	250 000	125 000	125 000
Less: Annual exclusion		(17 500)	(17 500)
Aggregate capital gain		107 500	107 500
Taxable capital gain (R107 500 x 25%)		26 875	26 875

Example 2 – 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 five 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 R6 100 000. Determine his capital gain or loss on disposal of the house.

Result:

His capital gain is calculated as follows:

The capital gain is R6 100 000 (proceeds) – R1 300 000 (base cost) = R4 800 000. The portion of the gain that relates to the period when the residence was a primary residence is 5/15, that is, R4 800 000 x 5/15 = R1 600 000.

	Primary residence R	Not a primary residence R	Total R
Gain	1 600 000	3 200 000	4 800 000
Less: PR exclusion	(1 500 000)	-	(1 500 000)
Capital gain	100 000	3 200 000	3 300 000

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 R1,5 million exclusion to that part.

Example 3 – More than one person having an interest in a residence which is not a primary residence of some of those persons

Facts:

Beatrix and Beatriz are sisters. They each own a 50% share in a house which Beatriz occupies as her primary residence. Beatrix does not live in the residence as she lives in another house. The sisters dispose of the residence and each realise a gain of R1 500 000 for their respective shares.

Result:

Beatriz will be entitled to the full primary residence exclusion of R1,5 million as she is the only person having an interest in the residence as a primary residence. Beatrix is not entitled to the primary residence exclusion as she did not occupy the residence as her primary residence.

11.2.3 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 when one person owns two residences and uses both as primary residences, except when para 48 applies. The latter provision allows for a two-year overlap under specified circumstances.

Example – 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:

As Quartus presented evidence that his personal and economic relations are closer to Cape Town than to Johannesburg, it is accepted that his Cape Town home is his primary residence.

Cape Town

	R
Proceeds	2 600 000
Less: Base cost	(500 000)
Capital gain	2 100 000
Less: Primary residence exclusion	(1 500 000)
Balance subject to CGT	600 000

Johannesburg

	R
Proceeds	1 800 000
Less: Base cost	(500 000)
Capital gain	1 300 000

Quartus will therefore include capital gains of R1 900 000 in his aggregate capital gain or loss for the year.

11.2.4 Restriction on use of the R2 million proceeds threshold for exclusion [para 45(4)]

Under para 45(1)(*b*) a natural person or special trust must disregard the capital gain or loss on disposal of a primary residence if the proceeds on disposal are R2 million or less. However, this exclusion does not apply if the natural person or special trust

- was not ordinarily resident in the residence throughout the period commencing on or after the valuation date during which that person or special trust held that interest, or
- used the residence or a part of it for the purposes of carrying on a trade for any portion of the period commencing on or after the valuation date during which the person or special trust held the interest.

These disqualifying criteria are required to ensure that the portion of a capital gain or loss that does not relate to the use of a residence as a primary residence is brought to account. A taxpayer who has such a tainted primary residence will similarly not qualify for the R1,5 million exclusion on the 'tainted' portion of any capital gain or loss.

Example 1 – When the R2 million threshold does not apply (period not ordinarily resident)

Facts:

Lizette acquired her primary residence in Durban in 1998. On 1 October 2002 she moved to Kriel where she purchased a new primary residence. She retained the Durban residence as a holiday home until 30 September 2007. On 1 October 2007 she sold the Kriel home and moved back to the Durban residence which she reoccupied as her primary residence. She sold the Durban residence for R1,9 million on 30 September 2009. The base cost of the Durban residence was R300 000.

Result:

The R2 million proceeds threshold for the exclusion of a capital gain or loss on disposal of a primary residence does not apply because Lizette was not ordinarily resident in the residence as her primary residence for a portion of the period on or after the valuation date (1 October 2002 to 30 September 2007 = 5 years). The overall gain is R1 600 000 [R1,9 million (proceeds) less R300 000 (base cost)]. Of this amount, 3/8 or R600 000 qualifies for the R1,5 million exclusion. The balance of R1 million (5/8 x R1,6 million) must be brought to account as a capital gain in determining Lizette's aggregate capital gain or loss.

Example 2 – When the R2 million threshold does not apply (trade usage)

Facts:

Antoinné acquired her primary residence in 1996. From 1 October 2004 until she sold it on 31 January 2010 she used 10% of the house as a home study and consulting room for her legal practice. The proceeds on disposal of the residence amounted to R2 million and its base cost was R500 000.

Result:

The R2 million threshold for the exclusion of a capital gain or loss on disposal of a primary residence does not apply because Antoinné used a portion of the house for the purposes of trade during the period on or after the valuation date. She will therefore have to determine a capital gain or loss. Of the overall gain of R1,5 million [R2 million (proceeds) less R500 000 (base cost)], R150 000 (10%) comprises a capital gain which must be accounted for in determining her aggregate capital gain or loss for the 2010 year of assessment. The balance of the overall gain of R1 350 000 (R1,5 million – R150 000) must be disregarded because it is less than the primary residence exclusion of R1,5 million.

11.3 Part-disposal of a primary residence

In certain circumstances part of the primary residence may be disposed of. This could happen, for example, when

- a part of the main residence is disposed of (for example, 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. Under para 46(*c*) the exclusion is not available when 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 in which 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 R1,5 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 R1,5 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 when 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 R1,5 million exclusion must be apportioned in relation to each interest so held.

Example 1 – Part-disposal of primary residence

Facts:

Wouter owns a large 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. Lynette and Wouter are not spouses.

Result:

Wouter's primary residence exclusion in respect of the part disposed of is R600 000 (R4 000 000 / R10 000 000 x R1 500 000).

His capital gain is determined as follows:

	R
Proceeds	4 000 000
Less: Base cost (40% x R2 000 000)	(800 000)
Gain	3 200 000
Less: Primary residence exclusion	(600 000)
Capital gain	2 600 000

After the disposal, under 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%	900 000
Lynette – 40%	600 000
	1 500 000

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
Less: Base cost (R2 000 000 – R800 000)	(1 200 000)
Gain	4 800 000
Less: Primary residence exclusion	(900 000)
Capital gain	3 900 000

Lynette's primary residence exclusion increases from R600 000 to R1 500 000 as she now owns 100% of the primary residence.

Example 3 – 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 a 'residence').

11.4 Awards of damages in respect of loss of a view

Following the *Paola*[440] case, there have been a number of cases in which 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 when 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. The proceeds in respect of a disputed claim will only accrue once it 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 under para 33.

For the purposes of para 45(1) the primary residence 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:

[440] *Paola v Jeeva NO & others* 2004 (1) SA 396 (SCA).

Award of damages

Base cost of part disposed of

	R
House (R500 000/R2 500 000 x R400 000)	80 000
Legal fees	10 000
	90 000
Primary residence exclusion used (R500 000/R2 500 000 x R1 500 000)	300 000

	R
Proceeds	500 000
Less: Base cost	(90 000)
Gain	410 000
Less: Primary residence exclusion	(300 000)
Capital gain	110 000

Disposal of house

The capital gain on disposal of Amanda's house is determined as follows:

	R
Proceeds	2 000 000
Less: Base cost	(320 000)
Gain	1 680 000
Less: Primary residence exclusion	(1 200 000)
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.

11.5.1 The size limitation [para 46(a)]

The primary residence exclusion only applies to so much of the land that does not exceed two hectares. In the case of land that exceeds two hectares, it will be necessary to determine the capital gain attributable to the two-hectare portion, and apply the R1,5 million exclusion against that portion.

11.5.2 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.

11.5.3 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.

11.5.4 Adjacent land

The word 'adjacent' as used in the words '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.[441] It has been held that a mine located four miles away from another was not adjacent thereto.[442] Each case must be judged on its own merits to determine whether the required degree of proximity is present.

Example – Apportionment when land exceeds two 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. At the time vacant land in the area was selling for R583 333 a hectare. He took occupation of the property immediately after it had been acquired and occupied it throughout the period of ownership until the property was sold, four years later. Over the period of ownership improvements amounting to R150 000 were effected to the property. These comprised the cost of perimeter fencing (R120 000) and the cost of a lock-up garage (R30 000). Repairs amounting to R18 000 were also carried out. The smallholding was sold for R6 000 000 and estate agent's commission of 8% (R480 000) was paid. The price of vacant land in the area at the time of sale was R1 666 667 a hectare. 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.
Proceeds – The market value of 3 hectares of land in the area was R1 666 667 x 3 = R5 000 000. It is therefore estimated that the residential building was sold for R6 000 000 – R5 000 000 = R1 000 000.
Acquisition cost – The market value of 3 hectares of land in the area at the time of acquisition was R583 333 x 3 = R1 750 000. It is therefore estimated that the residential building was acquired for R2 450 000 – R1 750 000 = R700 000.
Cost of improvements – The cost of the perimeter fencing has been allocated to the land and the lock-up garage has been allocated to the residential building. The garage is an 'appurtenance' that falls within the definition of a 'residence' in para 45.
Estate agent's commission – On land = R5 000 000 x 8% = R400 000. On building = R1 000 000 x 8% = R80 000.

	Land	Residential Building	Total
	R	R	R
Proceeds	5 000 000	1 000 000	6 000 000
Less:			
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)	-	-	-
Estate agent's commission on sale	(400 000)	(80 000)	(480 000)
Capital gain	2 730 000	190 000	2 920 000

The above method of apportionment is presented for illustrative purposes and may not be appropriate in other cases. Any method of apportionment must be logical, fair and reasonable and take into account the facts and circumstances of the particular case.

[441] *City of Wellington v Borough of Lower Hutt,* [1904] AC 773.
[442] *Kimberley Waterworks Co, Ltd v De Beers Consolidated Mines, Ltd* [1897] AC 515 at 518.

The next step is to determine the portion of the capital gain on the land (R2 730 000) that is attributable to the primary residence. That portion, together with the capital gain on the residential building, will comprise the capital gain on the primary residence (before applying the primary residence exclusion).

	Primary Residence (2 ha) R	Remaining Land (1 ha) R	Total R
Land	1 820 000	910 000	2 730 000
Residential buildings	190 000	-	190 000
Capital gain	2 010 000	910 000	2 920 000
Less: Primary residence exclusion	(1 500 000)	-	(1 500 000)
Balance subject to CGT	510 000	910 000	1 420 000

The capital gain on the land has been allocated on an area basis as follows:
R2 730 000 x 2/3 = R1 620 000 (primary residence portion)
R2 730 000 x 1/3 = R910 000 (1 ha remaining land portion).

Paragraph 46(*b*) refers to the land not exceeding two hectares and places the requirement that such land, with or without appurtenances on it, 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 on it, 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 when not ordinarily resident

Paragraph 47

Paragraph 47 applies when an individual or special trust

- disposes of an interest in a residence which is or was a primary residence, and
- that individual or a beneficiary of that special trust or a spouse of that individual or beneficiary, was not ordinarily resident in that residence throughout the period on or after the valuation date during which that individual or special trust held that interest.

Under these circumstances, the portion of the capital gain or loss to be disregarded under para 45 must be determined with reference to the portion of the period during which that individual, beneficiary or spouse was ordinarily resident.

It follows that the overall capital gain or loss must be split into ‘primary residence’ and ‘non-primary residence’ portions, with only the primary residence portion of the overall capital gain or loss qualifying for the exclusion under para 45. The non-primary residence portion of the overall capital gain or loss must be fully accounted for and is not subject to exclusion under para 45, although the annual exclusion may be available to the extent that it has not been used against other capital gains and losses. The apportionment must be done on a time basis with reference to the period on or after the valuation date. The fact that the person may not have been resident in the residence before valuation date is not taken into account. It is not permissible to apportion the overall capital gain by using the market value of the property on the date of ceasing to be resident. Only time apportionment is permitted.

Paragraph 47 is subject to paras 48 and 50. The latter two provisions relax the apportionment rule by deeming the person to be ordinarily resident in a residence even though in reality this is not the case.

The meaning of the words 'ordinarily resident' has been considered in a number of court decisions in an income tax context. The principles laid down in these cases can also be used as guidelines as to its meaning in the context of the primary residence provisions.[443]

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 until she emigrated from South Africa on 30 April 2004. She placed the property on the market in 2009 and finally sold it for R6 000 000 on 31 January 2010.

Result:

Upon emigration, Seni is no longer considered ordinarily resident in South Africa 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 South Africa retains its tax jurisdiction over the property under para 2(1)(*b*). The period of residence is determined as follows:

Tax year	Primary residence	Not a primary residence	Total
	Months	Months	Months
2003	5	-	5
2004	12	-	12
2005	2	10	12
2006	-	12	12
2007	-	12	12
2008	-	12	12
2009	-	12	12
2010	-	11	11
	19	69	88

	R
Proceeds	6 000 000
Less: Base cost	(1 000 000)
Gain	5 000 000
Less: Portion of gain relating to period of ordinary residence and qualifying for primary residence exclusion (19/88 x R5 000 000)	(1 079 545)
Capital gain	3 920 455

If she has no other capital gains or losses in the year of disposal, this amount will be reduced further by the annual exclusion of R17 500.

[443] See SARS Interpretation Note 3 'Resident: Definition in Relation to a Natural Person – Ordinarily Resident' [online], (4 February 2002) and the cases cited therein. Available at <http://www.sars.gov.za/home.asp?pid=54958> [Accessed 8 December 2011].

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 before 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 when 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 because he would probably be considered to be ordinarily resident there after valuation date, no apportionment of any capital gain realised would be necessary. However, the facts of each case would have to be 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.

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.[444]

[444] See ITC 961 (1961) 24 SATC 648 (F).

11.7 Disposal and acquisition of primary residence

Paragraph 48

Paragraph 47 provides for apportionment when a person was not ordinarily resident in a primary residence throughout the period on or after the valuation date. Paragraph 48 prevents this apportionment by deeming a natural person or a beneficiary of a special trust to have been ordinarily resident in a residence when that person or beneficiary was absent from it for a continuous period not exceeding two years. This rule applies in four situations.

11.7.1 Residence vacated and offered for sale [para 48(a)]

This item deals with the case of an overlapping period of ownership. It overrides the general rule in para 45(3) which provides that a person may not have more than one primary residence at the same time.

This item applies when

- a residence was a person's primary residence,
- at that time it was offered for sale, and
- vacated

due to the acquisition or intended acquisition of a new primary residence.

This concession will not apply to any period during the two years in which the residence was let. This is because para 48(*a*) requires the residence to be vacated, and para 49 is not subject to para 48.

Example – 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.

11.7.2 Erection of new primary residence [para 48(b)]

This item caters for the situation in which land has been purchased with the intention of erecting a primary residence on it. Land on its own would not be a primary residence as the definition of a 'residence' means 'any structure'. A primary residence cannot exist without a 'structure'. Therefore, for the duration of the time taken to erect a structure, (that is, a home) that period would not qualify as the owner's ordinary residence without this overriding provision. It effectively allows 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.

11.7.3 Primary residence rendered accidentally uninhabitable [para 48(c)]

This item is similar to para 48(*b*) and caters for cases in which a primary residence is rendered accidentally uninhabitable, for example, is destroyed, by fire, flood, earthquake, landslide, wind or other similar act.

11.7.4 Death of person with an interest in a primary residence [para 48(d)]

This item applies to the two-year period after the death of the person who held an interest in the primary residence. During this period 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. See **16.1.3.3**.

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.

In each of the above cases, if the actual period exceeds two years, the concession will be limited to two years, and an apportionment will be necessary.

11.8 Non-residential use

Paragraph 49

The purpose of this paragraph is to reduce the capital gain or loss disregarded under the primary residence exclusion when 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 in which the property was at some stage used as a primary residence but not for the entire period of ownership after the valuation date.

A primary residence becomes tainted during any period in which 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 10 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
Less: Base cost (R350 000 + R250 000)	(600 000)
Capital gain	2 050 000
Less: Part in respect of period not ordinarily resident (R2 050 000 x 15/25)	(1 230 000)
	820 000
Less: Part partially used for trade purposes (R820 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 under 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 annual exclusion is applied.

Example 2 – Apportionment of capital gain between domestic and business use

Facts:

Alfredo owns a five-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 guesthouse. 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 2007 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, dining-room, 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
Less: 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 R1,5 million exclusion (R900 000 – R1 500 000). 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 used 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.

Use of residence for trade purposes by other persons

Paragraph 49 provides for apportionment of the primary residence exclusion where the person who disposes of the residence or the beneficiary of the special trust uses it for the purposes of trade. It does not address the situation in which a person other than that person or beneficiary uses the residence for trade purposes without the payment of rent, such as a spouse or child of the person. It follows that apportionment cannot be applied in such cases. Nevertheless, para (*b*)(ii) of the definition of a 'primary residence' in para 44 requires that the residence be used by the person or beneficiary 'mainly for domestic purposes'. When, say, a child of the owner used 51% of the residence for trade purposes, it could not be said that the person or beneficiary had used the residence mainly for domestic purposes and the person or special trust would be denied the primary residence exclusion.

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 (under 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 was let for say, six years, the full six years will be regarded as non-residential use, and not just the period in excess of five years. It is an all or nothing concession and is not subject to apportionment.

- The qualifying person would have to actually reside in that primary residence for a continuous period of at least one year before 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 before 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 before 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 while tenants occupy the let property. This paragraph, therefore, would not override the general principle contained in para 45(3);

- The qualifying person must be temporarily absent from the Republic or employed or engaged in carrying on business in the Republic at a location further than 250km from the residence. The first part of this condition caters for persons who remain ordinarily resident in the Republic, such as diplomats. The second part is an anti-avoidance provision. It enables a resident who lives in South Africa the opportunity to let a primary residence provided that he or she is employed or was engaged in carrying on business in the Republic at a location further than 250km from the primary residence being let. The 250km must be measured as the crow flies. In this regard s 5 of the Interpretation Act 33 of 1957 provides as follows:

  > '5. **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 – Spouses each owning residence and working within 250km

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 before 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 while letting Zebediah's residence. Both are employed within 20km of their respective residences.

Result:

Paragraph 50 is inapplicable 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

11.10.1 Introduction

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.

11.10.2 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

Under para 29(1)(*c*) read with para 31(1)(*f*) farmers must choose one of the following methods to value their farms:

- The value contemplated in para (*b*) of the definition of the term 'fair market value' in s 1 of the Estate Duty Act which is the value determined by a Land Bank valuer; 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 when

- 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.

When a person disposes of a pre-valuation date farm property to a third party, the proceeds will be the amount received or accrued in respect of the sale. If the market value method is adopted for determining the valuation date value of the farm, either market value or Land Bank value may be used depending on which value was determined by 30 September 2004 and adopted. In most cases the Land Bank value is lower than the market value. This will affect the quantum of the capital gain or loss. See also **8.35.5**.

11.10.3 Methods of valuation

The methodology suggested below 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:

11.10.4 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.

11.10.5 Proceeds in excess of R300 000

When 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.

11.10.6 Comparable sales

When two farms in the same area share similar 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. If 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.

11.10.7 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.

11.10.8 Time-apportionment base cost (TAB)

TAB can be used to determine the valuation date value of a primary residence on a farm when 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.

11.10.9 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. If 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

The tax consequences that flow from the transfer of a residence out of a company after the expiry of the relief measures described in **Appendix A** (which ended on 30 September 2002), **Appendix B** (which ran from 11 February 2009 to 30 September 2010) and **Appendix C** (which runs from 1 October 2010 to 31 December 2012) 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.
- It is unlikely that the company will qualify for the lower corporate tax rates applicable to a small business corporation. In order to qualify as a small business corporation, s 12E(4)(*a*)(iii) requires that

> ‘not more than 20 per cent of the total of all receipts and accruals (other than those of a capital nature) and all the *capital gains* of the company or close corporation consists collectively of investment income and income from the rendering of a personal service’.

(Emphasis added.)

The definition of the term ‘investment income’ in s 12E(4)(*c*) includes

> ‘any proceeds derived from investment or trading in financial instruments (including futures, options and other derivatives), marketable securities or immovable property’.

A residential property holding company would typically carry out no trading activities. It is therefore likely that 100% of its receipts and accruals will consist of a capital gain on sale of the property, thereby disqualifying it as a small business corporation.

Example – Transfer of a residence out of a company when para 51A does not apply

Facts:

Ronnie owns all the shares in Ronprops (Pty) Ltd ('Ronprops'). The only asset of Ronprops is a house in Umhlanga in which Ronnie's parents live rent free. Ronnie purchased the shares in the company from Barry on 30 May 1995 at a price of R100 000. The market value of the property on 1 October 2001 was R2 million, and the current market value on 31 December 2010 is R3 million. 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. In order to eliminate the cost of keeping the company alive and to reduce the future tax consequences of holding the property in the company, Ronnie instructed his conveyancing attorney to transfer the property into his name and asked his accountant to liquidate the company as soon as the transfer had been made. The balance sheet of Ronprops appeared as follows on 31 December 2010, the day before the residence was transferred into Ronnie's name.

Balance sheet – 31 December 2010

	R
Share capital	100
Loan account	49 900
Non-distributable reserve	2 950 000
	3 000 000
House – at current market value	3 000 000
(Original cost, 1 August 1990 = R50 000)	

The company was finally dissolved on 28 February 2011.

Result:

CGT in the company

Under para 75(1) the property is deemed to be disposed of by the company for an amount received or accrued equal to its market value on the date of distribution, namely, R3 million. The base cost is the higher of

- R2 million using market value, or
- R1 659 091 using TAB (see below).

TAB = B + [(P – B) x N/(N + T)]
= R50 000 + [(R3 000 000 – R50 000) x 12/22]
= R1 659 091.

Therefore market value will be used as the base cost.

	R
Proceeds	3 000 000
Less: Base cost	(2 000 000)
Capital gain	1 000 000
Taxable capital gain R1 000 000 x 50%	500 000
CGT R500 000 x 28%	140 000

STC in the company

An amount of R3 million will be returned to Ronnie, made up as follows:

	R
CTC	100
Loan account R49 900 + 140 000 (CGT) + R255 455 (STC)	445 355
Dividend	2 554 545
Returned to Ronnie	3 000 000

The amount of the dividend is a balancing figure, that is, the value of the property awarded to the shareholder less the portion not comprising a distribution (that is, the repayment of the loan account) less the CTC. The minimum amount distributable as a dividend can be calculated as follows:

	R
Profits before CGT and STC	2 950 000
Less: CGT	(140 000)
Profit available for distribution before STC	2 810 000
Accounted for as follows:	
Dividend R2 810 000 x 100/110	2 554 545
STC R2 554 545 (dividend) x 10%	255 455
	2 810 000

The CGT consequences for the shareholder

On dissolution of the company Ronnie disposes of his shares under para 77(1)(*a*).

Ronnie's choices under para 26(1) for determining the valuation date value of his shares are

- market value of R1 950 100,
- 20% of proceeds, being R100 x 20% = R20, or
- TAB = B + [(P – B) x N/(N + T)]
  = R100 000 + [(R100 – R100 000) x 7/17]
  = R58 865

Paragraph 27 applies because the shares have been disposed of at an historical loss (cost R100 000; proceeds R100). Under para 27(3)(*b*) Ronnie must use the lower of market value and TAB as the valuation date value because the market value on valuation date exceeds the cost of the shares.

	R
Proceeds (para 35)	100
Less: Base cost (TAB)	(58 865)
Capital loss	(58 765)

Ronnie has received an extraordinary dividend contemplated in para 19, determined as follows:

	R
Dividend received during the 2 years before the disposal of the shares	2 554 545
Less: 15% of proceeds R100 x 15%	(15)
Extraordinary dividend	2 554 530

Since the capital loss does not exceed the extraordinary dividend it must be fully disregarded under para 19.

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
500 000	0	0
500 000	5	25 000
1 000 000		
2 000 000	8	160 000
3 000 000		185 000

The total tax cost to Ronnie is therefore R140 000 (CGT) + R255 455 (STC) + R185 000 (transfer duty) = R580 455.

Note: Had Ronnie used the residence mainly for domestic purposes from 11 February 2009 he could have taken advantage of the window of opportunity ending on 31 December 2012 provided by para 51A to transfer the residence into his own name thereby avoiding transfer duty, CGT and STC (see **Appendix C**).

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

A capital gain or loss determined in respect of the disposal of a personal-use asset of a natural person or a special trust must be disregarded [para 53(1)].

A 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'.

Examples of personal-use assets include artwork, jewellery, household furniture and effects, a microlight aircraft or hang glider with a mass of 450kg or less, a boat that is 10 metres or less in length, veteran cars, private motor vehicles (including a vehicle used mainly for business purposes in respect of which a travel allowance is received), stamp or coin collections (but excluding gold or platinum coins whose value is mainly derived from the metal content). In order to qualify as a personal-use asset the asset must be used 'mainly' for non-trade purposes. The word 'mainly' has been held to mean more than 50% (see **11.1.2.3**).

For the reasons set out in **7.1** personal-use assets do not include the following [para 53(3)]:

- 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 which exceeds 450kg.[445]
- A boat exceeding 10 metres in length.
- A financial instrument as defined in s 1.
- 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-

[445] The Regulations issued by the Civil Aviation Authority define a 'microlight aeroplane' as one 'the empty mass of which does not exceed 450 kilograms'. See <http://www.caa.co.za/> [Accessed 8 December 2011].

metre 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 these assets will be subject to CGT, the losses made on disposal of certain of them are disregarded under 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 under 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 a domestic pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, 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 fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund approved under the Income Tax Act.[446]

12.4 Long-term assurance

Paragraph 55

12.4.1 What is a 'policy'? [para 55(2)]

For the purposes of para 55(1), para 55(2) provides that the term 'policy' means

> 'a policy as defined in section 29A with an insurer'.

Section 29A(1) defines the term 'policy' as follows:

> '**"[P]olicy"** means a long-term policy as defined in section 1 of the Long-term Insurance Act.'

The term 'long-term policy" is defined in s 1 of the Long-term Insurance Act as follows:

> '**"[L]ong-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:

[446] Paragraph 54(*b*) was amended to include a reference to pension and provident preservation funds by s 56 of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

> '**"[L]ife 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.

12.4.2 Disregarding of capital gains and losses by original beneficial owner [para 55(1)(a)(i)]

Paragraph 55(1)(*a*)(i) provides that any capital gain or loss on disposal of a long-term policy must be disregarded by its original beneficial owner or one of its original beneficial owners. The type of policy envisaged is one that gives rise to the receipt or accrual of an amount in the hands of the original beneficial owner or owners upon its disposal. The exclusion applies to a long-term policy as defined in the Long-term Insurance Act 52 of 1998, issued by a South African insurer.

Example – Disposal of policy by original beneficial owner

Facts:

John and Jack are the original beneficial co-owners of an endowment policy. They donate the policy to Jill. Jill then cedes the policy back to Jack. Finally, Jack receives the policy proceeds on maturity from the insurer.

Result:

Disposal by John and Jack to Jill:

Since the policy was donated, John and Jack are deemed to have received or accrued proceeds equal to the market value of the policy under para 38. However, under para 55(1)(*a*)(i) they must disregard any capital gain or loss on disposal of the policy as they were original beneficial owners at the time of the donation.

Disposal by Jill to Jack:

Under para 38 Jill is deemed to have acquired the policy at market value on the date of acquisition. She must account for any capital gain or loss arising on the cession to Jack, as she was not an original beneficial owner.

Receipt of proceeds on maturity by Jack:

Under para 55(1)(*a*)(i) Jack must disregard any capital gain or loss arising on termination of the policy, as he was one of the original beneficial owners.

12.4.3 Exclusion of certain second-hand policy proceeds

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 in para 55(1)(*a*) to (*d*).

12.4.3.1 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:

> '**"[D]ependant"**, 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.'

When an individual during his or her lifetime cedes a policy to another person (other than a spouse or dependant under the Pension Funds Act, 1956), 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 in which the original beneficial owner nominates another person as the beneficiary upon the life insured's death. If the original beneficial owner has ceded the policy to a person (other than a spouse or dependant under the Pension Funds Act, 1956), 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 initial owner not being the original beneficial owner for the entire duration of the policy. The second or a subsequent third party owner who cedes the policy will, however, not qualify for exclusion from CGT in respect of any capital gain arising on that cession, assuming that none of the other exclusions in para 55 apply.

Example 1 – Cession of policy between spouses

Facts:

Paul and Steve are involved in a same-sex union which the Commissioner is satisfied is likely to be permanent. Paul is the original beneficial owner of a policy, which he cedes to Steve. What are the CGT implications for Steve upon surrender of the policy if

(*a*) Paul donates the policy to him, or

(*b*) he pays Paul something for the policy?

Result:

Paul and Steve are spouses as defined in s 1 and the roll-over provisions of para 67 apply. In other words, Steve takes over Paul's expenditure and any valuation date market value for the purpose of determining the base cost of the policy.

Policy ceded for no consideration:

Any gain or loss arising in Steve's hands will be excluded by para 55(1)(*a*)(ii).

Policy ceded for consideration:

Steve will be subject to CGT when he surrenders the policy. The exclusion in para 55(1)(*a*)(ii) does not apply if any amount was paid or is payable for the cession of the policy.

Example 2 – Cession of policy to nominee

Facts:

Sam is the original beneficial owner, but not the life assured, of an endowment policy. He nominates Hazel as the beneficiary and thereafter cedes the policy to her for R1. What are the implications for Hazel when she surrenders the policy?

Result:

Hazel is the nominated beneficiary (nominee), but despite this, any capital gain or loss arising in her hands on surrender of the policy will be subject to CGT because she paid R1 for the policy. The exclusion in para 55(1)(*a*)(ii) only applies when the nominee does not pay an amount for the policy.

12.4.3.2 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.

Example – Surrender of policy acquired from former spouse under a divorce order

Facts:

Zeb and Agnes were married under customary law in 1956 and their marriage complies with the requirements set out in the Recognition of Customary Marriages Act 120 of 1998. Zeb is the original beneficial owner of an endowment policy. Zeb and Agnes divorce and it is ordered by the court that Zeb's policy be ceded to Agnes. Agnes surrenders the policy.

Result:

Under para 55(1)(*a*)(iii) no capital gain or loss will arise in Agnes' hands when she surrenders the policy.

12.4.3.3 The employee / director exclusion [para 55(1)(b)]

An amount will be excluded from CGT when it is derived by any person in respect of any policy, when the person

- is or was an employee or director whose life was insured under that policy, and
- any premiums paid by that person's employer were deducted under s 11(*w*).

This exclusion applies to so-called conforming policies under s 11(*w*). This includes key-man policies as well as policies taken out by an employer on the life of an employee or director as part of a deferred compensation scheme.

In the case of a deferred compensation scheme under which an employee or director retires and takes over the policy from the employer for no value, the value of the policy at the date of termination will be included in the employee's or director's gross income under para (*d*) of the definition of the term 'gross income', being an amount received or accrued in respect of the relinquishment of office or employment. When the policy finally pays out, or when it is ceded to a third party, any capital gain or loss will be excluded under para 55(1)(*b*). 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).[447]

Example – Cession of policy to director when premiums not deducted under s 11(*w*)

Facts:

ABC (Pty) Ltd (ABC) takes out a conforming 'key-man' policy on the life of Bradley, one of its directors. ABC does not claim a deduction in respect of the policy premiums under s 11(*w*). Bradley resigns as director and wishes to take cession of the policy.

Result:

The policy will be regarded as a 'second-hand' policy and the proceeds will be subject to CGT in Bradley's hands. Paragraph 55(1)(*b*) only provides for an exclusion if the employer claimed a deduction under s 11(*w*). As ABC did not claim a deduction the requirements of para 55(1)(*b*) were not fulfilled. Since ABC is the original beneficial owner of the policy no capital gain or loss will arise in its hands should it receive any proceeds from Bradley in respect of the policy [para 55(1)(*a*)(i)].

12.4.3.4 The partners and shareholders exclusion [para 55(1)(c)]

This provision concerns so-called buy-and-sell arrangements which occur when partners or shareholders take out insurance against the death, disability or severe illness[448] 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 under 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

[447] This was clarified by the amendment of the provision by the Revenue Laws Amendment Act 45 of 2003, effective 22 December 2003.

[448] With effect from 22 December 2003 this provision was amended by the Revenue Laws Amendment 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).

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 provision does not cover the cession of a portion of a policy to an incoming partner or shareholder. In the event of such a cession the policy will be a second-hand policy in the hands of the cessionary and any capital gain or loss will have to be accounted for by that cessionary when it eventually pays out.[449]

Example – The buy-and-sell exclusion

Facts:

Abe and Bart are partners, and have drawn up a properly structured buy-and-sell agreement, funded by long-term policies. Under the arrangement Abe is the owner (payer and beneficiary) of a policy on the life of Bart and Bart is the owner (payer and beneficiary) of a policy on the life of Abe. The partnership is dissolved and the parties wish to retain the policies on their own lives. Abe cedes his policy to Bart and Bart cedes his policy to Abe.

Result:

Any capital gain or loss in the hands of Abe and Bart on ultimate surrender of the policies will be excluded under para 55(1)(*c*).

12.4.3.5 The pension, provident or retirement annuity fund policy exclusion [para 55(1)(d)]

A capital gain or loss will be excluded for CGT purposes when

- a policy was originally taken out on the life of a person,
- that policy is provided to that person or dependant by or in consequence of that person's membership of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, and[450]
- an amount is received or accrued in respect of the disposal of that policy.

In such cases the retirement fund would have been the original owner of the policy. The member may be given the option to take over the policy upon retirement and may thereafter retain, surrender or cede the policy. However, when the member subsequently cedes such a policy to a dependant, the dependant will not qualify for the exclusion, since the policy would not have been provided to that dependant in consequence of the member's membership of the retirement fund.

Example 1 – Policy ceded to member of retirement fund

Facts:

Dave is a member of a pension fund. He is the life assured on an individual policy held by the fund. On retirement the policy is ceded by the fund to Dave. Dave surrenders the policy.

[449] See Harry Joffe 'Capital Gains Tax and Business-assurance Policies' (June 2009) *De Rebus* 37.
[450] The reference to pension and provident preservation funds was inserted into para 55(1)(*d*) by s 57 of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

Result:

Any capital gain or loss arising in Dave's hands on surrender of the policy will be excluded for CGT purposes.

Example 2 – Proceeds of policy paid to dependant of member of retirement fund

Facts:

Shirley is a member of a provident fund. She is the life assured on a policy that was taken out by the fund. She has one legal dependant being her son Denys. She dies and the policy proceeds are paid to Denys.

Result:

Any capital gain or loss arising in Denys' hands will be excluded for CGT purposes.

12.4.3.6 Group life policies

It is accepted that an employee is the beneficial owner of a policy when that employee pays all the premiums under a group life policy and that employee or his or her nominees are the beneficiaries under the policy.

In the context of shares, the meaning of 'beneficial owner' was considered in *Standard Bank of South Africa Ltd & another v Ocean Commodities Inc & others* in which Corbett JA stated the following:[451]

> '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 & 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 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 above at 447H–453A).'

From the above it is clear that a '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 under which the employee pays all the premiums, any capital gain or loss arising in respect of that policy must be disregarded under

- para 55(1)(*a*)(i) when a disability benefit is paid to the employee, or

[451] 1983 (1) SA 276 (A) at 288.

- para 55(1)(*a*)(ii) when death benefits are paid to the spouse, nominee, dependant or deceased estate of the employee.

12.4.4 Second-hand policies subject to CGT

12.4.4.1 Non-qualifying second-hand policies

A 'second-hand policy' conventionally refers to a policy that has been ceded absolutely to an independent third party on the traded policy market. Capital gains and losses arising on the disposal of such a policy will be subject to CGT in the 'second-hand' recipient's hands unless specifically excluded by para 55.

12.4.4.2 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, that is, 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.

12.4.4.3 Determination of capital gains and losses on second-hand policies

Determination of base cost

The base cost of a second-hand policy acquired before 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*)]
- Surrender [para 11(1)(*b*)]

- Withdrawal in whole or part) (paras 11(1)(*b*) and 33)
- Donation [para 11(1)(*a*)]
- Death (para 40)
- Commencement or cessation of residence [para 12(2)(*a*)]

The maturity of a policy (or the attainment of an option date) is not in itself a disposal. Policies are open-ended and will continue past the maturity date unless there is an intervention by the policyholder to surrender the policy or to withdraw proceeds from the policy. The only significant change to certain policies on 'maturity' may be a guarantee provided on the investment portion of the policy.

12.4.4.4 Part-withdrawals from second-hand policies

Each time a policyholder makes a withdrawal from a second-hand policy a part-disposal will occur, and it will be necessary to determine a capital gain or loss in respect of the part disposed of. The base cost of the part disposed of is determined under para 33 in accordance with the following formula:

Base cost of part disposed of =

$$\frac{\text{Amount withdrawn}}{\text{Market value of policy immediately before withdrawal}} \times \text{Base cost}$$

This can become fairly complex and a market value will have to be obtained immediately before each withdrawal. For an example of a part-disposal when TAB has been adopted see Example 2 in **8.37.2.**

Example – 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. The market value of the policy on 1 October 2001 was R90 000. Keith made the following withdrawals:

Date	Amount	Market value immediately before 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 year of assessment

	R
Proceeds	5 000
Less: Base cost	(4 500)
R5 000/R100 000 x R90 000	
Capital gain	500

Base cost after part-disposal: R90 000 – R4 500 = R85 500.

2004 year of assessment

	R
Proceeds	6 000
Less: Base cost R6 000/R108 000 x R85 500	(4 750)
Capital gain	1 250

Base cost after part-disposal: R85 500 – R4 750 = R80 750.

2006 year of assessment (final withdrawal)

	R
Proceeds	120 000
Less: Base cost (R120 000/R120 000 x R80 750)	(80 750)
Capital gain	39 250

12.4.4.5 Foreign policies subject to CGT

No exclusion is granted in respect of 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 term ‘policy’ as defined in para 55(2). Under that subparagraph ‘policy’ means for the purposes of para 55(1)

> ‘a policy as defined in section 29A with an insurer’.

Under para 1 an 'insurer' means

> ‘an insurer as defined in section 29A(1)’.

Under s 29A an ‘insurer’ means

> ‘any long-term insurer as defined in section 1 of the Long-term Insurance Act’.

Under 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.

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 when 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 under 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 under 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.[452]

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 acquirer of the claim. It is submitted that this calls for a hypothetical enquiry as to whether the acquirer would have been subjected to tax on the amount of the unrealised income or capital gain at the date of acquisition had that acquirer immediately disposed of the claim at that point at its face value. For example, if the acquirer were a tax-exempt body or non-resident then the requirement would not be met. In the case of a debt owed by one group company to another, it is likely that the debtor company will have to disregard any capital gain arising from the waiver of the debt under para 12(5)(*a*)(*bb*). As a result, the creditor will not be able to secure a capital loss.

Ring-fencing under para 39 inapplicable

Paragraph 56(2) applies 'despite paragraph 39'. This means that 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 when 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.

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 under para 12(5). Ben is a non-resident and therefore falls outside the taxing jurisdiction of South Africa under para 2.

[452] This provision came into operation as from the commencement of years of assessment ending on or after 1 January 2005.

Example 2 – Capital loss allowable when debtor taxed on capital gain under 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 under 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 under para 56(2)(*a*).

Example 3 – Cession of debt at less than face value to moneylender [para 56(2)(*b*)]

Facts:

Alan, Bert and Carl are brothers. Alan owes Bert R100 payable in five 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 *moneylender*. 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 *moneylender* the profit will be spread over the period of the loan under 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, while 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 under 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 South Africa, it is reasonable to assume that when Bart repays the loan she will realise a capital gain of R2 000. Under 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.

12.6.1 Definitions [para 57(1)]

Paragraph 57(1) contains two definitions that apply for the purposes of para 57.

'**"[A]ctive 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. It follows that 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.

Non-qualifying assets

The intention is to exclude assets generating passive income and to rather target active business assets.

A '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.

> '**"[S]mall 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 determining whether a business qualifies, the market value of all the assets, regardless of their nature, must be taken into account. Furthermore, the liabilities of the business must be ignored for this purpose. In the case of a business operated by a partnership or company the threshold of R5 million relates to the assets of the partnership or company as a whole, and not to the fractional interest of each partner or shareholder in the underlying assets of the business. Thus a partnership consisting of two equal partners which has assets of R10 million will not qualify as a 'small business', despite the fact that the fractional interest of each partner in the assets of the partnership does not exceed R5 million.

12.6.2 Requirements for exclusion [para 57(2)]

Under para 57(2), only a natural person may disregard a capital gain under 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 before 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 a '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 under this paragraph.

12.6.3 Amount to be disregarded [para 57(3)]

Under para 57(3) the sum of the amounts to be disregarded under para 57(2) during a person's lifetime may not exceed R750 000 (2006 and earlier years of assessment: R500 000).[453] The disregarded amount is therefore cumulative and is not in respect of each business or asset disposed of.

12.6.4 Time limit for disposal of assets [para 57(4)]

Under para 57(4) all capital gains qualifying under para 57(2) must be realised within two years of the first qualifying disposal.

12.6.5 Disposal of multiple small businesses [para 57(5) and (6)]

Under para 57(5) a natural person operating more than one small business may include all qualifying disposals for every such small business in determining the capital gain to be disregarded.

Under para 57(6) when a person disposes of more than one small business, the total market value of all assets in respect of all those businesses may not exceed R5 million.

Example – Disposal of small business assets

Facts:

On attaining the age of 55 on 15 January 2010 Elias wishes to retire. He operates a fleet of five 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 personally does not do any driving.

Elias owes nothing on these vehicles. He has found a buyer for this business who takes it over 'lock, stock and barrel' for R700 000 on 28 February 2010. Of this amount, R200 000 relates to self-generated goodwill that had a nil base cost and the remaining R500 000 relates to the price paid for the taxis. The cost, total capital allowances claimed for tax purposes to date of sale and consideration received for each taxi are as follows:

	Cost	Capital Allowances	Consideration received
	R	R	R
Taxi 1	150 000	150 000	20 000
Taxi 2	175 000	175 000	30 000
Taxi 3	200 000	200 000	40 000
Taxi 4	225 000	135 000	160 000
Taxi 5	250 000	50 000	250 000
	1 000 000		500 000

[453] The exclusion was increased from R500 000 to R750 000 by s 34 of the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

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

	Cost received	Capital Allowances	Base cost	Consideration	Recoupment	Capital gain
	R	R	R	R	R	R
Taxi 1	150 000	(150 000)	-	20 000	20 000	-
Taxi 2	175 000	(175 000)	-	30 000	30 000	-
Taxi 3	200 000	(200 000)	-	40 000	40 000	-
Taxi 4	225 000	(135 000)	90 000	160 000	60 000	-
Taxi 5	250 000	(50 000)	200 000	250 000	50 000	-
	1 000 000			500 000		-

Capital gain on sale of taxis	-
Capital gain on sale of goodwill	200 000
Total	200 000

Note: Had Taxis 4 and 5 been sold above cost, the resulting capital gain realised on their disposal would not have qualified to be disregarded under para 57(2), since they would not have been held for a continuous period of at least five years.

Brewery

Under para 57(2)(*c*) Elias may only disregard so much of the capital gain on disposal of his member's interest as relates to active business assets of a small business carried on by the close corporation. It is therefore necessary to determine the portion of the assets of the close corporation that qualify as 'active business assets'. The shares held by the close corporation are not an active business asset as they comprise financial instruments. The liabilities of the close corporation are ignored, since para 57(2)(*c*) refers to 'assets' and not 'net assets'.

Determination of capital gain on disposal of member's interest

Active business assets to total assets (R2 million/(R2 million + R1,75 million)) 53,33%

	Active	Non-active	Total
	53,33	46,67%	100%
	R	R	R
Proceeds	960 000	840 000	1 800 000
Less: Base cost	(53 333)	(46 667)	(100 000)
Capital gain	906 667	793 333	1 700 000
Less: Remaining exclusion	(550 000)	-	(550 000)
Capital gain	356 667	793 333	1 150 000

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 R750 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 total 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 R550 000 (R750 000 – R200 000) of the portion of the capital gain realised upon the disposal of his member's interest which qualifies for the small business exclusion (R906 667).

12.6A Disposal of micro business assets

Paragraph 57A

A registered micro business as defined in the Sixth Schedule must disregard any capital gain or loss in respect of a disposal by that business of

- immovable property to the extent that it was used for business purposes, and
- any other asset used mainly for business purposes.[454]
- For the purposes of this paragraph the above assets are referred to as 'micro business assets'.

The presumptive turnover tax imposed on a 'registered micro business' under the Sixth Schedule acts as a substitute for any CGT that may arise on the disposal of micro business assets. Under para 6 of the Sixth Schedule the taxable turnover of a registered micro business includes 50% of all receipts of a capital nature from the disposal of micro business assets.

Under para 3(*e*) of the Sixth Schedule a person does not qualify as a micro business for a year of assessment if the total of all amounts received by that person from the disposal of the above assets exceeds R1,5 million over a period of three years. The three-year period comprises the current year of assessment and the immediately preceding two years of assessment, or such shorter period during which that person was a registered micro business. This measure is designed to prevent abuse and to cater for the occasional disposal of a large asset such as immovable property.

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 under para 20(1)(*c*)(ix) (option acquired on or after valuation date) or 20(1)(*f*) (option acquired before valuation date but exercised after that date).

[454] Under s 80(2) of the Revenue Laws Amendment Act 60 of 2008 para 57A comes into operation on 1 March 2009 and applies in respect of years of assessment commencing on or after that date.

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 million. At the date of exercise of the option the market value of the farm was R1 250 000.

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. Were it not for para 58 read with para 20(1)(*c*)(ix) Geert would have had proceeds on disposal of the option equal to the difference between the market value of the farm on the date of exercise (R1 250 000) and the strike price (R1 000 000) = R250 000. This would have resulted in a capital gain of R250 000 – R100 000 = R150 000. Instead, this capital gain is disregarded and will only be brought to account when the farm is disposed of, assuming that it maintains its market value.

The grantor

The person who granted Geert the option will have a disposal under para 11(1)(*f*), proceeds of R100 000 under para 35 and a zero base cost under 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 under para 11(1)(*b*) (the option would have terminated or expired), a base cost of R100 000 under para 20(1)(*a*) and no proceeds under para 35. He will therefore have a capital loss of R100 000 when the option lapses.[455]

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 under para 11(1)(*a*), proceeds of R150 000 under 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 under para 20(1)(*a*) and a capital loss of R150 000. Paragraph 20(1)(*c*)(ix) is inapplicable 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, under para 58 the loss must be disregarded. Instead, the cost of the option is added to the base cost of the land under para 20(1)(*c*)(ix).
Mark's capital gain is determined as follows:

	R
Proceeds	100 000
Less:	
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

Under 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[456] and Australia.[457] The reason for this 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 before the injury, illness or defamation.

[455] It is assumed in this example that para 18 does not apply. A capital loss on the lapsing of an option must be disregarded when para 18 applies (for example, if the option was in respect of the intended acquisition of a primary residence).
[456] Section 51(2) of the Taxation of Chargeable Gains Act, 1992.
[457] Section 118–37 of the Income Tax Assessment Act, 1997.

Example – 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 which 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 him a further R20 000 in full and final settlement, while 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 under para (*d*) of the definition of the term 'gross income'. The R20 000, being of a capital nature and unrelated to his employment, falls outside para (*d*)[458] and is excluded from CGT under para 59.

This exclusion does not, however, 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 (para 60)

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 if 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,[459] 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. In *C: SARS v Brummeria Renaissance (Pty) Ltd & others*[460] it was held that it did not follow that if a receipt or accrual cannot be turned into money, it has no money value. The ability to turn a prize into money is merely one of the tests for determining whether an accrual has a money value. The court confirmed that the test was objective, not subjective. It follows that even if a prize is non-transferable it can still have a money value.

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

[458] See ITC 1289 (1979) 41 SATC 149 (T).
[459] Conducted under the Lotteries Act 57 of 1997.
[460] 2007 (6) SA 601 (SCA), 69 SATC 205.

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.

Following the SCA decision in *FirstRand Bank Limited v National Lotteries Board*[461] that the bank's 'Million-a-month' competition comprised an illegal lottery, it is clear that winnings from the competition are subject to CGT.

Example – 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' racehorse winnings (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 racehorse 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 (para 61)

Paragraph 61

Paragraph 61 deals with the CGT consequences for a holder of a participatory interest in a portfolio of a collective investment scheme in securities (CISS). The term 'portfolio of a collective investment scheme in securities' is defined in s 1 as follows:

> '**"[P]ortfolio of a collective investment scheme in securities"** means any portfolio comprised in any collective investment scheme in securities contemplated in Part IV of the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002), managed or carried on by any company registered as a manager under section 42 of that Act for the purposes of that Part.'

Before its amendment by the Taxation Laws Amendment Act 17 of 2009, para 61 referred to a collective investment scheme 'contemplated in paragraph (*e*)(i) of the definition of "company" in section 1'. This referred to a CISS, which was deemed to be a company, even though in reality it was a trust. Paragraph (*e*)(i) was deleted by s 7(1)(*a*) of the Taxation Laws Amendment Act 17 of 2009[462] with the result that a CISS or so-called 'equity unit trust' is no longer a company for the purposes of the Act, and reverts to its true status, namely, a vesting trust.

If beneficiaries have vested rights in the assets of a trust, actions by the trustees are actions on behalf of the beneficiaries. Since the assets of the trust are vested in the beneficiaries they must, under the conduit-pipe principle determine a capital gain or loss each time the vesting trust disposes of an asset on their behalf. The trust is thus out of the picture for CGT purposes because it has disposed of its assets to the beneficiaries under para 11(1)(*d*). However, had these principles been applied to a CISS administrative difficulties would have

[461] 2008 (4) SA 548 (SCA).
[462] The deletion comes into operation as from the commencement of years of assessment commencing on or after 1 January 2010.

resulted because of the large number of sales of financial instruments undertaken by a CISS during a year of assessment. Paragraph 61 accordingly suspends the conduit-pipe principle for a ciss. Under para 61 a holder of a participatory interest in a CISS must

- determine a capital gain or loss in respect of the participatory interest when it is disposed of, and
- use the proceeds on disposal of that participatory interest and its base cost to make that determination.

A holder of a participatory interest in a portfolio of a collective investment scheme in property (CISP) must determine a capital gain or loss on disposal of that interest under para 67A – see **13.4**.

Section 25BA regulates the conduit-pipe principle for ordinary income. It provides that income distributed by the portfolio within a year of receipt or accrual must be accounted for by the beneficiary, while amounts not so distributed are taxed in the portfolio. Section 25BA does not apply to an amount of a capital nature.

Some background on the regulatory framework applicable to a CISS

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 Act is based on internationally accepted principles and best practices.

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 (para 62)

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. Before 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*)	Government of the Republic in the national, provincial or local sphere.
(*b*)	A public benefit organisation contemplated in para (*a*) of the definition of a 'public benefit organisation' in s 30(1) that has been approved by the Commissioner under s 30(3).[463]
(*c*)	A person approved by the Commissioner under s 10(1)(*c*A): An Institution, board or body (but not a company, CC, trust, water services

[463] This provision was amended by s 52(*a*) of the Revenue Laws Amendment Act 20 of 2006 to remove the reference to a PBO that was exempt from tax under s 10(1)(*c*N). The amendment was required because of the introduction of partial taxation for PBOs with effect from years of assessment commencing on or after 1 April 2006.

	provider, black tribal or regional authority etc) that • conducts scientific, technical or industrial research • provides necessary or useful 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 (i.e. mutual loan association, fidelity fund, indemnity fund, trade union, chamber of commerce or industries or association thereof, local publicity association, • company, society or other association of persons established to promote the common interests of members carrying on any particular kind of business, profession or occupation, approved by the Commissioner subject to such conditions as the Minister may prescribe by regulation.
(*d*)	A person referred to in • s 10(1)(*c*E) – Any political party registered under s 36 of the Electoral Act 45 of 1979, • s 10(1)(*e*): ➢ A body corporate established under the Sectional Titles Act 95 of 1986, ➢ A share block company established under 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 in respect of common immovable property.
(*e*)[464]	A recreational club which is a company, society or other organisation as contemplated in the definition of a 'recreational club' in s 30A(1) that has been approved by the Commissioner under s 30A.

[464] Inserted by s 52(*c*) of the Revenue Laws Amendment Act 20 of 2006. This provision ensures that capital gains and losses arising from donations of assets to recreational clubs will continue to be excluded. Clubs were previously exempt under s 10(1)(*d*)(iv)(*aa*) and donations to such bodies qualified for exclusion under para 62(*c*). Clubs now qualify for partial exemption under s 10(1)(*c*O) and for this reason are now addressed under para 62(*e*).

Vesting of an asset by a trust

Any capital gain arising on the vesting of an asset by a trust in the Government, a provincial administration, organisation, person or club contemplated in para 62(*a*) to (*e*) cannot be attributed to such a body under para 80(1) since they are specifically excluded from its ambit. As a consequence such capital gains remain in the trust. For purposes of para 62, the act of vesting an asset by a trust in such a body is likely to be a 'donation' if the trustee is acting in accordance with the benevolent intention of the founder as embodied in the trust deed. It follows that under these circumstances any capital gain or loss arising in the trust upon such a vesting must be disregarded under para 62.

Example – Donation to public benefit organisation

Facts:

Sea (Pty) Ltd donated vacant immovable property with a market value of R1 000 000 to a South African 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' under para 11(1)(*a*). Under 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 under para 62.

12.12 Exempt persons (para 63)

Paragraph 63

This provision requires that a person must disregard any capital gain or loss in respect of the disposal of an asset

- when any amount constituting gross income of whatever nature,
- would be exempt from tax under 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 [for example, certain professional bodies – s 10(1)(*d*)(iv)(*bb*)],
- partial exemption from tax in respect of certain types of receipts or accruals of certain persons (for example, the levy income of a body corporate or share block company [s 10(1)(*e*)], PBOs and recreational clubs [s 10(1)(*c*O)],
- exemption (complete or limited) in respect of certain types of income (for example, 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. In evaluating whether a person's future gross income from any

source would be exempt from tax under 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 professional body may lose its exempt status if it does something contrary to regulations prescribed by the Minister.

The untaxed policyholder fund of a long-term insurer is exempt from tax under s 29A(9). The owners of policies in this fund include pension, provident, retirement annuity and benefit funds as well as persons whose gross income of whatever nature would be exempt from tax under s 10 [s 29A(4)(*a*)]. Since the untaxed policyholder fund is not exempt under s 10, it does not derive its exemption under para 63, but rather from having a zero inclusion rate under para 10(*b*)(ii).

The receipts and accruals of the following funds are exempt from income tax under s 10(1)(*d*)(i):

- pension fund,
- pension preservation fund,
- provident fund,
- provident preservation fund,
- retirement annuity fund, or
- a beneficiary fund defined in s 1 of the Pension Funds Act 24 of 1956.

Consequently, these funds must disregard all their capital gains and losses under para 63.

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. PBOs and recreational clubs are also excluded from para 63 since the introduction of the system of partial taxation for these bodies. PBOs are addressed under para 63A, and recreational clubs under para 65B.

Example – 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 realised 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 under 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 under s 10.

12.13 Public benefit organisations

Paragraph 63A

12.13.1 The system of partial taxation

A system of partial taxation for PBOs that undertake trading activities was introduced by the Revenue Laws Amendment Act 31 of 2005 through an amendment to s 10(1)(*c*N).[465] PBOs previously disregarded all their capital gains and losses under para 63, which applies to persons who are completely exempt from tax no matter what type of activity they undertake. Once PBOs became potentially taxable, they could no longer seek refuge under para 63, and it was necessary to introduce a new provision to cater for the CGT consequences of PBOs. This came in the form of para 63A, which applies to years of assessment commencing on or after 1 April 2006.[466] The position is therefore that

- before their first year of assessment commencing on or after 1 April 2006 PBOs fell under para 63, and
- after that date they fall under para 63A.

Much of the material in these notes is also addressed in Interpretation Note 44.[467]

12.13.2 Valuation date of PBOs

Under para (*a*) of the definition of the term 'valuation date' in para 1 the valuation date of a person who ceases to be an exempt person under para 63 is the date on which that person ceases to be an exempt person. Since all PBOs fall outside para 63 with effect from the introduction of partial taxation of PBOs, it follows that the valuation date of PBOs in existence on 1 April 2006 will be the first day of their first year of assessment commencing on or after 1 April 2006. For example, a PBO with a March year end will have 1 April 2006 as its valuation date, since this is the commencement of the 2007 year of assessment.

The valuation date value of a pre-valuation date asset forms part of the base cost of that asset and ensures that any pre-valuation date growth or decline in value is disregarded for CGT purposes.

The following methods of determining the base cost of an asset on valuation date are available:

- Market value of the asset on that date (paras 26, 27, 29 and 31).
- 20% of [proceeds less allowable para 20 expenditure incurred on or after the valuation date] (para 26).
- The time-apportionment base cost (TAB) of the asset (para 30).
- The weighted-average method under para 32(3A). This is only available for the four categories of identical asset listed in the provision (listed shares, participatory interests in collective investment schemes, gold and platinum coins whose prices are published in a newspaper, and listed s 24J instruments). This is unlikely to be of

[465] Section 10(1)(*c*N) was amended by s 16(1)(*a*) of the Revenue Laws Amendment Act 31 of 2005. The amendment came into operation on 1 April 2006 and applies in respect of any year of assessment commencing on or after that date.
[466] The effective date of para 63A was introduced by s 64(2) of the Taxation Laws Amendment Act 8 of 2007.
[467] SARS Interpretation Note 44 'Public Benefit Organisations (PBOs): Capital Gains Tax' [online], (31 August 2007), available online at <http://www.sars.gov.za/home.asp?pid=55887> [Accessed 8 December 2011].

much relevance to a PBO because the exclusion of capital gains and losses on such assets under para 63A(*a*) discussed below.

Under para 29(4), a PBO may not adopt or determine the market value of an asset unless it has valued the asset within two years from the valuation date. There is, however, no time limit for the valuation of financial instruments listed on a recognised exchange and participatory interests in South African collective investment schemes (see **8.33.8.2**). The early submission requirements for valuation forms relating to the high-value assets listed in para 29(5) do not apply to PBOs [para 29(8)].

The table below summarises the valuation dates for PBOs in existence on 1 April 2006 and the final date by which they must complete their valuations.

Table 1 – Summary of valuation dates for PBOs in existence on 1 April 2006

Year of assessment ending on the last day of	Valuation date	Final day for completion of valuation
March	1 April 2006	31 March 2008
April	1 May 2006	30 April 2008
May	1 June 2006	31 May 2008
June	1 July 2006	30 June 2008
July	1 August 2006	31 July 2008
August	1 September 2006	31 August 2008
September	1 October 2006	30 September 2008
October	1 November 2006	31 October 2008
November	1 December 2006	30 November 2008
December	1 January 2007	31 December 2008
January	1 February 2007	31 January 2009
February	1 March 2007	28 February 2009

If TAB is adopted for an asset acquired by a PBO for no consideration before the valuation date, 'B' in the TAB formulae must be determined in accordance with the principles set out in **8.5A**.

12.13.3 Disregarding of capital gains and losses (para 63A)

Under para 63A a PBO approved by the Commissioner under s 30(3) must disregard any capital gain or loss in respect of the disposal of three categories of asset.

Category 1 – Non-trade assets [para 63A(a)]

This category applies to assets not used by the PBO on or after valuation date in carrying on any business undertaking or trading activity. This category covers assets that are not 'used' but are 'held', such as investments in the nature of shares, or participatory interests in collective investment schemes. It also includes assets used exclusively for non-trade purposes, such as an asset used exclusively in carrying on a public benefit activity (PBA). Only the usage of the asset on or after the valuation date is taken into account, with any trade usage before that date being ignored.

Example 1 – Asset used exclusively on or after valuation date in carrying on PBAs [para 63A(*a*)]

Facts:

A PBO's year of assessment ends on 30 April. It provides health care services to poor and needy persons. It acquired immovable property on 30 June 2003 from which it provided health care services. During the period 30 June 2003 to 30 April 2006 30% of the property

was let to third parties while the remaining usage was in respect of PBAs. Since the valuation date the property was used exclusively in carrying on PBAs. The property was sold on 30 September 2006 resulting in a capital gain of R100 000.

Result:

Under para 63A(*a*) the R100 000 capital gain must be disregarded as the property was used exclusively on or after the valuation date (1 May 2006) to carry on PBAs. Any trade usage before valuation date is disregarded.

Example 2 – Assets held (not used) by PBO [para 63A(*a*)]

Facts:

An approved PBO conducts the sole activity of caring for homeless children. It has invested surplus funds in a collective investment scheme. The PBO disposes of its participatory interest in the collective investment scheme at a capital gain of R25 000 to fund the purchase of additional accommodation.

Result:

The capital gain must be disregarded under para 63A(*a*), since the participatory interests were 'held' by the PBO and not 'used' in carrying on a business undertaking or trading activity.

Category 2 – Minimal trading assets [para 63A(b)(i)]

This category applies when substantially the whole of the use of the asset by the PBO on and after valuation date was directed at a purpose other than carrying on a business undertaking or trading activity. An example of such an asset is one that is used, say, 10% of the time for trading purposes and 90% of the time for PBO activities. The words 'substantially the whole of the use' are accepted by SARS to mean 90% or more. However, to overcome certain practical difficulties, SARS will accept a percentage of not less than 85%.[468] Such assets do not fall into the first category because they are used, albeit to a limited extent, in carrying on a business undertaking or trading activity.

The percentage of the asset used for trade or business purposes must be determined using a method appropriate to the circumstances. For example, a proportion based on time, floor area or a combination of the two may be appropriate.

