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SOUTH AFRICA: TAXING CAPITAL GAINS

Michael Keen, Russell Krelove and Leonard Burman

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Preface

In response to a request from the Minister of Finance for technical assistance on proposals for the taxation of capital gains, a mission comprising Messrs. Michael Keen (Head), Russell Krelove (both FAD) and Leonard Burman (FAD fiscal expert) visited Pretoria from November 30 to December 14,2000.

The mission held detailed discussions with: Ms Maria Ramos (Director-General, National Treasury); Mr. Martin Grote (Chief Director, Tax Policy Chief Directorate) and other staff of the National Treasury: Mr. Kosie Louw (General Manager. Law Administration, South African Revenue Service (SARS)) and other staff of SARS; Professor Keith Engel (US Treasury resident tax advisor to the National Treasury); Mr. Rob Barrow (Deputy Executive Officer in the Financial Services Board); staff of Statistics South Africa; and Professor Michael Katz, chair of the Tax Reform Commission. The mission also outlined its preliminary findings to members of the Portfolio Committee on Finance of the National Assembly and of the Select Committee on Finance of the National Council of Provinces.

This draft report sets out the preliminary findings of the mission, and is subject to review at IMF headquarters. Comments are invited.

Summary

A. Core principles in designing the capital gains tax

Bringing capital gains into the income tax will rectify a deep weakness of the South African tax system. It will reduce the presently considerable opportunities for avoiding tax by converting other forms of income into capital gains, and it will bring greater fairness. By expanding the tax base it will facilitate the general program of rate reduction that is underway. Though not an easy tax to design, nor an uncontroversial one, the high degree of inequality and the sophistication of financial markets in South Africa make the proper taxation of capital gains particularly urgent.

To ensure that the tax meets its objectives as effectively as possible, it is important to bear a few core principles in mind:

- Capital gains should be taxed as fully as other forms of income (especially from capital). Any preferential treatment will leave in place the same kinds of avoidance problems and inequities as arise at present, albeit of more limited scope.

- Concessional treatment of particular kinds of investment or particular kinds of investor within the capital gains tax (CGT) regime rapidly creates scope for avoidance, and a consequent need for defensive measures to close such schemes down. The complexities of CGT rules in other countries stem in large part from the need to deal with avoidance opportunities created by such special treatment. The policy objectives that underlie such provisions could in many cases be better pursued by other, better targeted measures.

- Some degree of complication is inherent in taxing gains when they are realized rather than, as would be ideal, when they accrue. This makes it especially important to avoid additional complexities - such as indexation - which yield little obvious benefit to the efficiency of the overall tax system.

- Experience shows that it is especially important not to provide any concessional treatment to gains realized at death or when gifts are made. For the wealthy and well-advised, this can be equivalent to a permanent amnesty.

- A Primary purpose of the CGT is to help the government achieve its equity objectives, ensuring that the most wealthy pay their fair share of taxes. Especially in the early days of the tax, as experience with the tax grows amongst taxpayers and tax administrators alike, bringing relatively small gains into tax should not be a priority.

B. Economic impact of the tax

By reducing avoidance opportunities and the distortions of real economic activity, the CGT will improve the efficiency with which the resources of South Africa are allocated.

The impact on private savings is likely to be slight, because the effective tax rate proposed is so low that (especially given the continued availability of assets not subject to the tax) the impact on the after-tax return is likely to be small, and because savings are generally reckoned to be relatively unresponsive to after-tax returns. The beneficial effect of the tax on tax revenues, and hence the fiscal position of the public sector, will tend to increase national savings.

The level of national investment is also likely to be little affected, since foreign investors will be unaffected by the tax (so that any reduction in the savings of South African residents may be offset by changes in investment from abroad).

The asset prices most likely to show some effect are those of long-lived assets. Conversely, the tax confers a windfall gain on holders of exempt assets.

Once the tax is fully mature (in the sense that all gains prior to the effective date have been realized), it is likely to raise about R1-2 billion per year, around 1-2 percent of current tax revenue. This revenue gain will increase with the growth of the economy.

B. Main Recommendations

Applying these general principles to the draft legislation made public on December 12 2000, the report makes the following main recommendations:

Difficulties caused by the preferential treatment of capital gains

- Consider increasing the inclusion rate for individuals and special trusts.

- If the individual inclusion rate is raised, consider establishing a lower inclusion rate for gains on corporate stock.

The distinction between capital and revenue

- Wherever practicable, require taxpayers to make an irrevocable declaration of intent when acquiring a potential capital gains asset.

- Allow interest expenses in acquiring business assets as an increase in basis whenever they are not otherwise deductible against ordinary income and the gain on disposal of the asset is taxable.

Capital losses

- Consider limiting the period for which capital losses maybe carried forward, coordinating this with the adoption of similar rules for revenue items.

Annual exclusion

- Err on the side of caution in setting a sufficiently high annual exclusion - perhaps in the range R20,000 to R30,000 - to ensure smooth administration of, and compliance with, the new CGT. perhaps lowering it later as the capacity of tax administration and taxpayers increases.

- Include wash sale rules to limit exploitation of the annual exclusion.

Other exclusions

Principal residences

- Enact, as proposed, a cap on the exclusion of the gain on primary residences, set at a level to exclude most transactions from the tax.

Small business retirement relief

- Under-55s in good health could be made eligible for the exclusion, provided the proceeds are rolled into an approved retirement saving vehicle.

- As the retirement savings industry, including its tax treatment, is reformed, the CGT-free business disposal provision should be better integrated into the system - perhaps dispensed with altogether - to ensure fair treatment of all taxpayers.

Personal use assets

- Consider either (a) including more personal use assets in the list of those subject to CGT or (b) include all gains on sales of personal use assets in the CGT, but exempt sales below some threshold amount.

Death and gifts

- Capital gains should be taxed upon death or gift, as specified in the draft legislation, This is a major strength of the proposal.

- The proposed 4 percentage point reduction in estate and donations tax rates seems appropriate compensation for the additional tax at death imposed by the CGT.

- Consider treating donations of capital assets to charity as realization events, and allowing a tax deduction for the full arms-length value of the asset.

- If the previous recommendation is adopted, consider limiting it to in-kind contributions that directly advance the charitable purpose of the recipient organization

Financial assets

Unit trusts

- The price-to-price proposal is a reasonable accommodation to ease administrative and compliance costs, but should be limited to widely held diversified funds that are not subject to the direct control of shareholders. In particular:

- 'Wrap funds' - which allow shareholders to instruct the fund manager to buy and sell individual funds or shares - should be taxed at the shareholder level on all gains and losses as they are realized.

Marking to market

- Since mark-to-market methods are largely untried, they should not be adopted by South Africa at this time.

- Nevertheless, because of its potential advantages for administration, compliance, and economic efficiency, and the increasing sophistication of South African financial markets, the feasibility of a mark-to-market regime will need to be examined for the longer term.

Aspects of the CGT at business level

Treatment of depreciable assets

- As in the present draft, do not allow CGT-free rollovers.

- Consider restricting reinvestment relief to small businesses.

Business reorganizations

- Ensure that there will be no CGT consequence of business restructuring that involves no change of ownership.

Implementation

- Assess the incentive and opportunities for taxpayers to split capital-gains producing assets among family members prior to implementation of the CGT.

- Seek further technical assistance on drafting issues.

I. Background

This chapter sets out the factual and conceptual context for the main discussion

A. The macroeconomic and reform context

Since 1994 the South African authorities have successfully addressed a number of severe macroeconomic imbalances, achieving significant reductions in inflation and fiscal deficits. Accompanying the macroeconomic stabilization, rates of growth in GDP and investment have improved in the last six years. Real GDP growth averaged 2.3 percent per year over 1995–99, compared to 0.2 percent over 1990–94. For the future, the fundamental policy challenge remains that of raising growth potential even higher in order to achieve substantive progress in reducing unemployment and poverty. This will require further increases in investment and savings rates, and the continued implementation of key structural reforms.

Budgetary restraint is evidenced by a reduction in the national government fiscal deficit from the equivalent of 5 percent of GDP in 1994/95 to 2 percent in 1999/2000 (well under the original budget target of 2.8 percent of GDP).[1] This performance is due in part to impressive tax collection efforts, underpinned by significant improvements in tax policy and administration.

The tax reform effort has been strongly influenced by the work of the Katz Commission on Taxation, which in a series of reports has laid out a blueprint for reforms, based on the principle of broadening tax bases in order to bring tax rates down, including for taxes that bear on saving and investment. Reform has involved, for instance, reductions in the standard company tax rate from 40 percent to 30 percent (and to 15 percent for small businesses). For the personal tax, the number of tax brackets has been reduced, and rates lowered.

National government revenue totaled R204 billion in 1999/2000, just under 25 percent of GDP (Table 1.1). Taxes on income and profit constituted about 60 percent Of the total, with individual income tax, at R117 billion, constituting the major component, equivalent to 42 percent of total revenue. Indirect taxes made up 38 percent of total revenue, dominated by value-added tax (VAT) and excises. A number of taxes on property, including on gifts, estates, real estate and marketable securities transactions make up, at R3.1 billion, a modest but important part of revenue.

[1] The fiscal year begins on April 1.

Table 1. South Africa: National Government Revenue, 1999/2000

	R billion	Share (percent)
Total Revenue	203.5	100.0
Total Tax Revenue	199.6	98.1
Taxes on Income and Profit	117.2	57.6
Individuals	86.2	42.4
Companies	21.7	10.7
STC	2.7	1.3
Tax on Retirement Funds	5.7	2.8
Other	0.9	0.4
Taxes on Property	3.6	1.8
Donations tax	0.0	0.0
Estate Duty	0.3	0.1
Property Transfer Duty	1.7	0.8
Marketable Securities Tax	1.0	0.5
Other	0.6	0.3
Taxes on Goods and Services	77.3	38.0
VAT	46.5	22.9
Excises	24.4	12.0
Trade taxes 1/	6.3	3.1
Other taxes	1.6	0.8
Nontax revenue	3.9	1.9
Memorandum items	(percent of GDP)	
Total Revenue	24.9	
Total Tax Revenue	24.4	
Income Taxes	14.3	
Taxes on Goods and Services	9.5	

Source: National Treasury. Budget Review, 2000.

1/ Includes trade tax revenue that is transferred to SACU members under the SACU revenue-sharing agreement.

B. Current situation and the proposed Capital Gains Tax

Current treatment of capital gains

Capital gains are at present essentially untaxed, with the definition of gross income for the income tax explicitly excluding ‘receipts or accruals of a capital nature.’ The distinction between revenue items (taxable as income) and capital items (now exempt), which follows the UK tradition, rests on a case law test of intent: an item is revenue if purchased with a view to enjoy a flow of dividends, interest or the like (the fruit of the tree) and capital if it is purchased with an intention to resell (the tree itself).

In practice, it appears that taxpayers are often able to declare their intent ex post, once the return from the asset is known: thus assets that prove loss-making can be declared as revenue (making the loss deductible against income tax) and those that prove profitable declared as capital (removing the gain from tax).

Listed shares held for more than five years are treated as capital. This creates a lock-in problem, with an incentive to defer realization of gains until (and realize losses before) the asset has been held for five years. Moreover, by entering other transactions the more sophisticated shareholder is able to realize the gains effect whilst postponing their realization for tax purposes beyond the critical fifth year. They could, for instance, borrow against security of the shares. That creates a risk from subsequent movement in the share price, but other strategies remove that too. The investor might simply sell the shares short. Equivalently, they might borrow the value of the shares and simultaneously sell a call and buy a put on the same asset.[2] Such strategies are likely to be worthwhile only for taxpayers with substantial sums at stake; but these are precisely the taxpayers who, for reasons of both revenue and fairness, it is especially important to bring into the tax net.

The current proposals

In the Budget Speech of February 2000, the authorities committed to the taxation of capital gains with effect from April 12001. Explanatory materials, setting out key features of the proposed tax, were issued for comment later in the year. Towards the end of the mission (on December 11) draft legislation was made public.

The discussion in this report is based on that public draft, and all subsequent references are to that. Formally, the legislation is an amendment of the Income Tax Act (bringing gains into tax along with other income), but it is convenient to refer simply to the proposed ‘capital gains tax’ (CGT). Central features are summarized in Box 1.1.

[2] Shuldiner (2000) lists five ways of achieving the same effect

Box 1.1 South Africa: Key features of the proposed CGT

- The tax applies only to gains accrued after the implementation date. set at April 1, 2001:
- Tax is charged, in general, on realization;
- Net gains below a **threshold** of R 10,000 are excluded from tax: symmetrically, losses are carried forward only to the extent that they exceed R 10,000;
- For natural persons and special trusts-trusts, that is, for the infirm-only 25 percent of the net gain is included in taxable income. For businesses (and non-special trusts), **inclusion** is 50 percent:
- Capital **losses** may be offset only against capital gains, and net losses may be carried forward indefinitely;
- There is no **indexation;**
- **Death, gifts and donations** (other than to charity) trigger liability to capital gains tax: the rates of estate and donations tax are to be cut from 25 to 21 percent:
- **Exemptions** are given for sales of a primary residence, charitable gifts, personal use assets other than a few specifically listed. and—up to a lifetime maximum of R500,000 - for small businesses sold on retirement;
- **Reinvestment relief is** provided by enabling CGT due on sales of rapidly depreciated assets to be paid over five years (without interest) if the proceeds are spent on similar assets;
- Holdings in **unit trusts** are taxed on a 'price to price' basis in the hands of the unit-holder: CGT is due only when the unit-holder investor sells units;
- **Pension funds** are exempted, pending a wider review of the tax treatment of pensions; and
- Transitional rules are included to remove from tax gains accrued prior to the effective date, and to establish proper base cost at the effective date.

Related taxes

The impact and proper design of the CGT depends on wider features of the tax system and its interaction with them.

Marginal rates under the **personal income tax,** which is levied on an individual basis, rise in steps from 18 percent to 42 percent (on taxable income in excess of R200,000). Relief is provided by way of a 'rebate' (that is, a tax credit). Special trusts are taxed at individual rates: others receive less generous treatment. Interest income is fully taxable, but only to the extent that it exceeds R3,000 per annum; interest payments, including in relation to personal residences, are not deductible. Those whose income is mainly salary and less than R 60,000 per annum, are not required to file; in practice, only about one-fifth of individual taxpayers file.

South Africa has recently moved to a residence basis for income tax, and the CGT will be on the worldwide gains of South African residents.

Corporations are generally taxed at 30 percent (with a lower rate for small businesses). In addition, dividends are generally subject to a **secondary tax on companies** (SCT), at 12.5 percent, with no adjustment at shareholder level: SCT is, in effect, a final withholding tax. Inter-corporate dividends are exempt from SCT if received from a wholly-owned subsidiary. Dividends paid by unit trusts and fixed property companies are also SCT-exempt (to the extent financed from their own dividend receipts), and exempt at the individual level to the extent that they reflect the unit's receipt of dividends. Special rates apply to mining and oil extraction companies. Insurance companies are taxed at 35 percent in respect of income from company policies, and 30 percent on income from policies held by individuals. Retirement funds pay tax on their interest and rental receipts at 25 percent, and are untaxed on other receipts.

