



Comprehensive Guide to Capital Gains Tax

Capital Gains Tax

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Preface

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

This guide is not an 'official publication' as defined in s 1 of the Tax Administration Act and accordingly does not create a practice generally prevailing under s 5 of that Act. It is also not a binding general ruling under s 89 of Chapter 7 of the Tax Administration Act. Should an advance tax ruling be required, visit the SARS website for details of the application procedure.

This work reflects the law as at 15 January 2020 as amended by the Taxation Laws Amendment Act 34 of 2020. The 2020 tax rates have generally been used in this guide. The 2020 rates apply to companies with years of assessment ending between 1 April 2019 and 31 March 2020 and to persons other than companies with years of assessment commencing on 1 March 2019.

This issue of the guide follows the author's retirement on 31 July 2020. Besides some minor changes, this issue addresses the following new topics:

- Proceeds from short-term insurance (**9.1.7**)
- Capital losses arising from loans, advances or credit to which s 7C applies (**12.5A**)
- Disregarded capital gains and para 80 (**14.11.6A**)
- Life rights (**16.4.10**)
- Other similar interests (**24.1.4**)
- Government grants (**24.15**)

The new material listed above was reviewed by SARS.

For more information you may

- visit the SARS website at **www.sars.gov.za**,
- visit your nearest SARS branch,
- contact your own tax advisor or tax practitioner,
- contact the SARS National Contact Centre
 - if calling locally, on 0800 00 7277; or
 - if calling from abroad, on +27 11 602 2093 (only between 8am and 4pm South African time).

Comments on this guide may be e-mailed to **policycomments@sars.gov.za**.

Disclaimer

This guide is provided for general guidance only. It is largely the work of a single author and because of its size has not been fully subjected to the normal rigorous review processes within SARS. The views expressed in the guide may therefore not in all cases coincide with SARS's official position on a particular issue. In cases of doubt users of the guide should consider obtaining a non-binding opinion or an advance tax ruling from SARS.

While every precaution has been taken to ensure the accuracy of the information in this guide, SARS will not be liable to any person for inaccurate information, omissions or opinions contained in this guide.

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ABBREVIATIONS

In this guide unless the context indicates otherwise,

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

References to statutory provisions

para	Paragraph
paras	Paragraphs
s	Section
ss	Sections

Acronyms

BESA	Bond Exchange of South Africa
CDE	Capital development expenditure
CFC	Controlled foreign company as defined in s 9D(1)
CGT	Capital gains tax
CIPC	Companies and Intellectual Property Commission established under s 185 of the Companies Act 71 of 2008
CISS	Portfolio of a collective investment scheme in securities
CTC	Contributed tax capital as defined in s 1
FEC	Forward exchange contract
FIFO	First-in-first-out
GG	<i>Government Gazette</i>
GN	Government Notice
IAS	International accounting standard
JSE	The exchange operated by JSE Ltd which facilitates trade in securities under the style of ‘Johannesburg Stock Exchange’ and is licensed as an exchange under the Financial Markets Act 19 of 2012.
LIFO	Last-in-first-out
MV	Market value
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
PBA	Public benefit activity contemplated in the Ninth Schedule
PBO	Public benefit organisation
PV	Present value
REIT	Real Estate Investment Trust as defined in s 1(1) which is listed as a REIT on the JSE.
SA	Republic of South Africa
STC	Secondary Tax on Companies

TAB	Time-apportionment base cost
VAT	Value-added tax
VDV	Valuation date value

Tax Court

C	Cape Tax Court (formerly Cape Income Tax Special Court)
EC	Eastern Cape Special Court
F	Federation of Rhodesia and Nyasaland Income Tax Special Court (from 1957 to 1964)
G	Gauteng Tax Court
K	Kimberley Tax Court
J	Johannesburg Tax Court
N	Natal Income Tax Special Court
NA	Northern Special Court
P	Pretoria Tax Court
SEC	South Eastern Cape Tax Court
SR	Southern Rhodesia Income Tax Special Court
SW	South West Africa Income Tax Special Court
T	Transvaal Income Tax Special Court
U	Special Court for the Union of South Africa (from 1 June 1926 to 1950)
WC	Western Cape Tax Court

Other legal references

(A)	Appellate Division of the Supreme Court of South Africa
AC	Law reports, Appeal Cases, House of Lords
AD	Reports of the Appellate Division of the Supreme Court of South Africa
All ER	All England Law Reports
All SA	All South African Law Reports
ALR	Australian Law Reports (1973 to date)
ATR	Australian Tax Reports
BCA	Court of Appeal, Botswana
BCLR	Butterworths Constitutional Law Reports
BH	Bophuthatswana High Court
(C)	Cape Provincial Division of the Supreme Court of South Africa
(CC)	Constitutional Court
ChD	Law Reports, Chancery Division (1876 – 1890)
CIR	Commissioner for Inland Revenue
CLR	Commonwealth Law Reports
CPD	Reports of the Cape Provincial Division of the Supreme Court of South Africa
C: SARS	Commissioner for the South African Revenue Service
(E)	Eastern Cape Division of the Supreme Court of South Africa
EDC	Eastern District Court Reports, Cape of Good Hope, 1880 – 1909
ER	English Reports
(FC)	Federal Supreme Court of the Federation of Rhodesia and Nyasaland
FCA	Federal Court of Australia
FCR	Federal Court Reports
FCT	Federal Commissioner of Taxation (Australia)
HC of A	High Court of Australia
IRC	Inland Revenue Commissioners
JTLR	Juta's Tax Law Reports
KB	Law Reports, King's Bench Division
LAWSA	<i>The Law of South Africa</i> , LexisNexis Butterworths
(N)	Natal Provincial Division of the Supreme Court of South Africa
NO	<i>Nomine officio</i> ('in the name of office')

NNO	Plural of <i>nomine officio</i>
NPD	Reports of the Natal Provincial Division of the Supreme Court of South Africa
QBD	Law Reports, Queen's Bench Division
RAD	Rhodesia Appellate Division
SA	South African Law Reports
<i>SA Merc LJ</i>	<i>South African Mercantile Law Journal</i> , Juta & Company Ltd
SATC	South African Tax Cases Reports
SC	Reports of the Supreme Court of the Cape of Good Hope from 1880
SC	Court of Session Cases (Scotland)
(SCA)	Supreme Court of Appeal
(SCD)	Special Commissioners' Decisions
Sc LR	Scottish Law Reporter 1965 – 1925
SIR	Secretary for Inland Revenue
SpC	Special Commissioners
STC	Simon's Tax Cases
(T)	Transvaal Provincial Division of the Supreme Court of South Africa
TC	Reports of Tax Cases, England
TC	United States Tax Court Reports
TPD	Reports of the Transvaal Provincial Division of the Supreme Court of South Africa
TS	Transvaal Supreme Court Reports
<i>TSH</i>	<i>Tax Shock, Horror</i>
UKHL	House of Lords (United Kingdom)
US Tax	
Ct LEXIS	United States Tax Court
(W)	Witwatersrand Local Division of the Supreme Court of South Africa
WLD	Reports of the Witwatersrand Local Division of the Supreme Court of South Africa
WLR	Weekly Law Reports

Chapter 1 – Introduction

1.1 Reasons for the introduction of CGT

For a more comprehensive commentary on the reasons for the introduction of CGT, see the Briefing by the National Treasury's Tax Policy Chief Directorate to the Portfolio and Select Committees on Finance Wednesday, 24 January 2001.¹ Briefly the reasons for the introduction of CGT are as follows:

1.1.1 International benchmarking

Many of South Africa's trading partners introduced CGT years ago. It was introduced in the United States in 1913,² in the United Kingdom in 1965,³ in Canada in 1971⁴ and in Australia in 1985.⁵ Many African countries also have CGT, for example, Botswana, Malawi, Nigeria and Zimbabwe. Some of these developing countries limit their CGT for administrative reasons to share and property transactions while others simply treat capital gains as ordinary income.

1.1.2 Horizontal equity

Haig-Simons⁶ define income comprehensively as

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

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

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

¹ 'Capital Gains Tax In South Africa' (24 January 2001) available at <<http://www.ftomasek.com/NationalTreasury.pdf>> [Accessed 2 November 2020].

² It was introduced following the introduction of the Sixteenth Amendment to the US Constitution which enabled Congress to impose a federal income tax. Some uncertainty persisted between 1913 and 1921 whether capital gains formed part of income tax. In 1921 all doubts were removed when the US Supreme Court ruled in *Merchants' Loan and Trust Co v Smetanka* (1921) 255 US 509 that income includes the gain from capital realized by a single isolated sale of property held as an investment, as well as a profit realized by sales in a business of buying and selling such property.

³ Introduced under the Finance Act, 1965 on 6 April 1965. The CGT applied to disposals of assets from that date. Gains and losses accruing before that date were excluded by using time-apportionment rules, or the taxpayer could elect to determine a 'Budget Day' valuation on that date.

⁴ The tax became effective in 1972 with 'valuation day' or V-day as it is known, being 31 December 1971. Taxpayers had the choice of using original cost or market value on valuation day as the base cost on valuation day.

⁵ Applies to assets acquired after 19 September 1985.

⁶ See RM Haig 'The Concept of Income – Economic and Legal Aspects' in *The Federal Income Tax* (1921) Columbia University Press and H Simons *Personal Income Taxation* (1938) The University of Chicago Press.

An individual who invests R100 000 on fixed deposit at 10% a year has the same ability to pay as one who invests R100 000 in shares and derives a dividend of 3% and a capital gain of 7%. Without CGT the latter individual pays dividends tax of only 20% on the dividend while the former pays up to 45% on the interest income (excluding the exempt portion). The same principle applies to individuals earning salary income compared to those deriving income in the form of capital gains.

1.1.3 Vertical equity

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

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

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

1.1.4 The shift from income to capital

When capital gains are not taxed, taxpayers have an incentive to recharacterise income as capital. There are many ways in which this can be done, some more complex than others. The classic example of this used to be the restraint of trade payment. Popular before the amendment of the Income Tax Act in 2000⁷ it was commonplace for employees to be paid 'restraint of trade' payments. In many cases these were little more than disguised remuneration.

Taxpayers are also encouraged to shift from income-bearing investments to those that produce capital gains. This shift erodes the tax base and results in an artificial allocation of resources. An example is to be found when money is invested offshore. One way of doing this is to invest the money in a fund and earn interest on the capital, which would be taxed. The alternative is to invest the money in a roll-up fund from which interest is not paid to the investor but retained by the fund. As a result, the value of the shares in the fund increases by the amount of the retained interest. When the shares are sold it can be argued that the difference between the original cost of the shares and the selling price is a non-taxable capital gain. The return on investment is the same but the tax consequences are very different. Sometimes the income to capital shift requires the hand of time – for example instead of disposing of shares within a year an investor waits three years to take advantage of s 9C which deems the proceeds to be of a capital nature. Frequently the intention is the same – to make a profit on disposal of the shares, though in the latter case investors will invariably claim that the investment was made to earn dividend income.

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

⁷ Paragraph (cA) was inserted into the definition of 'gross income' in s 1 by s 13(1)(f) of the Taxation Laws Amendment Act 30 of 2000 deemed to have come into operation on 23 February 2000 and applicable in respect of any amount received or accrued on or after that date.

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

1.1.5 Economic efficiency

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

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

1.1.6 Tax-base broadening

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

For more detailed information on the case for introducing CGT see the papers presented by Krever⁸ and Brooks⁹ to the Portfolio Committee on Finance.

1.2 Historical development of CGT in South Africa

1.2.1 Previous Commissions of Enquiry

The idea of taxing capital gains is not new in South Africa. In 1969, the Franzsen Commission¹⁰ proposed a limited form of capital gains tax on immovable property and marketable securities, while in 1986 the Margo Commission¹¹ recommended that capital gains should not be taxed. In 1995 the Katz Commission in its third report¹² considered the merits and demerits of a capital gains tax in South Africa. It declined to make firm recommendations because of the complexity of CGT administration and the lack of capacity of the Inland Revenue at that time.

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

⁸ RA Krever 'A Capital Gains Tax for South Africa' [online], (25 January 2001). Available at <<http://www.ftomasek.com/RickKreverDraft.html>> [Accessed 2 November 2020].

⁹ N Brooks 'Taxing Capital Gains is Good for the Tax System, the Economy and Tax Administration' [online], (26 January 2001). Available at <<http://www.ftomasek.com/NeilBrooksRevised.pdf>> [Accessed 2 November 2020].

¹⁰ Taxation in South Africa: First Report of the Commission of Enquiry into Fiscal and Monetary Policy in South Africa, November 1968, printed for the Government Printer, Pretoria by Cape and Transvaal Printers TD, Cape Town B932/5,000 at 48.

¹¹ Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa, 20 November 1986, The Government Printer, RP34/1987, Pretoria.

¹² Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, 1995, The Government Printer, Pretoria.

1.2.2 The Guide – 23 February 2000

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

1.2.3 The First Draft – 12 December 2000

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

1.2.4 The Second Draft – 2 March 2001

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

The interest and participation of the public in commenting on the draft Bills and participating in the public hearings of the Committees were of invaluable assistance in formulating the legislation.

1.2.5 The introduction of CGT into legislation

The Taxation Laws Amendment Bill (B17 – 2001) was tabled in the National Assembly on 5 April 2001, passed by the National Assembly on 16 May 2001, passed by the National Council of Provinces on 22 May 2001, and assented to by the Acting President on 13 June 2001. It was accompanied by a comprehensive *Explanatory Memorandum* that formed the foundation of this guide. CGT was finally introduced into South African law by the Taxation Laws Amendment Act 5 of 2001, which was promulgated on 20 June 2001. A summary of the changes made to CGT legislation since its introduction is contained in **1.2.6**. Over the years there have been many amendments to the Eighth Schedule. Some of these changes have been consequential on other changes to the main body of the Act such as the discontinuation of STC and the introduction of dividends tax while others have been prompted by a desire for simplification. Some areas which have proved particularly troublesome include the treatment of returns of capital from shares (paras 76 to 77), reduction of debt (para 12(5) [repealed] and its replacement para 12A), para 43 (assets denominated in foreign currency) and foreign currency assets and liabilities (paras 84 to 96 [repealed]). The treatment of deceased persons and their estates underwent a complete overhaul with effect from 1 March 2016 in order to address long-standing anomalies and interpretation difficulties, many of which preceded the introduction of CGT.

1.2.6 Table of amendments to CGT legislation

Table 1 – Amendments to CGT legislation

Act	Bill no. and date tabled	Volume no, Government Notice no, Government Gazette no and date promulgated	Details
Taxation Laws Amendment Act 5 of 2001	B 17—2001 Tabled 5.4.2001	Vol 432, GN 550, GG 22389 of 20.6.2001	Inserts Eighth Schedule.
Revenue Laws Amendment Act 19 of 2001	B 36—2001 Tabled 22.6.2001	Vol 433, GN 709, GG 22532 of 27.7.2001	Amends paras 2, 20, 23, 32, 45, 46, 55, 60, 66, 84 and 86 of the Eighth Schedule.
Second Revenue Laws Amendment Act 60 of 2001	B 84—2001 Tabled 7.11.2001	Vol 438, GN 1333, GG 22923 of 12.12.2001	Amends paras 1–4, 6, 7, 11, 12, 15, 18, 20, 24, 26, 28, 29, 30–32, 35, 38, 39, 40, 42–45, 47, 49, 52, 53, 55, 61, 65, 67, 74, 76, 80, 81, 84 and 86 of the Eighth Schedule; substitutes paras 25, 27, 34, 56, 58 and 59 of the Eighth Schedule; inserts Part III of Chapter II, para 67A of the Eighth Schedule and repeals para 85 of the Eighth Schedule.
Taxation Laws Amendment Act 30 of 2002	B 26—2002 Tabled 20.6.2002	Vol 446, GN 1047, GG 23709 of 5.8.2002	Amends paras 29, 32 and 84 of the Eighth Schedule.
Revenue Laws Amendment Act 74 of 2002	B 67—2002 Tabled 6.11.2002	Vol 450, GN 1581, GG 24181 of 13.12.2002	Amends paras 1, 2, 4, 10, 11, 12, 13, 14, 20, 24, 26, 27, 29, 30, 31, 32, 33, 38, 40, 41, 51, 53, 55, 56, 57, 72, 74, 76, 78, 79, 84, 95, 96 and 86 of the Eighth Schedule. Substitutes paras 25, 43, 61, 63, 67A, 81 and Part XIII (now comprising paras 84 to 97) of the Eighth Schedule and Part III of Chapter II (now comprising ss 41 to 47). Inserts para 64A of the Eighth Schedule.
Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003	B 26—2003 Tabled 15.5.2003	GG 25047 of 31.05.2003	S 4(3) (trust asset in respect of which the donor or deceased estate has elected to be the holder). S 28 (base cost limitation in respect of exchange control amnesty applicants).
Regulations issued under s 30 of the Exchange		GG 25511 of 29.09.2003 Notice No. R.1368	Regulation 4 (base cost of asset in respect of which election has been made; deemed disposal events pertaining to such asset).

Act	Bill no. and date tabled	Volume no, Government Notice no, Government Gazette no and date promulgated	Details
Control and Amendment of Taxation Laws Act			Regulation 7 (suspension of attribution rules during period of election).
Revenue Laws Amendment Act 45 of 2003	B 71—2003 Tabled 18.11.2003	GG 25864 of 22.12.2003	Amends paras 1, 2, 11, 12, 19, 20, 27, 30, 33, 39, 43, 55, 62, 67, 67A, 72, 74, 75, 78, 84, 86, 88, 92, 93, 94 and 96 of the Eighth Schedule. Inserts paras 20A, 67B and 67C. Substitutes paras 63, 65 and 66 Amends ss 41 to 47.
Taxation Laws Amendment Act 16 of 2004	B 8—2004 Tabled 18.06.2004	GG 26612 of 27.07.2004	Amends paras 1, 39, 65, 67C, 75, 76 and 78.
Revenue Laws Amendment Act 32 of 2004	B 24—2004 Tabled 09.11.2004	GG 27188 of 24.01.2005	Amends paras 1, 2, 3, 4, 11, 12, 13, 20, 20A, 25, 33, 38 and 56. Inserts paras 35A and 39A. Amends ss 41, 43, 45, 46 and 47. Inserts ss 24B, 24M, 24N and 35A.
Revenue Laws Amendment Act 31 of 2005	B 40—2005 Tabled 08.11.2005	GG 28450 of 01.02.2006	Amends paras 1, 2, 8, 11, 12, 20, 24, 30, 33, 38, 39, 42, 43, 55, 56, 64 64B, 72, and 76.
Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006	B 14—2006 Tabled 13.06.2006	GG 29068 of 25.07.2006	Amends paras 5, 45, 57 and 64B.
Revenue Laws Amendment Act 20 of 2006	B 33—2006 Tabled 02.11.2006	GG 29603 of 07.02.2007	Amends paras 11, 20, 24, 29, 30, 31, 40, 43, 62, 64, 64A, 67, 80 and 92. Inserts paras 63A and 65B.
Taxation Laws Amendment Act 8 of 2007	B 18—2007 Tabled 07.06.2007	GG 30157 of 08.08.2007	Amends paras 20, 29, 31, 39, 63. A, 64B, 65B, 66 and 84.
Revenue Laws Amendment Act 35 of 2007	B 42—2007 Tabled 30.10.2007	GG 30656 of 08.01.2008	Amends paras 12, 19, 20, 42, 43, 64B, 65, 66, 67, 67A, 74 and 76. Inserts paras 42A, 67AB and 76A. Repeals para 79.
Taxation Laws Amendment Act 3 of 2008	B 13—2008 Tabled 19.03.2008	GG 31267 of 22.07.2008	Amends paras 1, 12, 13, 20, 24, 40, 42, 54, 55, 64B, 74, 76, 76A, 80.
Revenue Laws Amendment Act 60 of 2008	B 80—2008 Tabled 21.10.2008	GG 31781 of 08.01.2009	Amends paras 11, 12, 13, 20, 24, 40, 64B, 67A, 67AB, 76, 78 and 80. Inserts para 57A.
Taxation Laws Amendment Act 17 of 2009	B 10—2009 Tabled 01.09.2009	GG 32610 of 30.09.2009	Amends paras 5, 13, 19, 25, 40, 45, 61, 64, 74, 75 and 80. Inserts paras 43A and 67D.

