REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

TAXATION LAWS AMENDMENT BILL, 2001

[W.P.1—'01]

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List of Abbreviations

CFE: Controlled foreign entity
CGT: Capital gains tax
STC: Secondary tax on companies
TAB: Time-apportionment base

INTRODUCTION

The Taxation Laws Amendment Bill, 2001, introduces amendments to the Transfer Duty Act, 1949; the Estate Duty Act, 1955; the Income Tax Act, 1962; the Stamp Duties Act, 1968; the Value-Added Tax Act, 1991; and the Skills Development Levies Act, 1999.

INTRODUCTION OF CAPITAL GAINS TAX ("CGT")

The Minister of Finance announced in his Budget Speech on 23 February 2000 that a CGT was to be introduced with effect from 1 April 2001. A guide to the key principles of the proposed CGT was published on 23 February 2000 and public comment was invited. As a result, SARS and the National Treasury received and considered over 300 submissions and held meetings with a number of associations and industry groupings.

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

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

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

DESIGN AND CORE RULES OF CAPITAL GAINS TAX ("CGT")

It was decided to incorporate the CGT as an integral part of the Income Tax Act as CGT is regarded as a tax on income. This approach has administrative advantages as the existing provisions and procedures of the Income Tax Act can be used to collect CGT. If CGT was introduced as a separate tax, provisions would have had to be introduced for matters such as returns, assessments, payment and recovery of tax, and objection and appeals, which are already provided for in the Act.

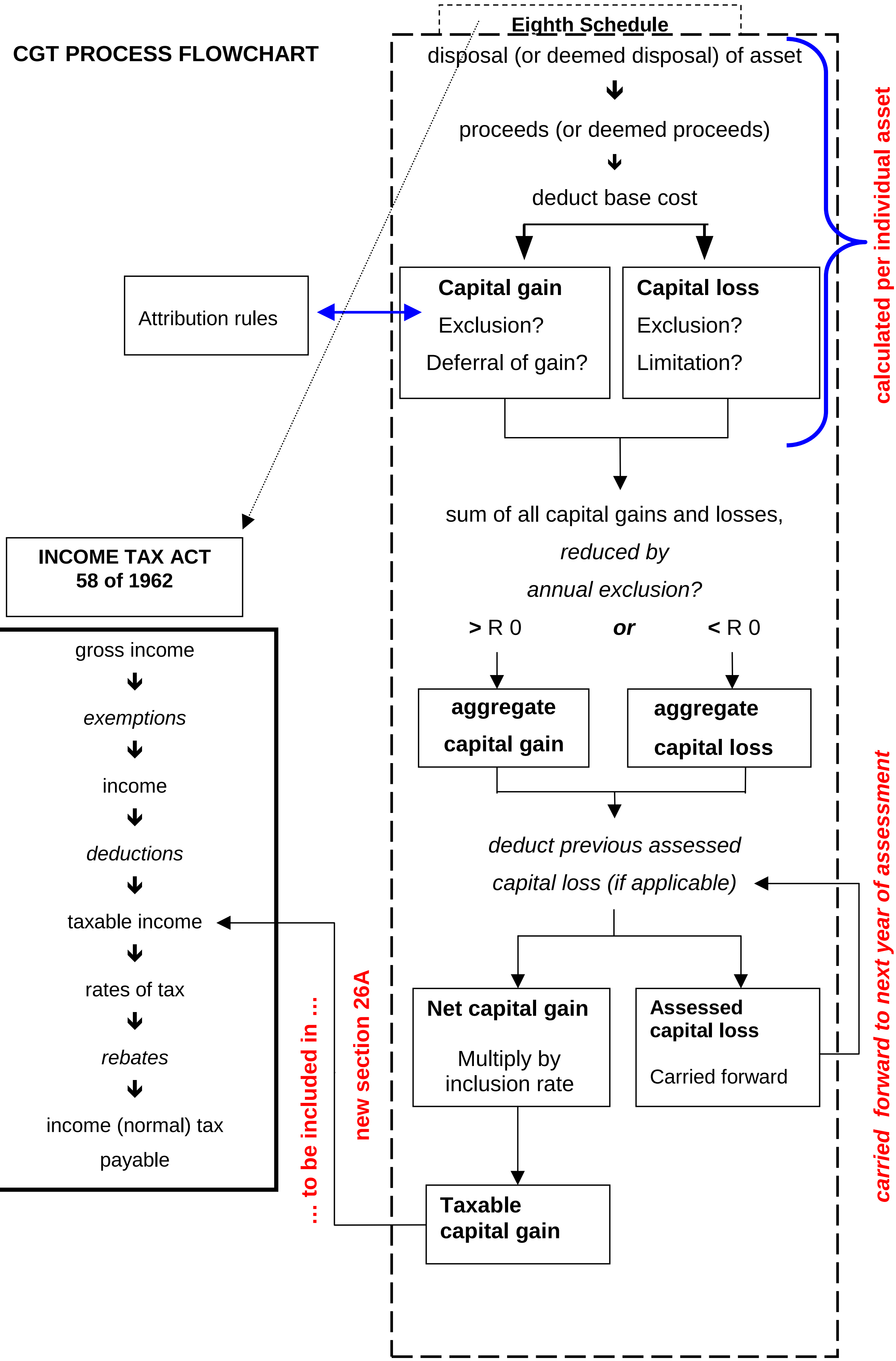
The proposed Bill furthermore makes provision for a number of changes to the present Income Tax Act to deal with consequential issues and to ensure that the administrative procedures of that Act operate for CGT.

A number of consequential amendments had to be introduced to other Acts, such as the Transfer Duty Act, the Stamp Duties Act and the Secondary Tax on Companies (STC), to cater for a concession to allow natural persons to transfer their primary residences from companies or trusts to themselves free of transfer duty, stamp duty, CGT and STC.

An Eighth Schedule has been proposed in terms of which the amount of the taxable capital gains and assessed capital losses will be determined. A new section 26A has been proposed in terms of which the taxable capital gain will be included in the person's taxable income, which therefore forms the link between the Act and the Eighth Schedule.

It will be observed that the style of drafting used in the Eighth Schedule differs from that used in the rest of the Act. The intention is to make the Act more accessible and a start has, therefore, been made in this Schedule to strike a balance between simplicity and clarity on the one hand, and technical correctness on the other.

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



CGT PROCESS FLOWCHART
Eighth Schedule
disposal (or deemed disposal) of asset
proceeds (or deemed proceeds)
deduct base cost
Capital gain
Exclusion?
Deferral of gain?
Capital loss
Exclusion?
Limitation?
calculated per individual asset
Attribution rules
sum of all capital gains and losses,
reduced by
annual exclusion?
> R 0
or
< R 0
aggregate capital gain
aggregate capital loss
deduct previous assessed
capital loss (if applicable)
Net capital gain
Multiply by inclusion rate
Assessed capital loss
Carried forward
carried forward to next year of assessment
Taxable capital gain
INCOME TAX ACT
58 of 1962
gross income
exemptions
income
deductions
taxable income
rates of tax
rebates
income (normal) tax
payable
… to be included in …
new section 26A

OVERVIEW OF THE CORE PROVISIONS OF CAPITAL GAINS TAX

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

Determination of a capital gain or loss

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

The happening that really triggers any CGT event is the disposal of an asset. Unless such a disposal occurs, no gain or loss arises.

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

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

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

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

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

The rules around base cost are, however, fully dealt with in Part V of the Eighth Schedule.

The following example illustrates the calculation of a capital gain:

Example

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

Asset	100 shares
Disposal event	Sale of the shares
Proceeds	R30 000 (Sale price)
Base cost	R10 000 (Purchase price)
Capital gain	= R30 000 – R10 000
	= R20 000

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

Various capital gains or losses must be disregarded or are limited for purposes of determining a capital gain or loss. These limitations and disregardings are dealt with in Parts IV, VII and VIII.

The Eighth Schedule also provides for the roll-over of certain capital gains. In these circumstances the recognition of these gains are delayed for CGT purposes and held over until the happening of a future event. These rules are dealt with in Part IX.

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

Aggregate capital gain or aggregate capital loss

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

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

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

- Firstly, all a person's capital gains and/ or losses are added together; and
- thereafter, the total amount of such capital gains and/or losses is reduced by the annual exclusion, i. e. R10 000, in the case of a natural person.

Example

Capital gain on sale of holiday house	50 000
Capital loss on sale of shares	20 000
Sum of capital gains and losses	30 000
Annual exclusion	10 000
Aggregate capital gain	R20 000

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

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

Determination of net capital gain or assessed capital loss

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

Example 1

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

Example 2

Aggregate capital loss for 2003	50 000
Assessed capital loss for 2002	50 000
Assessed capital loss for 2003	R100 000

Determination of taxable capital gain

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

The proposed inclusion rates to be used in arriving at a taxable capital gain are set out in the table below.

Type of Taxpayer	Inclusion rate %	Statutory rate %	Effective rate %
Individuals	25	0 – 42	0 – 10.5
Retirement Funds	N/A	0	N/A
Trusts • Unit • Special • Other	 N/A 25 50	 30 0 – 42 32 – 42	 N/A 0 – 10.5 16 – 21
Life Assurers • Individual policyholder fund • Company policyholder fund • Corporate fund • Untaxed policyholder fund	 25 50 50 0	 30 30 30 0	 7.5 15 15 0
Companies	50	30	15
Small business corporations	50	15 – 30	7.5 – 15
Employment companies	50	35	17.5
Permanent establishments (branches)	50	35	17.5
Tax holiday companies	50	0	0

Inclusion of taxable capital gain in taxable income

Once a person’s taxable capital gain has been determined, that taxable capital gain is included in the person’s taxable income in terms of section 26A of the Income Tax Act, 1962. Thereafter, the ordinary rates of tax are applied to the person’s taxable income (which now includes taxable capital gains) to determine a person’s normal income tax liability.

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

CLAUSE 1

Amendment of section 1 of the Transfer Duty Act, 1949

Subclause (a): it is proposed that a definition of "company" be inserted in this Act which is similar to that used in the Income Tax Act and includes both foreign and local companies, associations and close corporations.

Subclause (b) and (c): it is proposed that the definition of “property” be amended to refer specifically to land in the Republic. A definition of “Republic” thereafter follows in *subclause (c)*.

Subclause (d): As the word ”spouse” used in the above-mentioned Act does not include a number of persons who are married or are partners in a marital-like union, the provisions of the Act may be unconstitutional. It is proposed that a definition of ”spouse” be inserted to provide that the word "spouse" includes a partner of a person—

a) in a marriage or customary union recognised in terms of the laws of the Republic;
b) in a union recognised as a marriage in accordance with the tenets of any religion; or
c) in a same sex or heterosexual union which the Commissioner is satisfied is intended to be a permanent.

It is also proposed that, in the absence of any proof to the contrary, the marriage or union contemplated in *(b)* and *(c)* be deemed to be a marriage or union without community of property.

CLAUSE 2

Amendment of section 9 of the Transfer Duty Act, 1949

The definitions of ”an interest” and ”primary residence” in paragraph 44 of the Eighth Schedule to the Income Tax Act, 1962, exclude residences owned by companies (including close corporations) or trusts from the concession of disregarding R1 million of the capital gain made on the disposal of a primary residence. In order to allow persons whose residences are owned by a company or trust to enjoy the R1 million exclusion from CGT, a number of tax concessions have been made to assist these persons to transfer ownership of the property from the company or trust into their hands. A limited period is proposed during which the transfer can be made free of transfer duty and stamp duty. The transfer of the residence must be at market value and it is proposed that no CGT will be payable on the gain.

In the case of companies, it is proposed that the potential liability to STC as a result of the declaration of the residence as a dividend *in specie*, or the declaration of dividends out of the gain on the disposal of the residence, be exempt from this tax. All of these concessions are subject to certain conditions being met. The conditions proposed which must be met to enjoy the transfer duty exemption on the transfer of a residence from a company are—

- the acquirer of the residence must be a natural person and that residence must constitute that person's ”primary residence” for CGT purposes when acquired by that natural person;
- the acquisition must take place on or after the promulgation of the Taxation Laws Amendment Act, 2001, but not later than 30 September 2002;
- the natural person alone or together with that person's spouse must hold all the share capital of the company or member’s interest in the close corporation, as the case may be, from 5 April 2001 to the date of registration in the deeds registry of the residence in the name of the natural person or jointly in the name of that person and that person's spouse;
- that natural person or that person's spouse must have ordinarily resided in that residence and used it mainly for domestic purposes as his or her or their ordinary residence from 5 April 2001 to the date of that registration;
- that registration of the residence must take place not later than 31 March 2003.

It is proposed that the exemption, only apply in respect of the portion of the land on which the residence is situated and unconsolidated adjacent land as—

- does not exceed two hectares;
- is used mainly for domestic or private purposes together with that residence; and
- is disposed of at the same time and to the same person as the residence.

The conditions proposed that must be met on the transfer of a residence from a trust are—

- the person acquiring the residence must be a natural person and that residence must constitute that person's "primary residence" for CGT purposes when acquired by that natural person;
- the acquisition must take place on or after the promulgation of the Taxation Laws Amendment Act, 2001, but not later than 30 September 2002;
- that person must have disposed of that residence to the trust by way of donation, settlement or other disposition or must have financed all the expenditure actually incurred by the trust to acquire and to improve the residence;
- that person or his or her spouse must have ordinarily resided in that residence and used mainly for domestic purposes as his or her or their ordinary residence from 5 April 2001 to the date of the registration in the deeds registry of the residence in the name of that person or jointly in the names of that person and that person's spouse; and
- the registration of the residence must take place not later than 31 March 2003.

The same limitation on the size, use and disposal of the property acquired, as applies to acquisitions from companies, also applies to acquisitions from trusts.

CLAUSE 3

Amendment of section 1 of the Estate Duty Act, 1955

A definition of "spouse" was inserted into the Estate Duty Act, 1955 in 2000 to provide that it includes—

(a) any spouse in a marriage recognised in terms of South African law;
(b) a spouse in a marriage entered into in accordance with a system of religious law which is recognised in the Republic; or
(c) the partner of a person in a permanent same-sex life relationship.

As the exclusion of partners in a permanent heterosexual relationship may be unconstitutional, it is proposed that this definition be amended. The definition now includes a partner of a person—

(a) in a marriage or customary union recognised in terms of the laws of the Republic;
(b) in a union recognised as a marriage in accordance with the tenets of any religion; or
(c) in a same sex or heterosexual union which the Commissioner is satisfied is intended to be a permanent.

It is proposed that the deceased and a marriage or union contemplated in *(b)* or *(c)* above be deemed to be a marriage or union without community of property in the absence of any proof to the contrary.

CLAUSE 4

Amendment of the First Schedule to the Estate Duty Act, 1955

It is proposed that, for capital gains tax purposes, a natural person be treated as having disposed of all of his or her assets on the day before death. As the imposition of both capital gains tax and estate duty may have an impact on the liquidity of the deceased estate, it is proposed that the estate duty rate be reduced from 25 per cent to 20 per cent. This reduction is based on projections of additional tax payable once the capital gains tax has reached its steady state. Although the reduction will therefore overcompensate for the introduction of capital gains tax in its early years, this is unlikely to result in behavioural shifts and a phased reduction is therefore not proposed.

CLAUSE 5

Amendment of section 1 of the Income Tax Act, 1962

Paragraphs (a), (d) and (k): These paragraphs insert certain definitions in section 1, which refer to concepts used in the Eighth Schedule.

Paragraph (b) and (c): The definition of “assessment” is amended to also include an assessment of an assessed capital loss for capital gains tax purposes.

Paragraph (e), (f) and (j): It has been proposed that a definition of ”spouse” be introduced in a number of the Acts administered by the Commissioner to meet the requirements of the Constitution. The details of the definition are set out in more detail in clause 1 which deals with the identical definition proposed for the purposes of the Transfer Duty Act, 1949. As the definition of “spouse” treats all married persons and partners in marital-like unions as spouses, it is proposed that the definition of ”married woman” be amended and the definition of "married" be deleted.

Paragraph (g): It is proposed that a definition of “permanent establishment” be inserted in section 1 of the Act, and that that definition be deleted in section 31.

Paragraph (h): It is proposed that a proviso be added to the definition of "representative taxpayer". The proviso will make it clear that the concept of income also includes capital gains and that the normal duties of a representative taxpayer will also apply to capital gains.

Paragraph (i): The definition of “special trust” is included in the tax proposals each year when the rates of tax are fixed by the Minister of Finance as the tax rates applicable to special trusts differ from those of other trusts. The concept of a special trust is now also being used in the Eighth Schedule for capital gains tax purposes and it is proposed that a definition of “special trust” be included in section 1 of the Act.

A special trust is a trust created solely for the benefit of a person who suffers from a mental illness as defined in the Mental Health Act, 1973, or a serious physical disability, where that mental illness or disability incapacitates that person from earning sufficient income to maintain himself or herself, or where it incapacitates him or her from managing his or her own financial affairs.

Paragraph (k): The amount of the taxable capital gain which is determined in accordance with the provisions of the Eighth Schedule, is included in the taxable income of a person in terms of section 26A. The definition of “taxable income” must, therefore, be amended as it currently only refers to the amount of income less the allowable deductions against that income.

A paragraph is incorporated to also refer to all amounts, which are included or deemed to be included in taxable income in terms of the Act, which includes the taxable capital gains.

CLAUSE 6

Amendment of section 3 of the Income Tax Act, 1962: Exercise of powers and performance of duties

Section 3(4) provides that certain discretionary powers of the Commissioner in terms of the Act are subject to objection and appeal. The Eighth Schedule grants certain discretionary powers to the Commissioner and it is proposed that these powers be made subject to objection and appeal.

CLAUSE 7

Amendment of section 5 of the Income Tax Act, 1962: Levy of normal tax and rates thereof

Section 5(10) makes provision that where the income of a taxpayer includes—

- any special remuneration;
- an amount received by or accrued to him or her upon or because of the termination or impending termination of his or her services;
- a lump sum benefit from a pension, provident or retirement annuity fund; or
- an amount contemplated in paragraph 15(3) or 17 or 19(1) of the First Schedule,

the tax rate to be applied in respect of the taxable income shall be determined as the rate applicable before taking into account any such special remuneration, amount in respect of termination of services, lump sum or First Schedule amounts. It is proposed that section 5(10) be amended to provide that any amount of taxable capital gain included in the taxable income of a person must be excluded in determining the rate of tax to be applied in respect of any lump sum benefit or any amount received or accrued upon termination or impending termination of services.

CLAUSE 8

Amendment of section 6quat of the Income Tax Act, 1962: Rebate in respect of foreign taxes on income

The amendment to section 6*quat* will prevent double taxation on capital gains of residents attributable to the disposal of assets situated outside the Republic. It provides a credit against South African tax for foreign taxes levied on these gains. Consistent with international norms for preventing double taxation and with South Africa's international tax treaties, the provision only applies to gains realised on assets outside the Republic. International tax norms provide the source country with primary taxing rights over gains from the disposal of assets. The source country is the country in which the assets are situated. Where a person is liable to both South African tax and foreign tax in respect of a capital gain realised on the disposal of an asset situated in the Republic, under the Republic's agreements for the avoidance of double taxation and international norms, it will be the responsibility of the foreign jurisdiction to provide a tax credit for South African tax levied in respect of the gain.

CLAUSE 9

Amendment of section 9D of the Income Tax Act, 1962: Investment income of controlled foreign entities

Section 9D of the Income Tax Act, 1962, provides for the imputation of the net income of a controlled foreign entity (CFE) to the shareholders that are residents of the Republic. A portion of the net income of the CFE, which is proportionate to the shareholding or interest of that shareholder in the CFE, is taxed in the hands of the shareholder.

It is proposed that section 9D be amended to make specific provision for the way in which the taxable capital gain or assessed capital loss of the CFE is to be determined to be taken into account in calculating the net income of the CFE. It is proposed that specific provisions be inserted to provide that—

- any capital gain or capital loss of such entity must be determined with reference to the currency in which it conducts the majority of its transactions; and
- where an entity only becomes a CFE after 1 October 2001, the valuation date for purposes of the determination of any taxable capital gain or assessed capital loss of that CFE, will be the date that it became a CFE.

CLAUSE 10

Amendment of section 9E of the Income Tax Act, 1962: Taxation of foreign dividends

In terms of the definition of a "foreign dividend" in section 9E, an amount derived by a person from the disposal of a share or interest in the fixed capital in a company contemplated in that definition, is deemed to be a foreign dividend to the extent that the company or a subsidiary of the company has undistributed profits which were available for distribution to that person. This provision was inserted as an anti-avoidance measure as capital gains were not taxable at the time that the provision was introduced.

Taking into account that the capital gain in respect of the disposal of shares may now be subject to tax, it is proposed that a further exclusion be inserted in the definition of "foreign dividend" to provide that the proceeds from the disposal of a share or interest in such a company will not be taxed as a foreign dividend to the extent that it has been taken into account in the determination of the taxable capital gain or assessed capital loss of such person under the provisions of the Eighth Schedule.

CLAUSE 11

Amendment of section 10A of the Income Tax Act, 1962: Exemption of capital element of purchased annuities

With effect from years of assessment commencing on or after 1 January 2001, income derived by residents from foreign sources became taxable.

The capital element of a purchased annuity received in terms of an agreement entered into between a purchaser and an insurer is exempt in terms of the provisions of section 10A.

Where the capital element of an annuity contract has been paid in a foreign currency it is proposed that the cash consideration given be converted to Rands by applying the ruling exchange rate on the day the consideration was actually paid.

CLAUSE 12

Amendment of section 22 of the Income Tax Act, 1962: Amounts to be taken into account in respect of values of trading stock

In terms of the provisions of paragraph 12 of the Eighth Schedule it is proposed that certain events be treated as disposals and acquisitions for purposes of capital gains tax.

In this regard, paragraph 12 *inter alia* proposes that where assets that are not held as trading stock of a person, commence to be held as trading stock of that person, that person will be treated as having disposed of those assets for a consideration equal to the market value of the assets and to have immediately reacquired the assets at a cost equal to the market value of the assets.

It is proposed that section 22(3), which provides for the amounts to be taken into account in respect of cost of trading stock, be brought in line with paragraph 12 of the Eighth Schedule. It is proposed that section 22(3) be amended to provide that the cost price of any trading stock which is in terms of the provisions of paragraph 12(2)(*c*) of the Eighth Schedule treated as having been acquired at a cost equal to the market value, shall be that market value.

Section 22(8) specifically provides that where a taxpayer—
(a) has applied trading stock for his private or domestic use or consumption; or
(b) has applied trading stock for purposes of making a donation or disposed of it other than in the ordinary course of his trade, or distributed any trading stock *in specie* or otherwise applied trading stock for any purpose other than the disposal thereof in the ordinary course of his trade,

and the cost price of the trading stock has been taken into account in the determination of the taxable income of the taxpayer, that taxpayer must be deemed to have recovered or recouped an amount equal to the cost price (in the case of *(a)*) or the market value of the trading stock (in the case of *(b)*) and that amount must be included in the taxpayer's income.

No specific provision is made in subsection (8) where assets which were held as trading stock by any taxpayer cease to be held as trading stock by such taxpayer. Although the Courts have interpreted the words of the existing provisions to include these circumstances, it is proposed that this be included in section 22 to clarify any uncertainty in this regard. Where a person therefore ceases to hold an asset as trading stock and that asset becomes, for example, an asset which will be subject to CGT, the closing value of that asset for trading stock purposes will be its market value.

CLAUSE 13

Substitution of section 25C of the Income Tax Act, 1962: Income of insolvent estates

Section 25C deals with the situation where the estate of a natural person has been voluntarily or compulsorily sequestrated. When a person's estate is sequestrated three distinct taxable entities arise:

- the insolvent prior to date of sequestration;
- the insolvent estate;
- the insolvent after date of sequestration.

It is proposed that this section be amended in two important respects:

Removal of reference to business undertaking

Previously section 25C treated the estate of the person prior to sequestration and his or her insolvent estate as one and the same person only where a business undertaking was carried on by the insolvent and this was transferred to his or her insolvent estate. Since capital gains and losses can arise in circumstances other than where a business undertaking is carried on, it is proposed that the ambit of section 25C be expanded by removing the reference to a business undertaking. As a result, the proposed section 25C will now in all instances treat the estate of the person prior to sequestration and his or her insolvent estate as one and the same person. This has the effect of crystallising all capital gains and capital losses in the hands of the insolvent estate. It also has the effect of permitting an assessed loss or assessed capital loss to be carried forward from the insolvent prior to sequestration into his or her insolvent estate.

Treatment of person where order of sequestration is set aside

A new subsection (1)(*b*) has been added to address the position of a person released from sequestration where an order of sequestration has been set aside. Previously the Income Tax Act was silent on this aspect, except section 20(1)(*a*)(i) which dealt with the position of an assessed loss. This refers to the situation where a provisional order of sequestration has been set aside or where, on appeal, a final order of sequestration has been set aside. It does not apply to a person who has become rehabilitated through an application for rehabilitation (Section 124 of the Insolvency Act, 1936) or through the effluxion of time (section 127A of that Act). Although in the latter cases the sequestration comes to an end in terms of section 129 of the Insolvency Act, the original order remains a *fait accompli* and is not set aside.

The proposed section 25C will deem the estate of the ex-insolvent and his or her insolvent estate to be one and the same person where the order of sequestration has been set aside. This means, for example that:

- assets falling within the ambit of the Eighth Schedule will be taken over by the ex-insolvent at the base cost of the insolvent estate.
- assets subject to capital allowances will be recouped in the hands of the ex-insolvent even though those allowances may have been claimed by that person prior to sequestration or by his or her insolvent estate.
- an assessed loss or assessed capital loss may be taken over by the ex-insolvent from his or her insolvent estate.

CLAUSE 14

Insertion of section 26A in the Income Tax Act, 1962: Inclusion of taxable capital gain in taxable income

This section provides for the inclusion in the taxable income of a person of any taxable capital gain of that person determined in accordance with the provisions of the Eighth Schedule. This amendment is consequential upon the insertion of the Eighth Schedule in the Income Tax Act, 1962.

CLAUSE 15

Amendment of section 29A of the Income Tax Act, 1962: Taxation of long-term insurers

During 1999 various amendments were effected to the provisions regulating the taxation of long-term insurance companies to address a number of deficiencies which caused a significant decrease in the tax paid by the industry. One such deficiency, was the excessive amount of expenses an insurer could claim against its relatively small taxable income base (investment income) in its policy holder funds. This was solved by way of the introduction of a formula, in terms of which the deductibility of expenses not directly attributable to investment income (i.e. selling and administration expenses) should be determined. This formula limited the expenses on the basis that dividends and capital gains were not taxable. As certain dividend income (foreign dividends) and capital gains will now become taxable, it is proposed that the formula be adjusted to eliminate the possibility of a double taxation of amounts transferred from policyholder funds to the corporate funds and to allow a portion of selling and administrative expenses in respect of capital gains taxed in policyholder funds which would not otherwise be allowed as a deduction.

As the inclusion rates for capital gains of the individual policyholder fund and the company policyholder funds are different, it is proposed that separate formulae be introduced for the two funds which would take into account the inclusion rate of 25 per cent for the individual policyholder fund and the inclusion rate of 50 per cent in the case of the company policyholder fund.

Only capital gains accruing from 1 October 2001 will be subject to tax, therefore, the full impact of tax on capital gains on the value of assets of the individual policyholder fund and the company policyholder fund of an insurer will only be felt a number of years after the introduction of CGT. For this reason the amended formula will be phased in over a period of five years from years of assessment commencing on or after 1 January 2002. The way the phasing in will operate is that percentages will be determined under both the current and new formulae. Five sixths of the difference will be deducted from the percentage determined by applying the new formula for the first year of assessment the new provisions apply, four sixths for the second year and so on until the sixth year when only the new formulae will apply. As stated in 1999, the new provisions will be closely monitored to determine whether it has the desired outcome.

In order to provide clarity on the tax treatment of the transfer of assets between the different funds of an insurer all transfers shall be effected by way of a disposal of the assets transferred at the market value thereof and the fund to which the assets are transferred is deemed to have acquired those assets. The four funds of an insurer are also deemed to be separate persons and connected persons for purposes of the subsections of section 29A dealing with the transfer of assets, for the application of the

Eighth Schedule and certain other sections of the Act. These provisions have an effect on the way paragraphs 12(2)*(f)* and 38 of the Eighth Schedule are to be applied.