Example 3 – Determination of 'substantially the whole of the use' on a time basis [para 63A(*b*)]

Facts:

A religious institution has a year end of 30 April and has been approved by the Commissioner as a PBO under s 30. It acquired a manse in 1995 for occupation by its resident minister. The minister's term of office ended on 30 June 2006 and the manse was let to a third party from 1 July 2006 to 31 July 2006. The newly appointed minister took occupation on 1 August 2006. The manse was sold on 31 March 2007.

[468] See SARS Interpretation Note 24 (Issue 2) 'Public Benefit Organisations (PBOs): Trading Rules – Partial Taxation of Trading Receipts' [online], (31 August 2007), available at <http://www.sars.gov.za/home.asp?pid=55886> [Accessed 8 December 2011].

Result:

The PBO's valuation date is 1 May 2006 (the first day of its first year of assessment commencing on or after 1 April 2006). The PBO held the asset for eleven months from the valuation date to the date of sale (1 May 2006 to 31 March 2007). During this period the manse was used to carry on PBAs for ten months and let for one month. This represents a usage of 90,9% (10/11 x 100) for carrying on PBAs from the valuation date. This means that the PBO has used substantially the whole of the manse from the valuation date in carrying on its PBAs. Paragraph 63A(*b*)(i) is applicable and the PBO must accordingly disregard any capital gain or loss on the disposal of the manse.

Example 4 – Determination of 'substantially the whole of the use' on a floor area basis [para 63A(*b*)]

Facts:

A PBO with a February year end provides counselling services to prisoners and conducts its PBAs from its own premises. The PBO uses only a portion of the house for counseling services and lets the remaining rooms to third parties at a market-related rental. The whole area of the property is 210 m^2. The area of the property which is let is 30 m^2 and the balance of 180 m^2 is used for PBAs. The financial year end of the PBO is 28 February. The property is sold on 30 June 2009 realising a capital gain. Valuation of the property took place on 1 March 2007.

Result:

As from the first day of its first year of assessment commencing on or after 1 April 2006 (that is, from 1 March 2007), the PBO is subject to para 63A. In this case floor area provides an appropriate basis for determining whether the property was substantially used to conduct PBAs on or after the valuation date. The area used for carrying on PBAs in relation to the whole property is 85,7% (180/210 x 100). Accordingly the capital gain on sale of the property must be disregarded, as substantially the whole of the property was used in carrying on PBAs (more than 85%).

Example 5 – Determination of 'substantially the whole of the use' on an hourly usage basis [para 63A(*b*)]

Facts:

An educational institution that has been approved under s 30 has acquired a separate property for purposes of development as sports grounds. Hockey fields and tennis courts were constructed. During school holidays and over periods when the facilities are not used by the PBO, they are let to outside sports clubs, coaches and other third parties at market-related rates on which the PBO is partially taxed with effect from the commencement of its financial year ending 31 December 2007. The PBO is obliged to dispose of the property on 8 March 2009 as a result of a commercial development on the adjoining properties and a capital gain is made on the transaction. Hourly usage of the property by third parties is 12%, with PBA usage being 88%.

Result:

The PBO has used substantially the whole of the property from the valuation date in carrying on its PBAs. The capital gain on disposal of the property must accordingly be disregarded under para 63A(*b*)(i).

Category 3 – Permissible trading assets [para 63A(b)(ii)]

This category applies when substantially the whole of the use of the asset by the PBO on or after valuation date was directed at carrying on a business undertaking or trading activity contemplated in s 10(1)(*c*N)(ii)(*aa*), (*bb*) or (*cc*). The permissible activities covered by these provisions are set out in the table below.

Table 1 – Permissible business undertakings or trading activities

Section 10(1)(*c*N)(ii)	**Type of business undertaking or trading activity**
(*aa*)	One that • is integral and directly related to the sole object of that PBO as contemplated in para (*b*) of the definition of a 'public benefit organisation' in s 30, • is carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost, and • does not result in unfair competition in relation to taxable entities.
(*bb*)	An undertaking or activity of an occasional nature that is undertaken substantially with assistance on a voluntary basis without compensation.
(*cc*)	An undertaking or activity approved by the Minister by notice in the *Gazette*. The Minister must be satisfied about various factors before granting approval, such as the scope and nature of the activity, its relationship with the sole or principal object of the PBO, its profitability and any economic distortion that may result from the exemption.

See comments under category 2 on SARS's interpretation of the phrase 'substantially the whole of the use'.

Example 6 – Asset used to carry on a permissible trading activity [para 63A(*b*)(ii)]

Facts:

An approved PBO conducts PBAs of providing facilities for the care of mentally disabled persons. As a therapeutic and remedial activity, the PBO has acquired a plot of land on which the disabled are taught to grow vegetables. The produce is primarily used for own consumption and any surplus is sold to a local home industry. All the labour is undertaken by the residents. The PBO disposes of the land on which the vegetable gardening takes place resulting in a capital gain.

Result:

The vegetable gardening activity falls within the permissible trading rules of s 10(1)(*c*N)(ii)(*aa*) as it forms part of the PBA of caring for and providing training for the residents. The capital gain on sale of the land is disregarded for CGT purposes.

Example 7 – Asset used to carry on a permissible trading activity [para 63A(*b*)(ii)]

Facts:

A PBO conducts PBAs of caring for poor and needy persons over the age of 60. The PBO holds an annual fete as a fundraising event for which it has acquired a marquee. The fundraising event is undertaken with the assistance of volunteers and the items which are sold are all donated.

Result:

This event qualifies as an occasional trading activity which falls within s 10(1)(*c*N)(ii)(*bb*). If the marquee is sold, any resulting capital gain or loss must be disregarded for CGT purposes.

Example 8 – PBOs: Determination of valuation date values

Facts:

- A PBO with a 31 March year end owns immovable property on which it carries on its PBAS.
- The property was acquired on 1 June 1996 at a cost of R40 000.
- With effect from 1 June 2006 the PBO let 20% of its property to a commercial business at an arm's length rental.
- No expenditure was incurred in respect of improvements to the property from date of acquisition.
- On 31 December 2011 the PBO disposed of the property for proceeds of R110 000.
- The estate agent's commission amounted to R7 000.
- The PBO determined that the market value of the property on 1 April 2006 was R80 000.

Determine the capital gain or loss on disposal of the property assuming that the valuation was performed on

- 31 March 2008, or
- 31 August 2008.

Result:

The valuation date of the PBO is 1 April 2006, namely, the first day of its first year of assessment commencing on or after 1 April 2006. If the PBO wishes to adopt the market value method for determining the valuation date value of the property, the valuation should be determined by 31 March 2008, namely, within two years of the valuation date. It follows that

- when the valuation was done on 31 August 2008, the market value was not determined timeously and the PBO must resort to the time-apportionment basis (TAB) or the 20% of proceeds method to determine the base cost of the property as at 1 April 2006, and
- when the valuation was performed on 31 March 2008, the market value was determined timeously and the PBO may adopt the market value of the property on 1 April 2006 as the valuation date value of the property. The PBO is also entitled to use the TAB or 20% of proceeds methods if it so chooses.

Time-apportionment basis (TAB)

Valuation date = 1 April 2006 (note 1)
N = Number of years before valuation date (1 June 1996 to 31 March 2006), determined as follows:

1 June 1996 to 31 May 2005 = 9 years
1 June 2005 to 31 March 2006 = 10 months (treated as a full year)

N = 9 + 1 = 10

T = Number of years after valuation date (1 April 2006 to 31 December 2011)
1 April 2006 to 31 March 2011 = 5 years
1 April 2011 to 31 December 2011 = 9 months (treated as a full year)
T = 5 + 1 = 6

P = Amount received or accrued reduced by selling expenses (note 2)
= R110 000 – R7 000 = R103 000

TAB = B + [(P – B) x N/(N + T)]
= R40 000 + [(R103 000 – R40 000) x 10/(10 + 6)]
= R40 000 + (R63 000 x 10/16)
= R40 000 + R39 375
= R79 375

Base cost = TAB + post-valuation date costs
= R79 375 + R7 000
= R86 375

Capital gain = Proceeds – base cost
= R110 000 – R86 375
= R23 625

Note:
1. The TAB calculator for PBOs and recreational clubs on the SARS website can be used to determine TAB for a PBO as it can handle variable valuation dates.

2. This example assumes that no improvements were made on or after the valuation date. Had such improvements been made, the proceeds formula in para 30(2) would have had to be applied to determine 'P'.

20% of proceeds method

Valuation date value = 20% x (proceeds less post-valuation date expenditure)
VDV = 20% x (R110 000 – R7 000)
VDV = 20% x R103 000
VDV = R20 600

Base cost = VDV + post-valuation date expenditure
= R20 600 + R7 000
= R27 600

Capital gain = Proceeds – base cost
= R110 000 – R27 600
= R82 400

Market value method (valuation done on or before 31 March 2008)

Base cost = Market value on 1 April 2006 + post valuation date costs
= R80 000 + R7 000
= R87 000

Capital gain = Proceeds – base cost
= R110 000 – R87 000
= R23 000

12.14 Assets used to produce exempt income (para 64)

Paragraph 64

A person must disregard any capital gain or loss in respect of the disposal of an asset which is used by that person solely to produce amounts which are exempt from normal tax under s 10 or s 12K[469] (receipts and accruals from the disposal of a 'certified emission reduction'). Excluded from this concession are

- assets of PBOs [s 10(1)(*c*N)],
- assets of recreational clubs [s 10(1)(*c*O)],
- assets used to produce interest that is exempt under the so-called basic dividend and interest exemption [s 10(1)(*i*)(xv)],
- shares or participatory interests in collective investment schemes that are used to produce exempt dividend income [s 10(1)(*k*)], and
- a copyright of a person who is the first owner [s 10(1)(*m*)].

Assets of PBOs are dealt with under para 63A. Recreational clubs are granted roll-over relief under para 65B.

12.15 Awards under the Restitution of Land Rights Act [para 64A(*a*)]

Paragraph 64A(*a*)

Persons who were dispossessed of their land as a result of racially discriminatory laws or practices may seek compensation under 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 submitted 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 on disposal of this nature must be disregarded.

This provision does not apply to a person whose land is expropriated under the Restitution of Land Rights Act. Although para 64A refers to 'compensation', this is not compensation paid to the person whose land is expropriated. The type of compensation envisaged in para 64A is that which is of the same nature as a 'restitution of a right to land' and 'an award', that is, it is compensation paid to a land claimant. A person whose land is expropriated may, however, be entitled to roll-over relief under para 65 (see **13.1**).

The base cost of land acquired by a claimant must be determined by applying the barter or exchange principle described in **8.5**, that is, the expenditure incurred under para 20 in acquiring such land would be equal to the market value of the right to claim the land which has been given up in exchange for the land.

[469] The reference to s 12K was inserted by s 76(1) of the Taxation Laws Amendment Act 17 of 2009 and is deemed to have come into operation on 11 February 2009 and applies in respect of disposals on or after that date.

12.16 Government scrapping payments [para 64A(*b*)]

Paragraph 64A(*b*)

A person must disregard any capital gain or loss in respect of a disposal that resulted in that person receiving a government scrapping payment, if the Minister has by Notice in the *Gazette* identified the programme or scheme for purposes of para 64A.[470]

A grant received by or accrued to a person under the taxi recapitalisation programme announced by the Minister of Finance in the 2006 medium term budget policy statement is exempt from tax with effect from 31 October 2006 for the purposes of para 64A.[471] Under the programme the Government pays taxi operators R50 000 for each minibus taxi handed over for destruction.

12.17 Recreational clubs (para 65B)

Paragraph 65B

12.17.1 Background

Section 10(1)(*d*)(iv)(*aa*) used to provide a complete exemption from income tax for the receipts and accruals of any

> 'company, society or other association of persons established to—
>
> (*aa*) provide social and recreational amenities or facilities for the members of such company, society or other association; or
>
> (*bb*) [not applicable],
>
> approved by the Commissioner subject to such conditions as the Minister may prescribe by regulation'.'

As a consequence, for CGT purposes, approved recreational clubs enjoyed complete exclusion from CGT under para 63.

This changed with the introduction of a system of partial taxation for recreational clubs. Section 10(1)(*d*)(iv)(*aa*) was deleted by s 10(1)(*k*) of the Revenue Laws Amendment Act 20 of 2006 and a new s 10(1)(*c*O)[472] was introduced to deal with clubs.

The deletion of s 10(1)(*d*)(iv)(*aa*) came into operation on 1 April 2007 and applies to a club as from its first year of assessment commencing on or after that date, that is, it is aligned with the commencement date of s 10(1)(*c*O).[473]

Extension of the old dispensation

Clubs enjoying approval under s 10(1)(*d*)(iv)(*aa*) were required to reapply for approval under s 30A by no later than 31 March 2009. It since emerged that many clubs missed the

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[470] Paragraph 64A(*b*) was inserted by s 55 of the Revenue Laws Amendment Act 20 of 2006, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.
[471] GN 365 *GG* 34233 of 29 April 2011.
[472] Section 10(1)(*c*O) was inserted in the principal Act by s 10(1)(*j*) of the Revenue Laws Amendment Act 20 of 2006. Under s 10(3) of Act 20 of 2006, s 10(1)(*c*O) came into operation on 1 April 2007 and applies to a club as from its first year of assessment commencing on or after that date.
[473] See s 97(1) of the Taxation Laws Amendment Act 8 of, 2007, which amended s 10(3) of the Revenue Laws Amendment Act 20 of 2006. Under the amendment, s 10(1)(*k*) of Act 20 of 2006 comes into operation on 1 April 2007 and applies in respect of any year of assessment commencing on or after that date.

deadline for lodging their applications for approval under s 30A because they were unaware of the change in legislation.

Representations were made to give clubs that had missed the 31 March 2009 deadline more time to reapply for exemption. Consequently, the deletion of s 10(1)(*d*)(iv)(*aa*) was deferred by s 95(1) of the Taxation Laws Amendment Act 17 of 2009 for the clubs described below. The amendment, which adds s 10(4) to the Revenue Laws Amendment Act 20 of 2006, reads as follows:

> '(4) Paragraph (*k*) of subsection (1) shall come into operation on 1 April 2007 and applies in respect of any year of assessment commencing on or after that date: Provided that the receipts and accruals of a company, society or other association of persons which was approved by the Commissioner under section 10(1)(*d*)(iv) of the Income Tax Act, 1962, will continue to be exempt from tax until the earlier of—
>
> (*a*) the last year of assessment ending on or before 30 September 2010;
>
> or
>
> (*b*) the year of assessment preceding the year of assessment during which section 10(1)(*c*O) applies to the receipts and accruals of that company, society or other association of persons.'

This means that a club that had approval under s 10(1)(*d*)(iv)(*aa*) and which had not applied for approval under s 30A, will continue to enjoy complete exemption from income tax under s 10(1)(*d*)(iv)(*aa*) up to and including its last year of assessment ending on or before 30 September 2010. If a club enjoying exemption under s 10(1)(*d*)(iv)(*aa*) applied before 31 March 2009 for approval under s 30A for a year of assessment ending before 30 September 2010, that club must comply with s 10(1)(*c*O) from the effective date of that provision (that is, from the first day of the club's first year of assessment commencing on or after 1 April 2007). In other words, those clubs will not be given an extension of their original complete exempt status under s 10(1)(*d*)(iv)(*aa*).

The new dispensation

Under the new regime recreational clubs are subject to a system of partial taxation, the cornerstones of which are ss 10(1)(*c*O) and 30A and para 65B. In order to enjoy partial exemption under s 10(1)(*c*O), clubs must apply to the Commissioner for approval under s 30A.

Clubs are now potentially taxable on investment income and trading income not integral and directly related to the provision of social and recreational amenities or facilities for club members that exceeds the greater of

- 5% of total membership fees and subscriptions due and payable, and
- R100 000[474] [s 10(1)(*c*O)(iv)].

As a result of the loss of their complete exempt status, clubs are no longer able to automatically disregard capital gains and losses on the disposal of any of their assets. Apart from falling outside para 63, they will also not qualify for exclusion under para 64 as that provision now specifically excludes any asset used to produce exempt receipts and accruals contemplated in s 10(1)(*c*O).

[474] Under s 16(1)(*b*) of the Revenue Laws Amendment Act 60 of 2008 the amount of R100 000 was substituted in s 10(1)(*c*O)(iv)(*bb*) for the previous amount of R50 000. The amendment comes into operation on 1 March 2009 and applies in respect of years of assessment commencing on or after that date.

Roll-over relief is, however, granted in respect of the disposal of recreational club property under para 65B. But unlike PBOs, no exclusion applies to the disposal of investments such as shares and participatory interests in collective investment schemes.

A club approved under s 30A that loses its approval status and fails to transfer its assets and liabilities to another approved club or South African PBO must include an amount equal to the market value of its assets less its *bona fide* liabilities in its taxable income in the year of assessment in which approval is withdrawn [s 30A(8)]. There is no relationship between this inclusion in taxable income and the Eighth Schedule, since it does not give rise to a deemed disposal or acquisition of the errant club's assets. There is clearly a strong incentive for clubs to remain within the ambit of s 30A.

The valuation date of a club for CGT purposes is the date on which it becomes partially taxable under s 10(1)(*c*O) (that is, when it falls outside para 63). See in this regard para (*a*) of the definition of the term 'valuation date' in para 1. Thus a club that has been approved under s 30A before 31 March 2009 and which was in existence on 1 April 2007 that has a 31 March year-end will have a valuation date of 1 April 2007. The valuation dates for clubs in existence on 1 April 2007 which were approved under s 30A on or before 31 March 2009 are summarised in the table below.

Table 1 – Valuation dates for recreational clubs in existence on 1 April 2007 (other than clubs to which Table 2 applies)

Year of assessment ending on the last day of	Valuation date	Final day for completion of valuation
March	1 April 2007	31 March 2009
April	1 May 2007	30 April 2009
May	1 June 2007	31 May 2009
June	1 July 2007	30 June 2009
July	1 August 2007	31 July 2009
August	1 September 2007	31 August 2009
September	1 October 2007	30 September 2009
October	1 November 2007	31 October 2009
November	1 December 2007	30 November 2009
December	1 January 2008	31 December 2009
January	1 February 2008	31 January 2010
February	1 March 2008	28 February 2010

Table 2 – Valuation date for recreational clubs exempted under s 10(1)(*d*)(iv)(*aa*) which had not applied for approval under s 30A by 31 March 2009

Year of assessment ending on the last day of	Valuation date	Final day for completion of valuation
March	1 April 2010	31 March 2012
April	1 May 2010	30 April 2012
May	1 June 2010	31 May 2012
June	1 July 2010	30 June 2012
July	1 August 2010	31 July 2012
August	1 September 2010	31 August 2012
September	1 October 2010	30 September 2012
October	1 November 2009	31 October 2011
November	1 December 2009	30 November 2011
December	1 January 2010	31 December 2011
January	1 February 2010	31 January 2012
February	1 March 2010	28 February 2012

Under para 29(4)(*b*)(i) clubs have to value their assets within two years of their valuation date if they wish to adopt the market value method. However, para 29(4)(*b*)(ii) provides that the two-year valuation limit does not apply to

- financial instruments listed on a recognised exchange, and
- participatory interests in South African collective investment schemes in securities (CISSs) or property shares (CISPs).

The market value of these financial instruments must be determined in accordance with para 31(1)(*a*) and (*c*)(i) respectively (see **8.33.8.2**).

The CGT 2L valuation form must be submitted with the return of income covering the year in which the assets are disposed of. The early submission requirements relating to the high-value assets referred to in para 29(5) do not apply to clubs [para 29(8)].

Clubs that do not comply with the two-year valuation period will have to use TAB (para 30) or the '20% of proceeds' method (para 26).

A TAB Calculator for PBOs and recreational clubs which can handle variable valuation dates is available on the SARS website.[475]

A club that is established on or after 1 April 2007 does not have a valuation date, since it acquires its assets at cost (or deemed cost equal to market value if acquired by donation or bequest).

SARS has published a *Tax Guide for Recreational Clubs*.[476]

12.17.2 Application of para 65B

Paragraph 65B applies to recreational clubs approved by the Commissioner under s 30A. Such a club can elect to apply para 65B to the disposal of an asset the whole of which was used mainly for purposes of providing social and recreational facilities and amenities for members of the club. The reference to 'the whole of which' was clearly intended to preclude from roll-over relief an asset a part of which is used exclusively for non-recreational use, such as the long-term letting of a floor of a clubhouse. In *SBI v Lourens Erasmus (Eiendoms) Bpk*[477] Botha JA held that the word 'mainly' prescribed a purely quantitative standard of more than 50%. Thus if a club lets out its building less than 50% of the time while using it for recreational purposes during the rest of the time, it will qualify under para 65B.

Examples – The whole of which is mainly used

Example 1

A club lets out its building less than 50% of the time while using it for the remaining period to carry on social and recreational activities in terms of its sole or principal object.

Result:

The building will qualify for roll-over relief for CGT purposes.

[475] See <http://www.sars.gov.za/home.asp?pid=179> [Accessed 8 December 2011].
[476] See <http://www.sars.gov.za/home.asp?pid=54773> [Accessed 8 December 2011].
[477] 1966 (4) SA 444 (A), 28 SATC 233 at 245.

Example 2

A social club owns a building, the area of which is 300 square metres. The club only uses one room (21 square metres) once a week for its social activities and lets the remainder of the building as office accommodation.

Result:

If the club sells the building it will not be entitled to elect the roll-over relief because the whole of the building was not mainly used to provide social facilities for its members.

The following requirements must be met before the election can be made:

- Proceeds must accrue to the club in respect of the disposal, and must exceed or be equal to the base cost of the asset (that is, a capital gain or break-even situation).
- An amount at least equal to the receipts and accruals from the disposal has been or will be expended to acquire one or more replacement assets all of which will be used mainly for such purposes. In other words, para 65B will not apply when less than the amount derived from the disposal is spent on replacement assets. While the new assets need not necessarily fulfill the same function as the old asset, they must be used mainly for purposes of providing social and recreational facilities and amenities for club members.
- The contracts for the acquisition of the replacement asset or assets must all have been or will be concluded within 12 months after the date of the disposal of the asset. The replacement asset or assets must all be brought into use within three years of the disposal of the asset. The Commissioner may, however, extend the period within which the contract must be concluded or asset brought into use. However, the period may not be extended by more than six months, and then only if all reasonable steps were taken to conclude the contracts or bring the assets into use.
- The asset must not be deemed to have been disposed of and to have been reacquired by the club. This could occur for example, when a club asset is converted to trading stock, in which case para 12(2)(*c*) will trigger a disposal and reacquisition.

12.17.3 Disregarding of capital gain [para 65B(2)]

A club that makes the election must disregard any capital gain when determining its aggregate capital gain or loss, subject to para 65B(3), (4) and (5).

12.17.4 Apportionment of capital gain across multiple replacement assets [para 65B(3)]

The capital gain derived from the disposal of the old asset must be apportioned to the replacement assets in accordance with the following formula:

$$\frac{\text{Receipts expended on replacement asset}}{\text{Receipts expended on acquiring all replacement assets}} \times \text{Capital gain}$$

12.17.5 Recognition of capital gain [para 65B(4)]

When a club disposes of a replacement asset, any capital gain apportioned to that asset under para 65B(3) must be treated as a capital gain in respect of the replacement asset. This does not apply when the capital gain has been brought to account elsewhere under para 65B, for example, because the contract for the replacement asset was signed too late or the asset was not brought into use within the prescribed time.

12.17.6 Failure to conclude contract or bring assets into use [para 65B(5)]

This provision deal with the consequences when

- a club fails to conclude a contract, or
- fails to bring any replacement asset into use
- within the period prescribed in para 65B(1)(*c*)(ii) and (iii).

In such event the club must

- treat the capital gain contemplated in para 65B(2) as a capital gain on the date on which the relevant period ends,
- determine interest at the prescribed rate on that capital gain from the date of that disposal to the above date, and
- treat that interest as a capital gain on the above date when determining the club's aggregate capital gain or loss.

Example 1 – Roll-over relief: one replacement asset

Facts:

The Rovers Recreational Club, which has a year-end of 30 June, has been approved by the Commissioner under s 30A. The club acquired its clubhouse in 1980 by donation and determined its market value on 1 July 2007 (its valuation date) at an amount of R9 million. On 31 December 2007 the club extended its restaurant at a cost of R1 million.

On 20 April 2008 the club sold its clubhouse for R12 million and elected to apply para 65B to the disposal. The whole of the clubhouse was used mainly for social and recreational purposes.

On 10 November 2008 the club entered into an agreement to acquire a new clubhouse at a cost of R15 million. The club took occupation of its new premises on 1 January 2009.

Determine the CGT consequences of the disposal and replacement of the clubhouse.

Result:

The club qualifies to use para 65B for the following reasons:

- The proceeds from the disposal of the clubhouse exceed its base cost [R12 million less (R9 million plus R1 million)].
- An amount at least equal to the proceeds from disposal of the clubhouse has been expended (proceeds from disposal of clubhouse are R12 million and the cost of the new clubhouse is R15 million).
- The contract for the replacement of the clubhouse was entered into within 12 months after its disposal (the date of disposal of the clubhouse was 20 April 2008 and the agreement for the acquisition of the new clubhouse was signed on 10 November 2008).
- The new clubhouse was brought into use within three years of the disposal of the clubhouse (the clubhouse was sold on 20 April 2008 and the new clubhouse was occupied on 1 January 2009).

The capital gain on the disposal of the clubhouse is determined as follows:

	R
Proceeds	12 000 000
Less: Base cost (R9 000 000 + R1 000 000)	(10 000 000)
Capital gain	2 000 000

Under para 65B(2), the aggregate capital gain of R2 million is disregarded and deemed to be a capital gain in respect of the new clubhouse when it is eventually disposed of.

Example 2 – Acquisition of more than one replacement asset

Facts:

The Lily Whites Cricket Club, an approved recreational club under s 30A, has a year-end of 30 June. It acquired land and buildings for R1 million in March 2004 which were used to provide social and recreational facilities for its members. Improvements of R15 000 were effected to the change rooms on 1 August 2007. The land and buildings were sold to a developer on 30 April 2008 for R3 515 000. The market value of the property on valuation date, which is 1 July 2007, is R2 million. The club elects to apply para 65B to the disposal of its land and buildings.

On 31 May 2008 the club concluded an agreement with Woodglen Primary School for the acquisition of its playing field and cricket ground at a cost of R2 million. On 30 June 2008 the club concluded another agreement to purchase an adjacent property with a building suitable for a new clubhouse at a cost of R3 million. In both cases the assets (replacement assets) were acquired for purposes of providing social and recreational amenities or facilities to the club's members. The club moved into the new clubhouse and began using the playing field on 30 November 2008.

Determine the CGT consequences of the disposal of the club's land and buildings.

Result:

Capital gain on disposal of the club's land and buildings

	R	R
Proceeds		3 515 000
Less: Base cost		
Market value – 1 July 2007	(2 000 000)	
Improvements – 1 August 2007	(15 000)	(2 015 000)
Capital gain to be disregarded		1 500 000

Roll-over relief – para 65B

The disposal of the club's land and buildings qualifies for roll-over relief under para 65B for the following reasons

- The proceeds from the disposal of its land and buildings exceed its base cost (the sale realised a capital gain of R1 500 000).
- An amount at least equal to the proceeds from disposal of its land and buildings has been expended (proceeds from sale of its land and buildings amounts to R3 515 000 and the cost of the replacement assets amount to R5 000 000).
- The contracts for the acquisition of the replacement assets were entered into within 12 months of the disposal of its land and buildings (disposal date of its land and buildings was 30 April 2008 and the agreements for the acquisition of replacement assets were signed on 31 May 2008 and 30 June 2008 respectively).

- The new clubhouse was brought into use within three years of the disposal of the club's land and buildings (land and buildings was sold 30 April 2008, new club house was occupied on 30 November 2009).

Capital gain apportioned to cricket ground (replacement asset)

$$\frac{\text{Receipts expended on replacement asset}}{\text{Receipts expended on acquiring all replacement assets}} \times \text{Capital gain}$$

= R2 000 000/R5 000 000 x R1 500 000
= R600 000 to be taken into account when the replacement asset is disposed of.

Capital gain attributable to adjacent property with a building suitable for a new clubhouse (replacement asset)

$$\frac{\text{Receipts expended on replacement asset}}{\text{Receipts expended on acquiring all replacement assets}} \times \text{Capital gain}$$

= R3 000 000/R5 000 000 x R1 500 000
= R900 000 to be taken into account when the replacement asset is disposed of.

12.18 Disposal of equity shares in foreign companies (para 64B)

Paragraph 64B

12.18.1 Effective date

Paragraph 64B came into operation on 1 June 2004 and applies in respect of the disposal of any equity share in any foreign company on or after that date. A number of important amendments were made to para 64B that took effect on 8 November 2005, including a decrease in the percentage shareholding required to qualify for the exclusion, and the introduction of highly complex anti-avoidance provisions in para 64B(3) and (4). Further amendments came into effect on 1 October 2007 as a result of the introduction of part-disposal treatment of capital distributions under para 76A.

12.18.2 Background

In the 2003 Budget Review, the Minister of Finance announced his intention to allow the tax-free repatriation of foreign dividends back to South Africa. This dividend exemption, known as the 'participation exemption', was subsequently introduced into s 10(1)(*k*)(ii)(*dd*). One of the requirements for the exemption is that the South African shareholder receiving the dividend must hold at least 20% of the equity shares and voting rights in the foreign company (before 8 November 2005 = 25%). The participation exemption 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. Paragraph 64B gives effect to this tax-free disposal. It is probably best described as a 'participation exclusion', since it applies to both capital gains and losses. In broad terms South African shareholders are allowed to make a tax-free sale of foreign shares in a foreign company in which they hold an interest of at least 20% as long as that sale is made to non-residents. The latter requirement encourages the repatriation of foreign funds to South Africa.

12.18.3 Definitions [para 64B(1)]

This subparagraph contains two definitions that apply for the purpose of para 64B.

12.18.3.1 Definition – 'foreign company'

> '**"[F]oreign company"** means—
>
> (*a*) a foreign company; or
>
> (*b*) a headquarter company.''

The term 'foreign company' is defined in s 1 as follows:[478]

> '**"[F]oreign company"** means any company which is not a resident.'

A domestic company will normally be resident in South Africa as a result of being incorporated, established or formed in South Africa.[479] But a domestic company can be deemed to be exclusively a resident of a foreign country under a tax treaty.[480]

The term 'headquarter company' is defined in s 1.

12.18.3.2 Definition – 'Foreign financial instrument holding company'

Paragraph 64B(1) defines a 'foreign financial instrument holding company' (FFIHC) to mean

> 'a foreign financial instrument holding company as defined in section 41'.

Essentially a FFIHC is a foreign company as defined in s 1, when more than the 'prescribed proportion' of all the assets of that company, together with the assets of all 'influenced companies' in relation to that foreign company, consist of financial instruments. The term 'influenced company' is defined within the definition of an 'associated group of companies' in s 41. In simple terms it is one in which at least 20% of the equity shares and voting rights are held by an influencing company. Also defined in s 41 is the term 'prescribed proportion'. Again, in simple terms the prescribed proportion comprises

- half of the market value, or
- two-thirds of the actual cost

of all assets. The expression 'two-thirds of the actual cost' must be disregarded if any asset of the foreign company is deemed not attributable to a pe of that company under para (*d*) of the proviso to s 9D(6) (this relates to hyperinflationary currencies).

When equity shares are to be disposed of to members of the same group of companies, the prescribed proportion may alternatively be determined at half the book value of the assets according to the most recent set of audited financial statements, or two-thirds of the market value of all the assets.

There are a number of exceptions such as the exclusion of certain trade debts and licensed financial institutions such as banks and insurance companies.

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[478] The definition was inserted by s 6(1)(*h*) of the Taxation Laws Amendment Act 7 of 2010 with effect from the commencement of years of assessment commencing on or after 1 January, 2011.
[479] Paragraph (*b*) of the definition of 'resident' in s 1.
[480] See exclusion from definition of 'resident' in s 1.

12.18.4 Exclusion of capital gains and losses on disposal of foreign company shares [para 64B(2)]

12.18.4.1 The 'at least 20%' shareholding and voting rights requirement [para 64B(2)(a)(i)]

A person holding 20% or more[481] of the equity shares and voting rights[482] 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 or an interest contemplated in para 2(2) (when 80% or more of the market value of the equity shares is directly or indirectly attributable to immovable property in South Africa).

In determining whether a person holds at least 20% of a foreign company's equity shares and voting rights, 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.

In the case of a person other than a company such as an individual or a trust, only that person's direct interest is taken into account in determining whether the 20% threshold has been met. No account is taken of the interests of connected persons in relation to that person. But in the case of a company, the interest is determined by adding together the interest of the company and the interest of any other company forming part of 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 at least 20% of the foreign company's equity shares and voting rights immediately before 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 year 1 Dumisani, 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 under 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 exclusion.

Example 2 – Determination of percentage interest in the case of a group company (1)

Facts:

Holdco Ltd, a South African company owns all the shares in Abacus (Pty) Ltd, which in turn owns 14% of Brutus Inc, an oil refining company registered in Bermuda. Holdco owns 6% of

[481] Previously the required holding was 'more than 25%'. This was changed to 'at least 20%' by s 79(1)(*a*) of the Revenue Laws Amendment Act 31 of 2005. The amendment came into operation on 8 November 2005.

[482] The reference to voting rights was inserted by s 58(1)(*b*) of the Taxation Laws Amendment Act 3 of 2008, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

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 is at least 20%. In this case their combined interests amount to 14% + 6% = 20%, 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 10% 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) + 10% (B) + 5% (D) = 19%.
Since the group together does not hold at least 20% of C, D does not qualify for the participation exclusion in para 64B. No regard must be had to B's indirect interest in C via D in determining the group's interest.

When must the 'at least 20%' 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 before that disposal the person held an interest of at least 20%.

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 51% interest for proceeds of R200 000. Finally on 31 March 2007 she disposed of her remaining 19% interest in the company for proceeds of R80 000.

Determine which of Ashini's capital gains are excluded for CGT purposes under the participation exclusion 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 2007 R80 000 – R20 000 = R60 000

The capital gain of R15 000 will be excluded under para 64B because the shares were disposed of after 18 months and Ashini held a 75% interest in the company before the disposal which exceeded the required > 25% threshold which applied before 8 November 2005

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% which exceeded the required > 25% threshold.

The capital gain of R60 000 will be subject to CGT because Ashini held only 19% of the shares immediately before the disposal, which is less than the 'at least 20%' requirement for exclusion that applied on or after 8 November 2005.

Example 5 – Application of participation exclusion upon loss of CFC status

Facts:

South African Company owns all the shares of CFC Holdings. CFC Holdings owns all the shares of CFC Operating. CFC Operating has a total value of R5 million, of which R2 million represents portfolio financial assets that generate s 9D(2A) net income. South African Company has a R2,3 million base cost in the CFC Holding shares. CFC Holding has a base cost of R1,7 million in the CFC Operating shares. CFC Operating has a base cost of R600 000 in the portfolio financial assets generating s 9D(2A) net income.

South African Company sells all the CFC Holdings shares for R5 million cash. The sale is to a wholly owned foreign group, which eliminates CFC status for both the holding company and the operating companies transferred.

Result:

Under para 12(2)(*a*), CFC Operating is deemed to dispose of all its assets as a result of its loss of CFC status upon the sale of CFC Holdings. This results in a capital gain of R1,4 million (R2 000 000 – R600 000) for South African Company under s 9D. This capital gain translates into a base cost increase of R1,4 million for both the CFC Holdings and CFC Operating shares under para 20(1)(*h*)(iii). Likewise, CFC Holdings is deemed under para 12(2)(*a*) to dispose of the CFC Operating shares as a result of its loss of CFC status. But the capital gain on disposal is excluded under the participation exclusion in para 64B(2)(*b*). The actual sale of CFC Holdings by South African Company is also excluded under s 64B(2).

SA Company

Base cost of CFC Holdings shares	R
Initial cost of acquisition	2 300 000
Capital gain imputed from CFC Operating [para 20(1)(*h*)(iii)]	1 400 000
Base cost	3 700 000

Disposal – sale of shares [para 11(1)(*a*)]

	R
Proceeds (actual)	5 000 000
Less: Base cost (as above)	(3 700 000)
Capital gain	1 300 000

This capital gain is disregarded under para 64B(2)(*b*), being a disposal to a non-resident.

Capital gain imputed from CFC Operating (s 9D) – see belowR1 400 000

CFC Holdings

Base cost of CFC Operating shares:	R
Initial cost of acquisition	1 700 000
Capital gain arising in CFC Operating upon it ceasing to be a CFC [para 20(1)(*h*)(iii)]	1 400 000
Base cost	3 100 000

Deemed disposal – cessation of CFC status [para 12(2)(*a*)]

	R
Proceeds	5 000 000
Less: Base cost	(3 100 000)
Capital gain	1 900 000

This capital gain is disregarded under para 64B(2)(*b*) as it results from the application of para 12(2)(*a*) (cessation of CFC status).

CFC Operating

Market value of assets upon ceasing to be a CFC:

	R
Factory assets	3 000 000
Portfolio financial assets	2 000 000
	5 000 000

Deemed disposal of portfolio financial assets – cessation of CFC status [para 12(2)(*a*)]

	R
Proceeds	2 000 000
Less: Base cost	(600 000)
Capital gain imputed to South Africa Operating under s 9D	1 400 000

Exclusion of s 8E hybrid equity instruments

The proviso to para 64B(2)(*a*) requires that

> 'in determining the total equity shares in a foreign company, there shall not be taken into account any share which would have constituted a hybrid equity instrument, as contemplated in section 8E, but for the three year period requirement contained in that section'.

Section 8E deals with debt disguised as shares. It deems dividends received or accrued on certain types of shares ('hybrid equity instruments') to be interest in the hands of the shareholder. The term 'hybrid equity instrument' as defined in s 8E(1) means

> (*a*) any share other than an equity share which the relevant company is obliged to redeem in whole or in part within a period of three years from the date of issue thereof, or which may at the option of the holder be redeemed in whole or in part within the said period, or in respect of which the holder has a right of disposal which may be exercised within the said period; or
>
> (*b*) any share other than a share contemplated in paragraph (*a*), if—
>
> (i) the holder has a right of disposal in respect of such share which may be exercised within a period of three years from the date of issue thereof or at the time of issue of that share, the existence of the company issuing that share is to be terminated within a period of three years or is likely to be terminated within such period upon a

reasonable consideration of all the facts at the time that share is issued; and

(ii) such share does not rank *pari passu* as regards its participation in dividends with all other ordinary shares in the capital of the relevant company or, where the ordinary shares in such company are divided into two or more classes, with the shares of at least one of such classes, or any dividend payable on such share is to be calculated directly or indirectly with reference to—

(*aa*) any specified rate of interest;

(*bb*) the amount of capital subscribed for such share; or

(*cc*) the amount of any loan or advance made directly or indirectly by the shareholder or by any connected person in relation to the shareholder.'

It follows that in determining the percentage interest in a foreign company no regard must be had to any 'hybrid equity instruments' as defined in s 8E. Furthermore, for this purpose shares will be regarded as hybrid equity instruments despite the fact that they may have passed the three-year rule in s 8E.

Example 6 – Impact of s 8E 'hybrid equity instruments' in determining qualifying percentage holding for participation exclusion

Facts:

Angus holds the following shares in Scotty Ltd, a retail company incorporated in the United Kingdom:

90 000 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 three 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 exclusion in para 64B.

Result:

The B Class ordinary shares must be disregarded in determining Angus's percentage interest in Scotty Ltd, as they are hybrid equity instruments under s 8E. Since Angus only holds 90 000/500 000 (18%) of the A Class ordinary shares, he will not qualify for the participation exclusion.

12.18.4.2 The 18-month holding requirement [para 64B(2)(a)(ii)]

The exclusion applies to a person that has held an interest of at least 20% of the equity shares and voting rights in the foreign company for at least 18 months. Once the 18-month period has been reached, and while it is maintained in respect of a *de minimis* holding of at least 20%, the exclusion applies to the disposal of any equity shares in the company, even if they have been held for less than 18 months.

If a person disposes of the equity shares in tranches, the exclusion will only apply while the person holds at least 20% of the equity shares and voting rights in the company. As soon as the person falls below the 20% threshold, any further capital gains and losses may not be

disregarded, despite those shares having been held at an earlier time when the threshold was exceeded.

Example 1 – The 18-month rule

Facts:

Three years ago Celia acquired 75% of the equity shares and voting rights in a foreign trading company. Six months ago she acquired the remaining 25% shares. As a result of a sharp downturn in the company's prospects she disposed of her entire holding to a non-resident. The 75% holding realised a capital gain of R100 000 while the 25% holding realised a capital loss of R40 000. All the shares were acquired as a long-term investment.

Result:

Both the capital gain and capital loss must be disregarded because Celia held at least 20% of the equity shares and voting rights in the company for at least 18 months before she disposed of her entire holding.

Example 2 – Disposal of shares in tranches

Facts:

Ernest holds 30% of the equity shares and voting rights in Foreign Trading Co. He has held the shares for five years, but because the company's prospects have deteriorated, he decides to sell his shares. In order not to flood the market he disposes of the shares to non-residents in two tranches of 11% and 19% respectively, with a gap of three months between each sale. The 11% holding realises a capital gain of R1 million, while the 19% holding realises a capital gain of R2 million.

Result:

Ernest must disregard the capital gain of R1 million, since he held at least 20% of the shares immediately before the disposal of his 11% holding. However, he must account for the capital gain of R2 million, since immediately before he sold the 19% holding he only held 19% of the company's equity shares. Had Ernest sold the shares in tranches of 10% and 20% respectively, he would have disregarded any capital gain or loss on disposal of both tranches.

A special rule applies if the person is a group company that acquired the shares from another group company. 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 acquires 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 3 – 18-month rule when 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 under 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).

12.18.4.3 The non-resident purchaser requirement [para 64B(2)(b)]

The resident disposing of the equity shares in the foreign company must disregard any capital gain or loss on that disposal when those shares are disposed of

- to any person other than a resident or a CFC,
- in the circumstances contemplated in para 12(2)(*a*), where those circumstances arise directly or indirectly as a result of a disposal to a person contemplated in the preceding bullet point, or
- by a person to a CFC in relation to that person or to any other CFC that forms part of the same group of companies as that person.[483]

Paragraph 12(2)(*a*) would apply, for example, when the foreign company ceases to be a CFC because some of its shares have been sold by the resident shareholder or any other resident shareholder to a non-resident, resulting in more than 50% of the CFC's shares becoming owned by non-residents. It would also apply if the CFC issued further shares to a non-resident which diluted the interests of resident shareholders below the 'more than 50%' threshold thus causing a loss of CFC status.

The third bullet point would apply, for example, if Holdco owned 70% of CFC 1 and CFC 2, and then sold CFC 2 to CFC 1.

12.18.5 Capital gain on disposal of CFC to connected person [para 64B(3)]

The capital gains participation exclusion operates in conjunction with the participation exemption for foreign dividends contained in s 10(1)(*k*)(ii)(*dd*). The exclusion of capital gains is intended to facilitate internal restructurings of offshore foreign subsidiaries. The exclusion also allowed for the sale of certain foreign shareholdings to foreign persons with the expectation that the loss of foreign shareholdings would be replaced with valuable consideration. However, it became apparent that some multinationals were seeking to use the exclusion so as to divest themselves of their foreign subsidiaries with foreign subsidiary ownership transferring abroad with little or no consideration remaining within South Africa's jurisdiction. These transactions also contained schemes that attempted to avoid any STC so as to achieve a wholly tax-free divestiture. In order to remedy these concerns para 64B(3) and (4) were introduced. These anti-avoidance measures came into operation on 8 November 2005.

Under para 64B(3) any capital gain disregarded as a result of the participation exclusion in para 64B(2) or (5)[484] is treated as a net capital gain under para 8(*b*) in certain

[483] Paragraph 64B(2)(*b*) was substituted by s 58(1)(*c*) of the Taxation Laws Amendment Act 3 of 2008, and deemed to have come into operation on 21 February 2008 and apply in respect of an interest disposed of on or after that date, unless that disposal is the subject of an application for an advance tax ruling accepted by the Commissioner before that date. allows the sale of shares in a CFC to another CFC provided this is done within a 'group of companies' as defined in s 1.

[484] The reference to subpara (5) was inserted by s 58(1)(*d*) of the Taxation Laws Amendment Act 3 of 2008, and deemed to have come into operation on 21 February 2008 and apply in respect of an interest disposed of on or after that date, unless that disposal is the subject of an application for an advance tax ruling accepted by the Commissioner before that date.

circumstances. The treatment of an amount as a net capital gain has the effect that no capital losses for the year of assessment or assessed capital loss brought forward from the preceding year of assessment may be set off against the amount. Before para 64B(3) can be applied four requirements must be fulfilled.

First requirement [para 64B(3)(a)]

Before the disposal the foreign company being disposed of must be a CFC in relation to

- the person claiming the participation exclusion, or
- any other company in the same group of companies as that person.

Second requirement [para 64B(3)(b)]

The equity share in the CFC must have been disposed of to a connected person in relation to that person either before or after that disposal.

Third requirement [para 64B(3)(c)]

The third requirement will be fulfilled if any one of three scenarios prevails.

First scenario [para 64B(3)(c)(i)]

Under the first scenario the person must have disposed of the equity shares

- for no consideration, or
- for a consideration which does not reflect an arm's length price.

This scenario does not apply when the company has distributed the CFC's shares in the circumstances contemplated in the second scenario.

Second scenario [para 64B(3)(c)(ii)]

The second scenario applies when the equity shares in the CFC were disposed of by way of a distribution. However, this scenario does not apply when

- the full amount of that distribution
  - was subject to STC or would, but for s 64B(5)(*f*), have been subject to STC (intra-group relief applicable to dividends declared out of post-group profits) *[para 64B(3)(c)(ii)(aa)]*, or
  - was included in the income of a shareholder of that company or would but for s 10(1)(*k*)(ii)(*dd*) (foreign dividend participation exemption) have been so included *[para 64B(3)(c)(ii)(bb)]*.

Third scenario [para 64B(3)(c)(iii)]

The third scenario deals with a secondary or third disposal of any consideration received or accrued from the sale of the equity shares in the CFC. For example, if the equity shares in the CFC were sold to a non-resident for R100 on credit and the resulting debt asset is disposed of in the circumstances contemplated in the provision, the provision will apply. The provision goes one step further and also applies when the initial consideration is exchanged for another amount and that second amount is then disposed of in the manner contemplated in the provision. This could happen when the CFC's shares are sold in exchange for a debenture and that debenture is then exchanged for other shares which are then disposed of under the provision.

The above disposal must form part of a transaction, operation or scheme involving the disposal of the CFC equity shares.

The disposal of the consideration must meet one of the following requirements:

First scenario [para 64B(3)(c)(iii)(aa)]

The provision will apply when the consideration or substituted consideration is disposed of

- for no consideration, or
- for a consideration which does not reflect an arm's length price.

This scenario does not apply when the company distributes the consideration in the circumstances contemplated in the second scenario below.

The second scenario [para 64B(3)(c)(iii)(bb)]

The provision applies when the consideration or substituted consideration is disposed of by a distribution by a company. This scenario does not apply when

- the full amount of that distribution
- ➢ was subject to STC or would, but for s 64B(5)(*f*), have been subject to STC (intra-group relief applicable to dividends declared out of post-group profits) *[para 64B(3)(c)(iii)(bb)(A)]*, or
- ➢ was included in the income of a shareholder of that company or would but for s 10(1)(*k*)(ii)(*dd*) (foreign dividend participation exemption) have been so included *[para 64B(3)(c)(iii)(bb)(B)]*.

The fourth requirement [para 64B(3)(d)]

The CFC ceased in terms of any transaction, operation or scheme of which the disposal of the interest in the equity shares forms part, to be a CFC in relation to

- the person disposing of its shares, or
- other company in the same group of companies as that person.
- In relation to the above
- regard must be had solely to any rights contemplated in para (*a*) of the definition of the term 'participation rights' in s 9D, and
- no regard must be had to any election exercised under s 9D(13).

Paragraph (*a*) of the definition of the term 'participation rights' in s 9D(1) refers to

> 'the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature, in that company'.

Under s 9D(13) a resident (together with any resident connected person) who holds at least 10% but not more than 20% of the participation rights and voting rights of a foreign company can elect that it be treated as a CFC. As noted above, this election must be ignored for the purposes of determining whether the foreign company has ceased to be a CFC. Under s 9D(1) a 'controlled foreign company' is one in which more than 50% of the participation rights or voting rights are held or are exercisable by one or more residents.

Example 1 – Denial of participation exemption when CFC distributed STC free to parent company [para 64B(3)]

Facts:

Foreign Parent owns all the shares of South African Company. South African Company owns all the shares of CFC. Foreign Parent forms South African Newco. South African Company has R10 million of corporate profits. CFC has a current market value of R6 million and South African Company has a base cost of R1,3 million in the CFC shares. All of CFC's business operations are exempt from tax under the s 9D(9)(*b*) foreign business establishment exemption. South African Company sells the CFC shares to South African Newco in exchange for a note issued by South African Newco. South African Company and South African Newco elect roll-over relief for CGT purposes under s 45. South African Newco then distributes CFC to Foreign Parent.

Result:

It is assumed that ss 80A to 80L and substance over form principles do not apply, Paragraph 64B(3) triggers a capital gain in South African Newco under para 8(*b*). This overrides the para 64B(2) exclusion. Paragraph 64B(3) applies because

- the foreign company is a CFC in relation to South African Newco [para 64B(3)(*a*)],
- South African Newco and Foreign Parent are connected persons in relation to each other before or after the disposal [para 64B(3)(*b*)], and
- the full distribution by South African Newco is not subject to STC as a result of the lack of corporate profits [para 64B(3)(*c*)(ii)(*aa*)]

South African Newco therefore has a capital gain of R4,7 million arising as a result of the distribution (R6 million – R1,3 million).

Example 2 – Denial of participation exclusion when debt arising from disposal of CFC disposed of at non-arm's length price [para 64B(3)]

Facts.

The facts are the same as Example 1, except that South African Newco sells CFC to Foreign Parent in exchange for a note of R6 million. South African Newco later cancels the note owing by Foreign Parent after earning interest of R60 000.

Result:

It is assumed that ss 80A to 80L and substance over form principles do not apply. The sale by South African Newco of CFC for the note is excluded from CGT under para 64B(2). However, the cancellation of the note triggers a capital gain of R4,7 million under para 64B(3) because

- the foreign company is a CFC in relation to South African Newco [para 64B(3)(*a*)],
- South African Newco and Foreign Parent are connected persons in relation to each other before or after the disposal [para 64B(3)(*b*)], and
- the note acquired as a result of the sale of the CFC was disposed of by South African Newco at a non-arm's length price [para 64B(3)(*c*)(iii)(*aa*)].

Example 3 – Effect of para 8(*b*) treatment

Facts:

The facts are the same as Example 2, except that South African Newco has been in existence for many years and has an assessed capital loss brought forward from the previous year of R5 million.

Result:

The result is the same as Example 2. The capital gain of R4,7 million triggered by para 64B(3) cannot be offset by the assessed capital loss due to the direct inclusion under para 8(*b*).

12.18.6 Second stage disposal of CFC [para 64B(4)]

If para 64B(3) does not apply because any distribution provided for in para 64B(3)(*c*)

- would have been subject to STC but for having made an election under s 64B(5)(*f*) (intra-group relief) or
- would have been included in the income of the company to which that distribution was made had it not used the foreign dividend participation exemption in s 10(1)(*k*)(ii)(*dd*),

and the company to which that distribution was made, disposes of any amount of that distribution in the circumstances contemplated in para 64B(3)(*c*)(i), (ii) or (iii), that company must be treated as having disposed of the equity share in that foreign company by means of a disposal which is or was disregarded under para 64B(2).

In other words, the capital gain on disposal of the CFC that was disregarded in the hands of the first resident company is transplanted into the second resident company in which it will be subject to CGT and ring-fenced against other capital losses or an assessed capital loss brought forward from the previous year.

Example – On-distribution of consideration arising from disposal of CFC [para 64B(4)]

Facts:

Foreign Parent owns all the shares of South African Company 1. South African Company 1 owns all the shares of South African Company 2. South African Company 2 owns all the shares of CFC with a current market value of R20 million and a base cost of R3 million. All of CFC's business operations are exempt from tax under the s 9D(9)(*b*) foreign business establishment exemption. South African Company 2 sells CFC to Foreign Parent in exchange for a note. South African Company 2 distributes the note to South African Company 1 [which is STC free by virtue of s 64B(5)(*f*)].

Result:

The sale of CFC to Foreign Parent by South African Company 2 for the note is tax free under para 64B(2). The distribution of the note to South African Company 1 does not trigger para 64B(3) because although the dividend is exempt from STC under s 64B(5)(*f*) it would have been subject to STC in South African Company 2's hands had it not made the election under s 64B(5)(*f*). However, South African Company 1 steps into the shoes of South African Company 2 for purposes of para 64B. South African Company 1 would accordingly be

subject to para 64B(3) if South African Company 1 manages to dispose of the note without any valuable consideration in return and without any corresponding STC.

12.18.7 Disregarding of capital gain or loss arising from capital distribution [para 64B(5)]

Paragraph 64B(5) was inserted[485] as a result of the introduction of paras 67A and 76A and the triggering of a part-disposal when a capital distribution is received by or accrues to a holder of a participatory interest in a CISP or a shareholder of a company. Its provisions are intended to provide similar relief to that conferred on foreign dividends under s 10(1)(*k*)(ii)(*dd*), and it carries the same purpose, namely, to encourage the repatriation of funds to South Africa. It provides that a person must disregard any capital gain or loss determined in respect of any capital distribution contemplated in para 67A, 76, 76A or 77 received by or accrued to that person from a foreign company [other than a foreign financial instrument holding company or an interest contemplated in para 2(2)][486] when that person (whether alone or together with any other person forming part of the same group of companies as that person) holds at least 20% of the total equity shares and voting rights in that company.[487]

In determining the total equity shares in a company, no account must be taken of any share which would have constituted a hybrid equity instrument under s 8E, but for the three-year period requirement contained in that section.

The exclusion also does not apply in respect of any distribution which forms part of any transaction, operation or scheme under which any capital gain is disregarded while any corresponding expenditure is taken into account by that person or any connected person in relation to that person in determining the liability for tax of that person or connected person, as the case may be, under the Act.

Unlike para 64B(2), the exclusion also applies to an FFIHC and a company referred to in para 2(2) – that is, one in respect of which 80% or more of the value of its shares represent immovable property in South Africa.

12.18.8 Exclusion of portfolio in collective investment scheme [para 64B(6)]

Paragraph 64B does not apply in respect of any capital gain or loss determined in respect of

- the disposal of any equity share in any portfolio of a collective investment scheme contemplated in para (*e*) of the definition of a 'company' in s 1, and
- any distribution contemplated in para 64B(5) by any such portfolio.[488]

[485] Inserted by s 77(1)(*b*) of the Revenue Laws Amendment Act 35 of 2007, deemed to have come into operation on 1 October 2007 and applies in respect of any distribution on or after that date.
[486] The exclusion of an FFIHC and interest in a company holding South African immovable property was inserted by s 81 of the Revenue Laws Amendment Act 60 of 2008 and is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.
[487] The references to paras 67A, 76A and voting rights were inserted by s 58(1)(*e*) of the Taxation Laws Amendment Act 3 of 2008. Insofar as the amendment relates to paras 67A and 76A, it is deemed to have come into operation on 1 October 2007 and applies in respect of a distribution on or after that date. Insofar as it relates to voting rights, the amendment is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.
[488] Paragraph 64B(6) inserted by s 77(1)(*b*) of the Revenue Laws Amendment Act 35 of 2007, deemed to have come into operation on 1 October 2007 and applies in respect of any distribution on or after that date.

Chapter 13 – Roll-overs

PART IX: ROLL-OVERS

13.1 Involuntary disposal (para 65)

Paragraph 65

The Revenue Laws Amendment 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.

13.1.1 The position before 22 December 2003

A capital gain arising on the expropriation, loss, or destruction of an asset (other than a financial instrument) is held over until the disposal of its replacement asset.

This provision also applies to the spouse of a person who is declared insolvent. Under 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 when 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.

In the case of a person who is not a resident, the original asset must have been located in South Africa in order to give rise to a capital gain or loss [para 2(1)(*b*)]. The replacement asset must therefore also be an asset situated in South Africa 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.

A person who does not meet the commitment to either conclude a contract or bring an asset into use within the specified period must recognise the held-over gain 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.

13.1.2 The position on or after 22 December 2003

13.1.2.1 Summary of provisions

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

13.1.2.2 Introduction

Paragraph 65 enables a person to elect to defer a capital gain when an asset has been disposed of by way of operation of law, theft or destruction. The words 'operation of law' were substituted for the word 'expropriation' by the Revenue Laws Amendment Act 45 of 2003. *Black's Law Dictionary*[489] describes these words as follows:

> '[O]peration of law. The means by which a right or a liability is created for a party regardless of the party's actual intent <because the court didn't rule on the motion for rehearing within 30 days, it was overruled by operation of law>.'

The words are wider than 'expropriation' and would cover, for example, a property disposed of pursuant to the gazetting of a land claim under the Restitution of Land Rights Act 22 of 1994. In other words, it is not required of a taxpayer to contest such a claim through the courts in order to secure the roll-over relief conferred by para 65. The relief would not, however, apply to a person who disposes of an asset under the mere threat of the lodging of a claim under any law.

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.

13.1.2.3 Conditions under which an election to defer a capital gain may be made [para 65(1)]

A person can elect that para 65 apply 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 (for example, expropriation), theft or destruction.
- Proceeds must accrue to the person by way of compensation (for example, an insurance payout).
- The proceeds must be equal to or exceed the base cost of the asset (that is, a capital gain or break-even situation). When a capital loss arises this provision does not apply, as most persons would want to claim the capital loss in the year of

[489] Bryan A Garner and Henry Campbell Black (1860–1927), 8 ed (2004) Thomson/West, St Paul, MN.

assessment in which it arises. This provision also applies when 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.

- If 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 when 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 asset referred to in the provision as 'replacement asset or assets'. The description of the new assets as replacement assets is intended to be more than just a label. The replacement asset must fulfill the same function as the old asset. For example, if a person receives compensation for the expropriation of a farm and invests the proceeds on loan account in a company, para 65 will not apply. A new farm must be acquired. It is also worth noting that the new asset must be 'brought into use' – a clear indication that the provision is directed at tangible replacement assets. The use of the words 'has been' indicates that it is possible to acquire a replacement asset before disposing of the old asset. When 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 South African source under s 9(2), namely,

  - any South African immovable property (including shares in a property company under certain conditions),
  - any other asset of a resident not forming part of a PE outside South Africa and which is not subject to foreign taxation, and
  - any other asset of a non-resident that forms part of a PE in South Africa.

  This provision is designed to prevent a non-resident who would be subject to CGT on South African immovable property or assets of a PE in South Africa from replacing such assets with non-taxable assets from a non-South African source.

- The relief applies when 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 in which 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 before 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 be 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 in which a deemed disposal and immediate reacquisition is triggered.

13.1.2.4 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

- para 65(4), which spreads the capital gain in proportion to capital allowances on any depreciable replacement assets,
- para 65(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
- para 65(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 – 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 under 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. Under 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.

13.1.2.5 Allocation of capital gain over multiple replacement assets (para 65[3])

This paragraph applies when 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 for the purpose of para 65(4) and (5), which deal with depreciable assets.

Example – 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.

13.1.2.6 Depreciable assets – spreading of capital gain in proportion to capital allowances on replacement asset [para 65(4)]

If a person acquires a depreciable replacement asset, the capital gain on disposal of the old asset must be recognised as the deductions or 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:

$$\text{Disregarded capital gain attributed to replacement asset} \times \frac{\text{Allowance or deduction claimed in year of assessment}}{\text{All qualifying allowances or deductions for all years of assessment based on cost or value of replacement asset at date of acquisition}}$$

If 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 – 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. Under 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 000 x R30 000/R150 000 (20%) = R4 000

13.1.2.7 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 when 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 under para 65 when 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.

13.1.2.8 Failure to conclude contract or bring replacement asset into use [para 65(6)]

This provision provides for the recognition of any disregarded capital gain when 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:

> '**"[P]rescribed 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): Provided that where the Minister fixes a new rate in terms of that Act, that new rate applies for purposes of this Act from the first day of the second month following the date on which that new rate came into operation;

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		Rate
From	**To**	**%**
1 September 1999	29 February 2000	14,5
1 March 2000	30 September 2002	13
1 October 2002	31 March 2003	15,5
1 April 2003	30 June 2003	16,5
1 July 2003	31 August 2003	15
1 September 2003	30 September 2003	14
1 October 2003	30 November 2003	13
1 December 2003	31 October 2004	11,5
1 November 2004	31 October 2006	10,5
1 November 2006	28 February 2007	11,0
1 March 2007	31 October 2007	12,0
1 November 2007	29 February 2008	13,0
1 March 2008	31 August 2008	14,0
1 September 2008	30 April 2009	15,0
1 May 2009	30 June 2009	13,5
1 July 2009	31 July 2009	12,5
1 August 2009	31 August 2009	11,5
1 September 2009	30 June 2010	10,5
1 July 2010	28 February 2011	9,5
1 March 2011	Until change*	8,5

*Last updated: 1 March 2011.