Act	Bill no. and date tabled	Volume no, Government Notice no, Government Gazette no and date promulgated	Details
			Substitutes para 51.
Taxation Laws Amendment Act 7 of 2010	B 28—2010 Tabled 24.08.2010	GG 33726 of 2 November 2010	Amends paras 2, 12, 20, 29, 31, 38, 42, 43, 43B, 45, 51, 61, 62, 64B, 67A, 74, 78 and 96. Inserts paras 43B and 51A.
Taxation Laws Amendment Act 24 of 2011	B 19—2011 Tabled 25.10.2011	GG 34927 of 10 January 2012	Amends paras 5, 12, 19, 20, 43, 51A, 55, 57, 64B, 74, 75, 76, 76A, 77 and 78. Inserts para 76B. Substitutes para 43A. Repeals Part XIII (paras 84 to 96).
Rates and Monetary Amounts and Amendment of Revenue Laws Act 13 of 2012	B 10—2012 Tabled 13.03.2012	GG 35775 of 9 October 2012	Amends paras 5, 10, 45 and 57.
Taxation Laws Amendment Act 22 of 2012	B 34—2012 Tabled 25.10.2012	GG 36122 of 1 February 2013	Amends paras 1, 3, 8, 10, 11, 12, 13, 19, 20, 23, 32, 38, 40, 42, 43, 43A, 56, 61, 64A, 64B, 65, 66, 67A, 67B, 74, 75, 76, 76A, 76B and 78. Inserts para 12A Repeals para 67A, 67AB and 78.
Rates and Monetary Amounts and Amendment of Revenue Laws Act 23 of 2013	B 12—2013 Tabled 18.06.2013	GG37104 of 2 December 2013	No amendments to Eighth Schedule.
Taxation Laws Amendment Act 31 of 2013	B 39—2013 Tabled 24.10.2013	GG 37158 of 12 December 2013	Amends paras 11, 12A, 13, 16, 20, 31, 32, 35, 43, 53, 56, 57, 57A, 61, 62, 64, 64B, 67C, 68, 75, 76, 77 and 80 Repeals para 42A.
Taxation Laws Amendment Act 43 of 2014	B 13—2014 Tabled 22.10.2014	GG 38405 of 20 January 2015	Amends para 1, 10, 11, 12, 12A, 15, 20, 29, 31, 41, 43, 44, 67B and 77 Inserts para 63B
Tax Administration Laws Amendment Act 44 of 2014	B 14—2014 Tabled 22.10.2014	GG 38406 of 20 January 2015	Amends para 29.
Rates and Monetary Amounts and Amendment of Revenue Laws Act 13 of 2015	B 15B—2015 Tabled 12.08.2015	GG 39421 of 17 November 2015	Period 1 March 2015 to 29 February 2016: Increases the maximum marginal rate of normal tax for individuals, deceased and insolvent estates and special trusts from 40% to 41%.

Act	Bill no. and date tabled	Volume no, Government Notice no, Government Gazette no and date promulgated	Details
			Increases the rate of normal tax for trusts from 40% to 41%.
Taxation Laws Amendment Act 25 of 2015	B29B—2015 Tabled 27.10.2015, passed by National Assembly 26.11.2015	GG 39588 of 8 January 2016	Amends, amongst others, definition of 'connected person' in s 1(1), s 9C, 9H, 12P, 12T, 19, 25, 25BB, 35A, 40C Inserts, amongst others, s 9HA and 40E Amends paras 2, 3, 4, 11, 12A, 13, 20, 29, 31, 35, 40, 41, 43, 55, 57A, 64B, 65, 66, 67, 76B and 80. Inserts para 64C.
Taxation Laws Amendment Act 15 of 2016	B17—2016 Tabled 26.10.2016	GG 40562 of 19 January 2017	Amends, amongst others, s 9C, 9H, 9HA, 12J, 12P and 25. Amends paras 11, 38, 43, 47, 49,50, 66 and 76B. Substitutes para 64A. Inserts para 64D.
Taxation Laws Amendment Act 17 of 2017	B27—2017 Tabled 25.10.2017	GG 41342 of 18.12.2017	Substitutes paras 12A and 43A Amends paras 35A, 55 and 80 Inserts para 64E Amongst others: Amends definitions of 'connected person', 'dividend', 'return of capital', ss 9C and 9D. Inserts s 7D and 8G. Substitutes s 19.
Taxation Laws Amendment Act 23 of 2018	B38—2018 Tabled 24.10.2018	GG 42172 of 17.01.2019	Amends para 1 ('disposal', 'market value'), 2, 5, 10, 12A, 35, 39, 43A, 45, 55, 57, 64B and 80. Repeals para 67. Substitutes para 72. Amends (amongst others), s 1(1) ('company', 'dividend', 'financial instrument', 'Financial Sector Conduct Authority', 'Financial Services Board' and 'Financial Services Board Act' deleted), 'identical share', 'Financial Sector Regulation Act', 'Insurance Act', 'official rate of interest', 'REIT' and 'relative', s 6quat, 9, 9C, 9D, 9HA, 9J, 10(1)(yA), 10B, 11F, 12J, 12Q, 18A, 19, 22B, 24I, 24L, 25 and 41. Inserts s 9HB.
Taxation Laws Amendment Act 34 of 2019	B18B—2019 Tabled 30.10.2019 (as amended)	GG 42951 of 15.01.2020	Amends para 1 ('market value'), 12A, 19, 20, 29, 35, 38, 40, 43, 43A, 56 and 80.

Act	Bill no. and date tabled	Volume no, Government Notice no, Government Gazette no and date promulgated	Details
	by the Standing Committee on Finance)		Amends (amongst others) s 1(1) ('dividend', 'return of capital'), 9D, 9HA, 9HB, 40CA, 41, 42, 44, 45 and 47.
Taxation Laws Amendment Bill, 2020	B27—2020 Tabled 28.10.2020		Amends paras 2, 12, 12A, 20A, 42, 64B and 80. Substitutes para 34. Amends s 1 ('financial instrument' and 'REIT'), s 7C, 9, 9D, 9H, 9J, 10(1)(yA), 12J, 18A and 25B. Inserts s 9K. Substitutes s 40CA.

1.2.7 Retrospective amendments

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

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

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

In *Robertson & another v City of Cape Town & another; Truman-Baker v City of Cape Town*¹⁵ the court considered whether retrospective legislation was unconstitutional. It concluded that apart from certain provisions pertaining to criminal law, the Constitution of the Republic of South Africa, 1996 does not contain any express provisions barring retrospective legislation.¹⁶

The passing of retrospective legislation in other constitutional democracies (India, the United States and Canada) has not been found to be unconstitutional.

*Pienaar Brothers (Pty) Ltd v C: SARS & another*¹⁷ involved an amalgamation transaction under s 44. Under the arrangement, old co (the amalgamated company) transferred all its assets to new co (the resultant company and applicant) in return for shares in new co. Those shares were then distributed by old co to its shareholders and its existence was terminated

¹³ *National Director of Public Prosecutions v Carolus & others* 2000 (1) SA 1127 (SCA).

¹⁴ 1995 (3) SA 51 (C) at 64A–B.

¹⁵ 2004 (5) SA 412 (C).

¹⁶ At 452.

¹⁷ 2017 (6) SA 435 (GP), 80 SATC 1.

through liquidation. The distribution was exempt from STC under s 44(9). In its books new co credited its share capital and share premium account with the value of the assets acquired. It later effected a reduction in its share premium account, which it claimed was exempt from STC under the exclusion in para (f) of the then definition of 'dividend' in s 1.

Towards the end of 2006 SARS and National Treasury became aware that s 44 was being used to permanently avoid the payment of STC through the use of s 44(9) and para (f) of the definition of 'dividend' and that this needed to be addressed through the introduction of appropriate amending legislation. The following events then took place:

- 20 February 2007 – Minister of Finance announced that retrospective legislation would be introduced to deal with certain STC anti-avoidance arrangements.
- 21 February 2007 – SARS issued a media release in which it stated that the exemption in s 44(9) was to be withdrawn with immediate effect.
- 27 February 2007 – Draft Taxation Laws Amendment Bill released, reflecting the proposed deletion of s 44(9) and (10), deemed to come into operation on 21 February 2007.
- 16 March 2007 – Amalgamation transaction between old co and new co under s 44 completed.
- 3 May 2007 – Share premium of new co distributed to its shareholders.
- 7 June 2007 – Taxation Laws Amendment Bill published. It no longer proposed the deletion of s 44(9) and (10) but instead proposed the insertion of s 44(9A), which tainted the share premium of the resultant company to the extent of the profits available for distribution in the amalgamated company. In other words, the amalgamated company continued to enjoy the STC exemption under s 44(9) but the resultant company would have to pay STC on the tainted portion of its share premium account when it reduced its share premium. It also proposed that the amendment would be retrospective to 21 February 2007.
- 8 August 2007 – The Taxation Laws Amendment Act 8 of 2007 was promulgated. Section 44(9A) was deemed to come into operation on 21 February 2007 and applied to any reduction in the share premium account of a resultant company on or after that date.

SARS later raised an STC assessment in respect of the reduction in new co's share premium account based on s 44(9A) and it was this assessment that was the subject of the application.

New co argued that at the time it entered into the amalgamation transaction and effected the reduction in its share premium, s 44(9A) had not been inserted in the Act, nor was it made aware of an intention to introduce s 44(9A). It became aware of s 44(9A) only when the bill was released in June 2007. Before that time, it had been indicated that s 44(9) would be deleted, which in fact never happened.

It argued that the retrospective insertion of s 44(9A) was unconstitutional.

In a 156-page judgment Fabricius J held that the backdating of s 44(9A) was not unconstitutional.

Some of the principles emerging from the judgment are the following:

- There are two main tests for determining the constitutionality of legislation, namely, a rationality test and the more exacting test of reasonableness or proportionality.
- If the tax statute is rationally connected to a legitimate purpose, no precise warning of retrospective legislation is required, if one at all.
- A warning given of an impending change to tax legislation need not result in the exact same amendment that is ultimately made. such an approach would undermine the parliamentary process and the public participation process completely.
- A precise warning need not be given in each and every case, nor need a warning, of whatever ambit, be given in all cases. A proper approach is to judge the legality of retrospective amendments on a case-by-case basis, having regard to the various considerations referred to in the judgment.

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

Under s 5(2) the Minister may announce changes to the rates of tax chargeable on taxable income in the annual budget from a date or dates determined by the Minister in the announcement. These changes apply for a period of 12 months from the effective date of the rate change, subject to Parliament passing legislation giving effect to the announcement. Similar provisions giving the Minister the authority to change monetary amounts have been introduced into the Eighth Schedule in relation to the annual exclusion [para 5(3)], inclusion rate [para 10(2)], primary residence exclusion [para 45(1A)], and small business asset exclusion [para 57(7)].

Chapter 2 – Capital v revenue

2.1 The words ‘of a capital nature’

The words ‘of a capital nature’ are to be found in several sections of the Act, and are relevant for determining what is taxed on income account under sections of the Act and on capital account under the Eighth Schedule.

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

- Section 1(1), definition of ‘gross income’ – which excludes ‘receipts or accruals of a capital nature’, but includes certain amounts ‘whether of a capital nature or not’.
- Section 9C – which deems the amount received or accrued or expenditure incurred in respect of an equity share held for at least three years to be of a capital nature.
- Section 11(a) (general deduction formula) – which permits a deduction for expenditure and losses actually incurred in the production of income in carrying on a trade ‘provided such expenditure and losses are not of a capital nature’.
- Section 11(c) (deduction for certain legal expenses) – which limits the deduction to so much of the expenses as ‘is not of a capital nature’.
- Section 11E (Deduction of certain expenditure incurred by sporting bodies) – which provides a deduction for expenditure ‘not of a capital nature’ on development and promotion of sporting activities.
- Section 12E (Deductions in respect of small business corporations) – under which a company will qualify as a small business corporation if not more than 20% of its total receipts and accruals (other than those of a capital nature) and all its capital gains consists collectively of investment income and income from the rendering of a personal service.
- Section 18A (Deduction of donations to certain organisations) – in s 18A(3), which deals with the donation of property in kind and excludes ‘immovable property of a capital nature where the lower of market value or municipal value exceeds cost’. Such property is dealt with in s 18A(3A).
- Section 24J(3) includes in gross income the amount of any interest determined under that section ‘whether or not that amount constitutes a receipt or accrual of a capital nature’.
- Section 24L(3) – which deems a premium or like consideration received or receivable by a person under an option contract to accrue on a day-to-day basis ‘other than an amount of a capital nature’.
- Section 25BA (amounts received by or accrued to certain portfolios of collective investment schemes and holders of participatory interests in portfolios) – which allows a flow-through of income to holders of participatory interests under specified circumstances but does not apply to ‘an amount of a capital nature’.
- Section 37G (determination of taxable income derived from small business) which enables the Minister of Finance to make regulations to facilitate compliance with the Act by individuals carrying on small business. The Minister may prescribe ‘the manner in which expenditure of a capital nature incurred is to be treated’.
- Section 80B (Tax consequences of impermissible tax avoidance) – which enables the Commissioner to determine the tax consequences of impermissible tax avoidance

arrangements, including reallocating or re-characterising a receipt or accrual of a capital nature.

- First Schedule – para 14 deems an amount received by or accrued to a farmer from the disposal of a plantation not to be a receipt or accrual of a capital nature, regardless of whether disposed of together with the land on which it is growing.
- Sixth Schedule – a number of references are made to receipts or accruals of a capital nature for the purposes of determining the turnover of a micro business.
- Tenth Schedule (oil and gas activities) – a number of references are made to the deduction of expenditure of a capital nature in relation to oil and gas rights.

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

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

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

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

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

Sections of the Act	Eighth Schedule
RECEIPTS AND ACCRUALS	
General rule: Any amount received or accrued of a revenue nature (s 1(1) – definition of ‘gross income’).	Receipts or accruals of a capital nature excluded from the definition of gross income in s 1(1) which relate to the disposal of assets.
Receipts or accruals of a capital nature specifically included in the definition of ‘gross income’.	Amounts of a revenue nature deemed to be of a capital nature under s 9C (three-year rule for equity shares).
Any discount arising on the acquisition of a debt in terms of or in respect of a financial arrangement is deemed to be gross income under s 24J(3), regardless of whether it is of a capital nature (see 24.4).	
REALISED AND UNREALISED GAINS	
Gains arising under certain employee share incentive arrangements under ss 8A (when option exercised), 8B (when shares disposed of within five years) and 8C (on date of vesting).	Unrealised receipts or accruals of a capital nature on date of death [s 9HA(1)].
Amounts of a revenue nature deemed to be received by or accrued to a person upon ceasing to be a resident, ceasing to be a CFC or on becoming a headquarter company (s 9H).	Amounts of a capital nature deemed to be received by or accrued to a person upon ceasing to be a resident, ceasing to be a CFC or on becoming a headquarter company (s 9H).

Sections of the Act	Eighth Schedule
	Section 8B gains when shares held for at least five years.
EXPENDITURE AND LOSSES	
General rule: Expenditure and losses actually incurred of a revenue nature incurred in carrying on trade and which are in the production of income [s 11(a)].	Expenditure and losses of a capital nature excluded from sections of the Act by s 11 and which qualify under para 20. The qualifying para 20 expenditure generally relates to the acquisition or disposal of assets.
Amounts of a capital nature that are specifically allowed as a deduction (for example, repairs [s 11(d)], leasehold improvements [s 11(g)], capital allowances (for example, s 11(e), 12B, 12C and so on).	Certain amounts of a revenue nature allowed under para 20 that do not qualify under s 11 (e.g. one-third of interest paid in acquiring listed shares).
Specified capital expenditure incurred by farmers (para 12 of First Schedule and s 17A).	
Losses arising on vesting of equity instruments under s 8C.	

Capital expenditure not qualifying under the Eighth Schedule

Since the Eighth Schedule is concerned with capital gains and losses on the disposal of assets, there will be some expenses of a capital nature that will not fall into either the main body of the Act or the Eighth Schedule. Such expenditure is likely to include amounts of a capital nature not incurred for the purpose of creating or improving an asset and which is not otherwise provided for (for example, bond registration and bond cancellation costs¹⁸).

2.3 Double deductions and double taxation

Although the Eighth Schedule applies to both capital assets and trading stock,¹⁹ double deductions and double taxation are generally prevented by para 20(3)(a) (expenditure) and para 35(3)(a) (receipts or accruals). To the extent that the double taxation issue is not addressed specifically, there is²⁰

‘a “necessary implication” that the same amount shall not be taxed twice in the hands of the same taxpayer . . .’

An example of a provision in which this principle needs to be applied is para 76B, which deals with the treatment of returns of capital as a base cost reduction. That provision makes no exception for share-dealers that would have included the return of capital in gross income.

¹⁸ Bond registration and bond cancellation costs are specifically excluded from base cost under para 20(2).

¹⁹ See the wide definition of ‘asset’ in para 1.

²⁰ Per De Villiers JA in *CIR v Delfos* 1933 AD 242, 6 SATC 92 at 112.

2.4 Common law principles

The Income Tax Act does not define the words 'of a capital nature'. The line between income and capital has often been blurred and the source of much litigation between taxpayers and the *fiscus* over many decades. In deciding these disputes South African courts have over the years developed a number of tests or guidelines for distinguishing between the two concepts. However, there is²¹

'no single infallible test of invariable application'.

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

The onus of proving that an amount is of a capital or income nature rests on the taxpayer under s 102 of the Tax Administration Act. In *CIR v Middelman*²² the court stated that in order to discharge the onus a taxpayer must

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

In capital v revenue disputes the legal principles are well established, and the vast majority of cases are won or lost on the facts. The importance of establishing the true facts by gathering sufficient evidence cannot be over-emphasised. This evidence-gathering is particularly important in presenting a case before the tax court, for once that court has made a finding of fact it cannot, except on certain limited grounds, be overturned on appeal.²³ As was pointed out by Innes CJ in *CIR v George Forest Timber Co Ltd*,²⁴

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

2.4.1 Receipts and accruals

2.4.1.1 Intention

2.4.1.1.1 Introduction

The most important test for determining the capital or revenue nature of a particular receipt or accrual is the taxpayer's intention in acquiring the asset (ITC 1185²⁵).

In *CIR v Stott Wessels* JA stated the following:²⁶

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

²¹ *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271 at 279.

²² 1991 (1) SA 200 (C), 52 SATC 323.

²³ In *Rossi & others v C: SARS* (2011) 74 SATC 387 (SG) it was said that 'where the High Court does have jurisdiction to hear and determine income tax cases it would appear to be in respect of legal issues alone'.

²⁴ 1924 AD 516, 1 SATC 20 at 23.

²⁵ (1972) 35 SATC 122 (N).

²⁶ 1928 AD 252, 3 SATC 253 at 254.

The determination of a person's intention requires more than a superficial assessment, as was emphasised by Erasmus J in ITC 1719²⁷ when he said that the intention of a taxpayer must

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

2.4.1.1.2 Change of intention

In *John Bell & Co (Pty) Ltd v SIR*²⁸ Wessels JA stated that

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

2.4.1.1.3 Intention of a company

Wessels JA stated in *Elandsheuwel Farming (Edms) Bpk v SBI* that²⁹

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

(Translated from the Afrikaans.)