CLAUSE 16

Amendment of section 31 of the Income Tax Act, 1962: Determination of taxable income of certain persons in respect of international transactions

A definition of "permanent establishment" is inserted in section 1 of the Act. Section 31 is, therefore, amended to delete the definition of "permanent establishment" in subsection (1). This amendment is consequential upon the insertion of the Eighth Schedule in the Income Tax Act, 1962.

CLAUSE 17

Amendment of section 64 of the Income Tax Act, 1962: Rate of donations tax

Section 64 of the Income Tax Act, 1962, fixes the rate of donations tax at 25%. In line with the reduction in the estate duty rate and the treatment of a donation as a disposal for capital gains tax purposes, it is proposed that the donations tax rate be reduced from 25% to 20%.

CLAUSE 18

Amendment of section 64B of the Income Tax Act, 1962: Exemption from secondary tax on companies (STC) in respect of the distribution or disposal of residence to natural persons

In terms of the provisions of the Eighth Schedule, there is an exclusion of up to R1 million of the capital gain determined in respect of the disposal of an interest in a primary residence. In order to qualify for this exemption, the person who disposes of the interest in the primary residence must be the natural person who used the residence as his or her ordinary residence.

For various reasons many individuals have bought their residences in companies or close corporations. The exemption will, therefore, not apply when that company or close corporation disposes of a residence.

In order to give individuals the opportunity to transfer their primary residences into their personal names to qualify for the exemption, it is proposed that section 64B be amended to provide that secondary tax on companies (STC) will not apply where the interest in such a residence is—

- distributed as a dividend *in specie*; or
- sold, in which case any capital profit realised on sale may be distributed free of STC.

The distribution of shares in a share block company will also qualify for the exemption. To qualify for this exemption, the interest in the residence must have been distributed or disposed of on or before 30 September 2002 and the distribution of the capital profits must be completed on or before 31 March 2003.

There are also a number of other requirements and restrictions pertaining to this exemption:

- all the shares in the company must have been owned by the natural person and his or her spouse between 5 April 2001 and the date of registration of the property in the deeds registry. This means, for example, that the exemption is not available where a residence is held by a subsidiary company;
- the person or his or her spouse must have been ordinarily resident in the residence and used it mainly for domestic purposes as his or her or their ordinary residence between 5 April 2001 and the date of registration;
- after the distribution or disposal, the residence must meet the criteria of a primary residence in the hands of the persons taking transfer;
- where the residence is situated on land that exceeds two hectares, the portion of the dividend relating to the excess will not qualify for STC exemption;
- the portion of a dividend that relates to land that is not used mainly for domestic or private purposes together with the residence will not qualify for STC exemption;
- all the land must be transferred at the same time as the residence in order for the dividend to qualify for exemption.

Taxpayers may take advantage of this concession with effect from the date of promulgation of the Act.

Example

Alton transferred his house into Zed Property (Pty) Ltd at a market value of R250 000 on 1 March 1995. The market value of the property on 1 October 2001 is R500 000. The balance sheet of Zed Property (Pty) Ltd on 1 October 2001 appears as follows:

Share capital - 2 shares of R1 each	2
Non-distributable reserve	250 000
Shareholder's loan	249 998
	R500 000
Property - at market value	R500 000

The non-distributable reserve arose as a result of the revaluation of the property on 1 October 2001. Alton has indicated that he wishes to take advantage of the primary residence exclusion by transferring the property out of the company into his own name.

The provisions of section 64B(5)(*k*) should be read and dealt with in terms of the following:

- Section 9(16) or (17) of the Transfer Duty Act, 1949 - which enables a primary residence to be transferred from a company or trust free of transfer duty.
- Item 7*(e)* of the First Schedule to the Stamp Duties Act, 1968 - which enables a stamp duty-free transfer of a mortgage bond.
- Paragraph 51 of the Eighth Schedule - which stipulates that the residence must be treated as having been disposed of at market value on 1 October 2001. Since the market value of the property on 1 October 2001 will constitute its base cost, no capital gain or capital loss will arise in the hands of the company.
- The provisions of the company's memorandum and articles of association - which will have to be examined to determine whether there are any restrictions on the distribution of capital surpluses.

- *Alternative 1*: Distribute property *in specie* - section 64B(k)(i)

Dr. Non-distributable reserve	250 000	
Cr. Distributable reserve		250 000
Dr. Dividend	250 000	
Dr. Shareholder's loan	250 000	
Cr. Property		500 000

In this case the dividend of R250 000 will be exempt from STC provided that the distribution of the residence takes place between the date of promulgation of the Bill and 30 September 2002.

- *Alternative 2*: Sell property - section 64B(k)(ii)

Dr. Shareholder's loan	500 000	
Cr. Property		500 000
Dr. Non-distributable reserve	250 000	
Cr. Profit on sale of property		250 000
Dr. Dividend	250 000	
Cr. Shareholder's loan		250 000

It has been assumed that the size of the property does not exceed two hectares. Any capital profit attributable to the area exceeding two hectares would attract STC if distributed in the normal course of business. Such a distribution may, however, be exempt in terms of section 64B(5)*(c)* if made in anticipation of or during the course of winding-up or deregistration.

CLAUSE 19

Amendment of section 66 of the Income Tax Act, 1962: Notice by Commissioner requiring returns for assessment of taxes under this Act and the manner of furnishing returns and interim returns

Section 66 of the Income Tax Act, 1962, provides that the Commissioner shall annually give public notice that all persons who are liable to taxation and are required to furnish returns for the assessment of tax, must furnish returns for the purposes of assessment.

These persons specifically include—

- persons whose gross income includes remuneration that exceeds an amount to be stated by the Commissioner;
- persons whose gross income includes any interest or taxable dividends exceeding R4 000 (in the case of persons aged 65 years and older), or R3 000 (in any other case), or persons whose gross income includes amounts derived other than by way of remuneration or interest, if the gross income exceeds an amount to be stated by the Commissioner;
- any company; and
- any person required by the Commissioner in writing to render a return of income.

It is proposed that a further provision be inserted to require persons whose aggregate capital gain or aggregate capital loss for the year of assessment exceeds an amount to be stated by the Commissioner in the notice referred to above, to submit a return.

Section 66(7A) and (7B): In order to facilitate the movement by SARS towards the electronic submission of various tax returns, a provision is to be inserted to authorise the Commissioner to accept electronic or digital signatures of such returns as being valid for purposes of income tax.

The proposed subsection (7A) provides that such an electronic signature is binding for purposes of the Act.

The proposed subsection (7B) provides that the Minister may promulgate rules and regulations setting out the requirements and the procedures to be followed for submitting returns in an electronic format, should it be required.

CLAUSE 20

Substitution of section 68 of the Income Tax Act, 1962: Income and capital gain of married persons and minor children

Section 68 of the Income Tax Act, 1962, provides that any income received by or accrued to or in favour of any person married in or out of community of property, which is in terms of section 7(2) deemed to be income received by or accrued to such person's spouse, must be included by that spouse in the return of income required to be rendered by the spouse under the Act.

It is proposed that this provision be extended to also provide that any capital gain which is taken into account when determining the aggregate capital gain or aggregate capital loss of such person's spouse in terms of the Eighth Schedule, must also be included in the return of that spouse.

Similarly, every parent is required to include in his return any income received by or accrued to or in favour of any of his minor children, either directly or indirectly, from himself or his wife. It is proposed that, as both husband and wife are taxpayers in their own right, the reference to the wife of the taxpayer be deleted. Any capital gain or capital loss of a minor child in respect of any transaction entered into directly or indirectly with a parent, which is taken into account in the determination of the aggregate capital gain or aggregate capital loss of the minor child, must also be included in the return of the parent.

CLAUSE 21

Insertion of sections 70A in the Income Tax Act, 1962: Returns of information by unit portfolios

It is proposed that a new section 70A be inserted in the Act to make provision for returns of information by Unit Portfolios. In terms of the proposed section 70A, every unit portfolio must furnish to the Commissioner an annual return in such form and within such time as the Commissioner may prescribe, showing—

- the names and addresses of all unit holders in that unit portfolio who have disposed of their units in that unit portfolio on or after 1 October 2001;

- the number of units disposed of by each unit holder;
- the cost of those units determined on the weighted average basis;
- the proceeds on disposal of those units;
- the gain derived from or loss incurred in respect of the disposal of those units;
- in the case of any natural person, his or her identification number or if he or she is not in possession of a South African identity document, any other form of identification; and
- in the case of any person other than a natural person, that person's registration number.

The use of the weighted average basis for these returns does not prevent unit holders from using one of the other permissible bases for determining the base cost of identical assets and capital gains or losses, provided that they have retained sufficient records to do so.

Insertion of section 70B in the Income Tax Act, 1962: Return of information in respect of financial instruments administered by portfolio administrators

It is proposed that a new section 70B be inserted in the Act to make provision for returns of information by portfolio administrators. In terms of the proposed section 70B every person (other than a pension fund, provident fund, retirement annuity fund or an insurance company in respect of financial instruments held for policy holders) who—

- administers a portfolio of financial instruments, as contemplated in the Eighth Schedule, on behalf of any other person; and
- has the mandate of that other person to buy and sell such financial instruments on that other person's behalf,

must furnish to the Commissioner an annual return in such form and within such time as the Commissioner may prescribe, showing—

- the names and addresses of all persons on behalf of whom financial instruments have been disposed of on or after 1 October 2001;
- the number of financial instruments disposed of on behalf of each such person;
- the cost of those financial instruments determined on the weighted average basis;
- the proceeds on disposal of those financial instruments;
- the gain derived from or loss incurred in respect of the disposal of those financial instruments;
- in the case of any natural person, his or her identification number or if he or she is not in possession of a South African identity document, any other form of identification; and
- in the case of any person other than a natural person, that person's registration number.

The use of the weighted average basis for these returns does not prevent investors from using one of the other permissible bases for determining the base cost of identical assets and capital gains or losses, provided that they have retained sufficient records to do so.

CLAUSE 22

Insertion of section 73A in the Income Tax Act, 1962: Record keeping by persons deriving income other than remuneration

This clause, which was previously contained in section 75(1)(*f*) of the Act, deals with record keeping by persons whose gross income consists of amounts other than remuneration. Apart from being rephrased this provision remains essentially unchanged. Failure to comply with this section without just cause remains an offence in terms of section 75(1)(*f*).

Insertion of section 73B in the Income Tax Act, 1962: Record keeping in relation to taxable capital gain or assessed capital loss

This section proposes new record keeping requirements to ensure compliance with the provisions of the Eighth Schedule. Unlike section 73A which is targeted at persons earning income other than remuneration, all persons in possession of assets which can give rise to capital gains or capital losses are required to retain the relevant records.

The relevant records must be retained for a period of four years from the date of submission of the return of income in which a capital gain or capital loss is reflected.

Persons not required to render returns of income who have capital gains or capital losses in excess of R10 000 are required to retain all records pertaining thereto for a period of five years from the date of disposal of the assets concerned.

Insertion of section 73C in the Income Tax Act, 1962: Retention period of records where objection and appeal lodged

This provision proposes that the four-year retention periods referred to in sections 73A and 73B be overridden where a person has lodged an objection or appeal against an assessment. The new section requires the records relevant to the objection and appeal to be retained until the assessment becomes final.

CLAUSE 23

Amendment of section 75 of the Income Tax Act, 1962: Penalty on default

It is proposed that section 75(1)*(f)*, which previously provided a penalty for failure to retain certain records, be amended as follows:

- the details of the records required to be kept by persons deriving income other than remuneration, be moved to the new section 73A;
- the provision be extended to make it an offence to fail to comply with the provisions of the new sections 70A, 70B, 73A, 73B and 73C. Persons contravening these sections without just cause are liable on conviction to a fine or to imprisonment for a period not exceeding 12 months.

CLAUSE 24

Amendment of section 76 of the Income Tax Act, 1962: Additional tax in the event of default or omission

This amendment is consequential upon the insertion of the Eighth Schedule in the Income Tax Act, 1962.

CLAUSE 25

Amendment of section 78 of the Income Tax Act, 1962: Estimated assessments

This amendment is consequential upon the insertion of the Eighth Schedule in the Income Tax Act, 1962.

CLAUSE 26

Amendment of section 79 of the Income Tax Act, 1962: Additional assessments

This amendment is consequential upon the insertion of the Eighth Schedule in the Income Tax Act, 1962.

CLAUSE 27

Amendment of section 82 of the Income Tax Act, 1962: Burden of proof as to exemptions, deductions or abatements, disregarding or exclusions

This amendment is consequential upon the insertion of the Eighth Schedule in the Income Tax Act, 1962.

CLAUSE 28

Amendment of section 83A of the Income Tax Act, 1962: Appeals to specially constituted board

This amendment is consequential upon the insertion of the Eighth Schedule in the Income Tax Act, 1962.

CLAUSE 29

Amendment of section 89quat of the Income Tax Act, 1962: Interest on underpayments and overpayments of provisional tax

This amendment is consequential upon the insertion of the Eighth Schedule in the Income Tax Act, 1962.

CLAUSE 30

Amendment of section 90 of the Income Tax Act, 1962: Persons by whom normal tax is payable

Section 90 provides that any tax imposed in terms of the Act and interest thereon is payable by the person who received the income or to whom or in whose favour it accrues, or any representative taxpayer liable to assessment for the payment of the tax and interest under the Act.

A person may, however, recover so much of the tax paid by him as is due to the inclusion in his or her income of any income deemed to have been received by him or her in terms of section 7 of the Act. It is proposed that these provisions be extended to subsection (8) of section 7. It is also proposed that this provision be extended to provide for the recovery of tax from the person entitled to the proceeds on the disposal of an asset, where the capital gain determined in respect of that disposal is included in the taxable income of a person in terms of the attribution rules in paragraphs 68 to 72 of the Eighth Schedule.

CLAUSE 31

Amendment of section 91 of the Income Tax Act, 1962: Recovery of tax

Section 91 of the Income Tax Act, 1962, prescribes the procedure for the recovery of tax where a person fails to pay tax or interest when such tax or interest becomes due or is payable by that person.

Subsection (4) provides that so much of any tax payable by any person as is due to the inclusion in his income of any income deemed to have been received by him or to be his income in terms of section 7, may be recovered from the assets producing such income.

It is proposed that a provision be inserted to provide that so much of any tax payable by any person as is due to the inclusion in the taxable income of such person of any capital gain in terms of paragraphs 68 to 72 of the Eighth Schedule, may also be recovered from the proceeds from the disposal of the asset which gave rise to the capital gain.

CLAUSE 32

Amendment of section 95 of the Income Tax Act, 1962: Liability of representative taxpayer

This amendment is consequential upon the insertion of the Eighth Schedule in the Income Tax Act, 1962.

CLAUSE 33

Amendment of section 103 of the Income Tax Act, 1962: Transactions, operations or schemes for purposes of avoiding or postponing liability for or reducing amounts of taxes on income

This amendment is consequential upon the insertion of the Eighth Schedule in the Income Tax Act, 1962.

It is proposed that the assessed loss anti-avoidance provisions of section 103(2) be extended to deal with the utilization of an assessed loss, capital loss or assessed capital loss against a 'tainted' capital gain. The proposed amendments deal with such capital gains in much the same way as the existing law deals with tainted income that has been sought to be set off against an assessed loss. The set-off of the offending capital gain is disregarded, meaning in effect that the assessed loss, capital loss or assessed capital loss is ring-fenced and only available for set-off against untainted capital gains.

Example 1

A company has a tainted capital gain of R100 000, an untainted capital gain of R25 000 and a capital loss of R200 000.

Taxable capital gain = R100 000 x 50% inclusion rate = R50 000
Assessed capital loss = R200 000 – 25 000 = R175 000

The taxable capital gain of R50 000 will be included in the company's taxable income, and the assessed capital loss will be carried forward to the following year of assessment.

Example 2

A company has a tainted capital gain of R100 000, an untainted capital gain of R150 000 and an assessed loss before the inclusion of any taxable capital gain of R200 000.

Taxable capital gain = R100 000 + R150 000 = 250 000 x 50% = R125 000

Portion of taxable capital gain that may not be set off against assessed loss:

$$= \frac{\text{Tainted capital gain}}{\text{Sum of all capital gains and losses}} \times \text{Taxable capital gain}$$

$$= \frac{100\ 000}{250\ 000} \times 125\ 000$$

$$= \text{R50 000}$$

Therefore assessed loss = 200 000 – (125 000 – 50 000) = R125 000

Two assessments will be issued, one reflecting a taxable income of R50 000 and the other an assessed loss of R125 000.

It is further proposed that section 103(4), which imposes a presumption of a tax avoidance purpose on a taxpayer unless the contrary is proven, include a reference to a capital loss or assessed capital loss.

CLAUSE 34

Amendment of section 107 of the Income Tax Act, 1962: Regulations

Section 107 authorises the Minister of Finance to make regulations to give effect to the objects and purposes of the Act. A specific paragraph has been inserted by subsection (1) to enable the Minister to make regulations regarding the valuation of fiduciary, usufructuary or other like interests in property. This will enable the Minister to make regulations for purposes of the Eighth Schedule. Subsection (2) provides that the Regulations may prescribe penalties for any contravention thereof or failure to comply therewith, not exceeding a fine of R1 000. It is proposed that this amount be increased to R2 000.

CLAUSE 35

Amendment of paragraph 4 of the First Schedule to the Income Tax Act, 1962

In terms of the proposed provisions of paragraph 12 of the Eighth Schedule certain events will be treated as disposals and acquisitions for CGT purposes.

In this regard, this paragraph *inter alia* proposes that where assets not held as trading stock of a person, commence to be held as trading stock of that person, that person will be treated as having disposed of those assets for a consideration equal to the market value of the assets and to have immediately reacquired the assets at a cost equal to the market value of the assets.

It is proposed that paragraph 4 of the First Schedule to the Act, which provides for the determination of the value of livestock and produce, be brought into line with paragraph 12 of the Eighth Schedule. In this regard it is proposed that paragraph 4 of the First Schedule be amended both in the case of farmers who were carrying on farming operations in the previous year and for farmers who commence or recommence farming. Any livestock or produce held by the farmer, otherwise than for the purposes of farming operations and which the farmer during the year of assessment commences to hold as trading stock, is deemed to be held at market value.

CLAUSE 36

Amendment of paragraph 5 of the First Schedule to the Income Tax Act, 1962

It is proposed that paragraph 5(2) of the First Schedule which deems livestock to be included in closing stock at market value be deleted as it is inconsistent with section 25C which treats the estate of an insolvent prior to sequestration and the insolvent estate as one and the same person. The subparagraph is also inconsistent with section 22 which does not contain a similar provision. It also has the effect of creating an anomalous situation where an order of sequestration is set aside. In such a case the insolvent prior to sequestration would be treated as having disposed of livestock at market value, thereby generating a profit. After sequestration the ex-insolvent would take over the opening stock from the estate at market value which could generate a loss when livestock is included in closing stock at standard value.

A consequence of the proposed amendment is that the liability for tax on the difference between market value and standard value will be shifted into the insolvent estate, and in the case of a company, into the post-liquidation period. Any tax claim arising in the estate or in the company would represent a cost of administration in terms of section 97(2)(*c*) of the Insolvency Act, 1936 rather than a preferent claim (see *Van Zyl NO v CIR* [1997] 1 All SA 340 (C), 59 SATC 105).

CLAUSE 37

Amendment of paragraph 19 of the Fourth Schedule to the Income Tax Act, 1962

This amendment is consequential upon the insertion of the Eighth Schedule in the Income Tax Act, 1962.

CLAUSE 38

INSERTION OF THE EIGHTH SCHEDULE IN THE INCOME TAX ACT 58 of 1962

PART I: GENERAL

Paragraph 1: Definitions

This paragraph proposes the introduction of a number of definitions for use in the Eighth Schedule. Where words or phrases used in the Eighth Schedule are also used in the Act, it is proposed that the words and phrases also be defined in section 1. The words defined in section 1 have the same meaning when used in the Eighth Schedule.

The definitions are in most cases self-explanatory or refer to paragraphs where amounts are determined. For example, the definitions of "capital gain", "capital loss", "aggregate capital gain", "aggregate capital loss", “net capital gain”, “assessed capital loss” and "taxable capital gain" are all used in the determination of the amounts referred to in paragraphs 3 to 10. Where reference is made to a paragraph in the definition, the definition will be dealt with in that paragraph.

The definition of "asset" is of importance, as CGT is not triggered until an asset is disposed of. A wide definition has been proposed which includes all forms of property and all rights or interests in such property. Currency is excluded because this is dealt with in Part 13 of the Schedule.

The definition of "financial instrument" is also intended to cover any possible type of financial instrument.

"Value shifting arrangement" is a new concept which is proposed and which is dealt with in detail below.

Value shifting arrangement

What is value shifting?

Value shifting involves the effective transfer of value from one entity to another without constituting an ordinary disposal for CGT purposes.

Why have value shifting legislation?

Without specific rules, entities could manipulate the value of assets in order to obtain a CGT benefit.

Do other countries have such legislation?

Value shifting anti-avoidance provisions are, for example, contained in the Australian and United Kingdom tax legislation. In both countries the primary focus is on shares, though land transactions are also addressed. The proposed provisions are somewhat different from those found in other jurisdictions as the proposed core rules and South African common law deal with certain cases that must be dealt with specifically in other jurisdictions.

Where is value shifting most prevalent?

It is found typically between connected persons, for example:
- between parents and their children
- within groups of companies

What are some examples of value shifting?

- Issue of shares at a discount
- Variation of rights attaching to shares or interests in land (e.g. manipulating voting or dividend rights)
- Buying back of shares at below market value

Example

Bongo is the sole shareholder of Why (Pty) Ltd in which he holds 2 shares of R1 each. The retained income in the company amounts to R99 998. The market value of the shares on 1 October 2005 is R100 000. The base cost of Bongo's 2 shares on valuation day is R50 000. On 1 October 2005, Why (Pty) Ltd issues a further share of R1 to Bongo's daughter, Cynthia, at a cost of R1. The position may therefore be summarised as follows:

	Before	After
Share Capital	R2	R3
Retained income	R98 998	R98 998
Market Value 1.10.2005	R100 000	R100 000
Market value per share	R50 000	R33 333

1. Determination of whether a value shifting arrangement has occurred

The issue of shares to Cynthia constitutes a 'value shifting arrangement' as defined in paragraph 1 of the Eighth Schedule in that:

- There is an arrangement
- Bongo has retained an interest in Why (Pty) Ltd
- There has been a change in the rights or entitlements in the interests in Why (Pty) Ltd
- The change in interest occurred other than as a result of a disposal at market value
- The market value of Bongo's interest has decreased from R100 000 to R66 666
- Cynthia has acquired an interest in Why (Pty) Ltd

2. Calculation of Bongo' capital gain

2.1 Determination of proceeds – paragraph 11(1)(g) and paragraph 35(2)

Paragraph 11 includes as a disposal:

'*(g)* the decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement.'

Paragraph 35(2) provides for the proceeds to be determined as follows:

'(2) The amount of the proceeds from a disposal by way of a value shifting arrangement is determined as the market value of the person's interests to which subparagraph 11(1)*(g)* applies immediately prior to the disposal less the market value of the person's interests immediately after the disposal, which amount shall be treated as having been received or accrued to that person.'

Market value of Bongo's interest before disposal	= R100 000
Market value of Bongo's interest after disposal	= R 66 666
Decrease in market value (proceeds on disposal)	= R 33 333

2.2*. Determination of Bongo's base cost – paragraph 23(a)*

Applying the formula:

$$Y = \frac{\text{MV of interest before disposal - MV of interest after disposal}}{\text{MV of interest before disposal}}$$

$$= \frac{100\,000 - 66\,666}{100\,000}$$

$$= 33\%$$

Base cost attributable to disposal of Bongo's interest = R50 000 x 0.33 = R16 500

2.3 Determination of Bongo's capital gain

Capital gain = Proceeds – base cost
= 33 333 – 16 500
= R16 833

3 Determination of Cynthia's base cost – paragraph 23(b)

Cost of Cynthia's share in Why (Pty) Ltd	= R1
Increase in value of Cynthia's interest	= R33 333 (see 2.1 above)
Revised base cost	= R33 334

Paragraph 2: Application

The purpose of this paragraph is to define the scope of the legislation and to prescribe who is subject to CGT and which assets of such persons are subject to CGT.

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

The paragraph proposes a distinction between a resident, which is a defined word in section 1, and a non-resident. It is proposed that—

- a resident be subject to CGT on the disposal of any asset whether in the Republic or outside,
- a non-resident be subject to CGT on the disposal of—
  - (i) any immovable property or any interest or right in immovable property situated in the Republic,
  - (ii) any asset of a permanent establishment of the non-resident through which a trade is carried on in the Republic.

It is proposed that the term "an interest in immovable property situated in the Republic" which is held by a non-resident, be broadened. It is proposed that it include a direct or indirect interest of at least 20 per cent held by a person (together with a connected person in relation to that person) in the equity share capital of a company or other entity, where 80 per cent or more of the market value of the net asset value of the company or other entity at the time of disposal is attributable to immovable property situated in the Republic.

PART II: TAXABLE CAPITAL GAINS AND ASSESSED CAPITAL LOSSES

Paragraph 3: Capital gain

It is proposed that a capital gain be determined for each asset disposed of during a year of assessment by deducting the base cost of the asset as contemplated in paragraph 20 from the proceeds as contemplated in paragraph 35, where the proceeds exceed the base cost.

In the case of an asset disposed of in a previous year of assessment, it is proposed that the capital gain be—

- so much of any amount of proceeds as is received or accrued during the current year of assessment which has not been brought into account in determining the capital gain or loss; or
- so much of the base cost of the asset that has been taken into account in determining the capital gain or loss as has been recovered or recouped in the current year of assessment.

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

Paragraph 4: Capital loss

It is proposed that a capital loss be determined for each asset disposed of during a year of assessment by deducting the base cost of the asset as contemplated in paragraph 20 from the proceeds from the disposal of that asset as contemplated in paragraph 35, where the base cost exceeds the proceeds.

In the case of an asset disposed of in a previous year of assessment, it is proposed that the capital loss be—

- so much of the proceeds received or accrued as a result of the disposal of the asset that have been taken into account during any year of assessment in determining the capital gain or loss—
  - as that person is no longer entitled to during the current year of assessment as a result of the cancellation, termination or variation of an agreement or any other reason;
  - as has become irrecoverable during the current year of assessment;
  - as has been repaid or become repayable during the current year of assessment; or
- so much of the base cost of the asset that has not been taken into account during any year of assessment in determining the capital gain or loss of that disposal, as has been paid or become due and payable during the current year of assessment.

Certain capital losses may be disregarded in terms of Parts IV, VII and VIII.

Paragraph 5: Annual exclusion

Although gains or losses in respect of most personal use assets are excluded from the CGT system, it has been decided to introduce a threshold (annual exclusion) to exclude the total of smaller gains and losses from CGT. This will reduce compliance costs, simplify the administration of the tax and underpin the SITE system by keeping small gains and losses out of the system.

The annual exclusion of a natural person and a special trust in respect of a year of assessment is R10 000. Where a natural person dies during the year of assessment, that person's annual exclusion for that year is increased to R50 000.

Paragraphs 6 and 7: Aggregate Capital Gain and Aggregate Capital Loss

All capital gains and losses for a year of assessment are aggregated and the resultant gain or loss in the case of a natural person and special trust is reduced by the amount of the annual exclusion in order to arrive at a person's aggregate capital gain or aggregate capital loss.

Paragraph 8 and 9: Net Capital Gain and Assessed Capital Loss

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

Paragraph 10: Taxable Capital Gain

Where a person has arrived at a net capital gain for the current year of assessment this is multiplied by the inclusion rate applicable to that person to arrive at a taxable capital gain. This amount is then included in the taxable income of the person in terms of section 26A for the year of assessment and taxed at normal income tax rates applicable to that person.

PART III: DISPOSAL AND ACQUISITION OF ASSETS

Paragraph 11: Disposals

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

It is proposed that a disposal be any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset. A list of events included in this concept are set out in this paragraph, namely—

- events which constitute the alienation or transfer of ownership of an asset (e.g. a sale, donation, cession, etc.);
- events which amongst others include the expiry or abandonment of an asset;
- the scrapping, loss or destruction of an asset;
- the vesting of an interest in an asset of a trust in a beneficiary. (This is dealt with in more detail in paragraphs 80 and 81.)
- the distribution of an asset by a company to a shareholder;
- the granting, renewal, extension or exercise of an option;
- the decrease in value of a person’s interest in a company, trust or partnership as a result of a value shifting arrangement. (See in this regard the examples under paragraph 1.)