Estate duty is charged at 25 percent on estates over R1 million. Gifts and donations attract **donations tax** at 25 percent, with an annual exclusion (R25,000 for natural persons, R 5,000 for others). Gifts to charitable, educational or religious bodies are exempt from donations tax, and deductible against income tax at cost basis.

Transfer duty applies to sales of immovable property at rates rising to 8 percent for natural persons (on sales above R 250,000) and 10 percent for others; transfers between taxpayers registered for VAT are exempt. Transactions in **marketable securities** are taxed at 0.25 percent.

Revenue from these taxes is shown in Table 1.1 above.

C. Fundamental considerations in taxing capital gains

The purposes of a tax on capital gains

In the classic Haig-Simons approach to taxation, the ideal tax base is 'comprehensive income,' meaning the sum, over the tax period, of increases in purchasing power from all sources. These sources include capital gains that arise in the period, which should therefore be taxed in the same way as all other forms of income. In this view, less than full taxation of capital gains creates inequity in the treatment of taxpayers who have the same 'ability to pay' tax, as proxied by their comprehensive income, but derive that income in different forms. Moreover, less than full taxation of capital gains erodes the ability to tax other forms of income, given the ease with which one kind of income can be converted into another: instead of issuing interest-bearing debt, for instance, a borrower could issue zero-coupon bonds[3] (whose return arises solely in the form of capital appreciation) and so generate a return to the saver in the form of capital gains rather than interest. Such avoidance activities bring inequity, in terms of the comprehensive income benchmark, erode revenues and distort real economic activity (favoring assets that generate returns in the form of capital gains rather than dividends or interest: forestry, for example, over manufacture).

[3] Also known as an original issue discount (OID) instrument.

Haig-Simons is not the only approach to tax design, however. Another strong tradition argues for excluding from tax all forms of capital income - including capital gains - and so levying tax only on consumption. A variety of advantages are claimed for taxing consumption rather than income: that it does not distort savings decisions:[4] that consumption is a better proxy for economic well-being, and so a better indicator of ability pay-especially if coupled with an effective tax on inheritances - than is income (which is potentially subject to wide transitory variation from year to year);[5] and that it may be easier for the authorities to administer and for taxpayers to comply with. Very few countries, however, have gone fully down this route, though many have taken important steps in that direction.

A third approach is that of the 'dual income' tax adopted by several Nordic countries over the last decade. This schedular approach retains a progressive tax schedule for labor income but subjects all forms of capital income - including capital gains - to a separate tax levied at a low and constant marginal rate.

There is no firm theoretical basis for preferring any of these schemes over the others. in particular, there is no general presumption that all sources of income should be taxed at the same rate, but nor is there any presumption that capital income should be untaxed: exempting capital income leaves savings decisions undistorted, but by increasing the rate at which labor income must be taxed to raise the same amount of revenue worsens distortion of labor supply decisions. Establishing the appropriate tax structure on alternative forms of income thus requires making some value judgement on how best to achieve fairness, and at the same time, balancing distortions on a range of margins. It is also, in practice, a matter of ensuring consistency with widely-accepted notions of fairness in taxation. There appears to be widespread agreement in South Africa in favor of levying tax on a broad-based measure of income. Even after the introduction of the CGT, however, the income tax will be far from one on comprehensive income: dividends will be taxed at a flat 12.5 percent, for instance, while interest income will be taxed like other income only beyond a specific exclusion amount.

There are, in any event, two common features of all these approaches that are especially relevant to the design of a capital gains tax. First, under all of these schemes capital gains are taxed in the same way as other forms of capital income: none calls for any distinction. for instance, between returns enjoyed as dividends and those enjoyed as capital gains. Second, under virtually all of these schemes an explicit tax on capital gains has an important role as an anti-avoidance device.[6] Thus a CGT could serve a very useful

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[4] This is in contrast to the feature of the Haig-Simons approach that the return to savings is effectively taxed twice: once when the income from which savings are made is received, and again when the return is earned.

[5] Indeed a consumption tax can be seen as a tax on lifetime income, in the sense that (with a single marginal tax rate, and ignoring bequests) two taxpayers with the same present value of income over their lifetimes will pay the same present value of tax. That is not the case with an annual Haig-Simons tax.

[6] An exception is a consumption tax administered by allowing a deduction for purchases (and full taxation of sales) of designated 'registered assets.' Capital gains on such assets are then taxed implicitly when they are sold.

purpose even if it raises little revenue in itself: the revenue gain may show up instead as increased collections elsewhere under the income tax.

Does South Africa need a CGT?

The argument has been made in the South African context, however, that a CGT is unsuitable for developing countries and, moreover, is vanishing in developed countries. Neither is true. Table 1.2 provides detail on CGTs in force in a range of countries, not only in the OECD but also in some middle income countries. More fundamentally, the force of the equity, anti-avoidance, and efficiency cases for taxing capital gains depend not on the average level of real income but on the degree of inequality that the tax system seeks to address and the sophistication of financial markets that the rich and well-advised can use to avoid taxation. Both considerations point to the potential importance of taxing capital gains in South Africa. Inequality remains high by international standards.[7] And financial markets are well-developed: the Johannesburg Stock Exchange is the 18th largest in the world, and the South African Futures Exchange the 16th largest. Nor is the CGT vanishing in developed countries. In some, most notably the US, periodic calls are heard for its abolition. More fundamentally, enhanced international mobility of capital is likely to put continued general downward pressure on all taxes on capital income - including, but not only, CGT. Nevertheless, faced with the avoidance problems that its absence creates, no country of which the mission is aware has abolished a general tax on capital gains.

What is true, however, is that the CGT is often amongst the most complex of taxes, so that enforcement can be problematic where tax administration and compliance abilities are weak. This, indeed, was one reason that the Katz commission recommended, some years ago, against the introduction of the tax. Much of this complexity arises, however, from the granting of special treatment to particular kinds of transactions. For as soon as any special provisions are introduced into the tax, the ease with which the well-off and well-advised can exploit the consequent loopholes creates a need for complex provisions to restrict the benefit to its intended purpose. The general principle of tax design that special provisions invite abuse and

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[7] Aron and Muellbauer (2000) report an income Gini coefficient for South Africa of 0.61, and note that amongst middle-income countries this is surpassed only by Brazil.

Table 1.2.South Africa: Capital Gains Taxation in Selected Countries, 1999 1/

Country	Top marginal rate Central/local	Equities (listed/unlisted) Short	Long	Years	Bonds Short	Long	Principal residence Short	Long	Immovable properly Short	Long	Exemption or Allowance	Relief	Loss carry-forward (+) or backward (-)	Losses offset against
OECD Countries														
Australia	47.0	I	I	n.a.	I	I	E	E	I	I	No	Avg.	...	CG
Austria	50.0	I	E	1	I*	E	I	E	E	I	No	No	No	n.a.
Belgium	55.0	E	E	n.a.	E	E	E	E	33	E	No	No	+5	CG
Canada	31.3	I*	I*	n.a.	I	I	E	E	I	I	Yes	...	Same as Corp.	Same as Corp.
Czech Republic	32.0	I	E	½	I	E	I	E	I	E	No	No	+7	...
Denmark	28.5/59	I	E-c/I	3	E*	E*	E	E	I	I	No	No	+5	CG-sub
Finland	38.0/57.8	28	28	n.a.	28	28	28	E	28	28	No	No	+3	CG
France	54.0	0, 26	0, 26	n.a.	0, 26	0, 26	E	E	I	Idx	Yes	Slicing	+5	CG-sub
Germany	55.9	I	E	1	I	E	I	E	I	E	Yes	Idx	-2, +Unlimit.	I
Greece	45.0	E / 20	E / 20	n.a.	E	E	E	E	E	E	No	Yes	5	I
Hungary	40.0	20	20	n.a.	20	20	E*	E*	20	0-20	...	No	...	...
Iceland	27.4	10	10*	n.a.	10	10	10	E*	10	10	No	Idx	No	CG-sub
Ireland	46.0	20	20	n.a.	20	20	E	E	20	20	Yes	Idx	+	CG
Italy	46.0	12.5	12.5	n.a.	12.5	12.5	E	E	E	E	No	...	+5	...
Japan	37.0	20*	20*	n.a.	20*	20*	0,I	0,20	50	20-40*	Yes*	No	No	CG-sub
Korea	40.0	E / 20	E / 20	n.a.	...	...	20-40	E –c	50	20-40	Yes	No	No	CG or I
Luxembourg	46.0	I	h	½	E	E	I*	E	I	h	Yes	Idx	No	CG-sub
Mexico	35.0	E	E	n.a.	E	E	...	...	...	...	...	...	...	...
Netherlands	69.0	E	E	n.a.	E	E	E	E	E	E	n.a.	n.a.	n.a.	n.a.
New Zealand	33.0	I	I	n.a.	I	I	E	E	E	E	n.a.	n.a.	n.a.	n.a.
Norway	41.5	28*	28*	n.a.	28	28	28	28	28	28	No	No	+10	I
Poland	40.0	E	E	n.a.	I	I	E*	E*	E	s-10	No	No	+3	I
Portugal	40.0	10	10	n.a.	E	E	r	R	I(.5)	I(.5)	No	Idx	5	CG
Spain	47.6	...	...	...	...	...	...	...	...	...	...	...	...	...
Sweden	25 / 59.75	30	30	n.a.	30	30	15	r,15	30	30	No	No	No	CG
Switzerland	11.5 / 31.5	E	E	n.a.	E	E	E	E	E	E	n.a.	n.a.	n.a.	n.a.
Turkey	55.0	E / E	E / I	1	See equities	See equities	I	E	I	E	No	No	No	n.a.
United Kingdom	40.0	I	I	n.a.	E	E	E	E	I	I*	Yes	Yes	...	...
United States	39.6	I	20	1	I	20	I	E – t	I	20		No	-3, +5	I-c, CG
Selected Other														
China	40.0	E / I	E / I	n.a.	I	I	I	I	I	I	...	No	No	No
Hong Kong	15.0	E	E	n.a.	E	E	E	E	E	E	n.a.	n.a.	n.a.	n.a.
Indonesia	30.0	s-.1/I	s-.1/I	n.a.	I	I	s-5	s-5	s-5	s-5	Yes	...	...	...
Malaysia	32.0	E	E	n.a.	E	E	E*	E*	30	0-20	Yes	No	+	CG-sub
Philippines	35.0	s-.5s/20	s-.5s/20	n.a.	3-30	3-30	s-5	s-5	s-5	s-5	...	...	...	...
Thailand	37.0	E / I	E / I	n.a.	E	E	I	I	I	I	n.a.	Avg.	No	No
Singapore	28.0	E	E	n.a.	E	E	E	E	E	E	No	No	No	CG-sub

Sources: Pricewaterhousecoopers; OECD; International Bureau for Fiscal Documentation; and Deloitte and Touche.

Codes: I = ordinary income; E = exempt;* = significant deviations; Idx = Indexing; #, # = progressive rates; c = applicable with some ceilings; h = half the gain is taxed; s-# rate applies to sales value; r = rollover provisions; CG = capital gains; CG-sub = capital gains of the same type (subgroup).

1/ The predominant tax treatment for each asset is presented, the actual tax treatment is often more complicated; a code (such as *, r, or c) is used only when it would apply in a significant number of cases. In addition, in some instances where there are transitional rules as part of a new policy, the table uses the new policy.

complexity applies with special force to the CGT. Some complexity is inherent, however, in the timing problems that arise in charging the tax, as discussed in the next sub-section.

The need for complexity to deal with these problems also arises, however - indeed is potentially even more urgent - when, as at present, capital gains are exempt from tax. It is important to bear in mind that South Africa does tax capital gains at present - but it does so at a rate of zero. Taxing them at a positive rate, and in a simple enough manner, could actually reduce the need for complex rules.

Accruals and realizations

The logic of the Haig-Simons approach calls for capital gains to be taxed on accrual (that is, as they arise), since it is accrual that increases the power to consume. In practice, however, they are generally taxed on realization (that is, when the asset is sold); and that is also true of the CGT proposed for South Africa. This reflects two main difficulties often seen in accrual taxation: the difficulty of establishing proper valuations for some assets other than when they are traded; and the possibility of forced liquidation if taxpayers felt obliged to seIl assets they would otherwise retain in order to pay CGT.

Taxing gains on realization rather than accrual has profound consequences for the design and effects of a CGT. It gives rise to a problem of selective realization: taxpayers can choose to realize losses (and so obtain the advantages of an immediate offset against other tax liabilities) whilst deferring the realization of gains (and so delaying the payment of tax). Indeed in the absence of restrictions it would be possible to exploit these timing differences so as to eliminate all tax liability. All that would be needed would be to buy and sell short the same asset, and at the end of the tax year close out whichever position showed a loss and carry forward whichever showed a gain; by holding these offsetting positions in large enough quantities, and adjusting each period, large enough losses could be generated to reduce liability in each year to zero and deferring all tax payment indefinitely. (If CGT were not payable at death, all lifetime taxes could be eliminated).[8] Straddles of this kind can be addressed explicitly in the CGT law, and the draft does so. More generally, most countries limit the extent to which capital losses can be offset against other income, often precluding it entirely. But there are many other avoidance opportunities stemming from selective realization; it has already been seen, for example, how holding period requirements can be circumvented by manipulating realization dates. It is the need to close avoidance opportunities from selective realization that underlies the complexity of many CGTs.

The problems caused by selective realization go even deeper than the arrangement of artificial transactions that reduce taxes paid without any effect on substantive business decisions. The lock-in effect that arises from the incentive to defer realizing gains can lead to a misallocation of resources as taxpayers find it advantageous to hold on to real assets that would be more effectively deployed by other taxpayers.

[8] Stiglitz (1983) describes several other strategies that, absent restrictions, also achieve this

The difficulties posed by taxation on realization have led to a search for methods that achieve the same effect as accrual taxation without incurring the two problems associated with accrual taxation itself. It is increasingly recognized that there do exist such schemes. One such is to apportion the gain at realization across the holding period and charge a tax upon realization that offsets the benefit of deferral otherwise enjoyed.[9] This avoids the need to value assets other than at disposal, and spares the taxpayer from producing cash until realization. It does rough justice, however, to the extent that the imputed path of gains differs from the actual.[10] Moreover, the scheme is likely to be perceived as complex. But it is not impracticable: Italy now uses a scheme of this sort.

It is also important to note that the first of the difficulties of accrual taxation - that of observing market value - simply does not apply to a wide range of assets. This opens the way to accrual taxation by means of ‘marking to market’: that is, simply subjecting to CGT the difference in the market value of the portfolio at end and start of the year. Financial intermediaries mark their books to market routinely as part of their normal commercial activities and to comply with regulatory requirements. Marking to market does leave a potential cash charge on unrealized gains. But it is not clear that this imposes any unreasonable hardship: one does not usually enquire how citizens meet their tax obligations, and, in any event, it will in many cases be possible to borrow against the taxed asset to meet the tax charge. There is little doubt that CGTs in many countries are likely to move in this direction, and the mission believes it important to consider the potential use of this method in South Africa. It is discussed at some length in Chapter VI.

D. Plan of the report

The coverage of this report is not exhaustive. The focus is on those issues that are either central to the design of the CGT and/or on which the proposals seem to the mission to be susceptible to improvement.