An updated list of prescribed rates is also available on the SARS website under Legal & Policy / Publications / Tables of interest Rates.[490]

13.1.2.9 Replacement assets comprising personal-use assets [para 65(7)]

If a replacement asset or assets constitute personal-use assets, para 65 does 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. If a person replaces a single asset with multiple assets, the relief will be denied in full should any one of those replacement assets be a personal-use asset.

[490] The table, last updated on 2 March 2011, is available from: <http://www.sars.gov.za/home.asp?pid=54745> [Accessed 8 December 2011].

Example – 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.

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 (para 66)

Paragraph 66

The Revenue Laws Amendment 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 before 22 December 2003

A capital gain arising on the disposal of an asset that qualifies for a capital allowance or deduction under s 11(*e*), 12B, 12C, 12E, 14 or 14*bis* 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 that are considered 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.

In the case of a person who is not a resident, the original asset must have been located in South Africa in order to give rise to a capital gain or loss [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.

A person who does not meet the commitment to either conclude a contract or bring an asset into use within the specified period must recognise the held-over gain 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 – 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 under 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

Income	R
Original cost	2 000 000
Less: Allowances claimed	(2 000 000)
Tax value – 30 September 2002	-
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 before 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)]
= R0 + [(R3 000 000 – R0) x 7/8]
= R3 000 000 x 7/8
= 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 because

- 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

Income	R
Original cost	500 000
Less: Allowances claimed	(500 000)
Tax value – 30 September 2002	-
Selling price	710 000
Recoupment	500 000

Eighth Schedule

	R
Selling price	710 000
Less: Recoupment	(500 000)
Proceeds	210 000

Determination of base cost

Market value

Since expenditure before 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)]
= R0 + [(R210 000 – R0) x 6/7]
= R210 000 x 6/7
= 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 inapplicable.

Truck

Income	R
Original cost	300 000
Less: Allowances claimed	(300 000)
Tax value – 30 September 2002	-
Selling price	350 000
Recoupment	300 000

Eighth Schedule

	R
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)]
= R0 + [(R50 000 – R0) x 4/5]
= R50 000 x 4/5
= 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 under s 11(*e*), are not equivalent to the capital allowances to be claimed in respect of the new aircraft under 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 when 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 apply 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 under s 11(*e*), 11D(2),[491] 12B, 12C 12DA, 12E, 14, 14*bis* or 37B.[492]

- The proceeds must be equal to or exceed the base cost of the asset (that is, a capital gain or break-even situation). Capital losses are unlikely to arise, as in most cases the person would claim a revenue loss in the form of an 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 when 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. If 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 when 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 deduction or allowance under s 11(*e*), 11D(2), 12B, 12C 12DA, 12E or 37B. The use of the words 'has been' indicate that it is possible to acquire a replacement asset before 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 South African source under s 9(2)(*b*), namely, any asset (other than immovable property) of a

  - resident not forming part of a permanent establishment (PE) outside South Africa which is not subject to foreign taxation, and

  - non-resident that forms part of a PE in South Africa.

When a resident replaces the asset with one located in a PE outside South Africa, any capital gain on that asset may be placed outside the South African tax net and for this reason para 66 will not apply. This could happen, for example, when an offshore company that is a resident (a CFC) has a foreign branch that carries on a 'foreign 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 South Africa (para 2). If the non-resident replaces such an asset with one that is not part of a PE in South Africa, the replacement asset will not fall

[491] The reference to s 11D(2) was inserted in para 66(1)(*a*), (*c*) and (4) by s 67 of the Taxation Laws Amendment Act 8 of 2007, deemed to have come into operation on 2 November 2006 and applies in respect of any disposal on or after that date.
[492] The references to ss 12DA and 37B was inserted in para 66(1)(*a*), (*c*) and (4) by s 79 of the Revenue Laws Amendment Act 35 of 2007, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2008.

within the South African tax net. For this reason the replacement asset must also form part of a PE in South Africa if the non-resident wishes to enjoy the deferral benefits of para 66 when disposing of the old asset.

- The relief applies when 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 in which 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 before 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 be 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 in which 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

- para 66(4), which spreads the capital gain in proportion to capital allowances on any depreciable replacement assets,
- para 66(5), which triggers any untaxed remaining portion of a capital gain when the replacement asset is disposed of, and
- para 66(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.
- para 66(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 when 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 para 66(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:

$$\text{Disregarded capital gain attributed to replacement asset} \times \frac{\text{Allowance or deduction claimed in year of assessment}}{\text{All qualifying allowances or deductions for all years of assessment based on cost or value of replacement asset at date of acquisition}}$$

Any allowances on improvements to a qualifying replacement asset 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 in which 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. When 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 under para 66 when 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 when 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 (para 67)

Paragraph 67

This rule provides for a deferral ('roll-over') of a capital gain or loss when an asset is transferred between spouses.

13.3.1 Scope and application

Paragraph 67 applies when 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.

The term 'spouse' is defined in s 1 as follows:

> '**"[S]pouse"**, 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.'

In divorce settlements it sometimes happens that the courts will take the assets of a discretionary family trust into account in arriving at a settlement.[493] This does not mean that the court has pierced the trust or declared it invalid; merely that the trust's assets have been taken into consideration in arriving at the amount payable out of the personal estate of one of the parties to the divorce. In these circumstances roll-over relief will apply because the assets are being transferred from one former spouse to the other, and not from the trust.

Example – Assets of a discretionary trust taken into consideration in arriving at a divorce settlement

Facts:

A and B are in the process of becoming divorced. A's estate is worth R50 and B's estate is worth R100. A is a beneficiary of a discretionary family trust. The value of the trust's net assets at the date of divorce is R100. The court determines that A has *de facto* control over

[493] *Badenhorst v Badenhorst* 2006 (2) SA 255 (SCA) and *Jordaan v Jordaan* 2001 (3) SA 288 (C). See also (January 2010) 82 *TSH* at 9.

the trust and hence that it is just and equitable that the trust be taken into account in arriving at a settlement.

Result:

The court directs that A must pay B R25. The amount of R25 comes out of A's assets, and not those of the trust. Thus, after the settlement the parties' assets are as follows:

	R
A's assets (R50 – R25)	25
Discretionary family trust's assets	100
	125
B's assets (R100 + R25)	125

The transfer of assets to the value of R25 from A to B qualifies for roll-over relief under para 67(2)(*b*).

By contrast, roll-over relief will not apply to assets of a discretionary trust that are distributed to a party to the divorce in his or her capacity as a beneficiary, since the trust is a separate legal person for tax purposes and not a 'spouse' as required by para 67(2)(*b*). In these circumstances the trustees would have exercised a discretion in awarding an amount to one of the divorced parties who is a beneficiary.

13.3.2 The transferor (disposing) spouse

Paragraph 67(1)(*a*) provides that the disposing spouse must disregard any capital gain or loss when disposing of an asset to his or her spouse.

13.3.3 The transferee (acquiring) spouse

Paragraph 67(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 and where applicable, from the executor of the deceased estate of that person's spouse,[494] namely,

- the dates of acquisition and incurral of expenditure,
- the expenditure incurred,
- the currency in which the expenditure was incurred,[495]
- the usage, and
- any amount received or accrued in respect of the asset that would have constituted proceeds on disposal of the asset had it been disposed of to a person other than the transferee.[496]

[494] Paragraph 67(1)(*b*) was amended by s 57(*a*) of the Revenue Laws Amendment Act 20 of 2006 to include expenditure incurred by the executor of the deceased estate of the transferor spouse. The amendment is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

[495] Paragraph 67(*b*)(iii) was amended by the Revenue Laws Amendment 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.

[496] Paragraph 67(1)(*b*)(v) inserted by s 80(1)(*c*) of the Revenue Laws Amendnment Act 35 of 2007, deemed to come into operation on 30 October 2007 and shall apply applies in respect of any asset disposed of on or after that date.

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. Any amount received by or accrued to the transferor that would have constituted proceeds on disposal of the asset is also carried across to the transferee spouse. One example of such an amount is a capital distribution from a company received or accrued on or after valuation date and 30 September 2007 [see para 76(1)(*b*)]. Another example arises when the transferor spouse has disposed of the asset under a suspensive sale agreement, has received some proceeds, and thereafter transfers the rights under the contract to the transferee spouse in whose hands the condition will be fulfilled.

Under para 29(4)(*a*)(iii) the transferee spouse is deemed to have adopted or determined any market value on valuation date that was adopted or determined by the transferor spouse.

Under 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 and his or her executor if deceased. 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 transferor spouse under para 68.

Example – Business use of asset before 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 before she acquired it will be taxable in her hands.

13.3.4 Assets acquired from a deceased spouse

Paragraph 67(2)(*a*) provides that a deceased person must be treated as having disposed of an asset to his or her surviving spouse, if ownership of that asset is acquired by that surviving spouse by

- *ab intestato* or testamentary succession, or
- as a result of a re-distribution agreement between the heirs and legatees of that deceased person in the course of liquidation or distribution of the deceased estate of that deceased person.[497]

The words '*ab intestato*' mean 'from a person dying intestate'. In such a case the assets of the deceased devolve upon the heirs according to the law of intestate succession.[498] Testamentary succession refers to the situation in which assets are bequeathed under a last

[497] Paragraph 67(2)(*a*) was amended by s 57(*b*) of the Revenue Laws Amendment Act 20 of 2006. The amendment deleted a reference to assets accruing to a spouse on date of death (which is not accurate, since they only accrue once the liquidation and distribution account is approved). It also inserted the reference to redistribution agreements. The amendment is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.
[498] Intestate Succession Act 81 of 1987.

will and testament. Roll-over relief does not apply to the transfer of an asset from the deceased estate to a surviving spouse in satisfaction of a maintenance claim by the surviving spouse under s 2 of the Maintenance of Surviving Spouses Act 27 of 1990 since such a claim does not arise by testamentary succession.

A deceased person will only qualify for roll-over relief under para 67(2)(*a*) if 'ownership' of the assets is transferred to the surviving spouse. Assets transferred to a *bewind* for the benefit of a surviving spouse will clearly meet this requirement, since the surviving spouse would be awarded ownership in the assets *ab initio*. But what of an asset transferred to a testamentary trust in which the surviving spouse is given a vested right in the asset under the will? Can a vested right be equated with ownership? It is considered that the legislature intended the word 'ownership' as used in para 67(2)(*a*) to refer to beneficial ownership. This intent can be seen from para 11(1)(*d*) which provides that the vesting of an asset in a beneficiary by a trustee is a disposal. Once vesting occurs the beneficiary must account for the CGT consequences of the asset despite ownership of the asset in reality remaining in the trust. Paragraph 11(1)(*d*) has the effect that ownership of the asset is deemed to have been transferred to the beneficiary for CGT purposes.

Under para 40(1) the assets of a deceased person are deemed to be disposed of at market value at date of death. Excluded from this deemed disposal are assets transferred to the surviving spouse of a deceased person as contemplated in para 67(2)(*a*) [para 40(1)(*a*)]. In this way the deceased is relieved of any CGT liability in respect of the relevant assets. Despite this non-disposal treatment under para 40(1)(*a*), para 67(2)(*a*) takes precedence and deems the deceased person to have disposed of his or her assets to his or her spouse for the purposes of para 67(1) when the spouse acquires ownership of those assets through intestate succession, inheritance or as a result of a redistribution agreement. This has the effect of making the roll-over provisions of para 67(1) applicable to the assets acquired by the transferee spouse. It will accordingly only be possible to finalise the CGT consequences for the deceased and his or her spouse once the liquidation and distribution account has lain open for inspection for the prescribed period and no objection has been lodged against it, for it is only at this point that the surviving spouse acquires ownership of the assets.

Under a redistribution agreement the heirs can agree to redistribute the assets of the estate among themselves. Heirs receiving assets worth more than what they originally inherited may, under the agreement, have to pay in the difference to the estate. The liquidation and distribution account will reflect the effect of the redistribution agreement, and as noted above, it will only be possible to finalise the CGT consequences for the deceased person and the surviving spouse once the account has lain open for inspection for the prescribed period without objection having been lodged against it.[499]

Assets inherited from a spouse before valuation date

Paragraph 67(2)(*a*) does not apply when a surviving spouse inherits an asset from his or her spouse before valuation date. In such a case there will be no roll-over of expenditure or dates of acquisition and incurral from the deceased spouse to the surviving spouse. There are several reasons for this. First, under para 67(2)(*a*) the deceased is deemed to have *disposed of* his or her assets to his or her spouse for the purposes of para 67(1). Under para 2, the Eighth Schedule only applies to disposals on or after the valuation date, and this includes a deemed disposal under para 67(2)(*a*). Secondly, para 97 applies to disposals between spouses during the transitional period, which implies that para 67(2)(*a*) does not apply retrospectively. Finally, there is a general presumption against the retrospective interpretation of a statute (see **1.2.7)**. Since para 67(2)(*a*) does not apply, the cost and date of acquisition must be ascertained from the facts. It is submitted that the time of acquisition in most cases is the date on which the survivor became unconditionally entitled to the asset.

[499] Section 35(12) of the Administration of Estates Act 66 of 1965.

In most cases this would be the date of confirmation of the liquidation and distribution account by the Master. The cost of acquisition must be determined in accordance with common law principles taking into account the extinction of the personal right to claim delivery – see **8.5A**. Usually 'B' in the TAB formula will be equal to the market value of the asset at the time of its acquisition by the transferee spouse. 'N', being the number of years before the valuation date will be determined from the actual date of acquisition described above, and not from the date on which the deceased spouse acquired the asset.

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 under 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 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 – Redistribution agreement

Facts:

Under Jack's last will and testament, he bequeathed his farm valued at R3 million to his wife Jill and his share portfolio valued at R2,5 million to his son Walter. The base cost of the farm in Jack's hands was R500 000, and that of the share portfolio, R700 000. Both the farm and the shares were acquired by Jack after valuation date. There is no primary residence on the farm. Jill and Walter entered into a redistribution agreement under which

- Walter would take over the farm and pay R500 000 into the estate for the benefit of Jill, and
- Jill would take over the share portfolio.

What are the CGT implications for Jack, Jill and Walter?

Result:

Jack

Jack will have a capital gain on disposal of his farm, determined as follows:

	R
Proceeds from deemed disposal	3 000 000
Less: Base cost	(500 000)
Capital gain	2 500 000

There will be no gain or loss in respect of the disposal of the shares, since there will be a roll-over to Jill under para 67(2)(*a*).

Jill

Jill will acquire the share portfolio at Jack's base cost of R700 000.

Walter

Walter will acquire the farm at a base cost of R3 million under para 40(2)(*b*). The R500 000 paid by Walter to the estate is disregarded, since para 40 is the sole determinant of Walter's acquisition cost for the purposes of para 20(1)(*a*).

13.3.5 Divorce of spouses

Paragraph 67(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 under 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	

13.3.6 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 para 67(1).

Example – Transfer of assets to non-resident spouse

Facts:

Bruce and Sheila plan to immigrate 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 R	Market Value 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 under para 38, while Sheila will only be liable for CGT when she disposes of the Plettenberg Bay property.

13.4 Interests in collective investment schemes in property (para 67A)

Paragraph 67A

13.4.1 Capital gain or loss to be determined on disposal [para 67A(1)]

This paragraph deals with a holder of a participatory interest in a 'portfolio of a collective investment scheme in property' as defined in s 1 (CISP). The s 1 definition reads as follows:[500]

> '"**[P]ortfolio of a collective investment scheme in property"** means any portfolio comprised in any collective investment scheme in property contemplated in Part V of the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002), managed or carried on by any company registered as a manager under section 51 of that Act for the purposes of that Part."

A CISP is 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.

13.4.2 Determination of capital gain or loss [para 67A(2)]

A holder of an interest in a CISP 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.

13.4.3 Amounts of a capital nature treated as proceeds [para 67A(3)]

[Effective 22 December 2003 and substituted with effect from 1 October 2007]

Under the Collective Investment Schemes Control Act, 2002 it is possible for a CISP to return capital 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.

Before 1 October 2007 the amount of cash or assets received from a CISP before disposal of the holder's interest were treated as proceeds on disposal of that interest.

Part-disposal treatment under para 67AB was introduced for such amounts with effect from 1 October 2007 and para 67A(3) was substituted with effect from that date.[501] In addition a transitional measure was introduced to deal with pre-1 October 2007 capital distributions under the weighted average method. The table below summarises the treatment of distributions of a capital nature received before, and on or after 1 October 2007.

Proceeds comprise

- the amount of any cash received, and
- the market value of any asset received determined on the date of its acquisition,

[500] The definition was inserted in s 1 by s 6(1)(*x*) of the Taxation Laws Amendment Act 7 of 2010 and deemed to have come into operation as from the commencement of years of assessment commencing on or after 1 January, 2010.

[501] Paragraph 67AB was inserted by s 82(1) of the Revenue Laws Amendment Act 35 of 2007 and para 67A(3) was substituted by s 81(1) of the same Act. Both amendments are deemed to come into operation on 1 October 2007.

- which do not constitute gross income in the hands of the holder. In other words, the amount will exclude interest or rent, but include an amount of a capital nature.

Table 1 – Treatment of a distribution of a capital nature of cash or asset from a CISP

Circumstance	Paragraph	Treatment of amount of cash or market value of asset
1. Specific identification and first-in-first-out methods		
DISTRIBUTION RECEIVED OR ACCRUED ON OR AFTER VALUATION DATE BUT BEFORE 1 OCTOBER 2007		
Interest disposed of before 1 October 2007	67A(3)(*a*)(i)	Treat as proceeds when the interest is disposed of.
Interest disposed of on or before 1 July 2011	67A(3)(*a*)(i)	Treat as proceeds when the interest is disposed of.
Interest not disposed of on or before 1 July 2011	67A(3)(*a*)(ii) 67AB(1)(*a*)	Treat as proceeds on a part-disposal on 1 July 2011.
DISTRIBUTION RECEIVED OR ACCRUED ON OR AFTER 1 OCTOBER 2007	67A(3)(*b*) 67AB(1)(*b*)	Treat as proceeds on a part-disposal when the distribution is received.
2. Weighted average method		
DISTRIBUTION RECEIVED OR ACCRUED ON OR AFTER VALUATION DATE BUT BEFORE 1 OCTOBER 2007		
Interest disposed of before 1 October 2007	67A(3)(*a*)(i)	Treat as proceeds when the interest is disposed of.
Interest held on 30 September 2007	67A(3A)	Determine weighted average base cost at end of day on 30 September 2007 by • deducting the amount of the cash or the market value from the base cost of the interests at the end of the day on 30 September 2007, and • dividing the result by the number of the interests held at the end of the day on 30 September 2007.
Interest disposed of before 1 July 2011	Core rules	No action required since base cost already reduced as at 30 September 2007. Determine capital gain or loss by deducting base cost from proceeds.
Interest still held on 30 June 2011	67AB(1A)	If base cost is a negative amount at the end of 30 June 2011 the holder must be treated as having a capital gain on 30 June 2011 equal to that negative amount, and the base cost of those participatory interests at the end of 30 June 2011 must be treated as nil.
Interest disposed of on or after 1 July 2011	Core rules	No action required since distribution deducted from base cost on 30 September 2007. Determine capital gain or loss by deducting base cost from proceeds.
DISTRIBUTION RECEIVED OR ACCRUED ON OR AFTER 1 OCTOBER 2007	67A(3)(*b*) 67AB(1)(*b*)	Treat as proceeds on a part-disposal when the distribution is received.

13.4.4 Weighted average method and distributions received before 1 October 2007 [para 67A(3A)]

Before 1 October 2007 a capital distribution was treated as proceeds on disposal of an interest in a CISP, even when the weighted average method in para 32(3A)(*b*) was adopted This was at odds with the base cost deduction method applicable to shares under the weighted average method under para 76(2). Consequently, para 67A(3A) was introduced[502] as a transitional measure to bring the treatment in line with that applied to shares. As described in the table in **13.4.3**, any capital distributions received before 1 October 2007 must be deducted from the weighted average base cost of interests held on 30 September 2007.

13.4.5 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 under 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*).

13.4.6 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 year of assessment 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 to the date of disposal of their participatory interests. Paragraph 67A is aimed at obviating this result. A CISS is exempt from CGT under para 61.

13.5 Part-disposal of interests in collective investment schemes in property

Paragraph 67AB

Paragraph 67AB came into operation on 1 October 2007[503] and introduced part-disposal treatment for amounts of a capital nature received from a CISP. This provision must be read with para 67A.

When an amount of a capital nature comprising cash or an asset is received or acquired by the holder of a participatory interest in a CISP, a part-disposal will be triggered under para 67AB as follows:

[502] Inserted by s 82(1)(*b*) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation on 1 October 2007.
[503] Paragraph 67A(3) was substituted by s 82(1)(*a*) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation on 1 October 2007.

13.5.1 Deemed part-disposal on 1 July 2011 for capital distributions received before 1 October 2007 [para 67AB(1)(a)]

Except when the weighted average method has been adopted,[504] if the capital amount was received or acquired before 1 October 2007 and the participatory interest is still held on 1 July 2011, a part-disposal is deemed to occur on 1 July 2011.

13.5.2 Deemed part-disposal when capital distributions received on or after 1 October 2007 [para 67AB(1)(b)]

If cash or an asset is received or acquired on or after 1 October 2007, a part-disposal is triggered on the date of receipt of the cash or date of acquisition of the asset, to the extent that the amount of that receipt does not constitute gross income in the hands of that holder.

13.5.3 The weighted average method and negative base cost on 30 June 2011 [para 67AB(1A)]

Under the weighted average method a holder of a participatory interest in a CISP who received a capital distribution before 1 October 2007 must deduct it from the base cost of that participatory interest at 30 September 2007 [para 67A(3A)]. Under para 67AB(1A),[505] if the base cost of the holder's interests is a negative amount at the end of 30 June 2011

- that holder must be treated as having a capital gain on 30 June 2011 equal to that negative amount, and
- the base cost of those participatory interests at the end of 30 June 2011 must be treated as nil.

13.5.4 Determination of the part disposed of [para 67AB(2)]

In determining a capital gain or loss in respect of the part-disposal, it is necessary to determine the portion of the base cost that has been disposed of under para 33. For the purposes of para 33(1) the market value of the part disposed of must be treated as being equal to the amount of the cash received or the market value of the asset acquired.

13.6 Transfer of a unit by a share block company to its member (para 67B)

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. Under 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.

[504] The reference to the weighted average method was inserted in para 67AB(1)(*a*) by s 83(1)(*a*) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation on 1 October 2007.

[505] Paragraph 67AB(1A) was inserted by s 83(1)(*b*) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation on 1 October 2007.

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 under para 20 of acquiring shares	Cost of acquisition.
(*b*)	Cost under 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 under para 29(4) in respect of share	Market value adopted or determined under 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 R1,5 million primary residence exclusion. Paragraph 67B is effective from 1 October 2001.

13.7 Mineral rights conversions and renewals (para 67C)

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 under that Act. It provides that there is no disposal under para 11 when 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 under 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

Paragraph 67C	Type of old right	Type of disposal to be disregarded	Roll-over relief
(*a*)	• Old order right, or • OP26 right as defined in Schedule II of the Mineral and Petroleum Resources Development Act 28 of 2002.	When an old order right or OP26 right wholly or partially • continues in force, or • is converted into a new right under the same Schedule.	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.
(*b*)	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.	When an existing right Is wholly or partially renewed under that Act,	

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.

13.8 Communications licence conversions

Paragraph 67D

Paragraph 67D[506] deals with the conversion of existing licences referred to in Chapter 15 of the Electronic Communications Act 36 of 2005 to new licences under s 93 of that Act. The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009 provides the following background to the insertion of para 67D:

> 'Telecommunications licences are regulated by the Independent Communications Authority of South Africa (ICASA). Under the current system, the old telecommunications licences were technologically specific. This meant that the services which mobile

[506] Paragraph 67D was inserted by s 77 of the Taxation Laws Amendment Act 17 of 2009 and is deemed to have come into operation on 1 January 2009 and applies in respect of licences converted on or after that date.

> telecommunications service providers offered were mutually exclusive from the services provided by non-mobile telecommunications service providers. In an effort to promote a more open and competitive environment, ICASA has sought to eliminate the system of exclusive rights granted to certain telecommunications companies for the provision of fixed communications or mobile cellular communications. In effect, all licences will be comprehensive – covering both fixed and mobile telecommunication operations.
>
> 'This conversion from existing narrow licences to new comprehensive licences has occurred pursuant to the direction of ICASA under the broad mandate of section 93 of the Electronic Communications Act 36 of 2005 (ECA). The conversions occurred pursuant to *Government Gazette* 31803 of 16 January 2009 . . .
>
> 'The industry-wide conversion under Section 93 of the ECA will not be treated as a disposal for capital gains tax purposes. The conversion is outside the control of the relevant parties and re-arranges telecommunication rights for the industry as a whole. The conversion should instead be viewed as a rollover event (with the tax attributes of the existing licences generally rolled over into the new licences) so that all gains and losses are deferred until the converted licences are subject to a subsequent disposal.
>
> 'More specifically, rollover treatment will be achieved by creating a dual set of rules (one for capital gains purposes and the other for deprecation purposes under normal tax). Both sets of rules will cover a simple conversion of an existing licence to a new licence as well as the conversion of multiple existing licences to a new licence and the conversion of a single licence into multiple licences. No provisions are necessary for telecommunications licences as trading stock.'

(Spelling of 'licenses' corrected.)

Paragraph 67D(1) provides for a no gain / no loss disposal of existing licences. The licensee is deemed to dispose of an existing licence for an amount equal to its base cost on the date of conversion.

Under para 67D(2) a new licence is deemed to be acquired at a cost recognised for the purposes of para 20 equal to the expenditure on the existing licence or licences which gave rise to that new licence. On a one-for-one conversion the expenditure on the existing licence is carried across to the new licence. On a consolidation of multiple existing licences into a single new licence, the aggregate cost of the existing licences is carried across to the new licence. On a split of an existing licence into multiple new licences, the cost of the existing licence must be allocated across the new licences in proportion to the relative market values of the new licences.

The licensee is deemed to have incurred the cost allocated to the new licence on the day immediately after the conversion.

Since the existing licence is deemed to be disposed of on the date of conversion, it follows under para 13(2) that the new licence is deemed to be acquired on the same date. A new licence will therefore always be a post-valuation date asset and the market value, TAB or 20% of proceeds methods used for determining a valuation date value for pre-valuation date assets cannot be used to determine the base cost of a new licence. This was done in order to keep the determination of base cost of a new licence as simple as possible.

Example – Conversion of existing licences to a single new licence

Facts:

Telecommunications Company owns two existing telecommunications licences – pre-existing Licence A and pre-existing Licence B. Pre-existing Licence A was acquired for R40 million on 1 April 1998 and has a useful life of 15 years. Pre-existing Licence B was acquired for R80 million on 1 January 2008 and has a useful life of 20 years.

In 2008 the company claimed a depreciation allowance of R4 million for pre-existing Licence B under s 11(*g*D), which was introduced in 2008. On 16 January 2009 both licences are converted into new Combined Licence under s 93 of the Electronic Communication Act. The new licence has a 20-year useful life.

Result:

The s 93 conversion does not result in a capital gain or a recoupment.
Combined Licence has an expenditure under para 20 (and a depreciable cost) of R116 million [R40 million plus R80 million less the R4 million previously deducted under s 11(*g*D)].

The depreciation of the R116 million is based on a 20-year useful life starting from the day immediately after conversion (17 January 2009).

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, or
- 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.

Under 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).

A beneficiary of a trust is a connected person in relation to a trust.[507] It follows that transactions between the trust and its beneficiaries must take place at market value (para 38). And from the trust's perspective capital losses arising from transactions with beneficiaries will be clogged (ring-fenced) (para 39), except in the case of certain rights, marketable securities or equity instruments disposed of to employees under s 8A or 8C [para 39(4)].

[507] Paragraph (*b*)(i) of the definition of 'connected person' in s 1.

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 to 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 under 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) 38(1)(*b*) 20 35 13(1)(*a*)(iiA), 38(1)(*b*) 20	*2008 and prior years of assessment* Trust not taxed – not a disposal Capital 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 Base cost of right disposed of = market value at time of vesting Base cost of asset acquired = market value at time of exchange *2009 and subsequent years of assessment* No capital gain or loss arises in the trust since it is deemed to distribute the asset at the time of vesting. No capital gain or loss in hands of beneficiary since exchange of rights deemed to occur on date of vesting (proceeds will equal base cost). 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*) 2(1)(*b*)	*2008 and prior years of assessment* 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

	13(1)(*a*)(iiA)	*2009 and subsequent years of assessment* No capital gain or loss arises in the trust since it is deemed to distribute the asset at the time of vesting. Vested interest in para 2(1)(*b*) asset – same provisions apply as for a resident beneficiary (no capital gain or loss). Vested interest in other assets – no capital gain or loss arises since such assets fall outside the Eighth Schedule.
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 (for example, annual exclusion, primary residence exclusion). [Subject to attribution to donor under 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 under 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 under 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	The capital gain is taxed in the trust in the year in which the asset is disposed of. When the earlier year gain is distributed in a subsequent year, no further gain or loss should arise in the trust or the beneficiary's hands, since • the Eighth Schedule does not make provision for the attribution of earlier year capital gains from resident trusts,

		• the withdrawal of an amount from a rand denominated bank account will not result in a further gain or loss because the para 38 proceeds should equal the base cost of the bank account, and • the receipt of the trust capital will not result in a gain in the beneficiary's hands because ➢ the beneficiary's right to claim the distribution will have a base cost equal to market value under para 38, and ➢ upon receipt of the distribution that right is disposed of for proceeds equal to that market value.
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 earlier year capital gains, including amounts that would have been capital gains had the trust been a resident	80(3)	Capital gains taxed in beneficiary's hands in year of vesting
Current year capital gain arising from vesting of asset contemplated in para 2(1)(*b*) (South African immovable property or assets of a permanent establishment in South Africa)	80(1)	Capital gain taxed in beneficiary's hands in year of vesting of asset
Vesting of current year capital gain arising from disposal of para 2(1)(*b*) asset	80(2)	Capital gain taxed in beneficiary's hands in year in which it vests

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 English Court of Chancery developed the trust 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 South African law. South African courts have evolved and are still in the process of evolving the law of trusts by adapting the trust idea to the principles of South African law.[508]

In the 1915 Appellate Division case of *Estate Kemp & others v McDonald's Trustee,* Solomon *JA* said the following:[509]

> '[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.*[510]

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 a 'person' in s 1 of the Income Tax Act includes 'any trust'. This definition was inserted following the decision in *CIR v Friedman & others NNO*[511] 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').

[508] *Braun v Blann & Botha NNO & another* 1984 (2) SA 850 (A) at 859.
[509] *Estate Kemp & others v McDonald's Trustee* 1915 AD 491 at 507.
[510] 1925 TPD 693, 1 SATC 163.
[511] 1993 (1) SA 353 (A), 55 SATC 39.

- Founder transfers ownership of assets to beneficiaries but control rests with the trustees ('*bewind*').
- Trustee administers affairs of another for example, 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*, 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

In a *bewind* 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* the ownership of the assets of the trust vests in the beneficiary, but the administration of the trust vests in the trustee or *bewindhebber*.[512]

For CGT purposes the *bewind* 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 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 under the last will and testament.

14.5.3 Vesting and discretionary trusts

Vesting trust – Under a vesting trust the assets and income of the trust are vested in the beneficiaries. The beneficiaries have vested rights to the income and or capital.

Discretionary trust – Under a discretionary trust 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.

While the above descriptions 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

[512] *Bafokeng Tribe v Impala Platinum Ltd & others* 1999 (3) SA 517 (BH) and *C: SARS v Dyefin Textiles (Pty) Ltd* 2002 (4) SA 606 (N), 65 SATC 126 at 131.

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 to 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 under the core rules and the attribution rules in paras 68 to 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 a '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 under s 10(1)(*c*N), and hence CGT under para 63A if it is approved by the Commissioner as a public benefit organisation (PBO) under s 30. In order 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 under 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 impossible 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 (for example, 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 United Kingdom criminal case should serve as a warning to persons making use of such trusts to conceal assets.[513]

Bare trust (or simple trust) – Under a bare trust (found in the United Kingdom especially) the beneficiaries have immediate and absolute entitlement to the income and capital of the trust,

[513] See P Webb 'Cold Stone Jug' (Nov/Dec 2003) *Accountancy SA* 29, also available online at <http://www.accountancysa.org.za/archives/2003/2003nov/columns/deathtaxes.htm> [Accessed 8 December 2011].

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.[514]

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 while not binding on the trustees, they will in practice give effect thereto. It can be amended at any time.

14.6 The trustee

The term 'trustee' is defined in s 1 as follows:

> '**"[T]rustee"**, 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.[515]

Although legal ownership of the trust assets vests in the trustee, a trustee does not enjoy beneficial ownership of the trust assets.[516] In this regard Joubert JA said the following in *Braun v Blann & Botha NNO & another*: [517]

> '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.'

In *Crookes NO & another v Watson & others* Steyn JA stated the following:[518]

> '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[519]

> '[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.[520]

14.7 Rights of beneficiaries

In order 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

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[514] See <http://www.hmrc.gov.uk/manuals/cgmanual/CG34320.htm> [Accessed 8 December 2011].
[515] Under para (*c*) of the definition of 'representative taxpayer' in s 1.
[516] *Estate Kemp & others v McDonald's Trustee* 1915 AD 491.
[517] 1984 (2) SA 850 (A) at 859.
[518] 1956 (1) SA 277 (A) at 305.
[519] 1961 (3) SA 833 (A), 24 SATC 282 at 840G – H.
[520] Section 9(1) of the Trust Property Control Act 57 of 1988; *Sackville West v Nourse & another* 1925 AD 516; *Administrators, Estate Richards v Nichol & another* 1999 (1) SA 551 (SCA).

- Personal and real rights

14.7.1 Vested rights

A 'vested right' can have a different meaning depending on the context in which the words are used. This was highlighted in the case of *Jewish Colonial Trust Ltd v Estate Nathan*[521] in which 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:[522]

> '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).[523] 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 (above) at 177 to the foot of p 181.'

The principles set out above and in a number of other cases are summarised in the table below.

Table 2 – Characteristics of a vested right

Case Law	Characteristic
Jewish Colonial Trust Ltd v Estate Nathan[524].	A vested right Is certain as opposed to a contingent right which is conditional.
In re Allen Trust ;[525] *Estate Dempers v SIR*[526] and ITC 1328.[527]	Enjoyment of a vested right may be postponed.
ITC 76[528] and *CIR v Polonsky*.[529]	A vested right is an accrued right.
ITC 1328 above.	It is not a necessary consequence of vesting that the beneficiary has a legal right to claim payment.
CIR & others v Sive's Estate.[530]	Property may be vested in a trustee purely for the purpose of administration.

[521] 1940 AD 163 at 175–6.
[522] (1980) 43 SATC 56 (N) at 60.
[523] At SATC 112.
[524] 1940 AD 163 at 175–6.
[525] 1941 NPD 156.
[526] 1977 (3) SA 410 (A), 39 SATC 95 at 112.
[527] (1980) 43 SATC 56 (N) at 59–60.
[528] (1927) 3 SATC 68 (U).
[529] 1942 TPD 249, 12 SATC 11.
[530] 1955 (1) SA 249 (A) at 269.

Greenberg & others v Estate Greenberg.[531]	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, that is, after confirmation of the liquidation and distribution account.
Hiddingh v CIR;[532] *Hansen's Estate v CIR*;[533] ITC 1656.[534]	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 & others v McDonald's Trustee;[535] *Braun v Blann & Botha NNO & another*.[536]	While 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 while the income or capital in the trust property can be vested in a beneficiary. A vested right is a personal right.[537]

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*[538] and *Rosen*[539] cases. The position can be compared to an agent acting on behalf of a principal, although a trustee is not an agent.[540] A beneficiary who has a vested right of this nature has an interest in the underlying assets. In *Hansen's Estate v CIR*[541] 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 *locus 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*, while the time of enjoyment is referred to as *dies venit*.[542]

14.7.2 Contingent rights

A contingent right is merely a *spes* – an expectation that might never be realised (see *Jewish Colonial Trust* case above and ITC 76.[543]

For example, a beneficiary will have a contingent right when a trustee has a discretion as to

[531] 1955 (3) SA 361 (A).
[532] 1940 AD, 11 SATC 54 at 211.
[533] 1956 (1) SA 398 (A), 20 SATC 254.
[534] (1998) 61 SATC 195 (C) at 200.
[535] 1915 AD 491.
[536] 1984 (2) SA 850 (A) at 860A.
[537] *SIR v Rosen* 1971 (1) SA 172 (A), 32 SATC 249 at 189; *CIR v Lazarus' Estate & another* 1958 (1) SA 311 (A), 21 SATC 379 at 320, 21 SATC 379; *Estate Kemp & others v McDonald's Trustee* 1915 AD 491 at 503 506 510; *Levin v Gutkin, Fisher & Schneier* 1997 (3) SA 267 (W) at 284D.
[538] *Armstrong v CIR* 1938 AD 343, 10 SATC 1 at 6.
[539] *SIR v Rosen* 1971 (1) SA 172 (A), 32 SATC 249 at 267.
[540] *Hoosen & others NNO v Deedat & others* 1999 (4) SA 425 (SCA) at 431G–H.
[541] 1956 (1) SA 398 (A), 20 SATC 246 at 255.
[542] Per Heher J in *Jowell v Bramwell-Jones & others* 1998 (1) SA 836 (W) 872G–H.
[543] (1927) 3 SATC 68 (U) at 70.

- 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.[544] 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*.

14.7.5 Exchange of rights

The position before the commencement of years of assessment ending on or after 1 January 2009

The definition of an 'asset' in para 1 is framed in wide terms and embraces both personal and real rights. A beneficiary of a trust 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 under para 11(1)(*a*).

Some commentators have argued that there is no separate acquisition of the actual asset upon its distribution by the trustee and hence no exchange of rights by virtue of para 11(2)(*e*) read with para 13(2). Paragraph 11(2)(*e*) states that there is no disposal

> 'by a trustee in respect of the distribution of an asset of the trust to a beneficiary to the extent that that beneficiary has a vested interest in that asset'.

And para 13(2) states that

> '[a] person to whom an asset is disposed of is treated as having acquired that asset at the time of disposal of that asset as contemplated in subparagraph (1)'.

Since there is no time of disposal by the trustee it is argued that there can be no time of acquisition by the beneficiary.

However, this analysis is flawed because para 13(2) does not regulate the time of acquisition of all assets. Merely because the disposing party does not have a disposal does not mean that the acquirer does not have an acquisition. For example, under para 11(2)(*b*) the issue

[544] *De Leef Family Trust NNO v CIR* 1993 (3) SA 345 (A), 55 SATC 207 at 216.

by a company of its own shares is deemed not to be a disposal, yet, it can hardly be suggested that a shareholder who receives those shares does not acquire them.[545]

Example 1 – Exchange of personal right for real right (old rules)

Facts:

The John Smith Will Trust was created under 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, under 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 realised 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 under para 38 because

- John is a connected person in relation to the trust, being a beneficiary,[546] 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).

Under 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 is a disposal under 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 the commentary on the exchange of an asset as a disposal event in **6.1.1.5**. 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 **8.5**.

Upon disposal of the farm John's capital gain is R600 000 [R1 800 000 (proceeds) – R1 200 000 (base cost)].

[545] See Gerard Swart 'Interpreting Some Core Concepts Governing the Taxation of Capital Gains' (2005) 17 *SA Merc LJ* 1 at 14.
[546] Paragraph (*b*)(ii) of the definition of 'connected person' in s 1.

The position as from the commencement of years of assessment ending on or after 1 January 2009

Three amendments have been effected by the Revenue Laws Amendment Act 60 of 2008 to prevent the triggering of a capital gain or loss in the hands of a beneficiary having a vested interest in an asset when the trustee distributes that asset to the beneficiary. These amendments involve the deletion of paras 11(2)(*e*) and 13(1)(*d*) and the insertion of para 13(1)(*a*)(iiA) which reads as follows:

> '**13. Time of disposal.—**(1) The time of disposal of an asset by means of—
>
> (*a*) 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 is, in the case of—
>
> (i) & (ii) [not applicable]
>
> (iiA) the distribution of an asset of a trust by a trustee to a beneficiary to the extent that the beneficiary has a vested interest in the asset, the date on which the interest vests.'

The effect of the above provision is to take the time of disposal of the asset by the trust back to the time of vesting of that asset. Correspondingly, under para 13(2) the time of acquisition of the asset by the beneficiary is taken back to the time when that beneficiary acquired a vested interest in the asset. When the trustee distributes the asset, there will still be a disposal by the beneficiary in the form of an exchange of the vested interest in the asset for a real right in the asset, but it will not give rise to a capital gain or loss because the proceeds (being the market value of the real right received or accrued) will equal the base cost of the vested interest in the asset (being equal to market value established under para 38 when acquired from the trust). Going forward, the base cost of the asset is equal to the amount by which the beneficiary is impoverished through giving up the vested interest in the asset, being the same market value.

Example 2 – Exchange of personal right for real right (new rules)

Facts:

The facts are the same as in the previous example, except that the transaction takes place during the 2009 year of assessment.

Result:

As in the above example John acquires the farm at a base cost of R1 000 000 under para 38(1)(*b*).

Exchange of personal right for real right

When John takes transfer of the farm there is a disposal under para 11(1)(*a*) as a result of the exchange of rights. This exchange is backdated to the time of vesting under para 13(1)(*a*)(iiA). The effect is that the proceeds from the disposal, being the real right in the farm, must be determined at the time of vesting which results in no capital gain or loss.

	R
Proceeds (market value of farm received – para 35)	1 000 000
Less: Base cost of vested right [para 38(1)(*b*)]	(1 000 000)
Capital gain or loss	-

Base cost of farm

The base cost of the farm is established under para 20(1)(*a*) through an exchange transaction, and is equal to the amount by which John was impoverished in giving up the vested right in the farm at the time of vesting, namely, R1 000 000.

Sale of farm

When John sells the farm there will be a disposal under para 11(1)(*a*) giving rise to a capital gain as follows:

	R
Proceeds from sale of farm (para 35)	1 800 000
Less: Base cost of farm [para 20(1)(*a*)]	(1 000 000)
Capital gain	800 000

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 rule subject to the core principles governing disposals, base cost and proceeds as well as to the general anti-avoidance and loss limitation rules. The disposal 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*) to (*b*A) of the definition of a 'connected person' in s 1, which read as follows:

> '**"[C]onnected person"** means—
>
> (*a*) in relation to a natural person—
>
> (i) any relative; and
>
> (ii) any trust (other than a portfolio of a collective investment scheme in securities) of which such natural person or such relative is a beneficiary;
>
> (*b*) in relation to a trust (other than a portfolio of a collective investment scheme in securities)—
>
> (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 and other than a portfolio of a collective investment scheme in securities), 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 beneficiary of the John Smith Trust.

Under 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, realising a capital loss of R500.

Result:

Under 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 use it against current or future capital gains arising from transactions with the Abe Trading Trust.

14.9 The CGT consequences of vesting trusts

14.9.1 What is a vesting trust?

A vesting trust can be described as one in which all the assets have been vested in the beneficiaries.

14.9.2 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 cannot be attributed to a beneficiary, and will either be taxed in the trust or be attributed to a donor under para 68, 69 or 72. No flow through of capital gains is permitted when 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 to 72 are addressed in **Chapter 15**.

14.9.3 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).

14.9.4 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 on vested rights).

14.9.5 Transfer of vested asset to beneficiary

Before the commencement of years of assessment ending on or after 1 January 2009 the transfer of a vested asset to a beneficiary resulted in an exchange of rights, requiring the determination of a capital gain or loss by the beneficiary. On or after this date as a result of the introduction of para 13(1)(*a*)(iiA) the transfer of an asset to a vested beneficiary results in no capital gain or loss. For a detailed explanation see **14.7.5**.

14.9.6 Admission of additional vested beneficiary

Some trust deeds permit a new beneficiary to invest cash in an existing vesting or *bewind* in which the market value of the assets differs from their base cost. These trust structures are typically set up as private equity funds. Under such an arrangement the new beneficiary

- will acquire a vested right in the pre-existing assets at market value, and
- the pre-existing beneficiaries will dispose of a fractional interest in those assets in exchange for a vested right in the cash invested by the new beneficiary.

This will trigger a capital gain or loss in the pre-existing beneficiaries' hands. The CGT treatment in these cases is similar to the admission of a new partner in a partnership.

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 under para 80 be taxed in the hands of the *resident* beneficiary in whom that right vests unless that gain is attributed to another person under para 68, 69, 71 or 72.

14.11 Attribution of capital gain to resident beneficiary (para 80)

Paragraph 80

14.11.1 Some general observations on para 80(1) and (2)

A trust is a 'person' for tax purposes and a taxpayer in its own right. Any capital gain or loss arising in a trust must therefore be determined and accounted for by that trust unless there is a specific rule which directs that the capital gain or loss must be accounted for by another person. Such a rule describes a process known as 'attribution'.

Two sets of attribution rules exist, namely,

- those that attribute a capital gain to a donor (paras 68 to 72), and
- those that attribute a capital gain to a beneficiary (para 80).

These rules only attribute capital gains; capital losses are never attributed, and thus will always remain in the trust.

A capital gain will usually arise in a trust when it disposes of an asset. Two of the most common forms of disposal by a trust are

- the sale of an asset by the trust to a third party [para 11(1)(*a*)], and
- the vesting of an interest in an asset of a trust in a beneficiary [para 11(1)(*d*)].

The proceeds that accrue to a trust upon the vesting of an asset in a beneficiary will usually be determined under para 38. This is because the beneficiary and the trust are connected persons in relation to each other, and in that situation the trust and its beneficiaries are required to account for the transaction at market value. In other words, the trust will have proceeds equal to the market value of the asset and the beneficiary will have a cost of acquisition for the vested right acquired equal to that same market value.

A capital gain may also have to be accounted for by a trust as a result of attribution, for instance, when a resident trust is a beneficiary of another trust. On the vesting of a capital gain through multiple discretionary trusts, see **14.11.5.1** [para 80(1)] and **14.11.6.3** [para 80(2)].

Paragraph 80(1) deals with the attribution of a capital gain from a trust to a resident beneficiary at the time of vesting. In the case of a non-resident beneficiary any capital gain arising in the trust on vesting will either be taxed in the trust or be attributed to a resident donor under para 72. The beneficiary, whether resident or non-resident, acquires the asset at the time of vesting at a base cost equal to its market value. After the asset has been vested in a resident or non-resident beneficiary the trust is out of the picture for CGT purposes since it has disposed of its asset under para 11(1)(*d*) and has nothing more to dispose of. After acquiring the vested interest in the asset, the beneficiary must account for any further capital gain or loss that arises when the asset is disposed of to a third party.[547] The trustee's role after vesting becomes that of a pure administrator whose actions are performed on behalf of the beneficiary – see **14.7.1**.

Importantly, a capital gain arising in a trust cannot be attributed to another person unless the attribution rules in paras 68 to 72 or 80 provide for it. This point is particularly important when dealing with non-resident beneficiaries (see **14.11.4**).

Paragraph 80(1) and (2) deal with attribution to resident beneficiaries, and are subject to the special attribution rules in paras 68 to 72. In other words, paras 68 to 72 take precedence over para 80(1) and (2). What this means is that the flow-through of a capital gain to a resident beneficiary under para 80(1) or (2) may be blocked when paras 68 to 72 apply. The relevant capital gain will instead be taxed in the hands of the person specified in these special attribution rules, which are described in the table below.

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

[547] See SARS Binding Private Ruling BPR 056 dated 23 October 2009.

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. Under para 2(1)(*b*), the Eighth Schedule only applies to the following assets of a non-resident:

- immovable property in South Africa,
- Any right or interest in immovable property in South Africa,
- Shares in a company holding immovable property in South Africa (under certain conditions), and
- Assets of a permanent establishment in South Africa.

Only these specific South African-source assets can give rise to capital gains in 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). Capital gains on 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, for example, 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)

The attribution rules in para 80(1) and (2) do not apply to the events set out in the table below:

Table 5 – Events not subject to attribution

Event	Treatment under 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 under 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 upon the vesting of assets in beneficiaries or as a result of the disposal of assets to third parties,	Capital losses remain in the trust.	
Capital gains that were subjected to CGT in an earlier year that are vested in a subsequent year.	Capital gains arising in the trust in respect of an earlier year that were not vested in that earlier year are taxed in the trust unless attributed to a donor under para 70. When subsequently vested they will not again be taxed in the beneficiary's hands.	
A capital gain arises in a trust but there is no corresponding capital profit available for vesting (see **14.11.6**)		
Asset vested in the Government, a provincial administration, organisation, person or club contemplated in para 62(*a*) to (*e*)	The trust must disregard any capital gain or loss under para 62.	Paragraph 80(1) precludes such attribution.[548]
A capital gain vested in a person, organisation, entity or club contemplated in para 62(*a*) to (*e*)	The trust will be subject to CGT on the capital gain unless it is attributed back to a donor under paras 68 to 72.	Paragraph 80(2) precludes such attribution.[549] The exclusion in para 62 does not apply because the capital gain does not arise from the disposal of an asset to the exempt / partially exempt entity.

The conduit-pipe principle and non-resident beneficiaries

The default position is that a trust must account for any capital gain or loss that arises when it disposes of an asset. As discussed in **14.11.1**, para 80 provides an exception to the default position by attributing a capital gain from the trust in which it arises to a resident beneficiary. No mention is made in para 80(1) and (2) of a non-resident beneficiary, and so no attribution to such a person is possible.

[548] Paragraph 80(1) was amended to preclude attribution to the entities contemplated in para 62(*a*) to (*e*) by s 86(*a*) of the Revenue Laws Amendment Act 60 of 2008. The amendment is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

[549] Paragraph 80(2) was amended to preclude attribution to the entities contemplated in para 62(*a*) to (*e*) by s 86(*b*) of the Revenue Laws Amendment Act 60 of 2008. The amendment is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

It has been argued[550] that the conduit-pipe principle established in *Armstrong v CIR*[551] and confirmed in *SIR v Rosen*[552] should apply as a matter of general application, notwithstanding that para 80(1) and (2) only permit attribution to resident beneficiaries. In other words it is contended that the capital gains arising on vesting are not taxable in the trust, but flow directly through to the non-resident beneficiaries under the common law. At issue is whether the legislature intended to modify the common law. In *Nedbank Ltd & others v National Credit Regulator & another* Malan JA stated the following:[553]

> 'The rule of interpretation is that a statutory provision should not be interpreted so as to alter the common law more than is necessary unless the intention to do so is clearly reflected in the enactment, whether expressly or by necessary implication:
>
> "[I]t is a sound rule to construe a statute in conformity with the common law, save where and insofar as the statute itself evidences a plain intention on the part of the Legislature to alter the common law. In the latter case the presumption is that the Legislature did not intend to modify the common law to any extent greater than is provided in express terms or is a necessary inference from the provisions of the enactment."[80]
>
> 'Steyn[81] cautioned:
>
> "'n Doelbewuste afwyking moet nie verwring word om in die vorms van die gemene reg te kan inpas nie.".'
>
> [80] *Mills v Starwell Finance (Pty) Ltd* 1981 (3) SA 84 (N) at 87B – D and further *S v Leeuw* 1980 (3) SA 815 (A) at 823F – G; *Casserley v Stubbs* 1916 TPD 310 at 312; *Joss v Board of Executors* 1979 (1) SA 780 (C) at 782A – C; *Gouws v Theologo & others* 1980 (2) SA 304 (W) at 306C – D; *Shell South Africa (Edms) Bpk v Gross h/a Motor Maintenance* 1980 (4) SA 151 (T) at 152H – 153A; *Johannesburg Municipality v Cohen's Trustees* 1909 TS 811 at 818.
>
> [81] L C Steyn *Die Uitleg van Wette* (5 ed) (1981) at 99.

The above quote from *Steyn* can be translated as follows:

> 'An intentional deviation must not be distorted in order to fit into the forms of the common law.'

In the matter under discussion the key question is whether the legislature plainly intended to deviate from the common law by necessary implication because the legislature did not exclude the common law in express terms.

In *The Queen v The Inhabitants of Watford,* Lord Denman CJ stated the following:[554]

> 'It is important to keep in view the state of the law, with which we must assume that the Legislature was acquainted, when that statute passed.'

In *Fluor Corporation and Affiliates v The United States* Bryson, Circuit Judge, echoed the above principle in stating that[555]

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[550] David Clegg 'Non-Resident Beneficiaries of a Trust and the Conduit Principle' (January 2008) 57 *The Taxpayer* 7, Trevor Emslie 'CGT: Resident, Non-Resident and PBO Trust Beneficiaries' (May 2010) 59 *The Taxpayer* 84 and follow-up article by the same author in (September/October 2010) 59 *The Taxpayer* 162, and Lynette Olivier and Michael Honiball *The Taxation of Trusts in South Africa* (1 November 2009) Siber Ink, South Africa at 139.
For views which agree with those expressed in this guide see C Divaris (2009) 79 *TSH* and (2010) 87 *TSH;* M L Stein *Capital Gains Tax – Stein* [CD-ROM] (*My LexisNexis:* March 2010) in 10.1, *Silke* in § 24.127 and R C Williams *Capital Gains Tax – A Practitioner's* Manual 2 ed (2005) Juta Law Publishers at 80.
[551] 1938 AD 343, 10 SATC 1.
[552] 1971 (1) SA 172 (A), 32 SATC 249.
[553] *Nedbank Ltd & others v National Credit Regulator & another* [2011] JOL 26939 (SCA) at 22.
[554] (1846) 9 QB 626 at 635.
[555] 126 F.3d 1397; 80 A.F.T.R.2d 97-6022, 97-2 USTC P 50,615 in 47.

> '[f]amiliar principles of statutory construction teach that Congress is presumed to be aware of judicial interpretations of the law, and that when Congress enacts a new statute incorporating provisions similar to those in prior law, it is assumed to have acted with awareness of judicial interpretations of the prior law. See *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 382 n. 66, 102 S.Ct. 1825, 1841 n. 66, 72 L.Ed.2d 182 (1982); *Lorillard v. Pons*, 434 U.S. 575, 589, 98 S.Ct. 866, 875, 55 L.Ed.2d 40 (1978); *Kelly v. United States*, 826 F.2d 1049, 1052 (Fed.Cir.1987).'

This principle has also been recognised by the courts in South Africa. In *Fundstrust (Pty) Ltd (In Liquidation) v Van Deventer* Hefer JA stated the following:[556]

> 'The principle that Parliament is presumed to be acquainted with the existing law and with the interpretation of earlier legislation by the Courts can only be applied if the words in question had acquired a settled and well-recognised judicial interpretation before the relevant legislation was passed (*Ex parte Minister of Justice: In re R v Bolon* 1941 AD 345 at 360).'

It can thus be assumed that the legislature was aware of the conduit-pipe principle at the time it enacted para 80. Indeed if one has regard to the historical developments relating to the taxation of trusts and their beneficiaries in South Africa it is plain that this was the case.

The general rule of interpretation is that a statute must be construed as a whole.[557] It is, therefore, also necessary to look beyond para 80 to determine why that provision was worded in the way that it was at the time of its enactment.

In *Trustees of the Phillip Frame Will Trust v CIR*[558] it was held that a trust was not a 'person' for tax purposes and that making a trustee a 'representative taxpayer' did not make a trust a taxable entity. As a result of this case the definition of a 'person' was amended in 1991[559] to include 'any trust'. At the same time, s 25B was inserted[560] to ensure that the conduit-pipe principle could continue to be applied to income vested in the same year of assessment in which it was derived. Without s 25B(1) the conduit-pipe principle would have been blocked because the effect of deeming a trust to be a 'person' was to cause a trust to be a taxpayer in its own right.

In *Rosen's* case Trollip JA stated the following:[561]

> 'Consequently *Armstrong's* case in my view authoritatively established the conduit principle for general application in our system of taxation *in appropriate circumstances*.
>
> . . .
>
> 'The principle rests upon sound and robust common sense; for, by treating the intervening trustee as a mere administrative conduit-pipe, it has regard to the substance rather than the form of the distribution and receipt of the dividends.'

(Emphasis added.)

In arriving at its conclusion the court was primarily concerned with the problem of economic double taxation between a company and its shareholders. Mrs Rosen had received a distribution of income derived from dividends earned on shares held by a trust, and one of the issues facing the court was whether she was entitled to the 'dividend allowance', whose purpose was to alleviate economic double taxation. At that time dividends were taxable in the hands of individuals and to prevent effectively taxing a company's profits twice (that is, in

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[556] 1997 (1) SA 710 (A) at 732
[557] Per Centlivres JA in *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A), 15 SATC 381 at 389.
[558] 1991 (2) SA 340 (W), 53 SATC 166. The decision of the court *a quo* was upheld in *CIR v Friedman & others NNO* 1993 (1) SA 353 (A), 55 SATC 39.
[559] Amended by s 2(1)(*b*) of the Income Tax Act 129 of 1991.
[560] Inserted by s 27(1) of the Income Tax Act 129 of 1991.
[561] At SATC 267.

the company and in the shareholder's hands) a dividend allowance was granted to the shareholder under the then s 19(3). The court held that the income retained its character as dividends in Mrs Rosen's hands, and she was therefore entitled to the dividend allowance.

There is a vast difference between the legislative provisions that prevailed at the time of the *Armstrong* and *Rosen* cases and the provisions that are currently enacted. In the case of a discretionary trust the trustee is no longer merely an 'administrative conduit pipe' for tax purposes. The trust has been clothed with its own separate legal *persona* and is a taxable entity in its own right. The trust is the beneficial owner of its assets until they are disposed of through vesting [para 11(1)(*d*)] or otherwise (for example, by sale). There is also no question of double taxation in the way in which para 80 operates. The intention of the legislature in not providing for attribution to non-resident beneficiaries was to prevent loss to the *fiscus*, since non-residents are only subject to CGT on a limited range of assets (immovable property in South Africa and assets of a PE in South Africa). The capital gains are derived by the trust and are clearly within South Africa's taxing jurisdiction. South Africa has a right to keep such capital gains within its jurisdiction by only permitting attribution to resident beneficiaries. There is accordingly no question of discrimination against non-resident beneficiaries. The legal maxim *expressio unius est exclusio alterius*[562] supports the view that by specifically only mentioning a resident beneficiary in para 80(1) and (2) the legislature intended to exclude non-resident beneficiaries.

The conduit-pipe principle cannot, therefore, be applied to override the legislative intent. Paragraph 80 remains the sole mechanism for attributing a capital gain arising in a trust to a beneficiary.

If a capital gain has not been attributed out of a trust to a specific person then the 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 beneficiary of a trust in the year in which it arises will be taxed in 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 under para 72 in the hands of the resident who made that donation, settlement or other disposition.

It has also been contended that the legislature recognised the conduit-pipe principle in relation to non-resident beneficiaries in para 72. The argument is that para 72 states that the capital gain must be disregarded in determining the aggregate capital gain or loss of the person in whom it vests, being, so it is contended, the non-resident beneficiary who was entitled to the capital gain under the conduit-pipe principle. However, para 72 does not mention a trust or beneficiaries. It was framed in wide terms and covers a variety of situations involving, amongst others, non-resident individuals, resident trusts with non-resident beneficiaries and non-resident trusts with non-resident beneficiaries. For example, if a non-resident trust sold immovable property in South Africa any resulting capital gain would vest in that trust and would have to be disregarded by it and taken into account by the resident donor. Even if the trustee of a non-resident trust vested such a capital gain in a non-resident beneficiary in the same year of assessment, the capital gain would still vest in the trust for CGT purposes because para 80(2) does not apply to a non-resident beneficiary. The same result would apply if a resident trust disposed of an asset and vested the resulting capital gain in a non-resident beneficiary. Again, the capital gain would vest in the resident trust for CGT purposes and it would have to disregard the capital gain. In the latter regard

[562] The expression of one thing implies the exclusion of the other. This maxim of interpretation was applied by De Villiers JA in *SA Estates and Finance Corporation Ltd v CIR* 1927 AD 230, 2 SATC 193 at 195. Although it was noted that the maxim 'was one which had at all times to be applied with great caution', the court found that its use was legitimate in the case under review.

para 72 refers to the *person* in whom the capital gain vests. There will be circumstances in which the person in whom a capital gain vests has no need to disregard the capital gain. In such a case the reference to a person disregarding a capital gain will simply not apply.

Vesting of capital gain arising in an earlier year of assessment

The vesting in a beneficiary of a capital gain that arose in an earlier year of assessment is not subject to attribution under para 80(2) since that provision only deals with a current-year vesting.

However, the vesting of a capital 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 an earlier-year capital gain 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 arise in the ordinary course of events.

14.11.5 Vesting of asset [para 80(1)]

The vesting of an interest in an asset of a trust in a beneficiary triggers a disposal by the trust under para 11(1)(*d*). When a capital gain is determined in a trust on vesting of an asset in a resident beneficiary, the gain must be disregarded by the trust and taken into account by the resident beneficiary [para 80(1)].