There are a number of specific events listed which are **not** treated as a disposal. They are—

- the transfer of an asset by a person as security for a debt and the re-transfer of that asset by the creditor to that person upon release of the security;
- the issuing by a company of its shares or debt and the granting of an option by that company to acquire shares or debt in that company;
- the issuing by a unit trust of its units and the granting of an option by that unit trust to acquire units in that unit trust;
- the issuing of any bond, debenture, note or other borrowing of money or obtaining of credit;
- the distribution of a trust asset by a trustee to a beneficiary who has a vested right to that asset. (This is dealt with in more detail in paragraphs 80 and 81.);
- the change of ownership of an asset as a result of the termination of appointment or appointment of a new trustee, executor, curator or administrator;
- a disposal made to correct an error in the registration of immovable property in that person’s name in the deeds registry;
- the lending of any marketable security in terms of a “lending arrangement” as defined in the Stamp Duty Act and the return of a similar security to the lender.

Paragraph 12: Events treated as disposals and acquisitions

This clause deals with a number of events that are proposed to be treated as disposals for the purposes of the Eighth Schedule. It is proposed that if an event described in the paragraph occurs the person will be treated as having disposed of the asset described in that subparagraph at the time of the event and to have immediately reacquired the asset at a cost equal to the market value. It is proposed in paragraph 13(1)*(g)* that the time of the events contemplated below (except in the case of transfers between the four funds of an insurer) is the date before the day that the event occurs. In the case of transfers between such funds it is the date the event occurs.

The following are the proposed events in subparagraph (2) of this paragraph—

- When a person emigrates or otherwise ceases to be a resident, all that person's assets except—
  - immovable property or an interest or right in immovable property situated in the Republic as contemplated in paragraph 2(1)*(b)*;
  - assets of a permanent establishment through which that persons carries on a trade in the Republic during the year of assessment.
- The asset of a person who is not resident which—
  - becomes an asset of that person's permanent establishment in the Republic otherwise than by way of acquisition. For example, the person brings an asset he or she owns in another country to the Republic for purposes of the permanent establishment; or
  - ceases to be an asset of that person's permanent establishment otherwise than by way of disposal i.e. the person withdraws the asset from the permanent establishment for personal or other use.
- An asset of a person that is not held as trading stock, which becomes trading stock. The person will in terms of section 22(3) be treated as having acquired the trading stock at market value for ordinary income tax purposes. For CGT purposes the person is treated as having disposed of the asset at market value which brings symmetry to the transaction.
- A personal use asset held by a natural person, which ceases to be a personal use asset of that person otherwise than by disposal. What is contemplated, for example, is an asset which becomes trading stock of that person.
- An asset which is not held as a personal-use asset, which commences to be held as that person's personal asset. This event is the converse of subparagraph *(d)*.
- The activities of insurers are treated as being conducted in four separate funds for income tax purposes. Transfer of assets by insurers between these funds are treated as disposals at market value.

The proposed subparagraphs (3) and (4) establish the base cost of certain assets under certain circumstances.

Subparagraph (3) provides that when trading stock of a person ceases to be trading stock of that person, otherwise than by way of disposal, that person will be treated as having disposed of that trading stock for a consideration equal to the amount included in that person's income in terms of section 22(8) and having immediately reacquired those assets for a cost equal to that amount. Section 22(8) deems the cost of trading stock which ceases to be trading stock to have been recovered at an amount equal to the market value of that trading stock. This subparagraph effectively means that in these circumstances the person owning that trading stock is treated as having a base cost equal to the market value of the trading stock on the date he or she is treated as having reacquired those assets.

Subparagraph (4) deals with a person who becomes a resident of the Republic. The person is treated as having disposed of all assets, other than those mentioned below, on the day before becoming a resident and to have acquired the assets at market value. The assets not treated as having been disposed and reacquired are—

- any immovable property or an interest or right in immovable property situated in the Republic;

- an asset of a permanent establishment through which that person carries on a trade in the Republic during the year of assessment.

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

Subparagraph (5) provides that where a debt owed by a person to a creditor has been reduced or discharged by the creditor without full consideration for that reduction or discharge, the debtor will be treated as having acquired a claim on that portion of the debt that was reduced or discharged for no consideration, and thereafter disposed of that claim for an amount equal to the reduction or discharge. As the base cost of that claim is deemed to be nil, the debtor will, therefore, have a gain equal to the amount of the reduction or discharge. This treatment is consistent with that of the core rules in respect of the reacquisition of a person's own debt.

Example 1

Ecks Ltd borrows R10 million from its controlling shareholder, Expert Ltd. Prior to Ecks Ltd's listing, Ecks Ltd repays R4 million and Expert Ltd cancels the remainder of the debt in order to improve Ecks Ltd's balance sheet. Ecks Ltd is treated as having acquired R6 million of its own debt for no consideration and of having disposed of the debt for R6 million. The capital gain on this transaction is therefore R 6 million.

Example 2

On 1 March 2002 Ecks Ltd issues 10 000 debentures of R10 000 each, bearing an annual interest of 12 per cent, expiring in 10 years. In 2004, interest rates have fallen significantly and each R10 000 note is selling in the market for R8 000. Ecks Ltd repurchases half the issued debt in the open market. As soon as it holds its own debt, the debt is automatically extinguished by way of merger. At that time it realises proceeds of R50 million, being the release from an obligation as a result of a disposal of the debt it purchased, less R40 million, being the cost of acquiring the debt. The capital gain on this transaction is therefore R10 million.

Paragraph 13: Time of disposal

The time of disposal is an important core rule as it dictates when the capital gain or capital loss will be brought to account. This paragraph proposes different time rules for the different forms of disposal.

Item (1)*(a)* proposes rules for events, acts, forbearances or the operation of law which results in the change of ownership of an asset. It is further divided into items which deal with the time of disposal of specific events. The time of disposal of—

(i) an agreement subject to a suspensive condition, is the date that condition is satisfied;

(ii) an agreement which is not subject to any condition, is the date that the agreement is concluded;

(iii) a donation of an asset, the date of compliance with all the legal requirements for a valid donation;

(iv) the expropriation of an asset in terms of law, the date the person receives the full compensation for the expropriation of the asset which that person agreed to or which was finally determined by a competent tribunal or court;

(v) the conversion of an asset, the date that the asset is converted,
(vi) the granting, renewal or extension of an option, the date that option is granted, renewed or extended;
(vii) the exercise of an option, the date the option is exercised;
(viii) the termination of an option granted by a company to acquire a share, unit or debenture of that company, is the date of the event when that option terminates; or
(ix) any other case, the date of change of ownership.

Item (1)*(b)* proposes that in the case of the forfeiture, termination, redemption, etc., of an asset, the date of disposal is the date of extinction of the asset.

Item (1)*(c)* proposes that in the case of the scrapping, loss or destruction of an asset, the date of disposal is either—

- when the full compensation for the scrapping, loss or destruction is received; or
- when no compensation is payable, the later of the date when the scrapping, loss or destruction is discovered or when it is established that no compensation will be payable.

Item (1)*(d)* proposes that the vesting of an interest in an asset of a trust in a beneficiary, is the date it so vests.

Item (1)*(e)* proposes that the distribution by a company to a shareholder, is the date the asset is distributed, as contemplated in paragraph 75.

Item (1)*(f)* proposes that in the case of a value shifting arrangement, the date of disposal is the date the value of that person's interest decreases. (See example in paragraph 1)

Item (1)*(g)* proposes that in the case of the events treated as disposals in paragraph 12 (these are the events treated as disposals such as emigration, assets that commence to be held as trading stock and *vice versa*), except the assets transferred between funds of an insurer, the time of disposal is the date before the day the event occurs. The transfer of assets between funds of an insurer as contemplated in item *(f)* is treated as having taken place on the date the transfer occurs.

Subparagraph (2) proposes that where an asset is disposed of to a person, the person to whom the asset is disposed of, is treated as having acquired that asset at the time of disposal of that asset as contemplated in subparagraph (1).

Paragraph 14: Disposal by spouses married in community of property

This paragraph proposes that where spouses are married in community of property and one spouse disposes of property, and that property—

- falls within the joint estate of the spouses, the disposal will be treated as having been made in equal shares by each spouse, and
- was excluded from the joint estate of the spouses, the disposal will be treated as having been made solely by the spouse making the disposal.

PART IV: LIMITATION OF LOSSES

Paragraph 15: Personal use aircraft, boats and certain rights and interests

The vast majority of personal use assets are excluded from the proposed capital gains tax. However, certain personal use assets that are likely to generate substantial capital gains as a result of market forces are included. These personal use assets may be subdivided into two categories—

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

This clause deals with the first category of assets. It would be theoretically correct to determine capital gains or losses on the disposal of assets in this category by reference to a base cost that has been reduced by applying a notional wear and tear allowance to reflect personal use and consumption. This would be complex for both taxpayers and the administration and, in common with other jurisdictions, it is proposed that losses on disposal be disregarded and that only gains in excess of the unadjusted base cost be taxed. The existing provisions in respect of capital allowances will apply where the assets are used both for trade and for personal use.

Example

Duncan purchases a light aircraft for R1 000 000, which he uses for visits to his private game farm. He disposes of the aircraft for R900 000 six months later when he disposes of the game farm.

Proceeds	900 000
Base cost	1 000 000
Cost	1 000 000
Capital allowance	-
Loss	100 000
Disregarded	100 000
Capital loss	-

Paragraph 16: Intangible assets acquired prior to valuation date

Substantial abuses of the valuation of intangible assets have been encountered in the past and continue to be encountered, albeit on a lesser scale, on the acquisition of businesses. These abuses were the genesis of the amendments to section 11*(g*A*)* of the Act in 1999 and the review of the taxation of intangible property announced in the Budget Review 2001.

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

Example

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

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

Paragraph 17: Forfeited deposits

It is proposed in this paragraph that losses as a result of the forfeiting of deposits in respect of assets, which are not intended for use wholly and exclusively for business purposes, be disregarded.

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

- gold or platinum coins, of which the market value is mainly attributable to the material from which they are minted (e.g. Kruger Rands);
- immovable property, excluding a primary residence (e.g. a holiday home);
- financial instruments (e.g. shares and unit trusts);
- any right or interest in these assets.

Paragraph 18: Disposal of options

This provision proposes a restriction on the capital losses determined in respect of the abandonment, expiry or disposal of options on most personal-use assets as these assets are not subject to CGT and the reduction in their value can be mainly attributable to personal use.

If a person entitled to exercise an option abandons it, allows it to expire or disposes of it in any other manner (other than by way of exercising thereof), it is proposed that any loss made be disregarded except in the following circumstances.

The option was to—

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

Paragraph 19: Losses on the disposal of certain shares

Paragraph 19 contains an anti-avoidance provision designed to prevent persons from generating artificial capital losses through dividend stripping. In a typical dividend stripping transaction, a person purchases a share which is expected to distribute a dividend, receives that dividend, and then generates a loss on the immediate resale of the underlying share. This temporary holder of the share incurs no economic loss as a result of the transaction because this temporary holder receives both a dividend along with the offsetting loss on resale. However, if form governs, the temporary holder of the share generates an artificial tax benefit because the dividend is tax-free at the shareholder level with a capital loss on resale. The capital loss is artificial because the base cost on purchase reflects pre-acquisition earnings to be distributed. Although the transaction generates an STC charge, this tax is not borne by the investor but by the company paying the dividend.

Dividend stripping can occur with respect to both short-term holdings as well as long-term holdings. Dividend stripping with long-term holdings typically requires that the dividend involved be of an extraordinary nature because only dividends of an extraordinary nature have a long-term negative impact on the value of underlying shares. The Eighth Schedule proposes that only dividend stripping of an extraordinary nature be targeted. It is proposed that dividend stripping on a short-term basis be ignored because such share transactions are most likely of an ordinary revenue nature. Moreover, any loss resulting from short-term dividend stripping will most likely be completely offset by either the Marketable Securities Tax or Stamp Duty.

In order for a capital loss on the sale of a share to be disregarded under this paragraph, the transaction must fall within two parameters. First, the share must not have been held for more than two years before resale. This two-year period will be extended (i.e. will not include days) for periods in which the risk on the shares is hedged with offsetting positions. Second, the shares must have carried the right to participate in one or more dividends that are extraordinary in the aggregate. Dividends are extraordinary to the extent those dividends exceed 15 per cent of the proceeds received or accrued on disposal of that share.

Example 1

Eleanor purchases a preference share on 1 January 2002 for R150. She receives a dividend of R12 on 1 July 2002 and another dividend of R12 on 1 July 2003. She sells the preference share for R140 on 1 September 2003.

Before taking into account paragraph 19, Eleanor has a R10 loss on the sale of the preference share (R140 proceeds less R150 base cost). However, paragraph 19 applies because the aggregate dividends received within the 2-year period exceed 15 per cent of the proceeds on sale. The aggregate dividends over the 2-year period are R24 (2 x R12), and the 15 per cent amount is R21 (15 per cent of R140), resulting in a R3 extraordinary dividend. Therefore, after taking paragraph 19 into account, Eleanor can claim only R7 of the R10 amount as a capital loss.

Example 2

Tea (Pty) Ltd has 100 000 issued ordinary shares. The ordinary shares each have a par value of R10 and a market value of R50. Franz purchases 100 ordinary shares on 1 April 2002 for R5 000, and on 1 June 2003 he surrenders the shares to Tea (Pty) Ltd for

R5 000 in a share buy back. Of the R5 000 received by Franz, R1 000 is out of share capital and R4 000 constitutes a dividend.

Before taking into account paragraph 19, Franz has a R4 000 loss on the sale (R1 000 proceeds less R5 000 base cost). However, paragraph 19 applies because the dividend portion of the buy back is extraordinary. The extraordinary portion equals R3 850 (the R4 000 dividend minus R150 (15 per cent of the R1 000 proceeds). Therefore, after taking paragraph 19 into account, Franz can claim only R150 out of the R4 000 amount as a capital loss.

The anti-loss rule of paragraph 19 is subject to certain exceptions. Distributions from unit trusts are excluded because any high yields from these investments typically do not represent an accumulation of prior profits. Foreign dividends are excluded because foreign dividends generate ordinary income at the shareholder level, thereby undoing any benefit that a shareholder may receive from a sale at a capital loss. Lastly, dividends between group companies fall outside this paragraph because pre-acquisition earnings are fully subject to STC within those structures, and both the payer and the payee within these structures are economically joined, i.e. the ultimately owners receive no significant net benefit from a transaction that generates a capital loss along with a liability to STC.

PART V: BASE COST

Paragraph 20: Base Cost of asset

This paragraph proposes what may and may not form part of the base cost of an asset.

Domestic expenditure and expenditure in the production of exempt income

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

Direct costs of acquisition and disposal – Items 20(1)(*a*) - (*c*))

It is proposed that the following amounts actually incurred form part of base cost. The expenditure must, however, all be directly related to the cost of acquisition, creation or disposal of the asset. All these amounts would by implication include value-added tax not allowed as an input credit for VAT purposes:

- Cost of acquisition.
- Cost of creating an asset
- Cost of obtaining a valuation for CGT purposes
- Remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor
- Transfer costs
- Stamp duty, transfer duty or similar duty
- Advertising costs to find a seller or to find a buyer
- Moving costs – but only in acquiring or disposing of an asset. For example, this would exclude the costs incurred by a company of moving assets to a new branch.
- Installation costs including foundations and supporting structures

- A portion of the donations tax payable by a donor of an asset (see example 1 below)
- A portion of the donations tax payable by a donee of an asset (see example 2 below)
- Cost of exercising an option to acquire an asset

Example 1

Gerrie donates a yacht to his son at a time when its market value is R1 250 000. The base cost of the yacht before taking into account any donations tax paid is R750 000. Gerrie paid donations tax of R245 000, calculated as follows.

Market value of asset donated	1 250 000
Section 56(2)(*b*) abatement	25 000
	R1 225 000
Donations tax @ 20%	R245 000

Allowable addition to base cost $= \frac{\text{(MV of asset – base cost)}}{\text{MV of asset}} \times \text{Donations tax}$

$= \frac{1\ 250\ 000 - 750\ 000}{1\ 250\ 000} \times 245\ 000$

$=$ 500 000/1 250 000 x 245 000

$=$ R98 000

Therefore base cost of yacht = 750 000 + 98 000

= R848 000

The purpose of this provision is to achieve parity with the estate duty that would have become payable on the gain had the donor died on the date of donation. The formula ignores the effect of the R25 000 donations tax abatement, the R1 million estate duty abatement and the time value of money.

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

Value of yacht (includes gain of 500 000)	1 250 000
CGT paid (500 000 x 10,5%)	52 500
	R1 197 500
Estate duty @20%	R239 500

Estate duty levied on gain = (500 000 – 52 500) X 20%

= 447 500 x 20%

= R89 500

Total tax collected on gain = 52 500 +89 500 = R142 000

Comparing this with the donation of the yacht, and assuming that the R25 000 abatement has been utilised against other donations, the tax collected will be as follows:

Donations tax	=	1 250 000 x 20%
	=	R250 000

(Includes donations tax on gain of 500 000 x 20% = R100 000)

Capital gain	=	1 250 000 – (750 000 + 100 000)
	=	R400 000
Capital gains tax	=	400 000 x 10,5%
	=	R42 000

Total tax collected on gain = R100 000 + R42 000 = R142 000

Example 2

Hannelie acquires a yacht by donation from her father at a time when its market value is R1 250 000. The donations tax due by her father was R245 000, calculated as follows:

Market value of asset donated	1 250 000
Section 56(2)(b) abatement	25 000
	R1 225 000
Donations tax @ 20%	R245 000

As her father failed to pay the donations tax to SARS within the prescribed period, Hannelie was held liable for the sum of R245 000 in terms of section 59 of the Income Tax Act. Assuming that her father was liable for CGT on a gain of R500 000 as a result of the donation, she may add the following amount to the base cost of her yacht.

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

$$= \frac{500\ 000}{1250\ 000} \times 245\ 000$$

$$= \text{R98 000}$$

Costs of establishing, maintaining or defending a legal title or right in an asset - Item (1)(*d*)

It is proposed that expenditure actually incurred in establishing, maintaining or defending a legal title to or right in that asset be allowed as part of base cost.

Example

Ignatius operates a night club in an upmarket area. The city council wishes to expropriate the night club's premises. The cost of legal fees in resisting the expropriation may be added to the base cost of the premises.

Cost of improvements or enhancements to value of asset - Item (1)*(e)*

It is proposed that the cost of improving or enhancing an asset also be added to base cost. Provided that the improvement or enhancement is reflected in the state or nature of the asset at the time of disposal.

Example

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

Jeannee's base cost will be R300 000 + R10 000 = R310 000. The replacement of the kitchen is not added to the base cost as it considered to be a repair and the jacuzzi is not added to base cost as it no longer exists as part of the property.

Option acquired before, asset acquired after 1 October 2001 – Item (1)(*f*)

As noted above, it is proposed that the cost of an option that is exercised form part of the base cost of the underlying asset. An exception to this rule is proposed where the asset is acquired after 1 October 2001 as a result of the exercise of an option acquired before that date. In such a case it is proposed that the market value of the option on 1 October 2001 be included in base cost.

Example

On 1 July 2001 Kosie paid R10 000 for a six-month option to acquire a beach cottage at a price of R300 000. On 1 October 2001 the market value of the option was R5 000. He exercised the option on 1 December 2001 and paid R300 000 for the cottage. The base cost of Kosie's cottage will therefore be R300 000 + R5 000 = R305 000.

Current costs – Item (1)(*g*)

It is proposed that certain holding costs of assets that are used wholly and exclusively for business purposes, shares listed on a recognised stock exchange or an interest in a unit portfolio be added to the base cost of these assets.

The proposed holding expenditure is:

- repairs and maintenance, insurance, protection
- rates and taxes on immovable property
- interest on loans used to directly finance the cost of acquiring an asset and any improvements thereto
- interest on amounts used to repay existing loans

In the case of listed shares and unit trusts, it is proposed that only *one-third* of the expenditure is allowable. This reflects the fact that where such assets are held on capital account the bulk of such expenditure is incurred in order to earn dividend income.

Examples

Non-qualifying interest – private purpose

Lucy obtains a bond which she uses to purchase a holiday home that she lets out from time to time.
Reason: The interest is incurred partly for private purposes and is therefore not wholly and exclusively laid out for business purposes.

Non-qualifying interest – indirectly incurred

Mark purchased a piece of vacant land on which he intends to build a factory. He financed the acquisition by means of a bank overdraft. The next day he won the Lotto and repaid the overdraft. Shortly thereafter, after squandering his winnings at a casino he had to resort to the overdraft to purchase a private motor vehicle.
Reason: There is no longer a direct relationship between the overdraft and the land.

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

Nico incurs interest in financing the cost of repairs, maintenance and insurance.
Reason: The interest is not related to the cost of acquiring or improving an asset.

Qualifying interest - Vacant land acquired for business purposes

Obert incurs interest directly in financing the purchase of vacant land for the purpose of erecting a factory building.
Reason: Directly related to the cost of acquisition. Note that such pre-production interest would not qualify in terms of the Income Tax Act under section 11(*b*A*)* since that section does not include land - ITC 1619 (1996), 59 SATC 309 (C)).

Substitution of a loan used to acquire or improve an asset

Penelope purchased a piece of vacant land on which she intends to build a factory. She financed the acquisition by means of a R100 000 17% loan from the Thrifty Bank. After six months the Friendly Bank offers her the same loan at 14%. She repays the Thrifty Bank loan with the proceeds from the Friendly Bank loan. Penelope is entitled to claim the interest on the second loan. (See (ITC 1020 (1962) 25 SATC 414)

Interest incurred in financing the cost of shares

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

Interest incurred	15 000
Non allowable portion (2/3 x R15 000)	(10 000)
Interest that may be added to base cost	R5 000

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

Where, for example, an employee acquires an asset from an employer at a price less than market value, the difference will constitute a taxable fringe benefit in the employee's hands. It is proposed that any gain that has been so taxed may be added to the base cost of the asset. This subparagraph proposes that the following gains be included in base cost:

- options granted to employees in terms of section 8A
- recoupments in respect of assets in terms of section 8(5)
- taxable fringe benefits in terms of the Seventh Schedule
- in the case of an interest in a CFE (controlled foreign entity):
  - the proportion of net income taxed in terms of section 9D
  - *less*: exempt foreign dividends in terms of section 9E(7)*(e)*(i).

Assets acquired as a result of a value shifting arrangement – Item (1)(*h*)

Where a person acquires or disposes of an asset as a result of a value shifting arrangement, it is proposed that certain adjustments be made to the base cost of the asset. These adjustments are explained in paragraph 23.

Amounts excluded from base cost – Subparagraphs (2) and (3)

Prohibition on the claiming of certain current costs – Subparagraph (2)

Except to the extent referred to above, it is proposed that the following expenses not form part of base cost:

- borrowing costs, including interest or raising fees;
- repairs, maintenance, protection, insurance, rates and taxes, or similar expenditure.

Example

Petro purchased her primary residence on 1 October 2001 with the assistance of a R1,5 million mortgage bond. She disposed of the residence five years later at a profit of R2 million, R1 million of which is subject to CGT. She may not claim the interest on the bond as part of the base cost of the residence.

Other exclusions from base cost - Subparagraph (3)

It is proposed that base cost be reduced in the following circumstances:

- Expenditure already claimed in determining taxable income for normal tax purposes. Expenditure allowable in determining taxable income otherwise than in terms of the Eighth Schedule may not be added to base cost. This provision prevents the double deduction of expenditure.
- Expenditure recovered or recouped. This item mirrors the recoupment provisions of section 8(4)*(a)* and *(m)* of the Act.

Example

Uriah buys an asset from Vlok for R50 000 in 5 equal annual instalments of R10 000. After 7 years Uriah has still not paid the last instalment. Vlok agrees to accept R5 000 in full and final settlement. The base cost of the asset will be R50 000 - R5 000 = R45 000.

- Expenditure unpaid and not due and payable when asset is disposed of. This is essentially an anti-avoidance measure.

Example

Roger buys an asset from Sebueng. The purchase price is payable in annual instalments of R10 000 over five years. After two years Roger sells the asset to Tolstoy for R25 000, and continues to pay off the loan to Sebueng over the next 3 years. The base cost of Roger's asset in the year of disposal will be R10 000 x 2 = R20 000. The outstanding payments will be treated as capital losses in the years in which they are paid.

Paragraph 21: Limitation of expenditure

This paragraph embodies more or less the same principles as are contained in section 23B of the Act (Prohibition of double deductions). Its purpose is twofold.

Firstly, it is proposed that where an amount qualifies as allowable expenditure in determining a capital gain or a capital loss under more than one provision of the Eighth Schedule, the amount or portion thereof, shall not be taken into account more than once in determining that capital gain or loss. (An anti double-count provision).

Secondly, it is proposed that no expenditure shall be allowed in terms of paragraph 20(1)*(a)* or *(e)* where it has in fact qualified under any other provision of the Eighth Schedule but has been limited in terms of that other provision. (An anti "carry forward" provision).

In the case of a disposal of an asset by way of donation, where the donor pays donations tax, in terms of paragraph 20(1)*(c)*(vii), the donations tax allowable as expenditure for purposes of determining base cost is calculated in terms of paragraph 22. Any balance that is not allowable as expenditure in terms of this paragraph may not then qualify as "expenditure actually incurred" in terms of paragraph 20(1)*(a)*.

Paragraph 22: Amount of donations tax to be included in base cost

Paragraph 20 proposes that a donor be entitled to add a portion of the donations tax paid to the base cost of a donated asset. This clause contains the formula to be used in calculating the allowable portion of such tax. See paragraph 20 for an example and explanation of the formula.

Paragraph 23: Base cost in respect of value shifting arrangement

This paragraph sets out the formulae proposed to be applied to the parties to a value shifting arrangement. For a full explanation of value shifting, the formulae and illustrative examples, see paragraph 1 “value shifting arrangement”.

Paragraph 24: Base cost of asset of a person who becomes a resident

It is proposed that this paragraph prescribe the treatment of immigrants disposing of assets other than those contemplated in paragraph 2(1)*(b)*(i) and (ii) (immovable property in the Republic or assets of a permanent establishment situated in the Republic) after they have become South African residents. Paragraphs 12(4) and 13(1)*(g)* propose that where non-residents become residents, their assets, other than those contemplated in paragraph 2(1)*(b)*(i) and (ii), be treated as having being disposed of on the day before they become resident in the Republic and then reacquired at market value on the same day.

The first subparagraph makes it possible for an immigrant to add any expenditure allowable in terms of paragraph 20 incurred after the date of immigration to the value of the asset as determined in subparagraphs (2) and (3) at the date of immigration.

It is proposed that immigrants value their assets not situated in the Republic upon the date that they take up residence in the Republic. They will, therefore, not be able to rely upon the time-apportionment base cost method or the “20% of proceeds rule” outlined in paragraph 26 and are restricted to using either the market value where permissible or the historic/original cost of the asset.

This paragraph envisages two distinct cases. The first is where both the proceeds and the allowable expenditure, as contemplated in paragraph 20, incurred prior to becoming a resident are less than the market value determined at the date of becoming a resident. In this case it is proposed that the immigrant must be treated as having acquired that asset at a cost equal to the higher of:

- the expenditure allowable in terms of paragraph 20 incurred in respect of that asset prior to the date of becoming a resident; or
- those proceeds less the expenditure allowable in terms of paragraph 20 incurred after that date in respect of that asset.

Two permutations are possible in the first case. Proceeds may be higher than expenditure before residence but lower than market value or expenditure before residence may be higher than proceeds but lower than market value.

Example 1

	Permutation 1	Permutation 2
Proceeds	R100 000	R75 000
Market value	R200 000	R200 000
Expenditure before residence	R50 000	R100 000
Expenditure after residence	R25 000	R25 000
Deemed base cost is the higher of:		
Expenditure before residence; or	50 000	100 000
Proceeds less Expenditure after residence	75 000	50 000
Therefore, base cost equals	R75 000	R100 000

Proceeds	100 000	75 000
Base cost	75 000	100 000
Capital gain / (loss)	R25 000	(R25 000)

In both permutations, the market value is not considered and the actual capital gain or loss allowable is determined in relation to historic cost.

The second case is where both the proceeds and the market value at the date of becoming a resident are less than the allowable expenditure, as contemplated in paragraph 20, incurred prior to becoming a resident. In this case it is proposed that the immigrant must be treated as having acquired that asset at a cost equal to the higher of:

- the market value; or
- those proceeds less the expenditure allowable in terms of paragraph 20 incurred after that date in respect of that asset.