Chapters II to VIII focus on design issues, the discussion in each case revolving around the draft legislation issued on December 12, 2000. Chapter IX considers briefly the economic impact of the tax, and Chapter X focuses on implementation issues. Technical detail on some of the mission’s analysis is provided in two appendices.

[9] This idea is described by the Meade Committee (1978).

[10] Another scheme, due to Auerbach (1991), avoids this by inferring a base cost from the sale price by assuming that in each period the investor has earned the risk-free rate of return. This though creates a potential charge on assets that have yielded an unexpected capital loss. Bradford (1995) shows that the Auerbach scheme is in turn a special case of a more general class of schemes that eliminate timing and offset games by specifying at the time an asset is acquired a date on which gain will be deemed to be realized and a rate at which it will be taxed.

II. THE (PREFERENTIAL) TREATMENT AND NATURE OF CAPITAL GAINS

This chapter reviews fundamental features of the approach to the taxation of capital gains proposed in the draft legislation.

A. The preferential treatment of capital gains

Proposals

Only 25 percent of the net gains realized by natural persons and special trusts are to be brought into tax; for all others, the inclusion rate is 50 percent. There is to be no indexing, and no variation of the inclusion rate with the length of the holding period. For natural persons and special trusts, there is an exclusion amount that is disregarded in calculating gain or loss; this is discussed in the next section.

Issues

Should capital gains receive preferential treatment?

In general

If capital gains were taxed on accrual, and inflation were zero, capital gains should be taxed at the same rate as all other income (under a comprehensive income tax) or at least (under a dual income tax) at the same rate as dividends and interest. At positive inflation rates, it is sometimes argued, CGT should either be indexed or gains taxed at a lower rate to compensate for the taxation of purely nominal gains.

This argument for preferential treatment is not compelling. Inflation introduces many other distortions into unindexed tax systems: the taxation of nominal interest payments, for example, means that tax is paid not only the real component of interest but also on, in effect, the repayment of principal. Removing one distortion will create others, and may not be an improvement.

A more persuasive argument for preferential treatment of capital gains is that a lower tax rate may mitigate some of the problems of lock-in caused by taxation on realization: the lower the tax rate, the less the incentive to defer realizing a gain or to accelerate realization of a loss. This beneficial efficiency effect, however, comes with an adverse equity effect: negating the tax benefit of deferral would call for a *higher* tax rate on capital gains.[11] The question then is how costly to society are the distortions of real resource allocation associated with lock-in. While there is little direct evidence on this, experience in the US is that realizations of equities are quite sensitive to transitory

[11] Equity and efficiency could in principle be more closely aligned by setting rates at a higher level and having them increase with the holding period. This would pose administrative problems of the kind associated with the more normal reduction with holding period. The mission knows of no country in which rates increase with the holding period.

changes in CGT rates, but little affected by permanent changes.[12] This suggests that underlying real business decisions are relatively little affected by the CGT, so that the costs of any lock-in effect may be small. The most serious are likely to arise when gains escape tax at death.

The case for generalized preferential treatment of capital gains in general is thus rather uneasy, the strongest being as a counterweight to the inefficiency of lock-in associated with realization taxation. In any event, however, many countries do provide some form of preference.

For traded equities

A distinct argument can be made for preferential treatment of capital gains on assets whose value derives from income that is itself fully taxed, the primary instance being traded equities. For since fundamental share prices reflect the present value of future after-tax payments to shareholders, increases in those prices due to improved earnings prospects will reflect the corporation tax to be paid on those earnings, so that taxing the gains themselves would be double taxation. The argument is especially powerful under 'classical' corporate tax systems, which - as in South Africa - provide no relief at shareholder level for taxes paid by the corporation.

As shown in Table 1.2, many countries do indeed exempt or otherwise[13] favor capital gains on equities. The problem is in any event mitigated in those which, unlike South Africa, attempt some integration of corporate and personal taxes in the treatment of dividends.

Business level gains

By similar logic, it could also be argued that it would be inappropriate double taxation to tax gains realized at business level if disposals of the business itself are subject to CGT. The logic of the comprehensive income tax, in particular, calls for accrued gains to be passed through and taxed at the level of the owners.

With gains taxed only on realization, however, exemption at the business level would in effect allow the owner to realize gains without triggering any CGT liability. In relation to depreciable assets, moreover, a charge must be levied on business-level gains in order to avoid distorting decisions on the sale of used assets. (This is discussed in Chapter VII).

While these considerations argue against a general preference for business-level gains, provision is commonly made to ensure that business reorganizations that involve no change of ownership do not trigger any tax liability.

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[12] Burman (1999) reviews the evidence on this.

[13] In Norway, for instance, an attempt is made to bring into CGT only gains other those accounted for by retentions.

Extent and form of the proposed preference

Preferential treatment can be provided in a number of ways: by indexing capital gains, by charging all capital gains at a low flat rate, or by including only some fraction of the gain into tax. Some countries extend especially favorable treatment to long-term gains (and short-term losses) by setting an inclusion rate that decreases with the holding period.

The mission believes it wise to reject the indexation option, on grounds of both principle (partial indexation of the tax system potentially being worse, as noted above, than none) and, especially, practice. Experience in the UK, in particular, shows that indexation can be a source of great complexity. With inflation now targeted at 3-6 percent, the costs of indexation are likely to outweigh the benefits.

It is wise too not to vary the effective rate with the length of time for which an asset is held. Such restrictions can serve some useful purpose in making it more difficult to convert ordinary income into gains. But, by the same token, a falling tax rate worsens lock-in,[14] and causes difficulties of the kind already experienced in South Africa under the five year safe harbor rule for equities. it can also add considerable complexity to the tax.

The choice is then between partial inclusion of the kind proposed and schedular taxation of gains at a preferentially low, constant marginal rate. The latter has the advantage of avoiding 'bunching' problems when individuals are pushed into higher marginal tax rate bands by realization of large gains. It is arguable, however, that this is acceptable as a rough offset to the benefit enjoyed from deferring realization of the gain. Taxation at a constant marginal rate also facilitates withholding at entity level of individual tax on realized gains (especially if there no exclusion of the kind discussed in the next section). But it gives up the prorgressivity in taxing capital gains for which some consensus appears to exist.

The form of relief proposed thus appears reasonable. Its extent, however, appears generous. With a 75 percent *exclusion* for individuals, those paying tax on their other income at the top marginal rate of 42 percent will pay tax on nominal capital gains at only 10.5 percent. (Of the relatively few countries that apply this form of relief, Canada, for instance, has an inclusion rate of 75 percent). Such a low inclusion rate directly limits the revenue potential of the CGT and, moreover, leaves a sufficiently large differential relative to the ordinary income tax to create significant incentive for tax arbitrage; indeed, the more serious is such game-playing the greater, all else equal, will be the revenue from the CGT.

As discussed above, a case can be made for setting a preferentially low fate on gains on corporate equities. At the low inclusion rate proposed, however, the mission would not think this complication worthwhile. If the inclusion rate were to be increased in the

[14] That, in fairness, is sometimes the objective, counteracting a perceived tendency of financial markets to 'short-termism.'

future, however, consideration might be given to retaining a differentially low rate on corporate equities.

The inclusion rate of 50 percent for businesses seems to the mission a reasonable compromise between the avoidance of double taxation and the prevention of tax-free realizations. The case for increasing this rate is somewhat weaker than that for increasing the personal inclusion rate.

Recommendations

- Consider increasing the inclusion rate for individuals and special trusts; and

- If the individual inclusion rate is raised, consider establishing a preference for gains on corporate stock.

B. Capital and revenue

Proposal

The determination of whether items are to be taxed as ordinary income tax or as capital gains is to be made by reference to the case law distinction between capital and revenue items discussed in Chapter I.

Interest is at present treated as a revenue item, not deductible for natural persons. Interest incurred in acquiring capital items is not to be deductible.

Issues

So long as capital gains and other income are taxed differently, some test will be needed to allocate transactions between the two. Introducing the CGT actually mitigates this deeper problem, since it reduces the potential gain from transforming revenue receipts in to capital receipts (and capital deductions into revenue deductions). Nevertheless, the need to make the distinction remains; the question is how best to do it.

An intent-based distinction makes almost no economic sense. Taxpayers' intention is presumably to manage their assets so as to make themselves as well-off as possible: when they acquire an asset, they presumably intend to later re-evaluate its performance and sell or retain accordingly.

Since the need to make the distinction arises from the policy decision to tax the two kinds of income differently, it is natural to implement it by reference to the basic policy rationale for that differentiation. Where capital gains arise 1argely as a return to labor (as with dealers) they are thus naturally taxed as ordinary income. It is tempting too to regard the length of time for which an asset is held as proxying the extent to which asset trade is a normal business activity: to treat gains realized in less than a year as revenue, for example. As emphasized above, however, differentiating treatment by holding period either creates lock-in problems or is easily circumvented.

There is no easy solution to the problem of distinguishing revenue from capital. It would be less of a problem, of course, if the inclusion rates for CGT were higher.

Beyond that, two points are clear. The first is the importance of establishing clear rules. The second is that the present rules provide ample opportunity for taxpayers to choose ex post, once the outcome of an investment is known, whether to treat an item as revenue or capital. This is unduly favorable to the taxpayer: wherever possible. investors should be required to commit ex ante to whether they regard an item as revenue or capital.

There has been discussion of whether interest expenses incurred in acquiring capital items should be deductible against the CGT. At present, there is a strong incentive to borrow against capital gains assets and take the interest against ordinary income: the mission understands that this may indeed be a significant problem in South Africa. Taxing capital gains mitigates this problem, however, and would do so even more if borrowing on the acquisition of capital gains asset were allowable as an increase in the base cost of the asset. Some matching rules for the allocation of interest expense will be needed; but they are needed already. Of course, no deduction should be given against capital assets the gain from which is not liable to CGT (such as residences), or which yield a return largely in the form of untaxed consumption benefits (such as personal use assets).

Recommendations

- Wherever practicable, require taxpayers to make an irrevocable declaration of intent when acquiring a potential capital gains asset; and

- Allow interest expenses in acquiring business assets as an increase in basis whenever they are not otherwise deductible against ordinary income and the gain on disposal of the asset is taxable.

C. The treatment of losses

Proposal

Capital losses are to be deductible only against capital gains, with indefinite carry forward (at no interest) and no carry back.

Issues

As discussed in Chapter I, selective realization means that, in the absence of restrictions, taxpayers would in principle be able to substantially eliminate their tax on ordinary income by engineering appropriate losses. For this reason, all CGTs of which the mission is aware limit the deductibility of capital losses, either in absolute amount (the US, for instance, allows offset against ordinary income only for US$3,000 of net capital loss) or altogether.

The safeguards in the proposed legislation appear adequate. As Table 1.2 shows, many countries limit the period for which losses may be carried forward (sometimes with different treatment for individuals and corporations). Though distorting and potentially inequitable, limiting carry forward to, say, five years might be a useful additional safeguard. However, since there is currently unlimited carry forward for losses on revenue account, anomalies would be introduced by introducing such a limit at present. It might be considered later in conjunction with the introduction of identical restrictions on other losses.

Suggestion

- Consider limiting the period for which capital losses maybe carried forward. coordinating this with the adoption of similar restrictions for revenue items.

III. THE ANNUAL EXCLUSION

Proposal

The first R10,000 of net gain would be excluded from the calculation of gain each year: symmetrically, the first R10,000 of net loss would also be excluded.

Issues

There is no place in the logic of the comprehensive income tax for a distinct exclusion for capital gains: its essence is that all forms of income be treated identically, so that any exclusion should apply only to their sum. The case for an exclusion is thus one of easing costs of administration (to the authorities) and compliance (to the taxpayer) by ignoring small amounts. In particular, there are evident practical advantages to ensuring that the CGT does not substantially increase the number of taxpayers who file. Table 1.2 shows that many countries do provide some such allowance.

The level of the annual excluision

The question is whether R10,000 is an appropriate de minimis amount.

Leaving behavioral responses aside for the moment, the best exclusion level is that which just balances the saving of administration and compliance costs from removing some taxpayers from the system against the revenue that is foregone by reducing the taxable gains of those with gains in excess of the exclusion amount. Precision would require data on collection costs and the likely distribution of gains that, unfortunately, are not available. Experience elsewhere does, however, point to one important stylized fact: the distribution of capital gains is highly skewed, with a small proportion of cases accounting for a very high proportion of the total. In the US, for example, 5 percent of returns reporting gains account for over 60 percent of all gains. Thus it should be possible to set a high exclusion and still capture the bulk of gains. In the US, an exclusion of $10,000 - roughly the same order of magnitude as the current UK threshold of £7,200 - would in 1993 have removed from tax about 75 percent of taxpayers but only about 36 percent of the gains.[15] In the South African context, where the average gain can be assumed to be lower, an exclusion at this level (about R75,000) would remove a higher proportion from tax, and so might be too large.

A better sense of the relevant trade-offs can be derived from illustrative calculations. Suppose, for example, that an exclusion of R10,000 would remove 40 percent of taxpayers with gains from the CGT, and that raising it to R20,000 would remove another 20 percent. Assuming that those who remain within the CGT would pay at the top marginal rate of 42 percent, and ignoring the revenue lost from those removed from tax,[16]

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[15] This ignores the reduction in the taxable gains of those above the exclusion.

[16] Both assumptions will be wrong, but at least they act in opposite directions. It would bc straightforward to explore alternative assumptions within the general framework set out in the text.

the revenue cost of this would be about R2,100 for each taxpayer removed from tax. That is not a pure loss to South Africa, however, since taxpayers gain by the same amount. The revenue effect is properly weighted by the extent to which society values R1 in the hands of the government more than it values R1 in the private sector. Supposing that this difference is 0.4,[17] the social cost of the revenue foregone is R840. The question then is whether administration and compliance costs otherwise incurred for each taxpayer removed from the system are greater or less than this amount: if greater - as with these illustrative numbers seems plausible - then increasing the exclusion to R20,000 is beneficial.

These calculations, it should be emphasized are mainly intended to describe a method that could be applied to better data than currently exist. They suggest, nevertheless, that even R20,000 may not be too high.

This illustration also emphasizes that the appropriate exclusion is higher the lower is the tax rate on capital gains: the lower the tax rate, the less revenue is foregone by increasing the exclusion. Thus the proposed low inclusion rate is itself an argument for a higher exclusion amount than would otherwise be the case.

These mechanical calculations ignore the possibility that taxpayers will exploit the annual exclusion by wash sales ('bed and breakfasting,' in UK parlance): that is, by selling appreciated assets at the end of one tax year and immediately repurchasing them at the start of the next. so making full use of the exclusion. In so far as this simply applies the exclusion on an accruals basis, this distortion may not be seen as a problem. To the extent that is likely to be the better-off and better-advised that take advantage of this, however, it may erode the perceived integrity of the tax. It may then be appropriate—especially if the annual exclusion is set higher than R10,000 - to include wash rules to disregard gains or losses on sales and repurchases of the same asset within a short interval (say, thirty days) around the end of the tax year. Such rules will not eliminate the problem, since investors might deal in similar rather than identical assets (not shares in the same company, for instance, but in companies in the same sector) but will impede these devices.

The exclusion also creates problems of selective realization: taxpayers will have an incentive to spread gains over time to take maximum advantage of the exclusion, and conversely to bunch losses so as to avoid wasting those that would otherwise fall below the exclusion. This too points to a lower exclusion than the mechanics above would suggest.