No attribution to non-resident beneficiaries

If a trustee vests an asset in a non-resident beneficiary, any resulting capital gain will remain in the trust, unless attributed to a resident donor under paras 68 to 72. Paragraph 80(1) provides no mechanism for attributing a capital gain to a non-resident beneficiary (see **14.11.4**). However, once vesting of the asset has taken place any further gain or loss arising on disposal of the vested asset must be accounted for by the beneficiary, whether resident or non-resident. In the case of non-resident beneficiaries, capital gains and losses will not arise after vesting unless the asset is immovable property in South Africa or an asset of a PE in South Africa [para 2(1)(*b*)].

No attribution of capital losses

There is also no mechanism for capital losses arising on vesting of an interest in an asset of a trust to be attributed to either resident or non-resident beneficiaries. Such losses must always be accounted for by the trust.

Attribution of a capital gain to a spouse married in community of property

Any capital gain arising on vesting of an interest in an asset of a trust in a resident beneficiary who is married in community of property is taxable in the hands of that beneficiary, and is not split between the beneficiary and his or her spouse. Note that para 14 only apportions a capital gain between spouses married in community of property when that gain arises on disposal of an asset by one of the spouses. It does not deal with an attributed capital gain arising on disposal of an asset by a trust.

Attribution to certain exempt bodies

Attribution to the various exempt and partially-exempt entities contemplated in para 62(*a*) to (*e*) (for example, an approved PBO or recreational club) is specifically precluded by para 80(1). However, any capital gain or loss arising on the vesting of an asset in such entities must be disregarded by the trust under para 62. This measure was introduced to

prevent the exempt or partially-exempt entity from being subject to CGT on an attributed capital gain.

14.11.5.1 Vesting of an asset through multiple discretionary trusts

Assume that discretionary Trust A's beneficiary is discretionary Trust B and Trust B's beneficiary is X, Trust A vests an asset in Trust B which results in a capital gain of R100 being attributed to Trust B under para 80(1). The question arises as to whether that capital gain can in turn be attributed by Trust B to X in the same year of assessment. Based on the wording of para 80(1), the view is held that Trust B must account for the capital gain, and the vesting of the same asset by Trust B in X will not result in the capital gain of R100 being attributed to X.

The words 'the trust' in para 80(1)(*a*) refer to the same trust in the opening words of the subparagraph, namely, the trust that determined a capital gain in respect of the vesting of an asset. No capital gain will arise in Trust B when it vests the asset in X because under para 38 Trust B acquires the asset for a base cost equal to market value at the time of vesting and its proceeds upon immediately vesting the asset in X are equal to that same market value. Trust B has therefore not determined a capital gain in respect of the vesting of an asset and para 80(1) can have no application.

14.11.6 Vesting of capital gain in same year of assessment [para 80(2)]

14.11.6.1 Application

Paragraph 80(2) applies when a capital gain is determined in respect of the disposal of an asset by a trust in a year of assessment during which a resident beneficiary [other than a person, organisation, entity or club contemplated in para 62(*a*) to (*e*)]

- has a vested interest, or
- acquires a vested interest (including an interest caused by the exercise of a discretion),
- in that capital gain but not in the asset, the disposal of which gave rise to the capital gain.

Paragraph 80(2) could apply to

- a discretionary trust when the trustee realises a capital gain on disposal of an asset to a third party and during the same year of assessment vests that capital gain in a resident beneficiary, or
- a vesting trust when the beneficiary has a prior vested right in the capital gain but not in the asset (this is similar to an income beneficiary).

When this occurs, the whole or the portion of the capital gain so vested

- must be disregarded for the purpose of calculating the aggregate capital gain or loss of the trust, and
- must be taken into account for the purpose of calculating the aggregate capital gain or loss of the beneficiary in whom the gain vests.

Any capital loss arising on disposal of an asset by a trust is not subject to attribution and will remain in the trust.

The special attribution rules in paras 68, 69, 71 and 72 take precedence over para 80(2).

A capital gain cannot be attributed to a person who is not a resident, since para 80(2) only allows for attribution to resident beneficiaries (see **14.11.4**).

Attribution is also not possible to the exempt and partially-exempt entities referred to in para 62(*a*) to (*e*), such as an approved PBO or recreational club. Such a capital gain must be accounted for by the trust, and may not be disregarded under para 62 because it does not arise from the disposal of an asset to such an entity, a pre-requisite for the application of para 62.

14.11.6.2 Vesting of capital gain in multiple beneficiaries

Should a capital gain arise in a discretionary trust, the trustee may

- vest it in multiple beneficiaries, or
- vest a part of it in a single or multiple beneficiaries and retain a portion in the trust. This may happen, for example, when the trustee wishes to use a portion of the capital gain against an unclogged capital loss that has arisen in the trust (that is, assuming para 39 does not apply).[563]

Example 1 – Vesting of capital gain in multiple beneficiaries

Facts:

The ABC Family Trust has three contingent beneficiaries, Nico, Ed and Deon, all of whom are South African residents over the age of 21. During year 1 the trustee disposed of immovable property which gave rise to a capital gain of R30 000. He immediately vested that gain in the three beneficiaries in equal proportions.

Result:

The capital gain of R30 000 is disregarded in the ABC Trust and each beneficiary is deemed to have a capital gain of R10 000 under para 80(2).

Example 2 – Vesting of portion of capital gain in multiple beneficiaries when trust has capital loss

Facts:

The facts are the same as in Example 1, except that the trust has a capital loss of R15 000 arising from the sale of some shares to a third party, and the capital gain on sale of the immovable property is R45 000. The trustee vested R30 000 in the three beneficiaries in equal shares, and retained the balance of the capital gain of R15 000 in the trust.

Result:

R30 000 of the capital gain of R45 000 is disregarded in the ABC Trust and each beneficiary is deemed to have a capital gain of R10 000 under para 80(2). The remaining portion of the capital gain (R15 000) is set off against the unclogged capital loss of R15 000, resulting in no gain or loss in the trust.

[563] Paragraph 80(2) was amended by s 58 of the Revenue Laws Amendment Act 20 of 2006 to include the italicised words 'the *whole or the portion of the capital* gain *so vested*'. The purpose of the amendment was to put it beyond doubt that a portion of a capital gain could be vested in single or multiple beneficiaries. The amendment is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

14.11.6.3 Capital gain flowing through multiple discretionary trusts

Can a capital gain flow through multiple resident discretionary trusts when it is vested by each consecutive trustee in the same year of assessment?

The words 'the trust' in para 80(2)(*a*) refer to the same trust mentioned in the opening words of the subparagraph, namely, the trust that has determined a capital gain in respect of the disposal of an asset.[564] A beneficiary that happens to be a trust does not determine a capital gain in respect of the disposal of an asset – it must simply account for the capital gain attributed to it under para 80(2)(*b*). Such an attributed capital gain cannot be further attributed.

It follows that a capital gain of a discretionary trust can only be attributed once and cannot flow through multiple resident discretionary trusts in the same year of assessment.

On the vesting of an asset through multiple discretionary trusts under para 80(1), see **14.11.5.1**.

Example – Consecutive vesting of capital gain by multiple trusts

Facts:

Trust B is a beneficiary of Trust A and Walter is a beneficiary of Trust B. Trust A and Trust B are discretionary trusts.

Trust A disposes of an asset in year 1 resulting in a capital gain which the trustee vests in Trust B in the same year of assessment. The trustee of Trust B then vests the same capital gain in Walter in year 1. All parties are residents.

Result:

Under para 80(2) the capital gain must be disregarded by Trust A and accounted for by Trust B. The attributed gain in Trust B is not one that arises from the disposal of an asset by Trust B. It cannot therefore be on-attributed to Walter.

14.11.6.3A Multiple vesting trusts and the flow-through principle

Unlike multiple discretionary trusts, the flow-through principle applies to multiple vesting trusts. This follows from para 11(1)(*d*), which results in the disposal of an asset of a trust to a beneficiary when that asset is vested in that beneficiary.

Example – Multiple vesting trusts and the treatment of a capital gain or loss

Facts:

Trust B has a vested interest in all the assets of Trust A. Muneer has a vested interest in all the assets of Trust B. In year 1 Trust A disposes of an asset to a third party.

[564] The words 'arises in a trust' which appeared in the opening words of para 80(2) were substituted with 'determined in respect of the disposal of an asset by a trust' by s 86(*b*) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009. The purpose of the amendment was to bring the wording in line with that used in para 80(1). As for the position before this amendment, the view is held that attribution of a capital gain through multiple discretionary trusts was not possible.

Result:

Trust A and Trust B are unaffected by the transaction for CGT purposes because they have already disposed of the asset to their respective beneficiaries on vesting under para 11(1)(*d*).

In year 1 Muneer must account for any capital gain or loss on disposal of the asset by Trust A. The actions of the trustee of Trust A are actions on behalf of Muneer.

The above applies whether Muneer is a resident or a non-resident.

14.11.6.4 Vesting of capital profits v capital gains

Under para 80(2) a trustee can vest a capital gain in a beneficiary. In determining what a trustee can vest, one must have regard to the trust deed, which is likely to refer to the accounting concept of profits of a capital nature. It could therefore be argued that it is impossible for a trustee to vest a capital gain, as it is an artificial tax concept that may bear little resemblance to the actual economic or accounting capital profit. But the legislation has to be given meaning, and the legislature no doubt intended that the vesting of a capital gain should as far as possible follow the real-life vesting of accounting capital profits.

In the context of pre-valuation date assets, it is evident that in some cases a capital gain will arise while for accounting purposes there may be a lesser capital profit, a loss or a break-even situation. In these situations vesting of the capital gain in a beneficiary will only be possible to the extent that a capital profit is available for vesting. The principle that a trustee cannot vest deemed income was established in *Hulett v CIR.*[565]

Can a capital gain arising under para 12(5) upon waiver of a trust loan be attributed to a resident beneficiary under para 80(2)? The first step in the enquiry should be to determine whether para 12(5) is in fact applicable. For example, if the founder of the trust sold an asset to the trust on loan account and later waived the loan, the base cost of the asset would have to be reduced under para 20(3)(*b*). In this situation para 12(5) would not apply because of the exclusion in para 12(5)(*a*)(*aa*)(B). The next enquiry is whether the capital gain is capable of vesting. Vesting will only be possible to the extent that there is a parallel accounting capital profit which can be vested under the trust deed. Assuming that the trust is solvent, the waiver of the loan would give rise to a capital profit (that is, debit loan, credit capital profit). The capital profit could then be vested by, for example, debiting the capital profit and crediting the beneficiary's loan account or by distributing it in cash. Under this scenario the capital gain would be regarded as having vested for the purposes of para 80(2). However, if, for example, the trust has accumulated accounting losses that exceed the capital profit, it is doubtful whether vesting can occur because the capital profit would be absorbed by the losses. It would in any event be imprudent for a trustee to vest a capital profit in these circumstances as it may put trust creditors at risk. The point is that capital gains cannot be vested under para 80(2) on the basis of nomination or election – there must be an actual vesting conferring unconditional entitlement to trust property on the beneficiary.

In conclusion, therefore, it may be possible to vest a para 12(5) capital gain, but it will depend on the facts and circumstances of the particular case.

[565] 1944 NPD 263, 13 SATC 58.

Example 1 – Capital gain but accounting capital loss

Facts:

The trustees of the ABC Family Trust have elected to use the weighted-average method to determine the base cost of listed shares. The following details relate to the disposal by the trustees of listed shares in XYZ Ltd:

	R
Original cost	100
Market value on valuation date	50
Proceeds	70

Result:

The capital gain of R20 (R70 – R50) cannot be vested in a beneficiary since there is an overall accounting capital loss of R30 (R70 – R100).

The reverse situation could also occur, namely, an accounting capital profit but a CGT capital loss. Since capital losses cannot be vested, the capital loss could not be attributed to a beneficiary even if the accounting capital profit were to be vested in that beneficiary.

If a capital profit exceeds a capital gain, it will be possible, based on the wording of para 80(2), for the trustee to attribute the entire capital gain to a beneficiary by distributing an equal amount of capital profit. In other words, it is not necessary for the entire capital profit to be distributed before it can be said that the capital gain has been attributed. However, should the trustee fail to specify what is being distributed, the allocation of the capital gain between the trust and the beneficiary will have to be done on a pro rata basis. This follows from the fact that a capital profit is fungible.

Example 2 – Attribution of capital gain when capital profit exceeds capital gain

Facts:

The ABC Family Trust is a discretionary trust. During a year of assessment the trust disposed of a pre-valuation date asset, details of which were as follows:

	R
Original cost	100 000
Market value on 1 October 2001	160 000
Proceeds	210 000

The accounting records reflected a capital profit of R110 000 (R210 000 – R100 000).

The trustees adopted the market value method for determining the valuation date value of the asset. This resulted in a capital gain of R210 000 – R160 000 = R50 000. Before the end of the year of assessment, the trustees passed a resolution vesting the capital gain of R50 000 in a beneficiary of the trust. The pre-CGT capital profit of R160 000 – R100 000 = R60 000 was retained in the trust.

Result:

Under para 80(2) the beneficiary will be subject to CGT on a capital gain of R50 000.

Example 3 – Attribution when capital profit exceeds capital gain and source of distribution is not specified

Facts:

The facts are the same as in Example 1 except that the trustee failed to specify the source of the distribution.

Result:

The capital gain of R50 000 will be apportioned as follows:

	R
To trust R50 000 x R60 000/R110 000 (taxed in trust)	27 273
To beneficiary R50 000 x R50 000/R110 000 [para 80(2)]	22 727
	50 000

14.11.7 Tax-saving 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. If a resident acquires a vested right to any amount representing the capital of any trust which is not a resident and

- the capital arose from
  - a capital gain of the trust; or
  - any amount which would have been a capital gain if the trust was a resident;

  determined in any previous year of assessment during which the resident had a contingent right to that capital[566]
- 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.

This provision mirrors s 25B(2A) in the Act. It does not have retrospective effect as the term 'capital gain' is defined in para 1 and refers only to a capital gain arising on or after the valuation date. Paragraph 80(3) does not address the attribution of a capital gain which arises in and is vested in the same year of assessment (that is, it only deals with prior year capital gains which have been capitalised).

[566] Paragraph 80(3)(*a*)(i) and (ii) were substituted by s 62 of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009. Before its amendment, para 80(3)(*a*)(ii) appeared to read as an alternative to para 80(3)(*a*)(i). It was, however, intended to widen the scope of para 80(3)(*a*)(i) and was amended to give effect to this intention.

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 under 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, under 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 under 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 under 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
Less: 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
Less: Base cost of remaining interest (R100 000 – 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 under 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, that is, 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 under para 20(1)(*g*) for inclusion in the base cost of her right to the new shares. The total base cost directly attributable under 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 under s 7(3) and para 73 – gain vested in non-resident beneficiary taxed in trust or attributed to resident donor under 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 under 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, under 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 year of assessment 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 on 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 R	Base cost R	Capital gain 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% a year, 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 under s 7(3).

The amount of the income so deemed to be that of Deborah must under 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 a 'primary residence' in para 44. The gain of R40 000 must be taken into account in Ian's hands under 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 beneficiary of a trust asset or of the capital gain determined in respect of the disposal of a trust asset is, under 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 year of assessment 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 under para 80, as she is not a resident. R10 000 of the gain will be deemed back to Deborah under para 72, while 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
Less: 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 (para 81)

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' under para 38(1)(*b*) as regards the vesting of a right to an asset in a beneficiary of a trust. 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 under para 38(1)(*b*), and
- the discretionary interest in the trust – dealt with under para 81.

Any expenditure incurred by a beneficiary under 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 – Sale of discretionary interest in a trust

Facts:

Johanna, Kim, Les and Marius are the beneficiaries of a discretionary trust. The only asset of the trust 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 was 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 under para 80(1). The base cost of Marius' vested interest in the house is R300 000 under 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 a 'special trust', paras 5(1), 10(*a*) and 82

The term 'special trust' is defined in both the Eighth Schedule under para 1 and in s 1 of the Act.

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. Under para 1 a special trust means

> 'a trust contemplated in paragraph (*a*) of the definition of "special trust" in section 1'.[567]

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

[567] Inserted by the Revenue Laws Amendment Act 74 of 2002 and came into operation from the commencement of years of assessment ending on or after 1 January 2003.

14.13.2 Testamentary trusts for relatives who are minors [para (b)]

The second category covers trusts whose beneficiaries are nominated under the will of a deceased person. In order 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.

Under 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 (2010: R17 500), the primary residence exclusion (2010: R1,5 million), the exclusion for personal-use assets or the exclusion for 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 (para 82)

Paragraph 82

Under the definition of a ‘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 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. Under 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. If the asset has been financed by a low or interest-free loan from the donor the amount that can be attributed is limited to

- the interest saving enjoyed by the trust,
- less any income deemed back to the donor under s 7.

There is no limit on the extent of the attribution of a capital gain in the case of an asset funded by a donation. Just as all the income generated by the asset will be deemed back to the donor under s 7, so too will the entire capital gain be deemed back to the donor under these rules. Attribution cannot occur after a donor ceases to exist, for example, because of death.

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 under Part X, nor can they be set off against attributable capital gains before 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 to 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 under 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. Once a gain has been vested this does not apply and it will flow through to a 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 words 'donation settlement or other disposition' are used throughout the attribution rules in paras 68 to 72. These words have received extensive judicial consideration in relation to s 7, the leading case being *Ovenstone v SIR*.[568] A summary of the main principles that South African courts have developed in interpreting these words are summarised below.

[568] 1980 (2) SA 721 (A), 42 SATC 55.

- 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 consideration it is not a donation (see *The Master v Thompson's Estate*[569] and *Estate Welch v C: SARS*[570] and the commentary on the latter case in **8.7**), (*Ovenstone* case above).

- 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*[571]).

- 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's* case above)

- The expression 'donation, settlement or other disposition' must be read *ejusdem generis*[572] as 'donation, settlement or other similar disposition' (*Ovenstone's* case above). In other words, the word 'disposition' must be given a restrictive meaning.

- In *CIR v Woulidge*[573] 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.

- If the disposition contains both appreciable elements of gratuitousness and of proper consideration, an apportionment may be made between the two elements. This is for the purpose of determining the deemed income received by or accrued to 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 above at 740D–F). See also *Joss v SIR*.[574]

- 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's* case above).

- 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 under the attribution rules. It can only be applied in the real world of commerce and economic activity where it serves considerations of

[569] 1961 (2) SA 20 (FC), 24 SATC 157 at 24F–26C, 48F–49C.
[570] *Welch's Estate v C: SARS* 2005 (4) SA 173 (SCA), 66 SATC 303.
[571] 1962 (3) SA 748 (A) at 753F, 24 SATC 729 at 735–6.
[572] Under 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.
[573] 2002 (1) SA 68 (SCA), 63 SATC 483.
[574] 1980 (1) SA 674 (T), 41 SATC 206.

public policy in the protection of borrowers against exploitation by lenders (*Woulidge's* case above).

In deciding whether a capital gain is attributable to a donation, settlement or other disposition, the principle established in *CIR v Widan*[575] 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. This should be fairly easy to determine in the case of an asset financed directly by an interest-free or low-interest loan.

15.3 Attribution of capital gain to spouse (para 68)

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 under 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 under this rule taken into account only in the hands of that spouse when 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 (April 2010) the Commissioner administered 17 different Acts, sections of two Acts and any regulation, proclamation, government notice or rule issued under the listed legislation or any agreement entered into under this legislation or the Constitution. Some of the more well-known Acts administered include the following:[576]

- Securities Transfer Tax Act 25 of 2007
- 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
- Value-Added Tax Act 89 of 1991
- Tax on Retirement Funds Act 38 of 1996
- Skills Development Levies Act 9 of 1999
- Unemployment Insurance Contributions Act 4 of 2002

This rule also applies when 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 when 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 to so much of that person's gain as exceeds the amount of that person's

[575] *CIR v Widan* 1955 (1) SA 226 (A), 19 SATC 341.
[576] See Schedule 1 of the South African Revenue Service Act 34 of 1997 for a list of legislation administered by the Commissioner.

reasonable entitlement to the gain. The latter amount is determined taking into account amongst other things, the nature of the relevant trade, the extent of that person's participation in it and the services rendered by that person.

A donation by a person to that person's spouse will as a 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 under para 67. However, if the donation was made mainly for purposes of avoiding a tax, duty or levy administered by the Commissioner, the subsequent disposal of the 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 when 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 O R Tambo International Airport. Since Barker takes a leading role in the business, while 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. Under para 67 Barker was treated as making no gain or loss on the transfer, while 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 under 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 (para 69)

Paragraph 69

This rule mirrors the rule embodied in s 7(3) and (4) under 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 when 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 on or after the valuation date had the funds been borrowed from the bank:

Year ended 28 February	R
2001 (R15 000 x 5/12)	6 250
2002	15 000
2003	15 000
2004	15 000
	51 250

Under para 69, R51 250 of the capital gain of R205 000 will be taxed in the hands of Lorna, while the balance (R153 750) will be taxed in the hands of Conrad (R76 875) and Bronwyn (R76 875). For the purpose of determining the portion of the capital gain to be attributed to Lorna, the interest saved by the trust before the valuation date has not been taken into account, as the capital gain did not arise during that period.

15.5 Attribution of capital gain subject to conditional vesting (para 70)

Paragraph 70

Under 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

- when 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 when 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 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. Under 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 2002 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 28 February 2005 the trustee sold the shares at a capital gain of R60 000. Of this amount he vested R10 000 in Frank, while 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. Under para 70, R45 000 of the capital gain left in the trust must be taxed in the hands of Trevor, while 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. Had Trevor donated the amount of R100 000 to the trust, the entire amount of R50 000 would have been attributed to him.

15.6 Attribution of capital gain subject to revocable vesting (para 71)

Paragraph 71

Under para 71 a capital gain arising as a result of a revocable vesting can in certain circumstances be attributed to the donor.

The circumstances are those in which

- 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 s 7(6) of the Income Tax Act.

Example – Revocable vesting

Facts:

Scrooge Jr, aged 25, is the sole beneficiary of the Scrooge Family Trust. Under the trust deed the trustee has the discretion to vest the assets or income of the trust in Scrooge Jr. In addition, the trustee also has the power to revoke the vesting of the income or assets in Scrooge Jr should the trustee be satisfied that Scrooge Jr has acted irresponsibly in managing his financial affairs.

During year 1 the trustee vested a piece of land in Scrooge Jr giving rise to a capital gain of R100 000 in the trust. In year 2, after Scrooge Jr 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 Jr.

Result:

Under para 71 the capital gain of R100 000 will be taxed in the Scrooge Family Trust in year 1. **Note:** It is irrelevant that the vesting was revoked in the subsequent year of assessment. Attribution occurs because 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 (para 72)

Paragraph 72

Attribution rules apply when

- a donation, settlement or other disposition is made by a resident to any person[577] (other than an entity that is not resident and which is similar to a public benefit organisation contemplated in s 30)[578] and
- a capital gain (including any amount that would have constituted a capital gain had that person been a resident)[579] 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.

The word 'vest' means 'become unconditionally entitled to'. Although it is usually used in describing the action of a trustee in conferring entitlement to a capital gain or asset on a beneficiary, the word is used in a wider sense in para 72. This can be seen from the absence of a reference to a trust or a beneficiary in para 72. Thus, for example, a capital gain (including any amount which would have constituted a capital gain) will vest

[577] This person could be a resident (for example, a resident trust) or a non-resident.
[578] 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.
[579] The words in brackets were inserted by the Revenue Laws Amendment Act 31 of 2005, came into operation on 1 February 2006, and apply in respect of any capital gain determined in respect of any disposal on or after that date.

- in a non-resident trust if the trustee sells an asset to a third party and retains the capital gain; or
- in a non-resident individual who sells the asset giving rise to that capital gain.

The words 'treated as having vested' would apply, for example, to a resident or non-resident trust if the trustee vests a capital gain in a non-resident beneficiary. In this situation para 80(2) does not permit the attribution of a capital gain to a non-resident beneficiary, and the capital gain will for CGT purposes be treated as having vested in the trust.

The words

> 'any amount that would have constituted a capital gain had that person been a resident'

were inserted in para 72(*b*) from 1 February 2006 to widen the meaning of a capital gain in the context of a non-resident for the purposes of para 72. Under para 2(1)(*b*) the Eighth Schedule only applies to two categories of assets of a non-resident, namely, South African immovable property and assets of a PE in South Africa. Were it not for the above words, it could be argued that non-residents cannot derive capital gains from the sale of other assets such as listed shares, and hence that such gains cannot be attributed back to the resident donor. Section 7(8), the ordinary income equivalent of para 72, was similarly amended in 2004.

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). Under 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 under 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 under para 72, and the remaining R5 000 will be taxed in the trust. Paragraph 80 makes no provision for a flow through of a capital gain to a non-resident beneficiary.

Paragraph 72 does not apply to a person who made a donation, settlement or similar disposition to a trust before 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 & related appeal*[580] the House of Lords held that an individual, who had transferred assets abroad before 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.

[580] [1997] 4 All ER 65.

15.8 Attribution of income and capital gain (para 73)

Paragraph 73

An amount of income and a capital gain derived from or attributable to a donation, settlement or other disposition made by a person might be subject to the attribution rules 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 capital 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. In applying s 7 the word 'income' is not used in its defined sense of gross income less exempt income. This was the finding of the court in *CIR v Simpson*,[581] a case that dealt with the meaning of the word 'income' as used in the equivalent of s 7(2). After examining the history of the provision the court held that the word 'income' should be given its ordinary meaning of profits or gains (that is, after allowable deductions).

Based on the principle that 'income' means 'profits or gains' it is submitted that exempt income (for example, local dividends) is subject to attribution under s 7. This will reduce the amount of the benefit that can be used to attribute any capital gain. In addition, it is considered that s 7 must be applied before para 73.

Example 1 – Attribution of exempt income and capital gain

Facts:

At the beginning of year 1 Dirk lent R100 000 interest-free to his family trust. Had the trust borrowed the funds from a bank it would have paid interest at the rate of 10% a year. The trust used the funds to purchase South African-listed shares. During the year dividends of R3 000 were received. On the last day of the year of assessment the shares were sold for R110 000. Assume that the disposal is on capital account and that the Trust did not distribute the income of the trust or the capital gain to any beneficiary.

Result:

The benefit derived by the trust from the loan is R100 000 x 10% = R10 000. First, R3 000 of the benefit is deemed back to Dirk under s 7(5) as it represents the 'profit' of the trust (cf *Simpson's* case). Secondly, the remaining benefit of R10 000 – R3 000 = R7 000 is used to attribute R7 000 of the capital gain to Dirk. The remaining portion of the capital gain (R3 000) is taxed in the trust.

If an asset was acquired with an interest-free or low-interest loan before the valuation date, the amount of the benefit derived before that date must not be taken into account in determining how much of the capital gain to attribute to the 'donor'. The benefit in this instance is the non-charging of interest at an arm's length rate. Since the Eighth Schedule was introduced with effect from 1 October 2001, and given that base cost is determined at that date, it can only be the non-charging of interest on or after that date that contributed to the capital gain.

There is also a general presumption against the retrospective application of a statute (see **1.2.7**). It follows that the incidence of the tax should not be determined by events that took place prior to the valuation date.

[581] 1949 (4) SA 678 (A), 16 SATC 268.

Example 2 – 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 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% a year.

The property was let from the date of acquisition until the date of disposal and the following rental income was derived:
1998: R95 000, 1999: R100 000, 2000: R105 000, 2001: R110 000, 2002: R110 000, 2003: R120 000.

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 its income or capital gain to the beneficiaries of the trust.

Result:

The net rental income derived by the trust, the amount deemed back to Wayne under s 7(5) and the balance that could not be deemed back because the income was insufficient is summarised below.

The maximum amount that can be attributed to Wayne each year is as follows:
1998 year of assessment (1 July 1997 to 28 February 1998): R1 000 000 x 15% x 8/12 = R100 000
Subsequent years of assessment: R1 000 000 x 15% = R150 000

Year ended 28 February	Net rental income	Amount attributed to Wayne under s 7(5)	Balance of benefit [15% x R1 million x period less amount attributed under s 7(5)]
	R	R	R
1998	95 000	95 000	5 000
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
			210 000

The capital gain derived by the trust is as follows:

	R
Proceeds	1 500 000
Less: Base cost	(1 200 000)
Capital gain	300 000

The portion of this gain to be attributed to Wayne under para 73 is determined as follows:

	R
2002 R40 000 x 5/12	16 667
2003	30 000
	46 667

The remaining portion of the capital gain of R300 000 – R46 667 = R253 333 will be taxed in the trust. The continuing donation of interest before 1 October 2001 has not been taken into account in determining the quantum of the capital gain to be attributed to the donor. It is considered that since the capital gain relates to the post-1 October 2001 period, only the donation of interest during that period should be taken into account.

See Example 6 in **Chapter 14** for another example of the application of this rule.

15.9 Amnesty – attribution after deemed disposal by electing party

Section 4(3)(*b*) of the Exchange Control Amnesty and Amendment of Taxation Laws Act, 2003; Regulations issued under s 30 of the aforementioned Act[582]

15.9.1 Background

Under s 4 of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003 (Amnesty Act), 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.

15.9.2 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.'

15.9.3 Attribution during the period of deemed ownership

The use of the word 'while' in s 4(3)(*b*) of the Amnesty Act makes it clear that attribution under 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

[582] GN R 1368 *GG* 25511 of 29 September 2003.

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.

15.9.4 Attribution before the period of deemed ownership

Section 4(3)(*b*) of the Amnesty Act only suspended attribution during the period of deemed ownership. It said nothing about the period before 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 before 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*) of the Amnesty Act – in other words, for the purposes of suspending the attribution rules.

15.9.5 Resumption of attribution upon cessation of deemed ownership

The use of the word 'while' in s 4(3)(*b*) of the Amnesty Act 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 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.

SARS is aware that some financial institutions are aggressively punting a scheme which they claim prevents attribution under s 7(8) and para 72 after cessation of deemed ownership. The scheme involves the transfer of the assets of the trust to a second trust (referred to as a 'pour-over' trust). The promoters of the scheme contend that this will break the link between the original donation and the disposal of the assets by the pour-over trust, and hence render s 7(8) and para 72 ineffective. SARS does not accept this contention, since the capital gain in the pour-over trust is attributable to, and the proximate cause of, the original donation.[583] Taxpayers entering into such schemes face the prospect of the imposition of penalties and s 89*quat* interest should they fail to declare income and capital gains arising in the pour-over trust.

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 Propco Ltd, a company registered in the Cayman Islands. Propco'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 required election under s 4 of the Amnesty Act in respect of the Propco 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.

[583] See *CIR v Widan* 1955 (1) SA 226 (A), 19 SATC 341.

Result:

On 1 March 2002 Michael became the deemed owner of the Propco 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 year of assessment the capital gain arising in the Michael 2 Trust of R3 000 000 – R2 100 000 = R900 000 will be attributed to Michael under 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.

15.10 Right of recovery

Section 90

Under the proviso to s 90, any person may recover so much of the tax paid by him or her as is due to the inclusion in his or her taxable income of any capital gain under para 68, 69, 70, 71 or 72 from the person entitled, whether personally or in a representative capacity, to the proceeds on the disposal of the asset, which gave rise to the capital gain. This provision is aimed at preventing a cash-flow problem for the donor who has a deemed capital gain but lacks the funds to pay the attributable tax. The right to claim the tax back from the donee is at the discretion of the donor. It is submitted that for the purposes of para 12(5) no capital gain will arise when the donor fails to exercise a right of recovery under s 90. Before para 12(5) can be applied there must be a debt in existence, and this will only arise when and if the donor elects to exercise his or her right of recovery.

Chapter 16 – Deceased estates

16.1 Disposal to and from deceased estate (para 40)

Paragraph 40

16.1.1 Application

Paragraph 40 deals with three categories of persons, namely

- the deceased person in the year of death,
- that person's deceased estate (a separate taxable entity), and
- the heirs or legatees.[584]

16.1.2 The deceased person

Under para 40(1) a deceased person is treated as having disposed of his or her assets for an amount received or accrued[585] equal to their market value on the date of death. Three[586] exceptions to this rule do not trigger a disposal. They are as follows:

- Assets transferred to the surviving spouse as contemplated in para 67(2)(*a*).
- 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 under para 55.
- An interest in South African pension, pension preservation, provident, provident preservation or retirement annuity funds or their foreign equivalents, if the capital gain or loss from the disposal of that interest would have been disregarded under para 54.[587]

Assets transferred to the surviving spouse qualify for roll-over relief under para 67. This relief is similar to that granted to a deceased spouse for estate duty purposes under s 4(*q*) of the Estate Duty Act 45 of 1955. 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 the surviving spouse. The surviving

[584] A legatee is a person entitled to a stated sum of money or a specified asset or collection of assets under the last will and testament of the deceased.

[585] Section 79(1)(*b*) of the Revenue Laws Amendment Act 60 of 2008 replaced the word 'proceeds' with the words 'an amount received or accrued'. This was done to prevent double taxation, since proceeds are the end result after applying para 35(3)(*a*). Certain amounts such as the standard value of livestock are included in the income of a deceased person on the date of death, and the amendment ensures that the market value of the assets on date of death will be reduced by such inclusions in income. The amendment is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009. As regards the period before the amendment, the proceeds must be reduced under the common law principle of a 'necessary implication' against double taxation (*CIR v Delfos* 1933 AD 242, 6 SATC 92 at 112).

[586] Before the deletion of para 40(1)(*b*) by s 79(1)(*a*) of the Revenue Laws Amendment Act 60 of 2008 with effect from 1 March 2006, there were four exclusions. Paragraph 40(1)(*b*) excluded bequests to approved PBOs but was deleted because of the exclusion in para 62 and in order to enable a PBO to establish a base cost for inherited assets.

[587] The reference to pension and provident preservation funds was inserted in para 40(1)(*d*) by s 54 of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

spouse will only pay CGT upon disposal of the asset. The roll-over relief applies automatically and neither the deceased person nor the surviving spouse can elect out of the relief. See **12.3 – Transfer of asset between spouses**.

As noted above, under para 40(1) assets bequeathed to a surviving spouse are not treated as a disposal on the date of death. An apportionment of the primary residence exclusion of R1,5 million will be required if a fractional interest in the deceased's primary residence is bequeathed to the surviving spouse and the balance to someone else. See notes on para 45 in **11.3.**

Under para 62 any capital gain or loss determined in respect of an asset bequeathed to the Government or any provincial administration, a PBO approved under s 30(1), a recreational club approved under s 30A, or certain other entities exempt under s 10 must be disregarded. See **12.11**.

16.1.2.1 Record-keeping and valuation issues

An executor will have to select a valuation method if the deceased held pre-valuation date assets at the date of death. Should the deceased have 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 a record of pre-valuation date expenditure exists) or the '20% of proceeds' method. Taxpayers should keep records of costs and valuations performed in order to enable their executors to properly determine capital gains and losses. In the case of South African-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 under 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.[588] 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. 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(1) of the Eighth Schedule provides that upon death all a person's assets (with some exceptions) are treated as being disposed of at market value. The result is that the difference between the standard value and market value constitutes proceeds for CGT purposes. Livestock acquired on or after the valuation date will have a base cost of nil under para 20(3)(*a*) to the extent that the cost of its acquisition has been allowed as a deduction under s 11(*a*). The deduction under s 11(*a*) may be limited under para 8 of the First Schedule.

[588] Paragraph 5(1) of the First Schedule.

Example – Livestock on hand at date of death of taxpayer

Facts:

At the time of his death Farmer Brown held the following livestock:

	Unit cost	Standard value at date of death	Market value
	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 under 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 the TAB, market value or 20% of proceeds method. Although livestock could in certain circumstances 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.

Under s 26(2) a person who enters into a sheep lease is deemed to continue farming operations and must account for the livestock in question under the First Schedule. Paragraph 3(3) of the First Schedule deems any livestock which is the subject of a sheep lease to be held and not disposed of by the grantor of the sheep lease. The effect of this provision is to disregard the fact that in reality many of the original livestock may no longer be alive at the time when the sheep lease terminates (for example, when the grantor dies). If the sheep lease was entered into before the valuation date and expires on the death of the grantor after the valuation date the livestock on hand at the date of the grantor's death will be regarded as pre-valuation date assets and the valuation date values may be determined using the market value on valuation date, TAB or 20% of proceeds method.

16.1.2.4 Executor disposing of livestock to third parties

The deceased estate will acquire the livestock at a base cost equal to its market value on the date of death [para 40(1A)(*a*)]. Under para 4(1)(*b*)(ii)(*aa*) of the First Schedule the deceased estate is deemed to acquire the livestock as opening stock at the same market value.

If the executor disposes of the livestock to a third party the income received or accrued is deemed to be income of any ascertained heir under s 25(1). If there is no ascertained heir

s 25(1) directs that the income must remain in the deceased estate. If any such income is attributed to an ascertained heir under s 25(1), any related deduction will similarly be attributed to that heir under s 25(2). The effect of deeming the income and deductions to ascertained heirs is that there will be no reduction of the proceeds or base cost in the deceased estate under paras 35(3)(*a*) and 20(3)(*a*). The effect of this is that there could be a capital gain in the deceased estate and an income gain of the same amount in the hands of an ascertained heir, resulting in economic double taxation. This problem does not arise when there is no ascertained heir since in that event paras 20(3)(*a*) and 35(3)(*a*) will apply to the deceased estate.

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.

16.1.2.5 Plantations and growing crops

Under 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 farmland on date of death. It will accordingly comprise part of the proceeds on the deemed disposal of the farm property under 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 when the sale agreement specifies an amount in respect of those crops.[589] 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.[590] The same treatment applies on death, and the value of the standing crops will simply be included in the market value of the farmland and will form part of the proceeds on disposal of the farmland on date of death under para 40(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 a depreciable asset must be brought to account as proceeds [normally proceeds are reduced by the amount of any recoupment under para 35(3)(*a*)]. On the treatment of capital development expenditure of farmers, see **8.22**. On the treatment of a recoupment of capital allowances in the deceased estate see **16.1.3.3**.

16.1.2.7 Usufructs created on death

Usufructs created on the death of a person must be valued under para 31(1)(*d*). This involves determining the present value of the annual right of use at 12% a year over the expected life of the person receiving the benefit, or when the right of enjoyment is a lesser period, over that lesser period. Under 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 **24.1.1** for a more detailed explanation and a number of examples.

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[589] See 'Farming – Growing Crops, Sale of' *Income Tax Practice Manual* at [A:F15].
[590] *Baikie v CIR* 1931 AD 496, 5 SATC 193.

16.1.2.8 Annual exclusion in year of death

Under para 5(2) the annual exclusion of a deceased person in the year of death is R120 000 (2008 to 2010), R60 000 (2007) and R50 000 (2006 and earlier years of assessment). The 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. It is not subject to apportionment even when the period of assessment is less than a year. For more on the annual exclusion see **5.3.**

16.1.2.9 Small business asset relief

Under para 57 a deceased person may qualify for relief from CGT on capital gains adding up to R750 000 (2006 and earlier years of assessment: 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 that person's death. See **12.6 – Disposal of small business assets on retirement**. To the extent that the R750 000 is not used 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. The estate is only entitled to the unused portion of the R750 000 and is not entitled to a further concession of R750 000.

The small business asset relief must be determined on an asset-by-asset basis. Under para 57(2) the asset must have been held for a continuous period of at least five years before 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 transferred directly to deceased estate or heir or legatee [para 40(1A)]

Paragraph 40(1A) determines the acquisition cost of an asset in the deceased estate or in the hands of an heir or legatee when the asset

- was treated as having been disposed of under para 40(1), and
- is transferred *directly* to the deceased estate, or to an heir or legatee.

The deceased estate or the heir or legatee as the case may be is deemed to have acquired the asset at a cost equal to the market value of the asset on the date of death of the deceased person. The deemed cost is treated as an amount of expenditure actually incurred for the purposes of para 20(1)(*a*). Paragraph 40(1A) was introduced[591] to deal with assets that are transferred directly to an heir or legatee instead of being routed through the deceased estate. This can happen, for example, with certain second-hand or foreign endowment policies. Before the amendment para 40(1) did not supply a rule for determining the acquisition cost of an asset acquired directly by an heir or legatee from the deceased person. This could result in economic double taxation, since the market value of the asset would already have been treated as an amount received or accrued in the hands of the deceased person on the date of death.

[591] Paragraph 40(1A) was inserted by s 71(1)(*b*) of the Taxation Laws Amendment Act 17 of 2009 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2010.

Further costs incurred under para 20 by the executor on an asset of the deceased estate will increase the base cost of that asset. Likewise, the base cost of an asset acquired by an heir or legatee directly from the deceased person must be increased by any further expenditure incurred under para 20 by the heir or legatee on that asset after the date of death of the deceased person.

The CGT treatment of assets disposed of by the executor can be divided into two categories:

- Assets disposed of to an heir or legatee.
- Assets disposed of to third parties.

16.1.3.2 Assets distributed to heirs or legatees [para 40(2)]

When the assets are finally distributed to the heirs or legatees 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[592] because under 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 capital gain nor a capital loss on disposal of assets to heirs or legatees. The above provision mirrors the treatment afforded to ordinary income when there are ascertainable heirs and legatees under s 25 of the Act.

It may happen that the deceased estate will acquire assets after the date of death. Typically this occurs when the estate holds share investments. For example, the estate as a shareholder may receive other shares as a dividend *in specie*. In this situation the executor must determine the base cost of the shares to the estate in accordance with the applicable base cost rule. For instance, shares received as a dividend *in specie* have a base cost equal to market value under para 76(3). However, if such shares are acquired as a result of an unbundling transaction under s 46, then it will be necessary for the executor to allocate some of the base cost of the unbundling company shares held on date of death to the unbundled company shares, and in that event para 76(3) would not apply. In such cases it is imperative to establish the exact nature of the underlying transaction so that the applicable base cost rules can be applied. Although this will not impact on the estate when the assets are awarded to heirs or legatees because of the no gain or loss treatment afforded to the estate, it will be of importance to the heirs or legatees in establishing the base cost of their inherited assets.

Paragraph 40(2) commences with the words '[s]ubject to paragraph 12(5)'. This means that para 12(5) overrides para 40(2) and takes precedence over that provision. As a result, if a debt owed to the deceased by an heir is cancelled under 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. See also **6.2.5.13**.

[592] Assets acquired by an approved PBO also used to be excluded from para 40(2) but this was amended by s 79(1)(*c*) of the Revenue Laws Amendment Act 60 of 2008 with effect from 1 March 2006 in order to enable them to establish a base cost for their inherited assets.

Should the will state 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.

Paragraph 40(2) used to refer to assets disposed of by a deceased estate to the trustee of a trust. These superfluous references have been deleted effective 1 March 2006 because the trust contemplated by the provision would in any event have been an heir or legatee in its own right.[593]

An heir acquiring an asset from a deceased estate in return for agreeing to take over a liability of the estate, or on condition of accepting a future obligation, must disregard that liability or obligation for purposes of determining the base cost of the asset. This follows from para 40(2)(*b*) which deems the cost of acquisition to be the base cost of the asset in the hands of the estate.

Example 1 – Inheritance of asset subject to acceptance of liability

Facts:

Mary's late father's estate comprised a house with a market value on date of death of R500 000. The house was bonded to the extent of R450 000. Mary informed the executor that she was willing to take over the bond. With the bank's consent, the house was awarded to Mary by the executor.

Result:

Under para 40(2)(*b*) the base cost of the house in Mary's hands is deemed to be R500 000. The fact that she will have to repay the bond of R450 000 is not taken into account.

Example 2 – Acceptance of asset subject to future obligation

Facts:

Under the last will and testament of his late father, Jimmy inherited the family farm subject to the condition that he pays an annuity of R60 000 a year to his mother for the remainder of her life. The farm had a market value on date of death of R2 000 000 disregarding the annuity obligation.

Result:

Under para 40(2)(*b*) the base cost of the farm in Jimmy's hands is deemed to be R2 000 000. Jimmy will not be entitled to add the cost of the annuity to the base cost of the farm. While the R60 000 a year cost to Jimmy is a cost to him of acquiring the farm, para 40(2)(*b*) takes precedence and is the sole and exclusive mechanism for determining the para 20 acquisition cost of the farm, and any actual acquisition costs incurred by Jimmy must be disregarded. Paragraph 21 will also prevent any double deduction. Jimmy's mother will be taxed on the annuity under para (*a*) of the definition of the term 'gross income'.

16.1.3.3 Assets realised by the executor [para 40(3)]

A capital gain or loss will arise in the deceased estate should the executor dispose of an asset other than by a distribution to an heir or legatee.

[593] Section 79(1)(*c*) of the Revenue Laws Amendment Act 60 of 2008 and s 71(1)(*c*) of the Taxation Laws Amendment Act 17 of 2009.

Unlike ordinary income, which flows through to ascertainable heirs or legatees and is taxed in their hands under s 25, capital gains and losses arising on the disposal of assets by an executor to a third party are trapped in the estate. To the extent that the sum of those gains and losses exceeds the annual exclusion, the estate will have to be registered as a new taxpayer with its own tax reference number. For internal administrative purposes SARS takes the deceased estate on register as a special trust.

In the case of the disposal of an asset on which the deceased enjoyed capital allowances, there will be a recoupment of those allowances under s 25(1) read with s 8(4)(*a*) which must be accounted for either by the deceased estate, or if there is an ascertained heir or legatee for whose immediate or future benefit the amount is derived, by that heir or legatee.[594] In arriving at the proceeds from the disposal of the asset, the executor must reduce the amount received or accrued by any recoupment in the deceased estate under para 35(3)(*a*) (this would only occur if there was no ascertained heir or legatee).

Example – Treatment of allowance asset by deceased estate and heir or legatee

Facts:

After the valuation date, Ed acquired a machine at a cost of R100 which he used in his manufacturing business. By the time Ed passed away, the machine had been fully depreciated under s 12C. Upon Ed's death the machine had a market value of R50. Ed's sole heir is his son Mark.

What are the consequences for Ed, Ed's deceased estate and Mark if Ed's executor

- disposes of the asset to a third party for R50 and awards the cash to Mark,
- disposes of the asset to a third party for R50 and there is no ascertainable heir, or the R50 is used to settle the estate debts, or
- the asset is awarded to Mark?

Result:

Deemed disposal by Ed

Under para 40(1) Ed is deemed to dispose of the asset for an amount received or accrued of R50. Since there is no recoupment of capital allowances on death, the proceeds from the deemed disposal are equal to R50. The base cost of the asset is nil by virtue of para 20(3)(*a*). Ed therefore has a capital gain of R50.

Asset disposed of and cash awarded to Mark

Had Ed still been alive and disposed of the asset, a recoupment of R50 would have resulted in his hands under s 8(4)(*a*). Under these circumstances s 25(1) deems the amount of R50 to be income in Mark's hands. Ed's deceased estate will have no capital gain or loss since it will have proceeds of R50 [the amount actually received or accrued under para 40(1)] less the base cost of R50 under para 40(2)(*a*).

[594] Under s 25(1) the recouped amount 'would have been income in the hands of the deceased person had it been received by or accrued to or in favour of such deceased person during his or her lifetime'. See SARS Interpretation Note 12 'Recoupments: Assets in a Deceased Estate' [online] (27 March 2003) available at. <http://www.sars.gov.za/home.asp?pid=54958> [Accessed 8 December 2011].

No ascertainable heir or income not used for heir's immediate or future benefit

Under s 25(1) Ed's estate is deemed to have an inclusion in its income of R50. For CGT purposes the proceeds from the disposal of the asset will be nil by virtue of para 35(3)(*a*). The base cost of the asset is R50 under para 40(1). The estate will therefore have a capital loss of R50.

Asset awarded to Mark

There are no income tax or CGT implications for Ed's estate under s 25(1). Mark acquires the asset at a base cost of R50. There is no income inclusion in Ed's estate or for Mark under s 25(1).

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 should be taxed at the same rate; enjoy the same inclusion rate (25%), and exclusions (for example, 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 (2010: R17 500) 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 annual exclusion 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.

Under 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 R1,5 million exclusion may only be set off against the portion of the gain applicable to the first two years following the date of death – see **11.7.4**.

Any capital gain or loss arising on the disposal of an asset by an executor in order to give effect to a cash bequest to a PBO will not be excluded under para 62. 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 Eighth Schedule. See in this regard the commentary in **9.4** on para 38, which also applies prospectively. When a person has died before the valuation date and the estate is not finalised by that 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 acquired before 30 September 2004. This would, of course have been unnecessary in the case of South African-listed shares, South African unit trusts, South African-listed warrants, agricultural and financial futures. The prices of these assets were published in the *Government Gazette* and are therefore established. An executor who has failed to value assets whose prices were not published in the *Gazette* must resort to the TAB or 20% of proceeds methods, both of which are likely to result in a lower base cost.

16.1.3.5 Massed estates

Massing occurs when spouses draw up a joint will providing for the massing of their estates. This is sometimes prompted by the prohibition on the subdivision of agricultural land under the Subdivision of Agricultural Land Act 70 of 1970. Massing is governed by s 37 of the Administration of Estates Act 66 of 1965. Typically the surviving spouse will receive the usufruct over the deceased's assets in return for giving up the bare *dominium* in his or her own assets. The bare *dominium* given up by the survivor is dealt with by the executor as if it were an asset of the deceased. Upon adiation, the surviving spouse's share of the bare *dominium* is disposed of to the deceased estate.

The CGT consequences for the deceased spouse are fairly straight forward and are governed by para 40(1) read with para 67(2). As regards the deceased person

- a capital gain or loss must be determined on the disposal of the bare *dominium* to his or her deceased estate, and
- he or she will qualify for roll-over relief under para 67(1) read with para 67(2) in respect of the usufruct granted to his or her surviving spouse.

The base cost of the bare *dominium* disposed of by the deceased person to his or her estate must be determined under the part-disposal rules in para 33. The proportion of the expenditure and any market value on valuation date to be allocated to the usufruct is determined in accordance with the ratio that the market value of the usufruct on date of death bears to the market value of the total asset on the same date. The portion of the total expenditure and any market value on valuation date that is attributable to the bare *dominium* will be the balance (that is, the total expenditure and any market value less the portion attributed to the usufruct).

Massing can result in a donation for donations tax purposes if the value of the usufruct received is less than the value of the bare *dominium* given up by the surviving spouse. However, this does not mean that para 38 will apply to the disposal by the surviving spouse to the deceased estate. First, a donation for the purposes of para 38 is something wholly gratuitous and the survivor usually receives the usufruct in return. Secondly, even if the proceeds do not represent an arm's length price, the surviving spouse and the deceased estate are not connected persons in relation to each other. A surviving spouse will not be able to add any donations tax paid under para 20(1)(*c*)(vii) to the base cost of the assets disposed of unless a common law donation has been made (that is, no *quid pro quo* is received) and the market value of the asset exceeds the allowable para 20 expenditure excluding the donations tax (para 22). See **8.7**.

There is some uncertainty as to how the proceeds received by the surviving spouse in respect of the usufruct are to be determined. Likewise, there is uncertainty as to how the base cost of the bare *dominium* acquired from that surviving spouse must be determined by the deceased estate. It is submitted that the matter must be dealt with under the core disposal rules on the basis of a barter transaction. To the extent that the value of the usufruct received by the surviving spouse exceeds the value of the bare *dominium* given up, the excess will be regarded as pure inheritance not forming part of the barter transaction.

Example – Massed estates

Facts:

John and Jane were married in community of property in 1980 and entered into a joint will that provided for the massing of their estates. Under the will, Jane is to receive a usufruct over her remaining life in respect of the family farm while the bare *dominium* in the farm is to be left to the John Family Trust. The farm was acquired by the couples' joint estate at a cost

of R1 000 000 in 2002. John passed away on 30 January 2007, and Jane thereafter adiated (accepted the terms of the joint will). At the time of her husband's death Jane would have been 65 at her next birthday. The market value of the farm on date of death was R5 000 000. Ignore the primary residence exclusion. What are the CGT implications for John and Jane?

Result:

John

Expectation of Jane's life according to Table A = 15,18 years
Present value of R1 a year for life: 6,841 61
Value of usufruct left to Jane:
R2 500 000 x 12% x 6,841 61 = R2 052 483.
Value of bare *dominium* left to John Family Trust = R2 500 000 – R2 052 483 = R447 517.
Base cost of bare *dominium* = R500 000 x R447 517/R2 500 000 = R179 007
Capital gain = R447 517 – R179 007
= R268 510

Under para 40(1)(*a*) there is no disposal of the usufruct by John as this is subject to roll-over treatment under para 67.

Jane

Jane has disposed of her share of the bare *dominium* in the farm which had a market value on the date of John's death of R447 517. She has received a usufruct with a market value of R2 052 483. Of this R447 517 represents proceeds under a barter transaction in respect of the bare *dominium* she has given up, while the balance (R1 604 966) represents pure inheritance.

Jane retains the usufruct portion of her share of the farm. She therefore has a capital gain, determined as follows:

	R
Proceeds	447 517
Less: Base cost	(179 007)
Capital gain	268 510

The base cost of Jane's usufruct is made up as follows:

Acquired from John's estateR500 000 – R179 007	320 993
Own portion retained	320 993
	641 986

When Jane passes away there will be a disposal of the usufruct under para 11(1)(*b*) without any proceeds (see **24.1.1**).

The John Family Trust

The John Family Trust acquires the bare *dominium* in the property from John's deceased estate at a base cost equal to the base cost in the estate [para 40(2)(*b*)]. The base cost of the bare *dominium* in the estate is made up as follows:

	R
Acquired from John	447 517
Acquired from Jane	447 517
	895 034

The base cost of the amount acquired from Jane is equal to the cost to the estate of awarding John's usufruct to Jane. In other words, it is similar to the result that would be

obtained under a barter transaction under which the cost to each party is the market value by which that party's assets have been diminished.

Reconciliation

Assuming that the farm was disposed of to a third party immediately before John's death:

	R
Proceeds	5 000 000
Less: Base cost	(1 000 000)
Capital gain	4 000 000

Sum of capital gains assuming farm sold at market value on day after date of death

	R	R
John – bare *dominium*		268 510
Jane – bare *dominium*		268 510
Jane – assuming usufruct sold		
Proceeds R2 052 483 x 2	4 104 966	
Less: Base cost	(641 986)	
Capital gain	3 462 980	3 462 980
John Family Trust		
Proceeds R447 517 x 2	895 034	
Less: Base cost	(895 034)	
No gain or loss	-	-
Total		4 000 000

16.1.4 Assets acquired by heirs, legatees or trustees 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. That base cost is the market value of the assets at date of death plus the cost of any improvements or other qualifying expenditure under para 20 incurred by the estate. The amount is treated as expenditure actually incurred for the purposes of para 20(1)(*a*) (base cost).

The spouse of a deceased person acquires the assets at the base cost of that deceased person under para 67(1) read with para 67(2).

Pre-valuation date inheritances

Paragraph 40(2) only applies to acquisitions by heirs on or after the valuation date because under para 2 the Eighth Schedule only applies to disposals on or after the valuation date, and this includes a deemed disposal under para 40(1).

Nevertheless, an asset acquired by inheritance before the valuation date will have an expenditure for the purposes of para 20 equal to its market value on the date on which it was unconditionally acquired – see **8.5A**. This will be relevant for the purposes of determining 'B' in the TAB formula. Other options for determining the valuation date value of inherited assets include the market value method and 20% of proceeds method.

An heir who acquires an asset from a pre-valuation date estate on or after the valuation date, acquires 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 nil, and unless that executor determines a market value, the heir may be faced with the prospect of taking over a nil base cost or, if the executor has incurred some post-valuation date expenditure, a low base cost from the estate.

A person who inherits an asset before valuation date from his or her spouse is not entitled to a roll-over of expenditure or dates of acquisition and incurral under para 67(1) (see **13.3.4**).

Example 1 – Determination of taxable capital gain of natural person in year of death

Facts:

Richard Spectre died on 31 August 2008 leaving the following assets:

	Base Cost R	Market value R
Primary residence	1 000 000	2 600 000
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 organisation, 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 R	Market value R	Capital gain/(loss) R	Exclusions /roll-overs R	Total R	Paragraph conferring non-disposal, exclusion or roll-over
Primary residence	1 000 000	2 600 000	1 600 000	(1 500 000)	100 000	45(1)
Holiday home	250 000	350 000	N/A – no Disposal			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	

	R
Sum of capital gains and losses	400 000
Less: Annual exclusion	(120 000)
Aggregate capital gain	280 000
Taxable capital gain (25% x R280 000)	70 000

Example 2 – 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	
	2009	2010
	R	R
Primary residence		2 300 000
Household furniture and effects	850 000	
Yacht		230 000
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:

2009

	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

The household furniture and effects are personal-use assets and any capital gain or loss on their disposal would have had to be disregarded in Richard's hands under para 53. Accordingly, the capital gain in his estate will also be disregarded under para 40(3).

The estate will be liable for CGT on the listed shares, calculated as follows:

	R
Capital gain	60 000
Less: Annual exclusion	(16 000)
Aggregate capital gain	44 000
Inclusion rate	25%
Taxable capital gain	11 000

2010	Proceeds	Base cost	Capital gain
	R	R	R
Primary residence	2 300 000	2 100 000	200 000

Yacht	230 000	205 000	25 000

The capital gain on the disposal of the primary residence must be disregarded as it is covered by the primary residence exclusion of R1,5 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	25 000
Less: Annual exclusion	(17 500)
Aggregate capital gain	7 500
Inclusion rate	25%
Taxable capital gain	R1 875

16.1.5 Asset disposed of by executor of South African estate of a non-resident

When a non-resident dies leaving South African assets it will be necessary for the Master to appoint an executor to wind up the South African portion of the estate. Except for any interest in immovable property in South Africa or assets of a PE in South Africa [see para 2(1)(*b*)] the assets of a non-resident fall outside the Eighth Schedule and are not subject to CGT. Thus a non-resident who held listed shares on the JSE immediately before death would not be deemed to have disposed of those shares under para 40(1). Even if the non-resident's South African estate is a resident, no capital gain or loss will arise should the executor dispose of the South African assets to a third party [except the assets referred to in para 2(1)(*b*)]. Under para 40(3) the disposal of an asset by the deceased estate of a natural person must be treated in the same manner as if the asset had been disposed of by that natural person. Since the natural person would not have derived a capital gain or loss on disposal of the assets, it follows that the same must apply to the deceased estate.[595] When para 2(1)(*b*) applies the matter will be dealt with in the same way as if the non-resident were a resident. The provisions of any applicable tax treaty should not be lost sight of.

16.1.6 Assets acquired by inheritance from non-resident estates

A person who acquires an asset by inheritance from a person who at the time of his or her death was not a resident must determine the base cost of the asset under

- para 40(2)(*b*) in the case of para 2(1)(*b*) assets (immovable property in South Africa or assets of a PE in South Africa), and
- para 20(1)(*h*)(v) in the case of other assets.

Under para 20(1)(*h*)(v) the base cost is equal to

- the market value of the asset immediately before the death of the person, and
- any expenditure contemplated in para 20 incurred by the executor in respect of the asset in the process of liquidation or distribution of the deceased estate.

Under s 107(2) of the Revenue Laws Amendment Act 20 of 2006 para 20(1)(*h*)(v) comes into operation as from the commencement of years of assessment ending on or after 1 January 2007. Before that date such assets will have a base cost of nil.

[595] See 'Capital Gains Tax on the Death of a Non-Resident' (2005) 54 *The Taxpayer* 144, in which SARS's response on the issue is published.

16.2 Tax payable by heir of a deceased estate (para 41)

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 in which 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.

When

- 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 CGT 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.[596] 50% of the net value of the estate must be used to settle the remaining CGT liability. Situations may arise in which the estate has insufficient cash resources to settle the portion of the CGT liability not taken over by the heir. In these circumstances the heir could inject the necessary funds into the estate in order to enable the executor to settle the estate's portion of the CGT liability. This would, of course, depend upon the heir's ability to raise the necessary funds.

The net value of an estate is determined under s 4 of the Estate Duty Act 45 of 1955 before deducting the R3,5 million allowance under 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 – 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

[596] The definition of 'prescribed rate' is contained in s 1 of the Act. See **13.1.2.8** for a table of prescribed rates of interest.

Liabilities

Bank loan secured over share portfolio	(2 500 000)
Sundry creditors	(350 000)
Net value of estate before CGT liability	300 000

The sole heir of Luke's estate, Luke Jr, 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 Jr'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 of it that can be taken over by Luke Jr 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	(120 000)
Aggregate capital gain	2 680 000
Taxable capital gain 25% x R2 680 000	670 000
Tax thereon @ 40%	268 000

Step 2 – Determine 50% of net value of estate before CGT liability

	R
Net value of estate before CGT liability	300 000
50% thereof	150 000

Step 3 – Allocate CGT liability between estate and heir

	R
Total CGT liability – as above	268 000
Less: Portion to be paid by estate – 50% of net value of estate	(150 000)
Portion to be taken over by Luke Jr	118 000

The executor thereafter sold the motor vehicle for R100 000 and paid SARS R150 000. Luke Jr arranged with his local SARS office to settle his portion of the CGT liability of R118 000 in monthly instalments over three years commencing from the time the Master authorised 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 sections of the Act

17.1.1 Recent amendments

The Revenue Laws Amendment Act 45 of 2003 introduced a number of amendments affecting individuals and their insolvent estates, namely,

- the introduction of a definition of the term '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 before 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 under s 6(2)(*a*) or interest exemption under s 10(1)(*i*)(xv).

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 before and after the date of sequestration. The above is summarised 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*), para (*b*)(i) of proviso	Individual before sequestration	First day of year of assessment	Day preceding date of sequestration
(*a*), para (*b*)(ii) of proviso	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 before 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 before 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.