Again, two permutations are possible in the second case. Proceeds may be higher than market value but both lower than expenditure before residence or market value may be higher than proceeds but both lower than expenditure before residence.

Example 2

	Permutation 1	Permutation 2
Proceeds	R100 000	R 75 000
Market value	R 50 000	R100 000
Expenditure before residence	R200 000	R200 000
Expenditure after residence	R 25 000	R 25 000
Deemed base cost is the higher of:		
Market value; or	50 000	100 000
Proceeds less Expenditure after residence	75 000	50 000
Therefore, base cost equals	R75 000	R100 000
Proceeds	100 000	75 000
Base cost	75 000	100 000
Capital gain / (loss)	R25 000	(R25 000)

As a result of the proposals made, where an immigrant does not value assets at the date of becoming resident, then reliance will have to be placed on expenditure allowable in terms of paragraph 20 incurred in respect of that asset prior to becoming resident as being the base cost. Where neither market value nor historic records are available, the immigrant will most probably be deemed to have no base cost in respect of that asset at the date of becoming resident.

Paragraph 25: Determination of base cost of pre-valuation date assets

It is proposed that the base cost of a pre-valuation date asset be the sum of the valuation date value of that asset, as determined in terms of paragraph 26 or 27, and the expenditure allowable in terms of paragraph 20 incurred after the valuation date in respect of that asset. This paragraph enables expenditure incurred after the valuation date to be added to base cost.

Paragraph 26: Valuation date value where proceeds exceed expenditure or expenditure in respect of an asset cannot be determined

The primary purpose of this paragraph is to propose the method to determine the valuation date value of an asset disposed of, after the valuation date where—

- that asset was acquired before the valuation date;
- proceeds exceed expenditure, allowable in terms of paragraph 20, incurred both before and after that date; and
- that asset is not an instrument as defined in Section 24J of the Income Tax Act. (These assets are dealt with in terms of paragraph 28).

Where all three criteria are met, it is proposed that the person be entitled to determine the valuation date value of the asset as any of the following:

- the market value of the asset on the valuation date as contemplated in paragraph 29;
- 20% of the proceeds from disposal of the asset after deducting from the proceeds the expenditure allowable in terms of paragraph 20 incurred after the valuation date; or
- the time-apportionment base cost of the asset, as contemplated in paragraph 30.

However, if a person has used the weighted average method of determining the base cost of that asset in terms of paragraph 32(5), that person may not adopt the time-apportionment base cost of that asset.

In essence, where a gain is anticipated with reference to expenditure incurred both before and after the valuation date, a person may elect any one of three alternative valuation date values and may do so at the date of disposal of that asset.

Where neither the person who disposed of an asset nor the Commissioner can determine the expenditure incurred before the valuation date, it is proposed that the person must determine the valuation date value of the asset as any of the following:

- the market value of the asset on the valuation date as contemplated in paragraph 29; or
- 20% of the proceeds from disposal of that asset after deducting from the proceeds the expenditure allowable in terms of paragraph 20 incurred after the valuation date.

Where a person adopts the market value as the valuation date value of that asset disposed of, and the proceeds from the disposal of that asset do not exceed the market value, it is proposed that the person must determine the valuation date value of the asset as the higher of—

- the expenditure allowable in terms of paragraph 20 incurred before the valuation date in respect of that asset; or
- those proceeds less the expenditure allowable in terms of paragraph 20 incurred after the valuation date in respect of that asset.

Example

Werner disposed of a pre-valuation date asset after the valuation date. Market value had been adopted at valuation date and proceeds do not exceed that market value. The relevant information is as follows:

Expenditure before valuation date	R100 000
Expenditure after valuation date	R 25 000

Market value at valuation date	R200 000
Proceeds upon disposal	R150 000

The valuation date value of the asset is determined as the higher of the expenditure before valuation date or the proceeds less expenditure after valuation date—

The higher of Expenditure before valuation date; or	R100 000
Proceeds less Expenditure after valuation date	R125 000
Therefore, valuation date value equals	R125 000
Base cost of the asset disposed of equals	R150 000 (125 000 + 25 000)

Proceeds	150 000
Base cost	150 000
Capital gain / (loss)	R Nil

This provision is in effect a loss limitation rule which eliminates "phantom" capital losses where the market value has been adopted at valuation date but proceeds exceed actual or historic cost. Any capital gain with reference to the actual or historic cost, however, is also disregarded.

Paragraph 27: Valuation date value where proceeds do not exceed expenditure

The primary purpose of this paragraph is to propose a method to determine the valuation date value of an asset disposed of, after the valuation date where—

- that asset was acquired before the valuation date;
- proceeds do not exceed expenditure, allowable in terms of paragraph 20, incurred both before and after that date; and
- that asset is not an instrument as defined in section 24J of the Income Tax Act. (These assets are dealt with in terms of paragraph 28).

Where all three criteria are met, it is proposed that the person may determine the valuation date value of the asset as any of the following:

- where the market value was not adopted on the valuation date, the valuation date value of that asset is the time-apportionment base cost of that asset; or
- where the market value was adopted on the valuation date, then that market value.

In essence, where a loss is anticipated with reference to expenditure incurred both before and after the valuation date, a person may elect any one of two alternative valuation date values and may do so at the date of disposal of that asset.

Where a person adopts the market value then it is proposed that the valuation date value of that asset disposed of must be determined as the lower of—

- the market value; or
- the time-apportionment base cost of that asset,

except where the expenditure allowable in terms of paragraph 20, incurred before the valuation date in respect of the asset exceeds both the proceeds from the disposal of that asset and the market value of that asset, in which case it is proposed that the person must determine the valuation date value of that asset as the higher of—

- the market value; or

- those proceeds less the expenditure allowable in terms of paragraph 20 incurred after the valuation date in respect of that asset.

Example 1

Xerxes acquired an asset 10 years before the valuation date for R100 000 which was disposed of 5 years after the valuation date for R80 000. Market value of R120 000 had been adopted at valuation date.

Expenditure before valuation date	R100 000
Market value at valuation date	R120 000
Proceeds upon disposal	R 80 000

As market value has been adopted, the valuation date value of the asset must be determined as the lower of—

- market value (MV); or
- the time-apportionment base (TAB) cost of that asset

Therefore, the lower of—

- 120 000; or
- TAB cost = 100 000 + [(80 000 – 100 000) x (10/(5+10))]
  = 100 000 + (-20 000 x 2/3)
  = 100 000 – 13 333
  = 86 667

equals R86 667

Proceeds	80 000
Base cost	86 667
Capital loss	R6 667

In this example, paragraph 27 is applicable as proceeds do not exceed expenditure allowable in terms of paragraph 20 incurred both before and after the valuation date. As the market value has been adopted and it exceeds expenditure allowable in terms of paragraph 20 (Paragraph 27(2) is therefore not applicable) the lower of MV or TAB is the valuation date value to be utilised. The effect is to limit the capital loss to the loss that would be allowable on a time-apportionment basis.

Example 2

Assume the same information as for example 1 but the expenditure allowable in terms of paragraph 20 incurred *before* the valuation also exceeds the market value (Paragraph 27(2) is applicable). Market value of R90 000 had been adopted at valuation date.

Expenditure before valuation ate	R100 000
Market value at valuation date	R 90 000
Proceeds upon disposal	R 80 000

The valuation date value of the asset must be determined as the higher of—

- market value (MV); or
- those proceeds less the expenditure allowable in terms of paragraph 20 incurred after the valuation date.

Therefore, the higher of—
- 90 000; or
- 80 000 (80 000 – Nil)

equals R90 000

Proceeds	80 000
Base cost	90 000
Capital loss	(R10 000)

In this example, paragraph 27 is applicable as proceeds do not exceed expenditure allowable in terms of paragraph 20 incurred both before and after the valuation date. As the market value has been adopted and it does not exceed expenditure allowable in terms of paragraph 20 incurred before the valuation date, the higher of market value or proceeds less expenditure after valuation date is the valuation date value to be utilised.

Paragraph 28: Valuation date value of an instrument

This paragraph deals with interest-bearing arrangements such as bank deposits, loans, stocks, bonds, debentures and similar assets.

It is proposed that the valuation day value of an “instrument” as defined in section 24J be determined using one of the following methods:
- the “adjusted initial amount” on 1 October 2001.
- the market value on 1 October 2001.

The “adjusted initial amount” is a term defined in section 24J. In essence it is the initial amount paid for the instrument, plus the cumulative amount of all interest accrued and amounts paid less all amounts received from date of acquisition to 1 October 2001.

The market value is the price which could have been obtained upon a sale of the instrument between a willing buyer and a willing seller dealing at arm's length in an open market.

Example

On 31 December 2000 Argh (Pty) Ltd, a company with a financial year end of 30 June, acquires a financial instrument with a term of two years at a discount of R1 200 000 to the face value of R10 000 000. Interest is receivable 6-monthly, calculated at 3% of the face value of the instrument. At maturity date, 31 December 2002, the instrument will be redeemed at par.

Step 1 – Calculation of the yield to maturity

The cash flows may be summarised as follows:

31 December 2000	(8 800 000)
30 June 2001	300 000
31 December 2001	300 000
30 June 2002	300 000
31 December 2002	10 300 000
	R 2 400 000

The accrual period is six months, and the resultant yield to maturity is therefore 6.50308% per accrual period.

Step 2 – Calculation of interest accrued for the year ending 30 June 2001

Interest accrued calculated as follows:
R8 800 000 x 6.50308% = R572 271

Step 3 – Calculation of interest accrued up to valuation date

Interest accrued calculated as follows:
(R8 800 000 + 572 271) x 6.50308 x 3/12 = R152 372

Step 4 – Calculation of "adjusted initial amount" on valuation date

Initial amount paid	8 800 000
Total cash inflows resulting from transactions	(300 000)
Total interest accrued to 30 September 2001	724 643
Adjusted initial amount	R9 224 643

Paragraph 29: Market value on valuation date

This is a transitional measure and deals with the requirements regarding the valuation of assets on valuation date. (Paragraph 31 contains the permanent market value rule.)

(a) **Market value of financial instruments listed in the Republic – paragraph 29(1)(*a*)(i)**

It is proposed that shares and other financial instruments listed on a recognised exchange in the Republic be valued at the average of the buying and selling prices quoted at close of business on each of the five days of trading preceding the valuation date. Since 29 and 30 September 2001 fall on a weekend, this means that the prices quoted from Monday 24 September 2001 to Friday 28 September 2001 will be used. The averaging of prices in this way was necessary to ensure that shares were fairly valued on 1 October 2001. Share prices can be manipulated upwards ("ramped") by substantial players in the market for the purpose of inflating the base cost of their shares. Share prices can also be distorted, upwards or downwards, at a single moment in time as a result of a thinly traded market.

In order to assist taxpayers SARS will do the necessary calculations and make the valuation date prices available to taxpayers by way of *Government Gazette*.

Example

The following table illustrates the last buying and selling prices of shares in Queue Limited on the JSE during the five trading days preceding 1 October 2001:

Date	Last buying price	Last selling price	Average
Monday 24 September 2001	200	210	205
Tuesday 25 September 2001	190	196	193
Wednesday 26 September 2001	185	195	190
Thursday 27 September 2001	180	190	185
Friday 28 September 2001	190	190	190
Total	945	981	963

In this case the valuation date value would be 963/5 = 192.6

(b) Financial instruments not listed in the Republic – paragraph 29(1)(*a*)(ii)

It is proposed that financial instruments listed on a recognised foreign exchange outside the Republic be valued at the average of the buying and selling prices quoted at the close of business on the last trading day preceding 1 October 2001. In the case of a dual listing, for example, a share listed on both the JSE and London Stock Exchanges, the price as computed in *(a)* above would be used.

(c) South African Equity unit trusts and Property unit trusts – paragraph 29(1)(*b*)(i)

It is proposed that these be valued according to the price that will be published by the Commissioner in the *Government Gazette* which will be:

- the average of the price at which a unit could be sold to the management company of the scheme (usually the "sell" price quoted in most newspapers);
- for the last five trading days before valuation date.

(d) Foreign unit trusts – paragraph 29(1)(*b*)(ii)

It is proposed that these units be valued according to:

- the last price published before valuation date;
- at which a unit could be sold to the management company of the scheme; or
- where there is not a management company, the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market.

In essence the above requirements are the same as those for local unit trusts except that there is no need to determine a five-day average. SARS for practical reasons cannot publish such prices and taxpayers will have to obtain these themselves, and retain the necessary supporting documents.

(e) Other assets

It is proposed that all other assets be valued at market value in terms of paragraph 31.

(f) Valuation of controlling interest in listed shares– paragraph 29(2)

A controlling interest in a listed company usually gives the shareholder the right to appoint the board of directors, pass resolutions and generally control the direction of the company. A person acquiring such an interest will usually pay a premium for the privilege, though in some cases it can happen that the shares will be disposed of at a discount. If such an interest were to be valued according to the normal prices quoted on an exchange, the result in most cases would be that the base cost of the shares would be understated. In order to avoid the problems inherent in valuing such an interest on valuation date, it is proposed that the premium or discount be determined at date of disposal by comparing the actual selling price with the price quoted the day before the announcement of the disposal. This premium or discount would then be applied to the base cost of the shares disposed of.

For this subparagraph to apply, it is proposed that the controlling interest:
- be held in a listed company;
- exceed 50%;
- be disposed of in its entirety:

and the buyer and seller not be connected persons.

The formula to be applied is set out in the example below:

Example

Sweet Pea Ltd holds 51% of the issued share capital of Pea Ltd, a company listed on the JSE for the past 6 years. Sweet Pea Ltd decides to dispose of its entire interest in Pea Ltd to Oh (Pty) Ltd.

Date of sale	1 October 2002
Total number of Pea Ltd shares held by Sweet Pea Ltd	3 000 000
Last buying price per Pea Ltd share on 30 September 2002 (per JSE)	R1.95
Last selling price per Pea Ltd share on 30 September 2002 (per JSE)	R2.05
Price per share in terms of sale agreement	R2.20
Average price per Pea Ltd share per paragraph 29(1)(a)(i)	R1.50

Step 1 - Calculate market value on valuation date

Valuation date market value (3 000 000 x R1.50)	4 500 000

Step 2 – Calculate control premium or discount

Average last price quoted = (1.95 + 2.05)/2
= R2.00

$$\text{Base cost adjustment} = \frac{\text{Price per sale agreement} - \text{Last price quoted}}{\text{Last price quoted}}$$

$$= \frac{(2.20 - 2.00)}{2.00}$$

$$= 10\%$$

Step 3 – Determine base cost

Control premium R4 500 000 x 10%	450 000
Base cost	R4 950 000

Step 4 – Determine capital gain

Proceeds 3 000 000 x R2.20	6 600 000
Base cost	4 950 000
Capital gain	R1 650 000

(g) Time limit on obtaining valuations - paragraph 29(4)

It is proposed that a taxpayer wishing to use the market value basis for determining the base cost of an asset must have the asset valued by no later than 30 September 2003.

(h) Compulsory submission of valuations - paragraph 29(5)

It is proposed that persons wishing to adopt the market value basis be required to submit proof of the valuation to the Commissioner. Where the value of the asset or assets exceeds the amounts set out in the table below, the form in which the proof must be submitted will be prescribed by the Commissioner.

Type of asset	Applies	Where market value exceeds
Intangible assets	Per asset	R 1 million
Unlisted shares	All shares held by the shareholder in the company	R10 million
All other assets	Per asset	R10 million

It is proposed that in these cases the proof be submitted with the first return submitted after 30 September 2003.

Example

Andrew owns 10 shares in Enne (Pty) Ltd, a company with a 31 August financial year end. His accountant carried out a valuation of his shares on 31 August 2002 and valued them at R1,5 million each as at 1 October 2001. The accountant's valuation of the assets in the company was the following:

Fixtures and fittings	R10 000 000
Goodwill	R2 500 000

Trademarks	R1 700 000	
Liquor licence	R800 000	

The fixtures and fittings are made up of numerous small items, each valued at less than R200 000.

Enne (Pty) Ltd submitted its return for the year ending 31 August 2002 on 31 August 2003 and obtained an extension to submit its 2003 return by 31 August 2004.

Andrew submitted his return for the year ending 28 February 2003 on 28 February 2004.

Assuming that Andrew and Enne (Pty) Ltd wish to adopt the market value basis for all their assets, proof of valuation must be submitted to SARS in respect of the following assets:

Asset	Reason	Proof to be submitted with return for year ending:
Shares in Enne (Pty) Ltd	MV > R10 million	28 February 2003
Intangible assets		
• Goodwill	MV > R1 million	31 August 2003
• Trademarks	MV > R1 million	31 August 2003

(i) Submission of proof of valuation upon disposal - para 29(6)

When an asset is disposed of, proof of valuation must be submitted with the return reflecting the disposal.

(j) Right of Commissioner to amend valuation or call for further particulars - para 29(7)

Where the Commissioner is not satisfied with a valuation, he may—

- call for further particulars relating thereto, or
- adjust the valuation.

The right to adjust the valuation has been made subject to objection and appeal.

(k) Period for performing valuations may be extended by Minister - para 29(8)

The period within which all valuations must be performed (that is, by 30 September 2003) may be extended by the Minister of Finance by notice in the *Government Gazette*.

Paragraph 30: Time-apportionment base cost

Paragraph 30, in essence proposes the formulae to be used in determining the time-apportionment base cost of an asset. This paragraph provides for two variations. The first, being where an asset was acquired before the valuation date and there were no additions or reductions to that asset in more than one year of assessment prior to the valuation date, before its disposal. The second, being where an asset was acquired before the valuation date and there were additions or reductions to that asset in more than one year of assessment prior to the valuation date, before its disposal.

The first variation mentioned above involves no further expenditure, as contemplated in paragraph 20, in respect of the acquired asset other than the actual cost of acquisition (including any qualifying expenditure incurred in the same year of assessment as the acquisition cost).

Example

Barbara acquired a piece of land in Johannesburg 30 years prior to the valuation date for R200 000 and disposed of that piece of land 10 years after the valuation date for R2 000 000. Barbara incurred no other expenditure allowable in terms of paragraph 20 during her ownership of the land and as she had not valued the land at valuation date, she adopted the time-apportionment basis in determining the valuation date value. Determine the capital gain that arises in Barbara's hands.

Paragraph 30(1) applies—

Y = B + [(P – B) x (N / (T + N))]
= 200 000 + [(2 000 000 – 200 000) x (30 / (10 + 30))]
= 200 000 + (1 800 000 x 30/40)
= 200 000 + 1 350 0000
= R1 550 000

Therefore, the time-apportionment base (TAB) cost equals R1 550 000.

Proceeds	R2 000 000
TAB cost	R1 550 000
Capital gain	R 450 000

Note that where expenditure was incurred in only one year of assessment prior to the valuation date, "N", in the above formula, is not limited to 20 years. Where Barbara had made improvements after the valuation date, for instance built a shopping centre, this would not have affected the valuation date value in terms of the time-apportionment base cost. Expenditure incurred after the valuation date would be added to the valuation date value in terms of paragraph 25 in order to determine the base cost of the asset.

The second variation mentioned above involves further expenditure (additions or reductions), as contemplated in paragraph 20, in respect of the acquired asset, other than just the actual cost of acquisition, incurred in more than one year of assessment, prior to the valuation date. Note that expenditure includes reductions to base cost such as wear and tear allowances.

Example

The facts are the same as in the example above, except that Barbara erected a shopping centre upon her piece of land, 2 years before the valuation date for R5 000 000 and one year after the valuation date she effected improvements to the shopping complex amounting to R1 000 000. She disposed of the shopping complex along with the land 10 years after the valuation date for R12 000 000.

As the total amount of expenditure allowable in terms of paragraph 20 was incurred in more than one year of assessment, the proceeds to be used in determining the TAB cost must be determined in accordance with the formula contained in paragraph 30(2) –

P = T x (B / (A + B))
= 12 000 000 x [(200 000 + 5 000 000) / (1 000 000 + (200 000 + 5 000 000))]
= 12 000 000 x (5 200 000 / 6 200 000)
= 12 000 000 x 0,8387
= 10 064 516

The purpose of this formula is to allocate the percentage of proceeds attributable to the period of ownership before valuation date.

Paragraph 30(1) is then applied—

Y = B + [(P – B) x (N / (T + N))]
= (200 000 + 5 000 000) + [(10 064 516 – (200 000 + 5 000 000)) x (20 / (10 + 20))]
= 5 200 000 + [(10 064 516 – 5 200 000) x 20/30]
= 5 200 000 + 3 243 011
= 8 443 011

Therefore, the time-apportionment valuation date value (VDV) equals R8 443 011.

Proceeds	R12 000 000
Time-app. VDV + Post-expenditure	R 9 443 011 (8 443 011 + 1 000 000)
Capital gain	R 2 556 989

Note that where expenditure was incurred in more than one year of assessment prior to the valuation date, "N", in the above formula, is limited to 20 years. In this example, Barbara loses 10 years in respect of her piece of land. However, this also means that although the major portion of his allowable expenditure relates to a period shortly before the valuation date, this too is spread back to the date of the first allowable expense forming the base cost of the asset. (In this case, it is spread back 18 years).

Example

Emme (Pty) Ltd wishes to dispose of one of its smaller factories along with all plant, involved in the manufacture of gadgets, and rather to concentrate on its core business of manufacturing widgets. The company concludes a deal to dispose of the factory with effect from 1 October 2011 for R12 000 000.

- The factory together with the land specifically acquired for it was erected during 1986 at a cost of R2 000 000 by Emme (Pty) Ltd and was used wholly or mainly for carrying on a process of manufacture. The building was subject to an initial allowance of 17,5% and an annual allowance of 2%.
- Plant costing R1 000 000 was acquired on 1 October 1986 and wear and tear was allowed by the Commissioner at the rate of 10% per annum on the reducing balance method.
- Additional new plant costing R1 500 000 was acquired on 1 October 1989 and was written-off over 3 years for income tax purposes.
- Additional plant costing R2 500 000 was acquired on 1 October 2008 and was written-off over 5 years for income tax purposes.

The company's year-end is 31 December. No valuation was carried out at 1 October 2001 and the company elects the time-apportionment basis to determine the capital gain.

Factory Building	
Original cost	2 000 000
Initial allowance (17,5%)	350 000
	1 650 000
Annual allowance (2%)	858 000
Tax value at date of disposal	R 792 000
Recoupment at disposal	R1 208 000

Plant acquired in 1986	
Original cost	1 000 000
Wear and tear	935 389
Tax value at date of disposal	R 64 610
Recoupment at disposal	R 935 389

Plant acquired in 1989	
Original cost	1 500 000
Wear and tear	1 500 000
Tax value at date of disposal	R Nil
Recoupment at disposal	R1 500 000

Plant acquired in 2008	
Original cost	2 500 000
Wear and tear	1 500 000
Tax value at date of disposal	R1 000 000
Recoupment at disposal	R1 500 000

As the total amount of expenditure in terms of paragraph 23 was incurred in more than one year, paragraph 30(2) is first applied—

Remember!
Recouped amounts must be deducted from proceeds in terms of paragraph 35(3):

12 000 000 – 1 208 000 – 935 389 – 1 500 000 – 1 500 000 = R6 856 611

P = 6 856 611 x (792 000 + 64 610 + Nil)/(792 000 + 64 610 + Nil + 1 000 000)
= 6 856 611 x (856 610 / 1 856 610)
= 6 856 611 x 0,46
= R3 154 041

Then the formula in paragraph 30(1) is applied –

Y = (792 000+64 610+Nil)+[(3 154 041–(792 000+64 610+Nil)) x 15/(11+15)]
= 856 610 + [2 297 431 x 15 /26]
= 856 610 + 1 325 441
= R2 182 051

Plant 2008 = 1 000 000 (Asset acquired after the valuation date, not subject to formula)

Total proceeds	6 856 611
Total base cost (2 182 051 + 1 000 000)	3 182 051
Capital gain upon disposal	R3 674 560

Paragraph 31: Market value

Paragraph 31, as summarised below, provides how the “market value” is to be determined for different kinds of assets. The term is used throughout the Eighth Schedule in a wide variety of circumstances, such as on valuation date (base cost), death, donation, emigration and immigration.

Type of asset	**Market value**
Financial instrument listed on a recognised exchange	Average of listed buying and selling prices at close of business on last trading day before disposal
Long-term insurance policy	Greater of: • Surrender value • Insurer’s market value (assume policy runs to maturity).
Unit trusts and property unit trusts	Management company’s repurchase price.
Foreign unit trusts	Management company’s repurchase price or if not available, selling price based on willing buyer, willing seller acting at arm’s length in open market.
Fiduciary, usufructuary and other like interests	Present value of future benefits discounted at 12% p.a. over life expectancy of person entitled to asset or lesser period of enjoyment. Commissioner may approve less than 12% where justified.
Property subject to fiduciary, usufructuary or other like interest	Market value of full ownership, less Value of fideicommissum or usufruct etc as determined above.
Immovable farming property	• Land Bank value (defined in Estate Duty Act) or • Price based on willing buyer, willing seller at arm’s length in open market. On disposal by death, donation or non-arm’s length transaction, the Land Bank value may only be used if it is used in determining the base cost of the disposer on- • Valuation date, or, where applicable, • date acquired by inheritance, donation or non-arm’s length transaction at Land Bank value.
Any other asset	Price based on willing buyer, willing seller at arm’s length in open market.

Unlisted shares	Price based on willing buyer, willing seller at arm's length in open market, ignoring any: • Restrictions on transferability • Stipulated method of valuation. If shareholder entitled to greater share of assets on winding-up, the value must not be less than the amount the shareholder would have received had the company been wound up.

Paragraph 32: Base cost of identical assets

The purpose of this clause is to propose rules for the determination of the base cost of assets which form part of a group of similar assets. Such assets are sometimes referred to as fungible assets. When an asset of this nature is sold it may not be possible to physically identify the particular asset that is being disposed of. Hence it is necessary to lay down identification rules. Examples include Kruger Rands, units in a trust and shares.

A dual test has been devised to identify these assets. First, if any one of the assets in a particular holding were to be sold, it would realise the same amount as any one of the other assets in that holding. Secondly, all the assets in the group must share the same characteristics.

Example

The following would each constitute a separate holding of identical assets:

- all A class ordinary shares in Elle Ltd
- all B class ordinary shares in Elle Ltd
- all 12% preference shares in Elle Ltd
- all 10% preference shares in Elle Ltd

Where such assets have unique identifying numbers, for example, share certificate numbers, that fact is ignored for the purpose of determining whether an asset is part of a holding of identical assets.

Taxpayers are permitted to adopt one of three alternative methods:

- specific identification
- first in first out
- weighted average

The weighted average method may not be used where the base cost of an asset is determined using time-based apportionment. This is due to the fact that under time-based apportionment it is necessary to know the date of acquisition of each asset. Where the assets are pooled this will not be possible.

Each of these methods is discussed below:

(a) Specific identification

Under the specific identification method the cost of each asset disposed of is discretely identified. This could be done, for example, by reference to share certificate numbers.

(b) First in first out (FIFO)

Under the FIFO method it is assumed that the oldest asset is sold first.

(c) Weighted average

There are at least two ways of determining the weighted average cost of identical assets. However, the *moving average* method must be used for the purposes of this paragraph. Under this method an average unit cost is computed after each acquisition of an asset by adding the cost of the newly acquired assets to the cost of the existing assets on hand and dividing this figure by the new total number of assets. An alternative method involves a periodic calculation of the weighted average cost. This is not acceptable for CGT purposes.

Once a method has been adopted in respect of a holding of assets, that method must be used until all the assets in the particular class have been disposed of. The purpose of this requirement is to prevent base cost manipulation.

Example 1

Christell has 1000 Kay Ltd preference shares, 2000 Kay Ltd ordinary shares and 50 Kruger Rands. She decides to use specific identification for the Kay Ltd preference shares, the FIFO method for the Kay Ltd ordinary shares and weighted average for the Kruger Rands. She sells 1500 of her 2000 Kay Ltd ordinary shares and, six months later, buys 3000 Kay Ltd ordinary shares. She must use the FIFO method until her holding of those shares has been exhausted, that is, until the remaining 3 500 shares have been disposed of.

Example 2

Daphne holds the following units in a unit trust:

Date purchased	No. of units	Cost per unit	Cost
1 October 2001	100	1.50	150
1 November 2001	50	1.60	80
1 December 2001	150	1.70	255
1 January 2002	100	1.35	135
	400		R620

On 28 February 2002 Daphne sells 125 units.