Against this, however, inexperience in administering and complying with the CGT suggest that it may be wise at this point to err on the side of caution in setting an exclusion sufficiently high to mitigate the risks of creating severe collection problems. Put another way, administration and compliance costs are likely to be especially high in the early years of the tax, so pointing to a relatively high exclusion. As experience

[17] The value of public revenue - the marginal cost of public funds - must exceed one in order for there to be any justification for raising any tax revenue, and will be larger the more difficult the government finds it to raise revenue. Estimates for developed countries place it in the broad range of 1 to 1.8.

grows - and knowledge acquired of the distribution of gains—so the exclusion level could be reduced.[18]

To some extent the effective exclusion level will fall automatically even if its nominal value is held constant. This is not only because of the usual effects of inflation, but also because taxable gains will accumulate gradually after the effective date of the tax: in year one, only one year's gains will be taxable, in year two, two year's gains will be taxable.

The structure of the annual exclusion

The question arises as to whether the exclusion for CGT should be consolidated with the R3,000 annual exclusion currently available for interest income. If interest and capital gains were taxed identically, neutrality considerations would dictate applicat ion of a single exclusion to the sum of the two. But they are treated very differently, with most taxpayers saving more by excluding interest income from tax than by excluding capital gains. Investors for whom the exclusion is a relevant constraint would then have an incentive to distort their holdings towards the generation of interest income. To prevent such distortions (and preserve revenue) there is thus a strong case for maintaining distinct exclusions.

The proposed form of the allowance against capital gains raises two equity considerations. First, the tax saved by excluding any fixed amount from tax increases with the taxpayer's marginal tax rate: excluding R10,000 of gains saves a taxpayer paying at the lowest marginal rate (18 percent) R475 (taking account of the 25 percent inclusion), but saves R1,050 for one paying at the top marginal rate (42 percent). It is not clear why the desire to exclude a de minimis amount should result in a greater benefit to the better-off. One might then think of providing a (non-refundable) tax credit rather than an exclusion. This would be straightforward to do if capital gains were subject to their own schedule. That will not be the case, however, and the interaction with liability arising from other income then creates difficulties with the credit approach, since the marginal tax rate implicit in any credit against CGT could not be appropriate for all taxpayers given that their other income implies that they will face different marginal tax rates on the first R1 brought into tax, creating potential jumps in liability.[19] While other ways of restricting the benefit of an exclusion could be devised, and especially at low levels of the exclusion, the gains from doing so are likely to be small relative to the complications.

Second, there is a sense in which setting aside the smallest losses is particularly regressive, since in practice it will often be those with larger lifetime resources who realize the larger losses. Clearly, however, it would be undesirable to require those who

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[18] Pre-announcing such a decrease may have undesirable effects in accelerating the realization of gains and deferring the realization of losses.

[19] Suppose taxpayers were allowed to exclude R10,000 of gain or claim a R475 credit. That would assess a large penalty (in percentage terms) on taxpayers in high brackets whose gains just exceed the R10.000 threshold. For a taxpayer in the top tax bracket, the penalty from crossing the threshold would equal R575 - the difference between the tax on R10,000 (Rl,050) and the credit (R475).

otherwise would not need to file to do so in order to carry forward losses. This is unlikely to be a serious concern at levels of exclusion for losses as low as proposed. At higher levels, however, thought might be given to devising notification procedures allowing those with small losses to preserve the chance of some future tax benefit.

Recommendations

- Err on the side of caution in setting a sufficiently high annual exclusion - perhaps R20,000 or more - to ensure smooth administration of. and compliance with, the new CGT, with the possibility of subsequently lowering it as capacity of tax administration and taxpayers increases.

- Include wash sale rules to limit exploitation of the annual exclusion.

IV. OTHER EXCLUSIONS: RESIDENCES, RETIREMENT RELIEF AND PERSONAL USE ASSETS

This chapter reviews some key items excluded from the CGT. (Another, on charitable donations, is discussed in the next chapter).

A. Primary residences

Proposal

The draft envisages that natural persons and special trusts - not companies or other trusts - be enabled to disregard gains in respect of a primary residence, including up to two hectares of vacant land, up to a maximum of R1,000,000. As a transition measure, relief from property transfer tax, stamp duties and capital gains will be given to those who transfer their primary residence from a company to themselves within one year of implementation of the law.[20]

Issues

Rationale for the exclusion

There are several possible reasons for the preferential treatment of owner-occupied housing. First, it could be that home ownership is felt to convey social benefits beyond those enjoyed by home-owners themselves. Even leaving aside the plausibility of such a view, however, a blanket subsidy to home ownership under the CGT is unlikely to be the best way of pursuing such a policy. It is poorly targeted, in that the largest benefits accrue to those who are likely to have purchased homes in any event; indeed to the extent that the tax benefit is capitalized in house prices the greatest beneficiaries will be those who already owned houses when he exclusion was announced. If for some reason it is felt desirable to encourage home ownership, it would be better to target the subsidy more precisely on those who are least likely to own a home, for example through means-tested reduced-interest rate mortgage loans.

A second reason for the exclusion could be practical.. Specifically, records could in a majority of cases be required to be kept over many years to verify costs of improvements made that should be added in determining the cost basis. This would significantly complicate compliance and administration of the tax, although the problems seem unlikely to be insurmountable. It may, nevertheless, be appropriate to sacrifice some equity in taxation for administrability.[21]

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[20] Primary residences are widely held within trusts or companies or closed corporations, for estate planning purposes or to avoid property transfer and stamp duties on subsequent sales. The transitional transfer exemption will not apply to transfers from trusts.

[21] Reinforcing this rationale is that the lock-in effect may be greater for homes because of the inherent lumpiness of transactions.

Third, this exclusion may be important to the political viability of the CGT proposal.

Design features

Most countries that tax capital gains provide an exclusion or offer substantial relief for gains arising on disposal of the primary residence (See Table 1.2).

Possibilities include placing a ceiling on the sales price of the residence for which an exclusion will apply, or on the size of the excludable gain. The former approach would preserve the administrative and compliance advantages of unlimited exclusion. The latter approach is more consistent with equity principles, but sacrifices simplicity: taxpayers would be required to keep records of expenditures, possibly extending over many years, against the chance of a future taxable gain. In either case, if a separate limit on the exclusion is introduced, it should be designed so that most owner-occupied houses qualify for complete exclusion. The draft legislation limits the gain per taxpayer to R1,000,000. While there are wide differences in housing prices and housing market dynamics in different regions of the country, this should be sufficient to exclude many house sates from tax. The limit should be reviewed periodically, to ensure that it remains consistent with equity norms, revenue needs, the general price level, and the administrative capacity to collect the tax.

Interaction of CGT with Propery Transfer Duty

One complicating feature in South Africa case is the interaction between the prospective CGT on residences with the Property Transfer Duty (PTD). The PTD is levied at progressive rates that reach 8 percent of the sales price of the property for natural persons.[22] While it is true that the two taxes are collected from different taxpayers—the seller would pay CGT and the purchaser PTD - their aggregate effect is likely to be independent of the side of the market on which each is levied, This has several implications. First, if the gain on the primary residence is excluded from CGT, as in the current proposal, it would still be taxed under PTD, although at rate independent of the taxpayer's income or the size of the gain. Second, if some portion of the gain on the residence were subject to CGT, this would constitute an increase in total tax on the transaction when it is also subject to PTD. If it is deemed necessary to offset this additional tax burden, one approach would be to cut PTD rates, as the draft proposes for estate and donation tax.[23]

[22] Transactions among businesses are taxed at a flat 10 percent under the PTD, but an exemption from PTD is given when the transaction is between VAT taxpayers; the PTD consequently bears mainly on sales of residential real estate.

[23] More generally, a case could be made that the PTD at the rates currently levied is a significant deterrent to property transfers, and encourages avoidance (e.g., through trusts and closed corporations) and evasion (e.g., through failing to register transfers), independent of the tax treatment of the capital gain.

The treatment of traditional marriages

The draft extends the primary residence exclusion to each person, regardless of the number of spouses and associated residences constituting the social arrangement. Whether this is the appropriate treatment depends on the rationale for the exclusion. Where there is an external social benefit to home-ownership, it can be argued that the preference should be extended to all spousal residences (while limiting the number of primary residences to the number of spouses). On the other hand, where there is a strong correlation between income and the number of spouses and residences, an equity case can be made for limiting the aggregate preference, either by limiting the aggregate value of the preference, the preference per transaction, or the number of residences for which the preference applies. In addition, the Constitution may place restrictions on the form of an appropriate structure of the preference as it relates to the family unit.

The optimal policy involves difficult political and legal considerations that the mission is not competent to pronounce upon, except to observe that the existence of traditional marriages will severely complicate attempts to limit the residence exclusion, and may tilt the balance toward eliminating the primary residence exclusion altogether.

Recommendation

- Enact, as proposed, a cap on the exclusion of the gain on primary residences. at a level sufficient to exclude most transactions from the tax, easing the administrative and compliance burden. This cap should be reviewed and adjusted periodically to remain consistent with equity norms, evolving revenue needs, and administrative capacity.

B. Small businesses and retirement

Proposal

A natural person holding a small business (gross asset value less than R 5 million), or businesses, can exclude capital gains on the disposal of associated active business assets up to a lifetime maxiinum of R500,000, provided the taxpayer has held them for at least 5 years and the disposal is in consequence of death, ill-health or other infirmity.,

Issues

This provision is intended to allow and encourage small business taxpayers to use the ownership of business assets as a tax-preferred vehicle for saving for retirement. By doing so, it provides an incentive to small business formation, although at the cost perhaps of a loss of some of the benefits of asset diversification, and at the cost of potentially introducing a lock-in distortion. This may be defensible when small businesses have limited access to outside sources of capital, requiring the owner to invest most of his or her personal wealth into the business and so precluding the use of other tax-favored vehicles for private retirement saving, such as retirement annuity funds.[24]

This rationale for the exclusion requires the taxpayer to demonstrate a longer-term commitment to the business. For this reason, a minimum holding period for the assets to qualify for the preferential treatment is defensible: and 5 years seems reasonable. The UK requires ten; but, interestingly, is phasing out this relief, which has been proved particularly complex.

To ensure equitable treatment, however, the extent of the small business preference should be consistent with the size of the tax preferences for retirement saving available to other taxpayers. The regulation and taxation of the retirement saving industry in South Africa is to be reviewed in the near future. In the interim, the limits placed on the extent of the exclusion in the proposal appear reasonable, and are broadly consistent with the treatment in countries that offer similar preferences. However these limits would need to be revisited as the small business preference is integrated into the reformed retirement savings regime.

While the logic of the exclusion would suggest that it apply to all business assets, not just active business assets, the restriction can serve a useful purpose in limiting abuse. Similarly, the logic would allow for exclusion of capital gains for those taxpayers younger than 55, provided the proceeds of the sale are rolled into a recognized retirement saving vehicle. This would further weaken the lock-in effect, making it more attractive to transfer control of the business assets to others when it is economically efficient to do so.

It is argued by some that capital gains taxation at death forces estates to sell family businesses and farms to pay the capital gains tax liability. The special retirement relief provided in the proposal is one approach to this problem, at the same time avoiding providing inordinate benefit to wealthy investors. Under the provision, gains up to R500,000 on small business assets would be exempt at death. In addition, with proper planning, a couple for example could avoid up to R1,000,000 of capital gain on a family business.

Recommendations

- Under-55s in good health could be made eligible for the exclusion, provided the proceeds are rolled into an approved retirement saving vehicle.

- As the retirement savings industry, including its tax treatment, is reformed. the CGT - free business disposal provision should be better integrated into the system - perhaps dispensed with altogether - to ensure fair treatment of all taxpayers.

[24] These funds are tax-favored in that: interest and rental income to the fund are taxed at less than the highest individual marginal rate; other types of income to the fund are not taxed; and a portion of any lump-sum payment from the fund to beneficiaries is tax free.

C. Personal use assets

Proposal

Except for a few explicitly listed - including large aircraft and boats, coins and immovables - personal use assets are to be disregarded for CGT. Losses on those included are in most cases also disregarded.

Issues

Since gains on personal use assets contribute to purchasing power just as much as gains on any other asset, they should in principle be taxable. This though would require taxpayers to keep records of every small purchase that might conceivably give a gain. It would also require, in principle, reducing the amount of any loss (or increasing any gain) by the diminution of value attributable to the derivation of consumption services from the asset. This would be extremely hard to monitor.

There is thus a strong case - stronger the lower is the annual exclusion - for some form of exclusion in respect of personal use assets.

One way to provide this is by a positive listing of items subject to the tax, as in the proposal. The difficulty with this is that any such listing is likely to miss items on which significant capital gains might be realized, such as cars or rugs, with consequent and potentially highly publicized cases in which large gains escape tax. From this perspective, the list in the current proposal is perhaps a little short: it might be extended to include, for example, antiques and works of art.

An alternative approach - adopted, for example, in Australia and Canada - is to disregard gains on sales of any personal use asset below some specified amount: say, R10,000. Deductions for losses might be limited to gains on personal use assets. This approach runs the risk of artificial splitting of transactions, and in principle still requires extensive record-keeping. But it spares the tax authorities a perpetual chase after high yield assets.

Recommendation

- Consider either (a) including more personal use assets in the list of those subject to CGT or (b) include all gains on sales of personal use assets in the CGT) but exempt sales below some threshold amount.

V. Death and donations

This chapter deals with two items whose proper treatment is central to the integrity and simplicity of the CGT: the treatment of gains at death, and of gifts (both in general and to charities).

A. Bequests and Gifts

Proposal

Bequests and gifts (other than between spouses) are to be realization events, attracting CGT. Any CGT paid at death will be deductible against estate tax. Losses on gifts are to be deductible only against capital gains on other gifts to the same party.

The rates of estate and donation tax are both reduced from 25 to 21 percent.

Issues

Importance of Taxing Capital Gains at Death

For the CGT to achieve its proper objectives, it is crucial that gains be fully taxed at death, and a major strength of the draft legislation that it proposes doing so.

Experience in countries which exempt gains at death, such as the UK and US, is that the effectiveness and integrity of the tax are severely compromised, The revenue loss can be significant: on one estimate, up to 75 percent of potential CGT revenue in the US is lost in this way.

Exemption at death enables wealthy taxpayers to engage in complicated and costly schemes to defer realization until death, thus avoiding capital gains tax liability and undermining the fairness of the wider tax system. Even without resorting to complicated and expensive avoidance measures, older investors have a strong incentive to hold onto appreciated assets - even poorly performing ones - and try to finance their retirements out of other assets. The lock-in effect from exemption at death can be profound, with the country’s resources wasted as investors are prompted to hold onto unproductive assets rather than sell to people who could put them to better use. (The retirement tax relief discussed in Chapter IV.B partially offsets this distortion for owners of small businesses.)

Even with taxation at death, of course, taxpayers have an incentive to defer realization until then; but the value of deferral schemes is significantly reduced. Full taxation at death should be a central component of the CGT.

Overall tax burdens on estates

Taxing capital gains at death, in combination with the existing estate tax, would cause the overall tax burden on estates to increase. To counter this, the draft legislation reduces the estate and donations tax rates by 4 percentage points, from 25 percent to 21 percent.