In *Tati Company Limited v Collector of Income Tax, Botswana* Smit JA stated the following:³⁰

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

The above was cited from *Wilson v CIR*.³¹

Intention of directors

In *CIR v Richmond Estates (Pty) Ltd* Centlivres CJ stated the following:³²

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

Intention of sole shareholder

If a single individual is the sole beneficial holder of the shares of a company, the intention of that individual as to the policy of the company can be accepted as that of the company (*Yates Investments (Pty) Ltd v CIR*³³).

²⁷ (2001) 64 SATC 73 (SEC) at 76.

²⁸ 1976 (4) SA 415 (A), 38 SATC 87 at 103.

²⁹ 1978 (1) SA 101 (A), 39 SATC 163 at 175.

³⁰ 1974 (BCA), 37 SATC 68 at 75.

³¹ 1926 CPD 63, 2 SATC 12 at 14.

³² 1956 (1) SA 602 (A), 20 SATC 355 at 361.

³³ 1956 (1) SA 612 (A), 20 SATC 368.

Changes in shareholders

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

Intention of controllers

In *SIR v Trust Bank of Africa Ltd* a management committee controlled the appellant company. Botha JA stated that he could³⁴

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

Memorandum of association

In *SIR v Rile Investments (Pty) Ltd* Corbett JA(as he then was) stated the following:³⁵

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

The mere fact that the memorandum of a company prohibits the dealing or trafficking in shares is not decisive as to whether the profits on sale of shares are of a capital nature. Such provisions while being of importance cannot be considered *in vacuo* and the court must consider all the circumstances of the case (*African Life Investment Corporation (Pty) Ltd v SIR*).³⁶

2.4.1.1.4 Mixed purposes and the dominant purpose

If a taxpayer has mixed purposes, the court will try to establish and give effect to the main or dominant purpose (*COT v Levy*).³⁷

In *SIR v The Trust Bank of Africa Ltd* Botha JA stated that in order for a profit to be regarded as being of a capital nature³⁸

‘a taxpayer is not obliged to exclude the slightest contemplation of a profitable resale’.

2.4.1.1.5 Alternative methods

If a person has two alternative methods of turning an asset to account, that is, selling it or using it to produce income, the profit on sale will be of a revenue nature (*Durban North Traders Ltd v CIR*).³⁹

³⁴ 1975 (2) SA 652 (A), 37 SATC 87 at 106.

³⁵ 1978 (3) SA 732 (A), 40 SATC 135 at 141.

³⁶ 1969 (4) SA 259 (A), 31 SATC 163 at 176.

³⁷ 1952 (2) SA 413 (A), 18 SATC 127 at 136.

³⁸ *SIR v The Trust Bank of Africa Ltd* 1975 (2) SA 652 (A), 37 SATC 87 at 102.

³⁹ 1956 (4) SA 594 (A), 21 SATC 85.

2.4.1.1.6 Taxpayer's testimony

In ITC 1185⁴⁰ Miller J stated in regard to determining a taxpayer's intention at the time of acquiring a property that,

'the *ipse dixit*⁴¹ of the taxpayer as to his intent and purpose should not lightly be regarded as decisive. It is the function of the court to determine on an objective review of all the relevant facts and circumstances what the motive, purpose and intention of the taxpayer were. Not the least important of the facts will be the course of conduct of the taxpayer in relation to the transactions in issue, the nature of his business or occupation and the frequency or otherwise of his past involvement or participation in similar transactions'.

Corbett JA (as he then was) expressed similar sentiments in *Elandsheuwel Farming (Edms) Bpk v SBI* when he stated the following:⁴²

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

2.4.1.1.7 Insufficient funds

If a company purports to have acquired land for the purpose of development as an investment, but has insufficient funds to implement that intention, this may indicate that the company's true intention was to acquire the property for the purpose of resale at a profit with the result that the proceeds will constitute income (*CIR v Lydenburg Platinum Ltd*,⁴³ *Yates Investments (Pty) Ltd v CIR*,⁴⁴ *Ropty (Edms) Bpk v SBI*⁴⁵).

2.4.1.1.8 No return or low return on investment

A property yielding a meagre return may be indicative of an intention to resell at a profit, in which case the profit will be on income account (*Yates Investments (Pty) Ltd v CIR*)⁴⁶.

The same applies to assets that do not produce an income, such as undeveloped land,⁴⁷ Krugerrands (see **2.4.3.2**) or diamonds.⁴⁸ But the taxpayer's intention and the surrounding circumstances must be taken into account. For example, in ITC 1283⁴⁹ a former Angolan resident converted his Angolan assets into coffee beans, which he imported into South West Africa from where he exported them overseas and obtained the proceeds in rand. The proceeds were held to be of a capital nature as the taxpayer's intention was merely to salvage his capital and he was not engaged in carrying on a business.

⁴⁰ (1972) 35 SATC 122 (N) at 123/4.

⁴¹ The taxpayer's testimony, meaning literally 'he himself said it'.

⁴² 1978 (1) SA 101 (A), 39 SATC 163 at 181.

⁴³ 1929 AD 137, 4 SATC 8.

⁴⁴ 1956 (1) SA 612 (A), 20 SATC 368.

⁴⁵ 1981 (A), 43 SATC 141.

⁴⁶ 1956 (1) SA 612 (A), 20 SATC 368 at 371/2.

⁴⁷ ITC 862 (1958) 22 SATC 301 (F).

⁴⁸ ITC 1608 (1996) 59 SATC 63 (T).

⁴⁹ (1978) 41 SATC 36 (SW).

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

In the landmark case of *Californian Copper Syndicate (Limited and Reduced) v Harris (Surveyor of Taxes)*⁵⁰ Clerk LJ stated the following:

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

The above was cited with approval in *Overseas Trust Corporation Ltd v CIR*.⁵¹

2.4.1.3 Fortuitous nature of the receipt or accrual

The receipts or accruals bear the imprint of revenue if they are not fortuitous, but designedly sought for and worked for (*CIR v Pick 'n Pay Employee Share Purchase Trust*).⁵²

2.4.1.4 The 'tree and fruit' analogy

In *CIR v Visser Maritz J* stated the following:⁵³

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

2.4.1.5 Continuity in carrying on business

In *CIR v Stott*⁵⁴ it was said that as a general rule, one or two isolated transactions do not constitute the carrying on of a business. In that case it was pointed out that while a company could be regarded as carrying on a business with a single transaction, this would usually not be the case with an individual. Citing *Smith v Anderson*,⁵⁵ Wessels JA stated the following:

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

But there are exceptions to this rule, one example being *Stephan v CIR*⁵⁶ in which an individual who salvaged a single ship's cargo was held to be carrying on business.

2.4.1.6 The 'filling a hole' test

A test which is sometimes applied when the receipt or accrual represents compensation is to ask whether the compensation was designed to fill a hole in the taxpayer's profits, or whether it was intended to fill a hole in his assets (*Burmah Steamship Co Ltd v IRC*).⁵⁷

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

Compensation received in respect of the loss or sterilisation of a fixed capital asset is of a capital nature.⁵⁸

⁵⁰ 41 Sc LR 694, 5 TC 159.

⁵¹ 1926 AD 444, 2 SATC 71 at 75.

⁵² 1992 (4) SA 39 (A), 54 SATC 271 at 280.

⁵³ 1937 TPD 77, 8 SATC 271 at 276.

⁵⁴ 1928 AD 252, 3 SATC 253 at 260.

⁵⁵ (1880) 15 ChD 247.

⁵⁶ 1919 WLD 1, 32 SATC 54.

⁵⁷ 1931 SC 156, 16 TC 67.

⁵⁸ See *The Glenboig Union Fireclay Co Ltd v Commissioner of Revenue* 12 TC 427.

In *CIR v Illovo Sugar Estates Ltd*⁵⁹ compensation received from the military for destruction of sugar cane plants which produced crops every two years over 14 to 16 years was held to be of a capital nature, while the compensation for growing crops was held to be of a revenue nature.

In *Estate AG Bourke v CIR*⁶⁰ a taxpayer received compensation for the destruction by fire of pine trees. It was held that the compensation was of a revenue nature. Pine trees do not renew themselves once felled. In the circumstances they represented the crop while the soil represented the income-earning structure. The loss of the pine trees was akin to the loss of the apples from an apple tree rather than to the loss of the apple tree itself.

In *Taeuber and Corssen (Pty) Ltd v SIR*⁶¹ a payment in restraint of trade was held to be of a capital nature.

2.4.1.7 No halfway house

In *Pyott Ltd v CIR* Davis AJA stated the following:⁶²

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

Despite the above comment, South African courts have applied apportionment to a single sum received when it was partly in respect of a restraint of trade and partly for services rendered. In *Tuck v CIR* Corbett JA stated that⁶³

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

2.4.1.8 Revenue derived from capital productively employed

In *COT v Booyens Estates Ltd* Wessels J stated that⁶⁴

'[i]ncome is, as a rule, revenue derived from capital productively employed'.

2.4.1.9 Fixed v floating capital

In *CIR v George Forest Timber Co Ltd* Innes CJ stated the following:⁶⁵

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

In *New State Areas Ltd v CIR*⁶⁶ Watermeyer CJ stated the following:

'[T]he distinction must be remembered between floating or circulating and fixed capital.

'When the capital employed in a business is frequently changing its form from money to goods and vice versa (e.g. the purchase and sale of stock by a merchant or the purchase of raw material by a manufacturer for the purpose of conversion to a manufactured article) and this is done for the purpose of making a profit, then the capital so employed is floating capital.'

⁵⁹ 1951 (1) SA 306 (N), 17 SATC 387.

⁶⁰ 1991 (1) SA 661 (A), 53 SATC 86.

⁶¹ 1975 (3) SA 649 (A), 37 SATC 129.

⁶² 1945 AD 128, 13 SATC 121 at 126.

⁶³ 1988 (3) SA 819 (A), 50 SATC 98 at 114.

⁶⁴ 1918 AD 576, 32 SATC 10 at 15.

⁶⁵ 1924 AD 516, 1 SATC 20 at 23.

⁶⁶ 1946 AD 610, 14 SATC 155 at 163.

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

2.4.1.10 Capital is held with an element of permanency

Vos J stated in *Bloch v SIR* that⁶⁷

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

2.4.1.11 Length of holding period

The length of time that an asset is held is generally an unreliable indicator of whether the proceeds from its disposal will be of a capital or revenue nature. While a lengthy holding period may be indicative of a capital intent, the period of holding is far less important than other factors such as the taxpayer’s intention in buying and selling the asset, and the manner in which the asset is dealt with. For example, in the *Natal Estates* case⁶⁸ farmland that had been held for more than 50 years was held to have been disposed of on revenue account because it was converted to trading stock. And at the other extreme, in ITC 1185⁶⁹ the proceeds on disposal of a property that was held for only seven months were held to be of a capital nature as a result of a new intervening factor (see below).

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

In ITC 1185⁷⁰ the appellant had acquired three properties as a long-term investment in 1968. In 1969 an industrial organisation announced that it would be relocating to the area, which caused a sharp rise in the value of the properties. Shortly after the announcement the appellant received a substantial offer and sold one of the properties at a substantial profit. In finding that the profit was of a capital nature, Miller J stated the following:⁷¹

‘The fact that a property is sold for a substantial profit very soon after it has been acquired is, in most cases, an important one in considering whether an inference adverse to the taxpayer should be drawn, but it loses a great deal of its importance when there has been a *nova causa interveniens*.’⁷²

2.4.1.13 Exchange of asset for shares

If a person exchanges an asset for shares, and the person’s intention in making the original investment is unclear, the court will be less ready to infer that the transaction was a scheme of profit-making than if the consideration was in the form of cash (*SIR v Rile Investments (Pty) Ltd*).⁷³

2.4.1.14 Conversion of trading stock to capital asset

In *CIR v Richmond Estates (Pty) Ltd* Centlivres CJ stated that⁷⁴

‘it may be as difficult to change from a trader to an investor for taxation purposes “as it is for a rope to pass through the eye of a needle” (*Gunn’s Commonwealth Income Tax*, 4th ed, sec 583)’.

⁶⁷ 1980 (2) SA 401 (C), 42 SATC 7 at 18.

⁶⁸ *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A), 37 SATC 193.

⁶⁹ (1972) 35 SATC 122 (N).

⁷⁰ Above.

⁷¹ Above at 128.

⁷² New intervening cause.

⁷³ 1978 (3) SA 732 (A), 40 SATC 135 at 152.

⁷⁴ 1956 (1) SA 602 (A), 20 SATC 355 at 361.

2.4.1.15 Realisation to best advantage

In *CIR v Stott*, a case dealing with the sale of land held as a capital asset by cutting it up into lots, the court stated the following:⁷⁵

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

The case has been applied in the context of converting blocks of flats to sectional title. See *Berea Park Avenue Properties (Pty) Ltd v CIR*⁷⁶ and ITC 1348.⁷⁷

2.4.1.16 Conversion of capital asset to trading stock

While a person is entitled to realise a capital asset to best advantage, there are limits. These constraints were revealed in the landmark case of *Natal Estates Ltd v SIR*. In that case the company disposed of farmland that it had held for many years by developing a township. In holding that the profits were of a revenue nature Holmes JA stated the following:⁷⁸

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

2.4.1.17 Sale of surplus land

A profit derived by a person who acquired land for investment purposes and subsequently disposed of a portion of it because it was surplus to his requirements was held to be of a capital nature (*CIR v Paul*).⁷⁹

2.4.1.18 Realisation period

In *Berea West Estates (Pty) Ltd v SIR*,⁸⁰ Holmes JA indicated that the process of realising a capital asset to best advantage might in certain circumstances need ‘the hand of time’. Thus, a deliberate delay in the disposal of a property in order to realise a better price will not on its own convert a capital asset to trading stock.

⁷⁵ 1928 AD 252, 3 SATC 253 at 261.

⁷⁶ 1995 (2) SA 411 (A), 57 SATC 167.

⁷⁷ (1981) 44 SATC 46 (EC).

⁷⁸ 1975 (4) SA 177 (A), 37 SATC 193 at 220.

⁷⁹ 1956 (3) SA 335 (A), 21 SATC 1.

⁸⁰ 1976 (2) SA 614 (A), 38 SATC 43 at 63.

2.4.1.19 Realisation companies and trusts

The concept of a realisation company is an important exception to the rule that a company that buys an asset for the purposes of resale at a profit will be taxed on revenue account. Typically, a realisation company is formed for the express purpose of realising to best advantage capital assets previously owned by its shareholders. Provided that it simply realises those assets and does not embark on a scheme of profit-making, any profits realised will be of a capital nature. A trust can also be used as a realisation vehicle. See *Realization Company v COT*,⁸¹ *Berea West Estates (Pty) Ltd v SIR*,⁸² and *JM Malone Trust v SIR*.⁸³ But a distinction must be drawn between a realisation company and one which acquires land as trading stock for the purpose of developing and selling it at a profit. In the latter case the company is carrying on an operation of business in carrying out a scheme for profit-making and the amounts realised will be revenue derived from capital productively employed (*C: SARS v Founders Hill (Pty) Ltd*).⁸⁴

2.4.1.20 Selling price based on future profits

The proceeds from the sale of a capital asset that are expressed as a fixed sum payable in instalments are of a capital nature. But the receipts will take on the character of income if a capital asset is sold by reference to future profits. This principle was confirmed by Rowlatt J in *William John Jones v The Commissioners of Inland Revenue* when he said that⁸⁵

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

(Cited with approval in *Deary v Deputy Commissioner of Inland Revenue*.⁸⁶)

2.4.1.21 Purpose of receipt or accrual

In *Volkswagen South Africa (Pty) Ltd v C: SARS*⁸⁷ the court had to consider the capital or revenue nature of a government grant in the form of Productive Asset Allowance (PAA) certificates which provided for customs duty rebates. The amount of this benefit was calculated as a percentage of the value of the manufacturer’s capital expenditure on items such as buildings erected or purchased, new plant, machinery and tooling, acquired in order to manufacture a rationalised range of light motor vehicles. SARS had included them in the taxpayer’s gross income, while the taxpayer argued that they were of a capital nature. The court agreed with the appellant’s suggested approach to resolving such matters, namely,

‘first, what was the real and basic cause of the accrual (or put somewhat differently, why or in respect of what conduct or activity was the grant made) and, secondly, whether that cause is, as a matter of fact, more closely associated with the equipment of the taxpayer’s income producing machinery (in which event it should be regarded as capital) or with its income-earning operations (in which event it should be regarded as revenue)’.

⁸¹ 1951 (1) SA 177 (SR), 17 SATC 139.

⁸² 1976 (2) SA 614 (A), 38 SATC 43.

⁸³ 1977 (2) SA 819 (A), 39 SATC 83.

⁸⁴ 2011 (5) SA 112 (SCA), 73 SATC 183.

⁸⁵ *William John Jones v The Commissioners of Inland Revenue* [1920] 1 KB 711, 7 TC 310 at 315.

⁸⁶ 1920 CPD 541, 32 SATC 92 at 97.

⁸⁷ [2018] 1 All SA 716 (SCA), 80 SATC 179.

The court noted that the House of Lords decision in *Seaham Harbour Dock Company v Crook (HM Inspector of Taxes)*⁸⁸ illustrated the importance of the purpose for which a government grant is paid. In the result, the court found that the accruals in respect of the PAA certificates were of a capital nature.

Note: On or after 19 January 2017 all government grants are included in the definition of 'gross income' under para (IC). The principle of examining the purpose for which a particular receipt or accrual is made may nevertheless be helpful in determining the capital or revenue nature of other types of receipt or accrual.

2.4.2 Expenditure

2.4.2.1 The 'once and for all' test

In *Vallambrosa Rubber Company v Farmer*⁸⁹ Lord Dunedin expressed the opinion that it was

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

The above was cited in *New State Areas Ltd v CIR*.⁹⁰

2.4.2.2 The 'enduring benefit' test

In *Atherton v British Insulated & Helsby Cables, Ltd*⁹¹ Lord Cave said the following:

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

The above was cited in *New State Areas Ltd v CIR*.⁹²

2.4.2.3 The true nature of the transaction

In *New State Areas Ltd v CIR* Watermeyer CJ, after reviewing a number of decisions of the courts in the United Kingdom said the following:⁹³

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

In each case the correct inference must be drawn from all the circumstances.⁹⁴

⁸⁸ (1931) 41 Ll. L Rep 95 (HL).

⁸⁹ 1910 SC 519, 5 TC 529.

⁹⁰ 1946 AD 610, 14 SATC 155 at 165.

⁹¹ 10 TC 155.

⁹² 1946 AD 610, 14 SATC 155 at 168.

⁹³ 1946 AD 610, 14 SATC 155 at 170.

⁹⁴ *De Villiers v CIR* 1929 AD 227, 4 SATC 86 at 88.

2.4.2.4 Income-earning structure v income-earning operations

In *SIR v Cadac Engineering Works (Pty) Ltd* Ogilvie Thompson JA stated the following:⁹⁵

‘Upon the facts so decided, it must then be determined whether the payment in issue is

- (i) part of the income-producing operations (and therefore a revenue expense); or
- (ii) mere equipment of the income-producing machine or structure (and consequently of a capital nature).’