Specific identification method

Daphne's records show that she sold the 50 units acquired on 1 November 2001 and 75 of those acquired on 1 December 2001.

Details of units sold	Quantity sold	Cost per unit	Base Cost
Acquired 1 November 2001	50	1.60	75.00
Acquired 1 December 2001	75	1.70	27.50
	125		R202.50

First in first out method

Under this method the assumption is that the oldest units are sold first. In this case the oldest units are the 100 purchased on 1 October 2001 and 25 of those purchased on 1 November 2001.

Details of units sold	Quantity sold	Cost per unit	Base Cost
Acquired 1 October 2001	100	1.50	150
Acquired 1 November 2001	25	1.60	40
	125		R190

Weighted average method

The weighted average unit cost is 620/400 = R1.55
The base cost of 125 units is therefore 125 x 1.55 = R193.75

Paragraph 33: Part-disposals

This paragraph proposes rules where part of an asset is disposed of. In such circumstances it is necessary to allocate part of the base cost of the asset to the part disposed of in order to determine the capital gain or loss in respect of that part. It is proposed that this be done according to the formula:

$$\frac{\text{Market value of part disposed of}}{\text{Market value of entire asset immediately prior to disposal}} \times \text{Base cost of entire asset}$$

The remainder of the base cost would be allowable on a future disposal of the part retained.

The formula described above would not apply where a part of the base cost of an asset could be directly attributed to—

- the part which is disposed of; or
- the part which is retained.

In such a case, specific identification could be used to determine the part of the base cost disposed of. This provision dispenses with the need for unnecessary valuations.

Some practical issues:

- Record keeping: A permanent record would have to be kept of the balance of the cost allocated to the part of the asset retained, for use in computing the gain or loss on any subsequent disposal or part-disposal.
- Composite acquisitions: Where the asset disposed of was obtained with other assets as part of a composite acquisition (for example, a single contract of purchase at an inclusive price embracing more than one asset), the purchase price would have to be apportioned to the respective assets broadly by reference to their market values at the date of acquisition.
- Disposal of usufructs and similar interests and subsequent enhancements: If the part-

disposal is a disposal of an interest in an asset for a limited period, so that at the end of the period the person is able to dispose of the whole unencumbered asset, the cost to be attributed to the final disposal would be the residue after the apportionment of part of the base cost to the first and any subsequent part-disposals. If at any time between disposals there is any enhancement expenditure, that expenditure would have to be added to the remaining base cost after the last part-disposal for the purposes of determining the base cost of the next disposal. The result is that an amount included in base cost would only be allowed once in the calculation of a capital gain or loss.

Example 1

Eric has held a two hectare piece of vacant land at Hermanus for a considerable length of time. He has been approached by a developer who has offered him R400 000 for half the property. An estate agent has valued the entire property at R1 000 000. The market value of the property on 1 October 2001 was R700 000, and Eric has elected to use the market value basis to determine base cost on valuation day.

Base cost of entire asset	700 000
Market value of part disposed of	400 000
Market value of entire asset	1 000 000

Base cost of part sold $= \frac{400\ 000}{1\ 000\ 000} \times 700\ 000$

= R280 000

Eric would realise a capital gain of R120 000 (400 000 – 280 000) if he were to dispose of portion of the vacant land to the developer.

Example 2

Fiona purchased two adjoining pieces of land ten years prior to valuation day within 6 months of each other. She paid R50 000 for the first piece and R75 000 for the other and thereafter had them consolidated. On 1 October 2006 she decided to re-subdivide the property and sell off the piece that cost her R50 000. She has elected to use the time-apportionment basis to determine base cost. She sells the piece for R170 000.

Proceeds	170 000
Expenditure (recognisable fraction)	50 000
Gain	R120 000

The property was acquired 10 years prior to valuation day and sold 5 years thereafter. Therefore the portion of profit to be added to expenditure is 10/15. The time-apportionment base cost of the asset is therefore R50 000 + (R120 000 x 10/15) = R130 000.

Proceeds	170 000
Time-apportionment base cost	130 000
Capital gain	R40 000

Paragraph 34: Debt substitution

In terms of the proposed Schedule the disposal by a person of an asset to a creditor in order to reduce or discharge a debt owed to that creditor would result in a disposal by the debtor as well as a disposal by the creditor.

The debtor would dispose of the asset for a consideration equal to the amount by which the debt owed to the creditor is reduced as a result of that disposal (see the proposed paragraph 35(1)*(a)*). The debtor would therefore determine a capital gain or a capital loss in respect of that disposal depending on whether or not that consideration would constitute proceeds and whether those proceeds will exceed the base cost of that asset.

The creditor, in turn, would dispose wholly or partially of his claim against the debtor for proceeds equal to the market value of the asset obtained in return. The creditor would, therefore, show a gain or a loss where the market value of the asset obtained from the debtor exceeds or is less than the amount by which the creditor's claim would be reduced. The creditor may have to account for this gain or loss as a capital gain or loss if that gain or loss is not taken into account for purposes of determining the creditor's taxable income before the inclusion of any taxable capital gain, for example, if a loss is not taken into account as a bad debt under section 11*(i)*.

The base cost, for the creditor, of the asset acquired from the debtor would in the absence of the proposed debt substitution rule be equal to the consideration given by the creditor, namely the amount of the claim given up by the creditor. This paragraph, however, proposes that the asset be treated as one acquired by the creditor at a base cost equal to its market value at the time. This prevents any double counting, in the creditor's hands, of an amount equal to the gain or loss determined in respect of the exchange of the creditor's claim for that asset.

Example

Gerrie owes Helen R1 000. Helen agrees to release Gerrie from that debt in return for the transfer, by Gerrie to Helen, of an asset to the value of R900 that Gerrie originally acquired for R500.

Gerrie's gain = proceeds - base cost = R1 000 - R500 = R500.
Helen's loss = base cost - proceeds = R1 000 - R900 = R100.

The base cost of Helen’s new asset is R900.

PART VI: PROCEEDS

Paragraph 35: Proceeds from disposal

It is proposed that the proceeds from the disposal of an asset is the amount received by or accrued to or which is treated as having been received by or accrued to or in favour of a person as a consequence of the disposal. The proceeds include—

- the amount by which any debt owed by that person has been reduced or discharged; and
- any amount accruing to the lessee from the lessor for improvement affected to the leased property.

The concept of received or accrued is the same as used for ordinary income in the Act.

It is proposed that the proceeds be reduced by the following amounts—

- any amount of the proceeds that is included in gross income or is taken into account when determining the taxable income of that person before the inclusion of capital gains. For example proceeds on the disposal of an asset are, therefore, reduced by any recoupments of wear and tear or capital allowance;
- any amount of the proceeds that has been repaid or has become repayable to the person to whom that asset was disposed of;
- any reduction as a result of, amongst others, the cancellation or termination of an accrued amount forming part of the proceeds of that disposal.

The proceeds from a disposal by way of a value shifting arrangement is dealt with specifically in paragraph 35(2). The proceeds are the difference between the market value of the interest in the company trust or partnership before the value shifting event takes place and the market value of that interest after the event has occurred. The proceeds are the amount by which the market value has decreased. (See the proposed paragraph 1 and 23 for further details and examples on value shifting)

Paragraph 36: Disposal of partnership asset

This paragraph proposes that the proceeds from the disposal of a partner's interest in a partnership asset be treated as having accrued to the partner at the time of the disposal. This is intended to provide certainty as to when capital gains or losses accrue.

The core rules of the Eighth Schedule which apply to all persons would apply to partners, as well as the existing provisions of the Act dealing with the submission of returns and the issuing of assessments.

Paragraph 37: Assets of trust and company

It is proposed that capital gains and capital losses determined in respect of most personal-use assets be disregarded. Also in the case of certain assets such as boats and aircraft not used for trade purposes, which will remain within the CGT system, it is proposed that capital losses determined in respect of them be disregarded. (see the proposed paragraph 15 for the reasons why it is proposed that the losses be disregarded.)

The purpose of this proposed paragraph is to prevent persons from circumventing these provisions by holding these assets in a closely held company or trust. The paragraph provides that—

- where a trust or company, the interest in which or shares of which, are owned directly or indirectly by a natural person;
- that trust or company owns assets such as a boats or aircraft or assets which if owned by natural persons would be personal-use assets;
- there is a decrease in the value of the assets of the trust or company after that person acquired the interest in the trust or company;
- the interest in the trust or company is thereafter disposed of by a person,

that person is treated as having disposed of the interest at proceeds equal to market value, as if the market value of the assets of the trust or company had not decreased.

The effect of the paragraph is to disregard any loss that person may suffer as a result of the decrease in the value of the assets. This paragraph does not apply where more than 50% of the assets of the trust or company consists used wholly and exclusively for trading purposes.

Paragraph 38: Disposal by way of donation, consideration not measurable in money and transactions between connected persons not at arm's length price

This paragraph proposes that a donation be treated as a disposal of an asset by the donor and an acquisition of that asset by the donee at market value. The rule also proposes that the market value of the asset be substituted for the actual consideration to which the parties agreed in the case of a disposal for a consideration not measurable in money and a disposal to a connected person (other than to a spouse) for a consideration which does not reflect an arm's length price.

Example 1

Johan donates a yacht exceeding ten metres in length to Indira as a token of his affection for her. There is no marital-like union between them at the time in spite of Johan's efforts to establish one. The yacht has a base cost of R1 000 000 and has a market value of R2 500 000 at the time of the donation.

Johan and Indira do not qualify as spouses. The base cost of R1 000 000 in the hands of Johan is therefore not transferred to Indira. The transaction is treated as a disposal by Johan for a consideration of 2 500 000. Johan will therefore realise a capital gain of R1 500 000 in respect of the donation, while Indira will be treated as having acquired the yacht at a base cost of 2 500 000.

Example 2

Keith sells an aircraft with a base cost of R1 000 000 and a market value of R3 500 000 to Lionel for a consideration that cannot be turned into money. Keith cannot treat the transaction as a disposal for a consideration having a value of nil and claim the base cost of the aircraft as a capital loss. Keith and Lionel will have to treat the transaction as a disposal and acquisition at R3 500 000. Keith will therefore realise a capital gain of R2 500 000 in respect of this disposal.

Example 3

Jay Ltd sells immovable property with a base cost of R1 000 000 to Eye (Pty) Ltd, a subsidiary of Jay Ltd, for R2 200 000. Eye (Pty) Ltd plans to use the immovable property for purposes of erecting a factory.

It turns out that the property is much sought after due to its situation and that Jay Ltd received unsolicited offers in respect of it from independent third parties right up to the moment of its sale to Eye (Pty) Ltd. The price on offer to Jay Ltd at the time of the sale to Eye (Pty) Ltd amounted to R2 900 000.

The price agreed to between Jay Ltd and Eye (Pty) Ltd is lower than the price that the property might have been expected to fetch had Jay Ltd and Eye (Pty) Ltd been independent persons dealing at arm's length. The market value (i.e. R2 900 000) of the property is therefore substituted for the consideration agreed to between Jay Ltd and Eye (Pty) Ltd.

Paragraph 39: Capital losses determined in respect of disposals to certain connected persons

This rule proposes that a person's capital loss determined in respect of the disposal of an asset to a connected person be treated as a "clogged" loss. It is proposed that the capital loss in question not be brought into account in determining that person's aggregate capital gains or aggregate capital loss for the tax year in which that disposal takes place. The loss will in effect be ring-fenced so that it could be deducted only from capital gains determined in respect of other disposals during that or any subsequent year to the same person to whom the disposal giving rise to that loss was made. The person to whom the subsequent disposals are made would have to, moreover, still qualify as a connected person at the time of those disposals. The definition of "connected person" will not extend, for purposes of this rule, to any relative of a natural person other than a spouse, parent, child, brother, sister, grandchild or grandparent of that person.

Example

During *year 1* Aitch Ltd sold undeveloped immovable property having a base cost of R1 000 000 to Gee (Pty) Ltd, a wholly-owned subsidiary, at its market value of R500 000. During *year 2* saw a further sale by Aitch Ltd to Gee (Pty) Ltd of undeveloped immovable property with a base cost of R500 000 and a market value of R400 000. This sale was effected at a price of R600 000. During year 3 Aitch Ltd sold a shopping complex with a base cost of R1 500 000 to Gee (Pty) Ltd at a market related price of R1 800 000. This was followed during *year 4* by the sale of all the shares held by Aitch Ltd in Gee (Pty) Ltd to a foreign developer not linked to Apex Ltd. Gee (Pty) Ltd subsequently made an offer to Aitch Ltd to buy the remaining immovable property held by Aitch Ltd. Aitch Ltd accepted the offer and sold the property that had been acquired by it at a base cost of R300 000 to Gee (Pty) Ltd at its market value of R800 000.

Year 1

Aitch Ltd cannot take the capital loss of R500 000 determined in respect of the first disposal to Gee (Pty) Ltd into account in determining its aggregate capital gain or aggregate capital loss for year 1, as that loss arose from a disposal to a connected person. It can only deduct that loss from gains from disposals to Gee (Pty) Ltd during that or a subsequent year made while Gee (Pty) Ltd qualifies as a connected person in relation to Aith Ltd.

Year 2

Aitch Ltd sold property with a base cost of R500 000 to Gee (Pty) Ltd at R600 000. The sale between the connected parties clearly took place at a price not reflecting an arm's length price. The market value of the property of R400 000 is therefore substituted in terms of paragraph 38 for the price agreed on between the parties. This results in a capital loss of R100 000 in respect of that disposal. There is therefore no gain from which the loss of R500 000 from year 1 can be deducted. The total amount of the clogged loss at the end of year 2 is therefore R600 000.

Year 3

Aitch Ltd can reflect a capital gain of R300 000 in respect of market value disposals to Gee (Pty) Ltd during the year. The clogged losses of R600 000 can therefore be brought into account against this capital gain, leaving a balance of R300 000 as a clogged loss.

Year 4

Aitch Ltd shows a capital gain of R500 000 in respect of the disposal, at market value, to Gee (Pty) Ltd. Gee (Pty) Ltd, however, no longer qualifies as a connected person in relation to Aitch Ltd at the time of that disposal. The clogged loss of R300 000 cannot therefore be deducted from that gain. It will remain a clogged loss until such time as Gee (Pty) Ltd again qualifies as a connected person in relation to Aitch Ltd when it may again be possible to deduct that loss from capital gains arising from disposals by Aitch Ltd to Gee (Pty) Ltd.

Paragraph 40: Disposal to and from deceased estate

The proposed treatment of capital gains and losses in the hands of heirs and legatees mirrors that afforded to ordinary income accruing in the estate in terms of section 25.

It is proposed that a deceased person be treated as having disposed of his or her assets at market value on the date of death with the exception of—

- assets transferred to the surviving spouse;
- assets bequeathed by the deceased to a public benefit organisation approved by the Commissioner in terms of section 30; and
- a long-term insurance policy of the deceased which if the proceeds had been paid to the deceased, the capital gain or capital loss would have been disregarded in terms of paragraph 55.

It is proposed that the deceased estate be treated as having acquired those assets at a cost equal to that market value. Where the assets are finally distributed to the heirs, legatees or to a trustee of a trust other than the surviving spouse or an approved public benefit organisation, it is proposed that—

- the deceased estate be treated as having disposed of the assets for proceeds equal to the market value of the asset; and
- the heir, legatee or trust be treated as having acquired such an asset at a cost equal to the base cost of the deceased estate in respect of that asset.

If the executor had, for example, incurred any expenditure contemplated in paragraph 20 in improving any asset, this cost would be treated as part of the base cost to the heir or legatee.

If during the winding up of the estate assets are disposed of (other than disposals to heirs, legatees or a trustee of a trust), it is proposed that the deceased estate be treated in the same manner as the deceased would have been treated, if the deceased had disposed of the asset. It is the intention that the estate would, for example, be taxed at the same rate, and enjoy the same inclusion rate and exclusions that the deceased would have enjoyed if the deceased had disposed of the assets.

Paragraph 41: Tax payable by heir of a deceased estate

It is proposed that, for capital gains tax purposes, a natural person be treated as disposing of all of his or her assets on the day before death. Capital gains tax will, therefore, be levied on the growth in the value of assets while estate duty will be levied on the net value of the deceased estate. There may be cases where a significant capital gains tax charge arises due to the growth in the value of the assets although the deceased estate is heavily indebted and would not be liable for estate duty.

As this may have an impact on the liquidity of the deceased estate it is proposed that where—

- the tax relating to the taxable capital gain of the deceased person exceeds 50% of the net value of the deceased estate, as determined for the purposes of the Estate Duty Act, 45 of 1955, before taking into account that tax; and
- the executor of the deceased estate is required to dispose of an asset to pay that tax,

an heir or legatee who would have been entitled to the asset may accept both the asset and the liability on condition that the portion of the capital gains tax exceeding 50% of the net asset value described above is paid by him or her. This liability would have to be paid within three years of the executor obtaining permission to distribute the asset and would bear interest at the rate prescribed by the Minister.

Example

Luke passed away holding a share portfolio, which he had acquired for R200 000, but which had appreciated to R3 million by the time of his death. He had secured a loan of R2.5 million on the strength of this portfolio, the bulk of which was transferred to his ex-wife in a divorce settlement and the remainder of which he spent prior to his death. The net value of the estate after allowable deductions (excluding the capital gains tax on the increase in value of the share portfolio) is R300 000.

Assuming that Luke is subject to tax at the maximum marginal rate, the tax relating to the taxable capital gain is R288 750, after taking into account the increased annual exclusion of R50 000 in the year of his death. As this exceeds 50% of the net value of the estate, (i.e. R150 000), it may be possible for his heir to defer payment of R138 750 in terms of this paragraph.

Paragraph 42: Short-term disposals and acquisitions of identical financial instruments

The type of transaction envisaged in this paragraph is commonly referred to as a “wash sale” or “bed and breakfasting” and usually involves the disposal of listed shares in order to crystallise losses immediately before the tax year-end followed by the repurchase of the same listed shares immediately thereafter.

At present it is proposed that this paragraph deal only with disposals realising capital losses. Should the annual exclusion ever be increased, this rule would probably need to be amended to include capital gains as well.

Under subparagraph (1), it is proposed that if a person sells financial instruments (e.g. listed shares) and buys those same financial instruments back within the 45-day period before or after the sale date, the loss cannot be immediately claimed for the purposes of

CGT. It should be noted that the person disposing of the financial instruments need not be the person reacquiring them. It is proposed that this rule should extend beyond just the seller and include connected persons. For the purposes of this paragraph, however, it is proposed that the term “relatives” be narrowed in scope.

Note that the rule would apply to a 45-day period *before* or *after* the sale date, to prevent “buying the financial instruments back” before they have even been sold. These periods will be extended (i.e. will not include days) for periods in which the risk on the shares is hedged with offsetting positions.

Where the paragraph applies, the seller will be treated as having received proceeds equal to the base cost of the financial instrument disposed of (i.e. there is no gain or loss for CGT purposes). The purchaser (if the same or a connected person), on the other hand, would be required to add the capital loss realised by the seller to the actual cost incurred in “repurchasing” the financial instruments. Effectively, the loss would be “held over” until such time as there is no restriction imposed upon the sale in terms of this rule.

Example

Mark buys 500 shares of Effe Ltd listed on a recognised exchange for R10 000 and sells them on 20 February 2002 for R3 000. On 1 April 2002, he buys 500 shares of Effe Ltd for R3 200. Since the shares were repurchased within 45 days of loss-sale date, paragraph 42 applies. Mark cannot claim his R7 000 loss. Instead, he must adjust his base cost for the “repurchased” shares. The base cost in terms of subparagraph 1(i) and (ii) for his “new” shares will be R3 200 (the actual cost) plus R7 000 (the held-over loss), therefore R10 200.

Mark would also be affected by this paragraph if he had purchased his “new” shares on 24 January 2002 and then made the loss sale on 20 February 2002. On the other hand, if Mark had waited and repurchased the 500 shares 46 days after the sale, paragraph 42 would not apply and the R7 000 capital loss would be allowable. The base cost of the 500 shares repurchased would equal the cost actually incurred.

What is the situation where fewer shares are repurchased than were originally sold for a loss? Would all of the loss be “held-over”? The answer is no. Only the portion of the loss attributable to the “washed” sales would be disallowed. If the person only bought back a portion of the shares sold, then only a portion of the loss would be disallowed. The concept of “grouping” the same financial instruments would not be applied, hence 500 listed shares would equate to 500 individual financial instruments and are not considered to be 1 financial instrument.

Example

If in the previous example Mark had only bought back 300 of the 500 shares (60%), he would be able to claim 40% of the loss on the sale, or R2 800. The remaining R4 200 of the loss disallowed in terms of this paragraph, would be added to the base cost of Mark’s 300 “new” shares. Therefore the base cost of his “new” shares would be R6 120. (300 “new” shares at a cost of R1 920 plus the held over loss of R4 200).

Paragraph 43: Assets disposed of or acquired in foreign currency

This paragraph proposes rules for the translation of expenditure incurred in a foreign currency and proceeds received or accrued in a foreign currency. As the proposed definition of an asset in paragraph 1 of the Eighth Schedule excludes foreign currency, these rules would apply to the acquisition and disposal of all foreign assets other than the conversion of foreign currency.

It is proposed that a resident who disposes of an asset for proceeds denominated in a foreign currency, after having incurred expenditure in respect of that asset in the same currency, determine the gain or loss on the disposal by translating both proceeds and the expenditure incurred into the currency of the Republic at the ruling exchange rate on the date of disposal.

In applying the provisions of this paragraph it is proposed that the term ‘ruling exchange rate’ would have the same meaning as it is defined in section 24I of the Income Tax Act.

Example

In 1998 Neil purchased a flat in Sydney for R400 000 or AU$135 000 in order to derive rental income. The market value of the property on 1 October 2001 is AU$220 000. In 2007 the property is sold for AU$270 000 when the AU$/R exchange rate is AU$1 / R4. The taxpayer elected to use the market value of the property as the valuation date value. The capital gain on disposal of the asset is determined as follows:

Proceeds	270 000
Base cost	220 000
Capital gain before translation	AU$50 000
Capital gain translated to Rand (AUS$50 000 X 4)	R200 000

Paragraph 43(2) also provides for the situation where a person disposes of an asset for proceeds denominated in a currency other than the foreign currency in which expenditure was incurred in respect of that asset. The gain or loss on the disposal must be determined by translating both proceeds and the expenditure incurred into the currency of expenditure at the ruling exchange rate on the date of disposal. Any further currency gain or loss in respect of the transaction, which may be subject to CGT, will have to be determined in terms of the provisions of Part XIII dealing with foreign currency.

PART VII: PRIMARY RESIDENCE EXCLUSION

Paragraph 44: Primary residence - definitions

This paragraph contains a number of proposed definitions that are pertinent to the whole of Part VII of the Eighth Schedule.

An interest

The definition of “an interest” contains three items—

- the first item envisages the case of actual ownership.
- the second item envisages the case where ownership is held via a share owned directly in a share block company or a similar foreign entity.
- the third envisages the case of, for example, a 99-year lease or any similar right, which may be disposed of by a qualifying person without ownership in the actual residence being affected.

It is proposed that where a person rents a residence, that person would have an interest in that residence in terms of this last item (a right of use or occupation) even although he or she does not own that residence. The effect of this is that where a qualifying person has an interest in a residence, that person's primary residence can be determined if he or she ordinarily resides therein as his or her main residence, and if that residence is used mainly for domestic purposes.

Primary residence

In order for a residence to qualify as a "primary residence", it is proposed that—
- the interest be held by a natural person or a special trust;
- that person, beneficiary or spouse of either such persons, must ordinarily reside therein as their main residence; and
- the residence must be used mainly for domestic purposes.

This means that a company, close corporation or trust (other than a special trust) owning a residence used as a primary residence by a shareholder, member or beneficiary would not qualify for the contemplated exclusion of a capital gain made upon disposal of such primary residence for CGT purposes.

The persons referred to in item *(b)* of this definition would include the spouse of either the natural person or the beneficiary of the special trust. The effect of this is to allow a primary residence to retain its status as a primary residence where one spouse resides in that residence and the other spouse who owns that residence does not reside therein, for whatever reason. This is subject to the various other provisions relating to primary residences. The intention of this extension to the definition is to make provision for cases where—
- the spouse owning the primary residence is forced to seek employment away from where the home is located;
- that spouse does not own another property qualifying as a primary residence; and
- the other spouse continues to reside in this primary residence.

A person who is a non-resident cannot have a primary residence in the Republic, as the person does not ordinarily reside in the Republic. A emigrant who retained his or her residence in the Republic may, however, qualify for the R1 million exclusion on an apportionment basis.

Residence

The proposed definition of "residence" means any structure, including a boat, caravan or mobile home, which is used as a place of residence by a natural person, together with any appurtenance belonging thereto and enjoyed therewith. The type of "structure" envisaged is one of a more permanent nature where the level of facilities make that structure habitable. An underground structure or a structure built into a cliff-face would possibly qualify as a residence whereas a tent would possibly not qualify as a residence.

It is clear from the proposed definitions, however, that where land is owned by a natural person, but that person lives in, for instance, a borrowed caravan, then that land would not qualify as a primary residence. A residence would mean any structure and as the person would not have an interest in the structure (the caravan), there would be no primary residence as defined. An "appurtenance" would be considered as an appendage or something forming part of the residence such as a separate garage, various outbuildings, a swimming pool or a tennis court.

Paragraph 45: General principle – primary residence exclusion

This paragraph proposes two basic principles regarding primary residences. The first principle places a limit of R1 million upon a capital gain or capital loss that may be disregarded for CGT purposes. In other words, where a capital gain or loss exceeds R1 million, the excess would be subject to CGT.

Example

Obert purchased a residence to be utilised solely as a primary residence on 1 October 2001 for a total cost of R1 250 000. Five years later Obert sells this primary residence for R2 500 000 in order to purchase another primary residence. Assuming Obert pays income tax at the maximum marginal rate of 42% and that he has no other capital gains or losses in the tax year in question, his additional income tax liability as a result of the capital gain realised is determined as follows.

Proceeds	2 500 000
Base cost	1 250 000
Capital gain	1 250 000
Disregarded in terms of paragraph 45(1)	1 000 000
Balance subject to CGT	250 000
Annual exclusion	10 000
Aggregate capital gain	R 240 000
Taxable capital gain (240 000 x 25%)	R 60 000
Tax payable (60 000 x 42%)	R 25 200

In this example, only 4,8% (R60 000 / R1 250 000) of the total capital gain is finally subjected to taxation.

The R1 million limitation also operates on a "per primary residence" basis and not on a "per person holding an interest in the primary residence" basis.

Example

The facts are the same as for the above example, except that Obert is married to Portia in community of property and the primary residence falls within their joint estate. Assuming that Portia has no other capital gains or losses in the tax year in question, Obert and Portia's taxable capital gains are determined as follows.

	Total	Obert	Portia
Capital gain apportioned in terms of paragraph 14	1 250 000	625 000	625 000
Disregarded in terms of paragraph 45(2)	1 000 000	500 000	500 000
Balance subject to CGT	R250 000	125 000	125 000
Annual exclusion		10 000	10 000
Aggregate capital gain		R115 000	R115 000
Taxable capital gain (R115 000 x 25%)		R28 750	R28 750

The second principle proposed is that only one residence may be a primary residence of a person for any period during which that person held more than one residence. This means that there could never be an overlapping period where two residences owned by one person are both used as primary residences, except when the provisions of paragraph 48, which allows for an overlap in specific cases, apply.

Example

After living in Cape Town for some years, Quartus purchases a home in Cape Town for R500 000 on 1 October 2001 and a home in Johannesburg for R500 000 on 1 October 2001. He owns a business that operates in both Cape Town and Johannesburg and spends six months of each year in each home, although he remains a Capetonian at heart and most of his social acquaintances and family are in Cape Town. Ten years later he retires and sells both homes in order to acquire a retirement cottage in a quiet coastal village. The Cape Town home is sold for R2 600 000 and the Johannesburg home for R1 800 000.

Cape Town

Proceeds	2 600 000
Base cost	500 000
Capital gain	2 100 000
Primary residence exclusion	1 000 000
Balance subject to CGT	R1 100 000

Johannesburg

Proceeds	1 800 000
Base cost	500 000
Capital gain	R1 300 000

Quartus will therefore include R2 400 000 in his aggregate capital gain or loss for the year.