Table 5.1 displays the effect of these provisions on total tax payable at death on a range of assumptions as to the proportion of the estate that has arisen as gain. When half of the estate is gain, CGT would add 4.1 percent to the combined estate and CGT liability at death. In that case, the reduction in estate tax rate approximately offsets the additional tax liability due to the CGT. In theory, the effective tax rate on estates could increase by over 8 percent, but that extreme is implausible. Much of the asset value at death is likely to be held in the form of interest bearing assets, small businesses, and pensions, which will not be subject to CGT under the proposal.[25] And many wealthy people are less than entirely self-made. Thus, capital gains are likely to constitute no more than 25 percent of most estates, adding at most just over 2 percent to the tax burden.

Table 5.1. South Africa: Effects of the proposals on tax payable at death (as percent of estate)

Capital Gain at Death	Current tax liability at death (estate tax only)	Proposed tax liability at death 1/	
		CGT 2/	CGT + Estate Tax
0	25.0	0.0	21.0
25	25.0	2.1	23.1
50	25.0	4.1	25.1
75	25.0	6.2	27.2
100	25.0	8.3	29.3

1/ Ignoring exclusions.
2/ Net of deduction against estate tax.

The inferiority of other ways of reducing tax payable at death

The potential increase in the tax burden at death has generated much discussion. Alternatives to that proposed include:

- *Allow CGT paid at death to be credited against estate tax.* This is not an attractive approach. Wealthy decedents would be effectively exempted from CGT (which for them would be entirely rebated on the estate tax); for them, there would be a potentially significant lock-in, and in incentive to engage in complicated strategies to ensure that any CGT charge at death remains small enough to be fully creditable against estate tax. Only the less wealthy decedents would bear any real CGT. Small businesses not eligible for retirement relief would be subject to the CGT, while large businesses would not be effectively taxed.

- *Increase the estate tax exclusion.* This has the advantage of reducing the number of estate taxpayers, but would not reduce effective marginal effective tax rates on assets subject to the estate tax.

[25] Estate tax return data from the US (1999) shows the only about half of the value of estates is comprised of stock shares, mutual funds (unit trusts), real estate, and business assets.

- *Provide holdover relief at death*, enabling the recipient of a bequest to acquire the tax basis of the donor: that is, the capital gain would not be taxed until the inheritor of the asset sold it. This avoids any immediate burden at death, and (compared to exemption) would reduce somewhat the incentive to hold assets until death solely to avoid tax. But the ability to defer tax through multiple generations provides a tax benefit—and lock-in—almost as great as an outright exemption. Moreover, the record keeping requirements to establish basis for an asset that is passed among generations, especially one that had been improved over time (giving rise to potentially numerous additions to basis) are daunting.

These methods are all inferior to that proposed. The purposes of the estate tax and the CGT are quite distinct, and anomalies will result if they are conflated. If some adjustment must be made to reduce tax payable at death, the best means is by lowering the tax targeted at death: the estate tax.

The importance of taxing gifts and bequests consistently

Since the difference between a gift and a bequest is largely a matter of timing and good heath, the two should be treated symmetrically. If capital gains are taxed at death, gifts should also be subject to CGT: otherwise taxpayers could avoid or defer the tax by giving assets away before they die. Many of the arguments above apply equally to gifts: in particular, CGT on gifts should not be creditable against the donations tax.

Recommendations

- Capital gains should be taxed upon death or gift as specified in the draft legislation.

- The proposed 4 percentage point reduction in estate and gift tax rates seems appropriate compensation for the additional tax at death imposed by the CGT, for most taxpayers.

B. Donations To Charities

Proposal

Capital gain or loss on any donation of capital assets to a public benefit organization (charity) would be disregarded. As under the existing income tax law, the base cost of the asset - purchase price plus the cost of improvements - of the asset will be deductible.

Issues

The proposal continues to allow a deduction only for the base cost of assets donated to charity. If capital gains were taxed at the same rate as ordinary income, this approach would be simple, and leave undistorted distort donors' decisions between making gifts in kind or in cash.

Given the differential tax treatment of capital gains and other income, however, the exclusion of capital gains on charitable donations creates a tax incentive for donors to sell a highly appreciated asset rather than donate it outright. For example, if a painting has market value R10,000,000 and a base cost of R1,000,000, a taxpayer in the 42 percent bracket would reduce her taxes by R420,000 if she donates the artwork to a museum (the base cost being deductible as ordinary income). If she instead sells the painting and donates the proceeds, she would pay R945,000 in capital gains tax (10.5 percent of R9,000,000) but then also claim a cash deduction worth R4,200,000 (42 percent of R10,000,000). She thus saves R2,835,000 in taxes by making the donation in cash rather than in kind.

For assets carrying a capital loss, on the other hand, the incentive is to donate directly rather than giving the sale proceeds. Assets with losses would effectively benefit from a 100 percent deduction for the loss if donated to charity, whereas only 25 percent would be deductible (against other gains) if the asset were sold and the loss realized for tax purposes.[26] (This problem could be avoided by requiring realization of the loss for tax purposes and allowing a deduction only for the market value).

The question then is whether there are any good reasons to distort donors' decisions between cash and kind. Tax administration considerations might justify discriminating against in-kind contributions. It is hard to accurately value unique assets such as art. The valuation of art and collectibles donated to museum-s and other charities is a major source of dispute between taxpayers and the revenue authority in many countries. In the US, the full market value of donations, rather than their base cost, is deductible against income tax,[27] so that taxpayers often claim inflated valuations to maximize their charitable deduction. The cost basis is easier to establish in cases where a taxpayer purchased or created the asset. Similarly, donations of cash are relatively easy to monitor, so encouraging cash donation eases tax administration.

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[26] Suppose a taxpayer in the 42 percent tax bracket donates property with a base cost of R20,000 and a fair market value of R10,000. She could claim a tax deduction worth R8,400 (42 percent of R20,000). If she sold the asset and donated cash, she would claim a capital loss of R10,000, worth at most R1,050 (10.5 percent of R10,000) in tax savings, and a charitable deduction of R4,200 (42 percent of the market value of R10,000). Thus she saves R3,150 (R8,400-R1,050-R4,200) in taxes by being able to deduct the full basis. Effectively, she gets to deduct the entire loss if she donates the property to charity, compared with 25 percent if she realizes it as a capital loss.

[27] Since capital gains on charitable gifts are not generally taxed in the US, this is an overly generous rule that artificially encourages in-kind over cash gifts.

On the other hand, one might not wish to make it difficult - as the present proposals potentially do - for charities to acquire particular assets especially important to their charitable activities. To counter this, it may be possible to allow taxpayers to deduct the full market value (and pay CGT on any gain) for the limited set of donations where in-kind contributions are preferable to cash. To deter avoidance, eligible donations could be limited to marketable securities, which have easily determined prices, and to art. collectibles, historic properties, and land that a recipient organization (certified by SARS) avers serves to advance its charitable purpose and which it plans to hold for at least 5 years. SARS would then decertify a charity that repeatedly sold assets before 5 years at a substantially lower price than the charitable deduction claimed.

Recommendations

- Consider treating donations of capital assets to charity as realization events, while allowing a tax deduction for the full arms-length value of the asset.

- If the preceding recommendation is adopted, consider limiting its applicability to in-kind contributions that directly advance the charitable purpose of the recipient organization.

VI. FINANCIAL ASSETS

The bulk of the revenue from the proposed CGT is likely to come from sales of financial assets, making their treatment especially important.

A. Marketable Securities

Proposals

In general, capital gain or loss arising from the sale of securities are to be taxable at the individual level. There are though exceptions for securities held by intermediaries:

- Capital gains or losses arising from sales of securities held by a unit trust are not to be included in the income of the trust or of the unit holder. Instead, gain or loss is only recognized when the unit holder sells shares in a unit trust; that is, on a 'price to price' basis.

- Capital gains and losses arising from transactions in a pension fund are not to be taxable to either the fund or the individual policy holder. (As noted earlier, the authorities intend to review the tax treatment of pensions within three years of enactment.)

- The treatment of capital gains and losses arising from transactions by an insurer depend on the fund for which the asset is held. Gains from assets held in the individual policy holder fund, for example, are included in the insurer's taxable income at a 25 percent rate and taxed at the business rate of 30 percent.[28]

- Capital gains and losses realized by a trust are included in the trust's income, with inclusion of 25 percent in the case of a special trust, and 50 percent for other trusts. An exception applies when a beneficiary has a vested interest in an asset of a trust, in which case there is full flow-through: that is, any gain or loss is treated as if it were realized by the beneficiary.

Issues

Taxation at individual or intermediary level?

In principle, the correct treatment of shares and other financial instruments held through intermediaries is to attribute any activity at the intermediary level to the shareholder. That is, a sale by the unit trust or pension fund should be treated exactly like a similar transaction made directly by the shareholder. This would ensure that tax considerations do not distort the decision on whether to hold an asset directly or through an intermediary.

[28] The other funds are for: corporate policy holders (50 percent inclusion, 30 percent rate); untaxed policy holders (zero effective CGT rate); shareholders of the insurance company itself (50 percent inclusion, 30 percent rate).

There are, however, potentially significant practical advantages to withholding CGT at the intermediary's level, not at shareholder level. Administration and compliance costs are generally reduced by limiting the number of entities that have to pay tax, and there are far fewer intermediaries than final shareholders. Moreover, the firms that manage large portfolios are much more sophisticated than most investors, and so better able to comply with a complex tax regime. With substantial financial assets at stake, they also have a strong incentive to comply with the tax law.

A fundamental issue in designing any withholding regime is that of whether the tax withheld by the intermediary is to be final - with no subsequent adjustment at individual level - or simply a payment toward the ultimate tax owed by the recipient. The STC, for example, is effectively a final withholding tax.

Alternatively, tax collected by the intermediary might be creditable against the taxpayer's overall liability. This could be more complicated for individuals than simply taxing them directly, because they would also have to do the credit calculation, and would also put burdens on the intermediaries. The tax authority would have to process - and match - tax returns from both intermediaries and individuals, compounding the administrative burden. For those reasons, creditable withholding model is probably not advisable if administrative capacity is limited.

From the point of view of some intermediaries, a drawback of even final withholding is that it can obscure the tax obligation realized by individuals.[29] Unit trust companies, for example, objected to a previous proposal to tax capital gains at the trust level because (among other reasons) this would reduce the returns paid to shareholders. Moreover, because the intermediary has to pay the tax from the assets in the fund, the tax could reduce assets under management. In contrast, insurers reportedly prefer to pay the tax at their level because they view it as a marketing advantage that proceeds of insurance are free from tax in the hands of the insured.

Another concern with final withholding is that it could place domestic financial intermediaries at a disadvantage relative to foreign entities. If domestic entities were to find it more costly to raise capital, domestic corporations might look abroad for their finance. There would then be pressure for potentially taxable intermediaries to move their operations offshore, which would be inefficient and reduce tax revenues.

The proposed legislation makes different choices as to the degree of flow-through of tax liability for different types of intermediaries, spanning the range from full flow through (for trusts in which beneficiaries have the right to access sales proceeds) to no flow-through (for unit trusts). In the case of unit trusts and insurers, the rules seem to be

[29] In theory, investment decisions should be unaffected by whether the unit trust or the shareholder nominally pays the tax. That is, the incidence does not depend on the statutory collection source. But some economists and psychologists question the rational model of savings behavior. Under some subrational models of behavior, there might be a 'flypaper effect,' - the incidence of the tax sticking to the statutory source obliged to pay the tax.

designed for administrative convenience. The non-taxation of pension fund assets is designed as an interim measure while the proper tax treatment of pensions relative to other investments is evaluated. While the variation reflects different priorities in the different sectors, it is potentially distorting. A more uniform approach would be preferable.

The treatment of unit trusts

In South Africa, as elsewhere, unit trusts (or mutual funds) have been growing in popularity. They provide a relatively inexpensive way for small investors to participate broadly in financial markets. By drawing into the market investors who might otherwise avoid investing in stocks, they may increase the availability of capital to South African corporations. As a result, taxing these funds in a way that does not impair that flow of capital is a high priority.

Under the draft legislation, shareholders in unit trusts will be taxed on a price-to-price basis. This is a generous rule. It allows investments made through unit trusts unlimited rollover, with no tax on the gain until there is a realization by the unit holder. If the same investments were made directly by the trust shareholders, they would be subject to CGT on every transaction.[30]

Although desirable in principle to attribute gains and losses to final shareholders, it creates significant complexity when those gains are reinvested. The issue is especially important in South Africa because unit trusts turn over their assets rapidly. Each reinvested capital gain produces a new small investment in the trust with a new base cost. When the unit holder ultimately sells shares in the trust, rules are required to determine which portion of the underlying assets have been sold to determine the base cost and gain. This calculation may require extensive records for assets held many years, or rules allowing the trust to track basis and report an average cost to the shareholder. Moreover, since realization of a gain triggers tax liability for the shareholder, the trust would face pressure to distribute gains rather than reinvest them, which adds to the cost of managing the trust.

Recommendations

- The price-to-price proposal is a reasonable accommodation to ease administrative and compliance costs, but should be limited to widely held diversified funds that are not subject to the direct control of shareholders. In particular:

- 'Wrap funds' - which allow shareholders to instruct the fund manager to buy and sell individual funds or shares - should be taxed at the shareholder level on all gains and losses as they are realized.

[30] This is how such trusts are taxed in the United States.

B. Mark-to-Market for Marketable Securities and Derivatives

Proposal

With few exceptions—for example, the income tax already requires that assets held as trading stock be ‘marked to market’ and taxed annually on a revenue basis—gains are to be taxed on realization.

Issues

As discussed in Chapter I many problems arise in taxing assets on realization. In the absence of effective anti-avoidance rules, taxpayers have the incentive and ample opportunity to accelerate the realization of gains and defer the realization of losses. For illiquid assets such as real estate and businesses, high transaction costs of selling can make CGT a secondary consideration. But for financial securities transaction costs are quite small, and it is relatively easy to manipulate the timing of sales. Moreover, the availability of derivatives and synthetic securities - which can be designed to replicate, or to bear almost any conceivable relationship to a marketable security - makes crafting effective anti-avoidance measures difficult. For that reason, it is worth considering measures that remove the ability of taxpayers to manipulate the timing of realizat ions.

One such approach, as noted in Chapter I, is the widespread adoption of mark-to-market methods where practicable. The mission does not believe, it should be emphasized, that the time for this approach is ripe in South Africa, not least because it remains largely untried. Nevertheless, experience elsewhere - and the intensified problems posed by synthetic securities - suggests that tax systems are likely to move increasingly in this direction. It is therefore worth spending some time envisaging how such a system might work in South Africa.

A model for accrual taxation

Widely traded securities held directly or through a unit trust, and derivatives based on such securities, could be taxed on a mark-to-market basis. That is, the change in value of such assets would be included in taxable income each year after applying the applicable exclusion. For an asset (or portion of an asset) held for the entire year, gain or loss would be determined by subtracting beginning of tax year value from end of tax year value. For an asset (or portion of an asset) purchased during the year, the beginning value is as of the purchase date; for an asset (or portion) sold during the year, the ending value is as of the sale date.