2.4.2.5 New asset need not be created

In *SIR v Cadac Engineering Works (Pty) Ltd* Ogilvie Thompson JA stated the following:⁹⁶

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

2.4.2.6 Protection of capital asset

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

(*CIR v Hilewitz*,⁹⁷ ITC 849, ⁹⁸ *Golby v SIR*⁹⁹)

2.4.3 Specific types of assets

2.4.3.1 Share transactions

2.4.3.1.1 The ‘for keeps’ test

The usual badge of a fixed, capital investment is that it is acquired for better or for worse, or, relatively speaking, for ‘keeps’, and will only be disposed of if some unusual, unexpected, or special circumstance, warranting or inducing disposal, supervened (*Barnato Holdings Ltd v SIR*¹⁰⁰).

More recently, however, Davis J observed in ITC 1867¹⁰¹ that the holding of shares ‘for keeps’ is reflective of an old, static economic order that no longer exists.

The sale of futures contracts is likely to be on revenue account, even if used as a hedge against losses on underlying shares held as capital assets (ITC 1756,¹⁰² *Wisdom v Chamberlain (Inspector of Taxes)*¹⁰³).

⁹⁵ 1965 (2) SA 511 (A), 27 SATC 61 at 71.

⁹⁶ 1965 (2) SA 511 (A), 27 SATC 61 at 75.

⁹⁷ [1998] JOL 1205 (T), 60 SATC 86 at 99.

⁹⁸ (1957) 22 SATC 82 (C).

⁹⁹ 1968 (3) SA 432 (O), 30 SATC 107.

¹⁰⁰ 1978 (2) SA 440 (A), 40 SATC 75.

¹⁰¹ (2013) 75 SATC 273 (WC) at 296.

¹⁰² (1997) 65 SATC 375 (C). The court did not have to decide on the merits of the case whether the profit on disposal of futures contracts held as a hedge was derived from a scheme of profit-making. The futures contracts in question had been held for about a year and the court noted that the appellant had failed to discharge the onus of proving that they had been held on capital account.

¹⁰³ (1969) 1 All ER 332 (CA).

2.4.3.1.2 The transaction-by-transaction principle

Just as an occasional swallow does not make a summer, so an occasional sale of shares yielding a profit does not of itself make a seller of shares, a dealer therein (*CIR v Middelman*¹⁰⁴).

2.4.3.1.3 Main purpose to derive dividend income

Shares bought for the dominant, main and overriding purpose of securing the highest dividend income possible will be of a capital nature when the profit motive is incidental (*CIR v Middelman*¹⁰⁵).

2.4.3.1.4 Secondary purpose

In *African Life Investment Corporation (Pty) Ltd v SIR* the court distinguished between a case in which the dominant purpose of the taxpayer was to derive dividend income with the realisation of profits merely being incidental, and one in which the taxpayer had a main but secondary or subsidiary purpose to realise a profit on sale of shares. In the former case the 'absolving dominant purpose' would render the profits to be of a capital nature, while in the latter case they would be on revenue account. Steyn CJ stated the following:¹⁰⁶

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

A profit will be of a revenue nature when realised by a taxpayer who has a secondary purpose of making a profit (*CIR v Nussbaum*¹⁰⁷).

A taxpayer, who purchased shares cum div (that is, ripe with dividends), received the dividends and then sold the shares ex div, was held to be taxable on revenue account in respect of the resulting profits on the grounds that he had a co-existent intention to make a profit (*CIR v Tod*¹⁰⁸).

2.4.3.1.5 Scope and frequency

The scale and frequency of a person's share transactions is of major importance, although not conclusive (*CIR v Nussbaum*¹⁰⁹).

2.4.3.1.6 Circumstances in which certain amounts received or accrued from disposal of shares are deemed to be of a capital nature

Section 9C

Section 9C came into operation on 1 October 2007 and replaced s 9B.

Section 9C(2) provides that any amount received or accrued (other than a dividend or foreign dividend) or any expenditure incurred in respect of an equity share as defined in s 9C(1) must be deemed to be of a capital nature if that equity share had, at the time of the receipt or accrual of that amount or incurral of that expenditure, been held for a period of at least three years. It applies to receipts and accruals in respect of a share, which includes a return of capital or foreign return of capital as well as amounts derived on disposal of a share. Expenditure incurred after a share has been held for at least three years will also be of a capital nature and

¹⁰⁴ 1991 (1) SA 200 (C), 52 SATC 323.

¹⁰⁵ Above.

¹⁰⁶ 1969 (4) SA 259 (A), 31 SATC 163 at 175.

¹⁰⁷ 1996 (4) SA 1156 (A), 58 SATC 283.

¹⁰⁸ 1983 (2) SA 364 (N), 45 SATC 1.

¹⁰⁹ 1996 (4) SA 1156 (A), 58 SATC 283.

could include expenditure relating to the cost of acquisition of the share (for example, if the amounts were incurred only after three years as a result of the purchase price being subject to an uncertain future event) and recurring costs such as interest and share-dealing expenses. Consequently, any capital gain or loss in respect of a share held for at least three years will be of a capital nature and subject to CGT.

The capital or revenue nature of any profit or loss on disposal of shares held for less than three years must be determined using the general capital versus revenue tests outlined in this chapter and is not deemed automatically to be of a revenue nature.

Equity share

The definition of 'equity share' in s 1(1) means

'any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution'.

Both the right to dividends and the right to capital must be restricted for a share not to comprise an equity share. It is submitted that the words 'dividends' and 'returns of capital' are used in their undefined sense, since no reference is made to foreign dividends and foreign returns of capital, which are separately defined in s 1(1). This view is supported by the fact that a return of capital in the defined sense represents an award of CTC. CTC is not a right attaching to a share in reality. Rather, it is an artificial tax concept and any award of CTC is left to the whim of the directors. The Companies Act defines 'distribution' to mean a transfer of money or other property of the company to holders of its shares, including a dividend amongst other things but does not define a dividend and does not refer to a return of capital. Regard must therefore be had to the company's memorandum of incorporation to determine the nature of the rights attaching to the company's shares in relation to dividends and returns of capital.

For purposes of s 9C, the above definition is then modified further by the definition of 'equity share' in s 9C(1). That definition includes a participatory interest in a portfolio of a collective investment scheme in securities and a portfolio of a hedge fund collective investment scheme but excludes

- a share in a share block company as defined in s 1 of the Share Blocks Control Act;
- a share in a non-resident company, other than a share listed on an exchange as defined in s 1 of the Financial Markets Act 19 of 2012 and licensed under s 9 of that Act; or
- a hybrid equity instrument as defined in s 8E.

Other examples of shares that do not qualify as equity shares under s 9C include a participatory interest in a collective investment scheme in property which is not a REIT and a non-participating preference share.

Examples of equity shares include

- a share in a REIT;¹¹⁰
- a share in a listed or unlisted resident company;
- a share in a non-resident company which is listed on a South African exchange (for example, on the JSE, ZAR X, 4AX, A2X and EESE);
- an interest in a close corporation; and
- a participatory interest in a portfolio of a collective investment scheme in securities and a portfolio of a hedge fund collective investment scheme.

Assuming there is no change of intention, a share acquired as trading stock remains trading stock until it is disposed of. It follows that there is no deemed disposal and reacquisition of the share at the end of the three-year holding period under para 12(3).

Automatic application to gains and losses

Section 9C applies to gains and losses and does not require an election. Its application is automatic and compulsory.

The capital or revenue nature of any profit or loss on disposal of shares held for less than three years must be determined using the general capital versus revenue tests outlined in this Chapter. The profit or loss is not automatically deemed to be of a revenue nature.

Deduction of general share-dealing expenses

A person who carries on a business of share-dealing will typically claim general expenses as a deduction against income under s 11. Such expenses may include bank charges, interest on money borrowed to buy shares, technical analysis software and telephone charges. After equity shares acquired as trading stock have been held for three years it will no longer be possible to claim such expenses in relation to those shares under s 11 because s 9C(2) deems them to be of a capital nature.

Recoupment of expenditure claimed under s 11

Expenses or losses claimed on shares held as trading stock will be included in income as a recoupment when the shares are disposed of.¹¹¹ This recoupment will not apply to the extent that the amount has already been taken into account under s 8(4)(a) or s 19 (as a result of a debt reduction), nor does it apply to equity shares in a REIT or 'controlled company' as defined in s 25BB(1), which is a resident, except to the extent that such amount was taken into account in determining the cost price or value of trading stock under s 11(a), 22(1) or (2).

Anti-avoidance measures

Section 9C contains a number of anti-avoidance measures. See Interpretation Note 43 for details.

¹¹⁰ A REIT is a resident company whose shares are listed on an exchange licensed under s 9 of the Financial Markets Act. Its shares must be listed as shares in a REIT and comply with the listing requirements of an exchange under s 11 of that Act.

A collective investment scheme in property that qualifies as a REIT is deemed to be a company for income tax purposes.

¹¹¹ Section 9C(5).

First in, first out

Under s 9C(6) the first-in-first-out method must be used to determine the length of time shares were held before being disposed of for the purposes of s 9C. This method is merely for the purpose of applying s 9C and does not affect any identification method adopted for determining the base cost of shares for CGT purposes. Thus, if the weighted-average method was adopted for purposes of determining the base cost of shares under para 32(3A), it must continue to be so used. The first-in-first-out method will merely be used to determine whether any shares sold were held for at least three years.

Roll-over of dates of acquisition

For the purposes of s 9C, should existing shares be surrendered in exchange for a greater or lesser number of shares in the same company as a result of a share split, consolidation, or a conversion under s 40A (conversion of close corporation to company) or s 40B (conversion of co-operative to company), the dates of acquisition of the old shares will be carried across to the new shares under s 9C(8).

This rule does not apply if

- the new shares carry different rights to the old shares, or
- any other consideration passes directly or indirectly between the person and the company as part of the share substitution (for example, a cash payment or shares in another company).

For a detailed review of section 9C, see Interpretation Note 43 (Issue 7) dated 8 February 2019 'Circumstances in which Certain Amounts Received or Accrued from the Disposal of Shares are Deemed to be of a Capital Nature'.

2.4.3.2 Krugerrands

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

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

Table 1 – Cases involving the disposal of Krugerrands

Case	Court's finding – capital or revenue	Period held	Intention in acquiring	Reason for selling
ITC 1355 ¹¹²	Capital	4 to 5 years	Bought as an investment to assist during bad times.	To assist family members (ill father, bedridden sister and provide dowry for sister).
ITC 1379 ¹¹³	Capital	1 to 13 years	Bought as an easily transportable	Sold all after repeated warnings that gold price was too high and would fall.

¹¹² (1981) 44 SATC 132 (C).

¹¹³ (1983) 45 SATC 236 (C).

Case	Court's finding – capital or revenue	Period held	Intention in acquiring	Reason for selling
			investment that retained its value.	
ITC 1525 ¹¹⁴	Revenue	12 years	To provide funds for a rainy day. Tendency to spend surplus cash on liquor.	Sold to inject capital into new business.
ITC 1526 ¹¹⁵	Revenue	8 months to 9 years	To provide a store of wealth for his children and protection from inflation.	Improvements to home and garden, buying two holiday apartments, a home for each of his daughters, repaying loan account, buying a car for his daughter, paying university fees and buying shares.
ITC 1543 ¹¹⁶	Capital	12 years	Bought by family company as hedge against inflation for benefit of children.	To finance reroofing of house, and to switch into shares because of a declining gold price.
<i>CIR v Nel</i> ¹¹⁷	Capital	13 years	Long-term investment. Hedge against inflation. No intention to sell but rather to bequeath to children.	Urgent need by taxpayer to purchase a car for his wife.

2.4.3.3 Assets acquired by donation or inheritance

The proceeds on disposal of a property acquired by inheritance will be of a capital nature unless the realisation becomes embedded in the usual trading of the taxpayer (*CIR v Strathmore Exploration Ltd*).¹¹⁸ Similarly, a profit made on disposal of land acquired by donation was held to be of a capital nature (ITC 458).¹¹⁹

¹¹⁴ (1991) 54 SATC 209 (C).

¹¹⁵ (1991) 54 SATC 216 (T).

¹¹⁶ (1992) 54 SATC 446 (C).

¹¹⁷ [1997] 4 All SA 310 (T), 59 SATC 349.

¹¹⁸ 1956 (1) SA 591 (A), 20 SATC 375 at 383.

¹¹⁹ (1940) 11 SATC 178 (U).

2.4.3.4 Lessors and lessees

2.4.3.4.1 Payments by lessee to lessor

Receipt by lessor

ITC 312¹²⁰ – In this case a lessor received an amount in respect of the premature cancellation of a lease. The court held that the amount represented compensation for the loss of rental income. The amount was therefore on income account.

In *CIR v Illovo Sugar Estates Ltd*¹²¹ the company's land was leased to the military authorities. Compensation received by the company in respect of standing crops was held to be of a revenue nature.

Payment by lessee

Although *SIR v John Cullum Construction Co (Pty) Ltd*¹²² did not involve a payment by a lessee to a lessor, the principle applied in this case may, depending on the circumstances, be relevant in such cases. It was held that a payment made to obtain a release from an onerous contract was deductible.

ITC 1600¹²³ – In this case a payment made by a lessee for the premature cancellation of various leases was held to be in the production of income and hence deductible.

In *C: SARS v BP South Africa (Pty) Ltd*¹²⁴ the respondent company made an up-front lump sum payment of rent covering a lease period of 20 years in order to secure sites from which its petrol could be sold. The court held that the amounts were of a capital nature in that they created an enduring benefit and were paid once and for all.

2.4.3.4.2 Payment by lessor to lessee

Receipt by lessee

ITC 175¹²⁵ – In this case the lessee was approached by the lessor with a considerable offer to surrender the lease. The receipt was held to be of a capital nature.

ITC 355¹²⁶ – In this case an amount received by a lessee for the surrender of lease rights was held to be of a capital nature. The court followed the decision in ITC 175 although it expressed some doubt on the correctness of that decision.

ITC 354¹²⁷ – In this case the lessee agreed to accept compensation for cancellation of the lease in the form of a life annuity. The court held that the amount fell to be included in the lessee's gross income under the equivalent of para (a) of the definition of 'gross income'.

Compensation received by a lessee from a lessor in respect of improvements effected by the lessee must be included in proceeds under para 35(1)(b) by the lessee if it is of a capital nature. An up-front payment by the lessor to the lessee as an inducement to enter into a lease will be of a revenue nature if it represents a discount on future rental payments.¹²⁸

¹²⁰ (1934) 8 SATC 154 (U).

¹²¹ 1951 (1) SA 306 (N), 17 SATC 387.

¹²² 1965 (4) SA 697 (A), 27 SATC 155.

¹²³ (1995) 58 SATC 131 (EC).

¹²⁴ 2006 (5) SA 559 (SCA), 68 SATC 229.

¹²⁵ (1930) 5 SATC 180 (U).

¹²⁶ (1936) 9 SATC 91 (U).

¹²⁷ (1936) 9 SATC 85 (U).

¹²⁸ See PWC 'Lease Inducement Payments' (August 2000) *Integritax* in which Australian and New Zealand cases are considered.

Payment by lessor

ITC 1267¹²⁹ – Payment by lessor to lessee to secure early termination of lease in order to obtain a higher rental. The court held that the amount was allowable, noting that the case was analogous to the *John Cullum Construction* case (above) and the *Palabora Mining* case.¹³⁰

2.4.3.4.3 Cost of drawing up a lease

In ITC 50¹³¹ the court held that the costs incurred by a lessee in drawing up a lease were of a capital nature, having been incurred once and for all. In ITC 215¹³² the court confirmed the disallowance of a half-share of legal expenses incurred by a lessee in drawing up a lease on the basis that it was not current expenditure.

¹²⁹ (1977) 39 SATC 146 (T).

¹³⁰ *Palabora Mining Co Ltd v SIR* 1973 (3) SA 819 (A), 35 SATC 159.

¹³¹ (1926) 2 SATC 123 (NA).

¹³² (1931) 6 SATC 133 (U).

Chapter 3 – Design and overview of the core rules

3.1 Integration into the Income Tax Act

At the time of its introduction, CGT was incorporated into the Act because it was, and still is, regarded as a tax on income.¹³³ This approach had administrative advantages, since the existing provisions and procedures of the Act were available to collect CGT. Had CGT been introduced as a separate tax, provisions would have had to be introduced for matters such as returns, assessments, payment and recovery of tax, and objections and appeals, which at the time were already provided for in the Act. The Act was amended to ensure that the administrative procedures operated for CGT. Since 1 October 2012 many of these administrative provisions have been moved to the Tax Administration Act.

The CGT provisions are largely contained in the Eighth Schedule and produce either a taxable capital gain or an assessed capital loss. In recent years, however, there has been a tendency to include provisions in the main body of the Act which also deal with CGT. Examples include s 9H (exit charge), s 9HA (disposal by deceased person), s 9HB (Transfer of asset between spouses), s 12P (Government grants), s 12Q (International shipping), s 12T (Tax-free investments), s 23O (Limitation of deductions by small, medium or micro-sized enterprises), s 24BA (Assets acquired in return for issue of shares), s 24M (Unquantified amounts), s 24N (Disposal of equity shares), s 25 (Taxation of deceased estates), s 25BB(5) (REITs), s 40C (Capitalization shares), s 40CA (Acquisition of assets for issue of shares or debt) and the corporate restructuring rules in ss 41 to 47. The advantage of this treatment is that a single provision can deal with capital assets, allowance assets and trading stock but it does have the disadvantage of scattering CGT provisions over many sections of the Act.

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

3.2 Drafting style

At the time of the introduction of the Eighth Schedule the style of drafting used in the Eighth Schedule differed from that used in the rest of the Act. The intention was to make the Act more accessible, and therefore a start was made in the Eighth Schedule to strike a balance between simplicity and clarity on the one hand, and technical correctness on the other. While the move towards plain English drafting¹³⁴ has assisted in making the law more readable, CGT remains a complex tax.

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

The Eighth Schedule brought with it some new words such as 'exclusion', 'disregarding' and 'roll-over'. The words 'exclusion' and 'disregarding' are useful because they can be used to refer to both gains and losses at the same time.¹³⁵ A 'roll-over' is a deferral.

¹³³ BGR 9 (Issue 4) dated 30 January 2020 'Taxes on Income and Substantially Similar Taxes for Purposes of South Africa's Tax Treaties'.

¹³⁴ The Australian CGT legislation has been drafted in plain English.

¹³⁵ For example, the annual and primary residence exclusions prevent gains from being subjected to CGT, while at the same time preventing losses from being claimed within specified limits.