Paragraph 46: Size of residential property qualifying for exclusion

This paragraph proposes parameters in respect of the size of the property qualifying for exclusion in terms of the primary residence provisions. It is proposed that a primary residence include the land upon which it is actually situated and may include other adjacent land which is used mainly for domestic or private purposes in association with that residence. The total of all the land may, however, not exceed two hectares. This could also include unconsolidated adjacent land, provided that upon disposal of the primary residence, any unconsolidated adjacent land is disposed of at the same time and to the same person as the primary residence itself.

Where the size of a property qualifying for exclusion as a primary residence exceeds two hectares it is proposed that a reasonable apportionment be required as any gain attributable to the property in excess of two hectares would be subjected to CGT.

Example

Rick acquires a smallholding, three hectares in size, shortly after 1 October 2001. The total cost of acquisition amounted to R2 450 000 and he took occupation of the property immediately after it had been acquired and occupied it throughout the period of ownership until the asset was sold, four years later. Over the period of ownership improvements amounting to R160 000 were effected to the property and repairs amounting to R18 000 were also carried out. The smallholding was sold for R6 000 000 and agent's commission of R480 000 was paid. The total property was used mainly for domestic purposes in association with the primary residence.

As the maximum size of the land qualifying for the primary residence exclusion is two hectares, an apportionment needs to be done.

The following calculation apportions the capital gain realised to the primary residence and the remaining land on the basis of the total size of the property.

	Land	Residential Building	Total
Proceeds	5 000 000	1 000 000	6 000 000
Acquisition cost	1 750 000	700 000	2 450 000
Cost of improvements	120 000	30 000	150 000
Repairs (not part of base cost)	-	-	-
Agent's commission on sale	400 000	80 000	480 000
Capital gain	R2 730 000	R190 000	R2 920 000

	Primary Residence	Remaining Land	Total
Land	1 820 000	910 000	2730 000
Residential buildings	190 000	-	190 000
Capital gain	2 010 000	910 000	2 920 000
Primary residence exclusion	1 000 000	-	1 000 000
Balance subject to CGT	R1 010 000	R910 000	R1 920 000

Alternative bases of performing the apportionment would also be acceptable, provided that such bases are reasonable.

Item *(b)* of the proposed paragraph 46 refers to the land not exceeding two hectares and places the requirement that such land, with or without appurtenances thereon, must be used mainly for domestic or private purposes in association with the primary residence. In other words, any portion of the land not used mainly for domestic purposes in association with the primary residence would not qualify for the exclusion. For example, one hectare of a two-hectare plot, which has a residence qualifying as a primary residence thereon, is used to grow vegetables for sale to a local market. This could not be used mainly for domestic purposes and hence only one hectare would qualify for exclusion as a primary residence.

Paragraph 47: Apportionment in respect of periods where not ordinarily resident

It is proposed that where a residence is utilised as a primary residence on or after 1 October 2001, a qualifying person would be required to apportion any capital gain or loss to be disregarded, as a result of not being resident in the residence, with reference to the period that he or she was ordinarily resident in that primary residence. This paragraph would be subject to both paragraphs 48 and 50. The term “ordinarily resident” is not a new term for income tax purposes and guidelines in terms of case law already exists in this regard.

Example 1

Seni buys a property for R1 000 000 on 1 October 2001. She uses the property as her primary residence right up until she emigrates from the Republic on 28 February 2003. She puts the property on the market in 2005 and finally sells it for R1 820 000 on 28 February 2005.

Upon emigration, Seni is no longer considered ordinarily resident in the Republic and hence, would not be considered ordinarily resident in her residence from the date of emigration. No deemed disposal of the property takes place on emigration as the Republic retains its tax jurisdiction over the property in terms of paragraph 2(1)*(b)*.

Proceeds	1 820 000
Base cost	1 000 000
Capital gain	820 000
Portion of gain relating to period of ordinary residence and qualifying for exclusion (17/41 X 820 000)	340 000
Balance subject to CGT	R480 000

If she has no other capital gains in the year of disposal, this amount will be reduced further by the annual exclusion of R10 000.

Example 2

Thomas’s employer transfers him from East London to Durban. He had owned his home in East London for 20 years and decides not to sell it but rather to allow his son, who is studying part time through a correspondence university, to live there for no consideration. He and his wife move to Durban where they rent a residence as Thomas only has two years to go until he retires. They spend their holidays in East London and stay in the home. Upon retirement Thomas and his wife intend returning to their home in East London. At this stage, their son intends having just completed his studies and is to move out of this home. The question arises as to whether Thomas may consider the residence in East London to have been his primary residence for the full period of ownership.

The crux of the matter revolves around paragraph 47, which would require apportionment where Thomas was not considered ordinarily resident in the East London home.

Paragraph 47(1)*(b)* does not require physical occupation but hinges on the concept of ordinary residence. In Thomas's case, as his intention was to return to the East London home (which he in fact did) and in view of the fact that he would probably be considered to be ordinarily resident there after valuation date, no apportionment of any capital gain realised would be necessary. It should be noted, however, that the facts of each case would have to be carefully considered in determining ordinary residence in respect of a primary residence. Should Thomas have been absent from his East London home for, say, 15 years, it would be far more difficult for him to argue that he was ordinarily resident in that home.

Example 3

Ursula owns a property in Johannesburg in which she and her husband, Victor, spend most of any given year. Both spouses are employed in Johannesburg and they are married out of community of property. Victor owns a residence in Plettenberg Bay in which he lived for three years before meeting his wife and moving to Johannesburg. He has lived in Johannesburg for two years at the time CGT is implemented. The home in Plettenberg Bay is now used as a holiday home by the couple, who spend most of their annual leave there. It is never occupied by anyone else and stands vacant for the rest of the year. Upon moving to Johannesburg, Victor had employed an armed response service in Plettenberg Bay to see to the security of his home. His intention is to claim this home as a primary residence and hence not pay capital gains tax upon its eventual disposal. Five years after valuation day, Victor decides to sell his home in Plettenberg Bay.

From the information at hand Victor would be considered not to be ordinarily resident in Plettenberg Bay. Victor resides in a home belonging to his wife where he is permanently located. He is employed in Johannesburg and has never returned to Plettenberg Bay other than for holidays. Victor would not be considered ordinarily resident in Plettenberg Bay and hence any capital gain made upon disposal of his residence in Plettenberg Bay would be subjected to CGT in full.

Paragraph 48: Disposal and acquisition of primary residence

The purpose of this proposed paragraph is to enable a natural person or a beneficiary of a special trust to be treated as having been ordinarily resident in a residence where that person was absent therefrom for a continuous period not exceeding two years, in four specific instances.

The *first* item deals with the case of an overlapping period of ownership. This would override the general rule contained in paragraph 45(3).

Example

Xolani is transferred from Knysna to Cape Town and struggles to sell her home in Knysna. In the mean time, she acquires a home in Cape Town and is able to eventually sell her Knysna home 18 months later. The overlapping period of ownership may be included as periods that both homes were considered to be ordinary residences and hence no apportionment is required.

The *second* item would cater for the situation where land has been purchased with the intention of erecting a primary residence thereupon. Land on its own would not be a primary residence as the proposed definition of residence means “any structure”. Where there is no structure there could not be a primary residence. Therefore, for the duration of the time taken to erect a structure, (i.e. a home) that period would not qualify as the owner’s ordinary residence without this overriding provision. It effectively would allow a person a two-year period in which to complete the erection of a residence to be used as a primary residence without penalising that person.

The *third* item is similar to the second and would cater for cases where a primary residence is rendered accidentally uninhabitable, for example, is destroyed, by fire, flood, earthquake, landslide, wind or other similar act.

The *fourth* item is the death of the person with an interest in the primary residence. It is proposed that for a two year period after death or until the residence is disposed of by the executor of the estate, whichever is the shorter, the deceased would be treated as having been ordinarily resident in the residence.

It would be unnecessary to specifically cater for improvements or renovations to a primary residence as the owner effecting them would still be considered to be ordinarily resident in that primary residence. A residence, as defined, exists and, therefore, qualifies as a primary residence.

Paragraph 49: Non-residential use

The purpose of this proposed paragraph is to reduce the capital gain disregarded in terms of the primary residence exclusion where a part of the primary residence was used for the purposes of carrying on a trade in relation to that part. The paragraph also caters for the situation where the property was at some stage used as a primary residence but not for the entire period of ownership after the valuation date.

Example

Yolandi acquired a residence on valuation date for R350 000 and resided therein for ten years. During this time she operated her media relations consulting business from the premises. Approximately 35% of the floor space was used for business purposes. Yolandi also claimed 35% of her current costs as a business expense against her business income for tax purposes. As an opportunity arose for her to expand her business ten years after she had acquired the property, she purchased another residence in which to live and converted her old residence into business premises. Fifteen years after converting the property she sold it for R2 650 000. Improvements over the years and all other costs associated with the acquisition and disposal of the property amounted to R250 000.

Proceeds upon disposal	2 650 000
Base cost (R350 000 + R250 000)	600 000
Capital gain	2 050 000
Period not ordinarily resident (2 050 000 x 15/25)	1 230 000
	820 000
Part partially used for trade purposes (820 000 x 35%)	287 000
Capital gain attributable to being a primary residence	R533 000

Yolandi will be able to exclude R533 000 of the total capital gain realised in terms of the primary residence exclusion. The balance, or R1 517 000 will be subject to CGT and will be aggregated with any other capital gains or losses arising in the year of disposal before the R10 000 annual exclusion is applied.

Paragraph 50: Rental periods

The purpose of this paragraph is twofold:

- to allow a qualifying person to rent out his or her primary residence without that rental activity disqualifying that period of ownership as non-residential usage (in terms of paragraph 49); and
- to provide a safe harbour for a qualifying person to be temporarily absent from his or her primary residence without affecting the "ordinary residence" status of that person in relation to that primary residence.

There are, however, a number of conditions that will apply:

- the primary residence will not be allowed to be let for more than five years. If a primary residence were let for more than five years, the full period would not be treated as residential usage (i.e. the qualifying person would not be treated as having used the primary residence for domestic purposes for the full period).
- the qualifying person would have to actually reside in that primary residence for a continuous period of at least one-year prior to and after the period that the primary residence was let. This condition would ensure that the residence is a primary residence of the qualifying person prior to letting the property and that the qualifying person would return to and resides in that property after the rental period;
- no other residence would be treated as the primary residence of the qualifying person during the period that a primary residence was let and retained its status as a primary residence of that qualifying person. As this paragraph would treat the property let as a primary residence of the qualifying person letting that property, this condition would prevent any overlap where another property owned by the qualifying person was actually used as a primary residence whilst tenants occupy the let property. This paragraph, therefore, would not override the general principle contained in paragraph 45(3);
- the qualifying person would have to be temporarily absent from the Republic or employed or engaged in carrying on business in the Republic at a location further than 250km from that residence. The first part of this condition caters for South Africans who are temporarily absent from the Republic but are still ordinarily resident in the Republic, i.e. persons who have not emigrated, such as diplomats. The second part is an anti-avoidance provision. It would allow a South African resident, residing in the Republic, the opportunity to let a primary residence provided that the qualifying person was employed or was engaged in carrying on business in the Republic, at a location further than 250km from the primary residence being let.

Example

Alta and Zebediah were recently married. Each spouse owned his or her own residence in Pretoria, had lived in their respective residences for more than one year prior to marriage, and had acquired his or her residence after valuation date. Upon marriage, Alta had moved into Zebediah's residence and let her residence for a period of five years. Both spouses intend returning to Alta's residence thereafter for five years whilst letting Zebediah's residence. Both are employed within 20km of their respective residences.

Paragraph 50 is not applicable as both spouses are employed within a 250km radius from their respective residences. They will, however, be able to apportion any gains that might arise upon the disposal of their respective residences in relation to the period that each residence qualified as a primary residence.

Paragraph 51: Transfer of a primary residence from a company or trust

As set out in more detail in clause 2, a number of provisions have been proposed to permit natural persons to transfer an interest in a residence from a company or trust to him- or herself without fiscal disadvantage.

In subparagraph (1) it is proposed that where an interest in a residence has been transferred from a company or trust to a natural person—

- the company or trust be treated as having disposed of that residence at market value on the valuation date; and
- that natural person be treated as having acquired that residence at market value on the valuation date.

The effect of this proposed provision would be that the capital gain or capital loss on the disposal of the residence would not be subject to CGT.

It is proposed in subparagraph (2) that subparagraph (1) only applies where—

- that natural person acquires that residence from that company or trust on or after the promulgation of the Taxation Laws Amendment Act, 2001, but not later than 30 September 2002;
- that natural person alone or together with his or her spouse directly held all the equity share capital in that company from 5 April 2001 to the date of registration in the deeds registry of the residence in the name of that natural person or his or her spouse or in their names jointly; or
- that natural person disposed of that residence to the trust by way of donation, settlement or other disposition or made funds available that enabled that trust to acquire the residence;
- that natural person alone or together with his or her spouse ordinarily resided in that residence and used it mainly for domestic purposes as his or her or their ordinary residence from 5 April 2001 to the date of the registration.
- the registration of the residence in the name of the natural person or his or her spouse or in their names jointly, takes place not later than 31 March 2003.

It is proposed that this paragraph only apply in respect of that portion of the property on which the residence is situated and adjacent land as—

- does not exceed two hectares;
- is used mainly for domestic or private purposes in association with that residence;
- is disposed of at the same time and to the same person as the residence.

PART VIII: OTHER EXCLUSIONS

Paragraph 52: General principle – Other exclusions

This paragraph provides that when determining the aggregate capital gain or aggregate capital loss of a person, any capital gains and capital losses must be disregarded in the circumstances and to the extent set out in Part VIII.

Paragraph 53: Personal use assets

It is proposed that all capital gains or capital losses determined in respect of personal use assets of a natural person or a special trust be disregarded. Personal-use assets are all the assets of a natural person or special trust except to the extent they are used for the purposes of carrying on of a trade or are assets listed in subparagraph (2) of the paragraph. (See the proposed paragraph 15 for the rationale for this exclusion)

The assets listed in subparagraph (2), which are proposed to be subject to CGT are the following—

- a coin made mainly from gold or platinum of which the market value is mainly attributable to the material from which it is minted or cast;
- immovable property;
- an aircraft, the empty mass of which exceeds 450 kilograms;
- a boat exceeding ten metres;
- a financial instrument which is defined in the Schedule;
- any fiduciary, usufructuary or other like interest, the value of which decreases over time; and
- a right or interest in any of the assets mentioned above.

While capital gains arising from those assets will be subject to CGT, the losses made on the sale of certain of these assets will be disregarded as indicated in the proposed paragraph 15.

Paragraph 54: Retirement benefits

It is proposed that retirement benefits paid in lump sums be disregard in determining any capital gain or capital loss. The exclusion covers—

- receipts in the form of a lump sum benefit as defined in the Second Schedule which is in essence amounts paid in consequence of membership of domestic pension funds, provident funds or retirement annuity funds; and
- lump sum benefits paid from any fund, arrangement or instrument situated outside the Republic which provides similar benefits under similar conditions to a pension, provident or retirement annuity fund approved in terms of the Income Tax Act.

Paragraph 55: Long-term assurance

Where a long-term policy as contemplated in the Long-term Insurance Act, 1998, issued by a South African insurer, is disposed of by the original owner or one of the original owners, and this results in the receipt or accrual of an amount in respect of the policy, it is proposed that any capital loss or gain as a result of this disposal be disregarded.

It is proposed that no exclusion be granted to the disposal of long-term policies with foreign long-term insurers. Although the build up in these policies is not subject to income tax in the Republic they will be subject to CGT on disposal by applying the normal principles for determining a capital gain or capital loss on disposal of the asset.

The general rule is that the exclusion provided for in this paragraph will not apply to the disposal of second hand policies, i.e. a policy that is purchased by or ceded to another person from the original owner. The reasons why second hand policies are subject to CGT are that—

- the preferential tax treatment afforded to insurance policies encourages long term savings. Second hand policies do not necessarily comply with this objective as the longer term investment objective is broken.
- these policies contain a speculative element which would otherwise escape taxation. Second hand policies are normally purchased at a discount to the returns that accumulated up to the date of purchase and future returns. This discount element should be taxed in full.
- the large majority of people who invest in these policies are high income earners paying tax at 42 per cent. By investing in second hand policies on a short term basis they enjoy the benefit of the low preferential tax rate of 30 per cent. By levying CGT on these policies the gap is closed to a large extent.

However, an exception to this general rule is proposed in the following limited circumstances: Receipts by or accruals to—

- the spouse, nominee, dependant or deceased estate of the original beneficial owner of a long-term policy with a South African insurer, provided that no amount has been or will be directly or indirectly paid in respect of the cession of the policy;
- the former spouse of the original beneficial owner to whom the long-term policy with a South African insurer was ceded in consequence of a divorce order or in the case of a marital-like union, an agreement of division of assets which has been made an order of court;
- a person in respect of any policy taken out on the life of an employee or director as contemplated in section 11*(w)*;
- a person in respect of a policy that was originally taken out on the life of any other person who was a partner of that person, or held any share or like interest in a company in which that person held any share or like interest, for the purpose of enabling that person to acquire, upon the death of that other person, the whole or part of—
    - that other person's interest in the partnership concerned; or
    - that other person's share or like interest in that company and any claim by that other person against that company,

  and no premium on the policy was paid or borne by that other person; and
- a person on whose life a policy was originally taken out in consequence of his or her membership of a pension, provident or retirement annuity fund.

Paragraph 56: Debt defeasance

This paragraph is proposed to prevent persons from receiving the benefit of losses on debt when the debt involved most likely represents a disguised gift or capital contribution, neither of which would otherwise create a capital loss. Under the specifics of this rule, a creditor cannot receive a loss on any disposal of a debt claim owed by a connected person, even if the disposal of that claim is to an unconnected person.

Example 1

In 2002, Catinka lends R5 000 to her son, Ben, who is resident in Bermuda. In 2003, Catinka cancels the loan after Ben fails to make any payments on the loan. Catinka must disregard the loss on the loan cancellation because the debtor is a connected person.

Example 2

Dave owns all the shares of Nee Ltd and Dee Ltd. Lee Ltd owes R100 000 to Dave that is in arrears. Dave sells the debt claim to Nee Ltd for R30 000. Dave must disregard the loss on the loan because the debtor is a connected person. The same result would apply even if Dave sold the debt claim to an unconnected party.

Paragraph 57: Disposal of small business assets

The purpose of this paragraph is to provide relief to small business persons who instead of providing for their retirement have reinvested their resources into their businesses.

It is proposed that for the purposes of the paragraph, a “small business” means a business of which the market value of all its assets at the date of disposal of the asset or interest in the business does not exceed R5 000 000. In ascertaining whether the business qualifies, one needs to consider the market value of all the assets, regardless of their nature and also regardless of the liabilities of the business.

In terms of subparagraph (2), it is proposed that only a natural person may disregard a capital gain in terms of the relief provided and only in respect of the disposal of an “active business asset”, if that asset or interest in a partnership or a company—

- had been held for a continuous period of at least five years prior to the disposal contemplated;
- that natural person had been substantially involved in the operations of the business of that small business during that period; and
- that natural person had attained the age of 55 years or the disposal was in consequence of ill-health, other infirmity, superannuation or death.

An “active business asset” means an asset used or held wholly and exclusively for business purposes, but excludes a financial instrument or any asset held in the course of carrying on business mainly to derive any income in the form of an annuity, rental income, a foreign exchange gain or royalty or any income of a similar nature. The intention is to exclude assets generating a “passive” type of income and to rather target active business assets.

In respect of a disposal, three instances are envisaged—

- the disposal of an active business asset of a small business owned by a natural person as a sole proprietor. What is envisaged is an economic unit loosely termed ‘business’ as opposed to individual assets. In the case of a sole proprietor, a business might mean a “taxi business” or a “printing business” or an “accounting business” or a "farming business" as distinct from all the assets of the sole proprietor, for instance, a primary residence, household furniture, or an investment in unit trusts.
- the disposal of an interest in each of the active business assets of a business, qualifying as a small business, owned by a partnership, upon that natural person’s withdrawal from that partnership to the extent of his or her interest in that partnership.

- the disposal of an entire direct interest in a company which consists of at least 10% of the equity of the company, to the extent that the interest relates to active business assets of the company which must qualify as a small business.

Disposals of assets held by trusts do not qualify for relief in terms of this paragraph.

Subparagraph (3) proposes a limit of R500 000 on the amount of the capital gain that may be excluded and further states that such exclusion may not exceed R500 000 during that natural person's lifetime. The exclusion is therefore cumulative and is not in respect of each business or asset disposed of.

Subparagraph (4) proposes a further limit on the natural person in stating that all capital gains qualifying must be realised within a two year period commencing on the date of the first disposal subject to the relief available in terms of paragraph 57.

Subparagraphs (5) and (6) are closely related. The former allows a natural person operating more than one small business to include all qualifying disposals for every such small business in determining the capital gain to be disregarded. The latter, however, limits all these small businesses to a cumulative R5 000 000 in respect of the market value of all assets.

Example

On attaining the age of 55 in 2010 Elias wishes to retire. He operates a fleet of taxis in the Gauteng Province as a sole proprietor and has done so for the past eight years. He is substantially involved in the operations of this business although he does not do any driving himself. The original cost of these taxis amounted to R1 000 000. Elias owes nothing on these vehicles and they have been fully depreciated for tax purposes. He has found a buyer for this business who takes it over "lock, stock and barrel" for R1 200 000 in February of that particular year.

Elias is also substantially involved in another business along with a business partner Fani. They incorporated a close corporation and a company six years ago. The close corporation operates a successful brewery. The market value of the brewing plant and equipment amounts to R2 000 000. A liability amounting to R750 000 in respect of this equipment is still outstanding. The only other asset owned by the close corporation is a 100% shareholding in the company. The company's only asset is the brewery building which is let to the close corporation for a market related rental. The market value of these shares amounts to R1 750 000. Elias and Fani each hold a 50% interest in the close corporation. Fani purchases Elias's interest in the close corporation upon his retirement for R1 800 000, 15 months after the disposal of his taxi business. The member's interest originally cost each party R100 000.

Taxi Business

Selling price		1 200 000
Recoupment		1 000 000
Proceeds		200 000
Base cost		Nil
Original cost	1 000 000	
Depreciation	1 000 000	
Capital gain		R200 000

Brewery

Active business assets to total assets (2m /(2m + 1.75m))	53.33%
Proceeds attributable to active business assets (1.8m x 53.33%)	R960 000
Base cost attributable to active business assets (100 000 x 53.33%)	R 53 333
Capital gain attributable to active business assets	R906 667

Elias is involved in two businesses, both qualifying as "small businesses". He has attained the age of 55, has owned or held an interest in the active assets for more than five years and has been substantially involved in the operations of both businesses. He may, therefore, disregard up to R500 000 of the capital gains realised provided that the disposals occur within a period of two years, which they do. Elias may, therefore, disregard the capital gain of R200 000 realised in the year that he disposes of his taxi business.

The following year he has no qualifying capital gains but in the year after that he may disregard R300 000 (R500 000 – R200 000) of the qualifying capital gain realised upon the disposal of his interest in the brewery. Notice that in this particular year his total capital gain amounts to R1 700 000 (R1 800 000 – R100 000). After deducting the R300 000 that may be disregarded, the balance of R1 400 000 will be subject to CGT.

Paragraph 58: Exercise of options

It is proposed in this paragraph that the capital gain or loss of a person determined in respect of the termination of an option as a result of the exercise by that person of that option be disregarded. The reason for this being that any amount paid for an option, other than a personal-use asset, will be allowed as part of the base cost of the asset in terms of the proposed paragraph 20.

Example

Geert purchases an option to acquire a farm for farming purposes. Geert pays R100 000 for the option to acquire the farm at a price of R1 000 000. When the option is exercised, the base cost in respect of the farm will be as follows.

Cost of acquisition (paragraph 20(1)*(a)*)	1 000 000
Cost of option (paragraph 20(1)*(c)*(ix))	100 000
Base cost	R1 100 000

The option which is an asset and which had a cost of R100 000 has terminated as a result of the exercising of that option. There is a capital loss of R100 000. This loss is disregarded in terms of this paragraph, otherwise the farmer would have enjoyed the benefit of the capital loss of R100 000 and have had the same amount included in base cost.

Paragraph 59: Compensation for personal injury, illness or defamation

This paragraph propose that a natural person or a special trust disregard a capital gain or a capital loss in respect of a disposal of a claim resulting in that person or trust receiving compensation for personal injury, illness or defamation of that person or beneficiary. The reason for this exclusion is that no capital gain can arise. Any compensation received is merely a restoration of the asset, being the natural person or beneficiary of the special trust, injured or defamed.

Paragraph 60: Gambling, games and competitions

As a general rule it is proposed that capital gains and losses arising from gambling, games and competitions not be subject to CGT. However, *capital gains* of this nature will be subject to CGT where they—

- are derived by companies, close corporations or trusts, or
- arise in respect of foreign gambling, games and competitions.

This paragraph encompasses all manner of activities such as horse racing, the National Lottery, casino winnings and the like. It is immaterial whether the winnings are in the form of a prize or cash.

Local gambling activities contribute to the *fiscus* indirectly in the form of betting taxes and value-added tax. In the case of the National Lottery a portion of the proceeds is used for the upliftment of the needy, which can be likened to a form of indirect taxation. Since foreign gambling does not contribute in this manner there is no reason to confer an exemption on such gains. In order to protect the tax base capital losses are in all instances disregarded.

Paragraph 61: Unit trust funds

It is proposed that any capital gain or loss be disregarded by a unit portfolio comprised in any unit trust scheme managed or carried on by any company registered as a management company under section 4 or 30 of the Unit Trusts Control Act, 54 of 1981. This paragraph therefore applies to regulated unit trust schemes that invest in financial instruments or shares in companies that own immovable property.

Investors in these unit trust schemes and similar collective investment vehicles abroad will be subject to capital gains tax on the disposal of their investments.

Paragraph 62: Donations and bequests to public benefit organisations

It is proposed that any capital gain or capital loss determined in respect of the donation of an asset to a public benefit organisation approved by the Commissioner in terms of section 30 must be disregarded.

Example

Sea (Pty) Ltd donated vacant immovable property with a market value of R1 000 000 to a SA university. The company had purchased the property 20 years earlier for R200 000 and paid R20 000 to transfer the property into its name.

The donation is a "disposal' and, in terms of paragraph 38, the company is treated as if it disposed of the property for proceeds equal to the market value of R1 000 000. The capital gain is R1 000 000 - (R200 000 + R20 000) = R780 000. This gain is disregarded in terms of paragraph 62.

Capital gains or capital losses determined in respect of bequests of assets to approved public benefit organisation are also excluded on the date of death of a deceased in terms of the proposed paragraph 40.

Paragraph 63: Exempt persons

This provision seeks to disregard all capital gains or losses in respect of the disposal by a person, body or institution that is exempt in terms of section 10 of the Act. This means that if the person, body or institution is presently exempt from income tax, this paragraph proposes that they be exempt from CGT.

Paragraph 64: Assets used to produce exempt income

While paragraph 63 seeks to disregard capital gains of persons exempt from income tax in terms of section 10, this paragraph seeks to disregard capital gains or losses in respect of the disposal of assets used to produce income that is exempt from income tax in terms of that section. It is proposed that the following assets be excluded from this concession—

- the assets used to produce the annual interest exemption(section 10(1)*(i)*(xv));
- shares from which dividends are received or accrue(section 10(1)*(k)*); and
- a copyright of a person who is the first owner (section 10(1)*(m)*).

PART IX: ROLL-OVERS

Paragraph 65: Involuntary Disposal

It is proposed that where a capital gain arises on the expropriation, loss, or destruction of an asset (other than a financial instrument), this gain be held over until the disposal of its replacement asset. In order to qualify for the holdover of the gain the taxpayer must satisfy the Commissioner that—

- an amount equal to the proceeds from the disposal of the original asset has been or will be used to acquire a replacement asset that is similar to the original asset,
- a contract to acquire the replacement asset has been or will be concluded within a year of the disposal of the original asset, and
- the replacement asset has been or will be brought into use within three years of the disposal of the original asset.

Where the taxpayer concerned is not a resident of the Republic, the original asset would have been situated in the Republic for capital gains tax to be applicable in terms of paragraph 2(1)*(b)*. The replacement asset must therefore also be an asset situated in the Republic as contemplated by that paragraph.

The Commissioner may extend the periods mentioned above by a maximum of six months depending on whether or not all reasonable steps were taken to conclude a contract or bring the replacement asset into use, as appropriate for the period to be extended.