For example, assume that an investor holds for the entire year 10,000 shares in Companies X and Y, both traded on the Johannesburg Stock Exchange (and, for simplicity, no other capital assets). Suppose the price per share of X is R100 on 1 January and R120 on 31 December; the price of Y is R200 on 1 January, R195 on 31 December. The taxpayer would report a gain on X of R200,000 (= (R120 – R100)*10,000)—that is, the difference between opening and closing values for the stock. Similarly, company Y produces a loss of R5 per share, for a total loss of R50,000. The net gain is thus

R150,000. After applying the R10,000 exclusion, the taxpayer would include R35,000 (25 percent of R140,000) in taxable income.[31]

Unit trusts would report to their shareholders and to SARS the accrued gain from the underlying securities over the course of the year, accounting for any purchases or redemptions made by the shareholder during the year under similar rules to those outlined above.[32] Mark-to-market assets held by other intermediaries would be included in the intermediary's taxable income as if they were held directly by the individual shareholder (that is 25 percent of net gain or 1OSS would be included in trust's taxable income), except that the annual exclusion would not apply.

Marking to market, it should be emphasized, deals neatly with the problems posed by synthetic and other securities that repackage returns into distinct instruments. Since it is the net value of assets that is brought it tax, offsetting transactions - such as a straddle - simply cancel out.

Anti-abuse rules would though be necessary to ensure that over-the-counter synthetic securities similar in character to portfolio assets or derivatives that are taxed under the mark-to-market regime would themselves be taxed on a mark-to-market basis even if the artificially constructed asset is not publicly traded. These rules could be difficult to enforce. Moreover, there could be distortions or arbitrage opportunities created if some assets or some traders are taxed on a mark-to-market basis and others are taxed on realization.

If the mark-to-market regime were adopted, the proposed R10,000 exclusion should apply only to any gain or loss on the mark-to-market assets.[33] A smaller exclusion - of, say, R2,000 - exclusion would apply to any net gain or loss arising from realization of capital assets. There are several rationales for providing a larger exclusion for mark-to-market assets. First, most of the taxable gains and losses accruing to small investors would arise from mark-to-market assets, so that a higher exclusion on such assets is better targeted to equity objectives. Second, a large exclusion can distort the timing of realization assets, but not mark-to-market assets. Third, there is no simple and consistent way to mingle mark-to-market and realization-basis assets for purposes of calculating the loss limit.

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[31] The STC would continue to apply to any dividends paid.

[32] For clarity of exposition, we assume that the tax would be collected from individual unit holders rather than as a withholding tax on unit trusts. The advantages and disadvantages of the two approaches were discussed in the previous section.

[33] Chapter III above recommended a higher annual exclusion. If such were adopted, a similarly high exclusion should apply to mark-to-market assets.

Discussion

Although many economists and lawyers advocate accrual taxation, there is little practical experience with such a regime. Italy has recently enacted accrual-basis taxation for most capital gains on mutual funds and other assets managed by a financial institution. In South Africa, traders are subject to a mark-to-market regime on gains or losses earned in their trading accounts. But the pitfalls in the new regime may not be apparent before it is tried.

Allowing current deductibility for losses under the mark-to-market regime would be a significant benefit to investors, but pose a risk for government finances. If asset markets were to decline, CGT revenues would decline (or even become negative) at the same time that other sources of revenues were falling and the costs of social safety net programs increasing. The tax cut that would arise naturally from the mark-to-market regime could provide a helpful stimulus to a flagging economy, but it might also be hard to explain to the public why the government is providing significant tax concessions to wealthy investors at a time of national hardship. The government could insure itself against this risk, in principle, by setting up a reserve fund with the excess revenues collected on mark-to-market assets when the economy is doing well. However, such a dramatic event as the near two-thirds decline in the Japanese stock market in the early 1990s would be difficult to provide against.

Administration and Compliance

A mark-to-market regime would be simple for taxpayers to comply with. They only need to know prices, which are published, at the beginning and end of the year. Thus, there would be no need to keep records of the base cost in mark-to-market assets over many years. Stockbrokers and unit trusts could report a single net gain or loss number to taxpayers, even for a large portfolio that is actively traded.

Mark to market could significantly simplify capital gains tax enforcement. Unit trust managers and stock brokers could be required to report to SARS accrued gain or loss on their customers' accounts. Such reporting would be much more difficult, and in some cases impossible, if gains are taxed on a realization basis. For example, brokers and unit trust managers may not have information about the cost-basis of assets held before the effective date of the legislation or transferred from other accounts.

The regime could reduce the customer-service costs of brokers and unit trust managers (as compared with a realization-based system), since taxpayers would not be calling to request information needed to calculate basis on a long-held asset.

Economic Effects

Mark-to-market eliminates the lock-in effect. Since timing of sale has no effect on tax liability, taxpayers are free to trade based on their own preferences and information without any tax implications.

By allowing deduction for losses, a mark-to-market regime could significantly reduce the risk of investing in volatile securities. Unlike a realization-based system, where losses must be limited to deter tax avoidance, mark-to-market treats gains and losses symmetrically: it reduces loss by as much as it reduces a gain of similar size (assuming that the taxpayer has sufficient income tax liability to absorb the loss).

Marking to market could significantly reduce tax avoidance opportunities through selective realization. Taxpayers cannot manipulate timing of securities and derivatives under this regime. It would also end taxpayers' ability to defer indefinitely realization of gain through the use of derivatives.

Since gains would be taxed, even if unrealized, liquidity-constrained taxpayers may have to sell some of their assets to meet their tax obligation. The R10,000 annual exclusion would alleviate or eliminate this problem for most taxpayers, however.

Taxing gains as they accrue, rather than when realized, solves the bunching problem - i.e., that a taxpayer can realize a very large gain in one year that reflects many years of modest capital appreciation and thus be subject to a large tax obligation. Mark-to-market automatically spreads such gains out as they accrue. Many or most gains of modest-income investors would never be taxed due to the annual exclusion. (The proposal would do nothing, however, for investments in family businesses and real estate, because they would continue to be taxed at realization. Those investments would benefit from the retirement relief provisions in the draft legislation.)

Argument for a lower inclusion rate for mark-to-market securities

Since taxing gains on a mark-to-market basis would eliminate the benefit of deferral, it would increase the effective CGT rate on such assets. That would be undesirable. Indeed, as discussed in Section II, there is a strong argument for taxing investments in equities more lightly than other gains. Moreover, if publicly traded assets are perceived to be more heavily taxed than other assets, companies may avoid listing on South Africa in order to escape the mark-to-market regime.

The proposed 25 percent inclusion rate poses a problem, however, because it is so low. The equivalent inclusion rate for marked to market assets might by 10 percent, for example, which might be so low as to not be worth the cost of administering. Thus, if a mark-to-market regime is adopted, there would be a strong case for increasing the inclusion rate for assets outside the regime to account for the benefit they receive from deferral.

New kinds of avoidance and evasion

The main concern is that, by distinguishing between classes of capital gains assets (between mark-to-market and realization), new arbitrage opportunities might be created. A similar concern would arise if mark-to-market assets are taxed at a lower rate than other capital assets.

The mark-to-market regime relies on asset prices being determined at arm's length: that is, without the possibility of manipulation. Concern has been raised that South African securities markets are relatively thin, and so subject to manipulation. Manipulation could, for example, depress asset prices at year end, generating losses that would be fully deductible under a mark-to-market regime. It is important to note, however, that such manipulation poses a similar or possibly even greater risk when assets are taxed upon realization. For instance, under mark-to-market, engineering a low market value at the end of one tax year would tend to increase liability over the next, unless an even lower price could be engineered a year hence.

These risks would have to be closely examined before a mark-to-market regime were adopted.

Recommendations

- Since mark-to-market methods are largely untried, they should not be adopted by South Africa at this time;

  Nevertheless, because of its potential advantages for administration, compliance, and economic efficiency, and the increasing sophistication of South African financial markets, the feasibility of a mark-to-market regime will need to be considered for the longer term.

VII. Aspects of the CGT at business level

This chapter considers two key aspects of the treatment of capital gains realized by businesses.

A. Depreciable assets and reinvestment relief

Proposal

The proposal leaves unchanged the ‘recoupment’ provisions of the income tax which tax as ordinary income the sum of past depreciation allowances enjoyed on assets sold (to the extent that the sales price exceeds the tax-depreciated value of the asset). The full capital gain on disposal of assets is brought into tax after application of the 50 percent exclusion.

Businesses disposing of real assets that received relatively fast write-off - plant, machinery, ships and aircraft - may spread the liability over five years if they reinvest the proceeds in plant or machinery.

Issues

The key policy consideration in designing a regime for the sale of business assets is to ensure that taxation does not distort the decision of whether to retain an asset or sell it. For depreciable assets, this requires that sale trigger a liability (taking buyer and seller together) that offsets two potential advantages of resale: that of ‘restarting the clock’ for depreciation (and so effectively claiming deductions twice on the same asset); and that of increasing the basis upon which depreciation allowances are claimed (to the extent that the price at which it is resold exceeds the initial cost of the asset). In many countries, the issues at stake apply largely to real estate, plant and machinery generally not being resold. In South Africa, in contrast, most commercial real estate does not attract depreciation allowances, whilst there is an active second hand market in plant and machinery. Indeed the depreciation of the Rand has generated significant nominal capital gains on machinery whose dollar price on world markets has remained relatively constant.

Offsetting the two advantages of resale requires two kinds of charge at resale:[34]

- A recoupment (or ‘recapture’) of depreciation allowances already claimed. In principle, this should be not of the simple sum of the allowances but of their present value equivalent at the time of sale (to reflect the interest enjoyed by taking deductions some time before the sale).

- A charge equal to the increased present value of depreciation allowances achieved by the stepping up of basis.[35] Note that this does not require taxing at ordinary rates the

[34] The argument here is developed in detail in Technical Appendix 1

[35] Here too there should in principle be an interest adjustment, raising the taxpayer’s base cost to reflect the interest charge incurred by holding on to the asset in order to realize the later step up.

full capital gain, but only the lesser amount that reflects the increased depreciation allowances to be enjoyed; equivalently, the full gain should be taxed at something lower than the rate against which the deductions are claimed.

Apart from the absence of an interest adjustment, recapturing is achieved under the present income tax provisions (which are to continue). The second charge, however. is entirely missing from the pre-CGT system; and asset sales consequently tax-favored. Since it requires that gains be taxed at less than the full rate, giving them the more favorable capital gains treatment is broadly appropriate: whether sales are encouraged or discouraged then depends on whether the effective rate of CGT is less or more than the product of the ordinary income tax rate and the depreciation allowances to be claimed per dollar of investment.

A number of countries, including the UK, provide rollover relief when the proceeds of an asset disposal are reinvested in similar assets: that is, the seller is deemed to have acquired the replacement assets at a base cost equal to the purchase price of those sold, so deferring liability. Such provisions - which run the risk of removing from charge the step up in basis - run counter to the logic of the argument above. It is sometimes argued, in support of such provisions, that taxing the gain on asset sales will intensify the lock-in problem. That ignores, however, the tax advantage of the step up in basis that is achieved by selling an appreciated depreciable asset. One way of viewing the approach described above is precisely as balancing the lock-in gain from holding onto the asset against the step up gain in selling: if the gain were not taxed, there would be an artificial incentive to sell. Thus no rollover provisions should be provided for depreciable assets.

It is also sometimes argued that taxation of gains on sales of real assets causes businesses, especially small ones, liquidity problems. The draft legislation responds to this concern by allowing the tax payment triggered by sale to be spread over five years. Since most of the assets concerned are depreciable over five years, the value of depreciation allowances allowed on their acquisition should be more than adequate to finance the delayed tax charges.

The benefit that investors enjoy from this provision, which is equivalent to receiving an interest-free loan from the government, appears a well-designed response to the 1iquidity issue. If, however, the relief is primarily intended to ease cash flow difficulties of smal1 enterprises, rather than to lock businesses into staying in the same line of activity, the benefit might be so retargeted.

Recommendations

- As in the present draft, do not given any rollover relief; and
- Consider restricting reinvestment relief to small businesses.

B. Business reorganizations

Proposal

The current draft is largely silent on this topic (beyond a rollover provision for transfers by natural persons into new business of which they hold more than 5 percent). Such reorganizations will instead fall under general provisions currently in the Income Tax Act.

Issues

To avoid distorting choice of business structures, provisions are needed to ensure that reorganizations which involve continuity of ownership do not trigger CGT liability. As the drafting procedure continues, the adequacy of the existing income tax provisions will need to be reviewed.

Recommendation

- Ensure that there will be no CGT consequence of business restructuring that involves no change of ownership.

VIII. Transition and implementation

This chapter reviews issues that arise in adopting the CGT.

A. Transitional arrangements

Proposals

Only capital gains arising after the implementation (or valuation) date of the tax are to be subject to CGT. The valuation date value of an asset may be determined by any of the following, at the option of the taxpayer: (i) the market value of the asset on the valuation date, to be determined within two years of the valuation date;[36] (ii) 20 percent of the proceeds of the disposal of the asset; or (iii) the time-apportioned base cost of the asset, calculated by adding to the acquisition cost of the asset an amount equal to the net proceeds of the sale reduced by the ratio of the number of years it was held prior to implementation to the total years held. Anti-avoidance measures mitigate the effects of excessive market valuations, and special rules restrict the cost basis in cases where the market value election yields anomalous results relative to both the actual acquisition costs of the asset and the proceeds from disposal.

Certain non-arms length and connected-party transactions during the period between the announcement of the CGT (February 23, 2000) and the valuation date will be disregarded in determining the date of asset acquisition and its base cost.

Issues

Incentive to overstate the valuation date value

When a CGT is introduced, the problem arises of determining a cost base from which to calculate the gain or loss on later disposal. One way to avoid this valuation problem is to apply the tax only to assets acquired after the implementation date of the tax (the approach chosen in Australia). This though creates severe a lock-in for assets acquired pre-implementation, since all future gains on such will be free of tax. It is much less distorting, and fairer, to proceed as proposed, subjecting to tax all assets acquired before implementation of the tax, but taxing only the gain that can be taken to have arisen after implementation.

Under this approach taxpayers do, however, have an incentive to overstate the cost basis of the asset, thereby generating a lower taxable net gain when the asset is sold. The anti-abuse rules proposed are similar to those used in a number of other countries that have introduced a CGT - in particular Canada, Ireland and the UK - and should be reasonably effective.[37] The fact that the taxpayer is in most cases given the opportunity to choose the

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[36] The deadline for valuation can be extended at the discretion of the Minister of Finance.

[37] However, Canada did not allow time apportionment when it introduced CGT, and Ireland eliminated the time apportionment option several years after introducing the tax.

method of calculation used to determine the cost basis will also limit the number of cases involving serious undervaluation of the cost basis.

Lead times for valuing assets

During the mission's discussions, concern was expressed that a sufficient time interval be provided in the law to allow the determination of market valuations for the large number of assets that are thinly traded and would thus require evaluation by a professional valuator. In this regard, the two year window provided in the draft law is welcome

Time apportionment

Allocating past gains on a straight line basis will allocate too much of the gain to the pre-implementation holding period if, as seems likely, those gains have accrued at a broadly constant proportionate rate. But it is wise to err on the side of generosity to the taxpayer and simplicity.