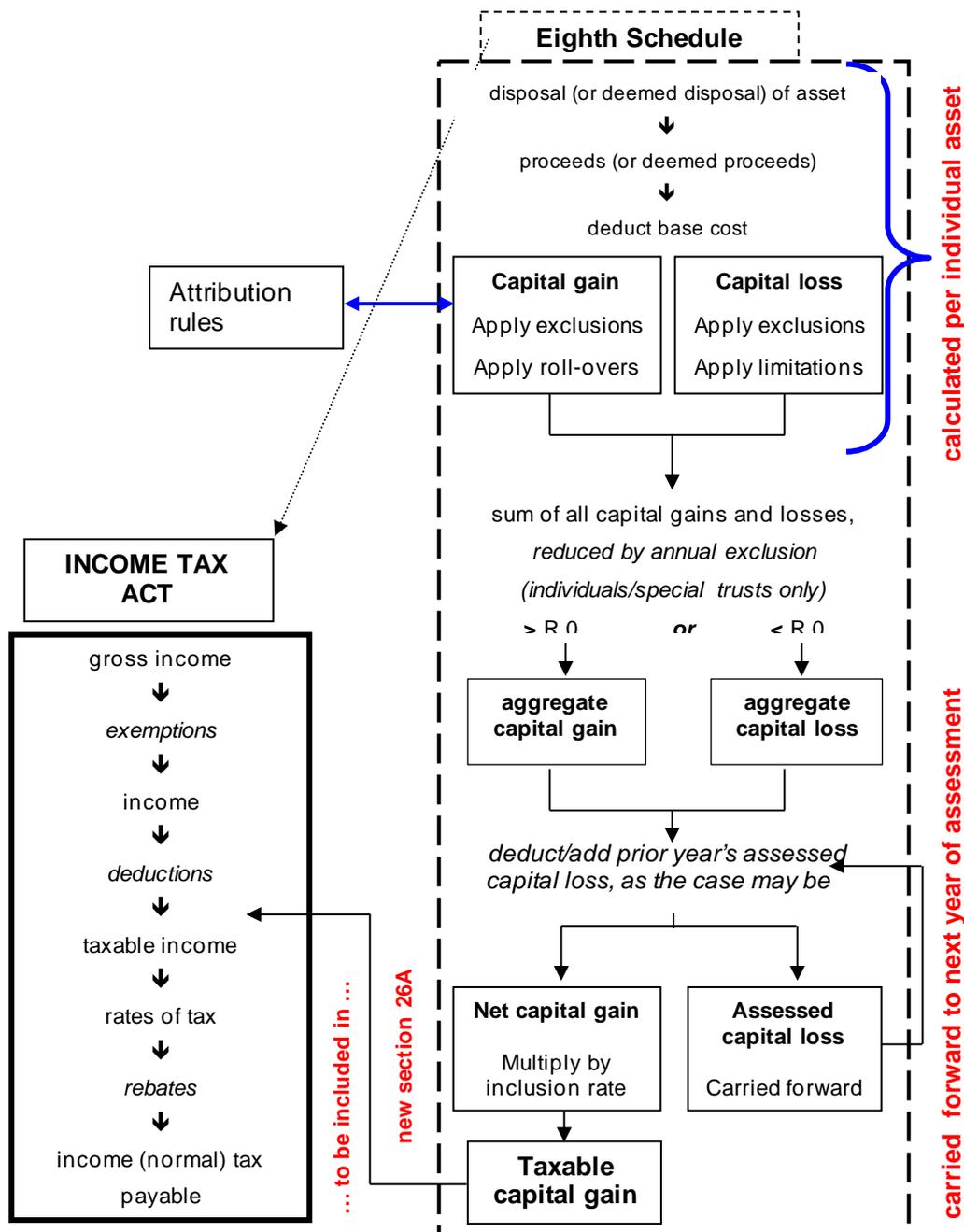
3.3 Use of other countries' tax legislation

In designing the Eighth Schedule reference was made to the legislation of a number of countries most notably Australia and the United Kingdom and to a lesser extent Canada, the United States and Ireland amongst others. Experts from Australia, the United Kingdom and United States provided invaluable assistance. For a number of reasons, no single country's CGT legislation could serve as a model for South Africa. Each country presented its own difficulties. For example, the Canadian legislation is integrated into that country's Income Tax Act; the United Kingdom's legislation¹³⁶ is contained in a separate Act that spans more than 500 pages, while Australia's CGT¹³⁷ applies only to assets acquired after 1985. The Australian approach may seem to be simpler in that it dispenses with the problem of determining valuation date values but it carries with it a number of disadvantages. First, it resulted in a lock-in effect – taxpayers were reluctant to dispose of their pre-1985 assets because it would mean reinvesting in taxable post-1985 assets. Secondly, astute tax planners devised all manner of schemes to shift value from post-CGT assets to pre-CGT assets, necessitating some fairly complex anti-avoidance legislation. And finally the result was a far more restricted tax base.

¹³⁶ The Taxation of Chargeable Gains Act, 1992.

¹³⁷ As contained in the Income Tax Assessment Act, 1997.

3.4 CGT process flowchart



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

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

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

Capital gains and losses are generally triggered by a disposal or an event treated as a disposal. Unless such a disposal or event occurs, no capital gain or loss arises. When an asset is disposed of in an earlier year of assessment, further capital gains and losses may be triggered in subsequent years of assessment, for example, if further proceeds accrue or further expenditure is incurred in relation to the asset disposed of.

An **asset** is defined as widely as possible and includes property of whatever nature and any right or interest to or in such property. CGT applies to all assets of a person disposed of on or after the valuation date (generally 1 October 2001 with PBOs and recreational clubs having later valuation dates), regardless of whether the asset was acquired by the person before, on or after that date. However, only the capital gain accruing from valuation date is subject to tax. The method of limiting the gain to accruals on or after valuation date is set out in Part V of the Eighth Schedule (see **Chapter 8**).

The concept of ‘disposal’ is more fully dealt with in para 11 of the Eighth Schedule and covers any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset. It also includes events treated as disposals under the Act, which are more fully dealt with in para 12 (for example, commencement of residence or change in usage) and ss 9H (cessation of residence) and 9HA (death of taxpayer).

Once an asset is disposed of, it gives rise to **proceeds**, which are more fully dealt with in Part VI of the Eighth Schedule (see **Chapter 9**). In the simplest case the amount received by or accrued to the seller of an asset represents the proceeds on its disposal.

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

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

The rules around base cost are fully dealt with in Part V of the Eighth Schedule (see **Chapter 8**).

The example below illustrates the calculation of a capital gain.

Example 1 – Determination of capital gain

Facts:

100 shares were purchased on 1 October 2001 at a base cost of R10 000 and were sold on 1 October 2019 for R50 000.

Result:

Asset	100 shares	
Disposal event	Sale of the shares	
		R
Proceeds (sale price)		50 000
Less: Base cost (purchase price)		<u>(10 000)</u>
Capital gain		<u>40 000</u>

The same principles apply in calculating a capital loss, but in that event 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 disregarded capital gains and losses are dealt with in Parts IV, VII and VIII of the Eighth Schedule (see Chapters 7, 11 and 12 respectively).

The Eighth Schedule also provides for the roll-over of capital gains under specified circumstances. The recognition of these gains is delayed for CGT purposes and they are held over until the happening of a future event. These rules are generally dealt with in Part IX of the Eighth Schedule (see **Chapter 13**). The corporate restructuring rules in ss 41 to 47 also provide roll-over relief. The transfer of an asset between spouses also qualifies for roll-over treatment and is dealt with in s 9HB (during the lifetime of the spouses) and ss 9HA(2) and 25(4) (on death of a spouse).

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

Aggregate capital gain or loss

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

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

Example 2 – Determination of aggregate capital gain

Facts:

The following gains and losses were derived during the 2020 year of assessment by an individual:

	R
Capital gain on sale of holiday house	120 000
Capital loss on sale of shares	(20 000)

Result:

Sum of capital gains and losses (R120 000 – R20 000)	100 000
Less: Annual exclusion	<u>(40 000)</u>
Aggregate capital gain	<u>60 000</u>

Annual exclusion

The annual exclusion of a natural person and a type-A special trust is as follows:

	R
2021 (proposed)	40 000
2017 to 2020	40 000
2013 to 2016	30 000
2012	20 000
2010 and 2011	17 500
2009	16 000
2008	15 000
2007	12 500
2006 and earlier years	10 000

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

	R
2021 (proposed)	300 000
2013 to 2020	300 000
2012	200 000
2008 to 2011	120 000
2007	60 000
2006 and earlier years	50 000

Net capital gain or assessed capital loss

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

Example 3 – Determination of net capital gain

	R
Aggregate capital gain for 2020	100 000
Less: Assessed capital loss for 2019	<u>(60 000)</u>
Net capital gain for 2020	<u>40 000</u>

Example 4 – Determination of assessed capital loss

	R
Aggregate capital loss for 2020	(60 000)
Assessed capital loss for 2019	<u>(50 000)</u>
Assessed capital loss for 2020	<u>(110 000)</u>

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

Taxable capital gain

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

Example 5 – Net capital gain

Facts:

During the 2020 year of assessment Gerhard sold 100 shares in ABC Ltd at a capital gain of R185 000. He also disposed of a rental property at a capital loss of R20 000. He had an assessed capital loss brought forward from the 2019 year of assessment of R25 000. Gerhard is in the highest tax bracket with a marginal tax rate of 45%.

Result:

Gerhard's CGT liability for the 2020 year of assessment is determined as follows:

	R
Capital gain on sale of shares	185 000
Capital loss on sale of property	<u>(20 000)</u>
Sum of capital gains and losses	165 000
Less: Annual exclusion	<u>(40 000)</u>
Aggregate capital gain	125 000
Less: Assessed capital loss brought forward	<u>(25 000)</u>
Net capital gain	<u>100 000</u>
Inclusion rate	40%
Taxable capital gain (add to taxable income)	<u>40 000</u>

Normal tax on the amount included in taxable income is R40 000 × 45% = R18 000.

Example 6 – Assessed capital loss*Facts:*

During the 2020 year of assessment Moira sold her 11-metre yacht at a capital gain of R20 000 and her shares in XYZ Ltd at a capital loss of R160 000. She had an assessed capital loss of R25 000 brought forward from the 2019 year of assessment.

Result:

Moira's assessed capital loss for the 2020 year of assessment is determined as follows:

	R
Capital gain on sale of yacht	20 000
Capital loss on sale of XYZ Ltd shares	<u>(160 000)</u>
Sum of capital gains and losses	(140 000)
Less: Annual exclusion	<u>40 000</u>
Aggregate capital loss	(100 000)
Assessed capital loss brought forward	<u>(25 000)</u>
Assessed capital loss	<u>(125 000)</u>

3.6 Inclusion, statutory and effective CGT rates for the 2020 year of assessment

The table below sets out the inclusion rates for determining a taxable capital gain, the statutory rates on taxable income and the resulting effective CGT rates for different classes of taxpayer.

Table 1 – Inclusion, statutory and effective CGT rates for the 2020 year of assessment

Type of Taxpayer	Inclusion rate %	Statutory Rate %	Effective CGT rate %
Individual, insolvent estate or deceased estate	40	0 – 45	0 – 18
Public benefit organisation	80	28	22,4
Recreational club	80	28	22,4
Small business funding entity	80	28	22,4
Retirement Fund	N/A	0	N/A

Type of Taxpayer	Inclusion rate %	Statutory Rate %	Effective CGT rate %
Portfolio of a collective investment scheme in property that qualifies as a REIT under the listing requirements ¹³⁸ of an exchange licensed under s 9 of the Financial Markets Act	80	28	22,4
Portfolio of a collective investment scheme other than a portfolio of a collective investment scheme in property	N/A	N/A	N/A ¹³⁹
Special trust as defined in s 1(1)	40	18 – 45	7,2 – 18
Trust (other than a special trust)	80	45	36
Life Assurer – individual policyholder fund	40	30	12
Life Assurer – company policyholder fund	80	28	22,4
Life Assurer – untaxed policyholder fund	0	0	0
Life Assurer – corporate fund	80	28	22,4
Life Assurer – risk policy fund	80	28	22,4
Company	80	28	22,4
Small business corporation	80	0 – 7 – 21 – 28	0 – 5,6 – 16,8 – 22,4
Micro business ¹⁴⁰	50	0 – 1 – 2 – 3	0 – 0,5 – 1 – 1,5
Taxable income derived by company in special economic zone	80	15	12

The statutory rates in the above table are for the 2020 year of assessment, which applies to

- an individual, deceased estate, insolvent estate, and trust with a year of assessment commencing on 1 March 2019;
- a company with a year of assessment ending on or after 1 April 2019;
- A public benefit organisation, recreational club or small business funding entity that is a company with a year of assessment ending on or after 1 April 2019; and
- A public benefit organisation or small business funding entity that is a trust with a year of assessment commencing on or after 1 March 2019 (a recreational club cannot be constituted as a trust).

¹³⁸ The listing requirements must be approved in consultation with the Minister and published by the appropriate authority, as contemplated in s 1 of the Financial Markets Act, under s 11 of that Act.

¹³⁹ A portfolio of a collective investment scheme (other than one in property) must disregard any capital gain or loss under para 61(3).

¹⁴⁰ Under para 57A micro business's assets are not subject to CGT. However, under para 6 of the Sixth Schedule 50% of the receipts of a capital nature from the disposal of micro business assets are included in taxable turnover.

Change in inclusion rates

Since CGT was introduced there have been two changes in the inclusion rates. The key periods are

- years of assessment commencing before 1 March 2012 (for example, the inclusion rate for an individual was 25% and for a company or trust, 50%);
- years of assessment commencing on or after 1 March 2012 but before 1 March 2016 (during this period the inclusion rate for an individual rose to 33,3% and for a company or trust, to 66,6%); and
- years of assessment commencing on or after 1 March 2016 (during this period the inclusion rate for an individual rose to 40% and for a company or trust, to 80%).

For example, a company with a financial year ending on 31 December 2016 would apply the inclusion rate of 66,6% for that year, since its first year of assessment commencing on or after 1 March 2016 would be the financial year ending on 31 December 2017 which commenced on 1 January 2017. The higher inclusion rate of 80% will therefore apply for the financial year ending on 31 December 2017. For a company with a year of assessment ending on the last day of February, the higher inclusion rate of 80% will apply to the financial year ending on 28 February 2017 or in other words, to disposals on or after 1 March 2016.

The higher inclusion rates for individuals and trusts will apply to the 2017 and subsequent years of assessment ending on 28 or 29 February.

The effective CGT rate on a capital gain (ignoring exclusions) is determined by multiplying the inclusion rate by the statutory rate. For the 2018 to 2020 years of assessment

- an individual in the top tax bracket would pay CGT at an effective rate of 18% ($45\% \times 40\%$) (2017: 16,4% ($41\% \times 40\%$));
- a company would pay CGT at an effective rate of 22,4% ($28\% \times 80\%$) (2017: 22,4%); and
- a trust would pay CGT at an effective rate of 36% ($45\% \times 80\%$) (2017: 32,8% ($41\% \times 80\%$)).

Under s 5(2) the rates of tax announced in the Budget apply from the effective dates determined by the Minister in the announcement and apply for a period of 12 months from those dates, after which Parliament must pass legislation to give effect to the changes within that period of 12 months.

Chapter 4 – The Eighth Schedule – Scope and definitions

PART I: GENERAL

Paragraphs 1 and 2

4.1 Definitions

Paragraph 1

4.1.1 Introduction

Paragraph 1 contains a number of definitions used in the Eighth Schedule. Words or phrases defined in the Eighth Schedule that are used in the rest of the Act are also defined in s 1(1). With the exception of the definition of ‘special trust’, the terms defined in s 1 have the same meaning when used in the Eighth Schedule.

The definitions are for the most part self-explanatory or refer to paragraphs or Parts of the Eighth Schedule in which amounts are determined. The table below sets out some of the terms defined in s 1(1) and para 1 that are used in the Eighth Schedule and indicates whether they are defined in s 1(1) or the Eighth Schedule. Cross-references to the sections of the guide in which these definitions are dealt with are also provided.

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

Definition	Paragraph/Part/Section in which comprehensively defined	Defined in para 1?	Defined in s 1(1)?	Reference in guide/IN
Aggregate capital gain	Paragraph 6	No ¹⁴¹	Yes	5.4
Aggregate capital loss	Paragraph 7	No ¹⁴²	Yes	5.4
Assessed capital loss	Paragraph 9	No	Yes	5.6
Asset	N/A – see below	Yes	No	See below
Base cost	Part V	Yes	No	8
Boat	N/A – see below	Yes	No	See below
Capital gain	Paragraph 3	Yes	Yes	5.1
Capital loss	Paragraph 4	Yes	Yes	5.2
Collateral arrangement	Section 1 of the Securities Transfer Tax Act	No	Yes	6.1.2
Connected person	Section 1(1)	No	Yes	IN67
Controlled foreign company	Section 9D	No	Yes	
Disposal; dispose	11 and amounts treated as disposals under Act	Yes	No	6
Dividend	Section 1(1)	No	Yes	

¹⁴¹ Deleted from para 1 by s 49(a) of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

¹⁴² Deleted from para 1 by s 49(b) of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

Definition	Paragraph/Part/Section in which comprehensively defined	Defined in para 1?	Defined in s 1(1)?	Reference in guide/IN
Equity share	Section 1(1)	No	Yes	
Financial instrument	Section 1(1)	No	Yes	
Foreign company	Section 1(1)	No	Yes	
Foreign dividend	Section 1(1)	No	Yes	IN93
Foreign return of capital	Section 1(1)	No	Yes	
Group of companies	Section 1(1) and s 41	No	Yes	
Individual policyholder fund	Section 29A(4)(b)	Yes	No	
Insurer	Section 29A(1)	Yes	No	
Linked unit	Section 1(1)	No	Yes	
Listed company	Section 1(1)	No	Yes	
Market value	Paragraph 31	Yes	No	8.35
Net capital gain	Paragraph 8	Yes	No	5.5
Permanent establishment	Section 1(1)	No	Yes	19.2.4
person	Section 1(1)	No	Yes	
Personal-use asset	Paragraph 53	Yes	No	12.2
Portfolio of a collective investment scheme, including the various types of portfolio	Section 1(1)	No	Yes	
Pre-valuation date asset	N/A – see below	Yes	No	See below
Primary residence	Paragraph 44	Yes	No	11.1.2
Proceeds	Part VI	Yes	No	9.1
Recognised exchange	N/A – see below	Yes	No	See below
Residence	Paragraph 44	Yes	No	11.1.3
resident	Section 1(1)	No	Yes	IN3/IN4
Return of capital	Section 1(1)	No	Yes	
Ruling price	N/A – see below	Yes	No	See below
Securities lending arrangement	Section 1(1)	No	Yes	
share	Section 1(1)	No	Yes	

Definition	Paragraph/Part/Section in which comprehensively defined	Defined in para 1?	Defined in s 1(1)?	Reference in guide/IN
Special trust	N/A – see below	Yes	Yes, but wider than para 1 definition	
spouse	Section 1(1)	Yes	No	
Taxable capital gain	Paragraph 10	No ¹⁴³	Yes	5.7
Valuation date	N/A – see below	Yes	No	See below
Value shifting arrangement	N/A – see below	Yes	No	See below and 21.3

4.1.2 Definition – ‘asset’

<p>‘ “[A]sset” includes—</p> <p>(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and</p> <p>(b) a right or interest of whatever nature to or in such property;’</p>

The definition of ‘asset’ is of importance because CGT is not triggered until an asset is disposed of. A wide meaning has been ascribed to the definition, which includes all forms of property and all rights or interests in such property. The exclusion of currency is dealt with below. A few examples of assets are listed below:

- land and buildings, for example, a factory building, a person’s home, or holiday home;
- shares;
- a participatory interest in a collective investment scheme;
- an endowment policy;
- collectables, for example, jewellery or an artwork;
- personal-use assets, for example, a boat;
- contractual rights;
- goodwill;
- a trade mark;
- a loan (see **24.4**);
- a bank account, whether local or foreign; and
- trading stock.

¹⁴³ Deleted from para 1 by s 49(c) of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

In *CIR v Estate CP Crewe & another* in relation to the determination of estate duties, Watermeyer CJ said the following:¹⁴⁴

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

It is therefore submitted that the word 'property' refers to anything that can be disposed of and turned into money. Things that are incapable of private ownership are excluded, that is, *res extra commercium*, which include *res communes* (things common to all inhabitants such as the sea and air) and *res publicae* (state property held for the benefit of inhabitants).¹⁴⁵ Furthermore, according to LAWSA,¹⁴⁶

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

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

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

The definition of 'asset' is not concerned with the capital or revenue nature of property. Trading stock is thus an asset for CGT purposes. A disposal of trading stock will not usually give rise to a capital gain or loss because double deductions and double taxation are prevented in determining base cost and proceeds by paras 20(3)(a) and 35(3)(a) respectively. For persons dying before 1 March 2016 the death of a taxpayer holding trading stock could have generated a capital gain but with the introduction of s 9HA the deemed disposal of trading stock on death will be fully on revenue account.