Where the taxpayer does not meet the commitment to either conclude a contract or bring an asset into use within the specified period, the gain that has been held over is recognised at the end of the specified period. An additional amount equal to the interest on the gain at the prescribed rate from the date of disposal of the original asset to the end of the specified period is calculated and is also recognised as a capital gain. This additional amount compensates the *fiscus* for the deferral in the taxation of the gain and obviates the need to reopen past assessments.

Example

Heidi's holiday house, which has a base cost of R550 000, burns down completely on 15 February 2002. The house is insured for its replacement cost of R600 000 and the insurance company settles her claim for this sum on 18 October 2002. Heidi contracts with a building contractor to rebuild her house on 21 November 2002 and the project is completed on 7 March 2003. She plans to spend the December 2003 holiday at her holiday house and does so.

The destruction of Heidi's holiday house is considered to be a disposal in terms of paragraph 11. However, the time of the disposal is regulated by paragraph 13, which provides that in this case the date of disposal is the date on which the insurance company paid out the full compensation due. As a result the house is treated as having been disposed of on 18 October 2002. In terms of paragraph 35 the proceeds of the disposal comprise the insurance payment that she received in consequence of the disposal of the house by destruction.

The result is that Heidi is treated as having disposed of her holiday house in the year of assessment ending on 28 February 2003 at a capital gain of R50 000. She is able to satisfy the Commissioner that she has concluded a contract to replace the destroyed holiday house within one year of its disposal and that she will bring its replacement into use within three years of its disposal. Heidi is therefore entitled to hold over the gain of R50 000 until she disposes of the replacement holiday house.

Paragraph 66: Reinvestment in replacement assets

It is proposed that where a capital gain arises on the disposal of an asset that qualifies for a capital allowance or deduction in terms of section 11(*e*), 12 B, 12C, 14 or 14*bis*, this gain be held over. In order to qualify for the holdover of the gain the taxpayer must satisfy the Commissioner that—

- an amount equal to the proceeds from the disposal of the original asset has been or will be used to acquire a replacement asset that qualifies for a capital allowance or deduction equivalent to the capital allowance or deduction for which the original asset qualified,
- a contract to acquire the replacement asset has been or will be concluded within a year of the disposal of the original asset, and
- the replacement asset has been or will be brought into use within a year of the disposal of the original asset.

The capital allowances and deductions considered to be equivalent for the purposes of this paragraph are as follows—

Original Asset		Replacement Asset
Section 11*(e)* – Machinery, plant, implements, utensils and articles.	➔	Section 11*(e)* – Machinery, plant, implements, utensils and articles.
Section 12B – Machinery, plant, implements, utensils and articles used for qualifying activities and/or trades. Section 12C – Machinery, plant, implements, utensils and articles used for qualifying activities and/or trades. Ships and aircraft. Section 14 – Ships. Section 14*bis* – Aircraft.	➔	Section 12B – Machinery, plant, implements, utensils and articles used for qualifying activities and/or trades. Section 12C – Machinery, plant, implements, utensils and articles used for qualifying activities and/or trades. Ships and aircraft.

The gain that has been held over is recognised in five equal annual instalments commencing on the date that the replacement asset is brought into use. Any portion of the gain that has not been recognised by way of these instalments is recognised when the taxpayer disposes of the replacement asset or ceases to use it for the purposes of trade.

Where the taxpayer concerned is not a resident of the Republic, the original asset would have been situated in the Republic for capital gains tax to be applicable in terms of paragraph 2(1)*(b)*. The replacement asset must therefore also be an asset situated in the Republic as contemplated by that paragraph.

The Commissioner may extend the periods mentioned above by a maximum of six months depending on whether or not all reasonable steps were taken to conclude a contract or bring the replacement asset into use, as appropriate for the period to be extended.

Where the taxpayer does not meet the commitment to either conclude a contract or bring an asset into use within the specified period, the gain that has been held over is recognised at the end of the specified period. An additional amount equal to the interest on the gain at the prescribed rate from the date of disposal of the original asset to the end of the specified period is calculated and is also recognised as a capital gain. This additional amount compensates the *fiscus* for the deferral in the taxation of the gain and obviates the need to reopen past assessments.

Example

Bee (Pty) Ltd sold various assets on 14 September 2002 in order to make funds available to purchase an aircraft costing R10 million. It had ordered the aircraft and made an up-front payment of R1 million to secure the order on 1 March 2002.

Asset	Acquired	Cost	Market value on valuation date	Selling Price
Aircraft	3 October 1994	2 000 000	2 800 000	5 000 000
Press	9 October 1995	500 000	650 000	710 000
Truck	6 October 1997	300 000	No valuation	350 000

The original aircraft qualified for the capital allowances contemplated in section 14*bis,* the press qualified for the capital allowances contemplated in section 12C and the truck qualified for the capital deductions in terms of section 11(*e*). The new aircraft is to be used for the purposes of trade and will qualify for the section 12C capital allowance when it is brought into use on 1 November 2002.

The disposal of the assets will have the following consequences in the year of assessment ending on 30 September 2002.

	Aircraft	Press	Truck
Ordinary Income			
Recoupment	2 000 000	500 000	300 000
Eighth Schedule			
Proceeds	3 000 000	210 000	50 000
Selling price	5 000 000	710 000	350 000
Recoupment	2 000 000	500 000	300 000
Base cost options			
- Valuation	2 800 000	210 000	0
Valuation	2 800 000	650 000	N/A
Substituted by paragraph 26(3)	N/A	210 000	N/A
- Time apportionment	2 625 000	180 000	40 000
- 20% of proceeds	600 000	42 000	10 000
Capital gain	200 000	0	10 000
Held over	200 000	0	0
Capital gain included in aggregate capital gain or loss	0	0	10 000

The capital gain in respect of the aircraft may be held over and recognised in five equal annual instalments commencing on 1 November 2002 as—

- an amount equal to the proceeds of R3 000 000 has been or will be used to acquire a replacement asset that qualifies for a capital allowance equivalent to the allowance granted in respect of the original aircraft,
- a contract has been concluded to acquire a replacement asset, and
- the replacement asset will be brought into use within a year of the disposal of the original asset.

The capital gain in respect of the truck may not be held over as the capital deductions in respect of the truck, which were claimed in terms of section 11*(e)*, are not equivalent to the capital allowances to be claimed in respect of the new aircraft in terms of section 12C.

In the year of assessment ending on 30 September 2003, Bee (Pty) Ltd will, therefore, reflect a capital allowance of R2 000 000 in respect of the new aircraft and a capital gain of R40 000 in respect of the truck.

Paragraph 67: Transfer of asset between spouses

This rule sets out the proposed treatment in the hands of a person of a disposal of assets to that person's spouse. It provides for the transfer of the base cost of an asset in a person's hands to that person's spouse where—

- the asset is transferred to that spouse during that person's lifetime or as a result of that person's death; or
- where that asset is transferred to that spouse in consequence of a divorce order or, in the case of the termination of a permanent marital-like union, in consequence of an agreement of division of assets that has been made an order of court.

Example

Irvine dies and leaves assets to the value of R750 000, that he acquired for a base cost of R80 000, to his wife Janice. The remainder of his assets were acquired by him at a base cost of R450 000 and are valued at R1 200 000 at the time of his death.

Irvine is treated in terms of paragraph 40 as having disposed of assets to the value of R1 200 000 as at the date of death. The transfer to Janice of the assets bequeathed to her is treated as a disposal by Irvine for no gain or loss. The base cost to Irvine of those assets, namely R80 000, is transferred to Janice along with those assets. Janice will therefore have to determine any capital gain or loss in respect of the disposal of any of those assets with reference to the base cost of those assets in Irvine's hands.

PART X: ATTRIBUTION OF CAPITAL GAINS

Paragraph 68: Attribution of capital gain to spouse

The proposed treatment of a person's capital gains that are derived directly or indirectly from that person's spouse mirrors that afforded to ordinary income in terms of section 7(2). That part of a person's capital gain as can be attributed to a donation, settlement or other disposition, or any transaction, operation or scheme made, entered into or carried out by that person's spouse is in terms of this rule taken into account only in the hands of that spouse where the latter made, entered into or carried out that transaction mainly for purposes of the avoidance of any tax administered by the Commissioner. This rule also applies where a person's capital gain is derived from a trade carried on by that person in association or in partnership with that person's spouse or where it is derived from that spouse or from a partnership or company at a time when that spouse was a member of that partnership or the sole, main or one of the principal shareholders of that company. The rule then applies in respect of so much of that person's gain as exceeds the amount of that person's reasonable entitlement to the gain. The latter amount is determined with regard to, *inter alia*, the nature of the relevant trade, the extent of that person's participation therein and the services rendered by that person.

A donation by a person to that person's spouse will as a general rule not result in a capital gain in that person's hands, as the base cost of that asset will be transferred to that spouse in terms of the proposed paragraph 67. Where the donation was, however, made mainly for purposes of avoiding a tax administered by the Commissioner, the subsequent disposal of that asset by the spouse to whom it was donated might result in the inclusion of any resultant capital gain in the hands of the spouse who made that donation. Such donation, settlement or other disposition made by a person to a trust of which that person's spouse is a beneficiary, might also result in the application of this rule where a trust asset or the capital gain from the disposal of such asset is subsequently vested in that spouse. See TRUSTS, TRUST BENEFICIARIES AND INSOLVENT ESTATES in Part XII for an example of the application of this rule.

Paragraph 69: Attribution of capital gain to parent of minor child

This rule mirrors the rule embodied in section 7(3) and 7(4) in terms of which income received by, accruing to or in favour of or expended for the benefit of a minor is in certain circumstances deemed to be that of a parent of that minor. Any amount of a minor child's capital gain or of a capital gain that has vested in or is treated as having vested in that child during the year in which it arose and that is attributable to a donation, settlement or other disposition made by a parent of that child, is treated as the capital gain of that parent. This rule also applies where the gain is attributable to a donation, settlement or other disposition made by another person in return for some donation, settlement or other disposition or some other consideration made or given by a parent of that child in favour, directly or indirectly, of that person or his or her family. See TRUSTS, TRUST BENEFICIARIES AND INSOLVENT ESTATES in Part XII for an example of the application of paragraph 69 in respect of the vesting of a trust asset in a minor.

Paragraph 70: Attribution of capital gain that is subject to conditional vesting

It is proposed in this paragraph that in certain circumstances capital gains arising as a result of a conditional donation or similar transaction be attributed to the donor.

The circumstances are—

- where a person has made a donation, settlement or other disposition which is subject to a stipulation or condition that such person or any other person has imposed, to the effect that a capital gain or portion thereof shall not vest in the beneficiaries until the happening of some event;
- a capital gain has arisen as a result of the donation during the year of assessment but has not vested in any beneficiary;
- the person who made the donation has been a resident throughout the same year of assessment.

In these circumstances the capital gain will be taken into account in determining the aggregate capital gain or loss of the person who made the donation, settlement or other disposition and disregarded in the determination of any other person's aggregate capital gain or loss.

This proposed provision is similar to the provisions of section 7(5) of the Income Tax Act.

Paragraph 71: Attribution of capital gain that is subject to revocable vesting

It is proposed in this paragraph that in certain circumstances capital gains arising as a result of a revocable vesting be attributed to the donor.

The circumstances are—

- where a donation, settlement or other disposition confers a right upon a beneficiary who is a resident to receive a capital gain attributable to that donation, settlement or other disposition;

- that right may be revoked or conferred upon another by the person who conferred it;
- such capital gain has in terms of that right vested in that beneficiary during a year of assessment throughout which the person who conferred that right has been a resident and has retained the power to revoke that right.

In these circumstances the capital gain will be taken into account in determining the aggregate capital gain or loss of the person who retained the power of revocation and disregarded in the determination of the aggregate capital gain or loss of the beneficiary.

This proposed provision is similar to the provisions of section 7(6) of the Income Tax Act.

Paragraph 72: Attribution of capital gain vesting in a person who is not a resident

This paragraph proposes attribution rules when—
- a donation, settlement or other disposition is made by a resident to any person (other than to a public benefit organisation contemplated in section 30 or a foreign entity as defined in section 9D of a similar nature); and
- a capital gain attributable to that donation, settlement or other disposition has arisen during a year of assessment, and has during that year of assessment vested in or is treated as having vested in any person who is not a resident (other than a controlled foreign entity, as defined in section 9D in relation to that person).

In these circumstances, the capital gain must be disregarded in the hands of the person in whom it vests and be taken into account when determining the aggregate capital gain or loss of the person who made the donation, settlement or other disposition.

Paragraph 73: Attribution of income as well as of capital gain

Where an amount of income as well as a capital gain has been derived from or is attributable to a donation, settlement or other disposition made by a person, the amount of that income as well as that capital gain might be subject to the attribution rules embodied in section 7 and the proposed paragraphs 68 to 72, respectively. This might result in the taxation of both amounts in the hands of the person who made the donation, settlement or other disposition. The proposed paragraph 73 limits the total amount of the income and gain that can be taxed in the hands of that person to the amount of the benefit derived from that donation, settlement or other disposition by the person to whom it was made. The quantified benefit to the latter person from, for example, an interest-free or low interest loan will therefore determine the extent to which any resulting income and capital gain can be attributed to the person who provided that benefit. See TRUSTS, TRUST BENEFICIARIES AND INSOLVENT ESTATES in Part XII for an example of the application of this rule.

PART XI: COMPANY DISTRIBUTIONS

Part XI of the Eighth Schedule incorporates the special rules that apply when a company distributes cash or other assets with respect to previously existing shares. Paragraph 75 addresses the impact of distributions at the distributing company level. Paragraphs 76 to 78 address the impact of distributions or issue of shares at the shareholder level.

Paragraph 74: Company distributions - definitions

This paragraph contains definitions of the following concepts, which are used in this Part—
'capital distribution' means any distribution (or portion thereof) by a company that does not constitute a dividend or that constitutes a dividend which is exempt from secondary tax on companies by reason of section 64B(5)*(c)*;
'company' means any 'company' as defined in section 1, except for any unit portfolio contemplated in paragraph (*e*) of that definition.
'distribution' means any transfer of cash or assets by a company to a shareholder in relation to a share held by that shareholder, including any issue of shares or debt in that company (or any option thereto), regardless of whether that transfer constitutes a dividend;
'share' means any issued share capital in relation to a company (or any fraction thereof) regardless of whether or not that issued share capital carries a right to participate in dividends or a capital distribution.

Paragraph 75: Distributions in specie by a company

As stated above, paragraph 75 regulates the impact of distributions of assets *in specie* at the distributing company level. This paragraph applies regardless of whether the distribution occurs during the life-time operations of the company, during liquidation, or otherwise.

If a distribution qualifies as a disposal of one or more assets, the distribution generates a capital gain or loss for the distributing company at market value as if the assets distributed were sold to the shareholder at market value. This rule exists as a matter of tax parity within the corporate tax system – a straight asset distribution should have the same tax impact as a company sale of the asset followed by a distribution of after-tax cash proceeds.

Any gain or loss just described occurs on the date when the distribution is declared by the company making the distribution (i.e. the date the distribution is approved by the directors or by parties of comparable authority). Paragraph 75 does not apply to the issue of shares (or options thereto) in the company making the distribution. These forms of distribution do not constitute a disposal by virtue of paragraph 11(2).

Example

Ay (Pty) Ltd has 100 issued ordinary shares, 90 of which are owned by Kevin and 10 of which are owned by Leoni. Among other assets, Ay (Pty) Ltd owns shares in Zulu (Pty) Ltd, an unconnected company, as well as land. The Zulu (Pty) Ltd shares have a market value of R180 000 and a base cost of R200 000. The land has a market value of R20 000 and a base cost of R7 000. Ay (Pty) Ltd distributes the shares in Zulu (Pty) Ltd to Kevin and the land to Leoni. Both distributions come partly from profits and partly from share capital.

The distributions of shares and land qualify as disposals at market value. Ay (Pty) Ltd realises a capital loss of R20 000 from the disposal of the shares and a capital gain of

R13 000 from the disposal of the land. As Kevin is a connected person in relation to Ay (Pty) Ltd, Ay (Pty) Ltd may only set off the capital loss of R20 000 against capital gains arising from transactions with him.

Paragraphs 76 to 78: Shareholder Level Consequences

- Paragraphs 76 to 78 address the shareholder-level consequences of various distributions. Paragraph 76 provides rules for distributions of cash or assets *in specie*. Distributions in liquidation are covered under paragraph 77. The issue by a company of its own shares is covered under paragraph 78.

Paragraph 76: Distributions of cash or assets in specie received by a shareholder

The purpose of this paragraph is to address the shareholder consequences of certain distributions of cash or assets *in specie* when a shareholder does not surrender any previously held shares in exchange (i.e. in a share buy-back or liquidation) Shareholders receiving distributions pursuant to this paragraph must reduce the base cost in the share carrying a right to participate in the distribution to the extent the distribution reduces share capital or share premium (i.e. the distribution is a capital distribution). This rule applies even if the capital distribution portion exceeds the base cost of the share (i.e. amounts reducing the base cost below zero are added to share proceeds upon subsequent disposition). The purpose of this rule is to ensure that tax-free distributions only create a deferral effect until disposal of the relevant share.

Example 1

Among other assets, Yankee (Pty) Ltd holds land with a R120 000 value and R50 000 in cash. Yankee (Pty) Ltd has 100 issued ordinary shares, all of which are owned by Martin, who has an aggregate R100 000 base cost in respect of the shares (i.e. R1 000 per share). Yankee (Pty) Ltd distributes the land and the cash to Martin. R90 000 of the distribution comes from retained income and the remaining R80 000 comes from share capital. The amount of R90 000 is subject to STC.

Paragraph 76 does not apply to R90 000 of the distribution because this portion constitutes a dividend. The remaining R80 000 reduces the base cost of the shares held by Martin to R20 000 (i.e. R200 per share).

Example 2

The facts are the same as in Example 1, except that the R60 000 of the distribution comes from retained income and R110 000 from share capital.

Paragraph 76 does not apply to R60 000 of the distribution because this portion constitutes a dividend. The remaining R110 000 of the distribution fully reduces the base cost of the shares held by Martin. This R110 000 reduction applies even though Martin initially held a base cost in the shares of only R100 000. The excess of R10 000 is added to proceeds upon subsequent disposal of the shares.

Example 3

The facts are the same as in Example 1, except that all the shares of Yankee (Pty) Ltd are owned by X-Ray Ltd. X-Ray Ltd has elected that the R90 000 be exempt from STC in terms of section 64B(5)(f).

The result is the same as Example 1. The R90 000 dividend amount does not constitute a capital distribution. The STC-free nature of the dividend has no impact on this analysis, unless exempt by virtue of section 64B(5)*(e)*.

Any assets received as a distribution of assets *in specie* will have a base cost equal to market value as at the date the distribution is approved by the directors of the distributing company or by persons of comparable authority. This rule applies regardless of whether the distribution constitutes a capital distribution or a dividend.

Special rules apply when a shareholder disposes of a pre-valuation date share and that shareholder received a capital distribution before the valuation date. Under these circumstances, a shareholder must deduct from the expenditure incurred with respect to that share any such capital distributions if the shareholder utilises the time apportionment base cost method upon disposal of that share. These rules are intended to mirror the basic share capital/share premium reduction rules, which similarly effectively reduce base cost (including reductions below zero).

Example

Natalie owns a share in Victor (Pty) Ltd, which she acquired for R1 000 on 1 October 1999. Natalie received a R300 cash distribution on 2 June 2000, of which R200 constituted a reduction in share capital. Natalie disposes of the share for R1 200 on 1 October 1 2004.

If Natalie utilises the time-apportionment method on disposal, R 800 is deemed to have been expended on the share on of the date of acquisition (R1 000 less R200) in terms of paragraph 30. Natalie has a valuation date value of R960 with respect to the share (R800 expenditure plus two fifths of the R400 appreciation), leaving post-valuation date gain of R240.

Paragraph 77: Distributions in liquidation or on deregistration received by a shareholder

This paragraph addresses the shareholder consequences of distributions during liquidation. This paragraph essentially contains timing rules that distinguish between liquidating and non-liquidating distributions. Shareholders receiving distributions before the date of liquidation potentially reduce the base cost in their previously held shares in accordance with paragraph 76. Shareholders receiving liquidating distributions are treated as having disposed of their shares, thereby crystallising shareholder gain or loss in respect of those shares. If a shareholder receives any capital distributions after the date of liquidation (as determined under subparagraph (1)), the distributions will be treated as a capital gain without any base cost offset.

Companies in the course of liquidation may conduct multiple distributions before all shares are cancelled. Subparagraph (1) effectively provides that companies in the course of liquidation, winding up or deregistration crystallise their gain or loss on the date of dissolution or deregistration, whichever occurs first. The date of dissolution typically occurs on the date of recording by the Registrar of Companies in terms of section 413(3) of the Companies Act, 1973. The date of deregistration typically occurs on the date of publication in the *Government Gazette* by the Registrar of Companies in terms of section 73(5) of the Companies Act, 1973. In the case of a liquidation or winding-up, the gain or loss can be crystalised even earlier on the date when the liquidator declares that no reasonable grounds exist to believe that the shareholder receiving the distribution (or any shareholders holding that same class of shares) will receive any further distributions. This declaration allows a shareholder to crystallise a loss without having to wait until the liquidation process is finalised.

Example

Uniform Ltd has 100 000 issued ordinary shares. Ophelia owns 20 shares in Uniform Ltd with an aggregate base cost of R500. On 14 March 2002 Uniform Ltd runs into financial difficulty and the directors announce their intent to liquidate the company. On 1 June 2002, Uniform Ltd ceases all active operations and distributes cash to its various shareholders. This cash distribution includes R100 of cash to Ophelia. On 20 October 2002, Uniform Ltd makes a final cash distribution and the liquidator declares that all remaining proceeds will go to creditors and no further distributions to shareholders are expected. Ophelia receives an additional R30 of cash in this distribution. On 19 December 2002, Uniform Ltd formally dissolves. None of the distributions described constitute dividends.

The date of disposal for Ophelia occurs on 20 October 2002 when the liquidator declares that no further distributions to the shareholders are expected (a date which occurs earlier than the date of formal dissolution). The R100 distribution occurs before this liquidation date and accordingly falls under paragraph 76, reducing Ophelia's base cost in the shares from R500 to R400. The R30 distribution occurs on the date that the liquidator declares that no reasonable grounds exists to believe that the ordinary shareholders will receive any further distributions. Ophelia is accordingly treated as having disposed of her shares held in Uniform Ltd on 20 October 2002 in exchange for R30, thereby generating a capital loss of R370 on that date (R30 proceeds minus the R400 base cost).

When determining the impact of distributions occurring in anticipation of a winding up, liquidation or deregistration, it is noted that a capital distribution includes dividends exempt from STC by reason of section 64B(5)(c).

The purpose of this inclusion is to achieve the same result that would have been obtained had a shareholder of a company in liquidation or deregistration disposed of his or her shares, prior to such a distribution. It should also be noted, for example, that the pre-1993 profits would be included in the base cost of any shares held on 1 October 2001. Failure to reduce base cost by these distributions or to include them in proceeds would therefore result in a fictitious loss. It is emphasised that these reserves are neither subject to STC nor CGT.

The purpose of including STC exempt dividends in this manner is to ensure that company distributions have either a capital gain/loss impact or an STC impact. The proposed legislation recognises the direct relationship between the value of a company's shares and the size of its dividend distributions. For example, assume a company is formed on 1 October 2001 with R1 share capital. Five years later it has post-acquisition reserves of R50 000. If its shares were sold for R50 001, a capital gain of R50 000 would result. Alternatively, if the company declared a dividend of R50 000 and thereafter disposed of its shares, there would be no gain or loss as the company would be reduced to a worthless shell. In the former case CGT would be payable whilst in the latter STC would be payable.

No such anti-avoidance rule exists for intra-group dividends exempt from STC because the clogged loss rule limits the usefulness of artificial losses between connected person and because intra-group dividends are eventually subject to tax when the dividend leaves the group.

The shareholder level consequence of share buy backs are fully taken into account under the basic disposal rules and are accordingly not covered by Part XI. Under the basic disposal rules, any shareholder who receives a distribution in redemption of a share is treated as having disposed of that share solely for the portion of the distribution (if any) constituting share capital or share premium (i.e. the capital distribution portion).

Example

Phoebe and Quintillian respectively own 80 per cent and 20 per cent of all Tango Ltd's shares. The base cost of Phoebe's shares is R3 000 000. Phoebe surrenders all of her shares in Tango Ltd for a R4 500 000 distribution. Of this amount, R1 200 000 represents share capital and R3 300 000 qualifies as a dividend.

Tango Ltd is subject to STC on the R3 300 000 dividend. Phoebe realises a capital loss of R1 800 000 upon disposal of her shares (R1 200 000 capital distribution less the R3 000 000 base cost in the shares redeemed). The use of this artificial capital loss is limited by the clogged loss rule of paragraph 39.

Paragraph 78: Share distributions received by a shareholder

Paragraph 78 addresses the shareholder level impact of a distribution when that distribution consists of the issue of shares by the company making the distribution. Share distributions of this kind fall into two classes:
- the issue of additional shares without the surrender of previously existing shares (i.e. the issue of capitalisation shares), and
- the issue of shares in substitution for shares previously held in the same company (e.g., share substitutions). Issues of capitalisation shares and share substitutions do not generate any capital gain or loss.

A capitalisation share generally have a zero base cost unless that share constitutes a dividend (i.e. possibly resulting from distributions of certain non-participating preference shares), the latter of which has a base cost equal to the dividend portion of the newly issued share. Issues of capitalisation shares have no base cost impact on previously held shares that carry the rights to participate in the capitalisation shares.

Shares distributed in substitution for previously existing shares shift base cost from the old shares to the new shares. This shifting in base cost applies regardless of whether the substitution occurs as part of an equal share-for-share exchange, subdivision or consolidation. The new shares receive an aggregate base cost equal to the previously existing shares surrendered in exchange. The aggregate base cost received is then allocated among the newly issued shares according to relative market values.

Example 1

Sierra (Pty) Ltd has 100 000 issued ordinary shares, each of which has a market value of R60. Rae holds a single Sierra (Pty) Ltd share with a base cost of R50. Sierra (Pty) Ltd distributes one new ordinary share to its shareholders for each ordinary share held.

The distribution of the additional ordinary share falls under subparagraph (1) because no previously held shares are surrendered in substitution. Rae retains the R50 base cost in the previously existing ordinary share and receives a zero base cost in the new share. (Note that the capital gain or loss on disposal of either share depends on whether Rae disposes of the share under the first-in first-out method, weighted average method, or specific identification method as prescribed under paragraph 32.)

Example 2

The facts are the same as in Example 1, except Sierra (Pty) Ltd announces a share split with Sierra (Pty) Ltd shareholders surrendering each of their previously held ordinary shares for two new ordinary shares.

The share split qualifies as a share distribution in substitution because previously held shares are being surrendered in exchange. Rae realises no capital gain or loss from the disposal of his or her previously existing share. Rae has the same aggregate R50 base cost in the two new shares with each new share receiving a base cost of R25 (i.e. R50 divided by the equal value of the two shares).

Special rules apply when a company distributes both shares and cash/assets *in specie* in exchange for previously held shares. Under this circumstance, the distribution must be divided into share and non-share elements as if both elements were separate yet simultaneous transactions. The share-for-share element falls under paragraph 78(2), and the non-share portion qualifies as a cash redemption.

Example

Romeo Ltd has 100 000 issued ordinary shares and 50 000 issued preference shares. The ordinary shares each have a market value of R20 and the preference shares each have a market value of R50. Salomi owns 1 preference share with a base cost of R12. Romeo Ltd enters into a substitution whereby each preference share surrendered will be substituted for two ordinary shares and R10 in cash. Of the R10 cash amount, R5 of the cash distribution qualifies as a dividend, and the remainder comes from share capital.

The transaction is treated as both a share substitution and a cash redemption. Romeo Ltd is treated as redeeming R10 of the preference share for cash and R40 of the preference share for the ordinary shares. Of the total R12 base cost in the preference share surrendered, R2.40 is allocated to the cash redemption (1/5th of R12), and R9.60 (4/5ths of R12) is allocated to the share substitution. Salomi has a capital gain of R2.60 on the cash redemption (proceeds of R5 less the base cost of R2.40). Salomi does not realise any capital gain or loss as a result of the share substitution and receives a R4.80 base cost in each ordinary share received (R9.60 divided by 2).