On sequestration a person's assets pass to that person's insolvent estate and this change of ownership would normally trigger a disposal under 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 before sequestration into his or her insolvent estate.

17.1.6 Setting aside of sequestration order

Section 79B(1A)

Under s 79B(1A) when 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 before 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 in which a provisional order of sequestration has been set aside or when, 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 under 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 (para 83)

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.

Under 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 (when gain is less than R1,5 million),
- furniture and effects, and
- private motor vehicles.

It also confers the same 25% inclusion rate on the insolvent estate.

Paragraph 83(2) effectively mirrors the treatment of assessed losses under s 20(1)(*a*)(i). It makes it clear that any assessed capital loss in the hands of the insolvent before sequestration is forfeited. In other words it may not be carried forward by the insolvent after date of sequestration. Note, however, that under s 25C an assessed capital loss may be carried forward to the insolvent estate on the basis that the person's estate before 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, when 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*.

The effect of a compromise benefit on an assessed capital loss is dealt with in 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 before that date. Although s 25C deems the insolvent person before sequestration and that person's insolvent estate to be 'one and the same person', this is only for the limited purposes of determining the amount of any deduction, allowance, set-off, recoupment, taxable capital gain or assessed capital loss of the insolvent estate. For other purposes the insolvent estate and the person before 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 before sequestration can be recouped in the estate, and
- debts included in the income of the person before sequestration can be claimed as bad debts under 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 before 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 – R17 500 (2010). Primary residence exclusion – R1,5 million (2010).
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 brought forward from the insolvent person before sequestration (s 25C). Annual exclusion must be reduced by any portion used by the person before sequestration (para 83(1) read with s 25C). 25% inclusion rate [para 83(1)]. Primary residence exclusion – R1,5 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 – R17 500 (2010). Primary residence exclusion – R1,5 million (2010).

The annual exclusion

The estate and the person before sequestration will have to share the annual exclusion. To the extent that the insolvent person has not used it before sequestration, any excess will be available for set-off against capital 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 before sequestration, the insolvent estate and the person after sequestration in that order.

Example 1 – Treatment of person before 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 2009 and this was made final on 31 October 2009. 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 March 2009 to 31 August 2009)	(100 000)
Assessed loss brought forward	(250 000)
Capital gain on listed shares – sold 31 July 2009	152 500
Assessed capital loss brought forward	(50 000)
Interest income (after exempt portion)	15 000
1 September 2009 to 28 February 2010	
Net loss from trade 1 September 2009 to 28 February 2010	(5 000)
Capital gain on sale of garage property (sold 31 October 2009)	1 800 000
Capital gain on sale of primary residence (sold 31 January 2010)	1 600 000

Result:

Cecil

Taxable income to date of sequestration (1 March 2009 to 31 August 2009)

	R
Capital gain – listed shares	152 500
Less: Annual exclusion	(17 500)
Less: Assessed capital loss brought forward	(50 000)
Net capital gain	85 000
Taxable capital gain 25% x R85 000	21 250
Net loss from trade	(100 000)
Assessed loss brought forward	(250 000)
Assessed loss carried forward	(328 750)

Cecil will be issued with an original assessment up to and including the day before the date of sequestration.

Cecil's insolvent estate

Capital gain on disposal of garage	1 800 000
Disposal of primary residence:	1 600 000
Primary residence exclusion	(1 500 000)
Annual exclusion	-
Net capital gain	1 900 000
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	(328 750)
Taxable income	156 250

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 August 2009. Cecil's estate is not entitled to the annual exclusion during the year ended 28 February 2010 as the full exclusion of R17 500 had been used 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 R17 500 in the year of sequestration. Since Cecil had used 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 September 2009 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 as a long-term investment at a cost of R100 000 on 31 October 2009. On 28 February 2010 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 a month).

Result:

Cecil's taxable income is determined as follows:

	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

Cecil's rebates must be halved under s 6(4). His annual exclusion is nil because it was used by him before sequestration.

17.3 Companies in liquidation

A company in liquidation remains the same taxable entity[597] 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 under s 97(2)(*c*) of the Insolvency Act 24 of 1936.[598] There is no procedure for proving such claims,[599] which enjoy a higher degree of preference than claims for income tax in respect of the pre-liquidation period under s 101. The liquidator in his capacity as public officer[600] 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 under para 75(1). An exception to this rule is, however, provided under 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.

[597] *Van Zyl NO v CIR* 1997 (1) SA 883 (C), 59 SATC 105.
[598] See the *van Zyl* case above at SATC 113/114.
[599] E de la Rey *Mars, The Law of Insolvency in South Africa* 8 ed (1988) Juta & Co Ltd, Wetton in § 21.5 at 400.
[600] 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 in relation 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 (para 74)

Paragraph 74

This paragraph contains a number of definitions that are discussed below.

18.1.1 Definition – 'distribution'

> '**"[D]istribution"** means any amount transferred or applied by a company for the benefit of any shareholder in relation to that company by virtue of any share held by that shareholder in that company, whether—
>
> (*a*) by way of a distribution; or
>
> (*b*) as consideration for the acquisition of any share in that company,
>
> but does not include any amount so transferred or applied by the company to the extent that the amount so transferred or applied constitutes—
>
> (i) shares in that company;
>
> (ii) an acquisition by a company of its own securities as contemplated in paragraph 5.67 of section 5 of the JSE Limited Listings Requirements, where that acquisition complies with the requirements prescribed by paragraphs 5.67 to 5.84 of section 5 of the JSE Limited Listings Requirements; or
>
> (iii) a redemption of a participatory interest in an arrangement or scheme contemplated in paragraph (*e*)(ii) of the definition of "company".'

The above definition is effective from 1 January 2011.[601] For the commentary on the previous definition, see issue 3 of this guide.

The definition of a 'distribution' is framed in wide terms. It bears its ordinary meaning modified by certain inclusions and exclusions.

A distribution is any

- amount,
- transferred or applied by a company,
- for the benefit of any shareholder in relation to that company,
- by virtue of any share held by that shareholder in that company.

The word 'amount' has been judicially considered in relation to the gross income definition to mean market value (see **9.1.1.1**). It is submitted that an 'amount' in the context of a distribution refers to the market value of property awarded to a shareholder.

[601] The previous definition was substituted by s 78 of the Taxation Laws Amendment Act 17 of 2009. The effective date of 1 January 2011 was inserted by s 154 of the Taxation Laws Amendment Act 7 of 2010.

The word 'transferred' covers a transfer of ownership of an asset, while the word 'applied' would cover the payment of a shareholder's debt or a payment to a person providing a service to a shareholder.

The amount must be for the 'benefit' of the shareholder. A shareholder would benefit from the payment of a dividend or a return of contributed tax capital. But a shareholder who pays a market-related consideration for an asset of the company does not derive a 'benefit'.

The amount must be derived 'by virtue of' a share in the company. It was held by Howie P in *Stevens v C:SARS*[602] that there was no material difference between the expressions 'in respect of' and 'by virtue of' in para (*c*) of the definition of 'gross income' in s 1, and that they connote a causal relationship. Applying this construction to the definition of a 'distribution', there must be a causal relationship between the amount transferred or applied and the share. It follows that an amount which is unrelated to a taxpayer's shareholding will not be derived 'by virtue of' a share. For example, the purchase by a taxpayer of an asset from the company at an arm's length price on the same terms that it is offered to the public would not be derived by virtue of the shareholder's shares in the company.

Inclusions

Paragraph (*a*) of the definition of a 'distribution' includes a distribution. This is a reference to the ordinary meaning of the term. In *CIR v Legal & General Assurance Society Ltd* Steyn CJ stated the following regarding the meaning of the word 'distributed' in the context of the definition of a 'dividend':[603]

> 'In my view, effect can be given to this apparent intention of the legislature by ascribing to "distribute", in the relevant context, the wider meaning of apportion, appropriate, allocate or apply towards.'

It is submitted that a distribution relates to something given to a shareholder without imposing an obligation to return it. The 'transfer' of an asset in exchange for a market-related consideration would not fall within the ordinary meaning of the word, particularly since it does not 'benefit' a shareholder, and would not necessarily be received 'by virtue of' a share.

Paragraph (*b*) of the definition specifically includes any consideration given by a company for the buy-back of its own shares. Because of the exclusion of certain JSE-listed shares discussed below, this specific inclusion applies to non-JSE-listed shares and those JSE-listed shares not covered by the exclusion. The effect is to make the non-dividend element of any consideration derived on a buy-back of non-excluded shares a capital distribution.

An issue that arises is whether such a capital distribution should give rise to a part-disposal under para 76A, or whether it should continue to be dealt with as a full disposal under para 11. It is submitted that it could not have been the intention of the legislature to trigger a part-disposal under para 76A because this could lead to absurd results. For example, assume that a company buys back shares from a shareholder. The base cost of the shares is R100 and their market value immediately before the buy-back is R200. The shareholder receives consideration of R200, R100 of which is paid from CTC and comprises a capital distribution. The result is that only R50 of the base cost can be allocated to the deemed part-disposal by virtue of the part-disposal formula in para 33 (R100 x R100/R200). It is then unclear how the remaining base cost of R50 should be dealt with. It may trigger a capital loss under the core disposal rules if they can be applied at the same time as the part-disposal. In any event, the purpose of para 76A is to trigger a disposal when the core rules do not apply. It is not intended as a substitute for the core rules. Under para 35 the proceeds upon a share buy-back will be equal to the amount received or accrued less any dividend

[602] 2007 (2) SA 554 (SCA), 69 SATC 1 at 7.
[603] 1963 (3) SA 876 (A), 25 SATC 303 at 315.

element. The dividend element is excluded under para 35(3)(*a*) because dividends are included in gross income under para (*k*) of the definition of 'gross income' in s 1.

Another effect of deeming a buy-back of shares to be a distribution is to bring para 75 into play when the consideration takes the form of an asset of the company, such as shares in another company. For example, ABC (Pty) Ltd buys back 100 of its own shares and gives 50 shares in XYZ Ltd as consideration for the buy-back. Under para 75 ABC (Pty) Ltd is deemed to dispose of the 50 XYZ shares at market value on the date of distribution. This will be the case even if ABC (Pty) Ltd's shareholder is not a connected person in relation to it (that is, para 75 has a wider application than para 38).

Exclusions

Paragraph (i) of the definition of a distribution excludes 'shares in that company'. The issue by a company of capitalisation shares will accordingly not comprise a distribution. Were this not the case such shares could constitute a capital distribution, which would trigger a part-disposal under para 76A of pre-existing shares.

Under para (ii) of the definition of a distribution, the buy-back of JSE-listed shares in compliance with paras 5.67 to 5.84 of the JSE Listings Requirements[604] is excluded as a distribution. As already discussed a buy-back of shares (regardless of whether they comprise a distribution) must be addressed under the core rules in paras 11 and 35. Since the excluded shares are not a distribution, they cannot be a capital distribution and thus the debate as to whether para 76A should apply does not arise.

In determining the proceeds under para 35 it must be borne in mind that no part of the consideration will comprise a 'dividend' as defined in s 1 because para (iii) of that definition also excludes a buy-back of JSE-listed shares complying with paras 5.67 to 5.84 of the JSE Listings Requirements. Since there is no dividend element to the consideration the proceeds will not be reduced on that account under para 35(3)(*a*). However, para 35(3)(*a*) would reduce any part of the consideration otherwise included in gross income, for example, in the case of a person holding the shares as trading stock.

A JSE-listed company can buy back its own shares in several ways, not all of which need to comply with paragraphs 5.67 to 5.84. It follows that not all buy-backs of JSE-listed shares will be excluded from the definitions of a 'dividend' in s 1 and a 'distribution' in para 74. A JSE-listed company can buy back its shares in the following ways:

- A dissenting shareholder buy-back under s 164 of the Companies Act 71 of 2008 [para 5.67(A)], This is not regarded as a repurchase for the purposes of the Listings Requirements. Thus the consideration will have to be split into dividend and non-dividend elements, with the non-dividend element comprising proceeds.
- A *pro-rata* repurchase by a company from all its shareholders. This type of buy-back does not need to comply with paras 5.67(B) to 5.84. Again, any consideration must be split between dividend and non-dividend elements, with the non-dividend element comprising proceeds.
- A specific repurchase, which includes a buy-back from option holders and an offer to named sellers. This type of buy-back must comply with paras 5.67 to 5.84, and is excluded as a dividend and a distribution.

[604] Service issue 14 of the JSE Listings Requirements can be found at <http://www.jse.co.za/How-To-List/Main-Board/Listing-requirements/JSE-listing-requirements.aspx> [Accessed 8 December 2011].

- A general repurchase, which addresses a buy-back on the open market. This type of buy-back must comply with paras 5.67 to 5.84, and is excluded as a dividend and a distribution.
- An odd-lot repurchase, which also has to comply with paras 5.67 to 5.84.

General repurchases on the open market were excluded from the definition of a 'dividend' because the shareholders in question would not be aware that it is the company that has bought back their shares. They would therefore not be in a position to obtain a split between the dividend and non-dividend elements of the purchase consideration. Had such repurchases not been excluded from the definition of a 'dividend', the company would have been liable for *STC* on the dividend element, while the shareholder would have included the full consideration as proceeds instead of only the non-dividend element.

It is unclear why specific repurchases and odd-lot repurchases were excluded from the definition of a 'dividend', since such shareholders should know that it is the company that is buying back their shares.

Paragraph (iii) of the definition of a 'distribution' excludes a redemption of a participatory interest in an arrangement or scheme contemplated in para (*e*)(ii) of the definition of 'company' in s 1. Paragraph (*e*)(ii) of the definition of a company refers to a

> 'portfolio comprised in any investment scheme carried on outside the Republic that is comparable to a portfolio of a collective investment scheme in participation bonds or a portfolio of a collective investment scheme in securities in pursuance of any arrangement in terms of which members of the public (as defined in section 1 of the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002)), are invited or permitted to contribute to and hold participatory interests in that portfolio through shares, units or any other form of participatory interest'.

Paragraph (iv) of the definition of a 'dividend' likewise excludes any amount that constitutes a redemption of a participatory interest in an arrangement or scheme contemplated in para (*e*)(ii) of the definition of a 'company'. It follows that such an amount will not comprise a capital distribution and must be fully accounted for as proceeds under para 35.

From a CGT perspective the more important definition is that of a capital distribution, discussed next.

18.1.2 Definition – 'capital distribution'

> '**"[C]apital distribution"** means any distribution (or portion thereof) by a company that does not constitute a dividend;'

The above definition is effective from 1 January 2011.[605] For commentary on the previous definition, see issue 3 of this guide.

18.1.2.1 What is a capital distribution?

A capital distribution is a 'distribution' as defined in para 74, excluding a dividend as defined in s 1. The definition of a 'capital distribution' seeks to embrace those amounts that have not been subjected to STC, the rationale being that a company distribution should either bear STC at company level or CGT at shareholder level.

[605] The previous definition was substituted by s 78 of the Taxation Laws Amendment Act 17 of 2009. The effective date of 1 January 2011 was inserted by s 154 of the Taxation Laws Amendment Act 7 of 2010.

The previous definition of a capital distribution, which applied up to 31 December 2010, included certain pre-1 October 2001 capital profits and pre-1993[606] profits distributed in the course or in anticipation of liquidation or deregistration under s 64B(5)(*c*). Since s 64B(5)(*c*) was deleted with effect from 1 January 2011 such distributions now comprise dividends subject to STC and are therefore excluded as capital distributions.

A capital distribution does not, however, include STC-exempt dividends under the old rationalisation and unbundling legislation that was effective before 1 October 2001.[607]

For the commentary on the composition of pre-1 January 2011 capital distributions, see issue 3 of this guide.

The following amounts will constitute a capital distribution, since they are excluded from the definition of a 'dividend' in s 1:

- A reduction of CTC as defined in s 1.
- Any consideration received or accrued for a buy-back of shares which does not have to comply with paras 5.67 to 5.84 of the JSE Listings Requirements.

CTC is defined in s 1 as follows:

> '**"[C]ontributed tax capital"**, in relation to a class of shares issued by a company, means—
>
> (*a*) in the case of a company that is not a resident and that becomes a resident on or after 1 January 2011, an amount equal to the sum of—
>
> (i) the market value of all shares in that company immediately before the date on which that company becomes a resident; and
>
> (ii) the consideration received by or accrued to that company for the issue of shares on or after that date; or
>
> (*b*) in the case of any other company, an amount equal to the sum of—
>
> (i) the stated capital or share capital and share premium of that company immediately before 1 January 2011 in relation to shares issued by that company before that date, less so much of the stated capital or share capital and share premium as would have constituted a dividend, as defined before that date, had the stated capital or share capital and share premium been distributed by that company immediately before that date; and
>
> (ii) the consideration received by or accrued to that company for the issue of shares on or after that date,
>
> reduced by so much of that amount as the company has transferred on or after that date to shareholders in relation to those shares, and has by the date of the transfer been determined by the directors of the company or by some other person or body of persons with comparable authority to be an amount so transferred: Provided that the amount so transferred to a shareholder of any class of shares is deemed to be an amount that bears to the total of the amount of contributed tax capital attributable to that class of shares immediately before the distribution the same ratio as the number of shares of that class held by that shareholder bears to the total number of shares of that class;

[606] Profits derived during any year of assessment ending not later than 31 March 1993 but excluding any profit arising from the revaluation of trading stock.

[607] The old rationalisation provisions are contained in s 39(2)(*a*) of the Taxation Laws Amendment Act 20 of 1994, while 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 is deemed not to be a dividend for the purposes of Part VII of Chapter II, which deals *inter alia* with STC.

Basic rules: additions, starting amounts and reductions

The CTC of a company is a notional amount derived from the value of any contribution made to a company as consideration for the issue of shares by the company. CTC will be reduced by any part thereof that is allocated by the company in a subsequent transfer to one or more shareholders.

As a general rule, the CTC of a company is based on amounts received by or accrued to a company as consideration for the issue of shares by the company. For instance, if an individual contributes an asset worth R100 to a public company in an offer of shares to the public, R100 is added to CTC. Applying basic principles, an amount received by or accrued to a company as consideration for the issue of shares would not only include cash or the value of an asset received by or accrued to the company. CTC would also include the value of services provided by a person to the company as consideration for a share issue or the cancellation of a loan account owed by the company as consideration for the issue of shares.

As a transitional measure, the share capital and share premium of a company immediately before 1 January 2011 will generally operate as the 'starting' CTC. However, amounts of share capital and share premium that would have constituted a dividend had they been distributed immediately before 1 January 2011 are excluded from 'starting' CTC. In other words, 'starting' CTC does not include 'tainted' share capital or share premium (that is, capitalised profits). Any portion of the equity share capital and share premium of a resultant company that was deemed to be a profit not of a capital nature available for distribution under s 44(9A) will also not form part of CTC.

In order for a transfer from a company to a shareholder to constitute a reduction of CTC (and accordingly not comprise a dividend), the definition of CTC requires that the directors (or persons with comparable authority) determine that the transfer constitutes a transfer of CTC. Without this determination (which could, for example, take the form of a company resolution), no reduction of CTC can occur (and the amount transferred would constitute a dividend subject to STC). In effect, the rules amount to a unilateral company election. In order for this determination to be valid, it must be made by the date of the transfer by the company to the shareholders. When the dividends tax comes into operation shareholders will have to be notified of the amount of any CTC under para 76(4), which is due to come into operation on the date on which the dividends tax is implemented – see **18.3.6**.

Example 1 – Determination of opening balance of CTC on 1 January 2011

Facts:

On 31 December 2010 Company X's capital employed comprised the following:

	R
100 000 shares of R1 each issued for cash	100 000
50 000 capitalisation shares of R1 each paid up out of revenue reserves	50 000
Share premium account (includes R60 000 of capitalised profits)	200 000
Retained income	500 000
	850 000

Determine Company X's opening balance of CTC at 1 January 2011.

Result:

Company X's CTC comprises the following:

Share capital contributed in cash	100 000
Share premium contributed in cash (R200 000 – R60 000)	140 000
CTC	240 000

If the capitalisation shares and the tainted portion of the share premium account had been distributed to shareholders immediately before 1 January 2011 they would have comprised a dividend. They must therefore be excluded from CTC along with the retained income.

Class-by-class and pro-rata shareholder rules

A company that has issued several classes of shares must maintain a separate record of CTC on a per-class basis. Therefore, CTC created by virtue of an ordinary share issue cannot be allocated or reallocated to preference shares. Similarly, distributions in respect of preference shares cannot be used to reduce the CTC associated with ordinary shares. If a company makes a distribution out of CTC in respect of a given class of shares, the CTC distributed will be allocated *pro rata* to the shareholders of that class of shares.

Example 2 – Allocation of CTC between shareholders in the same class

Facts:

Company Y has two ordinary shareholders (A and B) and one preferred shareholder (C). A owns 25 ordinary shares, and B owns the other 75 ordinary shares. Company Y has CTC of R150 in respect of its preference shares and R380 in respect of its ordinary shares. As part of a written company resolution when making a distribution to its ordinary shareholders of R200, Company Y decides to allocate R60 of the ordinary share CTC to shareholders A and B.

Result:

Shareholder A receives a distribution of R200 x 25% = R50, while shareholder B receives a distribution of R200 x 75% = R150.

The amount of CTC that is transferred to shareholders A and B is calculated as follows:

CTC transferred to A = R60 x 25% = R15.
CTC transferred to B = R60 x 75% = R45

Hence, shareholder A receives a dividend of R35 (that is, R50 less R15 of CTC). Shareholder B receives a dividend of R105 (that is, R150 less R45 of CTC). The dividend portion of the distributions is subject to STC, while the CTC portions comprise capital distributions for CGT purposes.

Example 3 – Allocation of CTC to shares of another class

Facts:

Company Z has one ordinary shareholder (A) and one preferred shareholder (B). Company Z has CTC of R380 for its preference shares and R150 for its ordinary shares. As part of a written company resolution when making a distribution to its ordinary shareholders of R200, Company Z decides to allocate the full R150 of ordinary share CTC and R50 of the preference share CTC to shareholder A.

Result:

Only R150 is a distribution of CTC to shareholder A, and will comprise a capital distribution for that shareholder. The balance of R50 is a dividend because it relates to CTC of another

class of shares. After the distribution the ordinary share CTC is reduced to nil, while the preference share CTC remains intact at R380.

18.1.2.2 Treatment of capital distributions

In determining a capital gain or loss a 'capital distribution' can be likened to proceeds under para 35. The general rules for dealing with capital distributions at shareholder level are contained in paras 76 and 76A, though they also carry consequences under the corporate restructuring rules in ss 41 to 47.

Under para 76 the para 20 expenditure forming part of the base cost of a share is reduced by capital distributions received or accrued before valuation date (except when the weighted-average method is used, in which case they are ignored). Capital distributions received or accrued on or after valuation date are subject to differing treatment depending on

- whether they were received before, or on or after 1 October 2007,
- when the shares are sold (this is of significance in relation to capital distributions received or accrued before 1 October 2007), and
- the type of share-identification method adopted (different rules exist for capital distributions received or accrued before 1 October 2007 when the weighted-average method is adopted).

Before 1 October 2007, post-valuation date capital distributions were treated as proceeds on disposal of a share, or as a reduction in base cost under the weighted-average method. Capital distributions received or accrued on or after 1 October 2007 are now treated as proceeds under all identification methods (specific identification, first in, first out or weighted average) and trigger a part-disposal of the related share under para 76A. Special transitional rules exist for capital distributions received or accrued before 1 October 2007 in respect of shares not disposed of before that date. Such amounts will be dealt with as proceeds either when the share is disposed of, or on 1 July 2011 if not disposed of by that date.

See **18.3** (para 76) and **18.4** (para 76A).

18.1.2.3 STC-exempt intra-group dividends

Intra-group dividends that are exempt from STC under s 64B(5)(*f*) are not treated as capital distributions. From an STC perspective this merely represents a deferral, since an intra-group dividend moves the subsidiary's profits into its holding company and those profits will be subject to STC when they leave the group. From a CGT perspective the value of the subsidiary's shares will decrease but the holding company's shares will increase by the same amount. Note that pre-acquisition dividends distributed before 1 January 2011 within a South African-resident group of companies are not a dividend[608] and will trigger a part-disposal of the subsidiary's shares held by the holding company. On or after 1 January 2011 the definition of a 'dividend' draws no distinction between distributions declared out of pre- and post-acquisition profits with the result that a pre-acquisition dividend is simply a dividend as defined in s 1.

18.1.3 Definition – 'date of distribution'

> '**"[D]ate 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 under a law, regulation or rule to which that company is subject, except where the distribution is made—

[608] Paragraph (*g*) of the definition of 'dividend' in s 1.

(*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;'

The above definition 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).

18.1.4 Definition – 'share'

'**"[S]hare"** in relation to a company means—

(*a*) any share, or member's interest, in that company whether or not that share or similar interest carries a right to participate beyond a specified amount in a distribution.

(*b*) . . . .'

The above definition includes

- a member's interest in a close corporation, and
- a share with limited rights to income or capital, such as a 7% redeemable preference share.

However, it does not include a participatory interest in a local CISS or CISP, both of which are not companies as defined in s 1.

Paragraph (*e*)(i) of the definition of a 'company' in s 1 was deleted by s 7(1)(*a*) of the Taxation Laws Amendment Act 17 of 2009 with effect from the commencement of years of assessment commencing on or after 1 January 2010. The effect of the deletion is that a local CISS is no longer a company for purposes of the Act and the participatory interest holders are no longer shareholders. Holders of participatory interests are now beneficiaries of a vesting trust (see **12.10**). Consequently, such a participatory interest falls outside Part XI. The Eighth Schedule is silent on how an amount of a capital nature derived by a holder of a participatory interest from a CISS should be treated. While such distributions may be hypothetically possible, it appears that they do not occur in practice.

An amount of a capital nature derived from a CISP is treated in the same manner as a capital distribution under para 67A(3) – see **13.4.3**.

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.

A distribution that results in the disposal of one or more assets 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.[609] The distribution of an asset *in specie* also includes a distribution by way of an interim dividend.[610] 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. Upon a disposal of an asset such as trading stock or a depreciable asset, the amount deemed to be received or accrued by the company under para 75 must be reduced under para 35(3)(*a*) by the amount included in the taxpayer's gross income (for example, as a result of a recoupment of capital allowances).[611]

Paragraph 75 does not apply to the issue of shares (or options thereto) in the company making the distribution. An issue by a company of its own shares is excluded as a distribution under para (i) of the definition of a 'distribution' in para 74. Furthermore, the issue by a company of its own shares or the granting of an option to acquire them is not a disposal under para 11(2)(*b*).

Example – 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. Amongst 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 CTC and partly from non-CTC sources.

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[612] 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

Paragraphs 76 to 78 address the shareholder-level consequences of various distributions.

Paragraph 76 sets out how a capital distribution of cash or an asset *in specie* is to be treated by a shareholder when a share is disposed of. For example, depending on when such a

[609] Before 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'.
[610] The reference to 'interim dividend' was inserted by the Revenue Laws Amendment Act 45 of 2003.
[611] Before 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.
[612] 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'.

capital distribution is received or accrues and on the identification method adopted, it may be treated as a reduction of pre-CGT expenditure, a reduction of base cost or as proceeds on disposal or part-disposal of a share).

Paragraph 76A contains the rules for triggering a part-disposal of a share when a capital distribution of cash or an asset *in specie* referred to in para 76 is received by or accrues to a shareholder. It also contains transitional rules for dealing with such capital distributions received or accrued before 1 October 2007, the date on which the part-disposal approach was implemented.

Paragraph 77 contains time of disposal rules which apply when a company is liquidated or deregistered. They specify when a share is deemed to be disposed of under such circumstances, and also deal with capital distributions which may arise after the date of deemed disposal.

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

18.3.1 Purpose and application

The purpose of para 76 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 the following situations:

- The surrender by a shareholder of shares held in a company in exchange for cash or assets from that company (that is, a share buy-back). Since share buy-backs involve a full disposal of a share they are dealt with under the core rules (paras 11 and 35). For more on why share buy-backs should not be dealt with under para 76 and 76A see **18.1.1**.

- The receipt or accrual by a shareholder of a capital distribution after the shares have been deemed to be disposed of under para 77 (which deals with deregistered or liquidated companies).

- The receipt or accrual of a capital distribution comprising a share in an unbundled company as a result of an unbundling transaction contemplated in s 46(1). Instead of treating such an amount as proceeds on disposal of the unbundling company's shares, a part of the para 20 expenditure or market value on 1 October 2001 of the unbundling company's shares is allocated to the unbundled company's shares under s 46(3).[613]

18.3.2 Treatment of capital distribution

The method of treating a capital distribution of cash or an asset *in specie* changed on 1 October 2007 with a move from a deferral approach to a part-disposal approach under para 76A. Before 1 October 2007 capital distributions were accounted for as proceeds on disposal of a share (or as a reduction in base cost under the weighted-average method). Thus capital distributions were merely carried forward until the related share was disposed of

[613] The exclusion from para 76(1) of shares acquired under an unbundling transaction was effected by s 81(1) of the Revenue Laws Amendment Act 31 of 2005, came into operation on 1 February 2006 and applies in respect of any distribution on or after that date.

and did not trigger a part-disposal of the share. Full disposal occurs under various circumstances, such as those in

- para 11 (for example, a sale, donation or redemption of a share),
- para 12 (for example, on cessation of residence or conversion of a share held on capital account to trading stock), or
- para 77 (dissolution or deregistration of a company).

Capital distributions received or accrued on or after 1 October 2007 now trigger an immediate part-disposal under para 76A. Capital distributions received or accrued between valuation date and 30 September 2007 must either be accounted for on the earlier of disposal of the share, or on 1 July 2011.

The change in policy was prompted because, firstly, deferred treatment had a negative impact not only on CGT collections, but also on STC collections, as some companies returned share premium to their shareholders STC free instead of paying dividends which would have attracted STC. The advantage was that the company paid no STC while the shareholders had no immediate CGT consequences. In some cases share premium contributed by one class of shareholders was diverted to another class of shareholders instead of paying dividends.[614] The amalgamation transaction provisions in s 44 were also abused to strip out dividends STC free from an amalgamated company followed by a share premium reduction by the resultant company, which only carried deferred CGT consequences for the former amalgamated company shareholders.[615] Secondly, from an administrative and audit perspective it is preferable to finalise the CGT consequences of capital distributions as and when they are received or accrued instead of having to keep a record of them for potentially many years until the related share is disposed of.

The table below sets out how capital distributions must be dealt with.

Table 1 – Treatment of capital distributions of cash or assets *in specie*

When capital distribution received or accrued	Paragraph 76	Identification method adopted	Treatment
Before 1 October 2001	(1)(*a*)	Specific identification or first in, first out	Reduce pre-1 October 2001 expenditure in respect of the share (but not below nil). This applies if TAB is used to determine the base cost.
	N/A	Weighted average	Not relevant (ignore).
On or after 1 October 2001 but before 1 October 2007	(1)(*b*)	Specific identification or first in, first out	• If the share is disposed of before 1 July 2011, the capital distribution is treated as proceeds on disposal. • If the share is still held on 1 July 2011, the capital distribution will be treated as proceeds on a deemed part-disposal on that date.

[614] This has been addressed by the introduction of para (iiiA) of the definition of 'dividend'.
[615] This abuse has been blocked by the introduction of s 44(9A) which taints the share capital and share premium account of the resultant company to the extent of the STC-free distribution by the amalgamated company.

	(2)	Weighted average	• Capital distributions received or accrued on or after 1 October 2001 but before 1 October 2007 must be deducted from base cost as and when received or accrued. • If the shares have been disposed of by 1 July 2011 a shareholder must calculate the capital gain in the normal way (proceeds less base cost). • If the shares are still held on 1 July 2011 and the base cost is negative as at the end of 30 June 2011, the negative amount is treated as a capital gain on 30 June 2011 and the base cost as at the end of 30 June 2011 is reset to nil.
On or after 1 October 2007	(1)(*c*)[616]	Specific identification, first in, first out or weighted average	Treat as proceeds when a share is partly-disposed of under para 76A.

18.3.2.1 Issue of shares and granting of options by company

Paragraph (i) of the definition of a 'distribution' in para 74 excludes the issue by a company of its own shares. An issue of capitalization shares can therefore not comprise a capital distribution. Furthermore, para 76(1) refers to a capital distribution of cash or an asset *in specie*, and not merely a capital distribution. A company's own shares are not considered to be an asset from its perspective. Likewise, the granting by a company of an option to take up its own shares is not considered to be an asset *in specie* for the purposes of paras 76 and 76A.

18.3.2.2 The meaning of 'shareholder'

The term 'shareholder' is defined in s 1. In the case of a company the term means

- the registered shareholder in respect of any share,
- except when some person other than the registered shareholder is entitled, whether in terms of any agreement or contract or otherwise, to all or part of the benefit of the rights attaching to the share so registered, that other person shall, to the extent that such other person is entitled to such benefit, also be deemed to be a shareholder.

In the case of a holder of a participatory interest in a foreign CISS, the term refers to

- the registered holder,
- except when some person other than the holder is entitled, whether by virtue of any provision in the trust deed entered into for the purposes of the relevant CISS or under the terms of any agreement or contract, or otherwise, to all or part of the benefit of

[616] Paragraph 76(1)(*c*) inserted by the Taxation Laws Amendment Act 3 of 2008, and deemed to have come into operation on 1 October 2007.

> the rights attaching to the participatory interest, that other person shall, to the extent that such other person is entitled to such benefit, also be deemed to be a shareholder

In the case of a close corporation or co-operative the term means any member of such close corporation or co-operative.

18.3.2.3 Market value of capital distribution of asset 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 carrying value.

Example – Market value of assets *in specie*

Facts:

Alex owns all the shares in Specieco (Pty) Ltd. On 30 September 2010 the company was placed in voluntary liquidation. At that time the company's balance sheet appeared as follows:

Capital employed

	R
Share capital	100 000
Capital and revenue profits	42 200
	142 200

Employment of capital

Asset – at cost	50 000
Cash	92 200
	142 200

On 28 February 2011, after settling the company's CGT and STC liability the liquidator awarded the balance of the cash and the asset to Alex. The market value of the asset on 1 October 2001 was R70 000 and its market value on 28 February 2011 was R100 000. The company valued the asset by 30 September 2004 and adopted the market value method for CGT purposes. The liquidator determined that the CTC to be awarded to the shareholder was R100 000, being the share capital originally contributed to the company. Determine the proceeds to be taken into account by Alex upon disposal of his shares.

Result:

Step 1 – Determine the company's CGT liability

	R
Proceeds (para 75)	100 000
Less: Base cost	(70 000)
Capital gain	30 000
CGT = R30 000 x 50% x 28%	4 200

Step 2 – Determine the company's STC liability

Assets available for distribution to shareholders before STC

Market value of asset	100 000
Cash R92 200 – R4 200	88 000
Less: CTC	(100 000)
Available for distribution as a dividend before STC	88 000
Less: STC R88 000 x 10/110	(8 000)
Dividend R88 000 x 100/110	80 000
Awarded to shareholder:	R
Capital distribution (proceeds)	100 000
Dividend	80 000
Distribution	180 000

18.3.2.4 Pre-CGT capital distributions cannot result in negative expenditure

Paragraph 76(1)(*a*) requires that the expenditure incurred under para 20 before valuation date be reduced. The use of the word 'reduced' means that when pre-valuation date capital distributions exceed the expenditure incurred before valuation date, the excess must be disregarded in the absence of any provisions to the contrary. The view is held that pre-valuation date 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 (for example, one-third of interest paid to acquire listed shares), the proceeds formula in para 30 will result in the entire gain being allocated to the post-CGT period. This also applies to selling expenses in respect of assets disposed of during years of assessment ending before 8 November 2005.

18.3.2.5 The approach of some other countries to the treatment of capital distributions

In the United Kingdom a part-disposal is triggered each time a capital distribution occurs.[617]

A more generous approach offering the advantage of deferral is adopted in the United States and Australia. In the US a distribution other than a dividend is treated as a reduction in 'adjusted basis' (base cost). If the adjusted basis turns negative, the excess is treated as a gain from the sale or exchange of property.[618] Likewise, in Australia a gain is triggered when the 'cost base' (base cost) turns negative.[619]

18.3.2.6 Record-keeping

Shareholders who received capital distributions before 1 October 2007 in respect of shares held on that date must retain a record of those capital distributions in order that they may be accounted for in the manner described in Table 1 in **18.3.2**.

In the case of pre-valuation date shares for which the specific identification or first-in-first-out methods have been adopted, the record should run from the date of acquisition in order that

[617] See s 122 of the Taxation of Chargeable Gains Act, 1992. The United Kingdom does, however, permit small capital distributions to be credited against base cost.
[618] Section 301(3) of the Internal Revenue Code, available online at <http://www.fourmilab.ch/ustax/www/t26-A-1-C-I-A-301.html> [Accessed 8 December 2011].
[619] See CGT event G1 – s 104–135(4) of the Income Tax Assessment Act, 1997.

the pre-valuation date expenditure can be reduced under para 76(1)(*a*) by any pre-valuation date capital distributions. This applies even if market value is adopted as the valuation date value since a shareholder will still need to have a record of pre-CGT capital distributions for the purposes of applying the kink tests in paras 26 and 27.

18.3.2.7 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, the 'expenditure incurred before valuation date' referred to in paras 26 and 27 is the expenditure so incurred reduced by any pre-CGT capital distribution under para 76(1)(*a*). Similarly, the proceeds on disposal used in the kink tests will include any post-CGT capital distributions under para 76(1)(*b*) or (*c*).

18.3.3 The weighted-average method [para 76(2)]

Under the weighted-average method, para 76(2) provides that any capital distributions received or accrued on or after the valuation date but before 1 October 2007 must be deducted from base cost. The base cost reduction method was used for the weighted-average method up to 30 September 2007 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. This rule does not apply to shares distributed under an unbundling transaction in s 46(1). Under an 'unbundling transaction' the base cost is not reduced. Instead, a portion of the para 20 expenditure or if applicable, market value on valuation date, of the shares in the unbundling company must be allocated to the unbundled company shares under s 46(3).[620]

Capital distributions received or accrued on or after 1 October 2007 are treated as proceeds on a part-disposal under para 76(1)(*c*) read with para 76A. In other words, the same treatment is applied whether a person uses the weighted-average, first-in-first-out, or specific-identification method.

Paragraph 76(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 1 – Shareholder receiving distribution comprising dividend and CTC

Facts:

Martin owns all the shares in Yankee (Pty) Ltd. Amongst other assets, Yankee (Pty) Ltd holds land with a market value of R120 000 and cash of R50 000. 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 is a dividend and the remaining R80 000 is a return of CTC. The amount of R90 000 is subject to STC. What are the implications for Martin if the amounts are distributed on

- 30 September 2007, or

[620] The exclusion of an unbundling transaction from para 76(2) was inserted by s 84 of the Revenue Laws Amendment Act 35 of 2007 and came into operation on 1 October 2007. The same treatment should, however, also be adopted for unbundling transactions before this date on the basis that under s 41(2) the corporate restructuring rules apply 'notwithstanding any provision to the contrary contained in the Act', barring some exceptions not relevant here.

- 1 January 2011

Result:

In both instances para 76 does not apply to R90 000 of the distribution because this portion is a dividend. The remaining R80 000 is a capital distribution of an asset in *specie*. If distributed on 30 September 2007 the amount must be treated as proceeds when Martin disposes of his shares. If he has not disposed of them by 1 July 2011, the amount must be treated as proceeds on a part-disposal on that date. If distributed on 1 January 2011 the amount must be treated as proceeds on an immediate part-disposal.

Example 2 – Pre-CGT capital distribution exceeding expenditure before valuation date

Facts:

On 1 November 1991 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 (dividend)	15 000
Assets (CTC)	110 000
	125 000

The market value of the shares on valuation date was R30 000.

On 28 February 2011 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, which do not trigger the proceeds formula.

Step 3 – Apply TAB formula

TAB = B + [(P – S – B) x N/(N + T)]
= R0 + [(R50 000 – R3 000 – R0) x 10/20]
= R23 500

Step 4 – Determine capital gain or loss

Capital gain = Proceeds – [VDV + post-CGT expenditure]
= R50 000 – [R23 500 + R3 000]
= R23 500

Market value

Capital gain = Proceeds – [VDV + post-CGT expenditure]
= R50 000 – [R30 000 + R3 000]
= R17 000

Applying the kink tests:

	R
Expenditure before valuation date	-
Expenditure after valuation date	3 000
Market value on valuation date	30 000
Proceeds	50 000

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 under para 26(1). Market value gives the most tax-efficient result.

Note: Had Martin sold the shares before1 March 2005, the result using TAB would have been different, since selling expenses triggered the proceeds formula for disposals during years of assessment ending before 8 November 2005.

Example 3 – Pre- and post-valuation date capital distributions

Facts:

On 1 November 1991 Maria acquired the entire share capital of Yankee Ltd at a cost of R100 000. In 1998 she received a distribution out of CTC 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.

On 28 February 2011 Maria disposed of her shares for proceeds of R150 000. The cost of valuing her shares for CGT purposes amounted to 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 cost of obtaining a CGT valuation of R7 000 [para 20(1)(*b*)].

Step 3 – Apply the proceeds formula

Proceeds = Amount realised (R150 000) + post-CGT capital distributions (R5 000) = R155 000

P = Expenditure before valuation date / total expenditure x proceeds
= R85 000/(R85 000 + R7 000) x R155 000
= R85 000/R92 000 x R155 000
= R143 206,50

Step 4 – Apply TAB formula

TAB = B + [(P – B) x N/(N + T)]
= R85 000 + [(R143 206,50 – R85 000) x 10/20]
= R85 000 + [R58 206,50 x 10/20]
= R85 000 + R29 103,25
= R114 103,25

Step 5 – Determine gain or loss

Capital gain = Proceeds – [VDV + post-CGT expenditure]
= R155 000 – [R114 103,25 + R7 000]
= R155 000 – R121 103,25
= R33 896,75

Market value

Capital gain = Proceeds – [VDV + post-1 October 2001 expenditure]
= R155 000 – [R80 000 + R7 000]
= R68 000

Applying the kink tests:

	R
Expenditure before valuation date	85 000
Expenditure after valuation date	7 000
Market value on valuation date	80 000
Proceeds	155 000

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 under para 26(1). TAB gives the most tax-efficient result.

Example 4 – 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 a share.

Result:

Proceeds = R300
Base cost of shares disposed of = 100 x -R0,50 = -R50
Capital gain = Proceeds – base cost
= R300 – (-R50)
= R300 + R50
= R350

Example 5 – Dividend exempt from STC under s 64B(5)(*f*)

Facts:

The facts are the same as Example 1, except that all the shares of Yankee (Pty) Ltd are owned by X-Ray Ltd. X-Ray Ltd has elected that the dividend of R90 000 be exempt from STC under s 64B(5)(*f*).

Result:

The result is the same as Example 1. The dividend of R90 000 is not a capital distribution. The STC-free nature of the dividend has no impact on this analysis. 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)].

18.3.4 Share-dealers

For the position affecting share-dealers before 1 January 2009 see issue 3 of this guide.

CTC received by or accruing to a share-dealer comprises gross income in that share-dealer's hands when the relevant shares are held as trading stock. At the same time a distribution of CTC constitutes a capital distribution, which can trigger a part-disposal under para 76A. This raises the issue of double taxation.

A capital distribution that is dealt with under para 35 will not result in double taxation by virtue of para 35(3)(*a*). This would apply, for example, to a full disposal such as a share buy-back, or a disposal under para 77 in which the proceeds coincide with the terminating event (that is, dissolution, issue by a liquidator of a certificate confirming that there will be no further distributions or deregistration).

However, in the case of a part-disposal under para 76A, Part XI contains no explicit method for eliminating double taxation. Since there is a necessary implication against double taxation in the Income Tax Act,[621] it is accepted that such amounts must not again be taken into account for CGT purposes, and their treatment as ordinary income will take precedence.

18.3.4A Capital distributions received on s 8C restricted equity instruments

Under s 8C(1A)[622] the receipt or accrual by a taxpayer of a capital distribution as contemplated in para 74 from a restricted equity instrument must be included in the taxpayer's income for the year of assessment during which the amount is received or accrues. Such a capital distribution will not trigger a part-disposal of a restricted share

[621] *CIR v Delfos* 1933 AD 242, 6 SATC 92 at 112.
[622] Section 8C(1A) was inserted by s 11(1)(*a*) of the Revenue Laws Amendment Act 60 of 2008 deemed to have come into operation on 21 October, 2008 and applicable in respect of a capital distribution received by or accrued to a taxpayer on or after that date.

because para 11(2)(*j*) provides that there is no disposal of a s 8C equity instrument before it vests as contemplated in s 8C.

18.3.5 Base cost of asset acquired by a shareholder as a result of a distribution [para 76(3)]

The receipt or accrual of a distribution of an asset *in specie* by a shareholder must be treated by that shareholder

- as having been acquired on the 'date of distribution' at an expenditure equal to its market value on that date,[623] and
- the expenditure must be treated as an amount of expenditure actually incurred and paid for the purposes of para 20(1)(*a).*

The term 'date of distribution' is defined in para 74.

This rule applies regardless of whether the distribution is a capital distribution or a dividend.

This rule does not apply to assets acquired before the valuation date because the Eighth Schedule only applies to disposals on or after the valuation date. The expenditure incurred on an asset of this nature must be determined according to common law principles having regard to the extinction of the personal right to claim delivery of the asset. The application of these principles may well provide the same result as para 76(3). See **8.5A**. This is relevant for determining 'B' in the TAB formula for such assets.

Pre-CGT unbundling of shares

The unbundled company shares

A shareholder who received shares under an unbundling transaction before the valuation date would usually acquire them for an expenditure equal to their market value under the principles discussed in **8.5A**. If 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 **8.5A**. The date of acquisition for the purposes of determining 'N' (period before valuation date) in the formula will be the date on which ownership of the shares was acquired. 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 unbundled shares are disposed of.

The unbundling company shares

Despite the fact that a pre-CGT unbundling distribution would have been exempt from STC under the old unbundling legislation,[624] it nevertheless falls outside the definition of a 'capital distribution'.[625] It follows that there is no means to reduce the expenditure in respect of the unbundling company shares under para 76(1)(*a*).[626] From the *fiscus's* point of view this is a somewhat perverse situation, since by rights a portion of the expenditure on the unbundling

[623] The term 'date of distribution' was inserted in para 76(3) by s 30 of the Taxation Laws Amendment Act 16 of 2004. The amendment came into operation as from the commencement of years of assessment ending on or after 1 January 2005.
[624] 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.
[625] Only dividends that are exempt from STC under s 64B(5)(*c*) are brought within the definition of 'capital distribution'.
[626] 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.

company's shares should be allocated to the unbundled company's shares. The problem only arises when TAB is used for 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 the post-CGT unbundling of shares 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.

18.3.6 Reporting of capital distributions to shareholders [para 76(4)]

Paragraph 76(4) is scheduled to come into operation when the dividends tax comes into operation on 1 April 2012.[627]

It provides as follows:

> 'Every company that makes a distribution to any other person and every person that pays a distribution to any other person on behalf of a company must by the time of the distribution or payment notify that other person in writing of the extent to which the distribution or payment constitutes a capital distribution.'

This provision was inserted in tandem with the introduction of the 'dividends tax' in Part VIII of Chapter II of the Act to replace STC on a future date. A key element of the dividends tax is the definition of the term CTC in s 1. In order for a transfer of CTC to shareholders to be valid, the definition of that term requires the amount to be determined by the board by the date of the transfer. This requirement would be met if shareholders and other intermediaries are informed of the transfer of CTC.

18.4 Part-disposal of shares

Paragraph 76A

Paragraph 76A was deemed to have come into operation on 1 October 2007.[628] It introduces part-disposal treatment for capital distributions referred to in para 76.

A person adopting the specific identification or first-in-first-out method for a share will have a part-disposal upon receipt or accrual of a capital distribution of cash or an asset *in specie* as set out in the table below.

Note: The Taxation Laws Amendment Bill, 2011 proposes a number of amendments to paras 76 and 76A which alter the dates in the table below. In essence the part-disposal approach is proposed to end on 31 March 2012 after which capital distributions will be dealt with as a reduction in base cost. It is proposed that the pre-1 October 2007 capital distributions no longer trigger a part-disposal on 1 July 2011 but rather be dealt with as a reduction in base cost on 1 April 2012.

[627] Paragraph 76(4) was inserted by s 84(1) of the Revenue Laws Amendment Act 60 of 2008 and comes into operation on the date on which Part VIII of Chapter II of the Income Tax Act, 1962. Under s 56(2) Part VIII comes into operation on a date determined by the Minister by notice in the *Gazette*, which date must be at least three months after the date of the notice.

[628] Paragraph 76A was inserted by s 85 of the Revenue Laws Amendment Act 35 of 2007.

Table 1 – Time of part-disposal triggered by capital distributions received or accrued [para 76A(1)]

When capital distribution received or accrued	Time of part-disposal
On or after valuation date but before 1 October 2007 if share not disposed of on or before 1 July 2011	On 1 July 2011
On or after 1 October 2007	When received or accrued

A shareholder adopting the weighted-average method under para 32(3A) would have deducted any capital distributions received or accrued on or after valuation date but before 1 October 2007 from the base cost of the shares under para 76(2). For this reason it was not possible to adopt the same rules that apply when specific identification or first in, first out are used for pre-1 October 2007 capital distributions.

Table 2 – Time of part-disposal of shares when capital distributions are received or accrued and the weighted-average method has been adopted [para 76A(1)(*b*) and (2)]

When capital distribution received or accrued	CGT treatment
On or after valuation date but before 1 October 2007 if share not disposed of on or before 1 July 2011	If the base cost is a negative amount at the end of 30 June 2011 • the negative amount is deemed to be a capital gain on 30 June 2011, and • the base cost of the shares at the end of 30 June 2011 is deemed to be nil [para 76A(2)].
On or after 1 October 2007	Part-disposal when amount received or accrued [para 76A(1)(*b*) read with para 76(1)(*c*)]

A part-disposal will not be triggered under any of the identification methods if a capital distribution is received or accrues on or after 1 October 2007 in the form of a share distributed under an unbundling transaction contemplated in s 46(1). Under s 46 a portion of the base cost of the unbundling company's shares is allocated to the unbundled company shares.[629]

The part-disposal calculation

The portion of the base cost disposed of when para 76A applies is determined under para 33(1) read with para 76A(3) using the following formula:

$$A = \frac{B}{C} \times D$$

in which

A = The portion of the cost of the shares, market value on 1 October 2001 or weighted average base cost to be allocated to the part-disposal.

B = The market value of the capital distribution received or accrued [para 76A(3)].

[629] Paragraph 76A(1)(*b*) amended by s 61(1)(*b*) of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation on 1 October 2007.

C = The market value of the shares immediately before the capital distribution is received or accrues.

D = The cost of the shares, market value on 1 October 2001 or weighted-average base cost to be allocated to the part-disposal, where applicable.

Example 1 – Capital distribution triggering part-disposal on or after 1 October 2007

Facts:

Tanya acquired a share in 2002 at a cost of R120. On 31 January 2011 she received a capital distribution of R20 in cash. The market value of the share at the close of business on 30 January 2011 was R200.

Result:

The capital distribution triggers a part-disposal. An amount equal to 10% of the R120 expenditure is allocated to the part-disposal (R20 capital distribution divided by R200 market value). Tanya will therefore have a capital gain of R8 (R20 proceeds less R12 allocable expenditure). The base cost of the share going forward is R120 – R12 = R108.

Example 2 – Capital distributions and the weighted-average method

Facts:

Dolores adopted the weighted-average method for base cost and identification purposes for her listed shares. The following is a summary of her weighted-average base cost of shares in ABC Ltd, a JSE-listed company:

		No of Shares	Price per share R	Base cost R
01.10.2001	Opening balance	200	1,00	200,00
30.06.2004	Buy	100	1,50	150,00
28.02.2007	Capital distribution			(20,00)
Subtotal		300	1,10	330,00
31.07.2007	Sell	(100)	1,10	(110,00)
Subtotal		200	1,10	220,00
31.12.2007	Buy	300	2,00	600,00
Subtotal		500	1,64	820,00
30.06.2008	Sell	(100)	1,64	(164,00)
Subtotal		400	1,64	656,00

The shares sold on 31 July 2007 realised R1,80 a share.

The shares sold on 30 June 2008 realised R3,00 a share.

On 31 December 2008 Dolores received a capital distribution of R60 from the 400 shares held at the time. The market value of the shares at close of business on 31 December 2008 is R3,00 a share.

Determine the capital gain or loss arising from the various sales and capital distribution receipts and the base cost after the last transaction.

Result:

Capital distribution – 28 February 2007

No capital gain or loss arises on the receipt of this capital distribution. Since the amount was received before 1 October 2007, it is deducted from the base cost of the shares.

Sale – 31 July 2007

	R
Proceeds 100 x R1,80	180,00
Less: Base cost	(110,00)
Capital gain	70,00

Sale – 30 June 2008

	R
Proceeds 100 x R3,00	300,00
Less: Base cost	(164,00)
Capital gain	136,00

Capital distribution – 31 December 2008

Proceeds	60,00
Less: Base cost R60/R1 200 x R656	(32,80)
Capital gain	27,20

The base cost of Dolores's shares after the capital distribution is as follows:

		No of Shares	Price per share R	Base cost R
Subtotal		400	1,64	656,00
31.12.2008	Capital distribution			(32,80)
Subtotal		400	1,56	623,20

Disposal before 1 July 2011 of shares carrying pre-1 October 2007 capital distributions

Under the specific identification and first-in-first-out methods, if a person disposes of a share on or before 1 July 2011 in respect of which capital distributions were received or accrued on or after valuation date but before 1 October 2007, those capital distributions must be added to the proceeds on disposal of the share under para 76(1)(*b*) read with the core disposal rules in paras 11, 12 and 77. If the weighted-average method has been adopted, such capital distributions will be reflected in the reduced base cost of the share under para 76(2).

Example 3 – Distributions preceding dissolution of a company (dividend subject to STC distributed first)

Facts:

Joe acquired all the shares in ABC (Pty) Ltd at a cost of R100 in 1995. The market value of the shares on 1 October 2001 was R400. The company was placed in voluntary liquidation on 31 December 2010 at which time its market value was R620 before any contingent liability for STC.

The R620 value was represented by

	R
Share capital (CTC)	100
Share premium (CTC)	300
Profits	220
	620

The company made the following distributions:

28 February 2011 – R200 dividend.

31 May 2011 – R300 CTC

30 June 2011 – R100 return of paid up share capital.

The company was finally dissolved on 31 July 2011.

Joe adopts the market-value method to determine the base cost of the shares

Determine the CGT consequences of each of the amounts received by Joe.

Result:

28 February 2011 – no impact on Joe as this is a dividend. STC of R20 is payable on the dividend of R200. After this distribution the market value of the company falls from R620 to R400 (that is, by the amount of the dividend plus the STC thereon)

31 May 2011 – The amount of R300 is a capital distribution which triggers a part-disposal under para 76A:

The base cost of the part disposed of is determined under para 33(1)(*b*) as follows:

Market value of asset on 1 October 2001 x capital distribution / market value immediately before disposal
= R400 x R300/R400
= R300

Capital gain = Proceeds – base cost of part disposed of
= R300 – R300
= Nil

30 June 2011 – The return of paid up share capital is a full disposal dealt with under para 35 read with para 77(1). The time of disposal is the date of dissolution, namely, 31 July 2011. Although the proceeds accrue on 30 June 2011 they are brought to account on 31 July 2011.

Capital gain = Proceeds – remaining base cost
= R100 – R100
= Nil

Example 4 – Distributions preceding dissolution of a company (CTC distributed first)

Facts:

The facts are the same as Example 3 except that the capital distribution of R300 occurs first, on 28 February 2011 and the dividend of R200 is declared next, on 31 May 2011. The date of return of the paid-up share capital and the date of dissolution remain the same.

Result:

28 February 2011

	R
Proceeds (capital distribution)	300
Less: Base cost of part disposed of R300/R600 x R400	(200)
Capital gain	100

It is assumed that the market value of the shares immediately before the capital distribution is R620 less the contingent liability for STC of R20 = R600.

31 May 2011 – Dividend – no impact except STC

31 July 2011 – Final dissolution of company

	R
Proceeds (para 35)	100
Less: Base cost (R400 – R200)	(200)
Capital loss	(100)

The capital loss is disallowed under para 26(3) (remaining expenditure = R50, remaining market value on 1 October 2001 = R200, proceeds R100).

18.5 Distributions in liquidation or on deregistration received by a shareholder

Paragraph 77

18.5.1 Purpose

The purpose of this paragraph is to provide rules for shareholders of companies that are being liquidated or deregistered, namely

- 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.

18.5.2 Capital distributions before disposal

Shareholders of companies that are to be liquidated or deregistered who receive capital distributions before disposal of their shares must deal with those capital distributions under paras 76 and 76A. In other words, for a company being liquidated or deregistered on or after 1 October 2007 capital distributions must be treated as follows:

- Pre-valuation date capital distributions reduce expenditure, but not below nil (not applicable if the weighted-average method is used).
- Capital distributions received or accrued on or after 1 October 2001 but before 1 October 2007 must be accounted for as proceeds on disposal of the shares, which will occur on the date specified in para 77(1). If the date of disposal falls after 1 July 2011 a deemed part-disposal will occur on 1 July 2011 under para 76A(1)(*a*). If the weighted-average method is used, these capital distributions must be deducted from the base cost of the shares and a capital gain or loss will simply be determined on

the date of disposal specified under para 77(1). A capital gain will be deemed to arise on 30 June 2011 if the base cost is negative at the end of that date [para 76A(2)].

- Capital distributions received or accrued on or after 1 October 2007 trigger part-disposal treatment under para 76A(1)(*b*).
- The return of the nominal share capital of a company that is being wound up represents proceeds under para 35 on a full disposal of the shares. Those proceeds must be accounted for on the date of disposal specified in para 77(1).

18.5.3 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

- 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 rule allows a shareholder to crystallise a loss without having to wait until the liquidation process is complete.[630]

18.5.3.1 Date of dissolution

Under s 83(1) of the Companies Act 71 of 2008 a company is dissolved as of the date its name is removed from the companies register unless the reason for the removal is that the company's registration has been transferred to a foreign jurisdiction, as contemplated in s 82(5) of that Act.

18.5.3.2 Date of deregistration

The date of deregistration of a company occurs on the date on which its name is removed from the companies register. The company is regarded as being dissolved as of that date (s 83(1) of the Companies Act 71 of 2008).

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.

18.5.4 Distributions after date of disposal [para 77(2)]

If a shareholder receives any further capital distributions after the date of disposal determined in para 77(1), the distributions are treated as a capital gain without a base cost deduction.

[630] The Australian legislation contains a similar provision. Under 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 realise 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 Act, 1992.

Example – 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 31 December 2010. On 28 February 2011 the liquidator distributed R100 in cash to Ophelia. At the same time he declared that all remaining proceeds would be paid to creditors and 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 on 30 June 2011. The company was finally dissolved on 30 November 2011. All the distributions described constitute CTC.

Result:

Under para 77(1) Ophelia is deemed to have disposed of her shares on 28 February 2011. In the 2011 year of assessment she will have a capital loss of R400 (R100 proceeds under para 76(1)(*b*) less R500 base cost). Under para 77(2) she will have a capital gain of R30 in the 2012 year of assessment.

18.6 Share buy-backs

Paragraphs 11(1)(*b*) and 35, s 1 definition of the term '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 CTC ('pure' share capital or share premium).

This follows from the following:

- 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 the term 'gross income' by virtue of para (*k*) of that definition, they will be excluded from proceeds under para 35(3)(*a*). What remains in proceeds is the non-dividend portion of the consideration received for the buy-back (that is, a return of CTC).

Note: On or after 1 January 2011 certain buy-backs of JSE-listed shares (for example, an open market buy back) are excluded from the definition of a 'dividend'. In these cases the full consideration received by or accrued to the shareholder will comprise the proceeds and there will be no reduction for any dividend element – see **18.1.1**.

Example – 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 an amount received or accrued of R4 500 000. Of this amount, R1 200 000 represents CTC 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 proceeds less the R3 000 000 base cost in the shares redeemed). The artificial capital loss will be subject to the provisions of paras 19 and 39. Under para 19 the loss must be reduced by the amount of any 'extraordinary dividend' received within two years before the disposal of the shares. In this case the shares would be disposed of by cancellation shortly after their acquisition by the company. Under para 39 any remaining capital loss will be clogged as the transaction was between connected persons.

18.7 Issue of shares or options for no consideration

Section 40C

Section 40C[631] determines the base cost of capitalisation shares and replaces para 78(1), which was deleted with effect from 1 January 2011 by s 85(1)(*a*) of the Revenue Laws Amendment Act 60 of 2008.[632]

Under s 47 of the Companies Act 71 of 2008, except if a company's memorandum of incorporation provides otherwise, a company may issue capitalization shares on a pro-rata basis to shareholders of one or more classes of shares. At the time the board passes the necessary resolution to award such shares, it may, subject to certain solvency requirements, resolve to permit any shareholder entitled to receive such an award to elect instead to receive a cash payment, at a value determined by the board (this type of capitalisation share is commonly referred to as a scrip dividend). Scrip dividends enable a company to retain cash for future investment and also have the benefit that no STC will be payable upon issue of the shares.[633]

Capitalisation shares issued before 1 January 2011

As noted above, the treatment of capitalisation shares issued before 1 January 2011 was regulated by para 78(1) read with the pre-1 January 2011 definition of a 'dividend' in s 1. Under that definition, the issue of a capitalisation share which comprised an equity share did not constitute a dividend. But the issue of a non-equity capitalisation share (for example, a non-participating preference share) comprised a dividend and was subject to STC.