The unissued share capital of a company is not property of the company. In *FCT v St Helens Farm (ACT) Pty Ltd* Barwick CJ stated the following:¹⁴⁷

'Until allotment and issue, which includes the entry of the allottee's name on the share register in respect of the allotted share or shares, there is no property in the unissued shares; and, in particular, there is not then, or for that matter at any other time, any property or proprietary right in or of the company in the unissued shares in its capital. The company has the capacity to allot and issue shares in its capital up to the amount of that capital, its nominal capital. But that capital is not property of the company. Indeed when allotted and issued the nominal amount of the issued share or shares constitutes in accounting terms a liability of the company.¹⁴⁸ But it is not property which comes to the allottee from, or by transfer from, the company. It is property which comes into existence by the allotment and issue, or more precisely, which is the consequence of such allotment and issue.'

In *Burman v CIR*¹⁴⁹ the taxpayer, a property speculator, held shares and a loan account in a property company. When the company failed, the taxpayer sought to claim a revenue loss in respect of the loan account. The court refused to allow the deduction on the basis that he was not a money-lender. The court rejected the argument that the shares and loan were a single economic unit even though it was intended that they be sold together. It was held by a majority

¹⁴⁴ 1943 AD 656, 12 SATC 344 at 352.

¹⁴⁵ F du Bois *Wille's Principles of South African Law* 9 ed (2007) Juta & Co at page 417.

¹⁴⁶ 'Impersonal Nature' 27 (Second Edition Volume) LAWSA[online] (My LexisNexis: 31 January 2014) in para 20.

¹⁴⁷ (1981) 146 CLR 337 (HC of A).

¹⁴⁸ With respect, the share capital of a company is not a debt of the company. In *CIR v Datakor Engineering (Pty) Ltd* 1998 (4) SA 1050 (SCA), 60 SATC 503 at 510 Harms JA held that redeemable preference shares were not debt of a company.

¹⁴⁹ 1991 (1) SA 533 (A), 53 SATC 63.

that such a view ignored the commercial reality and legal consequences of the loans. It follows that when property loan stock companies issue linked units comprising shares and debentures, the shares and debentures must be regarded as separate assets for CGT purposes. The implication of recognizing the two assets separately is that in some cases they will receive differing treatment for CGT purposes. For example, only the shares will qualify for non-disposal treatment under para 11(2)(f) in the case of a share split or consolidation. Similarly, only the equity share component can be considered for roll-over relief under s 42 (asset-for-share transactions). Roll-over relief has, however, been provided under s 43 when a linked unit¹⁵⁰ is exchanged for an equity share under a substitutive share-for-share transaction.

Deferred tax assets

For accounting purposes, a deferred tax asset can arise, for example, when income that will be recognised for accounting purposes in a later financial year is subject to tax in the current financial year. The tax paid is recognised as an asset in the current year's financial statements and expensed only in the year when the related income is recognised for accounting purposes. See in this regard IAS 12 'Income Taxes' which requires that deferred tax assets should be recognised when it is probable that taxable profits will be available against which the deferred tax asset can be utilised.

A deferred tax asset is merely an accounting creation and not an asset as defined in para 1. It follows that a deferred tax asset cannot be disposed of or acquired for CGT purposes.

Unbilled work in progress

For accounting purposes taxpayers in the services sector (for example, in the accounting and legal professions) sometimes treat unbilled work in progress as an asset on the balance sheet.¹⁵¹ Such work in progress is, however, merely an accounting creation and is not an asset for CGT purposes. In the tax computation the net profit before tax is increased by opening work in progress and decreased by closing work in progress. The effect of this reversal is simply to allow the current year's salaries and wages and other overheads as a deduction under section 11(a). Those amounts are an expense of a revenue nature because they do not create an enduring benefit and cannot be described as 'property' for the purposes of the definition of 'asset'. In addition the work in progress does not represent a personal right against the client for whom the service is rendered because it is not enforceable until the service is billed and there is agreement with the client on the amount of the fee.¹⁵² If an amount is stipulated for work in progress in the sale agreement, the amount received by the seller (for example, a retiring partner) is likely to be on revenue account.¹⁵³ If not separately stipulated, the amount would probably form part of goodwill.

¹⁵⁰ As defined in s 1(1).

¹⁵¹ See IAS 2 'Inventories' in para 19 which requires work in progress of service providers to be accounted for at cost (profit margins and non-attributable overheads are excluded).

¹⁵² See ITC 1824 (2007) 70 SATC 27 (P) in which it was held that there was no accrual in respect of a fee that had been billed but not accepted by the client.

¹⁵³ In ITC 1358 (1981) 44 SATC 155 (T) a retiring partner was held to be taxable on income account on receipt of a payment for unbilled work in progress. Similar results ensued in the Australian cases of *Stapleton v FCT* 89 ATC 4818 and *FCT v Grant* 91 ATC 4608. In *Grant's* case Jenkinson J followed Sheppard J's reasoning in *Stapleton* and concluded that work in progress in professional firms constituted an affair of revenue that represented what would in time become income when the work in question was complete.

Prepayments

Whether the prepayment of an expense is an asset for purposes of the Eighth Schedule is a question of fact. For example, the payment of an insurance premium one year in advance is unlikely to be an asset but rather an expense of a revenue nature which may be subject to s 23H. By contrast, the payment of rent in advance over several years is likely to give rise to an expense of a capital nature and an asset with an enduring benefit. In *C: SARS v BP South Africa (Pty) Ltd*¹⁵⁴ the respondent company made an up-front lump sum payment of rent covering a lease period of 20 years in order to secure sites from which its petrol could be sold. The court held that the amounts were of a capital nature in that they created an enduring benefit and were paid once and for all.

4.1.2.1 Corporeal property

Wille describes corporeal property as follows:¹⁵⁵

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

LAWSA describes the modern concept of corporeality as follows:¹⁵⁶

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

Examples: Land and buildings, plant and machinery.

4.1.2.2 Incorporeal property

Incorporeal things are things that cannot be seen, heard, touched, smelled or tasted. They are imaginary conceptions, such as real and personal rights.¹⁵⁷

Examples: A servitude, shares in companies, a member’s interest in a close corporation, goodwill of a business, patents, trade marks, designs, copyrights, a personal right which can be settled by a money payment, real right over a movable for example, a pledge. The right to trade has also been held to constitute incorporeal property – see **24.5**.¹⁵⁸

4.1.2.3 Immovable property

According to *LAWSA* immovable things¹⁵⁹

‘are things which cannot be moved from one place to another without damage or change of form⁸.’

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

Examples: *LAWSA* lists as immovables a piece of land as indicated on a diagram in the deeds registry; geological components of the land, for instance the soil and minerals under the surface; organic products of the land, such as vegetation, trees, ungathered fruits and unharvested crops; artificial annexures to the land, such as buildings and other installations; things permanently attached to a building or other constructions, such as plumbing, heating, cooling, electrical or other installations; and certain movables, such as the keys of a house,

¹⁵⁴ 2006 (5) SA 559 (SCA), 68 SATC 229 at 237 *et seq.*

¹⁵⁵ Above at 419.

¹⁵⁶ ‘Corporeality’ 27 (Second Edition Volume) *LAWSA* [online] (My LexisNexis: 31 January 2014) in para 19.

¹⁵⁷ *Wille* above at page 165.

¹⁵⁸ ITC 1338 (1980) 43 SATC 171 (T) at 174.

¹⁵⁹ CG van der Merwe ‘Movables and Immovables’ 27 (Second Edition Volume) *LAWSA* [online] (My LexisNexis: 31 January 2014) in para 51.

the cover of a well and a heap of manure on the land, which are destined to serve an immovable indefinitely.¹⁶⁰ The maxim *quicquid plantatur solo, solo cedit* (whatever is affixed to the soil belongs to the soil) is relevant in determining whether an item forms part of the land. Thus, even though a person buys land containing a plantation or a farm containing growing crops with the intention of felling the trees or harvesting the crops, the standing timber and growing crops nevertheless attach to the land and comprise immovable property. In *Timber Co v Celliers* Innes CJ stated that¹⁶¹

'by our law a forest tree growing upon the surface of the land is as much portion of the realty as the solidified coal contained beneath the surface'.

LAWSA also cites examples of rights acquiring the character of immovable property on registration against the title deeds of land: praedial and personal servitudes (like usufruct, use and habitation) over immovable property and real rights over immovable property such as a registered lease of not less than ten years¹⁶². A life right in a retirement village, which is a right of occupation, is a statutory real right established under the Housing Development Schemes for Retired Persons Act 65 of 1988. Under s 4A of that Act the holder of a life right has the same rights as a lessee under a registered long lease.

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

Incorporeal immovable property includes real rights over immovable property: a registered usufruct over immovable property, old and new order mineral rights, a registered *praedial* servitude and building restrictions.¹⁶³

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

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

(Emphasis added.)

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

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

- it is a real right (albeit limited),
- it is 'in respect of' the mineral and the related land (these words imply a close causal connection with the mineral and the land),

¹⁶⁰ CG van der Merwe 'Examples of movables and immovables' *LAWSA* Volume 27 (second edition volume) [online] (My LexisNexis: 31 January 2014) in para 53.

¹⁶¹ 1909 TS 909 at 911.

¹⁶² See para (b) of the definition of 'immovable property' in s 102(1) of the Deeds Registries Act 47 of 1937

¹⁶³ 'Incorporeal Movables and Immovables' 27 (Second Edition Volume) *LAWSA* [online] (My LexisNexis: 31 January 2014) in para 52, and *Wille* above at page 167.

- the removal of the subject matter of the right will cause damage to the land (the land has to be excavated to extract the mineral), and
- it is not dissimilar to a long-term lease, a usufruct or a servitude, all of which are rights of enjoyment of immovable property.

4.1.2.4 Movable property

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

Examples: Furniture, motor vehicles, ships and livestock.

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

4.1.2.5 Rights

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

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

Both types of rights can be assets for CGT purposes, depending on whether they fall within the definition of 'asset' in para 1. For example, currency is a real right but is excluded from the definition of 'asset', and not all rights may comprise 'property' (see **4.1.2**).

Personal rights

A personal right (*jus in personam*) is a right in or against a particular person or group of persons. The parties to a contract have rights against each other. Personal rights are of two types, namely,

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

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

For example:

- If A sells B an asset for a fixed sum, delivery and payment to take place in five years' time, B will have a personal right against A, namely, the right to expect A to deliver the asset to B on due date. Once delivery takes place, B will acquire either a personal right or a real right in the asset, depending on the nature of the asset. For example, if the asset was a share or debt claim it would be a personal right against the company or debtor but if it was a motor vehicle or land it would be a real right.
- All trust beneficiaries whether vested or discretionary, have a personal right of action against the trustees to perform their duties in accordance with the trust deed. A vested beneficiary will, in addition, have a personal right against the trustees to claim transfer of a trust asset or the income from a trust asset, depending on the nature of the vested right. Enjoyment of the right may be postponed until a future date. A Beneficiary holding

a vested right in a trust asset does not have legal ownership of the trust asset, which vests in the trustees, although such a beneficiary may enjoy beneficial ownership. However, a beneficiary of a *bewind* trust does retain ownership of the trust assets.

- With an unconditional bequest of immovable property, a real right does not vest in the legatee on the death of the testator but only a personal right enforceable against the executors, namely, a *jus in personam*. Once the liquidation and distribution account becomes final the heir or legatee acquires a *jus in personam ad rem acquirendam* (a right to claim payment, delivery or transfer of the bequest).

Real rights

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

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

Why recognise personal rights for CGT purposes?

If personal rights were not recognised as assets, it would not be possible to subject certain transactions to CGT.

There are many examples in the Eighth Schedule of personal rights being recognised as assets, as illustrated by the following examples:

- Paragraph 56 deals with the disposal by a creditor of a debt owed by a connected person. A creditor's claim against a debtor is a personal right.¹⁶⁴
- Under para 59 a natural person or a special trust must disregard a capital gain or a capital loss determined in respect of a disposal that resulted in that person or special trust receiving compensation for personal injury, illness or defamation of that person or a beneficiary of that special trust. A claim for such compensation is a personal right and its disposal can give rise to a capital gain or loss, hence the need for this exclusion.
- Under para 60 a person must disregard a capital gain or loss determined in respect of a disposal relating to any form of gambling, game or competition. A person who wins, say, a game, acquires a personal right against the organisers for the prize, and when the prize is awarded, the personal right would be discharged and could give rise to a capital gain, hence the need for this exclusion.
- Under para 64A a person must disregard any capital gain or loss in respect of the disposal that resulted in that person receiving restitution of a right to land, an award or compensation under the Restitution of Land Rights Act, 1994. A land claimant's claim for restitution is a personal right and when discharged through restitution could give rise to a capital gain or loss, hence the need for this exclusion.
- A share is a conglomerate or bundle of personal rights.¹⁶⁵ Paragraph 11(2)(b) treats the issue, cancellation or extinction of a share as a non-disposal. There would be no need for this rule if the personal rights making up a share were not assets.

¹⁶⁴ *Staegemann v Langenhoven & others* 2011 (5) SA 648 (WCC) at 652.

¹⁶⁵ *Standard Bank of South Africa Ltd & another v Ocean Commodities Inc & others* 1983 (1) SA 276 (A) at 288.

This topic is also explored in an article by Prof G Swart ‘Interpreting Some Core Concepts Governing the Taxation of Capital Gains’.¹⁶⁶

In an unreported case¹⁶⁷ the appellant company had made good the losses incurred by an employee share incentive trust and sought to claim these amounts as capital losses. The losses arose as a result of the trust acquiring shares at a higher price and then disposing of them to employees at a lower strike price under options which had been issued to them by the trust in earlier years. The company argued that it acquired a personal right against the trust to require it to issue the options to selected employees and to deliver the shares when the options were exercised. This personal right was, so the argument went, disposed of once performance of the trust’s obligations had taken place and its base cost was equal to the amount reimbursed to the trust. The court refused to accept that personal rights were assets for CGT purposes, and more specifically, stated that this particular personal right was not an asset for CGT purposes. It is considered that the court’s pronouncement that all personal rights are not assets for CGT purposes was misplaced for the reasons already mentioned. For a full commentary on the case, see **24.13**.

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

Facts:

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

Result:

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

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

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

Facts:

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

Result:

Errol acquired a personal right against the organisers for the payment of R10 million under the Lotto rules. When he was paid out, that personal right was extinguished, which resulted in a disposal. Errol has a capital gain of R10 million less the cost of his Lotto ticket of R10.

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

¹⁶⁶ (2005) SA Merc LJ 1.

¹⁶⁷ Case 13798/13931/14294, Gauteng Tax Court, 17 September 2019, unreported.

Is the right to claim payment an asset?

While the right to claim payment is a personal right, it will not always be recognised as an asset for CGT purposes, particularly when the amount represents proceeds in connection with the disposal of a pre-existing asset. For example, if A sells an asset to B for R100, the R100 will comprise proceeds, and it is not necessary to enter into a further asset analysis of the R100. But if A damages B's asset, A creates a right to claim payment from A in B's hands. That right to claim payment will be an asset for CGT purposes in B's hands because there is no other pre-existing asset. The position was aptly summed up in the United Kingdom case of *Zim Properties Ltd v Proctor*¹⁶⁸ in which Warner J stated the following:

'I have no difficulty in accepting that not every right to a payment is an "asset" within the meaning of the term in the capital gains tax legislation. Perhaps the most obvious example of one that is not is the right of the seller of property to be paid the purchase price. The relevant asset then is the property itself. What that shows, however, to my mind, is no more than the interpretation of the capital gains tax legislation requires, as does the interpretation of any legislation, the exercise of common sense, rather than the brute application of verbal formulae.'

4.1.2.6 Exclusion of currency

The definition of 'asset' excludes 'currency' but includes gold and platinum coins. The word 'currency' is not defined in the Act, but according to the *Shorter Oxford English Dictionary on Historical Principles*¹⁶⁹ it means:

'2. The fact or quality of being in circulation as a medium of exchange.'

According to this meaning, currency would not include

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

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

Cryptocurrencies such as Bitcoin are neither official South African tender nor widely used and accepted in South Africa as a medium of payment or exchange. As such, they are not regarded by SARS as a currency for the purposes of the Act.¹⁷⁰ Given their extreme volatility, Cryptocurrencies are likely to be held as a speculative asset of a revenue nature.

Why is local currency excluded? A rand that comprises legal tender is always worth a rand, and so the exchange of say, a R100 note for 10 R10 notes would in any event yield neither a gain nor a loss. Administratively it therefore makes no sense to trigger a disposal each time cash changes hands. Secondly, had cash been an asset the *fiscus* could have been exposed to numerous claims for the loss of cash. Not only would claims of this nature be difficult to validate, but numerous disputes could also arise over whether the cash that was lost was a personal-use asset.

¹⁶⁸ (1984) 58 TC 371 at 392F–G.

¹⁶⁹ A Stevenson 6 ed (2007) Oxford University Press.

¹⁷⁰ See SARS Media Release of 6 April 2018 available at <<http://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-tax-treatment-of-cryptocurrencies.aspx>> [Accessed 2 November 2020].

The exclusion of foreign currency

Unlike Australia and the United Kingdom, South Africa's definition of 'asset' excludes foreign currency (the definition excludes 'currency' which would include foreign currency). Before the 2012 year of assessment, capital gains and losses on foreign currency were determined separately under Part XIII, and for that purpose para 84 contained a definition of 'foreign currency asset'.¹⁷¹

The exclusion of local currency in Australia and the United Kingdom

In Australia, s 108-5 of the Income Tax Assessment Act, 1997 defines an asset for CGT purposes. Foreign currency is specifically included but the definition is silent on whether Australian currency is an asset. The ATO accepts that Australian currency is not an asset for the purposes of s 108-5 when it is used as legal tender.¹⁷² The ATO view is that Australian currency serves as a medium of exchange to facilitate a transaction. This view finds support in *FCT v Cooling*¹⁷³ in which Hill J observed that¹⁷⁴

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

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

Example – Loss of cash*Facts:*

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

Result:

Denys cannot claim a capital loss, since the cash is not an asset for CGT purposes.

Gold or platinum coins

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

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

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

is not a personal-use asset and is subject to CGT [para 53(3)(a)]. Whether the value of a gold or platinum coin is mainly (> 50%) attributable to its metal price rather than its scarcity value will be a question of fact. For example, if 40% of a proof Krugerrand's value were attributable

¹⁷¹ Part XIII (paras 84 to 96) was repealed by s 124(1) of the Taxation Laws Amendment Act 24 of 2011. The repeal was deemed to come into operation on 1 March 2011 and applies to years of assessment commencing on or after that date.

¹⁷² See ATO Tax Determination TD 2002/25 dated 20 November 2002.

¹⁷³ 1990 22 FCR 42, 21 ATR 13.

¹⁷⁴ At ATR 31.

to the gold price with the other 60% being attributable to its Numismatic value, it would comprise a personal use asset provided it was acquired for purposes other than trade.

Identical wording is used in paras 17(2)(a) and 18(2)(a) to permit the claiming of losses in respect of forfeited deposits and disposal of options in respect of such coins. Under para 32(3A)(c) the weighted-average method may be used for determining the base cost of gold or platinum coins the prices of which are regularly published in a national or international newspaper.

Cash on deposit with banking institutions

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

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

4.1.3 Definition – 'boat'

‘ “[B]oat” means any vessel used or capable of being used in, under or on the sea or internal waters, whether—

(a) self-propelled or not; or

(b) equipped with an inboard or outboard motor.’

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

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

4.1.4 Definition – 'pre-valuation date asset'

‘ “[P]re-valuation date asset” means an asset acquired prior to valuation date by a person and which has not been disposed of by that person before valuation date.’