Paragraph 79: Matching contributions and distributions

Paragraph 79 contains a special rule to prevent taxpayers from disguising gain on the disposal of shares through matching contributions and distributions. In transactions of this kind, the intended purchaser first purchases shares from the company as a contribution of capital. The company then distributes the recently contributed amount to a previously existing shareholder as a reduction in share capital. If form governs, the contribution is tax-free because the issue of company shares does not trigger a disposal, and a reduction in share capital only reduces the base cost of previously existing shares.

The matching contribution and distribution rule eliminates this result by treating any distribution as capital gain to the extent that the matching contributions and distributions are part of a scheme to avoid a capital gain on the disposal of shares by a shareholder and the shareholder receiving the distribution is a connected person in relation to the company making the distribution. (The connected person determination is made before the purchase of shares acquired through the matching contribution of capital.) Any shareholder generating capital gain under this rule cannot offset the gain with the base cost of previously held shares, and the base cost of previously held shares remains unaffected by the distribution.

Example

Tertia owns all the shares of Quebec (Pty) Ltd. The shares have an aggregate base cost of R100 000 and a market value of R500 000. Una is interested in purchasing the shares for R500 000, but Tertia does not want to generate a capital gain on the transfer. Pursuant to this aim, Una contributes R600 000 to Quebec (Pty) Ltd in exchange for a second class of ordinary shares that will possess majority voting control. Quebec (Pty) Ltd then distributes R500 000 to Tertia with respect to the previously held shares as a reduction in share capital.

Without the matching contribution/distribution rule, no capital gain or loss would be generated on the issue of Quebec (Pty) Ltd shares nor would any capital gain result from the distribution to Tertia. Tertia would simply reduce the base cost in her shares to zero (with the excess R400 000 being added to proceeds upon eventual sale). Under the matching contribution/distribution rule Tertia is deemed to have a capital gain of R500 000 on the distribution (without any base cost offset in the shares previously held by Tertia).

PART XII: TRUSTS, TRUST BENEFICIARIES AND INSOLVENT ESTATES

The disposal of an asset to or by a trust, for example by vesting it in a beneficiary of the trust, is as a general rule subject to the proposed general principles governing disposals, base cost and proceeds as well as to the general anti-avoidance and loss limitation rules. The disposal of an asset to a beneficiary is, for example, subject to the connected persons rule in the proposed paragraph 38 while a disposal to a trust might be subject to the "clogged losses" rule in the proposed paragraph 39. It is proposed that a capital gain arising from the disposal of a trust asset will be taxable either in the hands of the trust or, where an attribution rule applies, in the hands of a beneficiary or a person who made a donation, settlement or other disposition to the trust.

Paragraph 80: Capital gain attributed to a beneficiary

It is proposed that a capital gain determined in respect of the disposal of a trust asset to a resident who is a trust beneficiary be ignored in the hands of the trust and treated as that beneficiary's gain. A capital gain arising from the disposal of a trust asset will also be taxed in the hands of a beneficiary having no vested right to that asset if that gain is vested in that beneficiary in the year in which it arises. The proposed paragraph 80 is, however, subject to the attribution rules embodied in paragraphs 68, 69, 71 and 72 where that beneficiary is a spouse, a minor or a person who is not a resident or where the vesting of the asset or gain is revocable.

The taxable capital gain of a trust other than a special trust will be taxed at an effective rate of between 16% and 21%. The attribution of a capital gain to a donor or beneficiary who is a natural person or a person other than a trust will therefore result in a lower effective tax rate in respect of that gain. Capital losses determined in respect of the disposal of trust assets will, however, be trapped in the trust.

Vesting trusts

A trust asset that has been vested in a beneficiary, is held by the trustee on behalf of that beneficiary. Actions by the trustee in respect of that asset are actions on behalf of that beneficiary.

Example 1

Vernon invests R100 000 into a vesting trust. The trustee buys shares with the R100 000. The shares decline in value to R20 000 and Vernon sells his interest to Willem for R20 000, taking an R80 000 loss. The shares thereafter rebound in value to R100 000, at which point the trustee sells them for no gain or loss. The trustee then distributes R100 000 to Willem, saying it is a return of capital.

Vernon's interest in the trust is acquired for a base cost of R100 000 and consists of a claim against the trustee in respect of the assets of the trust vested in Vernon. Any action by the trustee in respect of those assets will be an action on behalf of Vernon. Any sale of those shares will therefore be effected on behalf of Vernon while the proceeds from such sale will accrue to or be received by the trustee on behalf of Vernon. Vernon's interest in the trust, namely the claim to the trust asset is, however, a separate asset that can be the subject of a separate disposal if Vernon is entitled to transfer that claim to another person. Vernon will therefore show a capital loss of R80 000 in respect of the disposal of the interest in the trust to Willem, while Willem will acquire the interest at a base cost of R20 000.

The subsequent sale of the shares by the trustee is a disposal on behalf of the person having a vested right to those shares, namely Willem. The trust will therefore not determine a capital gain or a capital loss in respect of the disposal of those shares as they are disposed of on behalf of a specific beneficiary and not for the benefit of the trust. The proceeds from that disposal accrue to or in favour of Willem. The disposal of those shares by the trustee results in the extinction of Willem's claim to those shares (thus constituting a disposal of that claim in terms of paragraph 11(1)) and the concurrent substitution of a new claim, namely the claim for the proceeds that accrue to or in favour of Willem. The disposal of Willem's claim to the shares (acquired by Willem at a base cost of R20 000) in return for the new claim to the proceeds of R100 000 therefore results in a capital gain of R80 000 in Willem's hands.

Willem acquires a new asset (the claim to the proceeds of the shares) in return for the disposal of Willem's previous claim to the shares. The cost of acquisition of the new claim is therefore equal to the value of the previous claim at the time of its disposal in return for the new claim, that is R100 000. The base cost to Willem of the new claim is therefore R100 000. The subsequent distribution of R100 000 to Willem will therefore amount to the extinction or disposal, in terms of paragraph 11, of Willem's remaining interest in the trust for an amount equal to its base cost, thereby resulting in no capital gain or loss.

Example 2

Xavier invests R100 000 into a vesting trust. The trustee buys shares with the R100 000. The shares decline in value to R20 000 and Xavier sells his interest to Yanga for R20 000, taking an R80 000 loss. The shares thereafter rebound in value to R100 000, at which point the trustee distributes them to Yanga.

The distribution of the vested assets to Yanga will in terms of paragraph 11(2)(e) not be a disposal of trust assets by the trustee but will amount to the disposal of Yanga's interest in the trust - the shares distributed to Yanga constitute a receipt in kind in Yanga's hands as a result of which Yanga's claim to the shares is extinguished. The shares are in effect exchanged for Yanga's interest in the trust. The value of those shares at the time of their distribution to Yanga, namely R100 000, is taken into account as the proceeds from the disposal of Yanga’s interest in the trust. Yanga will therefore realise a capital gain of R80 000 in respect of the disposal of the interest in the trust. The base cost to Yanga of the shares acquired as a result of that disposal will be equal to the value of Yanga's interest in the trust at the time of that disposal, namely R100 000.

Example 3

Zahir invests R100 000 into a vesting trust. The trustee buys shares with the R100 000. The shares rise in value to R200 000 at which point the trustee borrows R150 000 from a bank. The shares are used as security for the loan. The trustee distributes the proceeds of the loan to Zahir as a non-refundable payment in respect of her interest in the trust. Zahir subsequently sells the interest in the trust to Ashok for R50 000.

The distribution of R150 000 to Zahir represents a payment in satisfaction of part of Zahir's claim against the trustee for the vested asset. It therefore results in the extinction of part of Zahir's interest in the trust. The R150 000 in effect represents the proceeds from the part disposal of Zahir's interest in the trust. The capital gain in respect of this part disposal will be the following.

Portion of the base cost of entire interest (R100 000) attributable to the part disposed of:

$$= \frac{\text{Market value of part disposed of}}{\text{Market value of entire asset}} \times \text{Base cost of entire asset}$$

$$= \frac{150\ 000}{200\ 000} \times 100\ 000$$

$$= \text{R}75\ 000$$

Proceeds from part disposal of interest	150 000
Base cost of part disposed of	75 000
Capital gain	R75 000

The capital gain in respect of the disposal of the remaining interest in the trust will be the following.

Proceeds from the disposal of the remaining interest	50 000
Base cost of remaining interest (100 000 minus 75 000)	25 000
Capital gain	R25 000

Example 4

Bob invests R100 000 into a vesting trust. The trustee buys shares with the R100 000. The shares rise in value to R200 000 at which point the trustee borrows R150 000 from a bank by using the shares as security. The trustee advances the R150 000 to Bob as a loan. Bob is liable for the repayment of the bank loan as well as any interest payable in respect of it. The trustee is also empowered to sell the shares to repay any amount owing to the bank. The trustee subsequently surrenders the shares to the bank in full and final payment of the loan of R150 000 as well as of an amount of R30 000 payable as interest in respect of the loan.

The transfer of the shares as security for the loan obtained by the trustee does not amount to the disposal, on behalf of Bob, of those shares to the bank (see paragraph 11(2)(a)). There is also no disposal of an asset as a result of the loan advanced to Bob. No portion of the interest payable to the bank will qualify as part of the base cost of the shares as the loan was not used to finance the acquisition of the shares by the trust. The surrender of the shares to the bank in full and final settlement of the loan and finance charges owed to the bank will, however, amount to the disposal of the shares on behalf of Bob. The proceeds from that disposal will in terms of paragraph 35(1)(a) be equal to the amount of the debt extinguished on behalf of Bob, namely R180 000. This amount will accrue to or in favour of Bob and will therefore be taken into account as the proceeds from the extinction of Bob's interest in the trust. No capital gain will be determined separately in the trust in respect of the disposal of the shares to the bank as this was done on behalf of Bob.

Example 5

Catherine invests R100 000 into a vesting trust. The trustee buys listed shares with the R100 000. The shares rise in value to R200 000 at which point the trustee borrows R150 000 by using the shares as security. The trustee uses the proceeds of the loan to buy further shares on behalf of Catherine. The trustee subsequently sells the new shares for R230 000, uses some of the proceeds to repay the loan of R150 000 as well as an amount of R30 000 payable as interest in respect of the loan and distributes the remaining amount of R50 000 to Catherine.

The new shares purchased on behalf of Catherine vested in her at a base cost of R150 000. The base cost of Catherine's interest in the trust therefore increased from R200 000 to R350 000. The liability for the repayment of the loan and interest was also incurred on behalf of Catherine. A third of the interest of R30 000, namely R10 000, qualified in terms of paragraph 20(1)(g) for inclusion in the base cost of the new shares. The total base cost directly attributable in terms of paragraph 33(2) to Catherine's claim to the new shares therefore amounted to R160 000 while the total base cost of Catherine's interest in the trust amounted to R360 000. The trustee disposed of the new shares on behalf of Catherine for R230 000. The amount of R230 000 accruing to or in favour of Catherine represents the proceeds from the disposal of her claim to the shares disposed of by the trustee and results in a capital gain of R70 000 in her hands.

The base cost of the claim for the proceeds that accrued to Catherine in return for the disposal of her claim to the shares is equal to the value of the latter claim at the time of its disposal in return for the new claim, namely R230 000. The subsequent utilisation, on behalf of Catherine, of R180 000 of the proceeds for the payment of the amount owing to the bank and the distribution of the remaining R50 000 to Catherine extinguishes her claim for the payment thereof. Catherine's claim for the proceeds of the shares is therefore disposed of for an amount equal to the base cost of that claim. Catherine will show neither a capital gain nor a loss in respect of that disposal.

Discretionary trusts

It is proposed that the assets of a discretionary trust be treated as those of the trust until they are vested in a beneficiary. Such vesting will be treated as a disposal by the trust at market value. The capital gain determined in respect of that disposal will in terms of the proposed paragraph 80 be taxed in the hands of the beneficiary in whom that asset vested unless that gain is attributed to another person in terms of paragraphs 68, 69, 71 or 72, as seen above. The same applies in respect of a capital gain determined in respect of the disposal of trust assets to persons other than trust beneficiaries where that gain is vested in a trust beneficiary in the year in which it arises. Any such capital gain that is not vested in any trust beneficiary in the year in which it arises will, therefore, be taxed in the hands of the trust at the effective rates applying to trusts unless the gain was derived by reason of a donation, settlement or other disposition and is subject to conditional vesting. In this case it might be taxable in terms of paragraph 70 in the hands of the person who made that donation, settlement or other disposition.

Example

Deborah set up a trust in the Republic. The trustees of the trust are Deborah, Eileen (an accountant in Guernsey) and Fish (a lawyer in Johannesburg).

Deborah sold the following assets to the trust at market value. Had the disposals not been at market value they would have been treated as having been made at market value.

	Market value	Base cost	Capital gain/loss
Shares in Papa Ltd	800 000	200 000	600 000
Shares in Oscar Ltd	200 000	250 000	(50 000)
Undeveloped immovable property	500 000	100 000	400 000
Rent producing shopping complex	500 000	200 000	300 000
Deborah’s residence	100 000	20 000	80 000
	R2 100 000		

The trust qualifies as a connected person in relation to Deborah as the trust beneficiaries include her spouse and children. The disposals by Deborah to the trust are therefore governed by the connected persons rules governing the amount of the proceeds of such disposals (paragraph 38) and the clogging of capital losses determined in respect of such disposals (paragraph 39).

The capital loss of R50 000 can, in terms of paragraph 39, be deducted only from the capital gains determined in respect of the other disposals to the trust in the same or a subsequent tax year and not from gains from disposals to persons other than the trust. The capital gain of R80 000 in respect of the residence might qualify in Deborah's hands for the primary residence exclusion.

The sales took place on credit and Deborah's loan of R2 100 000 to the trust bears no interest and is payable on demand. The beneficiaries of the trust are Deborah's children Gail and Harold (a minor), Deborah's spouse Ian and a list of charitable and educational institutions. The trustees have an unfettered discretion regarding the vesting, in a beneficiary, of any trust income or of any trust assets or of any gain from the disposal of any trust assets. The trustees are also empowered by the trust deed to revoke the vesting of any trust asset in a beneficiary within a period of two years after such vesting.

The following events occur in the first year of the trust's existence.

- Gail emigrates.
- The trust earns rental income of R40 000 and dividend income of R12 500.
- The trustees exercise their discretionary powers at the end of that year by vesting the income of R52 500 in Harold.

	Market value	Base cost	Capital gain
• Deborah's residence is vested in Ian	140 000	100 000	40 000
• Undeveloped property is sold to a third party but the proceeds are not vested in any beneficiary	700 000	500 000	200 000
• Shares are vested in Gail	610 000	500 000	110 000
			R350 000

The interest-free loan of R2 100 000 qualifies as a donation, settlement or other disposition. The value of this benefit is equal to the amount of interest expenses saved by the trust as a result of this loan. Assuming that the trust would have been able to obtain a loan from a bank or other institution at an interest rate of 12.5% p.a., the trust saves an amount, during the first year, equal to the amount of interest that would have been payable at this rate, namely R262 500. The trust would not have been able to distribute the full amount of any trust income and the full market value of any trust asset to the trust beneficiaries had it been obliged to pay R262 500 in interest.

The rental income of R40 000 and the dividends of R12 500 would have had to be applied to pay the interest charge and can therefore be treated as having arisen by reason of the donation made by Deborah. The income that was vested in Deborah's minor child can therefore be taxed in her hands in terms of section 7(3).

The amount of the income so deemed to be that of Deborah must in terms of paragraph 73 be deducted from the total amount of interest saved by the trust as a result of the interest-free loan extended by Deborah. The remaining amount, namely R210 000, amounts to 60% of the capital gains of R350 000 realised by the trust in respect of the disposals during that year. The amount of R210 000 represents the maximum amount of the capital gain that may be attributed to Deborah. It represents the portion of the gains that would have had to be applied by the trust to pay interest at a market-related rate. The attribution rules in paragraphs 68 to 72 governing capital gains arising from a donation, settlement or other disposition therefore apply in respect of R24 000 (60% of R40 000) of the capital gain from the residence, R120 000 (60% of R200 000) of the capital gain from the undeveloped property and R66 000 (60% of R110 000) of the capital gain from the shares disposed of by the trust.

The trust cannot claim the primary residence exclusion in respect of the capital gain from the disposal of the residence to Ian. Were it not for the fact that the vesting was revocable (paragraph 71), the gain of R40 000 would have been taken into account in Ian's hands in terms of paragraph 80(1) unless Deborah made the donation, settlement or other disposition mainly for purposes of tax avoidance (paragraph 68). As it stands R24 000 of the gain will be taken into account in Deborah's hands and R16 000 in Ian's hands.

The vesting, in a trust beneficiary, of a trust asset or of the capital gain determined in respect of the disposal of a trust asset is, in terms of the trust deed, clearly subject to a contingent event, namely the exercise of the discretionary powers of the trustees. The capital gain of R200 000 in respect of the undeveloped property that was not vested in any beneficiary of the trust in the tax year in which it arose will therefore be subject to paragraph 70 with the result that R120 000 of that gain will be taken into account in Deborah's hands and the remaining R80 000 in the trust's hands.

Finally, the gain of R110 000 in respect of the shares vested in Gail will not be attributed to her in terms of paragraph 80 as she is not a resident. The gain vesting in Gail in the year in which it arose is, however, partly attributable to Deborah's donation, settlement or other disposition, with the result that R66 000 of the gain will be attributed to Deborah in terms of paragraph 72. The remainder of the gain will be taxed in the hands of the trust.

Paragraph 81: Base cost of interest in a discretionary trust

A beneficiary's interest in a discretionary trust will in terms of the proposed paragraph 81 be treated as having a base cost of nil if no trust asset has been vested in that beneficiary. The full proceeds from the disposal of that interest will therefore be treated as a capital gain. The position will change once a trust asset has been vested in a beneficiary of such a trust, as this will result in the addition of the market value of that asset as at the date it vested in the beneficiary, to the base cost of that beneficiary's interest in the trust.

Example

Johanna, Kim, Les and Marius are the beneficiaries of a discretionary trust the only asset of which is a holiday home. The trustees of the trust vested a portion of the house in Marius. The market value of that portion at the time it was vested in Marius amounted to R300 000. No rights to the house have, however, been vested in any of the other beneficiaries. Johanna and Marius sell their interests in the trust for R150 000 and R350 000 respectively.

The base cost of Johanna’s interest in the trust is nil while that of Marius is R300 000. Johanna's capital gain in respect of the disposal of her interest will therefore amount to R150 000 while that of Marius will amount to R50 000.

Paragraph 82: Death of a beneficiary of a special trust

It is proposed that a special trust be in effect treated as a natural person for purposes of the Eight Schedule. It will therefore qualify for the same annual exclusion (paragraph 5(1)), inclusion rate (paragraph 10), and exclusions in respect of a primary residence (paragraph 45(1)), personal-use assets (paragraph 53(1)), and compensation for personal injury, illness or defamation (paragraph 59). In terms of the definition of "special trust" (see clause 8(i)) a trust loses its status as special trust upon the death of the beneficiary of that trust. The rates of tax which will be applied to the taxable capital gain of the special trust will be the higher normal rates for trusts. The proposed paragraph 82 is aimed at preserving, for purposes of the Eighth Schedule, the status of a trust as special trust in spite of the death of the beneficiary. The trust will continue to be treated as a special trust until the earlier of the disposal of all assets held by the trust or two years after the beneficiary's death.

Paragraph 83: Insolvent estates of persons

The provisions of this paragraph must be read in conjunction with section 25C of the Income Tax Act. The purpose of the paragraph is to provide for—

- the treatment of assets in the hands of the insolvent estate of a natural person
- the forfeiture of an assessed capital loss by an insolvent.

Subparagraph (1) proposes that an asset disposed of by an insolvent estate be treated in the same manner as if that asset had been disposed of by that natural person. This ensures that the insolvent estate will be entitled to disregard and exclude the same amounts that the insolvent would have been entitled to disregard or exclude had he or she disposed of the assets of the insolvent estate. The purpose of this provision is to ensure that the insolvent estate will not be taxed on the disposal of personal use assets of the insolvent, such as a primary residence or private motor vehicle. It also confers the same 25% inclusion rate on the insolvent estate.

The proposal in subparagraph (2) effectively mirrors the treatment of assessed losses in terms of section 20(1)(*a*)(i). It makes it clear that any assessed capital loss in the hands of the insolvent prior to sequestration is forfeited. In other words it may not be carried forward by the insolvent after date of sequestration. Note, however, that in terms of the amended section 25C an assessed capital loss may be carried forward to the insolvent estate. However, any assessed capital loss remaining in the insolvent estate after all estate assets have been distributed will effectively be lost.

Section 25C provides an exception to this rule where the order of sequestration is set aside. In that case the assessed capital loss – or what remains of it in the insolvent estate – can be taken over by the ex-insolvent.

As regards the effect of a compromise benefit on an assessed capital loss, see paragraph 12(5). A release from an obligation effectively constitutes a capital gain.

PART XIII: FOREIGN CURRENCY

Part XIII of the Eighth schedule contains separate rules for determining capital gains or losses arising from currency transactions. These rules are in addition to the rules for determining capital gains or losses on the disposition of assets within a foreign currency as contemplated under paragraph 43.

Paragraph 84: Regulations

Paragraph 84 requires the Minister of Finance to issue regulations for determining a capital gain or loss with respect to currency transactions. These regulations must be issued before 31 July 2001. The regulations must then be incorporated into the Eighth Schedule by the close of 2002.

The regulatory approach for addressing currency transactions was chosen in order to allow sufficient time for public comment. Prior draft versions of the Eighth Schedule treated foreign currency as an “asset” for all purposes of determining capital gain or loss. This treatment meant that any transfer of foreign currency created a disposal. These disposals included the simple purchase of assets and movement of bank accounts within the same currency. After consultation and deliberation, this approach to foreign currency transactions was rejected.

Under the new approach, the Minister will prescribe regulations that will generate a currency gain or loss only upon certain uses of foreign currency. This approach essentially treats most transactions within same currency as a non-event. In terms of this tax theory, all holdings within the same currency can be viewed as comparable to the holding of a single asset where the capital gain or loss is only realised upon disposal of that asset by withdrawal from that currency. Thus, fund transfers within the same currency, acquiring assets or incurring expenditures within the same currency, or disposing of assets for the same currency of acquisition, will be disregarded.

Under the new approach capital gains or losses will only arise upon certain events viewed as withdrawals from a particular currency. Most obviously, any conversion of foreign currency into another currency will generate a capital gain or loss. The creation and disposal of foreign loans, forward exchange contracts, and foreign currency option contracts will similarly generate capital gains or losses because these instruments often operate as a means for currency speculation. Lastly, certain events and disposals that generate capital gains or losses for “assets” will generate currency gains or losses. This last category mainly involves certain events treated as disposals, such as emigration; and certain actual disposals, such as gifts, death, or company distributions.

As a collateral matter, the regulations will contain adjustments for determining a currency gain or loss, such as the calculation of currency base cost. The regulations will further disregard a capital gain or loss to the extent the currency at issue is already accounted for under section 24I or elsewhere under the Act. In terms of exception, the regulations will disregard conversions arising from currency held exclusively for subsistence or travel.

Paragraph 85: Limitation on foreign currency losses

Paragraph 85 contains a general loss limitation that limits all currency losses within a year to currency gains within that year. All excess losses will be carried into the succeeding year (subject to the same loss limitation mechanism). This loss limitation mechanism prevents taxpayers from eliminating their capital gains on their Eighth Schedule assets as a whole through artificial loss transactions, such as certain notional currency swaps.

PART XIV: MISCELLANEOUS

Paragraph 86: Transactions during transitional period

It is proposed that this rule apply in respect of assets acquired during the period from 23 February 2000 until and including the day before the valuation date. It is aimed at preventing persons from artificially inflating the base cost of an asset for purposes of determining its time-apportionment base cost in terms of paragraph 30. The measure covers all assets acquired during this period—

- under a transaction not effected at arm’s length; or
- directly or indirectly from a person qualifying as a connected person (either at the time of that acquisition or at any time up to a subsequent disposal of that asset within a period of three years after that acquisition). The term “connected person” is defined in the Income Tax Act, 1962, and includes, *inter alia*, any relative of a person.

The base cost of the asset in the hands of the person from whom it was acquired, as well as the period for which that person held the asset prior to that transaction, will be attributed to the person who acquired it should the latter wish to determine and use the time-apportionment base cost of that asset as its valuation date value.

This anti-avoidance measure will also cover any asset which—

- is reacquired within a period of ninety days of its disposal, during the transitional period, under a non-arm’s length transaction or its disposal directly or indirectly to a connected person; or
- replaces a substantially identical asset that was disposed of during the transitional period either under a non-arm’s length transaction or directly or indirectly to a connected person, if the replacement asset is acquired within a period of ninety days from the date of that disposal.

CLAUSE 39

Substitution of long title of the Income Tax Act 58 of 1962

This amendment is consequential upon the insertion of the Eighth Schedule in the Income Tax Act, 1962.

CLAUSE 40

Section 1 of the Stamp Duties Act, 1968

Definition of “company”: It is proposed that a definition of company be inserted in this Act which is similar to that used in the Income Tax Act and includes both foreign and local companies, associations and close corporations.

CLAUSE 41

Amendment of item 7 of Schedule 1 to the Stamp Duties Act, 1968

This clause proposes an exemption from stamp duty in respect of the hypothecation of a new bond, the cession or the substitution of the debtor where such hypothecation, cession or substitution is pursuant to the acquisition by a natural person of a residence contemplated in section 9(16) or (17) of the Transfer Duty Act. This is dealt with in more detail in clause 2.

This clause applies to any hypothecation, cession or substitution pursuant to the acquisition of a residence on or after the date of promulgation of the Taxation Laws Amendment Act, 2001.

CLAUSE 42

Amendment to Item 15 of Schedule 1 to the Stamp Duties Act, 1968.

This clause substitutes the existing paragraph (v) under the heading *"Exemptions from duty under paragraph (3)"*. The effect of this amendment is that the registration of transfer of any share in a shareblock company, as defined in the Shareblock Control Act, 1980, as a result of the sale or disposal of such share, is exempt from stamp duty. The exemption applies to the transaction where a company, close corporation or trust—

- sells or disposes of a share in a shareblock company to a natural person on or after the promulgation of the Taxation Laws Amendment Act, 2001, but not later than 30 September 2002;
- such immovable property to which such shares relate will constitute the primary residence of that natural person;
- that person—
  - ➢ alone or together with his or her spouse held all the share capital in the company from 5 April 2001 to the date of registration of the transfer of such shares in the name of the natural person or jointly in the name of that person and that person's spouse;
  - ➢ disposed of that residence to the trust by way of donation, settlement or other disposition or financed all the expenditure actually incurred by the trust to acquire or to improve the residence;
- that person alone or together with his or her spouse ordinarily resided in that residence and used it mainly for domestic residential purposes as his or her or their main residence from 5 April 2001 to the date of registration of transfer of such shares,
- the registration of the shares in the name of the name of the natural person or jointly in the name of that person and that person's spouse, took place before 31 December 2002.

It is proposed that this paragraph only apply in respect of that portion of the property on which the residence is situated and adjacent land as—

- does not exceed two hectares;
- is used mainly for domestic or private purposes in association with that residence;
- is disposed of at the same time and to the same person as that residence.

CLAUSE 43

Amendment of section 11 of the Value-Added Tax Act, 1991

The amendment gives effect to the decision by Government as announced by the Minister of Finance in his Budget Speech 2001, that sales of certain illuminating paraffin will bear VAT at the rate of zero per cent as from 1 April 2001.

CLAUSE 44

Amendment of section 28 of the Value-Added Tax Act, 1991

In order to facilitate the move by SARS towards the electronic submission of various tax returns, a provision is to be inserted to authorise the Commissioner to accept the signature of such returns as being valid.

The proposed section 28(5) prescribes by whom a return that is submitted must be signed and subsection (5) provides that the Commissioner may, in the case of any return furnished in electronic format, accept electronic or digital signatures as binding, valid signatures.

The proposed section 28(7) provides that the Minister may make rules and regulations setting out the procedures to be followed for submitting returns in an electronic format, should it be required.

CLAUSE 45

Insertion of section 6B in the Skills Development Levies Act, 1999: Electronic filing of statement

In order to facilitate the move by SARS towards the electronic submission of various tax returns, a provision is to be inserted to authorise the Commissioner to accept signatures of such returns as being valid.

The proposed section 6B provides that the Minister may make rules and regulations setting out the procedures to be followed for submitting returns in an electronic format, should it be required.

CLAUSE 46

Short title

This clause provides the short title of the Bill.