Under para 78(1) equity capitalisation shares were deemed to be acquired for an expenditure incurred and paid of nil on the 'date of distribution' as defined in para 74, while non-equity capitalisation shares were deemed to be acquired on the 'date of distribution' for an expenditure incurred and paid equal to the amount of the dividend. The purpose of granting a step-up in base cost for the non-equity capitalisation share was to prevent economic double taxation on the same amount (that is, STC at the company level and CGT at the shareholder level).

[631] Section 40C was inserted into the Act by s 47(1) of the Revenue Laws Amendment Act 60 of 2008 and comes into operation on 1 January 2011. The effective date of 1 January 2011 was introduced by s 139(1) of the Taxation Laws Amendment Act 7 of 2010, which amended s 47(2) of the Revenue Laws Amendment Act 60 of 2008.

[632] The effective date of 1 January 2011 was introduced by s 143 of the Taxation Laws Amendment Act 7 of 2010. An amendment of para 78(1) by s 111 of the same amending Act, effective 1 January 2011, would appear to have been made in error. It is accepted that s 143 takes precedence over s 111 on the basis that it is a later provision.

[633] Paragraph (ii) of the exclusion to the definition of a 'dividend' in s 1 excludes any amount transferred or applied by a company that 'constitutes shares in that company'.

Capitalisation shares issued before 1 January 2011 that constituted dividends were rare, since unlike normal capitalisation shares, they were subject to STC. For a more detailed discussion on the nature of such shares see the commentary on para 74 in **18.1**.

With the introduction of the new dividend definition from 1 January 2011 the need to distinguish between equity and non-equity capitalization shares has fallen away. This is because para (ii) of the definition of a dividend excludes any amount transferred or applied to the extent that it constitutes shares in the company. As a result a non-equity share will also be deemed to be acquired for an expenditure of nil under s 40C.

Example – Base cost of capitalisation shares issued before 1 January 2011 constituting a dividend

Facts:

On 30 November 2010 Ronen (Pty) Ltd issued 100 000 7% redeemable preference shares of R1 each to its existing ordinary shareholders on the basis of one preference share for each ordinary share held. The preference shares were issued out of retained income. Christine holds 1 000 ordinary shares and receives 1 000 preference shares. Christine immediately disposed of her preference shares at the market value of R1 a share.

Result:

Christine's preference shares will have a base cost of R1 000. Ronen (Pty) Ltd will pay STC of 10% x R100 000 = R10 000 in respect of the preference share issue as it constitutes a dividend. Christine will accordingly make neither a capital gain nor a loss.

Capitalisation shares issued on or after 1 January 2011

Section 40C applies when a company issues shares (or an option or other right for the issue of shares) to a person for no consideration. In such event, the expenditure actually incurred by the person to acquire the shares, option or right is deemed to be nil. The Act is silent on the date of acquisition of capitalisation shares, but it is submitted that this would occur on the date when the shareholder becomes unconditionally entitled to them.

Regardless of whether the shareholder is given the option of taking a dividend instead of a capitalisation share, the tax treatment for STC and CGT purposes is identical.

Issues of capitalisation shares have no base cost impact on previously held shares that carry the rights to participate in the capitalisation shares.

Example 1 – 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 issue of the additional ordinary share falls under s 40C because no previously held shares are surrendered in substitution. Rae retains the R50 base cost in the pre-existing ordinary share, while the new share is deemed under s 40C to have a base cost of nil. The capital gain or loss on disposal of each share depends on whether Rae disposes of the

share under the first-in first-out method, weighted-average method, or specific identification method under para 32.

Capitalisation shares acquired before valuation date

A shareholder has the option of adopting market value, TAB or 20% of proceeds for capitalisation shares acquired before the valuation date. This prevents the shareholder from being subjected to CGT on a pre-CGT gain.

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 need to exercise caution in the case of capitalisation shares disposed of before years of assessment ending on or after 8 November 2005, since any selling expenses incurred will result in the application of the proceeds formula in para 30(2). Since there would be nil expenditure before valuation date and the selling expenses after valuation date, the effect will be to allocate the overall gain into the post-CGT period. The proceeds formula will no longer be triggered by selling expenses in the case of capitalisation shares disposed of during years of assessment ending on or after 8 November 2005, because the TAB formula was amended to treat selling expenses as a reduction of proceeds (see **8.34.10**).

Example 2 – Base cost of pre-valuation date capitalisation shares sold during years of assessment ending on or after 8 November 2005

Facts:

John acquired 10 capitalisation shares in lieu of dividends from MVK Limited on 1 November 1991. He sold them on 15 February 2011 for R100 a share, and incurred selling expenses of R5 a share. The market value of the shares on valuation date was R60 a share.

Result:

The effect of adopting the three valuation date value methods is shown below.

Market value

Capital gain = proceeds – VDV – post-1 October expenditure
= R1 000 – R600 – R50
= R350

TAB

TAB = B + [(P – B) x N/(N + T)]
= R0 + [(R1 000 – R50) x 10/20
= R475
Capital gain = Proceeds – VDV – post-1 October 2001 expenditure
= R1 000 – R475 – R50
= R475

20% of proceeds

Proceeds = R1 000
Post-CGT expenditure = R50
Proceeds less post-1 October 2001 expenditure = R950
VDV = 20% x 950 = R190

Capital gain = Proceeds – VDV – post-CGT expenditure = R1 000 – R190 – R50 = R760

18.8 Share substitution

Paragraph 78

Paragraph 78 addresses the shareholder-level impact of the issue by a company of shares in substitution for shares previously held in the same company.

18.8.1 Share substitution unaccompanied by capital distribution [para 78(2)]

A share substitution contemplated in para 78(2) covers[634]

- a share split (subdivision), for example, 10 new shares for each old share,
- a consolidation for example, one new share for every 10 old shares, and
- a conversion of a company, close corporation or co-operative referred to in ss 40A and 40B of the Act.

An equal share-for-share exchange for example, one new share for one 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.

Under s 114 of the Companies Act 71 of 2008 the board of a company may propose, amongst others

- a consolidation of securities of different classes;
- a division of securities into different classes; and
- the exchange of any of its securities for other securities.

Thus, for example, a company could consolidate its class A and B ordinary shares into a single class of ordinary shares or it could split its ordinary shares into class A and B ordinary shares. It is an implicit requirement of para 78(2) that the totality of the rights before the substitution should equal the totality of the rights after the substitution. This can be inferred from para 78(2) because

- it is made subject to the value shifting provisions in paras 11(1)(*g*), 23 and 35(2), which means that the latter provisions take precedence;
- a part-disposal will be triggered to the extent that shareholders receive a capital distribution [see para 78(3)]; and
- it does not cover a conversion of one class of shares into shares of another class, for example, a conversion of preference shares to ordinary shares because it only makes an exception for a conversion under s 40A or 40B.

[634] The words 'or similar arrangement' were deleted from para 78(2) by s 85(1)(*b*) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

Example – Substitution of different classes of shares for pre-existing shares

Facts:

ABC (Pty) Ltd has an issued share capital of 100 000 ordinary shares with a market value of R10 000 each. As a precursor to another transaction the company cancels the ordinary shares and issues 3 A class ordinary shares and 2 B class ordinary shares to each shareholder in substitution for each existing ordinary share. The A and B class shares have a market value of R2 000 each.

The company contains two discrete businesses, A and B. The class A shares entitle the shareholders to dividends out of the profits of business A while the class B shares entitle shareholders to dividends out of the profits of business B.

Result:

The issue of the class A and B shares is regarded as a 'substitution' for the purposes of para 78(2).

The shareholder must disregard any capital gain or loss arising from the substitution [para 78(2)(*a*)].

Under para 78(2)(*b*) the details of the old shares are carried over to the newly issued shares, namely,

- any expenditure allowable under para 20,
- the date that expenditure was incurred,
- the date of acquisition, and
- any market value adopted or determined under para 29(4).[635]

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.

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.

How must the above provisions be applied in determining TAB in the case of a consolidation under which the previously held shares were acquired on different dates? It is submitted that this problem can be addressed by splitting the proceeds on the disposal of the consolidated share between the previously held shares, performing separate TAB calculations, and then combining the result. This is illustrated in the example below.

[635] Paragraph 78(2) and (3) were amended by s 116(1)(*b*) and (*c*) of the Revenue Laws Amendment Act 45 of 2003 to replace the reference to base cost with a reference to expenditure and market value. To the extent that 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 under para 29(4) was not backdated and therefore came into operation as from the commencement of years of assessment ending on or after 1 January 2004.

Example – Determination of TAB after consolidation

Facts:

Lani acquired the following ordinary shares in Millbrew Ltd:

Date	No of shares	Cost R
1 July 1990	100	100
1 August 2000	100	150
1 June 2004	100	250

On 31 October 2005 Millbrew Ltd consolidated its issued share capital by issuing 1 new share for every 3 existing shares. On 31 October 2006 Lani sold her shares for R1 200. Determine Lani's capital gain or loss assuming that she adopts TAB.

Result:

Lani's 100 consolidated shares are made up of a mix of pre- and post-valuation date shares that were acquired on different dates at different costs. She received R1 200/300 = R4 a share in relation to her previously held shares. Therefore her capital gain or loss is determined as follows:

Post-valuation date shares

	R
Proceeds 100 x R4	400
Less: Base cost	(250)
Capital gain	150

Pre-valuation date shares

Share bought on 1 July 1990

TAB = B + [(P – B) x N/(N + T)]
= R100 + [(R400 – R100) x 12/(12 + 6)]
= R100 + (R300 x 12/18)
= R100 + R200
= R300

Capital gain = R400 – R300
= R100

Share bought on 1 August 2000

TAB = B + [(P – B) x N/(N + T)]
= R150 + [(R400 – R150) x 2/(2 + 6)]
= R150 + (R250 x 2/8)
= R150 + R62,50
= R212,50

Capital gain = R400 – R212,50
= R187,50

Combined capital gain = R150 + R100 + R188 = R438

18.8.1.1 Pre-valuation date subdivisions and consolidations

In the case of a pre-1 October 2001 subdivision or consolidation para 78(2)(*b*) will not apply, since under para 2 the Eighth Schedule only applies to disposals on or after the valuation date. It follows that common law principles must be applied in determining the date of acquisition and cost of the replacement shares. The date of acquisition will be the date on which the shareholder became unconditionally entitled to the replacement shares. In a simple consolidation or subdivision the cost of acquisition will be equal to the market value of the shares surrendered in exchange (see **8.5**).

18.8.1.2 Conversion

As noted above, a capital gain or loss will not be triggered by a conversion under 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 close corporation to a company	Schedule 2 of the Companies Act 71 of 2008.
40B	From a co-operative to a company	Section 161A or 161C of the Co-operatives Act 91 of 1981. Section 62 of the Co-operatives Act 14 of 2005.

Example 1 – Share split

Facts:

Sierra (Pty) Ltd has 100 000 issued ordinary shares, each of which has a market value of R60. Rene holds a single Sierra (Pty) Ltd share with a base cost of R50.

Sierra (Pty) Ltd announces a share split under which its shareholders will surrender each of their previously held ordinary shares for two new ordinary shares.

Result:

The share split qualifies as a substitution because previously held shares are being surrendered in exchange. Rene realises no capital gain or loss from the disposal of her previously existing share. She has the same aggregate R50 base cost in the two new shares with each new share receiving a base cost of R25 (that is, R50 divided in equal value between the two shares).

18.8.2 Substitution of shares accompanied by capital distribution [para 78(3)]

Special rules apply when a company issues shares and at the same time makes a capital distribution of cash or assets *in specie* in exchange for previously held shares. When this happens, the transaction 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 under para 20 and any market value adopted or determined under 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 – Share substitution plus cash

Facts:

Romeo Ltd has 100 000 issued ordinary shares having a market value of R20 a share. Salomi owns 1 ordinary share with a base cost of R12. Romeo Ltd enters into a substitution under which each ordinary share surrendered will be substituted with 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 CTC.

Result:

The receipt of the capital distribution of R10 will trigger a capital gain in Salomi's hands. Under 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 previously held ordinary share of R12 is allocated as follows:

		R
To ordinary shares	(40/50 x R12)	9,60
To capital distribution	(10/50 x R12)	2,40
		12,00

Each ordinary share will therefore have a base cost of R4,80 (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.

18.9 Matching contributions and distributions

Paragraph 79

Paragraph 79 has been repealed and only applies to distributions before 1 October 2007.[636] Its repeal is consequential on the introduction of part-disposal treatment for capital distributions under para 76A with effect from 1 October 2007. The comments below therefore only apply to distributions before 1 October 2007.

Before its deletion para 79 contained 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

[636] Repealed by s 86 of the Revenue Laws Amendment Act 35 of 2007.

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 – 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 reduces the previously issued share capital by distributing R500 000 to Tertia 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	Examples of assets to which the relevant provisions apply
Paragraph 43(1) and (2)	All persons	The following assets are included through a process of elimination: • Immovable property situated outside South Africa • Assets of a PE situated outside South Africa • Loans, advances or debt • Movable assets which are subject to foreign taxation Excluded are para 43(4) assets, namely, foreign equity instruments and certain deemed South African-source assets.	The following assets of a resident: • A holiday home in France. • Plant forming part of a Singapore branch of a South African-resident company • A foreign bank account or a euro bond. • A foreign unlisted share subject to foreign tax. • A foreign endowment policy subject to foreign tax.
Paragraph 43(4)(*a*)	All persons	*Foreign equity instruments*	• Foreign listed shares. • Participatory interests in portfolios of foreign

Paragraph 43(4)(*b*)		*Deemed SA-source assets* • Immovable property in South Africa. • Any interest or right in or to immovable property in South Africa • Movable assets of a resident (other than assets of a foreign PE of that resident) which are subject to foreign taxation. • Assets of a PE in South Africa of a non-resident. *Paragraph 43(4)(b) exclusion:* Assets in the form of loans, advances or debt in foreign currency dealt with under Part XIII (paras 84 to 96) • Overall	collective investment schemes. • Gold and platinum coins. *Non-residents:* • Land and buildings situated in South Africa. • An interest of at least 20% in the shares of a company holding South African immovable property. • Plant held by a South African branch of a United Kingdom-resident company. • Residents: • Land and buildings situated in South Africa. • Foreign unlisted shares not subject to foreign taxation. • Foreign endowment policy not subject to foreign taxation. *Paragraph 43(4)(b)*

		exclusion from para 43(4)(*a*) and (*b*): Exchange items falling within s 24I.	*exclusion:* The following assets of a PE in South Africa of a non-resident individual: • Overseas bank deposits. • A loan denominated in foreign currency. *Overall exclusion from para 43(4)(a) and (b):* • A US Treasury bond.
Part XIII (para 84 to 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 • Individuals holding units of currency, loans, advances or debt in foreign currency as trading stock, and • Individuals or trusts in respect of ➢ forward	Exchange items: • Foreign currency assets or liabilities (see above), • Forward exchange contracts owed by or to a person	See above examples

	exchange contracts owed by or to them, and ➢ rights or contingent obligations to buy or sell foreign currency option contracts.	• Rights or contingent obligations under foreign currency option contracts.	

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 (para 43)

Paragraph 43

19.2.1 Historical position

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 four fundamental policy shifts deserve mention. The first was the introduction by the Revenue Laws Amendment 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 the Revenue Laws Amendment 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 South African-source assets are now treated in the same way as foreign equity instruments with their full currency movements falling within the CGT net. The third amendment effected by the Revenue Laws Amendment Act 31 of 2005 substantively changed the method of translation of foreign currency under s 25D[637] and para 43. The amendment to s 25D introduced the compulsory use of the spot rate for companies and trading trusts, except in the case of foreign permanent establishments in which case the average exchange rate is applicable. Under s 25D(3) individuals and non-trading trusts can elect to use the average exchange rate instead of the spot rate. The definition of an 'average exchange rate' in s 1 has been simplified and no longer makes provision for the weighted-average method. A definition of a 'spot rate' was also introduced into s 1 by s 3(1)(*l*) of the Revenue Laws Second Amendment Act 32 of 2005. The fourth amendment clarified and relaxed the translation rules. Instead of relying on references to s 25D the Revenue Laws Amendment Act 35 of 2007 inserted specific translation rules. The different rules for companies and trading trusts were also scrapped.

In order to assist the reader, the table below sets out the Amending Acts and their effective dates. When dealing with a disposal before years of assessment commencing on or after 13 December 2002, a disposal before 22 December 2003 or one before 8 November 2005 it would be best to check the wording of the paragraph as it read at the applicable time.

[637] Section 25D was substituted by s 35(1) of the Revenue Laws Amendment Act 31 of 2005. The amendment applies to any year of assessment ending on or after 8 November 2005.

Table 1 – Summary of amendments to para 43 and related provisions

Amended by	Amendment	Effective date
Section 38 of the 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 the Revenue Laws Amendment Act 74 of 2002	Substitutes entire paragraph.	Applies in respect of the disposal of any asset during any year of assessment that commences on or after 13 December 2002.
Section 101 of the Revenue Laws Amendment Act 45 of 2003	Substitutes subparas (1) and (2), partly substitutes subparas (4), (5) and (7) and inserts subpara (5A).	Applies to any disposal on or after 22 December 2003.
Section 75(1) of the Revenue Laws Amendment Act 31 of 2005	Substitutes the following: • subpara (1), • opening words in subpara (2), • subpara (2)(*c*)(ii), • subpara (4)(*b*)(i) and (ii), and • subpara (6)(*a*)	Applies in respect of any assets disposed of on or after 8 November 2005.
Section 35(1) of the Revenue Laws Amendment Act 31 of 2005	Substitutes s 25D	Came into operation on 8 November 2005 and applies in respect of any year of assessment ending on or after that date.
Section 3(1)(*a*) and (*l*) of the Revenue Laws Second Amendment Act 32 of 2005	Amends the definition of an 'average exchange rate' in s 1 Introduces a definition of a 'spot rate' in s 1.	Both amendments came into operation on 8 November 2005 and apply in respect of years of assessment ending on or after that date.
Section 76 of the Revenue Laws Amendment Act 35 of 2007	Amends para 43(1), 43(2)(*a*), (*b*) and (*c*)(ii) and 43(4)(i) and (ii)	Deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2008.
Section 100 of the Taxation Laws Amendment Act 7 of 2010	Deletes in opening words of para 43(2) references to denomination of foreign	Comes into operation on 1 January 2011 and

	currencies in relation to a permanent establishment. Substitutes a new definition of 'local currency' in para 43(7).	applies in respect of disposals made during years of assessment commencing on or after that date.

19.2.2 Overview of para 43

Table 1 – Overview of para 43

Paragraph 43	Application to type of asset	Deals with
(1)	Assets other than those in para 43(4)	Proceeds and expenditure in same foreign currency.
(2)	Assets other than those in para 43(1) or (4)	Proceeds or expenditure in different currencies
(3)	Deleted	
(4)	• Foreign equity instruments • Immovable property in South Africa • Movable assets of a resident that are not subject to foreign tax (but not assets in a foreign PE of that resident) • Assets of a PE in South Africa 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	Definitions

19.2.3 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 when 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.

19.2.4 Definitions [s 1, para 43(7)]

Paragraph 43 makes reference to a number of defined terms, some of which are defined in s 1, while others are defined in para 43(7).

19.2.4.1 Definition – average exchange rate (s 1)

Before years of assessment ending on or after 8 November 2005

> '**"[A]verage 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.'

Under the above definition, two methods were open to a taxpayer for the purpose of determining the average exchange rate before years of assessment ending on or after 8 November 2005.

The simple average method

This is discussed in more detail below in the commentary on the position applying to years of assessment ending on or after 8 November 2005.

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 words 'net amount' indicate 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.

Example – 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	11 000
2		50			50	10.5	525

3	200				200	10.75	2 150
4		100			100	11	1 100
5	250			2000	2250	10.8	24 300
6	300				300	10	3 000
7		150			150	9.5	1 425
8	400				400	8	3 200
9	600				600	7.6	4 560
10	100		500		600	8	4 800
11	50				50	8.5	425
12		500			500	8.2	4 100
					6 300		60 585
Weighted average exchange rate		60 585/6 300					9.616667

Years of assessment ending on or after 8 November 2005

> '**"[A]verage exchange rate"** in relation to a year of assessment means the average determined by using the closing spot rates at the end of daily or monthly intervals during that year of assessment which must be consistently applied within that year of assessment'.

The above definition differs from its predecessor in three important respects.

- First, the use of the weighted-average method has been discontinued.
- Secondly, the use of weekly rates for the purposes of determining the average exchange rate has been discontinued.
- Thirdly, a definition of a 'spot rate' has been introduced into s 1 of the Act (see **19.2.4.6**).

The method described in the above definition is a simple average of closing spot rates over the selected interval (365 days 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 South African Reserve Bank are available on the SARS website under Tax Types / Income Tax (IT) / Average exchange rates for a year of assessment.[638]

19.2.4.2 Definition – 'foreign equity instrument' (s 1)

> '**"[F]oreign 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

[638] Available from: <http://www.sars.gov.za/home.asp?pid=54666> [Accessed 8 December 2011] (Click on Table A or Table B). The Oanda website is also a useful source for average exchange rates, particularly for earlier years of assessment. Available from: <http://www.oanda.com/convert/fxhistory> [Accessed 8 December 2011].

(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 ADRs (American Depository Receipts).

Example – Depository receipts

Facts:

John, a resident, purchased 100 ADRs in Dracula Ltd, a Transylvanian company for $12 each via the New York Stock Exchange. The Bank of New York issued the ADRs 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 a **'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 the *Government Gazette* and is also available from the SARS website.[639] Paragraph (*a*)(ii) of the above definition is intended to cover exchanges that are not on the list of recognised exchanges.

Currency gains and losses on foreign equity instruments that constitute trading stock are fully taxable under s 9G. If such instruments are held as capital assets the currency gain or loss is determined under para 43(4).

19.2.4.3 Definition – 'permanent establishment' (s 1)

> '**"[P]ermanent 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: Provided that in determining whether a qualifying investor in relation to a partnership, trust or foreign partnership has a permanent establishment in the Republic, any act of that partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor;'

Article 5 of the OECD Model Tax Convention reads as follows:[640]

[639] GN R 997 *GG* 22723 of 2 October 2001. Available from: <http://www.sars.gov.za/home.asp?pid=3498> [Accessed 22 October 2011].
[640] The definition as it read on 9 April 2003. See: <http://213.133.111.71/allgemein/divers/oecd_tax_2003/node10.php> [Accessed 22 October 2011].

> ‘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 otherwise), shall not of itself constitute either company a permanent establishment of the other.’

Under 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.

19.2.4.4 Definition – 'foreign currency' and 'local currency' [para 43(7)]

'"**[F]oreign currency"** means currency other than local currency; and

'"**local currency"** means—

(*a*) in relation to a permanent establishment of a person, the functional currency of that permanent establishment (other than the currency of any country in the common monetary area);

(*b*) in relation to a headquarter company, the functional currency of that headquarter company; or

(*c*) in any other case, the currency of the Republic.'

Under para (*a*), the term 'local currency' could comprise a currency other than rands. However, the currencies of countries 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 South African Rand (for example, one Namibian dollar equals one rand). The currencies falling within this category are the Lesotho maloti, Namibian dollar and Swaziland emalangeni.

The term 'functional currency', as defined in s 1, is discussed in **19.2.4.5**.

Examples – Local currency

1. *Facts:*

   A resident has a branch in London which uses sterling as its functional currency.

   Result:

   The local currency is sterling.

2. *Facts:*

   A resident has a branch in Namibia which uses the Namibian dollar as its functional currency.

   Result:

   The local currency of the PE will be regarded as the rand because the Namibian dollar is a currency of a country in the Common Monetary Area.

19.2.4.5 Definition – 'functional currency' (s 1)

'"**[F]unctional currency"**, in relation to—

(*a*) a person, means the currency of the primary economic environment in which the business operations of that person are conducted; and

(*b*) a permanent establishment of any person, means the currency of the primary economic environment in which the business operations of that permanent establishment are conducted;'[641]

[641] This definition was inserted in s 1 by s 6(1)(*k*) of the Taxation Laws Amendment Act 7 of 2010 with effect from years of assessment commencing on or after 1 January, 2011.

For commentary on the above definition, see para 5 of Interpretation Note 63 'Rules for the Translation of Amounts Measured in Foreign Currencies' dated 19 September 2011.

19.2.4.6 Definition – 'spot rate' (s 1)

> '**"[S]pot rate"** means the appropriate quoted exchange rate at a specific time by any authorised dealer in foreign exchange for the delivery of currency.'[642]

Authorised dealers such as banks quote rates (prices) at which they will buy and sell foreign currency. These rates are based on prices quoted on foreign exchange markets which are subject to constant change and are determined by market forces of supply and demand. Rates of exchange are always quoted from an authorised dealer's point of view. In other words, the "buy" rate is the rate at which a dealer will buy foreign currency, while the "sell" rate is the rate a dealer will charge for selling foreign currency.

Thus, a resident that receives an amount expressed in a foreign currency will sell that foreign currency to a local authorised dealer in exchange for rand at the buying rate of exchange, since the dealer is buying the foreign currency from the resident. Conversely, a resident that settles a liability in a foreign currency will buy the required foreign currency from a local authorised dealer at the selling rate of exchange, since the dealer is selling foreign currency to the resident.

An 'appropriate' spot rate will depend on the facts and circumstances of the particular case, for example, banks have different rates depending on the quantity of currency being bought or sold.

19.2.5 Categories of asset

Paragraph 43 deals with two broad categories of asset

- Foreign equity instruments and certain South African-source assets [para 43(4)]
- Immovable property held outside South Africa by a resident, assets of a foreign PE of a resident, loans, advances or debt owing to a person in foreign currency and certain movable assets subject to foreign taxation (para 43(1) and (2)

For a summary with examples of para 43, see Table 1 in **19.1**.

Assets of a foreign PE of a resident, immovable property held outside South Africa by a resident, loans, advances or debt and certain movable assets subject to foreign taxation [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 situations in which

- 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)].

[642] This definition was introduced into s 1 by s 3(1)(*l*) of the Revenue Laws Second Amendment Act 32 of 2005 and deemed to have come into operation on 8 November 2005 and applies in respect of years of assessment ending on or after that date. The definition was introduced in tandem with the amendment of s 25D.

19.2.6 Proceeds and expenditure in same foreign currency [para 43(1)]

Paragraph 43(1) applies when both proceeds and expenditure are denominated in the same foreign currency. The capital gain or loss is determined in accordance with the table below.

Table 1 – Translation of foreign currency capital gain or loss into rands: para 43(1) assets

Paragraph 43	When does para 43(1) apply?	How capital gain or loss determined
(1)	When both the proceeds derived from, and the expenditure incurred in respect of, an asset are In the same foreign currency. *Excluded* from the above are para 43(4) assets, namely • foreign equity instruments, and • certain deemed South African-source assets.	• Step 1: Determine the capital gain or loss on disposal in the foreign currency. • Step 2: Translate the foreign currency capital gain or loss into rands by applying[643] • the average exchange rate for the year of assessment in which that asset was disposed of, or • the spot rate on the date of disposal of the asset.

Under para 43(1) no account is taken of the currency fluctuation between the date of incurral of the expenditure and the date of disposal. A decline over time in the rand against a particular foreign currency is to the benefit of a person holding a para 43(1) asset in that currency. 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 CFCs under s 9D(6) under which the foreign taxable income is brought back to rands at the average exchange rate during the relevant year of assessment.

Example 1 – Disposal of asset in respect of which proceeds are derived and expenditure is incurred in same foreign currency [para 43(1)]

Facts:

In 1998 Neil purchased a flat in Sydney for AU$135 000 in order to derive rental income. The market value of the property on 1 October 2001 was AU$220 000. In 2008 the property is sold for AU$270 000 when the average AU$/R exchange rate is AU$1 : R6,0663. Neil adopted the market value of the property as the valuation date value and elected to use the average exchange rate for the purpose of translating the capital gain to rands.

[643] The translation rules in para 43(1) were clarified after amendment by s 76(*a*) of the Revenue Laws Amendment Act 35 of 2007.

Result:

The capital gain on disposal of the asset is determined as follows:

Step 1: Determine capital gain in foreign currency

	AU$
Proceeds	270 000
Less: Base cost	(220 000)
Capital gain in foreign currency	50 000

Step 2: Translate capital gain in foreign currency to rands

Capital gain in foreign currency as above	AU$50 000
Average exchange rate	AU$1 : R6,0663
Capital gain in rands	R303 315

Example 2 – Foreign bank accounts

Facts:

In 2000 Carolyn invested $100 in the Caribbean Islands Shady Bank Inc. All went well until the 2008 year of assessment when the bank manager began speculating in the futures market. As a result, the bank was placed in liquidation, and on 29 February 2008 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. Carolyn elected to use the spot rate on 29 February 2008 which was $1 = R7,49225.

Result:

Under para 43(1) Carolyn must determine her capital loss in foreign currency [$40 (proceeds) – $100 (base cost) = $60 (capital loss)], and translate that capital loss into rands at the spot rate on 29 February 2008 (date of incurral of the loss), that is, $60 x R7,49225 = R450. She 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.

Example 3 – Loss on disposal of foreign loan involving s 24I and para 43(1)

Facts:

Greg holds sterling-denominated bonds as trading stock. On 1 March 2007 he lent £100 000 to Chelsea PLC, a United Kingdom-based investment company, when £1 = R14,22343. The loan was of a capital nature and unrelated to his bond-trading activities. Chelsea PLC was placed in liquidation on 29 February 2008 when the exchange rate was £1 = R14,86807. At that time it was established that there was no hope of recovery.

The average exchange rate for the year ending 29 February 2008 was £1 = R14,1675 and Greg wishes to use that rate.

Result:

Since Greg holds exchange items (sterling-denominated bonds) as trading stock, he must, under s 24I(2)(*c*) determine his exchange gain or loss under s 24I.

	R
£100 000 x R14,86807	1 486 807
£100 000 x R14,22343	(1 422 343)
Exchange difference	64 464

The exchange difference will be included in Greg's income under s 24I(3)(*a*). Had an exchange loss arisen it would have been deductible under the same provision read with s 11(*x*).

Greg will have a capital loss under para 43(1), determined as follows:

	£
Proceeds	-
Less: Base cost	(100 000)
Capital loss in sterling	(100 000)
Average exchange rate for 2008 year of assessment	R14,1675 : £1
Capital loss £100 000 x R14,1675	R1 416 750

19.2.7 Proceeds and expenditure in different currencies [para 43(2)]

Paragraph 43(2) does not apply when either para 43(1) or (4) applies.

It deals with the situation in which 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 on disposal of an asset that have been received or accrued in any currency.
- The 'currency of expenditure' is the expenditure actually incurred on the asset in a currency that differs from the currency of disposal.

Through a process of elimination, para 43(2) applies to the assets set out below whose proceeds and expenditure are in different currencies as described above. In each case para 43(1) will not apply because that provision deals with a situation in which an asset is acquired and disposed of in the same foreign currency. The reasons why the assets in question fall outside para 43(4) are indicated below.

- Immovable property located outside South Africa

Reason: Immovable property outside South Africa falls outside para 43(4) because it is not a foreign equity instrument, nor is it deemed to be a South African-source asset under s 9(2)(*b*), which refers to assets other than immovable property.

- Assets of a PE outside South Africa

Reason: Not deemed to be a South African-source asset by virtue of s 9(2)(*b*)(i)(*aa*) and hence falls outside para 43(4).

- Loans, advances or debt

Reason: First, para 43(4)(*b*) excludes any asset contemplated in para (*b*) of the definition of a 'foreign currency asset', which relates to any loan, advance or debt (of an individual or non-trading trust that does not hold an exchange item as trading stock). Secondly, the proviso to para 43(4) excludes any exchange item to which s 24I applies.

- Movable assets which are subject to foreign taxation

Reason: Not deemed to be a South African-source asset by virtue of s 9(2)(*b*)(i)(*bb*) and hence falls outside para 43(4).

Paragraph 43(2) deals with the disposal of assets

- forming part of a foreign PE;
- of a headquarter company; and
- that do not form part of a foreign pe or headquarter company.

The term 'local currency' is defined in para 43(7) and is used in para 43(2)(*a*) and (*b*). In relation to a foreign PE and a headquarter company it means its functional currency and in any other case it means the rand.

The term 'functional currency' is also used in para 43(2) and is defined in s 1 (see **19.2.4.5**).

19.2.7.1 Application to non-resident permanent establishments and headquarter companies

Paragraph 43(2) will apply to a foreign PE or headquarter company if

- the currency of expenditure is incurred or denominated in the functional currency but the currency of disposal is in another currency;
- the currency of disposal is received or accrued or denominated in the functional currency but the currency of expenditure is incurred in another currency; or
- neither the currency of expenditure nor the currency of disposal is in the functional currency.

The average exchange rate is used in para 43(2) to translate

- other currencies into the functional currency of a foreign PE or headquarter company, and
- any resulting capital gain or loss in that functional currency into rands.

Example – Application of para 43(2) to a foreign PE

Facts:

A South African company has a branch in London. The branch uses sterling as its functional currency. It has acquired and disposed of assets in various currencies in accordance with the table below. None of the assets comprise foreign equity instruments or deemed South African-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 functional 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 functional currency.
Sterling	US dollars	Yes – (*a*)	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 functional currency.

19.2.7.2 Application to immovable property held outside SA by a resident

Paragraph 43(2) can also apply to immovable property of a resident held outside South Africa which is not attributable to a foreign PE, such as a holiday home or investment property. 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 1 – Translation of proceeds or expenditure into local currency: para 43(2) assets

Paragraph 43(2)	**How proceeds and expenditure denominated**	**Translation method**
(*a*)	Expenditure actually incurred in rands, proceeds in another currency.	Translate proceeds into rands at average exchange rate in year of disposal.
(*b*)	Proceeds received or accrued in rands, expenditure in another currency	Translate para 20 expenditure into rands at average exchange rate in year expenditure incurred or treated as being incurred.
(*c*)	Neither proceeds nor expenditure in rands.	• 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 rands at average exchange rate in year of disposal.

It will be observed that when 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.

When 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 on the asset is ignored [para 43(2)(*c*)].

19.2.7.3 Currency of disposal not in existence at time of expenditure

Items (*b*) and (*c*) of para 43(2) deal with the situation in which 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 1 – 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 million. In 2011 he sold the home to a German businessman for €900 000 when the average rate for that year of assessment was €1 = R10.

Result:

His capital gain will be determined as follows:

	R
Proceeds (€900 000 x R10)	9 000 000
Less: Base cost	(5 000 000)
Capital gain	4 000 000

Example 2 – 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 2011 she disposed of it to a Belgian who had business interests in South Africa for R9 million. He settled the purchase price by transferring the funds to her from his South African bank account.

Result:

Moyra's capital gain will be determined as follows:

	R
Proceeds	9 000 000
Less: Base cost £400 000 x R12	(4 800 000)
Capital gain	4 200 000

Example 3 – Neither expenditure nor proceeds in local currency and currency of expenditure no longer in existence [para 43(2)(*c*)]

Facts:

Renaud, a South African resident, purchased a chateau in the south of France for 5 million French francs (FRF) on 1 October 1995 at a time when FRF 1 = R1. On 1 July 2011 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)]
= €762 000 + [(€800 000 – €762 000) x 6/6+4]
= €762 000 + [€38 000 x 6/10]
= €762 000 + €22 800
= €784 800

Step 2: Determine capital gain in currency of disposal

Determine the capital gain in euros.

	€
Proceeds	800 000
Less: 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

19.2.7.4 Application of para 43(2) to loans, advances or debts

As a rule, when a debt is denominated in a foreign currency, the debtor will repay the debt in the same currency. This would happen, for example, when a person invests in a foreign bank account. Should an investor ask 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, should the debt be 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.

19.2.8 Foreign equity instruments and assets sourced in the Republic [para 43(4)]

19.2.8.1 Application

Paragraph 43(4) applies to

- foreign equity instruments, and

- the following deemed South African-source assets:

➢ Immovable property in South Africa or any interest or right in or to immovable property in South Africa.

➢ Assets other than immovable property of

❖ a resident which have not been subject to foreign taxation (but excluding assets attributable to a PE outside South Africa), or

❖ a non-resident attributable to a PE in South Africa.

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 to 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.

19.2.8.2 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 1 – Summary of foreign equity instruments

Paragraph	Instrument description
(*a*)(i)	Listed shares on a recognised stock exchange outside South Africa.
(*a*)(ii)	Listed shares on a stock exchange outside South Africa that is comparable to a recognised exchange.
(*a*)(iii)	Listed shares on an inter-dealer quotation system outside South Africa
(*b*)	Participatory interest in a collective investment scheme carried on outside South Africa.
(*c*)	Index-linked investments outside South Africa
(*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 South African-source assets – see below.

19.2.8.3 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 South African source under s 9(2).

Excluded are assets

- contemplated in para (*b*) of the definition of a 'foreign currency asset' in para 84, and
- exchange items to which s 24I applies.

19.2.8.4 Deemed SA-source assets under s 9(2)

The s 9(2) assets that are included are comprised of two categories:

Category 1 – Immovable property in SA

- Immovable property situated in South Africa, 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 South Africa, whether held by a resident or a non-resident [s 9(2)(*a*)],

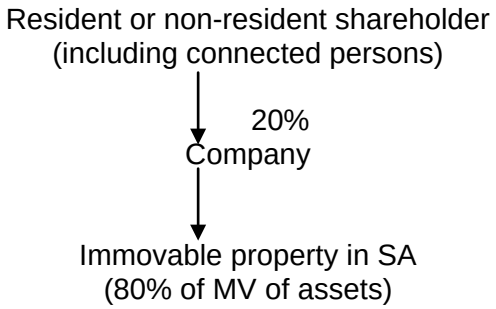
Category 2 – Assets other than immovable property in SA

- Assets of a resident which are
  - not attributable to a PE outside South Africa [s 9(2)(*b*)(i)(*aa*)], and
  - the proceeds from the disposal of which are not subject to any taxes on income payable to any sphere of government of any country other than South Africa [s 9(2)(*b*)(i)(*bb*)].
- Assets of a non-resident attributable to a PE in South Africa [s 9(2)(*b*)(ii)].

The term 'an interest in immovable property' includes

- any equity shares held by a person in a company,
- ownership or the right to ownership of a person in any other entity, or
- a vested interest of a person in any assets of any trust, if
  - 80% or more of the market value of those equity shares, ownership or right to ownership or vested interest, as the case may be, at the time of disposal thereof is attributable directly or indirectly to immovable property held otherwise than as trading stock, and
  - in the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20% of the equity shares in that company or ownership or right to ownership of that other entity.

Indirect interest in immovable property



For an example illustrating the determination of an indirect interest in immovable property, see **4.2**.

19.2.8.5 Exclusion of assets of a CFC from para 43(4)(b)

Under 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 para 43(4)(*b*) does not apply to the assets of a CFC which do not form part of a PE in South Africa. This means that such assets must be dealt with under 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 under para 43(2).

19.2.8.6 Exclusion of foreign currency assets (para (b) of definition of a 'foreign currency asset' in para 84)

Excluded from deemed South African-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:

> '**"[F]oreign 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:** Under 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 to 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.

19.2.8.7 Overall exclusion of exchange items to which s 24I applies

Excluded from both foreign equity instruments and deemed South African-source assets is any exchange item to which s 24I is applicable. The term 'exchange item' is defined in s 24I(1) as follows:

> **'"[E]xchange 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[644] to any

- company,
- trust carrying on any trade,
- Individual who holds any amount contemplated in para (*a*) or (*b*) of the definition of an 'exchange item' as trading stock, and
- Individual or trust in respect of any amount contemplated in para (*c*) or (*d*) of the definition of an '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 (that is, 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.

19.2.8.8 Translation of proceeds and expenditure into rands

When para 43(4) applies the capital gain or loss on the disposal of a foreign equity instrument or South African-source asset must be determined by translating

- the proceeds into rands at the average exchange rate for the year of assessment in which the asset was disposed of or at the spot rate on the date of disposal of the asset, and
- the expenditure incurred into rands at the average exchange rate for the year of assessment during which the expenditure was incurred or at the spot rate on the date on which the expenditure was incurred.

[644] Section 24I(2).

The above rules are as amended by s 76(*d*) of the Revenue Laws Amendment Act 35 of 2007, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2008. Before amendment, companies and trading trusts were obliged to use the spot rate, while individuals and non-trading trusts could elect under s 25D(3) to use the average exchange rate instead of the spot rate.

19.2.8.9 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 year of assessment in which the asset is disposed of, 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 South African blue chip companies on foreign exchanges.

19.2.8.10 The old para 43(4)

The comments below apply to disposals of foreign equity instruments that took place before years of assessment commencing on or after 13 December 2002. In other words, for individuals this refers to the 2003 and earlier years of assessment.

Before its amendment by the Revenue Laws Amendment 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 applicable spot or average exchange rate.

Example 1 – 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 during the 2004 year of assessment was R16 = £1. She sold the shares for £1 200 on 29 February 2008. The average rate during the 2008 year of assessment was R18 = £1. Stella elects to use the average exchange rate under s 25D(3).

Result:

Her capital gain will be determined as follows:

	R
Proceeds (£1 200 x R18)	21 600
Less: 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 [R18 – R16] = R2 000).

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 2 – 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.

On maturity (1 December 2010) the policy paid out £150 000. 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. Marisa elects to use the average exchange rate under s 25D(3).

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)
= R2 250 000 x R700 000/(R120 000 + R700 000)
= R2 250 000 x R700 000/R820 000
= R1 920 732

Step 3: Apply the TAB formula

TAB = B + [(P – B) x N/(N + T)]
= R70 000 + [(R1 920 732 – R700 000) x 5/15]
= R700 000 + [R1 220 732 x 5/15]
= R700 000 + R406 911
= R1 106 911

Step 4: Determine capital gain or loss

Capital gain = Proceeds – TAB – post-valuation date expenditure
= R2 250 000 – R1 106 911 – R120 000
= R1 023 089

19.2.9 Translation of deemed proceeds and base cost [para 43(5)]

This provision applies when

- 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.

In these circumstances

- the person disposing of the asset must treat the proceeds as being denominated in the currency of the base cost, and
- the person 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 1 – 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 – Deemed proceeds when 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:

Under 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 under para 43(1). John's estate is treated as having acquired the property at a base cost of £120 000 under para 40(1) read with para 43(5)(*b*).

19.2.10 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) when para 12(5) applies to a debt denominated in a foreign currency.

Under para 12(5) when 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.

Under 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 when 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 – 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:

Under 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. Under 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. Under 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 rands at the average exchange rate in the year of disposal

19.2.11 Market value on valuation date [para 43(6)]

A person who has adopted market value as the valuation date value of an asset must determine that market value 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 a 'weighted-average exchange rate').

Table 1 – Translation of market value into currency of expenditure

Paragraph 43	How proceeds and expenditure denominated	Currency into which market value must be translated and applicable rate on valuation date
(2)(*b*)	Proceeds in local currency, expenditure in another currency.	Rands using spot rate[645]
(4)	Proceeds and / or expenditure in foreign currency.	Rands using spot rate[646]
(2)(*c*)	Proceeds and expenditure in different foreign currencies.	Currency of disposal at ruling exchange rate

[645] Spot rate substituted for ruling rate by s 75(1)(*e*) of the Revenue Laws Amendment Act 31 of 2005, applicable in respect of any assets disposed of on or after 8 November 2005.
[646] See previous note.

Example – 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 cognisance 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. 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 – R240 = R60, and this is restricted to nil under 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, while 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 s 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 s 24I and the Eighth Schedule based on the type of taxpayer.

As a result, certain exchange items that were not dealt with under s 24I now fall within 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.

Under 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. Exchange differences may arise on a foreign loan, advance or debt that is used to finance a foreign asset. 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, while 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.[647] 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.[648]

Through a process of elimination, s 24I(11) only applies to foreign loans used to acquire the assets set out below, when 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,

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.

[647] Section 24I(11)(*a*).
[648] Section 24I(11)(*b*).

Chapter 20 – Foreign currency assets and liabilities

PART XIII: FOREIGN CURRENCY

20.1 Introduction and overview

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. Part XIII only applies to individuals holding foreign currency assets as capital assets and non-trading trusts (see para 85).

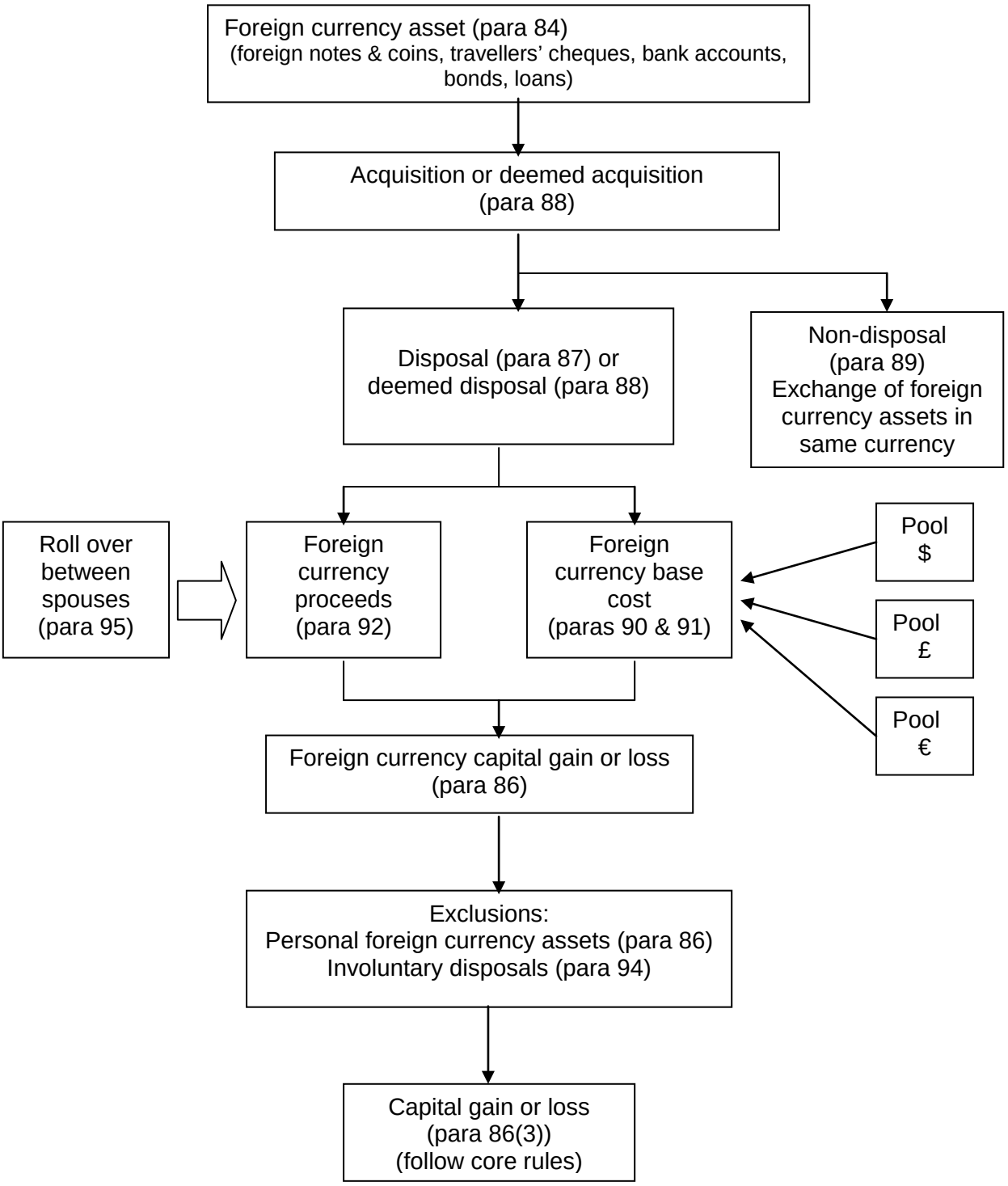
Note: Clause 124 of The Taxation Laws Amendment Bill, 2011 proposes to repeal Part XIII with effect from years of assessment commencing on or after 1 March 2011.

Table 1 – Quick reference guide to foreign currency

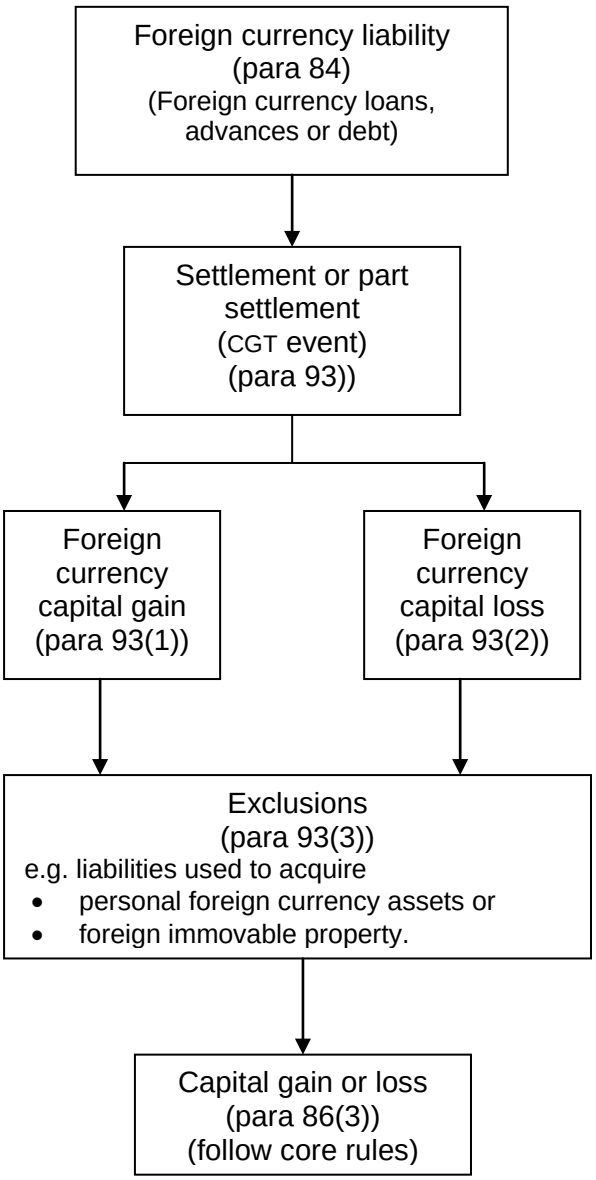
Para-graph	Topic	Summary
84	Definitions	• Foreign currency • Foreign currency asset • Foreign currency base cost • Foreign currency liability • Foreign currency proceeds • Personal expenses • Personal foreign currency asset • Valuation date
85	Application	Part XIII applies to • the disposal of foreign currency assets, • the settlement of foreign currency liabilities, • individuals holding foreign currency assets as capital assets, and • non-trading trusts. *Excluded* from Part XIII, but falling within s 24I are • companies, • trading trusts and • individuals holding foreign currency assets as trading stock.
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	Lists events that trigger a disposal of a foreign currency

	currency asset	asset (e.g. sale, donation, vesting, etc)
88	Events treated as acquisition or disposal of foreign currency asset	*Deemed disposals* • Cessation of residence • Section 24I becomes applicable to person • Foreign currency asset becomes personal foreign currency asset *Deemed acquisitions* • Pre-valuation date assets (1 March 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



20.2 Definitions

Paragraph 84

The following definitions apply for the purposes of Part XIII, unless the context indicates otherwise:

20.2.1 Definition – 'foreign currency'

'**"[F]oreign currency"** means any currency other than the currency of the Republic.'[649]

[649] The definition was amended by the Revenue Laws Amendment Act 45 of 2003 with effect from 22 December 2003. It previously referred to 'any currency which is not legal tender in the Republic.'

The word 'currency' refers to money in current circulation. Foreign currency therefore means foreign notes and coins in current circulation.

Excluded, for example, would be an old Roman gold coin. See in this regard the commentary on the definition of an 'asset' in **4.1.2**.

20.2.2 Definition – 'foreign currency asset'

> '"**[F]oreign 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, for example, 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)
- Traveller's 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.[650]

20.2.3 Definition – 'foreign currency base cost'

> '"**[F]oreign currency base cost"** means the base cost in respect of a foreign currency asset, as determined in accordance with paragraph 91.'

20.2.4 Definition – 'foreign currency liability'

> '"**[F]oreign 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.

20.2.5 Definition – 'foreign currency proceeds'

> '"**[F]oreign currency proceeds"** means the proceeds from the disposal of a foreign currency asset, as determined in accordance with paragraph 92.'

20.2.6 Definition – 'personal expenses'

> '"**[P]ersonal 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*) travelling or maintenance expenses.'

---

[650] Per Harms JA in *CIR v Datakor Engineering (Pty) Ltd* 1998 (4) SA 1050 (SCA), 60 SATC 503 at 509.

Examples of expenses falling under para (*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. These words are 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 under 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 words 'foreign personal-use asset' refer 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.

Examples of (*b*) include the cost of

- air, bus, taxi, rail or ship fares
- food, clothing, medicines, hospitalisation, and maintenance payments under a divorce settlement.

20.2.7 Definition – 'personal foreign currency asset'

> '"**[P]ersonal 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.'

20.2.7.1 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 traveller's cheques means that the holder will not be subject to CGT on any currency gains or losses made on them.

20.2.7.2 Cash equivalent

The words 'cash equivalent' used in (*a*) would include traveller's cheques.

20.2.7.3 Regular payment of personal expenses

A question arises as to the meaning of the phrase 'regular payment of personal expenses' which appears in both paras (*a*) and (*b*) of the definition of a 'personal foreign currency asset'. 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 *New Shorter Oxford English Dictionary on*

Historical Principles[651] 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.'

Foreign notes and traveller's cheques acquired for the purpose of defraying personal expenses tend to be held for short periods during the year of assessment while a person is on holiday overseas. In the context the purpose of acquiring the notes or cheques should be self-evident and they will be used for the regular settlement of personal expenses during the period that the person is overseas.

Foreign bank accounts on the other hand tend to be held on a long-term basis and so the meaning of 'regular' needs to be considered differently. 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.

20.2.7.4 One bank account for each currency

As regards (*b*), a person is allowed to select one bank account for each foreign currency as a personal foreign currency asset. It is therefore possible that a person could hold two or more foreign currency bank accounts (for example, a dollar account and a euro account) as personal foreign currency assets provided the requirements are met.

20.2.7.5 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.

Examples – 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

[651] Lesley Brown 4 ed (1993) Oxford University Press Inc., New York, United States of America in vol 1.

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.

20.2.8 Definition – 'valuation date'

'**"[V]aluation 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.'

20.2.8.1 Commencement date – 1 March 2003

The importance of the valuation date is that currency gains and losses in respect of the period before 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. Under para 88 a person is deemed to have acquired all their pre-valuation date assets on 1 March 2003.

20.2.8.2 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. Interestingly, this differs from para 12(2)(*a*) 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).

20.3 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 s 24I applies in respect of any foreign currency asset of that person in the relevant foreign currency.

Section 24I applies[652] to any

- company,
- trust carrying on any trade,
- individual holding any amount contemplated in para (*a*) or (*b*) of the definition of an "exchange item" as trading stock, and
- individual or trust in respect of any amount contemplated in para (*c*) or (*d*) of the definition of an "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 paras (*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 the following persons:

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.

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.

[652] Section 24I(2).

Result:

Currency gains and losses must be dealt with under 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 under 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 traveller's cheques. He holds no other foreign currency assets or liabilities.

Result:

The transaction must be dealt with under 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 under Part XIII and not s 24I.

6. *Facts:*

The facts are the same 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 under s 24I and not Part XIII.

20.4 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, in accordance with the table below.

Table 2 – Definitions of 'foreign currency capital gain' and 'foreign currency capital 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 when 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 when 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.

Example 1 – Adjustment of foreign currency capital loss by amount taken into account in determining taxable income

Facts:

Moira exports widgets to various overseas customers. On 1 July 2005 she sold a consignment of widgets to Acme Inc, a US-based company at a price of $100 on 30-day credit terms. Acme Inc was thereafter placed in liquidation, and on 28 February 2006 she received $40 from the liquidator who informed her that there was no hope of her receiving any further payments. She accordingly claimed the balance of the debt owing as a bad debt under s 11(*i*). Assume that the average exchange rate for 2006 was $1 = R7, and that the spot rate on 1 July 2005 was $1 = R6 and on 28 February 2006 was $1 = R6,50. Assume that Moira has no other items in her foreign currency base cost pool.

Result:

Moira included an amount of $100 x R6 = R600 determined under s 25D in her income when she sold the widgets. Of this amount, $60 x R6 = R360 related to the portion of the debt that

could not be recovered. The amount of the bad debt was $60 x R6,50 = R390 (translated at spot rate at the time the loss was incurred). However, under s 11(*i*) the bad debt allowance is limited to the amount included in her income, namely, R360.

Under Part XIII Moira's foreign currency base cost pool was as follows:

Date	Transaction	$	Average Rate	R
1 July 2005	Advance	100	7	700
28 February 2006	Receipt	(40)	7	(280)
28 February 2006	Bad debt	(60)	7	(420)
		-		-

Foreign currency base cost:

	R
As per pool	420
Less: Bad debt allowance [para 86(1)(*a*)]	(360)
Foreign currency base cost	60
Proceeds	-
Less: Foreign currency base cost	(60)
Foreign currency capital loss	(60)

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 2 – Determination of taxable capital gain of person with foreign currency capital gains and losses

Facts:

Muriel disposed of the following assets and foreign currency assets during the year ending 29 February 2008.

	R
Capital gain on disposal of shares	102 500
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 use of US bank account to purchase machine	(15 000)
	67 500

Result:

Her taxable capital gain for the year was determined as follows:

	R
Sum of capital gains and losses	67 500
Less: Annual exclusion	(15 000)
Aggregate capital gain / net capital gain	52 500
Inclusion rate	25%
Taxable capital gain	13 125

As can be seen, the foreign currency capital gain and loss are treated in the same way as an ordinary capital gain or loss.

20.5 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'.[653] These provisions are similar to the core disposal rules in para 11. They do not cover the settlement in whole or in part of a foreign currency liability, which is dealt with under 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.

20.6 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.

Deemed disposals [para 88(2), (3) and (5)]

The table below sets out the events that are treated as disposals of foreign currency assets (other than personal foreign currency assets).

[653] 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.

Table 4 – Events treated as disposals – para 88

Para-graph 88	Event treated as disposal of foreign currency asset	Date of deemed disposal
(2)	Person ceases to be resident.	Immediately[654] 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 term '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 South Africa, and
- their place of effective management changes to a country outside South Africa.

Tax treaties have rules on residence that in certain circumstances override domestic law. A person may therefore be resident under domestic law but non-resident for tax treaty purposes. The definition of a '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 tax treaty 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 1 – 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.

[654] The word 'immediately' was inserted by s 119 of the Revenue Laws Amendment Act 45 of 2003, effective 22 December 2003.

Result:

Under the physical-presence test in the definition of a '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 United States-South Africa double tax treaty. It defines a resident of South Africa as one who is ordinarily resident' in South Africa. Since South Africa's physical-presence test is ignored for the purpose of the tax treaty, South Africa 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 under 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 unrealised foreign currency capital gains and losses up to and including the day before s 24I becomes effective are taxed under Part XIII.

Example 2 – 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 unrealised 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 unrealised 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 a foreign currency capital gain or loss in para 86.

Example 3 – 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 unrealised 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

Para-graph 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.[655] • 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)]

Under 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 unrealised currency gains and losses that arose before the commencement of Part XIII, or in the case of a person who becomes a resident, to exclude unrealised currency gains and losses that arose while 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.

[655] Paragraph 88(1) amended with effect from 22 December 2003 by the Revenue Laws Amendment Act 45 of 2003. The amendment was of a textual nature.

Deemed acquisition on Part XIII becoming applicable [para 88(4)]

An example of a deemed acquisition under para 88(4) would be when 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*[656]

> '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)'.

Immediately before this deemed acquisition an amount would have been included in the individual's income under s 22(8)(*b*)(v) (deemed disposal of trading stock at market value) and under s 24I(12)(*b*) (deemed realisation 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) arises when 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.

20.7 Exchange of foreign currency assets denominated in same foreign currency

Paragraph 89

There is no disposal or acquisition when one foreign currency asset is exchanged for another, 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 1 – 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.

[656] 1956 (1) SA 602 (A), 20 SATC 355 at 361.

Result:

The withdrawal will not constitute a disposal and the deposit will not constitute an acquisition.

Example 2 – 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, while the purchase of the shares and Bank of England bond will constitute acquisitions.

Example 3 – 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 when either the asset surrendered or the asset acquired is a personal foreign currency asset [para 89(2)].

Example 4 – Exchange of foreign currency assets when 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 under 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 traveller's cheques that she used during her holiday to England.

Result:

The exchange of the fixed deposit for the traveller's cheques is a disposal, since the traveller's cheques are a personal foreign currency asset. The purchase of the traveller's cheques constitutes an acquisition, though any foreign currency capital gain or loss arising from their disposal will be excluded by para 86.