Incentive to split assets

The introduction of a CGT creates an incentive to split capital-gains producing assets, say among family members, to take advantage of several personal exclusions and also to lower total tax paid in the normal case where family members have widely differing incomes and face different marginal tax rates.[38] The draft law does not address this problem[39] The mission has no data on which to assess the possibilities for asset splitting, and it is unclear to what extent the incentive is attenuated by the gift tax and by anti-avoidance provisions in the income tax law.[40] At any rate, it appears that the asset could be split by selling parts (at fair market value) before the implementation date, so as not to trigger a tax liability, or by an inter-spousal gift of part of the asset, or by limited gifts, or even sale to dependent children. In the face of this uncertainty, it would be worthwhile assessing the issue, and if need be, to introduce provisions that will limit the opportunity for such avoidance.

[38] This incentive to split assets exists under an on-going CGT, but is enhanced in the period before the tax is introduced because the transfer does not result in a tax liability in the case where a capital gains occurs, and the cost base will be stepped up in any case on the valuation date.

[39] The non-arms length and connected party transactions rules in the draft law attempt only to control manipulation of the cost basis of the asset, not attempts to split the asset. In addition, the attribution rules with regard to spouses an children in the draft apply only to transactions after the implementation date.

[40] Inter-spousal gifts are exempt under the donations tax, while gifts to dependents in excess of the exemption level are taxable. Sales to dependents at fair market value are not subject to donations tax. While it is the case that for connected party transactions the purchaser inherits the cost base of the seller, this does not bite when the asset's cost base will in any event be revalued at the valuation date. It is unclear whether existing anti-avoidance rules in the income tax would catch the transactions contemplated here.

Recommendation

- Assess the incentive and opportunities for taxpayers to split capital-gains producing assets among family members each possessing a personal capital gains tax exclusion, and facing different marginal tax rates.

B. Implementation

Proposal

It is proposed that the CGT take effect from April 1, 2000.

Issues

Some concern has been expressed that this effective date may be too tight. Detailed draft legislation was made public on December 12, 2000 (differing in significant ways - in the treatment of unit trusts, for example - from previous announcements). Parliamentary scrutiny will begin in the latter part of January.

The mission has not looked in depth at issues of administration and compliance, but a few observations may nevertheless be helpful.

Preparations at SARS are underway. The first assessments affected will be of those dying after April 1 and of companies with tax years starting after April 2. Thereafter the assessment work will build up before starting in full when the individual tax returns are received after the close of the individual tax year on February 28, 2002. There is thus some lead time, which will need to be used well in training officials and developing audit strategies.

The private sector has less leeway. Unit trusts will be required to provide information on disposals by final investors from the effective date onwards. The mission is not in a position to judge how far this adds to their normal management information activities. More generally, a period of less than two months between final legislation and implementation may give little time for taxpayer education and legitimate planning activities.

It is important to the long run effectiveness of the tax, and to sustain taxpayers' respect for the wider tax system, that the CGT be effectively implemented from the outset. As the legislative and consultative process moves forward, account should be taken - and more information obtained on - any legitimate compliance concerns of the private sector.

There remain outstanding issues of detail on the legislation (ensuring proper treatment of business reorganizations, for instance), on which further technical assistance might usefully be sought.

Recommendation

- Seek further technical assistance on drafting issues.

IX. Economic impact of the CGT

This chapter provide a selective account of the likely effects of the CGT on some key aspects of economic performance.

A. Savings and investment

Especially given the low levels of saving and investment in South Africa, there is concern as to the effects of the CGT on these key aggregates. The mission believes they are unlikely to be large, and may even be beneficial.

Savings and investment are not the same thing in an open economy, the difference between them being capital flows with the rest of the world. Although South Africa retains some exchange controls on capital account, there appears to be significant openness on capital account. Since CGT is to be levied on a residence basis (except for immovable, less of a concern in this context), and so will not apply to foreign investors, effects on savings and investment must therefore be considered separately.

Investment

To the extent that foreign investors in South Africa (both direct and portfolio) are free to adjust their holdings, the impact on aggregate investment is likely to be small. Such investors are not directly affected by the CGT. Moreover, projects that the tax makes less attractive to South African residents are likely to become more attractive to non-residcmts. Thus any decline in residents' savings is likely to be offset by a capital inflow from abroad that leaves aggregate investment unchanged.

Savings

A residence-based CGT will tend to reduce the after-tax return that South Africans can earn on their savings (whether at home or abroad). But there are several reasons to believe that the effect on their savings will be small.

First, the CGT will directly affect only the after-tax return on capital gains assets. The return that residents can earn by investing in interest-yielding assets (at home or abroad) is unaffected. So it is only to the extent that investors' marginal assets are capital gains ones that there will be any effect on the incentive to save. (This is consistent with there being no effect even for investors who hold substantial amounts of gain assets: if they are constrained in the amount of such assets they hold, and so also hold lower yielding interest income, for instance, then even if the CGT affects the return on their intra-marginal assets it will not affect their incentive to save at the margin).

Moreover, to the extent that taxpayers are able to evade residence-based taxes by investing abroad and failing to report the income - a common problem around the world - they may also be able also to escape CGT; including, perhaps, gains on assets located in South Africa (by, for example, investing in South African companies listed abroad). While the new controlled foreign corporation rules provide some protection against this (by bringing into tax passive income earned through South African companies located abroad), some degree of evasion by investing abroad - perhaps a considerable amount - must be expected.

Second, the proposed effective rate of CGT is so low that - even for those whose marginal savings are affected - the impact on the net return on capital gains assets will be relatively small. Take, for example, an investor paying tax at the top marginal rate of 42 percent who holds an asset that yields a 10 percent capital gain each year. If the asset is to be sold after seven years, the CGT reduces the after-tax internal rate of return by only 0.8 points, to 9.2 percent; even if sold after two years, the net return falls only to 9 percent.

Third, empirical evidence from many countries suggests that savings are relatively unresponsive to the net interest rate. Combining this with the slight impact on net returns just described gives a small effect on savings. Suppose, for instance, an elasticity of savings with respect to the net interest rate of 0.4, which is at the high end of estimates for developed countries. Taking the impact on the net return for an asset held for two years in the preceding paragraph, savings would fall by 0.4 percent. For longer holding periods, the effect is even less.

Finally, to the extent that the CGT increases tax revenue it will tend to increase the savings of the public sector, so tending to offset any reduction in private saving. The extent of this effect is discussed in Section D below.

B. Financial decisions and financial markets

Financing decisions

At present, many corporation will find it attractive to finance their activities by retaining earnings rather than borrowing. This is because the cost of borrowing is reduced only by the 30 percent rate against which the corporation may deduct interest, whereas the cost of retaining earnings (the interest that the shareholder forgoes), is reduced by personal tax at up to 42 percent.[41] By increasing the tax payable on retained earnings, the CGT will thus go some way towards rectifying the tax bias towards retention finance created by the currently large excess of the top marginal rate of personal income tax over the rate of corporation tax. To eliminate this bias, it would be necessary (assuming shareholders pay at the top marginal rate) to tax accrued capital gains at a rate of about 17 percent.[42] Since the nominal rate of CGT for such shareholders will be only 10.5 percent, a preference for retentions remains. Eliminating it would require raising the inclusion rate to over 40 percent.

[41] Note that the cost of retaining earnings is not affected by the STC on dividends: retaining profits means avoiding dividend tax today, but dividend tax will have to paid in the future on the additional distributions that the retention generates. So long as the rate of STC does not change, it thus cancels out of the Calculation. The STC does, however, increase the cost of new equity finance, since in that case the dividend tax could be avoided by simply not purchasing the new shares.

[42] The calculation here is to find the accrual-equivalent rate of CGT, z, that equates the net return on R1 of interest payment (1-0.42) to that on R1 of retained corporate earnings (which is (1-0.3)(1-z)).

These considerations bear too on the 'dividend stripping' problem: the concern that taxpayers may pay dividends in order to reduce the value of the firm and so reduce their capital gains liability. This is unlikely to be a serious problem (and in any event should be less severe than under the present CGT rate of zero). First, if paying a dividend of R100 reduces the asset value by R100, then the additional CGT that a top rate taxpayer is thereby saved, R10.5, is less than the additional SCT of R12.5 incurred on the dividend. Second, to the extent that the asset value reflect anticipated future dividends. which will bear CGT, distributing R100 will increase the share price by less than R100, further increasing the tax penalty to the operation.

Indeed the more serious potential problem is the reverse of dividend stripping: the relatively low tax rate on capital gains gives firms an incentive to make payments to their shareholders by cutting dividends and instead repurchasing their own shares. Existing provisions of the income tax already close this opportunity, however, by deeming repurchases to be dividends (equal to the excess of price paid over capital subscription).

Asset prices

The CGT will tend to reduce the price of taxable gains-bearing assets (and, potentially, increase the price of those carrying capital losses). Take, for example, an investment that yields some fixed payment at its termination and nothing before; something like a forest that yields a cash flow only when the trees are cut and sold. Suppose too that the investment yields a pre-tax return of 10 percent per annum, and - as is realistic - that there is available to investors some non-CGT asset that yields an unchanging 10 percent after-tax return.[43] Then capital gains assets will have to earn that return too, and so the effect of the tax will be felt in a reduction in asset prices. With a two year holding period, the price falls by only 1.8 percent. The impact is larger, however, for longer holding periods (because the realized gain is larger), and becomes potentiality sizable: with a seven year holding period, price falls by 5.1 percent. The impact on long-lived assets, such as buildings may be noticeable even at the low intended rate.

Conversely, assets exempted from the CGT, including private residences and exempt private use items, are likely to increase in price as they acquire value as a shelter against CGT. Thus the tax will confer - and to the extent that it has already been discounted by the markets, already has conferred - a windfall gain on holders of such assets. This gain will be greater for assets, such as residences in prime locations and collectibles, that are in relatively inelastic supply.

C. Equity

A central attraction of a CGT is that it most of its revenue comes from those most able to pay it, thus enhancing the progressivity of the income tax. The proposed CGT is designed

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[43] This is the key difference between this example and that used above in discussing the impact on after-tax rates of return.

to be especially progressive, and likely to raise most of its revenues from the wealthiest South Africans.

No data exist upon which to base a firm estimate of the impact of a CGT by income group, but experience elsewhere confirms that the tax is highly progressive. In Canada (1997), 1 percent of returns accounted for 60 percent of capital gains; the same was true in the US (1993). In the UK, less than 0.1 percent of returns accounted for 60 percent of reported capital gains in 1997-1998, and paid more than 75 percent of all CGT taxes.

Capital gains are an important source of income for the wealthy, but much less so for the middle class. Over a ten-year period, capital gains accounted for almost 40 percent of the income of the richest 1 percent of taxpayers in the US. (Congressional Budget Office, 1997) By comparison, they made up only 5 percent of income for all non-elderly taxpayers, and 14 percent of income for all those over age 64.

For several reasons, the proposed South African CGT is likely to be even more progressive than even the highly progressive tax in the US: the proposed annual exclusion would remove from CGT a large percentage of South Africans; the distribution of income is much more skewed to the wealthy in South Africa; and the exclusions for principal residences and certain sales of businesses targets the CGT at those with substantial wealth.[44]

D. Tax revenue

A major goal of taxing capital gains is to increase tax revenue, both directly from the CGT and indirecty by improving the effectiveness of the regular income tax.

Experience elsewhere

As shown in Table 9.1, revenue from taxing capital gains varies widely across countries, depending on the base and rates of the tax and the robustness of the economy. In the US and Ghana, capital gains tax revenues account for over 2 percent of tax revenue: in many others it is much less, indeed barely perceptible.

Little evidence exists on the size of the indirect effect on the income tax base. This is extremely hard to measure, because capital gains tax changes are often accompanied by other major changes in tax rates or the tax base, confounding efforts to isolate the effect of the CGT alone. Nonetheless, there is no doubt that the lack of an effective CGT creates an incentive to convert other taxable income into untaxed capital gains.

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[44] It is sometimes said the progressivity of the CGT is overstated because the wealthiest are most able to engage in tax avoidance measures. That argument may itself be overstated. Despite a flourishing tax advice industry, the wealthy pay a great deal of tax on capital gains. Auerbach, Burman, and Siegel (1998) looked for evidence of the simplest form of tax avoidance by the rich - realizing capital losses and deferring capital gain - and found some, but much less than might be expected.

Far from vanishing, taxes on capital gains have actually been growing in revenue importance over the last two decades. In the 1980s, capital gains averaged 0.49 percent of revenues among the countries shown in Table 9.1; over the 1990s. the figure rose to 0.78 percent. Thus, if South Africa had typical experience of countries with a CGT, it could eventually expect to yield about R1.5 billion in annual revenue based on 1999/2000 tax revenues of about R200 billion.

Estimating likely CGT revenues

Lack of data makes it impossible to give a precise estimate of the revenue gain from the proposed CGT. Indirect evidence from several sources, however, suggests that the tax could eventually provide R1-2 billion per year.

The data limitations are daunting. Not surprisingly, no data exist on realizations of capital gains. But there are also no hard data on wealth holdings by individuals and businesses from which to make an estimate of capital gains. Instead, this section bases its estimates on three indirect approaches.

Table 1. South Africa: CGT revenues in selected countries

(In percent of tax revenue)

	1980-89	1990-99
Australia	0.07	0.18
Denmark	0.03	0.04
Finland	0.12	0.03
France	0.03	0.00
Ghana	N/A	2.84
Ireland	0.19	0.46
Italy	0.38	0.32
Korea	0.00	2.19
Netherlands	0.05	0.06
Spain	0.04	0.00
Sweden	0.26	0.26
Switzerland	0.99	0.81
United Kingdom	0.72	0.48
United States	2.53	2.43
Overall average (Unweighed)	0.49	0.78

Sources: IMF, GFS, OECD, Revenue Statistics database (November 2000); and staff estimates.

Approach 1 (Based on capital income in the National Income Accounts)

The South Africa Reserve Bank (SARB) estimates that capital income in South Africa totaled R171 billion in 1999. Based on comparable data from the US, about 12 percent of that - some R20 billion-could be expected to be taxable capital gains.[45] At an average tax rate of 10 percent, that would yield about R2 billion in individual capital gains tax revenue. Applying a 50 percent reduction for the exclusion and noncompliance, the yield would be about R1 billion per year (at current income levels) once the tax is fully phased in.

Approach 2 (Based on stocks of capital assets)

The SARB reports that life insurers held R317 billion in shares of stock in the first quarter of 2000. Aron and Muellbauer (1999) estimated that shares of stock held by households equaled about 25 percent of disposable income in 1999; disposable income was R774 billion, implying that households held roughly R193 billion in shares (directly and indirectly). Thus, in total, about R511 billion of corporate stock would potentially be subject to the individual CGT. Some of the shares held by insurers will be untaxed because they are pension assets, and others will be subject to the 15-percent effective capital gains tax rate on corporations, so the effective tax rate on shares held by insurers could be higher or lower than that on individuals. Also, this total excludes business assets and real estate, most of which will probably escape CGT.

By calculations outlined in Table 9.1, under plausible assumptions, capital gains realizations would come to average about 8 percent of the value of capital gains assets: about R41 billion.[46] Assuming a 10 percent average CGT rate, potential revenue would total about R4 billion. Applying again a 50 percent loss from the exclusion and noncompliance, this produces an ultimate yield of R2 billion.