This definition is used primarily in determining the base cost of assets acquired before the valuation date. The term 'pre-valuation date asset' can be found in s 43 and paras 12A, 20A, 25 to 27, 30 and 76B.

4.1.5 Definition – 'recognised exchange'

‘ “[R]ecognised exchange” means—

(a) an exchange licensed under the Financial Markets Act; or

(b)

- (c) an exchange in a country other than the Republic which is similar to an exchange contemplated in paragraph (a) and which has been recognised by the Minister for purposes of this Schedule by notice in the *Gazette*,¹⁷⁵

Both the JSE and the Bond Exchange of South Africa (BESA) fall under para (a). Before 1 February 2005 BESA fell under para (b). On 22 June 2009 BESA became a wholly owned subsidiary of the JSE. Other more recent exchanges include ZARX (Pty) Ltd (ZAR X), 4 Africa Exchange (Pty) Ltd (4AX), A2X Markets (Pty) Ltd (A2X) and Equity Express Securities Exchange (Pty) Ltd (EESE).

The list of recognised exchanges in countries outside the Republic was published in the *Government Gazette* and is also available on the SARS website under Legal Counsel / Secondary Legislation / Income Tax Notices.¹⁷⁶

4.1.6 Definition – ‘ruling price’

‘ “[R]uling price” means—

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

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

Example 1 – Higher bid by buyer

Facts:

The last sale of a share listed on the JSE took place at 4pm on 1 July at a price of R100 a share. Just before the close of the market at 5pm on that day, a buyer made a bid for 100 shares at R102 a share.

Result:

The ruling price of the share is R102, since the bid is higher than the last sale price.

¹⁷⁵ Some minor textual amendments were made to the definition by s 63 of the Revenue Laws Amendment Act 31 of 2005.

¹⁷⁶ GN R 997 in GG 22723 of 2 October 2001 and GN 1088 GG 30484 of 16 November 2007 which added the Channel Islands Stock Exchange.

Example 2 – Lower offer by seller*Facts:*

The last sale of a share listed on the JSE took place at 4pm on 1 July at a price of R100 a share. Just before the close of the market at 5pm on that day, a seller offered 100 shares for sale at R99 a share.

Result:

The ruling price of the share is R99, since the offer is lower than the last sale price.

Example 3 – Lower bid or higher offer*Facts:*

The last sale of a share listed on the JSE took place at 4pm on 1 July at a price of R100 a share. Determine the ruling price assuming that just before the close of the market at 5pm on that day

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

Result:

In both instances the ruling price is R100, since the bid is lower and the offer is higher than the last sale price.

For financial instruments listed on a recognised exchange outside the Republic, the ruling price is the same as described above if the exchange calculates the price in this manner, and if not, is the last price quoted in respect of the financial instrument at the close of business of the exchange.

4.1.7 Definition – ‘special trust’

‘ “[S]pecial trust” means a trust contemplated in paragraph (a) of the definition of “special trust” in section 1.’¹⁷⁷

The above definition of ‘special trust’ covers only trusts for persons suffering from a disability as defined in s 6B(1) which incapacitates those persons from earning sufficient income for their maintenance, or from managing their own financial affairs. For a more detailed commentary see **14.13**.

4.1.8 Definition – ‘valuation date’

‘ “[V]aluation date” means—

- (a) in the case of any person who after 1 October 2001 ceases to be an exempt person for purposes of paragraph 63, the date on which that person so ceases to be an exempt person; or
- (b) in any other case, 1 October 2001.’

¹⁷⁷ Inserted by Act 74 of 2002 and came into operation from the commencement of years of assessment ending on or after 1 January 2003.

*Valuation date of body ceasing to be exempt**The position between 22 December 2003 and the commencement of years of assessment ending on or after 1 January 2005*

Before its amendment by the Taxation Laws Amendment Act 16 of 2004, para (a) read as follows:¹⁷⁸

‘[I]n the case of any person contemplated in section 10(1)(cA) which after 1 October 2001 ceases to be an exempt person for purposes of that section and paragraph 63, the date on which that person so ceases to be an exempt person’

Under s 10(1)(cA) the receipts and accruals of certain government and quasi-government bodies are exempt from income tax. A body enjoying exemption under s 10(1)(cA) must also disregard any capital gain or loss under para 63. The valuation date of a body that ceases to be exempt under s 10(1)(cA) and para 63 is the date on which it ceases to be exempt.

All the provisions that applied to taxable persons who owned assets on 1 October 2001 will apply in the same manner to these bodies except that their valuation date will be the date that they lost their exempt status.

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

The current wording of para (a) applies to all exempt persons who become taxable, and not merely those who were previously exempt under s 10(1)(cA). Hence, s 10(1)(d) entities and public benefit organisations shifting to taxable status fall within the ambit of this rule. Since all PBOs fall outside para 63 with effect from the introduction of partial taxation for PBOs, their valuation date will be the first day of the first year of assessment commencing on or after 1 April 2006. For example, a PBO with a March year end will have a valuation date of 1 April 2006, since this is the commencement date of the 2007 year of assessment.

The valuation date of an approved recreational club for CGT purposes is the date on which it becomes partially taxable under s 10(1)(cO), that is, when it falls outside para 63. Clubs which applied for approval on or before 31 March 2009 have a valuation date equal to the first day of their first year of assessment ending on or after 1 April 2007. Thus, a club that has been approved under s 30A before 31 March 2009 and which was in existence on 1 April 2007 and that has a year-end of 31 March, will have a valuation date of 1 April 2007.

A club approved under s 10(1)(d)(iv) that failed to apply for approval under s 30A by 31 March 2009 will have a valuation date equal to the first day of the first year of assessment ending after 30 September 2010.

An unapproved club in existence on 1 October 2001 will fall outside the partial taxation dispensation and will have a valuation date of 1 October 2001. For more information on the tax implications of recreational clubs see *Tax Guide for Recreational Clubs* (Issue 3) dated 29 February 2016.

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

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

¹⁷⁸ Paragraph (a) of the definition inserted by s 90 of Act 45 of 2003, effective as from 22 December 2003.

4.1.9 Definition – ‘value shifting arrangement’

‘**Value shifting arrangement**’ means an arrangement by which a person retains an interest in a company, trust or partnership, but following a change in the rights or entitlements of the interests in that company, trust or partnership (other than as a result of a disposal at market value as determined before the application of paragraph 38), the market value of the interest of that person decreases and—

- (a) the value of the interest of a connected person in relation to that person held directly or indirectly in that company, trust or partnership increases; or
- (b) a connected person in relation to that person acquires a direct or indirect interest in that company, trust or partnership.’

Value shifting is a technique used to avoid CGT. For there to be a ‘value shifting arrangement’ the parties must be connected persons before the transaction. See **21.3** for a detailed explanation of these anti-avoidance provisions, including this definition.

4.2 Application to residents and non-residents

Paragraph 2

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

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

Paragraph 2 draws a distinction between a resident, which is a defined term in s 1(1), and a person who is not a resident.

- A resident is subject to CGT on the disposal of any asset whether in or outside South Africa;
- A non-resident is subject to CGT on the disposal of
 - any immovable property situated in South Africa held by the person; or
 - any interest or right of whatever nature to or in immovable property situated in South Africa including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources;¹⁷⁹ and
 - any asset effectively connected with¹⁸⁰ a permanent establishment through which that non-resident is carrying on a trade in South Africa.

As to the common law meaning of ‘immovable property’, see the notes under **4.1.2** on the definition of ‘asset’.

¹⁷⁹ The words ‘including ... resources’ were inserted to bring the meaning of immovable property in line with article 6(2) of the OECD Model Treaty and are effective from 1 January 2016.

¹⁸⁰ The words ‘effectively connected with’ replaced the words ‘which is attributable to’ with effect from 1 January 2016 to bring the provision in line with the language of the OECD Model Treaty. For example, see article 10(4) (dividends), article 11(4) (interest), article 12(3) (royalties) and article 21(2) (other income).

The term ‘permanent establishment’ is defined in s 1(1) as follows:

‘ “[P]ermanent establishment” means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development: Provided that in determining whether a qualifying investor in relation to a partnership, trust or foreign partnership has a permanent establishment in the Republic, any act of that partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor;’

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

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

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

- In the case of multi-tier structures the 80%+ test has been moved to the top of the chain.
- The gross market value of assets of the entity must now be analysed instead of the market value of its net assets.
- Vested rights in a trust are now included.

For the commentary on the law as it applied before 1 February 2006, see issue 5 of this guide.

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

Table 1 – Interests that comprise immovable property in SA

Type of interest	Requirement 1	Requirement 2
Any equity shares held by a person in a company	80% or more of the market value of the <ul style="list-style-type: none"> • equity shares, • ownership or right to ownership, or 	The person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20% of the equity shares ¹⁸² of that company.
Ownership or the right to ownership of a person in any other entity	<ul style="list-style-type: none"> • vested interest, • at the time of their disposal, • is attributable directly or indirectly, 	The person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20% of the ownership or right to ownership of the other entity.

¹⁸² The term ‘equity share capital’ was substituted with ‘equity shares’ with effect from 1 January 2011 by s 93(1) of the Taxation Laws Amendment Act 7 of 2010.

Type of interest	Requirement 1	Requirement 2
A vested interest of a person in any assets of any trust.	<ul style="list-style-type: none"> to immovable property held [in South Africa].¹⁸¹ 	Any percentage interest.

Before 17 January 2019 the 80% requirement excluded immovable property held as trading stock.¹⁸³

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

In determining whether 80% or more of the value of shares in a company is directly or indirectly attributable to immovable property in South Africa, any liabilities in the company must be disregarded. This principle is in line with the OECD's interpretation¹⁸⁴ of article 13(4) of the OECD model treaty, which provides as follows:

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

For accounting purposes self-generated goodwill is not reflected in the financial statements of an entity.¹⁸⁵ However, it is an asset forming part of the market value of the interest in an entity and should not be lost sight of when determining whether 80% or more of an entity's assets comprise immovable property.

In evaluating whether the shares in a holding company derive their value from immovable property, intra-group loans should be disregarded. Under para 2(2) it must be determined what percentage of the market value of the shares in the holding company is attributable to immovable property in South Africa. The emphasis is therefore on the value of the shares in the holding company rather than on the individual assets of the holding company viewed in isolation. Intra-company loans in this context do not add value to the shares in the holding company because a debit loan account of one group company will be offset by a credit loan account of another group company.

¹⁸¹ Before 17 January 2019 immovable property held as trading stock was excluded from para 2(2)(a).

¹⁸³ The words 'otherwise than as trading stock' in para 2(2)(a) were deleted by s 74 of the Taxation Laws Amendment Act 23 of 2018.

¹⁸⁴ OECD *Model Tax Convention on Income and on Capital: Condensed Version* (2017) OECD Publishing in para 28.4 at page 297.

¹⁸⁵ IAS 38 (AC 129) in para 48.

Example 3 – Elimination of intra-group loans*Facts:*

Holdco A owns two wholly owned subsidiaries, B and C. Each subsidiary's shares are valued at R50. B has share capital of R50 represented by a loan to C of R50. C has share capital of R50 and a loan of R50 from B which are represented by immovable property in South Africa of R100.

Result:

B's asset comprising the loan to C of R50 must be disregarded in determining whether the value of A's shares comprise immovable property. As a result, the only remaining asset to be considered is C's immovable property of R100 and consequently A's shares will comprise immovable property for the purposes of para 2(2).

A debit deferred tax account is not an asset for tax purposes and must be disregarded in determining whether 80% or more of the value of a company's shares are directly or indirectly derived from immovable property in South Africa.

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

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

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

'Gains derived by a resident of a Contracting State from the alienation of:

- (a) shares, other than shares quoted on an approved Stock Exchange, deriving their value or the greater part of their value directly or indirectly from immovable property situated in the other Contracting State, or
- (b) an interest in a partnership or trust the assets of which consist principally of immovable property situated in the other Contracting State, or of shares referred to in sub-paragraph (a) of this paragraph,

may be taxed in that other State.'

A United Kingdom resident would therefore be potentially subject to CGT in South Africa on the disposal of shares in an unlisted company holding South African immovable property. On the other hand, if the company were listed, the disposal of the shares would not attract CGT in South Africa. Treaties such as those with Luxembourg and the Netherlands¹⁸⁶ provide that sales of assets other than immovable property are taxable only in the country of residence. It is therefore necessary to establish what is meant by 'immovable property' for the purposes of the tax treaty. Article 13(1) of the tax treaty with Luxembourg, for example, states the following:

'1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.'

Article 6(2) of the same treaty defines 'immovable property' as follows:

'2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships, boats and aircraft shall not be regarded as immovable property.'

Two questions arise from article 6(2). The first question is what is meant by 'the law of the Contracting State'?

Section 35(1) of the Companies Act states that a share issued by a company is movable property. Yet, para 2(2) deems equity shares in a company to be an interest in immovable property if 80% or more of the value of those shares is directly or indirectly attributable to immovable property in South Africa and the person holds together with connected persons, directly or indirectly, at least 20% of the equity shares in the company. The Eighth Schedule therefore places a different meaning on such shares than the Companies Act.

Article 3(2) reads as follows:

'2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.'

Since tax treaties are concerned with tax laws, it is logical that those laws should take precedence when seeking to place a meaning on words used in a tax treaty. Article 3(2) is in line with this principle.

Vogel states in this regard:

'Art. 6 (2) refers to the State of situs' qualification: For the purposes of the convention, the term shall have the meaning which it has under the law of the contracting State in which the property is situated. In this connection, the term 'law' means the entire law rather than only tax law. If, however, private law of the State of situs attributes a meaning to that term which differs from the meaning it has under tax law, then the meaning shall prevail which it has under tax law (Art. 3 (2) goes even further in that, from the outset, it refers the State applying the convention exclusively to that State's own tax law; see *supra* Art. 3, m.no. 66). This arrangement brings about a uniform application of the convention in both States, since the State of residence is bound by the State of source's qualification when applying the convention (see *supra* Introduction, at m.nos. 94, 98).'

¹⁸⁶ Article 13(4) of the treaty with Luxembourg and Article 14(4) of the treaty with the Netherlands. Protocols with these countries are in the process of being finalized and should result in the question of shares in property companies being specifically addressed.

Proceeding on the basis that it is the tax law that takes precedence, the next question is whether para 2(2) brings a share in a property-owning company within article 6(2).

Paragraph 2(2) provides that for the purposes of para 2(1)(b)(i) an interest in immovable property includes shares in a company when the 80% market value and 20% shareholding requirements described in the subparagraph are met. Paragraph 2(1)(b)(i) provides that a non-resident will be subject to CGT on

‘immovable property situated in the Republic held by that person or any interest or right of whatever nature of that person to or in immovable property situated in the Republic including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources’.

While para 2(1)(b)(i) refers to immovable property situated in the Republic and any interest or right of whatever nature to or in such property, it does not define ‘immovable property’ in general terms.

The definition of ‘immovable property’ in article 6(2) is not restricted to corporeal immovable property such as that held under freehold or sectional title. It includes

‘rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources’.

Thus, under para (b) of the definition of ‘immovable property’ in s 102(1) of the Deeds Registries Act 47 of 1937 a registered lease of not less than 10 years is ‘immovable property’. A usufruct over immovable property, being an incorporeal real right, is also an interest in immovable property. Having established that article 6(2) includes interests which would be regarded as immovable property under the law of South Africa it must follow that an interest in immovable property referred to in para 2(2) should also fall within article 6(2).

Section 35A imposes a withholding tax which represents an advance payment for amongst others, CGT (being the tax contemplated in article 13) when a non-resident disposes of immovable property. Section 35A(15) defines immovable property as follows:

‘ “[b]immovable property” means immovable property contemplated in paragraph 2(1)(b)(i) and (2) of the Eighth Schedule.’

Section 35A thus broadens the meaning of immovable property to include shares in a property-rich company. This express definition should accordingly be applied when interpreting article 6 and hence article 13(1). It would defeat the legislative intent if the very section in the Act which enables the withholding of CGT in respect of ‘immovable property’ as defined in that section does not mean ‘immovable property’ as referred to in article 13(1) which is the article governing the taxing rights in respect of the self-same ‘Capital Gains’ falling within the ambit of s 35A.

Example 4 – Indirect interest of non-resident in immovable property in South Africa (on or after 1 February 2006 position)

Facts:

Aaron, a non-resident, owns a 25% interest in XYZ (Pty) Ltd (‘XYZ’) the balance sheet of which appears as follows as at 29 February 2020:

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

Assume there is no goodwill.

Aaron disposed of his shares on 1 March 2020. Determine whether he will be liable for CGT on the disposal of his shares in XYZ if the long-term loan financed the acquisition of

- the land and buildings, or
- the plant and machinery.

Result:

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

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

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

Example 5 – Indirect interest in immovable property through multi-tier structure (position on or after 1 February 2006)

Facts:

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

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

	T	U
	R	R
Land	900	-
Plant	-	100
Bond	<u>(100)</u>	<u>-</u>
Net assets	<u>800</u>	<u>100</u>

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

Result:

100% of the value of the shares in T is attributable to immovable property, and those shares are worth R800. 100% of the value of the shares in U is not attributable to immovable property and those shares are worth R100. S's shares are therefore worth R900 (R800 (value of T) + R100 (value of U)). Therefore, 88,89% of the value of S's shares is indirectly attributable to immovable property ($R800 / R900 \times 100$), and the same percentage will apply to the value of H's shares.

Roger is therefore subject to CGT on the disposal of his shares in H.

4.3 Source of capital gains and losses

Section 9(2)

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

Under para 2(1)(b), the CGT provisions apply to all assets of residents and the following assets of non-residents that are situated in South Africa:

- immovable property situated in South Africa held by the non-resident or any interest or right of whatever nature of that non-resident to or in immovable property situated in South Africa including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources; and
- any asset effectively connected with a permanent establishment of that non-resident in South Africa.

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

Disposal of immovable property in South Africa [s 9(2)(j)]

An amount will be received by or accrued to a person from a source within South Africa if

- it is in respect of the disposal of immovable property held by that person or any interest or right of whatever nature of that person to or in such property contemplated in para 2; and
- that property is situated in South Africa.

Under para 2(2) an interest in immovable property held by a person includes

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

if

- 80% or more of the market value of those equity shares, ownership or right to ownership or vested interest, as the case may be, at the time of their disposal, is attributable directly or indirectly to immovable property held, and

- in the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person) directly or indirectly, holds at least 20% of the equity shares in that company or ownership or right to ownership of that other entity.

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

Source of assets not falling under s 9(2)(j) [s 9(2)(k)]

Resident

An amount received by or accrued to a resident will be from a source within South Africa if

- it is in respect of the disposal of an asset other than an asset contemplated in s 9(2)(j);
- the asset is not effectively connected with a permanent establishment outside South Africa, and
- the proceeds from the disposal of the asset are not subject to any taxes on income payable to any sphere of government of any country other than South Africa.

Non-resident

An amount received by or accrued to a non-resident will be from a source within South Africa if

- it is in respect of the disposal of an asset other than an asset contemplated in para 9(2)(j); and
- is attributable to a permanent establishment in South Africa.

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

4.4 Precedence of sections of the Act over the Eighth Schedule

There are a number of situations in which both the Eighth Schedule and sections of the Act apply to the same amount, and the question then arises as to which takes precedence. The rule of interpretation when a section of the Act and a Schedule are in conflict was summed up as follows by Kotze JA in *African & European Investment Co Ltd v Warren & others*:¹⁸⁷

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

Examples of when a section of the Act takes precedence over the Eighth Schedule can be seen in paras 20(3)(a) and 35(3)(a) under which capital allowances reduce base cost and recoupments reduce proceeds respectively.