20.8 Foreign currency asset pool

Paragraph 90

Under 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, while 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 (for example, 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 before 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.

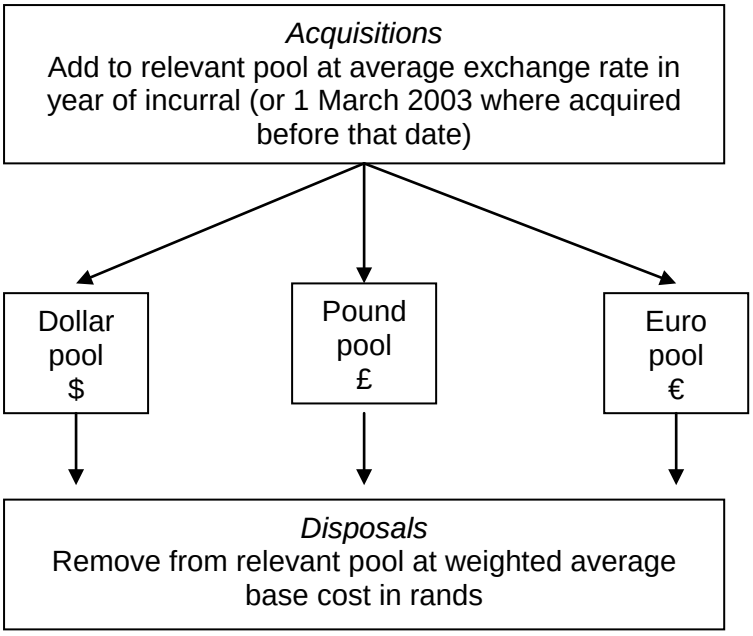
Determination of total asset pool base cost

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 United Kingdom 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*)].

Under 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 rands 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

20.9 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 year of assessment 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.

20.10 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 which was taken into account in determining that amount,[657]

determined outside Part XIII and relating to the disposal of that foreign currency asset.

The words 'value in foreign currency' refer to the currency of disposal. If the currency of disposal is rands, the rand amount must be translated back to the foreign currency of expenditure at the spot rate. Next, 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.

[657] Paragraph 92(*b*) was amended by s 59 of the Revenue Laws Amendment Act 20 of 2006 to include the words 'which was taken into account in determining that amount'. The amendment is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

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 under 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. Under 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. Under 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.

20.11 Settlement of foreign currency liability

Paragraph 93

This paragraph sets out the rules for determining the foreign currency capital gain or loss when 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) in which Ri > Rs
(2)	Foreign currency capital loss	F x (Rs – Ri) in which Rs > Ri
In which 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 1 – 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 under 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 under para 43(4).
(*d*)	To refinance any foreign currency liability which was used 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*) when 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 2 – 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 – R5) = R500 [para 43(4)]
Currency loss on liability: $100 x (R5 – R10) = -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 3 – 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 unrealised

foreign currency gains and losses incurred before the valuation date are not subject to CGT.[658]

20.12 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 that 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 an '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 United Kingdom 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, under para 94 Andrew must disregard the currency loss of R1 000.

20.13 Transfer of foreign currency assets between spouses

Paragraph 95

This provision provides roll-over relief to spouses when 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.

[658] Paragraph 93(4) inserted by s 119 of the Revenue Laws Amendment Act 45 of 2003, effective 22 December 2003.

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 realise a capital gain as follows:

	R
Proceeds ($5 000 x 10)	50 000
Less: Base cost ($5 000 x R8,03922)	(40 196)
Foreign currency capital gain	9 804

20.14 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) (*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 commencing or ceasing to be resident or a CFC
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 rands 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 or 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 Impermissible tax avoidance arrangements

Before 2 November 2006 tax avoidance schemes involving capital gains were dealt with under s 103(1).[659] On or after that date they must be dealt with under the rules governing impermissible tax avoidance arrangements under Part IIA of Chapter III of the Act (ss 80A to 80L).

21.2 Section 103(2)

The assessed loss anti-avoidance provisions of s 103(2) 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 and 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 using 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 capital gain was tainted under s 103(2) as it was part of a scheme to use 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.

[659] Section 103(1) was deleted by s 36(1)(*a*) of the Revenue Laws Amendment Act 20 of 2006 deemed to have come into operation on 2 November, 2006 and applicable to any transaction entered into on or after that date.

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 and an assessed capital loss.

21.3 Value shifting

21.3.1 Value-shifting provisions

The Eighth Schedule introduce a new concept into South African 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 under 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.

21.3.2 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.

21.3.3 Why is there a need for value-shifting legislation?

Without specific rules, entities could manipulate the value of assets in order to obtain a CGT benefit.

21.3.4 Do other countries have such legislation?

Value-shifting anti-avoidance provisions are, for example, contained in the Australian[660] and United Kingdom[661] 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 situations that must be specifically addressed in other jurisdictions. The donations tax and STC implications should not be lost sight of when considering a 'value shifting arrangement'.

21.3.5 When is value shifting most prevalent?

It is found typically between connected persons, for example:

- between parents and their children, and
- within groups of companies.

21.3.6 What are some examples of value shifting?

The following are some examples of value shifting:

- Issue of shares at a discount
- Variation of rights attaching to shares or interests in land (for example, manipulating voting or dividend rights)
- Buying back 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:

[660] The share value shifting provisions are contained in Part 3.3, Division 140 of the Income Tax Assessment Act 1997.
[661] Sections 29 to 34 of the Taxation of Chargeable Gains Act, 1992.

	Before R	After R
Share Capital	2	3
Retained income	99 998	99 998
Market Value 1 October 2005	100 000	100 000
Market value for each share	50 000	33 333

Step 1 – Determine 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
- Cynthia has acquired an interest in Why (Pty) Ltd

Step 2 – Determine Bongo's 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

Step 3 – Determine Bongo's base cost under 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

Step 4 – Determine Bongo's capital gain

	R
Proceeds	33 333
Less: Base cost	(16 500)
Capital gain	16 833

*Step 5 – Determine Cynthia's base cost under para 23(*b*)*

Cost of Cynthia's share in Why (Pty) Ltd	= R1
Increase in value of Cynthia's interest	= R33 333 (see above step 1)
Revised base cost	= R33 334

21.4 Losses arising from dividend stripping

Paragraph 19

Paragraph 19 contains a rule that limits a capital loss on disposal of a share when that disposal is preceded by dividends which in total are deemed extraordinary. The provision was fundamentally changed with effect from 1 October 2007 and its scope is now much wider.[662] In essence para 19 targets capital losses caused by dividends declared out of pre-acquisition profits.

The position before 1 October 2007

Before 1 October 2007, para 19 applies when

- a share is disposed of at a capital loss within two years of date of acquisition, and
- extraordinary dividends are received or accrued during that two-year period

The pre-1 October 2007 legislation was designed to target dividend stripping occurring within two years of *acquisition* of a share. 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 on short-term and long-term holdings. On long-term holdings it 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 income nature. Moreover, any loss resulting from short-term dividend stripping will most likely be completely offset by the securities transfer tax.

[662] Paragraph 19(1) was amended by s 72(1)(*a*) of the Revenue Laws Amendment Act 35 of 2007 and deemed to have come into operation on 1 October 2007 and to apply in respect of any share disposed of on or after that date.

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 have been held for less than two years before disposal. This two-year period is extended (that is, does not include days) for periods in which the risk on the shares is hedged with offsetting positions (for example, when the person has an option to sell). By extending the two-year holding period in this manner dividend stripping is discouraged because of the cost of taking out an extended option to sell and the delayed benefit of the capital loss. 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.

The position on or after 1 October 2007

On or after 1 October 2007, para 19 applies when

- a share is disposed of at a capital loss, and
- extraordinary dividends are received or accrued within the two-year period before the date of disposal.

The scope of para 19 is much wider because it now also targets shares which have been held for a period longer than two years. Previously if a person held a share for more than two years para 19 did not apply. But in its revised form the period of holding is irrelevant and any extraordinary dividends declared during the two years before or as part of[663] the disposal are taken into account in limiting any capital loss. The provision in its current guise is therefore likely to target capital losses arising on liquidation or deregistration of a company or upon a share buy-back as large dividends are typically declared when these events occur. The words 'as part of' were inserted to counter the argument that an extraordinary dividend forming part of the consideration payable to shareholders in a share buy-back was received at the same time or after the disposal of the shares.

Example 1 – Multiple extraordinary dividends derived two years before disposal

Facts:

Eleanor purchased a preference share on 1 January 2006 for R150. She derived dividends of R12 on 1 July 2006, 1 July 2007 and 1 July 2008 respectively and sold the preference share for R140 on 1 September 2008.

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 in aggregate the dividends received within the two-year period before disposal exceed 15% of the proceeds on sale. The sum of dividends derived over the two-year period are R24 (R12 x 2), and the 15% amount is R21 (R140 x 15%), resulting in a R3 extraordinary dividend. Therefore, after taking para 19 into account, Eleanor's capital loss is reduced by R3 from R10 to R7.

[663] The words 'or as part of' were inserted by s 69 of the Taxation Laws Amendment Act 17 of 2009 and are deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2010.

Example 2 – Extraordinary dividend upon liquidation

Facts:

Kate bought all the shares in ABC (Pty) Ltd at a cost of R1 million in 2002. On 1 March 2009 the company was placed into voluntary liquidation. On 1 May 2009 Kate received a liquidation dividend of R1 500 000 out of revenue profits and a return of R10 000 in respect of contributed share capital. The company was finally dissolved on 15 October 2009.

Result:

Were it not for para 19, Kate would have a capital loss on 15 October 2009, determined as follows:

	R
Proceeds	10 000
Less: Base cost	(1 000 000)
Capital loss	(990 000)

However, under para 19(1) ABC (Pty) Ltd has distributed an extraordinary dividend within two years of the disposal of the shares. The shares are deemed to be disposed of on the date of dissolution of the company under para 77(1)(*a*). Accordingly, the capital loss of R990 000 must be disregarded to the extent of the extraordinary dividend.

	R
Dividend	1 500 000
Less: 15% of R10 000 (proceeds)	(1 500)
Extraordinary dividend [para 19(3)(*c*)]	1 498 500

Since the capital loss of R990 000 does not exceed the extraordinary dividend, it must be fully disregarded.

Example 3 – Extraordinary dividends arising from a share buy-back

Facts:

XYZ (Pty) Ltd has 100 000 issued ordinary shares. The ordinary shares each have a par value of R10 and a market value of R50. Elizma purchases 100 ordinary shares on 1 April 2002 for R5 000, and on 1 June 2009 she surrenders the shares to XYZ (Pty) Ltd for R5 000 in a share buy-back. Of the R5 000 received by Elizma, R1 000 is out of share capital and R4 000 constitutes a dividend.

Result:

Before taking into account para 19, Elizma has a capital loss of R4 000 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 dividend equals R3 850 [the R4 000 dividend minus R150 (15% of the R1 000 proceeds)]. Therefore, after taking para 19 into account, Elizma's capital loss is reduced as follows:

	R
Capital loss before applying para 19	(4 000)
Less: Extraordinary dividend	3 850
Capital loss	150

Exception for group company distributions (para 19(2) – since deleted)

Paragraph 19(2) was deleted by s 72(1)(*b*) of the Revenue Laws Amendment Act 35 of 2007. The deletion came into operation on 1 October 2007 and applies in respect of any

share disposed of on or after that date. The commentary below relates to the pre-1 October 2007 position.

Paragraph 19(1) does 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.[664]

Under s 41(1) a 'shareholder' includes a registered shareholder except when 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 under s 10(1)(*k*)(ii)(*cc*) by reason of the company being a CFC under s 9D,[665]
- any dividend declared by a company contemplated in para (*e*) of the definition of a 'company' (that is, a portfolio comprised in any collective investment scheme in securities), and
- any dividend contemplated in s 11(*s*). Section 11(*s*) allows a company to claim a dividend as a deduction when its shares are held by a CISP (collective investment scheme in property shares). Such dividends are taxable in the hands of the unit holders.

Amendments linked to the dividends tax

The following amendments to para 19 will only come into effect when the dividends tax (due to replace STC) takes effect:

Paragraph 19(1), (3)(*a*) and (*c*) – the period during which extraordinary dividends are to be computed will be decreased from two years to 18 months. The 18-month period is consistent with the period used in para 43A and s 22B, which deal with dividends treated as proceeds on disposal of certain shares. The latter provisions also come into operation when the dividends tax comes into operation.

Paragraph 19(3)(*b*) – at present a dividend means a dividend as defined in s 1 excluding certain specified dividends (for example, taxable foreign dividends and dividends from a CISP). When the dividends tax is introduced a dividend will mean a dividend that is exempt from the dividends tax in s 64F.

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[664] Paragraph 19(2) was amended by the Revenue Laws Amendment 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.

[665] The reference to s 10(1)(*k*)(ii)(*cc*) was inserted by the Revenue Laws Amendment Act 45 of 2003, effective as from 22 December 2003. Previously the provision referred to an exempt dividend under s 9E(7)(*e*)(i).

21.5 Transitional period measures

PART XIV: MISCELLANEOUS

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 under 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 s 1 and includes, among other things, any relative of a person.

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 before 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 under 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. Under s 29A(6) and (7) an insurer is required to transfer assets between the four funds if there is a change in policyholders or a balancing of assets and liabilities is required. Paragraph 97 does not apply to these disposals as they are involuntary.

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. Jack and Jill have not 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 an asset within 90 days during transitional period from a connected person or under a 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 a connected person or under a 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) of the Act provides as follows:[666]

> 'The Commissioner must annually give public notice that all persons who are personally or in a representative capacity liable to taxation under this Act or who are required by the Commissioner to furnish returns for the assessment of tax, must furnish returns within the period prescribed in that notice, or such longer period as the Commissioner may allow, for the purposes of assessments in respect of the years of assessment specified in that notice.'

These annual notices can be found on the SARS website (<www.sars.gov.za>) under Legal & Policy / Legislation / Regulations and Government Notices / Income Tax Act, 1962 / Notices.

The notice covering the 2011 year of assessment[667] requires a return to be submitted by, amongst others,

> 'every company, trust or other juristic person, which is either a resident or which derives any gross income or capital gain from a source in the Republic;
>
> . . .
>
> 'every natural person who had capital gains or capital losses exceeding R17 500;
>
> . . .
>
> 'every resident to whom any income or capital gains from funds in foreign currency or assets outside the Republic could be attributed during the 2011 year of assessment in terms of the Act;

The figure of R17 500 is equal to the annual exclusion applicable to the 2011 year of assessment.

22.2 Return of information by managers of collective investment schemes

Section 70A

Under s 70A, every portfolio of a collective investment scheme in securities[668] or property[669] 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 on the sale of financial instruments and participatory interests in collective investment schemes during the year of assessment must be submitted in the form of an IT3(*c*) return. This return can be submitted manually or electronically – for details of the system specifications see the SARS website under Tax Types / Income Tax (IT) / 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

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[666] Section 66(1) was amended by s 9(1)(*a*) of the Revenue Laws Second Amendment Act 32 of 2005, the amendment being deemed to have come into operation on 1 January 2005 and applicable in respect of any year of assessment ending on or after that date.

[667] The 2011 notice was published in GN 531 *GG* 34393 of 1 July 2011.

[668] 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.

[669] 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.

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 under 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[670] 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. Under 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 the commentary in **22.2** on s 70A.

It will be observed that the weighted-average method under para 32(3A) has been prescribed for reporting purposes. See in this the commentary in **22.2** on s 70A.

22.4 Retention of records

Section 73B of the Act contains specific record-keeping requirements to ensure compliance with the provisions of the Eighth Schedule. Unlike s 73A, which is targeted at persons

[670] 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.

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.

The relevant records must be retained for a period of five years from the date on which the return of income reflecting the disposal was received by SARS.

Example – Retention of records

Facts:

Karen acquired a holiday home on 1 March 2002. The conveyancing attorney sent her the following documents:

- Copy of the sale agreement.
- Statement showing cost of property, transfer duty and conveyancing fees.

Over the years Karen made a number of improvements to the property for which she received purchase invoices.

On 31 January 2012 Karen sold the holiday home. Her attorney sent her the following documents:

- Copy of sale agreement.
- Statement showing consideration received less estate agent's commission, bond cancellation fee and cost of obtaining electrical compliance and borer certificates.

She reflected the disposal in her 2012 return of income, which she lodged with her local SARS branch office on 1 September 2012.

Result:

Karen must retain the purchase and sale documentation as well as the invoices relating to the improvements until 31 August 2017.

Persons not required to render returns of income who have capital gains or capital losses in excess of the amount contemplated in para 5(1) (that is, the annual exclusion)[671] 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

Under s 82 the burden of proving that

- a capital gain is not taxable
- an amount is to be disregarded or excluded under the Eighth Schedule

rests upon the taxpayer.

[671] Before its proposed amendment by s 5 of the Revenue Laws Second Amendment Act 60 of 2008, s 73B(2) referred to an amount of R10 000, being the annual exclusion when CGT was first introduced.

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 R500 000, or
- take the matter to the tax court.

Under s 83A(1)(*a*), when the tax in dispute exceeds R500 000,[672] an appeal would normally be referred directly to the tax court.

How is the R500 000 threshold determined when 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 R5 000 000 before the appeal needs to be referred to the tax court:

Future aggregate capital gain	R5 000 000
Inclusion rate	25%
Future taxable capital gain	R1 250 000
Tax saving thereon at 40%	R500 000

In other words, by using the assessed capital loss of R5 000 000 against a future aggregate capital gain of the same amount, R500 000 in tax would be saved.

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 under s 3(4) of the Act.

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 when 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 when a person's asset has, for example, been expropriated, stolen or destroyed. The

[672] As published in GN 271 *GG* 29742 of 28 March 2007 and applies to any appeal noted on or after 1 May 2007. Previous limits: R200 000 per GN 1429 *GG* 27070 of 10 December 2004, applicable to any appeal noted on or after 1 January 2005, and R100 000 per GN 1122 *GG* 21733 of 17 November 2000, with effect from 1 December 2000.

	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(1)(*b*) imposes 'additional tax' (that is, a penalty) on a taxpayer who omits from a return any amount which ought to have been included in it. The additional tax payable is equal to twice the difference between

- the tax as calculated on the taxable income returned by the taxpayer, and
- the tax properly chargeable on the taxable income as determined after including the amount omitted.

The Commissioner may remit the penalty if extenuating circumstances exist.

Under s 76(5) a taxpayer is deemed for the purposes of s 76 to have omitted an amount from a return if in determining taxable income as disclosed in it, the taxpayer deducts, sets off, disregards or excludes any amount the deduction, set-off, disregarding or exclusion of which is not permissible under the provisions of the Act, or shows as an expenditure or loss any amount which the taxpayer has not in fact expended or lost.

For CGT purposes s 76 could thus apply to

- the omission or understatement of a capital gain whether by straight omission, disregarding or exclusion,
- the overstatement of a capital loss which is set off against a capital gain in a year of assessment,
- the overstatement of an assessed capital loss which is carried forward and set off against an aggregate capital gain in any succeeding year of assessment.

If a taxpayer has an assessed loss in a year of assessment and omits or understates a taxable capital gain during that year, additional tax may be imposed under s 76(7) in a future year of assessment in which the taxpayer returns to a taxable income position. There is, however, no equivalent of s 76(7) to deal with the carry-forward of an overstated assessed capital loss when a taxpayer eventually derives a capital gain. An attempted set-off of an overstated capital loss or assessed capital loss against a capital gain is required before additional tax can be imposed under s 76.

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 under 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 issue of additional assessments. The provisions cover the situation in which 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 was inserted in the Act by s 30 of the Revenue Laws Amendment Act 32 of 2004 and was initially to come into operation on a date to be determined by the President by proclamation in the *Gazette*. This was intended to be changed to 1 September 2007 by the Revenue Laws Amendment Act 20 of 2006. However, that Act changed s 62 instead of s 30 with the result that the implementation date of *para* 35A of the Eighth Schedule was changed in error. Under s 87 of the Taxation Laws Amendment Act 8 of 2007 s 35A comes into operation on 1 September 2007 and applies in respect of any disposal on or after that date. In this regard it is submitted that the word 'disposal' should be given its Eighth Schedule meaning and the time of disposal rules in para 13 must be applied. Thus section 35A will not apply to unconditional sales concluded before 1 September 2007. In the case of a sale subject to a suspensive condition, it will apply to cases in which the condition is satisfied on or after 1 September 2007.

Under para 2, non-residents are subject to CGT on capital gains made on the disposal of

- immovable property in South Africa,
- any right or interest in immovable property in South Africa, and
- assets of a PE in South Africa.

The term 'immovable property' includes equity shares in a company

- in which a person together with connected persons in relation to that person holds at least 20% of those equity shares; and
- 80% or more of the market value of those equity shares is directly or indirectly attributable to immovable property in South Africa (but excluding such property held as trading stock).

The 80% market value rule also covers interests in other entities holding immovable property (including a vested interest in a trust). For detailed commentary on para 2(2) see **4.2**.

The term 'immovable property' is defined in s 35A(15), and means

> 'immovable property contemplated in paragraph 2(1)(*b*)(i) and (2) of the Eighth Schedule'.

On the common law meaning of immovable property see **4.1.2.3**.

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 South Africa that could be attached and their ties to South Africa are often tenuous. The introduction of a withholding tax for CGT purposes on disposals of immovable property in South Africa is designed to facilitate tax collection.

The withholding tax is based on the *selling price* of the immovable property. In other words, it is not directly related to any actual capital gain that may arise. If the amount withheld proves to be excessive (for example, because the property is disposed of at a capital loss or at a relatively small capital gain), the non-resident seller can request a directive from SARS to have a lower amount withheld [s 35A(2)].

While the withholding tax does not apply to disposals when the selling price is R2 million or less [s 35A(14)], this does not relieve the non-resident from paying CGT on any resulting taxable capital gain. In the case of a natural person the amount of CGT payable will depend on the person's level of taxable income which includes the taxable capital gain. Natural persons under the age of 65 who have no other South African-source income (for example, rental income) will only be liable to normal tax if their taxable income exceeds R43 000 for the 2008 year of assessment. That translates to a capital gain of R187 000 [R187 000 – R15 000 (annual exclusion) x 25% inclusion rate]. The tax threshold for a person 65 years or older is R69 000, which translates to a capital gain of R291 000.

Non-residents are unlikely to qualify for the primary residence exclusion, although there may be exceptions – see **11.1.2.4**.

The following forms are available on the SARS website:

- NR 02 (Declaration by purchaser for the sale of Immovable property in RSA by a non-resident),[673] and
- NR 03 (Application for tax directive by non-resident seller of immovable property in RSA).[674]

Table 1 – Summary of CGT withholding tax provisions

Section 35A	Subject	Description
(1)	Rate of withholding tax	Purchaser of immovable property in South Africa 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, for example, a bank guarantee. • Other assets in South Africa. • Whether the seller is subject to tax on the disposal.

[673] See <http://www.sars.gov.za/home.asp?pid=4153&tid=60&s=forms&show=889> [Accessed 19 April 2010].
[674] See <http://www.sars.gov.za/home.asp?pid=4153&tid=60&s=forms&show=889> [Accessed 22 October 2011].

		For example, the disposal may qualify for roll-over relief under ss 41 to 47, be exempt under a tax treaty, or in the case of a foreign embassy, exempt under s 10(1)(*a*). • Whether actual liability is less than the prescribed withholding rate. For example, when the seller can show that the property has been sold at a capital loss or when 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 amounts payable in foreign currency	If purchase price payable in foreign currency, amount withheld must be translated into rands 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. Any decision of the Commissioner in this regard is subject to objection and appeal.[675] 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

[675] Inserted by s 5(1) of the Revenue Laws Second Amendment Act 32 of 2005 and comes into operation on the date that s 35A comes into operation.

		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 when 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 • when 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. If 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 South African resident, for R10 million. The closing date of the sale is 10 June 2008 with the funds flowing at that date. Madeleine pays the R10 million using R800 000 of her cash savings and R9,2 million from 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 2008. Under the agreement, the local company must pay

- R20 million by 15 September 2008,
- R20 million by 15 September 2009, and
- R10 million on 15 September 2010.

All amounts are paid using bank borrowings.

Result:

Even though all the proceeds accrue on 15 September 2008, 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 2008,
- R1,5 million (7,5% of R20 million) on 15 September 2009, and
- R750 000 (7,5% of R10 million) on 15 September 2010.

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 South African commercial property to Jackie, a South African 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 South African resident for R5 million. On 25 June 2008, 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 2008.

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 – taxable capital gain excluded from the basic amount

Provisional taxpayers are required to make an estimate of their taxable income that will be derived for a year of assessment for the purposes of determining their first and second provisional tax payments.

The first provisional tax payment

Under para 19(1)(*c*) of the Fourth Schedule the estimate for the first period may not be less than the 'basic amount' unless the Commissioner accepts the lower estimate. The basic amount is

- the taxable income for the immediately preceding year of assessment if that year has been assessed, or
- if the year last assessed is not the immediately preceding year of assessment in relation to the year of estimation, the taxable income for the year last assessed is increased by 8% per year, calculated from the end of the year last assessed until the end of the year of estimation (proviso to para 19 of the Fourth Schedule). For example, assume that a taxpayer is making a provisional tax payment for the 2010 year of assessment and that the year last assessed is 2008. The 2008 taxable income (excluding any taxable capital gain) must be increased by 16% to arrive at the basic amount. In other words, it is 8% per year for 2009 and 2010.

Under para 19(1)(*d*) of the Fourth Schedule the basic amount excludes any taxable capital gain included in taxable income during the relevant year of assessment. Since capital gains tend to be irregular, their exclusion from the basic amount is intended to prevent a taxpayer's estimate of taxable income from being distorted by a non-recurring capital gain in the previous year.

The second provisional tax payment

For the second provisional tax payment, para 20(1) of the Fourth Schedule applies separate rules to taxpayers whose taxable income as finally determined is

- more than R1 million, or
- R1 million or less.

Taxpayers whose taxable income is more than R1 million

Taxpayers with actual taxable income as finally determined of more than R1 million must estimate their taxable income at an amount that is 80% or more of the actual taxable income as finally determined.

If their estimate is less than 80% of taxable income as finally determined, they face a penalty of up to 20% calculated on the difference between the normal tax payable on

- 80% of actual taxable income, and
- the estimated taxable income on which the provisional tax payment was based.

Taxpayers whose taxable income is R1 million or less

Taxpayers with actual taxable income as finally determined of R1 million or less must base their estimate of taxable income on an amount that is

- at least equal to the basic amount, or
- in any other case, at least equal to 90% of the actual taxable income as finally determined.

A taxpayer that estimates below the basic amount is subject to additional tax of 20% of the difference between the amount of normal tax calculated on

- the taxpayer's estimate, and
- an amount equal to 90% of the actual taxable income.

A word of caution

While a taxable capital gain is excluded from the basic amount for the purposes of the first provisional tax payment under para 19(1)(*d*)(i)(*aa*) of the Fourth Schedule, it is not excluded for the purposes of the second provisional tax payment in determining

- 80% of actual taxable income of taxpayers with a taxable income of more than R1 million, and
- 90% of actual taxable income of taxpayers whose taxable income is R1 million or less that choose to base their estimate on an amount that is less than the basic amount.

Caution therefore needs to be exercised to ensure that any actual taxable capital gain arising during the year of assessment is taken into account under these circumstances.

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 under s 89*quat* of the Act.

In determining whether such interest may be waived, s 89*quat*(3) must be applied in the normal way to determine whether there are reasonable grounds for contending that the capital gain should not have been included in taxable income. Typically only contentious capital gains will result in the waiver of interest, that is, cases in which the person is able to advance a cogent factual or legal argument in favour of exclusion of the capital gain. The interest may not be waived in cases in which the capital gain has been omitted or understated as a result of carelessness, ignorance or inadvertence.[676]

23.3 Provisional tax – can a capital gain make a person a provisional taxpayer?

Paragraph (*a*) of the definition of a 'provisional taxpayer' contained in para 1 of the Fourth Schedule provides as follows:

> '**"[P]rovisional taxpayer"** means—
>
> (*a*) any person (other than a company) who derives *by way of income* any amount which does not constitute remuneration or an allowance or advance contemplated in section 8(1).'

[676] See D S McAllister 'An Interesting Discretion' (2000) 14 *Tax Planning* 26 at 27, Butterworth Publishers (Pty) Ltd, Durban.

(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 2011 year of assessment Kim derived an annual salary of R100 000. She had no income from other sources. On 31 January 2011 she sold some listed shares, realising a capital gain of R27 500.

Result:

Under para 18(1)(*c*)(ii) of the Fourth Schedule Kim will not be a provisional taxpayer because

- she is below the age of 65,
- she did not derive any income from the carrying on of any business, and
- her taxable income for the 2011 year of assessment derived from interest, dividends and rental from the letting of fixed property did not exceed R20 000.

Example 2 – Capital gains and the third provisional tax payment

Facts:

The facts are the same as in Example 1, except that Kim also earned interest income of R42 301 during the 2011 year of assessment.

Result:

Kim will be a provisional taxpayer because of her interest income. The exemption in para 18(1)(*c*)(ii) of the Fourth Schedule only applies to a natural person

- who derives no income from carrying on any business, and
- whose taxable income derived from interest, dividends and rental from the letting of fixed property does not exceed R20 000.

In the 2011 year of assessment the interest exemption is R22 300 for a person under the age of 65, which leaves Kim with taxable interest income of R42 301 – R22 300 = R20 001.

When calculating her third provisional tax payment due by 30 September 2011, she will have to take into account the capital gain as follows:

	R	R
Salary		100 000
Interest	42 301	
Less: Exempt portion	(22 300)	20 001
Taxable capital gain (R27 500 – R17 500) x 25%		2 500
Taxable income		122 501

Kim will therefore have to base her topping-up payment on R122 501.

23.4 Impact of CGT on various deductions

Since a taxable capital gain is included directly in taxable income under s 26A it will have an impact on a number of the deductions that are based on a percentage of taxable income.

23.4.1 Deductions expressed as a percentage of taxable income

Because certain deductions in the sections of the 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 fund contributions – s 11(*k*)
- Retirement annuity fund contributions – s 11(*n*)
- Medical and dental expenses – s 18(2)(*c*)
- Donations to certain public benefit organisations – s 18A(1)

The impact of a taxable capital gain on each of these deductions is discussed below:

23.4.2 Pension fund contributions [s 11(k)]

Section 11(*k*) provides a deduction for pension fund contributions equal to

> '7,5 per cent of the remuneration (being the income or part thereof referred to in the definition of "retirement-funding employment" in section 1) derived by such person during such year in respect of his or her retirement-funding employment'.

The *quantum* of the deduction under s 11(*k*) is unaffected by a taxable capital gain because a taxable capital gain does not constitute income from retirement-funding employment.

23.4.3 Retirement annuity fund contributions [s 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) which provides a deduction in respect of

> '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), and any retirement fund lump sum benefit and retirement fund lump sum withdrawal benefit) the deductions or assessed losses admissible against such income under this Act (excluding this paragraph, sections 17A, 18 and 18A of this Act and items (*c*) to (*i*), inclusive, of paragraph 12(1) of the First Schedule); or'.
>
> (Emphasis added.)

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.

23.4.4 Medical and dental expenses [s 18(2)(c)]

Under s 18(2)(*c*) medical deductions for persons under the age of 65 who do not have a disability[677] are restricted. The amount qualifying as a deduction from taxable income is equal to the sum of the qualifying expenditure

[677] Section 33(1)(*b*) of the Revenue Laws Amendment Act 60 of 2008 replaced the reference to a 'handicapped person' with a reference to 'a person with a disability'. The amendment comes into operation on 1 March 2009 and applies to years of assessment commencing on or after that date.

> 'as in the aggregate exceeds 7,5 per cent of the taxpayer's taxable income (excluding any retirement fund lump sum benefit and retirement fund lump sum withdrawal benefit) as determined before allowing any deduction under this subparagraph'.

This has the effect of restricting the amount that a person who is under the age of 65 and does not have a disability can claim for medical expenses, since the threshold will be boosted by 7,5% of any taxable capital gain.

23.4.5 Donations to certain organisations [s 18A(1)]

Section 18A(1) provides that qualifying donations are restricted to so much of the sum of the donations

> 'as does not exceed ten percent[678] of the taxable income (excluding any retirement fund lump sum benefit and retirement fund lump sum withdrawal benefit) of the taxpayer as calculated before allowing any deduction under this section or section 18'.

It follows that taxpayers will be able to claim 10% of any taxable capital gain in determining the allowable portion of any qualifying donations.

23.4.6 Capital development expenditure (para 12(1)(c) to (i) of First Schedule)

Paragraph 12(3) of the First Schedule effectively limits the capital development expenditure in para 12(1)(*c*) to (*i*)[679] of that Schedule to the *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 farmland or houses on the farm used by non-employees.

23.4.7 Example

Example – Effect of capital gains on deductions

Facts:

The following details relate to an employee under the age of 65 for the 2011 year of assessment:

	R
Salary – pensionable	200 000
Bonus – non-pensionable	50 000
Capital gain	417 500
Pension fund contributions	16 000
Retirement annuity fund contributions	10 000

The taxpayer's employer contributed R1 195 a month to the employee's medical scheme during the 2011 year of assessment, while the employee contributed R1 500 a month out of his own funds. The employee had no dependants. In addition the employee incurred expenditure of R9 541 that was not recovered from the medical aid fund.

Result:

The employee's taxable income is determined as follows:

[678] Under s 18 of the Taxation Laws Amendment Act 8 of 2007 the previous rate of 5% was replaced with 10% effective on or after 1 March 2007.

[679] Paragraph 12(1A) of the First Schedule deems certain environmental expenditure falling within para 12(1)(*d*) and (*e*) of that Schedule to be expenditure incurred in the carrying on of pastoral, agricultural or other farming operations.

Step 1: Determine the taxable capital gain

	R
Capital gain	417 500
Less: Annual exclusion	(17 500)
Net capital gain	400 000
Inclusion rate	25%
Taxable capital gain R400 000 x 25%	100 000

Step 2: Determine the taxable income

		R
Salary – pensionable		200 000
Bonus – non-pensionable		50 000
Taxable benefit – medical scheme contributions		14 340
Gross income		264 340
Less: Deductions		
Pension fund contributions		(15 000)
Actual contributions	16 000	
Deductible contributions: R200 000 x 7,5%	(15 000)	
Balance carried forward	1 000	
Retirement annuity fund contributions		(9 651)
Actual contributions	10 000	
Deductible contributions: (R50 000 + R14 340) x 15%	(9 651)	
Balance carried forward	349	
Taxable capital gain – s 26A		100 000
Less: Capped amount of medical contributions [s 18(2)(*c*)(i)] R670 x 12		(8 040)
Subtotal		331 649
Medical claim subject to 7,5% limitation		
Employer contributions comprising taxable benefit [s 18(5)(*b*)]	14 340	
Own contributions	18 000	
Less: Portion deducted as capped contribution	(8 040)	
Expenses not recoverable from medical scheme	9 541	
Total claim subject to limitation	33 841	
Non-deductible portion R331 649 x 7,5%	(24 874)	
Deductible portion [s 18(2)(*c*)(ii)]	8 967	(8 967)
Taxable income		322 682

The normal rebates and tax rates will apply to the taxable income of R322 682. It will be observed that the taxable capital gain does not increase the deductible portion of pension and retirement annuity fund contributions but does reduce the medical deduction.

23.5 Rating formula

Section 5(10)

Section 5(10) makes provision that when 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 (this item has been deleted as from the commencement of years of assessment ending on or after 1 January 2009); 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) provides 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:

$$R = \frac{F}{B + D - (C + L + G)}$$

in which G represents the amount of the taxable capital gain included in taxable income under 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.

If 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 South Africa, under South Africa'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.

For more on the CGT implications of the s 6*quat* rebate, see SARS Interpretation Note 18 [Issue 2] 'Rebate or Deduction for Foreign Taxes on Income' 31 March 2009.[680]

[680] Available at <http://www.sars.gov.za/home.asp?pid=55886> [Accessed 22 October 2011].

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.[681] 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 the Revenue Laws Amendment 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 'controlled foreign company' is defined in s 9D(1) and means a foreign company in which

- more than 50% of the total participation rights are directly or indirectly held by South African residents other than persons that are headquarter companies, or
- more than 50% of the voting rights in that foreign company are directly or indirectly exercisable, by one or more South African residents other than persons that are headquarter companies.[682]

In the determination of indirect interests of residents in foreign companies the effective interest is calculated. A resident holding 80% of the equity shares in a foreign company which in turn holds 80% of the equity shares in another foreign company will have the effect that the indirect interest of the resident in the second foreign company is 64% (80% x 80%).

The proviso to the definition of a 'controlled foreign company' contains three important rules. These were amended by the Revenue Laws Amendment Act 31 of 2005,[683]

First rule – Disregarding of voting rights in or exercised via listed companies

No regard must be had to any voting rights in any foreign company

- which is a listed company, or
- if the voting rights in that foreign company are exercisable indirectly through a listed company.

[681] K Engel 'National Treasury's Detailed Explanation to Section 9D of the Income Tax Act' (June 2002), available online at <http://www.treasury.gov.za/divisions/epifr/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf> [Accessed 22 October 2011].

[682] The 'voting right test' was inserted by s 14(1)(*a*) of the Revenue Laws Amendment Act 31 of 2005 and came into operation on 8 November 2005 and applies in respect of any foreign tax year which commences on or after that date.

[683] The amendments came into operation on 8 November 2005 and apply in respect of any foreign tax year which commences on or after that date.

Second rule – Voting rights exercisable by CFC deemed to be exercisable by resident

Any voting rights in a foreign company which can be exercised directly by any other CFC in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50% of the voting rights are deemed for purposes of the definition of a 'controlled foreign company' to be exercisable directly by that resident.

Example – Determination of percentage voting rights when exercisable indirectly through a CFC

Facts:

Joy owns 80% of the voting rights in CFC 1. CFC 1 can exercise 60% of the voting rights in Foreign Company 2. Is Foreign Company 2 a CFC?

Result:

Yes, since Joy is deemed to exercise 60% of the voting rights in CFC 2. No regard is had to the indirect interest of 80% x 60% = 48%.

Third rule – Disregarding of de minimis interests held via listed companies and collective investment schemes

A person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50% of the participation rights or voting rights in a foreign company, if

- in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company, that person holds less than 5% of the participation rights of that listed company, or
- in the case of a scheme or arrangement contemplated in para (*e*)(ii) of the definition of a 'company' in s 1[684] or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person

➢ holds less than 5% of the participation rights of that scheme or arrangement, and

➢ may not exercise at least 5% of the voting rights in that scheme or arrangement,

unless more than 50% of the participation rights or voting rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other.

'Participation rights' means

- the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature, in that company, or

[684] Paragraph (*e*)(i) of the definition of 'company' refers to a 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 s 42 of that Act for purposes of that Part.

- in the case in which no person has any right in that company as contemplated above or no such rights can be determined for any person, the right to exercise any voting rights in that company.[685]

The second part of this definition was introduced to enable imputation of the net income of certain foreign mutual companies to be imputed to South African residents.

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, and
- exercise at least 10% of the voting rights,[686]

in the company.

(Paragraph (A) of proviso to s 9D(2).)

The determination of the 10% threshold is made at the end of the foreign tax year, or when 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 South African 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 (before 1 June 2004 under s 9E, and on or after that date under para (*k*) of the definition of the term 'gross income' in s 1). This necessitated the introduction of CFC legislation in the form of s 9D.

23.7.5 Imputation of foreign capital gain of CFC to SA resident

Section 9D of the Income Tax Act provides for the imputation of the net income of a CFC to South African-residents (other than headquarter companies) that directly or indirectly hold any participation rights in that CFC. It is a look-through measure that pierces the corporate veil and treats the income of the CFC as the income of the shareholder. Under s 9D(2) a portion of the net income of the CFC, which is proportionate to the participation rights of that resident in the CFC, is taxed in the hands of the resident.

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

[685] The voting rights test was inserted by s 14(1)(*c*) of the Revenue Laws Amendment Act 31 of 2005 and came into operation on 8 November 2005 and applies in respect of any foreign tax year which commences on or after that date.

[686] The reference to voting rights was inserted by s 14(1)(*d*) of the Revenue Laws Amendment Act 31 of 2005 and came into operation on 8 November 2005 and applies in respect of any foreign tax year which commences on or after that date.

- a resident for purposes of the definition of the term 'gross income', ss 7(8), 9E,[687] 10(1)(*h*), 10(1)(*h*A) and 25B and the paragraphs of the Eighth Schedule set out in the table below.

Table 1 – CGT provisions applicable to CFCs

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	Deleted.[688]
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).)

Under 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 Determination of base cost of pre-1 October 2001 assets

These notes apply to CFCs that were in existence on 1 October 2001. Section 9D(2A) makes para 2(1)(*a*) applicable to a CFC, which by implication also makes the provisions dealing with the determination of the valuation date value of pre-valuation date assets applicable to CFCs (such as paras 20, 25, 26, 27, 28, 29, 30, 31 and 32). A CFC that was in existence on 1 October 2001 will have a valuation date for CGT purposes of 1 October 2001. In other words, such a CFC must use 1 October 2001 for the purposes of determining any capital gain or loss in respect of the disposal of its pre-valuation date assets. It will therefore have to determine the base cost of its pre-valuation date assets in the same way as any other resident. If it wishes to adopt the market value method it must have valued its assets by 30 September 2004 [para 29(4)(*a*)(i)], except when those assets consist of South African-listed shares or South African participatory interests in collective investment schemes whose prices were published in the *Gazette* [para 29(4)(*a*)(ii)]. See **8.33.10.6** for the valuation submission requirements.

23.7.8 Valuation of assets on becoming a CFC on or after 1 October 2001

These notes apply when a company becomes a CFC on or after 1 October 2001.

From commencement of years of assessment ending before 1 January 2006

The valuation date of a company that becomes a CFC after 1 October 2001 is the date on which it became a CFC [s 9D(2A)(*e*)]. A CFC will be entitled to use any of the valuation methods prescribed for pre-valuation date assets (market value, TAB, 20% of proceeds or in the case of para 32(3A) assets such as listed shares, weighted average). In other words, the base cost of the CFC's assets held at the time it became a CFC must be determined in

[687] The reference to s 9E has been deleted with effect from 1 June 2004.
[688] The deletion of the reference to para 12 is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2006. The reference was deleted in consequence of the amendment of para 12(2)(*a*) which triggers a disposal by the CFC of all its assets (other than SA immovable property or assets of a PE in SA) when it ceases to be a CFC.

accordance with para 25, 26, 27, 28 and 32 and not para 12(4) which only permits market value.

From commencement of years of assessment ending on or after 1 January 2006

After its amendment by the Revenue Laws Amendment Act 35 of 2007, s 9D(2A)(*e*) provides as follows:

> '[W]here a foreign company becomes a controlled foreign company after 1 October 2001, the valuation date for purposes of the determination of any taxable capital gain or assessed capital loss in terms of the Eighth Schedule, shall be the day before such company becomes a controlled foreign company.'

Since the assets are deemed under para 12(2)(*a*) read with para 13(1)(*g*)(i) to be acquired on the same valuation date referred to in s 9D(2A)(*e*), it follows that they are not pre-valuation date assets, and hence TAB and the '20% of proceeds' method are not available options. It also follows that the two-year valuation time limit in para 29(4) will not apply.

Under para 12(2)(*a*) a company that commences to be a CFC is, subject to para 24, deemed to have disposed of and reacquired all its assets (other than certain deemed South African-source assets) at a cost equal to the market value of those assets. That cost is deemed to be an amount of expenditure actually incurred and paid for the purposes of para 20(1)(*a*). Under para 13(1)(*g*)(i) the date of acquisition, and hence the date on which the market value must be determined for the purposes of para 12(2)(*a*) is deemed to be the date immediately before the day on which the company commenced to be a CFC.

23.7.9 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 under s 10(1)(*k*)(ii)(*cc*) [before 1 June 2004 under s 9E(7)(*e*)(i)].

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)	-
Passive interest income	30
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.

23.7.10 Inclusion rate [s 9D(2A)(f)]

If 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%. If 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%.

23.7.11 Multi-tier CFCs

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 'controlled foreign company' 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 is contained in para 20(1)(*h*)(iii)(*bb*)[689] to deal with the determination of the base cost of an interest in a subsidiary CFC by a holding company CFC. See **8.13**.

Example – Disposal of subsidiary CFC in multi-tier CFC group

Facts:

Mark, a resident, owns 80% of Holdco, a CFC in the Channel Islands. Holdco in turn owns 80% of Subco which is also based in the Channel Islands. 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 years ending 28 February 2002 to 28 February 2006 Subco derived the following taxable income:

Year ending	£
28 February 2002	240
28 February 2003	300
28 February 2004	400
28 February 2005	500
28 February 2006	600

During 2005 Subco declared a dividend of £200 out of that year's profits, and in 2006 it declared a dividend of £300 out of 2006 profits.

On 28 February 2006 Holdco disposed of Subco for proceeds of £3 000. The average exchange rates during the 2002 to 2006 years of assessment were as follows:

[689] The multi-tier CFC base cost adjustment was previously contained in s 9D(2A)(*j*), which was deleted by s 14(1)(*g*) of the Revenue Laws Amendment Act 31 of 2005. The deletion came into operation on 8 November 2005 and applies in respect of any foreign tax year which commences on or after that date.

Year ending	£1=ZAR
28 February 2002	13,24567
28 February 2003	15,34491
28 February 2004	12,16030
28 February 2005	11,58580
28 February 2006	11,47500

Result:

Mark's indirect 64% effective interest in Subco (80% x 80%) makes Subco a CFC in relation to Mark.

Proportional amount of net income attributable to Holdco's interest in Subco

		R
2002	£100[690] x 13,24567 x 80%	1 060
2003	£300 x 15,34491 x 80%	3 683
2004	£400 x 12,1603 x 80%	3 891
2005	£500 x 11,5858 x 80%	4 634
2006	£600 x 11,4750 x 80%	5 508
		18 776

Tax-free dividends declared to Holdco:

	R
2005 £200 x 11,5858	2 317
2006 £300 x 11,4750	3 443
	5 760

The base cost of Holdco's interest in Subco is determined as follows:

	R
Market value on 1 October 2001 £1 500 x 13,3017	19 953
Proportional amount of net income of Subco attributable to Holdco	18 776
Less: Dividends	(5 760)
Base cost	32 969

Proceeds £3 000 x 11,4750	34 425
Less: Base cost (as above)	(32 969)
Capital gain	1 456

Amount to be imputed to Mark
Inclusion rate = 25%
Taxable capital gain = R1 456 x 25% = R364

	R
Mark's interest in this gain = 80% x R364	291
Net income of Subco attributed to Mark in 2006 R5 508 x 80%	4 406
Net income attributable to Mark in 2006	4 697

23.7.12 Definition – 'local currency' and para 43 [s 9D(2A)(k)]

For the purposes of para 43 the term 'local currency' as used in para 43 means in relation to

[690] £240 x 5/12 = £100. The net income has been apportioned to include only the post-1 October 2001 portion.

- the permanent establishment (PE) of a CFC the functional currency of that PE (other than the currency of any country in the common monetary area) [para 43(7)(*a*)], and
- the CFC itself, its functional currency [s 9D(2A)(*k*)].

Example – Local currency

Facts:

John is the sole shareholder of Johnco, a London-based investment company. Johnco uses sterling as its functional currency. Johnco has a branch in Bermuda that operates a property rental business. The branch's functional currency is the US dollar.

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.

23.7.13 Translation of capital gain or loss [s 9D(6)]

23.7.13.1 The general rule

The net income of a CFC (which includes any taxable capital gain) must be determined in its functional currency. The relevant foreign currency amount to be included in the income of the resident is then translated into rands at the average exchange rate for that year of assessment.

23.7.13.2 The special rule for para 43(4) assets [s 9D(6)]

A special translation rule applies to para 43(4) assets of a CFC (other than assets of a PE of that CFC outside South Africa) which comprise of the following:

- Foreign equity instruments
- Deemed South African-source assets:
  - Immovable property in South Africa
  - Any interest or right in or to immovable property in South Africa
  - Assets of a PE in South Africa.

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 CFC'S functional currency,
  - using the average exchange rate.

At first glance the translation of the rand capital gain or loss into the CFC's functional currency 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 under para 43(4). Under 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 South African 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's functional currency is sterling. The CFC sells a share listed on the NYSE during its financial year ended 30 June 2010 for proceeds of $150. The share was purchased on 1 October 2001 for $50. The relevant exchange rates (not based on reality) are as follows:

On 1 October 2001 R9 = $1 (ruling exchange rate)
Year ended 30 June 2010 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 under para 43(4)

	R
Proceeds ($150 x R10)	1 500
Less: 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 CFC's functional currency

Translate into £ using average exchange rate during the year ending 30 June 2010 = 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.

23.7.14 Designated country exemption [s 9D(9)(a)]

Section 9D(9)(*a*) was deleted by s 22(1)(*g*) of the Revenue Laws Amendment 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.

23.7.14.1 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 before the amendment when the designated country exemption was still in force.

23.7.14.2 The position before 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. Under the definition in s 9E(1), capital gains of any CFC are exempt when 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). Under 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 South Africa. See commentary on s 9E in **23.8**.

In determining the qualifying statutory rate

- the application of any tax treaty 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 an earlier year of assessment);
- the right to carry back foreign assessed losses must be ignored;
- the statutory rate is deemed to be the highest rate on the scale when the designated country imposes tax on a progressive scale of statutory rates of tax. [s 9E(1)].

23.7.15 Foreign business establishment [s 9D(9)(b)]

The CFC rules do not apply when the CFC is a company and its net income is attributable to any 'foreign business establishment' (including the disposal or deemed disposal of any assets forming part of that foreign business establishment)[691] in any country other than the Republic. The term 'foreign business establishment' is defined in s 9D(1) for the purposes of s 9D as follows:[692]

> "**[F]oreign business establishment"**, in relation to a controlled foreign company, means—
>
> (*a*) a fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year, where—
>
> (i) that business is conducted through one or more offices, shops, factories, warehouses or other structures;

[691] The words in brackets were inserted by s 14(1)(*j*) of the Revenue Laws Amendment Act 31 of 2005, came into operation on 8 November 2005 and apply in respect of any foreign tax year which ends during any year of assessment ending on or after that date.

[692] The definition was inserted into s 9D(1) by s 9(1)(*c*) of the Revenue Laws Amendment Act 20 of 2006, deemed to have come into operation on 2 November, 2006 and applicable in respect of any year of assessment ending on or after that date. It replaced the now-repealed definition of 'business establishment'.

(ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct the primary operations of that business;

(iii) that fixed place of business is suitably equipped for conducting the primary operations of that business;

(iv) that fixed place of business has suitable facilities for conducting the primary operations of that business; and

(v) that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic:

Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a controlled foreign company may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subparagraph (iii), and facilities as contemplated in subparagraph (iv) of any other company—

(*aa*) if that other company is subject to tax in the country in which the fixed place of business of the controlled foreign company is located by virtue of residence, place of effective management or other criteria of a similar nature;

(*bb*) if that other company forms part of the same group of companies as the controlled foreign company; and

(*cc*) to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the controlled foreign company;

(*b*) any place outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside the Republic where mining or production operations of natural resources are carried on, where that controlled foreign company carries on those prospecting, exploration, mining or production operations;

(*c*) a site outside the Republic for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude which lasts for a period of not less than six months, where that controlled foreign company carries on those construction or installation activities;

(*d*) agricultural land in any country other than the Republic used for *bona fide* farming activities directly carried on by that controlled foreign company; or

(*e*) a vessel, vehicle, rolling stock or aircraft used for purposes of transportation or fishing, or prospecting or exploration for natural resources, or mining or production of natural resources, where that vessel, vehicle, rolling stock or aircraft is used solely outside the Republic for such purposes and is operated directly by that controlled foreign company or by any other company that has the same country of residence as that controlled foreign company and that forms part of the same group of companies as that controlled foreign company.'

Since the net income of a CFC includes capital gains, the exemption also applies to the disposal of capital gain assets attributable to a foreign business establishment. Stated differently, if CFC factory income is exempt, so is any capital gain stemming from that CFC's sale of factory assets.

23.7.16 CFC Income of a passive nature (mobile foreign passive income) [s 9D(9)(b)(iii)]

23.7.16.1 Background

Besides satisfying the diversionary rules, CFC receipts and accruals attributable to a foreign 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 (for example, the sale of shares).

Lastly, passive receipts and accruals include all forms of currency gains (that is, s 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 (for example, to wholly owned CFCs). Immediate taxation of CFC passive income is consistent with international practice.

23.7.16.2 The position before 1 June 2004

No working capital exemption exists for passive items. As a result, a CFC cannot claim that passive income or gains are eligible for the foreign 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 exemption because a CFC could always contend that passive income could ultimately be used for a business undertaking. However, certain exemptions exist for passive income, such as the *de minimis* exemption and the exemption for banking, insurance, financial service, and rental businesses.

23.7.17 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 amount exceeding 5%) is 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 1 – *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.

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 2 – 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 foreign 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 3 – Non-application of *de minimis* rule when no foreign 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 foreign 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 foreign business establishment. The post-1 June 2004 changes to s 9D(9)(*b*)(iii)(*aa*) also clarify the interaction of this exemption with other s 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).

23.7.18 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.

23.7.19 The offshore-established intangible asset exception [s 9D(9)(b)(iii)(cc)]

This provision was inserted by s 14(1)(*m*) of the Revenue Laws Amendment Act 31 of 2005, came into operation on 8 November 2005 and applies in respect of any foreign tax year which ends during any year of assessment ending on or after that date.

Before the introduction of this provision, gains and losses on the disposal of all intangible assets were taxed under the CFC regime even though the asset may be attributable to a foreign business establishment of the CFC. Under this provision, certain intangible assets purchased, devised or developed outside South Africa qualify for the foreign business establishment exemption. Foreign intangible assets targeted for the relief are those assets which were held by that CFC for a period of at least 18 months before disposal as an integral part of any business conducted by that CFC and were so disposed of as part of the disposal of that business as a going concern. The reason for excluding South African developed intangible assets from this relief measure is that a group of companies which developed South African intangible assets and received the benefit of tax deductible development costs could otherwise transfer the assets offshore and obtain a tax-free amount on disposal thereof. Intangible assets with excellent growth potential should not be able to be transferred offshore and obtain tax-free treatment on the ultimate disposal thereof.

23.7.20 The net income attributable to foreign policyholders exemption [s 9D(9)(c)]

This exemption was introduced by s 14(1)(*n*) of the Revenue Laws Amendment Act 31 of 2005, came into operation on 8 November 2005 and applies in respect of any foreign tax year which ends during any year of assessment ending on or after that date.

Certain CFCs of South African insurance companies earn profits which will eventually be paid to policyholders who do not fall within the South African tax net. In order not to tax these profits under the CFC regime, this provision exempts the net income of the CFC which can be attributed to non-resident policyholders who are not CFCs. An additional requirement for the exemption to apply is that the policy must have been issued by a company which is licensed to issue any long-term policy as defined in the Long-term Insurance Act in its country of residence.

23.7.21 SA-source income subject to SA tax treaty benefits [s 9D(9)(e)]

Section 9D(9)(*e*) excludes from a CFC's net income any amount included in its taxable income.

A CFC is a non-resident and will only have a 'taxable income' in respect of amounts derived from a South African source. In the case of CGT this includes capital gains on immovable property or assets of a PE in South Africa. The purpose of this exclusion is to prevent the same amount from being taxed twice, that is, once as taxable income in the hands of the non-resident CFC and again in the hands of the South African-resident shareholder of the CFC.

23.7.22 Capital gain attributable to foreign business establishment or controlled foreign company of CFC [s 9D(9)(fB)]

A capital gain of a CFC will be excluded from its net income when the asset disposed of was attributable to any foreign business establishment of any other foreign company that forms part of the same group of companies as the CFC.[693]

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. In order to be part of the same group of companies the controlling company must hold at least 70% of the equity shares of the controlled company.

23.7.23 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 when the other company was a foreign financial instrument holding company immediately before the disposal of its shares. An extensive definition of a '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.

[693] The exemption of assets of the CFC itself that are part of a business establishment are addressed by s 9D(9)(*b*). This exemption was previously in s 9D(9)(*f*B) but was moved to s 9D(9)(*b*) by s 14(1)(*p*) of the Revenue Laws Amendment Act 31 of 2005, which came into operation on 8 November 2005 and applies in respect of any foreign tax year which ends during any year of assessment ending on or after that date.

23.7.24 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 who is also a resident, holds at least 10% but not 20% or more of the participation rights and voting rights in a CFC to elect that s 9D(9) shall not apply to the net income of the CFC.[694] 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 rebate under s 6*quat*. By making the election the resident can drill down into the CFC and access the underlying corporate tax. If an election has been made, any dividend subsequently distributed out of the relevant net income will be exempt under 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 when 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 foreign 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: Section 6*quat* rebate	(7)
Tax payable	21

If Carolyn makes an election under 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: Section 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.

[694] A number of amendments were made to s 9D(12) and (13) by s 14(1)(*q*) of the Revenue Laws Amendment Act 31 of 2005. These came into operation on 8 November 2005 and apply in respect of any foreign tax year which commences on or after that date. The main changes were the substitution of the 'not more than 25%' upper limit with 'not more than 20%', the introduction of a requirement that connected persons must be resident, and the fact that the resident and connected persons must hold the required percentage of both participation rights *and* voting rights.

Example 2 – Election to apply imputation to s 9D(9) excluded net income

Facts:

South African Company owns 19% of the ordinary shares of United Kingdom CFC. In 2005, United Kingdom Company generates £400 000 of active income attributable to a United Kingdom business establishment as well as £20 000 of passive income from related working capital. All this CFC income is subject to a 30% United Kingdom tax £420 000x 30% = £126 000). In 2006, United Kingdom 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*)].

23.7.25 Election to apply s 9D to a non-CFC [s 9D(13)]

Section 9D(13) enables a resident who, together with any connected person who is also a resident, holds at least 10% but not 20% or more of the participation rights and voting 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.[695] 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 rebate under s 6*quat*. By making the election the resident can drill down into the company and access the underlying corporate tax. If an election has been made, any dividend subsequently distributed out of the relevant net income will be exempt under 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 when 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 under s 9D(13)

Facts:

South African Company owns 15% of the ordinary shares of United Kingdom Company, the remainder of which is owned by an unconnected foreign individual. In 2005, United Kingdom Company generates £50 000 of passive net income subject to a 30% United Kingdom tax (£50 000 x 30% = £15 000). In 2006, United Kingdom Company distributes all remaining £35 000 (£50 000 – £15 000) 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 United Kingdom Company as if United Kingdom Company were a CFC. Hence, South African Company is deemed to receive £7 500 (£50 000 x 15%) of income along with

[695] See above footnote.

£2 250 (£7 500 x 30%) of s 6*quat* rebates (resulting in South African taxes of zero). South African Company can disregard all £5 250 (£7 500 – £2 250) 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) (deleted)
Section 10(1)(*k*)(ii)(*aa*) to (*dd*)

Section 9E was repealed by s 23(1) of the Revenue Laws Amendment 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. The table also reflects amendments effected by the Revenue Laws Amendment Act 31 of 2005 which came into operation on 8 November 2005 and apply in respect of any dividend received or accrued on or after that date.

Table 1 – Summary of provisions relating to s 9D and foreign dividends

Application of s 9D

- 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.

Type of foreign company	**Percentage shareholding and voting rights of resident**	**Treatment**
Any foreign company	0 – 100%	Dividends are exempt under s 10(1)(*k*)(ii)(*aa*) if declared out of profits • subject to tax in South Africa (N/A when those profits subject to tax at a lower rate under a tax treaty), or • derived directly or indirectly from dividends declared by South African resident company.

CFC	≥ 10% ≤ 20%	Normal rule: • Net income of CFC imputed to resident under s 9D. • Dividends declared out of imputed net income are exempt under s 10(1)(*k*)(ii)(*cc*). **Note:** Net income includes net income of subsidiary CFCS. For the purpose of determining whether foreign dividends exceed net income, net income, must also be reduced by ➢ foreign taxes payable on the net income, and ➢ foreign dividends exempt under s 10(1)(*k*)(ii)(*cc*) and (*dd*) or by reason of a s 9D inclusion. • Income from foreign business establishment not imputed (s 9D(9) exemption), but taxed in resident's hands when dividend declared (para (*k*) of definition of the term '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 under s 10(1)(*k*)(ii)(*cc*).
Not a CFC (e.g. because >50% of shares held by non-residents)	≥ 10% ≤ 20%	Normal rule: Section 9D inapplicable as company not a CFC. • Dividends taxable in hands of resident when declared (para (*k*) of definition of the term '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 under s 10(1)(*k*)(ii)(*cc*).
Any foreign company (CFC/non-CFC) except a foreign financial instrument holding company	At least 20% together with any other group company[696]	• Dividends – exempt under s 10(1)(*k*)(ii)(*dd*). **Note:** ➢ Section 8E hybrid equity instruments excluded when determining the percentage interest, ➢ Exemption does not apply if dividend part of transaction, operation or scheme under which income exempt but corresponding expenditure deductible by company/connected person (except expenditure in respect of delivery of goods and electricity) • Capital gains or losses on disposal of shares in foreign company – exempt under para 64B if ➢ held for at least 18 months, and ➢ disposed of to a non-resident.
Any foreign company	Less than 10%	• Dividends – taxable under para (*k*) of the definition of the term 'gross income'. Exception: Dual listed shares – dividend exempt under s 10(1)(*k*)(ii)(*bb*) [applies when > 10% of shares held by residents]. • Capital gain / loss on disposal of shares subject to CGT.