Table 9.1. South Africa: Approach 2 to estimating revenue from the CGT

a)	Long-term insurance shares	R299	
b)	Short-term insurance shares	R18	
c)	Trusts and stock 1/	R194	
d)	Total value of assets	R511	(a)+(b)+(c)
e)	Steady-state realization rate (percent)	8	
f)	Steady-state gains	R41	(d)*(e)
g)	Tax (10 percent average rate)	R4.1	

1/ Muellbauer and Aron estimate (25 percent) *R774 billion disposable income.

Approach 3 (Comparing gains-to-GDP ratio)

The top individual CGT rate in South Africa of 10.25 percent would be about 37 percent of the top CGT rate in the US over the last decade. That tax has raised from 1.9 to 5.2

[45] The capital income series does not exist in the US, but a similar number maybe constructed by adding interest, dividends, and corporate profits. Taxable capital gains averaged 12 percent of that estimate of capital income in the 1990s.

[46] See Appendix 2 for a derivation of the long run rate of capital gains realizations.

percent of GDP over the past ten years, averaging about 2.9 percent. Since the US tax rate is almost 3 times as large as the top South African tax rate, one would expect the yield here to be smaller. But certain features should enhance revenue in South Africa relative to the US. The lower rate should deter evasion and avoidance compared with the US, although the US has more resources to devote to enforcement than will be possible in South Africa for some time. Also South Africa has a broader base in several important respects - most notably, taxing capital gains at death. Gains in South African financial markets, however, have lagged behind gains in the US. Although that situation could easily reverse itself, suppose conservatively that South Africa would generate one half the gains of the US relative to GDP and that they would be taxed at one-third of the rate in the US. South Africa might generate about 0.5 percent of GDP as individual capital gains.[47] Using this very rough estimate, steady state gains - gains, that is, when the 'overhang' of pre-effective date gains has been eliminated - would be about R4 billion at 1999 levels of GDP. (The absolute amount of this revenue gain would be expected to grow with GDP).

Assuming once more that the exclusion and noncompliance further reduces the revenue by about half, the CGT would yield about R2 billion.

All three approaches lead to estimates consistent with the experience of other countries. It is therefore reasonable to conclude that, in steady state, the direct gain in revenue is likely to be on the order of R1 -2 billion per year, although this estimate carries more than the usual burden of uncertainty. In addition, an unquantifiable additional gain arises from discouraging income tax avoidance.

The build-up of CGT revenues after introduction

Some argue a new CGT that applies prospectively to gains after the date of enactment would produce little revenue for many years. That is too pessimistic.

Assuming 15 percent growth in nominal asset values, unrealized capital gains would comprise nearly a quarter of asset value in two years and half of asset value in five. Thus, substantial capital gains can arise fairly quickly after introduction. At that growth rate, if 20 percent of taxable assets turn over every year, capital gains would equal 8.6 percent of asset value in long-run steady state.[48] Gains would equal 4.4 percent of share value after only two years and 6.6 percent over four, so the steady-state is approached quite quickly. This is illustrated in Figure 9.1.

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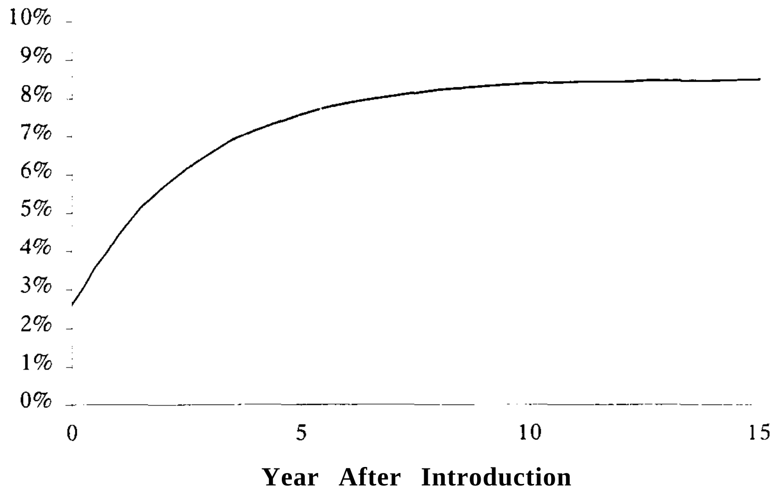
[47] This ignores corporate capital gains, which experience suggests will be a relatively small source of revenue.

[48] Appendix 2 derives a useful formula for the steady state revenue from the CGT, relative to the value of the stock of assets, as a simple function of the realization rate r and the rate at which capital gains accrues , showing this to be simply rg/(r+g). If 20 percent of all shares are sold each year, for instance, and gains arise at 15 percent per annum, steady state CGT revenues will be 8.57 percent of the value of the stock market. The appendix also sets out the detail of simulating the transition path of revenues to that steady state.

Figure 9.1. South Africa:
Realized Gain per Dollar of Share Value
By Number of Years from the Effective Date



Note: Accrual rate = 15%
Realization rate = 20%

Applying the phase-in pattern in Figure 9.1 to the R511 billion capital stock estimate derived in approach 3 above, and assuming a 15 percent nominal rate of growth in asset value, the CGT would yield less than R0.5 billion in the first year, but about R8 billion cumulatively over the first five years, and about R42 billion over the first ten. Thus, the CGT has the potential to be a small but worthwhile source of revenue.

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Technical appendix 1. The proper tax treatment of inter-business sales of depreciable assets

Suppose that at time 0 a business acquires an asset at price P(0). If the business holds the asset forever, it enjoys depreciation deductions of, in present value:

$$A(\infty,r)P(0), \tag{1}$$

where A(S,r) denotes the present value of depreciation allowances, per R1 invested, if the asset is held until time S and the interest rate is r.[49] If, on the other hand, the asset is sold at time T to another business for a price P(T), with that asset now treated for depreciation purposes in the same way as a new one, then the present value of allowances enjoyed by seller and buyer together is:

$$A(T,r)P(0) + A(\infty,r)P(T)e^{-rT}. \tag{2}$$

If the amounts in (1) and (2) differ, the tax system will - in the absence of any other measures - bias businesses towards either retaining the asset (if (1) exceeds (2)) or selling (conversely). To ensure that the tax system does not distort this aspect of real business decisions, a charge must be imposed in the event of sale that exactly offsets any difference between (1) and (2).[50]

Denoting by τ the tax rate against which depreciation deductions are taken, the required balancing charge at time T is:

$$\tau A(T,r)P(0)e^{rT} + \tau A(\infty,r)\{P(T) - P(0)e^{rT}\}. \tag{3}$$

This has two components:

- ➢ The first corresponds broadly to the recoupment of depreciation allowances enjoyed by the initial purchaser prior to sale that is already provided for in the income tax. The only difference is that the recoupment in (3) is not, as the law provides - in South Africa as elsewhere - of the undiscounted sum of depreciation allowances enjoyed (which is A(T,O)P(0)), but of their present value as of time T; that is, the recovery should in principle also include an interest charge.

- ➢ The second component eliminates the increase in depreciation allowances due to the step up in basis on sale. This too should in principle include an interest adjustment to basis to reflect the loss that the business has in effect suffered by having to wait for the step up. More fundamentally, note that this charge is not equivalent to taxing the full gain at the ordinary tax rate τ: it is not the gain as such that should be taxed, but

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[49] With declining balance depreciation at rate δ for example, $A(S,r) = (\delta/(\delta + r))(1 - e^{-iS})$. (The argument in the text applies to any depreciation schedule).

[50] The tax implications of this neutrality condition were first discussed by Brannon and Sunley (1976).

> the increased depreciation deductions it allows. Since $A(\infty, r)<l$ (even if the asset is entirely written off over its lifetime, deferral makes the present value of the deductions per R1 less than Rl), and since the basis should be increased to reflect interest foregone by the purchaser, the gain should be taxed at less than the ordinary rate. All else equal, the rate of tax on the gain should be lower the more slowly the asset is depreciated.

There are schemes that achieve the required effect without levying any explicit charge at the time of sale. The purchaser might be required to continue to depreciate on the same basis as the seller. Alternatively, the initial purchaser might be allowed to take the present value of deduction as an immediate deduction, with no allowance available to subsequent purchasers.[51] Used assets would then sell at a discount that reflects the non-availability of any allowance to subsequent purchasers, leaving the initial owner indifferent, in tax terms, to selling or retaining.

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[51] For example, with straight line depreciation over five years and an interest rate of 10 percent, the present value of allowances is $A(\infty, 0.1)= 0.83$; the initial purchaser under this scheme - proposed by Auerbach and Jorgenson (1980) - would immediately expense 83 percent of the purchase price.

Technical appendix 2. Estimating Time Path of Realizations and Steady State Levels

This appendix develops a simplified model of capital gains accruals and realizations and explains how it can be used to calculate the time path of realizations after a CGT is introduced, as illustrated in Figure 9.1.

If an asset gains value at a fixed rate and realizations are a fixed percentage of assets, then both the time path and steady state level of gains realizations may be calculated. Assume that gains grow at the constant rate g and that realizations occur at rate r. Assume for simplicity that gains occur discretely at the end of each period and that realization decisions happen at the same time. Assume also that taxes on capital gains are paid out of other income (so that payment of tax does not affect the rate of growth of asset value). Finally, normalize the initial value of assets to equal 1.

Under these assumptions, the value of asset at the beginning of time period t is:

(1) $V_t = (1+g)^t$ where $t = 0,1,2, \ldots$

The base cost of an asset is determined as follows:

(2) $B_t = rV_t + (1-r)B_{t-1}$

(with $B_0 = V_0 = 1$).

This simply states that the basis is the purchase value of assets sold at the end of last period plus the base cost of assets held last period. Solving the recursive equation yields the following expression:

(3) $B_t = rV_t + (1-r)rV_{t-1} + (1-r)^2rV_{t-2} + \ldots + (1-r)^{t-1}rV_1 + (1-r)^tV_0$

The accrued gain at the beginning of period t is:

(4) $A_t = V_t - B_t$

Substituting from (3) yields

(5) $A_t = V_t - [rV_t + (1-r)rV_{t-1} + (1-r)^2rV_{t-2} + \ldots + (1-r)^{t-1}rV_1 + (1-r)^tV_0]$

Dividing through by V_t produces the accrued gain as a percentage of asset value:

(6) $A_t/V_t = 1 - \{r + r(1-r)/(1+g) + \ldots + r[(1-r)/(1+g)]^{t-1} + [(1-r)/(1+g)]^t\}$

Defining

(7) $\beta \equiv (1-r)/(1+g) < 1,$

expression (6) is simply a partial geometric series plus another term. The solution is:

(8) $A_t/V_t = 1 - r\ \{(1-\beta^t)/(1-\beta)\} - \beta^t$

After some algebraic manipulation, (8) may be rewritten as:

(9) $A_t/V_t = \{(1-r-\beta)/(1-\beta)\}(1-\beta^t)$

Substituting from (7) into (9) and doing some further algebraic manipulation, (9) may be rewritten as

(10) $A_t/V_t = (1-r)g/(g+r)\ [1-\beta^t]$

Since β is less than 1, it vanishes as t gets large. Thus, the steady-state ratio of accrued capital gains to value is

(11) $A/V = (1-r)g/(g+r)$

Under the assumptions of the model, realizations (R_t will simply be a fraction, r, of accrued gains carried into the period, A_t, plus increases in share value during the period, gV_t. That is,

(12) $R_t = r[A_t + gV_t] = rV_t\ [A_t/V_t + g]$

Since realizations happen at the end of the period, it is helpful to show realizations as a fraction of end-of-period value, V_{t+1}. Since $V_{t+1} = (1+g)V_t$, that ratio may be written as:

(13) $R_t/V_{t+1} = r/(1+g)\{(1-r)g/(g+r)[1-\beta^t] + g\}$

$= rg/(1+g)\ \{(1-r)/(g+r)[1-\beta^t] + 1\}$

In the steady state, $t \rightarrow \infty$, and $\beta^t] \rightarrow 0$. Thus, steady-state realizations are

(14) $R/V = rg/(1+g)\ \{(1-r)/(g+r) + 1\}$

$= rg/(1+g)\ \{(1+g)/(g+r)\}$

$= rg/(g+r)$

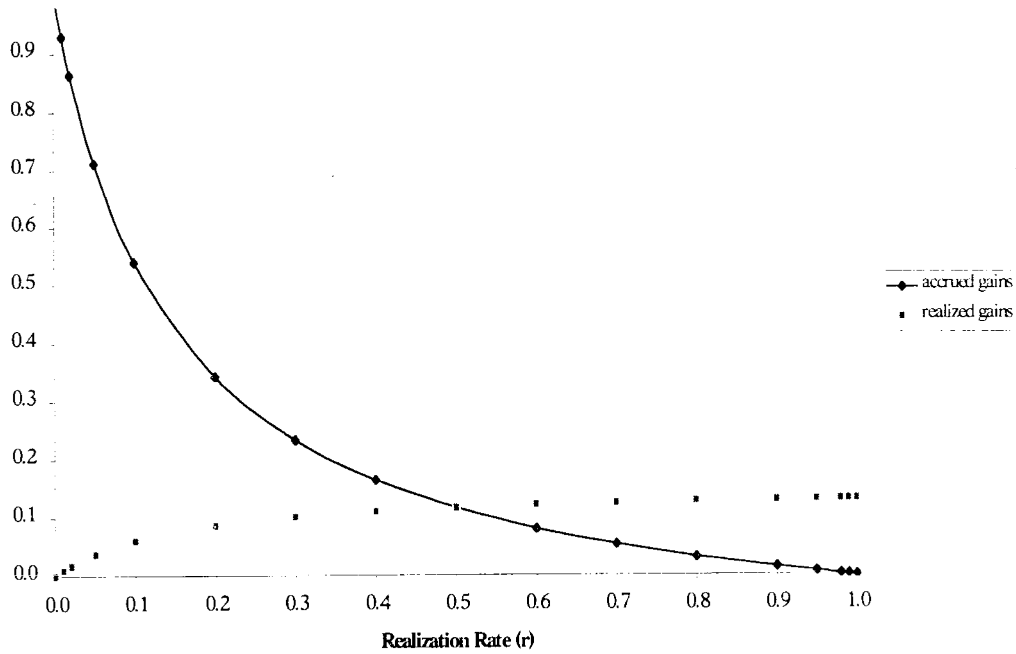
Note that equation (13) can be used to calculate realizations during the phase-in period (including the value of β^t for each time period). Note that period t=0 actually refers to the first year, since equation (13) refers to the end of period 0, and t=l refers to the second year, etc. To make the revenue calculations referred to in the text, it was assumed that the realizations reported for each year equal ½ of realizations from the end of the prior year and ½ of realizations for the end of the current year.[52]

[52] The mission intends to leave a copy of the spreadsheet that produced these estimates with the authorities.

The value at the end of the period (after assets have appreciated and gains have been realized) is simply A_{t+1}/V_{t+1}.

Figure A2.1 shows steady state realization and accrual ratios for different realization rates, (r).

Figure A2.1 South Africa Steady-State Gain as Fraction of Share Value by Realization Rate



Note: Asset growth rate (g) =15%