The position before 1 June 2004

As a rule, foreign dividends are taxable in the hands of South African 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 when the following two requirements are met:

The qualifying interest requirement

First, the dividend must be distributed directly or indirectly to a **resident**[697] holding a **qualifying interest** in the foreign company.

Under 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'.

[696] 'At least 20%' substituted for 'more than 25%' by s 16(1)(*e*) of the Revenue Laws Amendment Act 31 of 2005 and deemed to have come into operation on 8 November 2005 and applies in respect of any dividend received or accrued on or after that date.
[697] As defined in s 1.

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:

The facts are the same 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**[698] at a **qualifying statutory rate**[699] of at least 13,5% after taking into account the application of any tax treaty, 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 an earlier 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.

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 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 B's hands because:

- 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.

[698] See 'List of Designated Countries for the Purposes of Section 9E(8) of the Income Tax Act, 1962' GN 866 *GG* 21526 of 1 September 2000.
[699] As defined in s 9E(1).

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 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 South African 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 earlier 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
Less: Tax previously paid	(15 000)
Refund claimed	(7 500)

Result:

This right of recovery will not jeopardise the tax-free status of the foreign dividend in the South African resident's hands.

Chapter 24 – Treatment of specific types of assets

24.1 Limited interests

24.1.1 Usufructs

A 'usufruct' has been defined as[700]

> 'the right to use the thing of another in such a way as to preserve its substantial character'.

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 bare *dominium* holder may be entitled to dispose of the asset subject to a usufruct provided that it is replaced with another asset. A disposal under these circumstances will trigger a capital gain or loss in the hands of both the bare *dominium* holder and the usufructuary.

When a usufruct is granted there will be a part-disposal of the asset with the result that para 33(1) must be applied for the purpose of allocating the base cost of the asset to the part disposed of (the usufruct) and the part retained (the bare *dominium*). See Example 2.

In the case of a usufruct created under a last will and testament, a part-disposal will be triggered in the hands of the testator if the usufruct is bequeathed to the surviving spouse while the bare *dominium* is bequeathed to another person, such as a family trust. In these circumstances there will be a disposal of the bare *dominium* to the deceased estate under para 40(1), while there will be a roll-over to the surviving spouse under para 67(2)(*a*). It will be necessary to allocate the deceased's expenditure on the asset and any market value determined on valuation date between the bare *dominium* and the usufruct. The bare *dominium* portion will be used in determining any capital gain or loss under para 40(1) in the hands of the deceased person while the surviving spouse will take over[701] the balance of the deceased's expenditure and any market value and use them to determine the base cost of the usufruct and any resulting capital loss when the usufruct expires.

When the testator directs that a usufruct is to be created on his or her death and neither the usufruct nor the bare *dominium* in the asset are bequeathed to a surviving spouse, there will be a disposal of the full ownership in the asset to the deceased estate under para 40(1) and the executor will dispose of the usufruct to the usufructuary and the bare *dominium* to the bare *dominium* holder. This will require a part-disposal calculation on behalf of the deceased estate under para 33(1). A portion of the estate's base cost will be allocated to the usufructuary, while the balance, representing the bare *dominium* will either be allocated to an heir or, if there is no ascertainable heir at that stage, be retained by the estate.

[700] *Brunsdon's Estate v Brunsdon's Estate* 1920 CPD 159 at 174.
[701] It is considered that para 33(3)(*b*) does not prevent the base cost allocation to the surviving spouse because para 67, being the more specific provision, must be given effect.

The creation of successive usufructs by the testator will trigger successive part-disposals by the bare *dominium* holder (whether it be the estate or an ascertainable heir). See Example 5 below.

The CGT treatment of usufructuary and bare *dominium* interests is illustrated in the examples which follow.

Example 1 – Usufruct created on death

Facts:

On 31 July 2007 John Brown died and bequeathed his holiday home that he acquired in 2002 to his family trust subject to a usufruct in favour of his spouse over her remaining life. At the time of his death, John's spouse was 72 years old. 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.[702] What are the CGT implications for

- John,
- John's deceased estate,
- John's wife, and
- The John Brown Family Trust?

Result:

John (the deceased)

John's spouse will turn 73 at her next birthday. According to Table A (see **8.35.7**) she has a life expectancy of 10,24 years, and the present value of R1 a year over her remaining life is 5,72222.

The property is allocated between its component parts as follows:

	R
Market value	1 000 000
Usufruct (R1 million x 12% x 5,72222)	686 666
Bare *dominium*	313 334

There will be a deemed disposal of the bare *dominium* in John's hands at market value at date of death under para 40(1). Since the usufruct has been left to his spouse there is a roll-over in respect of that asset under para 40(1)(*a*) read with para 67(2)(*a*). The capital gain on disposal of the bare *dominium* will be as follows:

	R
Proceeds	313 334
Less: Base cost R400 000 x R313 334/R1 000 000	(125 334)
Capital gain	188 000

[702] It is assumed that property prices remained unchanged from the time of John's death until the date when the property was disposed of by the trust.

The base cost is apportioned under the part-disposal rule in para 33. John will be entitled to the enhanced R120 000 annual exclusion under para 5(2).[703]

John's deceased estate

Under para 40(1) John's deceased estate will acquire the bare *dominium* at market value of R313 334. Under para 40(2)(*b*) the heir (in this case the trust) will in turn acquire the bare *dominium* at its base cost to the deceased estate (R313 334). There is therefore no gain or loss in the deceased estate.

John's spouse (the usufructuary)

John's spouse (the usufructuary) acquires the usufruct at a rolled-over base cost of R274 666 (R400 000 – R125 334). When she passes away there is a disposal under para 11(1)(*b*) (an expiry or termination) of the usufruct without any proceeds. She cannot, however, claim the capital loss of R274 666 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. Upon expiry of a usufruct para 38 will not operate to deem any proceeds to be received by the usufructuary, nor will the bare *dominium* holder obtain a step-up in base cost. There are several reasons for this. First, a bare *dominium* in essence represents the future right of use after expiry of the usufruct. The bare *dominium* holder acquires that future right of use on day one from the person who had full ownership of the asset (the first-dying). On the death of the usufructuary the bare *dominium* holder cannot acquire what he or she already owns. Secondly, an expired usufruct has a market value of nil in the hands of the usufructuary. Once the usufruct expires there is nothing to pass on. Thus the usufructuary has a disposal as a result of the expiry of the usufruct, but this does not mean that the bare *dominium* holder acquires anything. The expiry of the usufruct is a one-sided disposal, similar to the scrapping of an asset. Paragraph 38 only applies when one person disposes of an asset and another person acquires that asset.

The CGT treatment of an expiring usufruct differs from that which applies for estate duty purposes. Under s 5(1)(*b*) of the Estate Duty Act 45 of 1955 when a usufructuary dies, the value of the usufruct based on the life expectancy of the person who takes over the right of use (or when a shorter period is stipulated, that period) is included in the usufructuary's estate.

The John Brown Family Trust (the bare dominium holder)

The base cost of the property in the hands of the trust is R313 334 – 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 R686 666 (R1 000 000 – R313 334). The base cost remains unchanged at R313 334 and is not affected by the expiry of the usufruct.

Some commentators have suggested that the bare *dominium* holder's base cost should be increased 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

[703] The annual exclusion on death was increased from R50 000 to R60 000 by the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

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 bare *dominium* holder never disposed of the future right of use pertaining to the period after expiry of the usufruct in the first place, and cannot therefore be said to have reacquired it. While the usufructuary may have had a disposal by expiry of the usufruct, it is not a disposal that can give rise to a corresponding acquisition in the hands of the bare *dominium* holder. When a usufruct ends it simply ceases to exist and is incapable of being transmitted to another person. Not all disposals give rise to corresponding acquisitions. For example, the scrapping of an asset does not give rise to an acquisition and the expiry of a usufruct is no different. 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 R	John's estate R	John's spouse R	John's Trust R	Total R
Proceeds	313 334	313 334	-	1 000 000	1 626 668
Less:					
Base cost	(125 334)	(313 334)	(274 666)	(313 334)	(1 026 668)
	188 000	-	(274 666)	686 666	600 000

Gain realised if property sold on day before death R1 000 000 – R400 000 = R600 000.

Example 2 – Disposal of bare *dominium* and usufruct on death

Facts:

Upon his death on 30 September 2006 John bequeathed the bare *dominium* in his holiday cottage to his family trust and the usufruct to his wife Sandy. At her next birthday after the death of her husband Sandy will be 65 years of age.

John had purchased the holiday cottage for R100 000 on 1 June 1997. The market value of the full ownership of the holiday cottage was as follows:

- On date of death – R1 000 000.
- On valuation date – R500 000.

Result:

John has effected a part-disposal of the holiday cottage. A capital gain or loss must be determined for the portion bequeathed to John's family trust. Under para 67(2)(*a*) the usufruct bequeathed to Sandy is subject to roll-over relief, and the para 20 expenditure, market value on valuation date and other details referred to in para 67(1)(*b*) that are carried across to Sandy must be determined.

The value of Sandy's usufruct on John's date of death is determined as follows:
Life expectancy – female aged 65 = 15,18 (see **8.35.7**)
Present value of R1 pa for life = 6,84161
Market value of property on date of death = R1 000 000
Annual value of usufruct = R1 000 000 x 12% = R120 000
Market value of usufruct on John's date of death under para 31(1)(*d*) = R120 000 x 6,84161 = R820 993
Market value of bare *dominium* on date of death under para 31(1)(*e*) = R1 000 000 – R820 993 = R179 007

Apportionment of expenditure

	R
Bare *dominium* = R100 000 x R179 007/R1 000 000	17 901
Usufruct = R100 000 x R820 993/R1 000 000	82 099
	100 000

Apportionment of market value on 1 October 2001

	R
Bare *dominium* = R500 000 x R179 007/R1 000 000	89 503
Usufruct = R500 000 x R820 993/R1 000 000	410 497
	500 000

Determination of capital gain on disposal of bare dominium

Using the market value method:

	R
Deemed proceeds (para 40)	179 007
Less: Base cost (market value)	(89 503)
Capital gain	89 504

Using the time-apportionment method:

TAB = B + [(P – B) x N/(N + T)]
= R17 901 + [(R179 007 – R17 901) x 5/(5+5)]
= R17 901 + [R161 106 x 5/10]
= R17 901 + R80 553
TAB = R98 454

Capital gain = R179 007 – R98 454
= R80 553

John's executor should therefore select TAB as this gives the lowest capital gain.

The expenditure attributable to Sandy's usufruct is R82 099 and its market value on 1 October 2001 is R410 497. These amounts will be used when Sandy dies in determining the capital loss on disposal (by expiry) of the usufruct (there will be no proceeds as the usufruct will be worthless on date of her death). If she uses the holiday home for private purposes, however, any capital loss must be disregarded under para 15(*c*).

Example 3 – 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 R313 334. The trust and its beneficiaries are connected persons in relation to each other (para (*b*) of the definition of a 'connected person' in s 1). As a result, the trust is deemed to have disposed of the usufruct at market value of R686 666 under 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 R686 666.

John's spouse

John's spouse is a connected person in relation to the trust (para (*b*) of the definition of a 'connected person' in s 1). Paragraph 38(1)(*b*) dictates that she is deemed to have acquired the usufruct at a base cost equal to its market value (R686 666). 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 R	John's estate R	John's spouse R	John's Trust R	Total R
Proceeds	1 000 000	1 000 000	-	1 000 000	2 000 000
Base cost	400 000	1 000 000	686 666	313 334	2 000 000
	600 000	-	(686 666)	686 666	-

Example 4 – Disposal of assets subject to usufruct

Facts:

Upon his death Oscar bequeathed the bare *dominium* in his share portfolio to the Oscar Family Trust and the usufruct to Anne, his surviving spouse. The share portfolio consisted of listed shares in two companies, the details of which were as follows on his date of death:

	Market value R	Base cost R
Alpha Ltd	50 000	10 000
Beta Ltd	60 000	16 000

At the date of his death, Anne was 39 years old.

According to Oscar's last will, the trustees of the Oscar Family Trust are entitled to dispose of the shares, but must replace them with other investments over which Anne will continue to hold a usufruct.

When Anne was aged 44 the trustees sold the shares in Alpha Ltd for R70 000 and used the proceeds to acquire shares in Charlie Ltd for R65 000, while the balance of R5 000 was placed in a call account. Assume that the Commissioner has approved a yield of 3% for the shares and 9% for the call account.

Determine the CGT consequences for Oscar, the Oscar Family Trust and Anne.

Result:

Oscar

At her next birthday, Anne will be 40 years old. According to Table A she has a life expectancy of 35,48 years. The present value of an annuity of R1 a year for 35,48 years at 3% using an Excel worksheet is
=PV(0.03,35.48,-1)
which gives a result of R21,65.
Value of usufruct over shares:
Alpha Ltd R50 000 x 3% = R1 500 x 21,65 = R32 475
Beta Ltd R60 000 x 3% = R1 800 x 21,65 = R38 970

Market value of bare *dominium*:
Alpha Ltd R50 000 – R32 475 = R17 525
Beta Ltd R60 000 – R38 970 = R21 030

Base cost attributable to part-disposal of bare *dominium*
Alpha Ltd R17 525/R50 000 x R10 000 = R3 505
Beta Ltd R21 030/R60 000 x R16 000 = R5 608

Oscar will therefore have a capital gain determined as follows:

Alpha Ltd

	R
Proceeds	17 525
Less: Base cost	(3 505)
Capital gain	14 020

Beta Ltd

	R
Proceeds	21 030
Less: Base cost	(5 608)
Capital gain	15 422

Since there is a roll-over in respect of the usufruct granted to his wife, Oscar does not have to determine a capital gain in respect of that part of the shares.

Under para 40(2) the Oscar Family Trust acquires the bare *dominium* in the shares at the following base cost:

	R
Alpha Ltd	17 525
Beta Ltd	21 030

Anne's base cost [rolled over from Oscar under para 67(1)] is as follows:

	R
Alpha Ltd (R10 000 – R3 505)	6 495
Beta Ltd (R16 000 – R5 608)	10 392

When the Alpha Ltd shares are disposed of for R70 000 Anne will have a capital gain determined as follows:

Anne's age at next birthday = 45
Life expectancy – Table A = 31,01

Charlie Ltd

Present value of R1 a year at 3% using an Excel worksheet is
=PV(0.03,31.01,-1)
= R20
Annuity R65 000 x 3% = R1 950
Present value of annuity = R1 950 x R20 = R39 000

Call account

Present value of R1 a year at 9% using an Excel worksheet is
=PV(0.09,31.01,-1)
= R10,34
Annuity R5 000 x 9% = R450
PV of annuity = R450 x R10,34 = R4 653
Disposal of usufruct over Alpha Ltd shares

	R
Proceeds R39 000 + R4 653)	43 653
Less: Base cost	(6 495)
Capital gain	37 158

The base cost of her usufruct is now as follows:

	R
Charlie Ltd shares	39 000
Call account	4 653
Beta Ltd shares (unchanged)	10 392

The Oscar Family Trust will have a capital gain in respect of the disposal of its bare *dominium* in the Alpha Ltd shares as follows:

	R
Bare *dominium* in Charlie Ltd shares (R65 000 – R39 000)	26 000
Bare *dominium* in call account (R5 000 – R4 653)	347
Amounts received or accrued in respect of disposal	26 347
Less: Base cost	(17 525)
Capital gain	8 822

The base cost of The Oscar Family Trust's bare *dominium* is now as follows:

	R
Charlie Ltd shares	26 000
Call account	347
Beta Ltd shares (unchanged)	21 030

Example 5 – Part-disposal of full ownership – successive usufructs

Facts:

Upon his death on 31 March 2009 Dave's last will and testament provided that his holiday cottage was to be dealt with as follows:

His eldest son Abe was to be given the usufruct for his lifetime. Upon Abe's death, a usufruct was to be granted to Abe's son Bart for his lifetime. Upon Bart's death the cottage was to be given to Bart's son, Carl. Bart and Carl's inheritance was conditional upon them being alive at the time they were due to inherit. This turned out to be the case. No improvements were made to the cottage from the time of Dave's death until it was sold by Carl.

At his next birthday after the death of his father Abe will be 65 years of age. Abe died on 31 May 2015. On that date, Bart will be 40 years of age at his next birthday. Bart died on 30 June 2045 at which point Carl inherited the cottage.

Dave purchased the cottage for R100 000 on 1 June 2002. The market value of the full ownership of the cottage was as follows:

- On date of Dave's death – R1 000 000.
- On date of Abe's death – R1 500 000.

Carl sold the cottage for R10 000 000 on 1 February 2050.

Determine the CGT consequences for Dave, Dave's estate, Abe, Bart and Carl.

Result:

Dave

Under para 40(1) Dave is deemed to have disposed of his holiday cottage for proceeds of R1 million. He has a capital gain as follows:

	R
Proceeds	1 000 000
Less: Base cost [para 20(1)(*a*)]	(100 000)
Capital gain	900 000

Dave's estate

Under para 40(1) Dave's deceased estate acquires the cottage at a base cost of R1 million. When the executor grants Abe the usufruct he triggers a part-disposal by Dave's deceased estate. The portion of the base cost disposed of by the deceased estate is determined as follows:

Life expectancy – male aged 65 = 11,77 (see **8.35.7**)
Present value of R1 pa for life = 6,13789
Market value of property on date of death = R1 000 000
Annual value of usufruct = R1 000 000 x 12% = R120 000
Market value of usufruct on Dave's date of death under para 31(1)(*d*) = R120 000 x 6,13789 = R736 547

The bare *dominium* held by the estate is reduced as follows:

	R
Cost of acquisition of full asset [para 40(1)]	1 000 000
Less: Usufruct granted to Abe	(736 547)
Base cost after first usufruct	263 453

Under para 40(2)(*a*) Dave's estate makes no gain or loss on the part-disposal to Abe since it is deemed to be made for proceeds equal to its base cost.

The granting of the second usufruct to Bart triggers another part-disposal by Dave's deceased estate as follows:

Life expectancy – male aged 40 = 29,54 (see **8.35.7**)
Present value of R1 pa for life = 8,0403
Market value of property on date of Abe's death = R1 500 000
Annual value of usufruct = R1 500 000 x 12% = R180 000
Market value of usufruct on Abe's date of death under para 31(1)(*d*) = R180 000 x 8,0403 = R1 447 254

Portion of Dave's estate's base cost that is disposed of:
R1 447 254/R1 500 000 x R263 453 = R254 189.

The base cost of the bare *dominium* held by Dave's estate is now as follows:

	R
Base cost after granting first usufruct	263 453
Less: Usufruct granted to Bart	(254 189)
Base cost after second usufruct	9 264

Again there is no capital gain or loss on the granting of the second usufruct as the proceeds are deemed to be equal to the base cost under para 40(2)(*a*).

Upon Bart's death the executor of Dave's estate awards the cottage to Carl for proceeds equal to the remaining base cost of R9 264. Under para 40(2)(*a*) Dave's estate makes no gain or loss and Carl acquires the cottage at a base cost of R9 264.

Abe

Under para 40(2)(*b*) Abe acquires the usufruct in the cottage at a base cost of R736 547. Upon his death the usufruct expires and there are no proceeds. Abe therefore has a capital loss of R736 547. This capital loss must be disregarded under para 15(*c*) to the extent that the cottage was not used for the purposes of trade.

Bart

Under para 40(2)(*b*) Bart acquires the usufruct in the cottage at a base cost of R254 189. Upon his death the usufruct expires and there are no proceeds. Bart therefore has a capital loss of R254 189. This capital loss must be disregarded under para 15(*c*) to the extent that the property was not used for the purposes of trade.

Carl

When Bart dies Carl acquires the cottage at the remaining base cost of the asset in Dave's deceased estate of R9 264 under para 40(2)(*b*). Carl's capital gain on disposal of the cottage is determined as follows:

	R
Proceeds	10 000 000
Less: Base cost [para 40(2)(*b*)]	(9 264)
Capital gain	9 990 736

24.1.2 Fideicommissa

A *fideicommissum* (plural: *fideicommissa*) is an arrangement under which full ownership of the asset is given to a person (the *fiduciary*). This includes the bare *dominium* and right of use and enjoyment of the asset. The fiduciary may not dispose of the asset and must care for it. Upon the fiduciary's death or after a fixed period, the asset must be passed on to another person (the *fideicommissary*). While the fiduciary holds the asset the fideicommissary merely has a *spes* (a hope) that he or she will outlive the fiduciary and take ultimate ownership of the asset. Should the fideicommissary die before the fiduciary, his or her estate will receive nothing.

Example – Fideicommissum

Facts:

Upon his death, Tom's last will and testament stated that his holiday home was to be left to his daughter Katie for her lifetime after which it was to pass to Katie's daughter, Jenny should she survive Katie. At the time of Tom's death

- the asset had a base cost of R100 000,
- a market value of R500 000, and
- Katie was 55 years old.

Katie died at the age of 70 and the asset was passed on to Jenny. Jenny disposed of the residence a few years later for R500 000.

What are the CGT implications for Tom, Katie and Jenny?

Result:

Tom

Under para 40(1) Tom has a capital gain of R500 000 (proceeds) less R100 000 (base cost) = R400 000.

Katie

The base cost of Katie's fiduciary interest is determined under para 31(1)(*d*) and (2) as follows:

Age next birthday	56
Life expectancy	21,86 years
Annual value of interest (R500 000 x 12%)	R60 000
PV of R1 a year @ 12% (Table A)	7,63363
PV of fiduciary interest: (R60 000 x 7,63363)	R458 017,80

Upon her death Katie has

- no proceeds (the value of her fiduciary interest expired on her death),
- a base cost of R458 018, and
- a capital loss of R458 018.

The capital loss will be limited under para 15(*c*) to the extent that Katie used the residence for purposes other than the carrying on of a trade. Should Jenny die before her, Katie would be able to deal with the asset as she pleases and its value will no longer decrease over time. Consequently the loss limitation rule in para 15(*c*) would no longer apply to Katie when she disposes of the asset.

Jenny

Under para 31(1)(*e*) the base cost of the residence in Jenny's hands is R500 000 – R458 018 = R41 982.

Upon disposal of the asset Jenny will have a capital gain determined as follows:

	R
Proceeds	500 000
Less: Base cost	(41 982)
Capital gain	458 018

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 under a lease agreement?
- Were they 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[704] 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 asset, 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. Any compensation received will reduce the expenditure incurred under para 20(3)(*b*).

In order to prevent this, para 33(3)(*c*) provides that there is no part-disposal of an asset by a person in respect of

> 'the improvement or enhancement of immovable property which that person leases from a lessor'.

The above wording came into operation on 1 February, 2006 and applies in respect of any improvement or enhancement effected on or after that date. Before this date there are three periods, one during which para 33(3)(*c*) applied (with slightly different wording) and two when it did not. This confusing situation was caused by the insertion (2003), deletion (2005) and reinsertion (2006) of para 33(3)(*c*). The effective dates and rules that apply since valuation date are summarised in a table in **8.37.6.3**.

[704] (1989) 52 SATC 28 (C) at 31.

If improvements are undertaken under a lease agreement, the question arises as to which deduction takes precedence – s 11(*g*) or the capital loss under 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' under 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. However, with the reinstatement of para 33(3)(*c*) this issue is only of academic interest, since there is no part-disposal of the base cost of the improvements until the end of the lease.

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 when para 33(3)(c) applies (on or after 1 February 2006 and a period before that date – see* **8.37.6.3***)* 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 when para 33(3)(c) did not apply (two periods before 1 February 2006 – see* **8.37.6.3)** The bare *dominium* in the improvements is disposed of at the time the improvements 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 the Revenue Laws Amendment Act 32 of 2004 and reinstated by the Revenue Laws Amendment Act 31 of 2005.
Obligatory improvements	Amount of improvements	Obligatory improvements are

effected under lease agreement	included in gross income (para (*h*) of gross income definition). An allowance is granted under s 11(*h*). No CGT consequences arise as there is no disposal of an asset by the lessor, merely an acquisition. The base cost of the improvements under para 20(1)(*h*)(ii)(*cc*) is the amount included in gross income (by para (*h*) of the definition of the term 'gross income' in s 1) less any allowance granted under s 11(*h*).	allowable under s 11(*g*). On disposal the amounts allowed under s 11(*g*) must be excluded from base cost – para 20(3)(*a*).
Voluntary improvements effected before valuation date	No expenditure incurred under para 20. Valuation date value (VDV) options include market value, 20% of [proceeds – post-1 October 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 in respect of 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 October 2001 improvements represents a pre-valuation date disposal. The result is that no capital loss can be claimed in respect of 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 under para 20 = base cost
Compensation paid by lessor	Forms part of base cost under para 20(1)(*e*). In the case of pre-1 October 2001 improvements, VDV determined using market value, TAB or 20% of proceeds.	Compensation included in proceeds under para 35(1)(*b*). Any compensation in respect of bare *dominium* disposed of before 1 October 2001 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 according to the lease agreement are less than the projected market-related rental. For example, assuming no future increases in rentals, if the lease has five years to run at a rental of R5 000 a month and the current market-related rental is R7 000 a month, then the 'asset' is the present value of R2 000 a 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 when 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.[705]
- A capital loss would usually arise in such cases.
- If the lease was taken out for a non-trade purpose para 15(*d*) would operate to disallow the loss.
- The question arises 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 paras 26 and 27 need to be considered.

Example 1 – Disposal of lease rights on termination of lease

Facts:

A lease terminates without proceeds.

	R
Amount paid for lease rights	Nil
Market value of lease rights on 1 October 2001	100 000
Proceeds on termination	Nil

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 or 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.

	R
Expenditure before valuation date	Nil
Market value on valuation date	100 000
Expenditure after valuation date	Nil
Proceeds	20 000

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 =

[705] 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.

R20 000 resulting in no gain or 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. If a debt arises from a sale of trading stock, the base cost of the debt is equal to the market value of the trading stock disposed of, since this is the amount by which the seller has been impoverished. See **8.5** on the establishment of the base cost of an asset acquired under a barter or exchange transaction.

Interest accrued that is added to a loan balance also comprises expenditure actually incurred. When an interest-bearing loan is advanced the lender acquires a personal right to claim interest from the borrower at a future date. This right would usually have a base cost of nil. When the interest accrues and is capitalised the personal right to claim the interest accrued is extinguished in exchange for the increase in the loan. The accrued interest is included in income but is eliminated from proceeds by para 35(3)(*a*) resulting in no gain or loss. The expenditure incurred on the increased loan balance is equal to the amount by which the lender has been impoverished.[706] The diminution in the value of the lender's assets is equal to the value of the personal right given up (see **8.5**). Should the capitalised interest subsequently become irrecoverable, the lender will be entitled to a deduction under s 11(*i*) in respect of the interest portion of the bad debt. In that event the base cost of the loan will have to be reduced under para 20(3)(*a*) by the amount so claimed.

Loan repayments

Depending on the circumstances, loan repayments should be dealt with by using either

- the cost-recovery method [para 20(3)(*b*)],
- the part-disposal method (para 33), or
- in the case of a s 24J instrument, the method prescribed in that section.

The cost-recovery method

This method is appropriate when the loan is advanced or acquired at face value. In this case a capital gain or loss would not normally be anticipated, and the repayments represent a

[706] ITC 1783 (2004) 66 SATC 373 (G) at 376.

recovery of base cost under para 20(3)(*b*). Paragraph 20(3)(*b*) provides that the expenditure in acquiring an asset must be reduced by any amount of that expenditure that

> 'has for any reason been reduced or recovered or become recoverable from or has been paid by any other person'.

This 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 under s 155 of the Companies Act 71 of 2008, or when debtors are disposed of as part of a going concern and the price paid is reduced below face value to account for the possibility of doubtful debts. 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 are proceeds arising from a part-disposal of the loan. Paragraph 33 contains two methods for determining the portion of the base cost disposed of, namely,

- the market value formula method [para 33(1)], and
- 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 before each repayment. The market value of a loan, particularly one that is interest-bearing, fluctuates constantly with prevailing interest rates and prospects of recovery. If there are numerous repayments it would be administratively burdensome to apply this method.

Alternatively, the specific identification method in para 33(2) can be applied to identify the portion of the base cost disposed of. This method recognises the fungible nature of a loan, that is, all parts of a loan have equal cost, are indistinguishable and identifiable by nomination.

Example – Determination of capital gain or loss on repayment of a loan using the part-disposal method

Facts:

An interest-free loan of R120 is acquired at a cost of R100, and is repayable in 5 equal annual instalments.

Result:

The base cost of each repayment is R20, and each year a capital gain of R24 – R20 = R4 will be realised.

Section 24J instruments

The term 'instrument' is defined in s 24J(1) and means any form of interest-bearing arrangement, including amongst others, stocks, bonds, debentures, bills, promissory notes, bank deposits, secured or unsecured loans, advances or debts

Section 24J sets out what constitutes interest, how it is to be calculated, when it accrues or is incurred and how and *when* an 'adjusted gain or loss on transfer or redemption of an instrument' is to be determined.

Under s 24J(4), the adjusted gain or loss on transfer or redemption of the instrument is deemed to accrue or be incurred, as the case may be, in the year of transfer or redemption. This provision overrides any timing rule in para 13, thereby excluding the use of the part-disposal method. The adjusted gain or loss contemplated in s 24J is the equivalent of a capital gain or loss when the instrument is held on capital account and acquired on or after the valuation date. In the case of a pre-valuation date instrument, however, the adjusted gain or loss may differ from the capital gain or loss. To the extent, for example, that the adjusted gain exceeds the capital gain the difference represents a pre-valuation date gain that is not subject to CGT.

If a loan is acquired at a discount (for example, as in the case of a zero coupon bond) the discount is deemed to be interest that must be included in the person's gross income under s 24J(3).[707]

Paragraph (*a*) of the definition of the term 'interest' in s 24J(1) includes the

> 'gross amount of any interest or related finance charges, *discount* or premium payable or receivable in terms of or in respect of a *financial arrangement*'.

(Emphasis added.)

It is submitted that the word 'discount' must be read *ejusdem generis* with the words 'interest and related finance charges'. The discount must also arise under a 'financial arrangement'. The facts and circumstances of each case must be considered in determining whether a particular discount is in the nature of interest or related finance charges. Another factor to be considered is whether the term of the instrument can be established. The word 'term' is defined in s 24J(1) and in relation to an instrument means

> 'the period from the issue or transfer, as the case may be, until the date of redemption thereof'.

The 'yield to maturity' (YTM) must be determined over the 'term' of the instrument. In some cases the term, and hence the YTM of the instrument may not be determinable. For example, this may be the case with a subordinated loan acquired for a nominal consideration under an offer of compromise under s 155 of the Companies Act 71 of 2008. For these reasons all 'discounts' may not be interest as contemplated in s 24J.

In conclusion, when the 'discount' is not in the nature of interest, the capital or revenue nature of the amounts recovered must be determined on the facts. If the loan was acquired as part of a scheme of profit-making it will be trading stock, and the proceeds will have to be included in gross income. On the other hand, if the loan is of a capital nature, a capital gain or loss must be determined under para 33.

If the discount is 'interest' as contemplated in s 24J, the interest accruals will be excluded from proceeds under para 35(3)(*a*). An 'adjusted gain or loss' will only arise under s 24J if the instrument is disposed of before maturity, and would only be quantifiable at the time of disposal. It follows that any capital gain or loss must be determined at the time of disposal as specified in s 24J(4). See also **8.31**.

[707] Section 24J(3) was amended by s 24(1)(*i*) of the Revenue Laws Amendment Act 32 of 2004 with effect from 1 January 2005 and applies in respect of any instrument issued, acquired or transferred on or after that date.

Disposal

If the repayments are treated as a recovery of cost, a disposal will occur upon the loan becoming fully repaid, since there will be a redemption or discharge of the debt under para 11(1)(*b*).

Under the part-disposal method, a part-disposal occurs each time the loan is repaid [discharge or redemption – para 11(1)(*b*)].

In the case of a s 24J instrument the time of disposal under s 24J(4) is the time of transfer or redemption of the instrument.

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

The treatment of a bad debt for CGT purposes depends on several factors which are summarised in the table below.

Table 1 – Treatment of irrecoverable debts

Type of loan	**Treatment**
Loan arising from the disposal of an asset which becomes irrecoverable in the same year of assessment	Reduce proceeds on disposal of asset under para 35(3)(*c*)
Loan arising from the disposal of an asset which becomes irrecoverable in a subsequent year of assessment	*Pre-valuation date asset:* Redetermine capital gain or loss under para 25(2) *Asset acquired on or after valuation date:* Determine capital loss under para 4(*b*)(i)(*bb*)
Loan arising otherwise than from the disposal of an asset	Determine capital loss under para 4(*a*) read with paras 11(1)(*c*) [disposal = loss] and 13(1)(*c*) [time of disposal]. If debtor and creditor are connected persons in relation to each other, any capital loss will only be allowable if the conditions in para 56(2) are met [for example, if the debtor determines a corresponding capital gain under para 12(5)].

Debt arising from disposal of an asset

The core disposal rules in para 11 do not apply to a debt arising from the disposal of an asset and the matter must be dealt with as a reduction in proceeds.

Thus, when the debt becomes irrecoverable in the same year of assessment in which the asset was disposed of, the proceeds are simply reduced in determining the capital gain or loss on disposal of the asset in that year under para 35(3)(*c*). The latter provision does not specifically refer to a reduction in proceeds as a result of irrecoverability, but such an eventuality would fall within the expression ‘any other event’.

If the debt arose from the disposal of a pre-valuation date asset and the debt becomes irrecoverable in a year of assessment subsequent to the year of disposal, the capital gain or loss on disposal of the asset must be redetermined in the year in which the debt becomes irrecoverable. The prior year capital loss or gain is reversed in the current year under para 3 or 4 respectively and the redetermined capital gain or loss taking into account the reduced proceeds is accounted for in the current year under para 3 or 4 read with para 25(2) (see **8.27.2**).

If the asset giving rise to the debt was acquired on or after the valuation date and the debt becomes irrecoverable in a subsequent year of assessment, a capital loss will arise under para 4(*b*)(i)(*bb*) by virtue of the irrecoverable proceeds.

Debt arising otherwise than from the disposal of an asset

If the debt arose otherwise than from the disposal of an asset the core rules apply. Paragraph 11 does not make specific reference to a bad or irrecoverable debt, but the situation is covered by para 11(1)(*c*) which refers to 'the scrapping, *loss* or destruction of an asset'. Under para 13(1)(*c*) the time of disposal will be on the later of the date when the loss is discovered and the date when it is established that no compensation will be payable.

A specific timing rule is not available under paras 4(*b*)(i)(*bb*) and 25(2), and it is therefore left to the taxpayer to determine on an objective basis having regard to the facts and circumstances of the case when the debt is incapable of being recovered. In ITC 592[708] a taxpayer had granted credit to customers on terms that extended over several years before finally writing some of them off as bad. As to when the debts became bad Ingram CJ stated that

> 'the taxpayer is entitled to claim the deduction of bad debts up to and as at the time he finally regards the debts to be bad'.

On the Australian Tax Office's approach as to when a debt becomes bad see Taxation Ruling TR 92/18 'Income Tax: Bad Debts'.[709] The approach of the IRS in the United States of America is set out below:[710]

> 'A debt becomes worthless when the surrounding facts and circumstances indicate there is no longer any chance the amount owed will be paid. To show that a debt is worthless, you must establish that you have taken reasonable steps to collect the debt. It is not necessary to go to court if you can show that a judgment from the court would be uncollectible. You may take the deduction only in the year the debt becomes worthless.'

SARS accepts that a debt will become irrecoverable when the taxpayer has exhausted all reasonable steps to recover it. As with the IRS approach this does not mean that taxpayers have to exhaust all their legal remedies, such as placing a debtor in liquidation if such action would not yield any recovery or if the cost of taking such action would exceed the likely recovery.

Irrecoverable loans to connected persons (para 56)

Under para 56(1) a creditor who disposes of a claim owed by a debtor who is a connected person in relation to that creditor must disregard any capital loss resulting from that disposal

[708] ITC 592 (1945) 14 SATC 243 (U) at 246.
[709] Available at: <http://law.ato.gov.au/atolaw/view.htm?dbwidetocone=06%3AATO%20Rulings%20and%20Determinations%20(Including%20GST%20Bulletins)%3ABy%20Type%3ARulings%3ATaxation%3A1992%3A%2305080000018%23TR%2092%2F18%20-%20Income%20tax%26c%20bad%20debts%3B#P23> [Accessed 22 October 2011].
[710] Publication 453 'Bad Debts Deduction', available at <http://www.irs.gov/taxtopics/tc453.html> [Accessed 22 October 2011].

except to the extent that para 56(2) applies. Under para 56(2) the creditor will be allowed the capital loss to the extent that the amount of the claim represents

- a capital gain which is included in the determination of the aggregate capital gain or loss of that debtor under para 12(5),
- an amount which the creditor proves must be or was included in the gross income of any acquirer of that claim,
- an amount that 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 under s 20(1)(*a*)(ii), or
- 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.

Examples of situations in which a creditor that is a connected person in relation to a debtor will not be allowed to claim a capital loss under para 56(1) include

- a resident creditor writes off an irrecoverable loan to a connected person who is not a resident,
- the debtor and creditor are part of the same group of companies as defined in s 41 and the exemption in para 12(5)(*a*)(*bb*) applies, or
- the debtor and creditor are connected persons and the debtor is a company that is being liquidated, deregistered or finally terminated and the exemption in para 12(5)(*a*)(*cc*) applies.

For more on para 56 see **12.5**.

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 under para 3(*b*)(ii).

The debtor

From the debtor's perspective the amount owed is a liability, so there is no CGT asset. However, when 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 nil, and
- 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*[711] Toohey J stated the following:

> '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[712] 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.*[713] 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 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 under para 11(1). The 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.[714] 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 under para (*c*A) of the definition of the term 'gross income' in s 1:

- individuals
- labour brokers without exemption certificates issued under the Seventh Schedule
- personal service companies, and

[711] (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 October 2011].
[712] (1980) 43 SATC 171 (T) at 174.
[713] 1975 (3) SA 649 (A), 37 SATC 129 at 138.
[714] 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.

- 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 under 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 under paras 3(*b*)(ii) and 4(*b*)(i)(*bb*). Under 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. Under para 4(*b*)(i)(*bb*) R110 000 of the 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:

When the buyer fails to obtain the bond 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 Share block companies and their shareholders

This paragraph examines the CGT implications of some situations that can arise in relation to a share block company as defined in s 1 of the Share Blocks Control Act 59 of 1980.

24.7.1 Conversion to share block company

Under s 10(*b*) of the Share Blocks Control Act 59 of 1980 any share of the company must confer a right to or an interest in the use of immovable property to the shareholder. The conversion of a company to a share block company consequently triggers a part-disposal by the company of an indefinite right of use in the property to the shareholders. The company will be left with the bare *dominium* in the property, which will be virtually worthless. Under para 11(1)(*e*) the distribution of an asset by a company to a shareholder is a disposal. Under para 75(1) the company is deemed to have disposed of the right of use and occupation for an amount received or accrued equal to its market value on the 'date of distribution' as defined in para 74. To the extent that the distribution comprises a dividend (as opposed to CTC) it will also carry STC implications for the company.

24.7.2 The impact on the shareholder

The conversion of a company to a share block company will trigger at least one, but potentially two, disposal events in the shareholder's hands.

The part-disposal

The receipt of the right of use and occupation by the shareholder will trigger a part-disposal of the shareholder's shares in the company under para 76A to the extent that it comprises a capital distribution. This would be the case to the extent that the directors determine that the distribution is to be effected by reducing the company's CTC. To the extent that the distribution comprises a dividend it will not trigger a part-disposal or comprise proceeds for *CGT* purposes.

The full disposal

The conversion of the company's shares to shares in a share block company triggers a full disposal of the shares in the shareholder's hands under para 11(1)(*a*) which lists 'conversion' as a disposal event.

The word 'conversion' is not defined in para 1. It has several ordinary meanings, but one that seems appropriate in the circumstances of para 11 describes 'conversion' as[715]

> '[t]he exchange of one type of security or currency for another.'

The conversion of a company to a share block company would, it is submitted, involve the exchange of shares in a company for shares in a share block company. Apart from having to surrender the old shares in order to effect the change of the company's name as required by s 9 of the Share Blocks Control Act, the conversion involves a substantial change in the

[715] See <http://www.thefreedictionary.com/conversionary> [Accessed 22 October 2011].

rights attaching to the shares. For example, the value of the right to receive a distribution on liquidation will decrease, while a new right, being the right of use, will attach to the shares under s 10(*b*) of the Share Blocks Control Act. The Share Blocks Control Act also places restrictions on how the company can operate. Because of these substantive changes in rights, the conversion of a company to a share block company is regarded as a disposal that must be approached in the same way as a barter or exchange transaction (see **8.5**). The proceeds from the disposal will be equal to the market value of the new shares (which will be worth considerably less because of the disposal of the right of use and occupation to the shareholder). The base cost of the new shares will be equal to the value of the old shares that have been surrendered following the distribution of the right of use and occupation. The base cost of the right of use and occupation will be equal to its market value under para 76(3).

Any capital loss which arises from the part-disposal or full disposal will probably be disallowed under para 19 as it will likely result from an extraordinary dividend.

Example – Conversion of company to share block company

Facts:

ABC (Pty) Ltd owns land and buildings consisting of a block of 10 flats. The shares in the company are owned by Rene who decided to convert the company to a share block company as contemplated in the Share Blocks Control Act. Rene has held the shares in the company from the time of its formation for many years as a capital asset and her intention in converting the company to a share block company is merely to facilitate the realisation of her capital asset to best advantage.

At the time of the conversion, the right of use was valued at R1 million. After the conversion each of the company's 10 shares of R1 each had stapled to it a right of use and occupation of a designated flat, lock-up garage and servant's quarters for an unlimited period as well as a right to use the common property. The company's balance sheet immediately before conversion appeared as follows:

	R
Share capital	10
Profits	226 000
Shareholders' loan	100 000
	326 010
Land and buildings – at cost	100 000
Cash	226 010
	326 010

Result:

For CGT purposes the awarding of the right of use and occupation to Rene triggers a disposal in the company for an amount received or accrued equal to market value under para 75(1). This results in CGT of R1 000 000 – R100 000 = R900 000 x 50% x 28% = R126 000.

The granting of a right of use in the property comprises a dividend as defined in s 1 since it represents an amount transferred to a shareholder by virtue of a share by way of a distribution. STC of R1 000 000 x 10% = R100 000 is payable on the market value of the distribution. It is assumed that no part of the distribution has been determined by Rene to come out of the company's CTC and that the bare *dominium* is worthless.

The dividend will not trigger a capital gain or loss in Rene's hands under para 76A as it does not represent a capital distribution.

The conversion of the company triggers a disposal of Rene's shares. The proceeds will be equal to the market value of the shares in the share block company (assume R10). It is assumed that the base cost of the shares being disposed of is R10 which results in no gain or loss for Rene on the conversion.

The base cost of the share block shares (excluding the right of use and occupation) is equal to the market value of the previously held shares of R10.

The base cost of the right of use and occupation attaching to the new shares is equal to its market value on the date of distribution under para 76(3), namely, R1 million.

24.7.3 Conversion of share block company to company

The conversion of a share block company to a company requires the cancellation of the right of use attaching to the shares. In addition the rights in the shares will change substantially as a result of the company no longer being subject to the restrictions imposed by the Share Blocks Control Act. These two factors result in a disposal of the shares in the share block company and attached right of use in return for shares in a company. The determination of the proceeds for the shareholder and the base cost of the right of use for the company will depend on how the transaction is structured (for example, whether the shareholder's loan account is credited with the market value of the right of use) and whether the shareholder and company are connected persons in relation to each other (the latter will trigger para 38).

24.7.4 Transfer of a unit in a share block company to a member

Under para 67B, the share block company must disregard any capital gain or loss upon transfer of a unit to a shareholder under item 8 of Schedule 1 to the Share Blocks Control Act. The member is given roll-over relief in respect of the transaction. See **13.6**.

24.7.5 The disposal of common property

It sometimes happens that the common property in a share block scheme is surplus to the requirements of the shareholders and is disposed of with attendant CGT consequences. Before the portion of the common property can be disposed of it is necessary to cancel the shareholder's right of use and occupation in the property concerned so that full ownership of the property can be restored to the share block company. The cancellation of the right of use and occupation will trigger a part-disposal in the shareholders' hands under para 33. The proceeds would be equal to the amount credited to each shareholder's loan account (that is, equal to the market value of the right of use and occupation surrendered). Once the full property has been sold to the third party the loan would be repaid to the shareholder. Although the share block company will have a disposal for CGT purposes it should result in no gain or loss because the company's base cost (established through the purchase on loan account) should equal the proceeds received or accrued on disposal to the third party.

The principles set out here also apply when the shareholders of a share block company wish to take over the freehold title to the company's property. The right of use and occupation attaching to the shares must first be cancelled so that full title can be restored to the company. Thereafter, the property can be transferred to the shareholders. It is understood that it is not possible for the company to create full title for the shareholders in the deeds registry by transferring the bare *dominium* to them; the right of use and occupation must first be cancelled.

24.8 The disposal of common property under a sectional title scheme

It sometimes happens that the common property in a sectional title scheme is surplus to the requirements of the owners and is disposed of with attendant CGT consequences.

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.

The part-disposal rules in para 33 will have to be applied 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. While the levy income of a body corporate or share block company may be exempt under s 10(1)(*e*), the exclusion provided by para 64 will not be applicable since the disposal is by the sectional title unit holders, not by the body corporate.

24.9 Nil paid letters

Companies sometimes raise additional capital on the stock exchange by a rights issue. Under such an arrangement, the company offers its existing shareholders the right to take up its shares at a certain price (usually below the prevailing market price) at a certain date. The rights that shareholders receive are known as 'renounceable nil paid letters of allocation' or more simply as 'nil paid letters' (NPLs). These NPLs are listed temporarily for a few weeks on the stock exchange until the close of the offer. A shareholder who accepts the offer will simply acquire the shares offered for the stipulated price. A shareholder who decides not to accept the offer may sell the NPLs on the stock exchange. An NPL is an asset as defined in para 1 and the provisions applicable to options apply equally to NPLs. Assuming that the relevant transactions fall on capital account, NPLs are treated as follows for CGT purposes:

- A shareholder who acquired the NPL on or after the valuation date from the company and who disposes of it on the open market must determine a capital gain or loss in the normal way, namely, proceeds on disposal less a base cost of nil, since nothing would have been paid for the NPL.
- A person who acquired the NPL on or after valuation date on the open market and who accepts the offer, must add the cost of the NPL to the base cost of the shares acquired under the offer under para 20(1)(*c*)(ix). Any capital gain or loss on exercise of the NPL is disregarded under para 58.

Note: The receipt of an NPL is not a capital distribution of an asset *in specie* as contemplated in para 76.

24.10 Demutualisation shares

When Sanlam Ltd and Old Mutual PLC demutualised and became listed companies in 1998 and 1999 respectively, they issued ordinary shares free of charge to their policyholders. The following should be noted when determining the base cost of demutualisation shares:

- 'B' in the TAB formulae will be nil since no expenditure would have been incurred before valuation date in respect of the shares.

- A person who adopts the market value or weighted-average methods must use the relevant prices published on the SARS website to establish a base cost for the shares.

Appendix A – Transfer of a residence from a company or trust (2002)

These notes relate to certain (now obsolete) CGT, STC and transfer duty relief measures that applied to the acquisition by a natural person of a primary residence from a company or trust between 1 October 2001 and 30 September 2002.

A.1 Introduction

The Eighth Schedule 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 when 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 when

- 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 of 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.

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

If 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 its repayment 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 two 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 when:

- 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 (for example, Bank A transfers the bond to Bank B)

Shares in a share block company

Item 15(*v*)

If

- 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 when 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 two 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 – 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:

Section 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 company.
- 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)

	R	R
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 under 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

Under para 51(1) when 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.

Unlike other provisions of the Eighth Schedule, para 51(1)(*b*) does not deem the market value to be a cost incurred and paid for the purposes of para 20(1)(*a*). However, this is clearly the intention and SARS accepts that the market value referred to in para 51(1)(*b*) is the deemed acquisition cost for purposes of determining the base cost of the primary residence.

The effect of this provision is that the capital gain or capital loss on the disposal of the residence by the company or trust 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

Paragraph 51(2) provides that para 51(1) only applies when

- 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. Under s 58 of the Act the disposal of property for a consideration that is less than an adequate consideration, that is, 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. The Commissioner will not seek to adjust the consideration when

- the transfer is exempt under 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

Appendix B – Transfer of a residence from a company or trust (2009 – 2010)

These notes relate to certain CGT, STC and transfer duty relief measures that apply to the acquisition by a natural person of a residence from a company or trust between 11 February 2009 and 30 September 2010.

B.1 Background

Paragraph 45 provides that only a natural person (individual) or special trust is entitled to disregard the whole or a portion of the capital gain or loss on disposal of that person's primary residence. Subject to certain exceptions

- if the proceeds exceed R2 million, the first R1,5 million of capital gain or loss must be disregarded, and
- if the proceeds are R2 million or less, the entire amount of any capital gain must be disregarded.

This exclusion does not apply to a company, close corporation or trust (whether discretionary or vesting) which owns a residence. In the notes that follow the term 'company' will also be used to refer to a close corporation.

Historically many individuals 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. A window of opportunity was granted in 2002 which enabled these persons to transfer their residences out of their companies or trusts into their own names without suffering any adverse CGT, STC or transfer duty consequences (see **Appendix A**).

Following the amendment of the Transfer Duty Act 40 of 1949 in 2002, it is no longer possible to avoid transfer duty by disposing of the shares or member's interest in a company holding residential property, or by substituting beneficiaries holding contingent interests in residential property of a discretionary trust.[716]

Before the amendments effected by the Revenue Laws Amendment Act 74 of 2002 the distribution of capital profits in anticipation of liquidation or deregistration or during the course of winding up of a company was exempt from STC. However, since the amendments, any capital profit derived by a company on or after 1 October 2001 is subject to STC, even if distributed in anticipation of liquidation or deregistration or during the course of winding up. Section 64B(5)(*c*) has been deleted with effect from 1 January 2011, meaning that the STC exemption for pre-CGT capital profits distributed in anticipation of liquidation or deregistration or during the course of winding up of a company has now also been removed.

The extension of the transfer duty provisions and the narrowing and subsequent removal of the STC exemption on the distribution of capital profits have made it costly from a tax point of view for a company or trust to dispose of a residence (see **11.11**). Not only will the company or trust not qualify for the primary residence exclusion, but the company will potentially be liable for CGT and STC. In the case of a trust the CGT consequences will be borne either by the trust (which pays CGT at the rate of 20%) or by a resident beneficiary if the trust's capital gain is attributed to that beneficiary under para 80. A natural person acquiring the residence will be subject to transfer duty.

[716] See ITC 1829 (2007) 70 SATC 106 (G) for a case in which it was held that the substitution of contingent beneficiaries of a trust resulted in a liability for transfer duty.

It has emerged that many individuals did not avail themselves of the 2002 opportunity with the result that they now face the adverse tax consequences described above when disposing of a residential property from a company or trust.

A further window of opportunity that operates on a roll-over basis, was introduced by the Taxation Laws Amendment Act 17 of 2009.

The Taxation Laws Amendment Act 7 of 2010, which was promulgated on 2 November 2010 inserts para 51A which widens the relief in a number of respects. It comes into operation on 1 October 2010, while para 51 applies to acquisitions not later than 30 September 2010. For more on para 51A see the *Guide to Disposal of a Residence from a Company or Trust.*

B.2 Taxes qualifying for exemption

The relevant provisions offer exemption from

- transfer duty on the transfer of the residence (s 9(20) of the Transfer Duty Act, 1949),
- STC on the distribution *in specie* of the residence [s 64B(5)(*k*)],
- dividends tax (which will replace STC on a yet-to-be-announced future date) on the distribution *in specie* of the residence [s 64F(i)],
- CGT on any capital gain realised by the company or trust (para 51), and
- income tax on any recoupment of allowances claimed by the company (para 51).

B.3 The transfer duty exemption

The transfer duty exemption requirements are contained in s 9(20) of the Transfer Duty Act 40 of 1949, which reads as follows:

> '(20) No duty shall be payable in respect of any acquisition of any interest in a residence as contemplated in paragraph 51 or 51A of the Eighth Schedule to the Income Tax Act, 1962 (Act No. 58 of 1962), where that acquisition takes place as a result of a transfer or disposal contemplated in either of those paragraphs.'

Section 9(20) in so far as it applies to a disposal under para 51 is deemed to have come into operation on 11 February 2009 and applies in respect of distributions made on or after that date and before 1 January 2012.[717] The reference to 'distributions' should be read as including a sale.

B.4 The STC exemption

The STC exemption is contained in s 64B(5)(*k*), which states that there shall be exempt from STC

> 'any dividend declared by a company to a natural person which constitutes a transfer of an interest in a residence contemplated in paragraph 51 of the Eighth Schedule'.

Section 64B(5)(*k*) is deemed to have come into operation on 11 February 2009 and applies to transfers made on or after that date in respect of disposals made before 1 October 2010.[718]

[717] Section 9(20) added by s 3(1)(*b*) of the Taxation Laws Amendment Act 17 of 2009 with its commencement date set by s 3(3) of that Act.
[718] Section 68(5) of the Taxation Laws Amendment Act 7 of 2010.

The STC exemption will thus only apply to a distribution of a residence *in specie* to the shareholders. It does not cover the distribution of a profit arising on a *sale* of the residence to the shareholders, as was the case under the 2002 window of opportunity. The entire profit – whether of a capital nature or not arising on distribution of the residence is exempt from STC. Unlike para 51A, there is no requirement that the company be liquidated or deregistered after the distribution.

B.5 The CGT and income tax exemption

Paragraph 51

Under para 51(1) when an interest in a residence has been transferred from a company or trust to a natural person as contemplated in para 51(2)

- the company or trust is deemed to have disposed of that interest for an amount equal to its base cost on the date of transfer thereof,
- that company or trust and that natural person must, for purposes of determining any capital gain or loss on the transfer of that interest, be deemed to be one and the same person with respect to
  - the date of acquisition of that interest by that company or trust and the amount and date of incurral by that company or trust of any expenditure in respect of that interest allowable under para 20, and
  - any valuation of that interest effected by that company or trust as contemplated in para 29(4).
- no allowance or deduction allowed to that company or trust in respect of that interest must be recovered or recouped by that company or trust or be included in the income of that company or trust in the year in which the transfer takes place; and
- that company or trust and that natural person must be deemed to be one and the same person for purposes of determining the amount of any allowance or deduction that is to be recovered or recouped by or included in the income of that natural person in respect of that interest.

The effect of para 51(1)(*a*) is that the capital gain or capital loss on the disposal of the residence by the company or trust will not be subject to CGT.

Paragraph 51(1)(*b*) has the effect that the transferee steps into the shoes of the transferor for the purpose of determining the transferee's base cost. In other words, in the case of a pre-valuation date residence, the costs and dates of acquisition of the residence and incurral of expenditure are carried across to the natural person. This will be relevant if the natural person adopts TAB for the purpose of determining a capital gain or loss on disposal of a pre-valuation date residence. Also, any valuation of the residence as at 1 October 2001 obtained by the company or trust before 30 September 2004 will be deemed to have been obtained by the transferee.

Paragraph 51(1)(*c*) ensures that the company will not suffer a recoupment of any allowance or deduction claimed on the residence. This includes an allowance or deduction granted under, for example,

- s 13*ter* (deduction for residential buildings),
- s 13*quat* (deductions for the erection or improvement of buildings in urban development zones), and

- a deduction under s 11(*a*) (cost price of trading stock) or s 22(2) (deduction for opening stock) for the cost or value of a residence held as trading stock. However, it is likely that a recoupment under s 22(8) would have been triggered when the shareholder first took occupation of the residence as his or her ordinary residence. At that point the residence would probably have ceased to be held as trading stock, thereby triggering a recoupment at market value under s 22(8)(*b*)(v).

Paragraph 51(2) provides that para 51(1) only applies if

- that natural person acquires that interest from the company or trust no later than 30 September 2010 [para 51(2)(*a*)],
- that natural person alone or together with his or her spouse directly held all the share capital or members' interest in that company from 11 February 2009 to the date of registration in the deeds registry of that residence in the name of that natural person or his or her spouse or in their names jointly [para 51(2)(*b*)(i)], or
- that natural person disposed of that residence to that trust by way of donation, settlement or other disposition or financed all the expenditure, as contemplated in para 20, actually incurred by the trust to acquire and to improve the residence [para 51(2)(*b*)(ii)], and
- that natural person alone or together with his or her spouse personally and ordinarily resided in that residence and used it mainly for domestic purposes as his or her or their ordinary residence from 11 February 2009 to the date of the registration contemplated in item (*b*)(i) [para 51(2)(*c*)].

Paragraph 51 only applies to 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.

Paragraph 51(2)(*a*) does not stipulate how the residence must be acquired by the natural person. It could therefore be acquired by a distribution *in specie*, or by a sale. While a sale by a company will qualify for CGT and transfer duty purposes, it will not qualify for the *STC* exemption.

Disposal by a company

The natural person taking transfer of a residence from a company must hold all the shares in the company

- directly, and
- alone or together with his or her spouse [para 51(2)(*b*)(i)]

The concession, therefore, does not apply if

- the residence is held by a subsidiary company,
- the shares in the company holding the residence are owned by a trust,
- more than one person holds the shares and those persons are not spouses, or
- the residence is disposed of to a spouse who is not a shareholder.

Thus, a husband holding all the shares 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.

Disposal by a trust

Paragraph 51 will not apply to a residence held by a trust if only part of the expenditure was financed by the individual taking transfer. For example, the relief will not apply if a third party paid for the addition of a room to the residence. All the expenditure' means 100% of it.

Unlike para 51(2)(*b*)(i), para 51(2)(*b*)(ii) does not state explicitly in whose name the residence must be registered. However, it follows from the wording of the provision that 'that natural person' (the one taking transfer) must be the one that donated the residence to the trust or financed all the acquisition and improvement expenditure in respect of the residence.

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
A and B jointly	Does not qualify, since para 51(2)(*b*)(ii) requires that the residence be donated or financed by a natural person. Unlike para 51(2)(*b*)(i) the words 'alone or together with his or her spouse' are not used.

If 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 its repayment will be regarded as having financed that expenditure.

Before the 2002 transfer duty amendments, some taxpayers purchased their residences by taking over a trust. The person and or that person's spouse became the new trustees and beneficiaries. The validity of these schemes, which purported to avoid transfer duty, was never 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. In fact the legal effect is that a new trust comes into existence and the new trust will have acquired the residence from the old trust.[719]

The residence requirement

Under para 51(2)(*c*) the natural person taking transfer of the residence must alone or together with his or her spouse have

- personally and ordinarily resided in that residence, and
- used it mainly for domestic purposes as his or her or their ordinary residence

[719] ITC 1829 (2007) 70 SATC 106 (G).

from 11 February 2009 to the date of registration in the deeds registry in the name of that natural person, his or her spouse or in their names jointly.

The word 'personally' was inappropriately inserted in para 51(2)(*c*) and seems to find its provenance in an earlier draft definition of the term 'primary residence'.[720] The word is problematic as it could imply continuous physical presence. It is not the intention that the provision should be construed in such a restrictive manner and it is accepted that the key requirement is that the person or his or her spouse must have ordinarily resided in the residence as his or her or their ordinary residence. A vacation home does not comprise an ordinary residence as it is typically occupied on an occasional basis and is not the place in which a person ordinarily resides.

The residence must be used 'mainly' for domestic or private purposes as an ordinary residence. 'Mainly' in this context means more than 50%. Thus, if a person used 10% of the residence for trade purposes it will not be disqualified under para 51. The usage of the residence before 11 February 2009 is irrelevant. For example, the fact that a person used the residence as his or her main home for many years before 11 February 2009 is irrelevant. The key question is how the residence was used on or after 11 February 2009 until date of registration. Thus if the company or trust has let the residence to a third party for any part of the period between 11 February 2009 and the date of registration in the deeds registry, the company or trust will not qualify under para 51. The same adverse result would ensue if the natural person acquired another primary residence during this period and left the residence vacant. There is no requirement that the person must continue to reside in the residence once it has been transferred out of the company or trust. A person is thus free to dispose of the residence after it has been transferred to that person. It is not, however, permissible to transfer the residence directly from the company or trust to a third party purchaser.

[720] Draft Taxation Laws Amendment Bill, 2001 dated 12 December 2001.

Appendix C – Transfer of a residence from a company or trust (2010 – 2012)

Paragraph 51A

Paragraph 51A was inserted into the Eighth Schedule by s 105 of the Taxation Laws Amendment Act 7 of 2010 and applies to the disposal of a residence from a company or trust on or after 1 October 2010 and before 1 January 2013. For a detailed commentary on para 51A and the related transfer duty, STC and dividends tax exemptions, see the Guide to Disposal of a Residence from a Company or Trust, which was released on 11 May 2011.[721]

[721] Available at <http://www.sars.gov.za/uploads/images/68463_Guidetodisposalofaresidence11May2011.pdf> [Accessed 8 December 2011].

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