¹⁸⁷ 1924 AD 308 at 360. See also *R v Kok* 1955 (4) SA 370 (T) at 374F–G and *Executive Council of the Western Cape Legislature v President of the RSA* 1995 (10) BCLR 1289 (CC) in para 33, 1995 (4) SA 877 (CC).

Chapter 5 – Taxable capital gain and assessed capital loss

PART II: TAXABLE CAPITAL GAINS AND ASSESSED CAPITAL LOSSES

5.1 Capital gain

Paragraph 3

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

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

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

5.1.2 Asset disposed of in an earlier year [para 3(b)]

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

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

Paragraph 3(b)	Event giving rise to capital gain in subsequent year
(i)	Receipt or accrual of further proceeds not previously accounted for.
(ii)	Recovery or recoupment of part of the base cost not previously accounted for, otherwise than by way of any reduction of any debt owed by the person. ¹⁸⁸
(iii)	In the case of a pre-valuation date asset <ul style="list-style-type: none"> • any capital gain redetermined in the current year, plus • if a capital loss arose the last time para 25 was applied, the amount of that capital loss.

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

The receipt or accrual of further proceeds in the current year of assessment from the disposal of an asset in an earlier year will give rise to a capital gain in the current year when those proceeds have not been taken into account

- during any year in determining the capital gain or capital loss in respect of that disposal; or

¹⁸⁸ The exclusion of a recovery or recoupment as a result of a reduction of debt was introduced by the Taxation Laws Amendment Act 22 of 2012 and applies to years of assessment commencing on or after 1 January 2013. The amendment was consequential upon the introduction of para 12A and s 19.

- in the redetermination of the capital gain or loss under para 25(2).

Under the first bullet point such a further receipt or accrual could arise as a result of the application of s 24M(1) (unquantified consideration deemed to accrue in the year it becomes quantified) or under common law principles (for example, when the additional amount was contingent on a future event at the time of the initial disposal).

The second bullet point applies when further proceeds are received from the disposal of a pre-valuation date asset in an earlier year. In these circumstances they must be taken into account under para 3(b)(iii) or 4(b)(iii). The capital gain or loss is determined *de novo* taking into account the further proceeds and the previous capital gain or loss is reversed as a capital loss or gain respectively.

Example – Proceeds accruing following disposal of asset

Facts:

Magdelene acquired business premises on 1 October 2001 at a cost of R1 million. On 29 February 2016 she sold the property to Kayzita on the following terms:

- R1 200 000 payable on 29 February 2016.
- The following amounts payable, each on condition that the net rental return exceeds 10% in the relevant year: R100 000 (2017), R110 000 (2018), R120 000 (2019), R130 000 (2020).

Result:

	2016	2017	2018	2019	2020	Total
	R	R	R	R	R	R
Proceeds	1 200 000	100 000	110 000	120 000	130 000	1 660 000
Less: Base cost	<u>(1 000 000)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(1 000 000)</u>
Capital gain	<u>200 000</u>	<u>100 000</u>	<u>110 000</u>	<u>120 000</u>	<u>130 000</u>	<u>660 000</u>
Paragraph	3(a)	3(b)(i)	3(b)(i)	3(b)(i)	3(b)(i)	

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

A further capital gain will arise in the current year when any portion of the base cost that was taken into account in determining a capital gain or loss in a previous year is recovered or recouped in the current year. A typical example of such a recoupment would be a cash refund. For years of assessment commencing on or after 1 January 2013 a recovery or recoupment as a result of a reduction of debt has been excluded as a result of the introduction of para 12A and s 19.

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

Example – Base cost recovery through reduction in purchase price*Facts:*

Bryan purchased a beach cottage in 2016 and shortly afterwards discovered that it was infested with white ants. The seller had not informed him of the infestation. He sold the property in 2017 and realised a capital gain of R50 000 on which he was assessed in that year. In the meanwhile, he sued the seller of the property for misrepresentation and after a protracted legal battle received a cash refund during the 2020 year of assessment of R18 000 for part of the purchase price.

Result:

The recovery of R18 000 will be reflected as a capital gain in Bryan's 2020 return of income under para 3(b)(ii).

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

Under para 25(2) the capital gain or loss on disposal of a pre-valuation date asset must be redetermined when any of the events listed in Table 1 under **8.27.2** occur in a year subsequent to the year of disposal. In essence, these events cover situations in which

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

A redetermined capital gain is treated as a capital gain under para 3(b)(iii). A capital loss previously determined or redetermined under para 25 is reversed as a capital gain under para 3(b)(iii). The net effect of the redetermination and reversal is thus recognised in the current year. For the reasons behind redetermination and examples see **8.27.2**.

5.1.3 Assets reacquired as a result of the cancellation of an agreement in a subsequent year of assessment [para 3(c)]

Paragraph 3(c) applies to a person that disposed of an asset to another person at a capital loss under an agreement. The person is one contemplated in para 20(4), namely, a person that reacquired that asset from that other person by reason of the cancellation or termination of that agreement and the restoration of both persons to the position they were in prior to entering into that agreement.

In these circumstances the person is treated as having a capital gain equal to any capital loss determined in respect of the prior disposal.

Paragraph 3(c) came into operation on 1 January 2016 and applies to any asset reacquired as a result of the cancellation or termination of an agreement during any year of assessment commencing on or after that date. It will thus apply to a contract entered into during a year of assessment commencing before 1 January 2016 as long as the contract is cancelled and the asset reacquired during a year of assessment commencing on or after that date.

Example – Capital gain arising as a result of cancellation of agreement*Facts:*

In year 1 Jed disposed of an asset to Mandy with a base cost of R100 for proceeds of R20 resulting in a capital loss of R80. In year 5 Mandy and Jed agreed to cancel the agreement. Mandy was relieved of having to pay the outstanding purchase price of R20 and Jed reacquired the asset. No other funds changed hands as a result of the cancellation.

Result:

In year 5 Jed will have a capital gain of R80 under para 3(c) but his base cost in the asset will be restored to R100 under para 20(4).

5.1.4 Assets disposed of before valuation date

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

5.1.5 Disregarding of capital gains under other provisions

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

5.2 Capital loss**Paragraph 4****5.2.1 Asset disposed of in current year [para 4(a)]**

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

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

5.2.2 Asset disposed of in an earlier year [para 4(b)]

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

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

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

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

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

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

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

Examples:

- The debtor to whom an asset has been sold is sequestrated or placed in liquidation.
- The debt is allowed to prescribe through a lack of recovery action.
- The seller is forced to repay part of the selling price as a result of misrepresentation or overcharging.

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

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

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

Examples:

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

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

Under para 25(2) the capital gain or loss on disposal of a pre-valuation date asset must be redetermined when any of the events listed in Table 1 under **8.27.2** occur in a year subsequent to the year of disposal. In essence, these events cover situations in which

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

A redetermined capital loss is treated as a capital loss under para 4(b)(iii)(aa). A capital gain previously determined or redetermined under para 25 is reversed as a capital loss under para 4(b)(iii)(bb). The net effect of the redetermination and reversal is thus recognised in the current year. For the reasons behind redetermination and examples see **8.27.2**.

5.2.3 Assets reacquired as a result of the cancellation of an agreement in a subsequent year of assessment [para 4(c)]

Paragraph 4(c) applies to a person that disposed of an asset to another person at a capital gain under an agreement. The person is one contemplated in para 20(4), namely, a person that reacquired that asset from that other person by reason of the cancellation or termination of that agreement and the restoration of both persons to the position they were in prior to entering into that agreement.

In these circumstances the person is treated as having a capital loss equal to any capital gain determined in respect of the prior disposal.

Paragraph 4(c) came into operation on 1 January 2016 and applies to any asset reacquired as a result of the cancellation or termination of an agreement during any year of assessment commencing on or after that date. It will thus apply to a contract entered into during a year of assessment commencing before 1 January 2016 as long as the contract is cancelled and the asset reacquired during a year of assessment commencing on or after that date.

Example – Capital loss arising as a result of cancellation of agreement

Facts:

In year 1 Sue disposed of an asset to Pat with a base cost of R20 for proceeds of R100 resulting in a capital gain of R80. In year 5 Pat and Sue agreed to cancel the agreement. Pat was relieved of having to pay the outstanding purchase price of R100 and Sue reacquired the asset. No other funds changed hands as a result of the cancellation.

Result:

In year 5 Sue will have a capital loss of R80 under para 4(c) but her base cost in the asset will be restored to R20 under para 20(4). Pat will be in a tax-neutral position, since he will be disposing of an asset with a base cost of R100 in return for proceeds of R100 under para 35(1)(a), being the debt from which he has been relieved.

5.2.4 Assets disposed of before valuation date

A portion of the expenditure incurred on or after the valuation date in respect of an asset disposed of before that date will not result in a capital loss under para 3(b). Under para 2 the Eighth Schedule applies only to disposals of assets on or after the valuation date. The loss of proceeds from such pre-valuation date disposals by reason of a cessation of entitlement, irrecoverability or repayment will also not constitute a capital loss. Nevertheless, a debt arising from a pre-valuation date disposal that becomes irrecoverable after the valuation date may give rise to a capital loss under the core rules. But unless the loan was worth its face value on valuation date the capital loss allowable will be something less than the face value, and would have to be determined using the time-apportionment, market-value or '20% of proceeds' method, subject to the kink tests in paras 26 and 27 (loan not comprising a s 24J instrument) or 28 (s 24J instrument) when applicable.

5.2.5 Disregarding of capital losses under other provisions

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

5.3 Annual exclusion

Paragraph 5

Although capital gains or losses in respect of most personal-use assets are excluded from the CGT system, a threshold (annual exclusion) is provided to exclude the total of smaller gains and losses from CGT. The purpose of the annual exclusion is to reduce compliance costs, simplify the administration of the tax and keep small gains and losses of persons not required to furnish a return of income out of the system.¹⁸⁹

The table below sets out the annual exclusion for various persons.

¹⁸⁹ See the annual notice to furnish returns, available on the SARS website under Legal Counsel / Secondary Legislation / Income Tax notices.

Table 1 – Annual exclusion

Person	Annual exclusion for a year of assessment								Comment
	2017 to 2020 R	2013, ¹⁹⁰ 2014, 2015 and 2016 R	2012 ¹⁹¹ R	2010 & 2011 ¹⁹² R	2009 ¹⁹³ R	2008 ¹⁹⁴ R	2007 ¹⁹⁵ R	2006 and earlier years of assessment R	
Natural person	40 000	30 000	20 000	17 500	16 000	15 000	12 500	10 000	
Natural person – in year of death	300 000	300 000	200 000	120 000	120 000	120 000	60 000	50 000	Not subject to apportionment.
Special trust for person with a disability	40 000	30 000	20 000	17 500	16 000	15 000	12 500	10 000	The annual exclusion remains available to a type- A special trust only until the earlier of

¹⁹⁰ The annual exclusion of R30 000 or R300 000 (on death) was increased by s 8(1) of the Rates and Monetary Amounts and Amendment of Revenue Laws Act 13 of 2012 and deemed to have come into operation on 1 March 2012 and applies to years of assessment commencing on or after that date.

¹⁹¹ The annual exclusion was increased to R20 000 by s 107(1) of the Taxation Laws Amendment Act 24 of 2011. The revised amount is deemed to have come into operation on 1 March, 2011 and applies to years of assessment commencing on or after that date.

¹⁹² The annual exclusion was increased to R17 500 by s 67 of the Taxation Laws Amendment Act 17 of 2009. The revised amount is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2010.

¹⁹³ The annual exclusion was increased to R16 000 by s 1(2)(c) of the Taxation Laws Amendment Act 3 of 2008. The revised amount is deemed to have come into operation on 1 March 2008 and applies in respect of a year of assessment commencing on or after that date.

¹⁹⁴ The annual exclusion was increased to R15 000 and R120 000 (year of death) by s 2(2)(b) of the Taxation Laws Amendment Act 8 of 2007. The revised amounts are deemed to have come into operation on 1 March 2007 and apply in respect of any year of assessment commencing on or after that date.

¹⁹⁵ The annual exclusion was increased by s 32 of the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

Person	Annual exclusion for a year of assessment								Comment
	2017 to 2020 R	2013, ¹⁹⁰ 2014, 2015 and 2016 R	2012 ¹⁹¹ R	2010 & 2011 ¹⁹² R	2009 ¹⁹³ R	2008 ¹⁹⁴ R	2007 ¹⁹⁵ R	2006 and earlier years of assessment R	
Deceased estate	40 000	30 000	20 000	17 500	16 000	15 000	12 500	10 000	<ul style="list-style-type: none"> the date when all the assets have been disposed of, or two years after the death of the beneficiary (para 82). <p>The annual exclusion of R40 000 is available in the year of death and each subsequent year. It is not subject to apportionment in the year of death [para 40(3)].</p>
Insolvent estate	40 000	30 000	20 000	17 500	16 000	15 000	12 500	10 000	<p>In the year of sequestration the annual exclusion for the person before sequestration and his or her estate may not together exceed R40 000. In subsequent years of assessment the insolvent estate will enjoy an annual exclusion of R40 000 [para 83(1)].</p>

Some points to note on the annual exclusion:

- It does not apply to companies, close corporations or trusts other than special trusts referred to in para (a) of the definition of 'special trust' in s 1(1) (a special trust created solely for persons with a disability as defined in s 6B(1) which incapacitates them from earning sufficient income for their maintenance, or from managing their own financial affairs). The annual exclusion is unavailable to the para (b)-type special trust created on death for relatives which include a beneficiary under the age of 18.
- It applies only to natural persons (individuals), type-A special trusts and persons treated as natural persons for the purposes of the Eighth Schedule (deceased and insolvent estates).
- It reduces both capital gains and losses. If capital losses were not reduced it would mean that an indefinite record of small losses would have to be kept by taxpayers who are not required to submit returns.
- The annual exclusion is not apportioned when the period of assessment is less than a year, for example, when a person dies or that person's estate is sequestrated.
- It is not cumulative. In other words, it is restricted to the sum of the capital gains or losses in a year. Any excess that is not used cannot be carried forward. It does not reduce an assessed capital loss that has been brought forward from a previous year – it is applied against the sum of the capital gains and losses for the year.
- The annual exclusion in the year of death is R300 000 (2012: R200 000; 2008 to 2011: R120 000; 2007: R60 000; 2006 and earlier years of assessment: R50 000). The reason for the increase in the year of death is that a person is deemed to have disposed of all that person's assets at market value on the date of death [s 9HA(1)]. This deemed disposal could cause a bunching effect, and to alleviate any hardship the deceased is effectively given 7,5 years' worth of annual exclusions.

The Minister may announce in the national annual budget contemplated in s 27(1) of the Public Finance Management Act that, with effect from a date or dates mentioned in that announcement, the annual exclusion will be altered to the extent mentioned in the announcement.

If the Minister announces a change in the annual exclusion, that alteration comes into effect on the date or dates determined by the Minister in that announcement and continues to apply for a period of 12 months from that date or those dates subject to Parliament passing legislation giving effect to that announcement within that period of 12 months.

5.4 Aggregate capital gain and aggregate capital loss

Paragraphs 6 and 7

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

Example 1 – Aggregate capital gain*Facts:*

Mahomed derived the following capital gains and losses during the 2020 year of assessment:

	R
Holiday home	175 000
Listed shares	(50 000)

Result:

Holiday home	175 000
Listed shares	(50 000)
Sum of capital gains and losses	125 000
Less: Annual exclusion	(40 000)
Aggregate capital gain (para 6)	<u>85 000</u>

Example 2 – Aggregate capital loss*Facts:*

Norma derived the following capital gains and losses during the 2020 year of assessment:

	R
Holiday home	(175 000)
Listed shares	50 000

Result:

Holiday home	(175 000)
Listed shares	<u>50 000</u>
Sum of capital gains and losses	(125 000)
Annual exclusion	<u>40 000</u>
Aggregate capital loss (para 7)	<u>(85 000)</u>

5.5 Net capital gain

Paragraph 8

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

- the amount by which the person's aggregate capital gain for that year exceeds the assessed capital loss for the previous year of assessment [para 8(a)], and
- when para 64B(3) applies, the amount of any capital gain disregarded under para 64B(1) or (2) during the current or any previous year of assessment [para 8(b)].¹⁹⁶

Paragraph 8(b) has the effect of ring-fencing the capital gain determined under para 64B(3). In other words, such a capital gain may not be offset against capital losses arising in the current year or against an assessed capital loss from the previous year. This anti-avoidance measure is aimed at certain schemes involving the participation exclusion in para 64B. A capital gain disregarded by a company under para 64B(1) or (2) is reinstated as a ring-fenced net capital gain if the company falls under para 64B(3). For more on para 64B see **12.19**.

¹⁹⁶ Paragraph 8(b) was inserted by the Revenue Laws Amendment Act 31 of 2005. It is evident from the context of the amendment that it comes into operation on the same date as para 64B(3) and (4), namely, 8 November 2005.

5.6 Assessed capital loss

Paragraph 9

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

Table 1 – Determination of assessed capital loss

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

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

5.7 Taxable capital gain

Paragraph 10

A net capital gain for the current year of assessment is multiplied by the inclusion rate applicable to the person to arrive at the taxable capital gain. The inclusion rates reflected in the table below apply to years of assessment commencing on or after 1 March 2016. The previous increase took effect on 1 March 2012. See also 3.6 for a more detailed list of rates applicable to a range of entities.

Table 1 – Inclusion rates

Type of person	Paragraph 10	Inclusion rate effective 1 March 2016 %	Inclusion rate effective 1 March 2012 %
Natural person The following are treated as natural persons under the paragraphs indicated: <ul style="list-style-type: none"> An insolvent estate [para 83(1)] A deceased estate [para 40(3)] 	(a)	40	33,3
Special trust – as defined in s 1(1) (includes trusts for persons with a disability, and testamentary trusts for minors)	(a)	40	33,3

Type of person	Paragraph 10	Inclusion rate effective 1 March 2016 %	Inclusion rate effective 1 March 2012 %
Insurer – individual policyholder fund	(b)(i)	40	33,3
Insurer – untaxed policy holder fund	(b)(ii)	0	0
Insurer – company policyholder fund	(b)(iii)	80	66,6
Risk policy fund ¹⁹⁷	(b)(iv)	80	66,6
Any other case, which includes a <ul style="list-style-type: none"> • company • close corporation • company which is not a resident deriving taxable income as defined in s 1(1) • corporate fund of an insurer • public benefit organisation • recreational club • trust (normal) 	(c)	80	66,6

5.8 Inclusion in taxable income

Once a taxable capital gain has been determined, it is included in taxable income under s 26A, which reads as follows:

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

The ordinary rates of tax are then applied to the taxable income to determine the normal income tax liability.

The Minister may announce in the national annual budget contemplated in s 27(1) of the Public Finance Management Act that, with effect from a date or dates mentioned in that announcement, the inclusion rate in para 10 will be altered to the extent mentioned in the announcement.

If the Minister makes such an announcement, that alteration comes into effect on the date or dates determined by the Minister in that announcement and continues to apply for a period of 12 months from that date or those dates subject to Parliament passing legislation giving effect to that announcement within that period of 12 months.¹⁹⁸

¹⁹⁷ The inclusion of a risk policy fund comes into operation on 1 January 2016.

¹⁹⁸ Paragraph 10(2).

5.9 Set-off of gains and losses

5.9.1 Set-off of taxable capital gain against assessed loss

A taxable capital gain reduces a locally derived assessed loss contemplated in s 20. This not-so-obvious fact follows from the definition of 'taxable income' which is defined in s 1(1) as follows:

‘ “[T]axable income” means the aggregate of—

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

It is evident from this definition that taxable income can be a negative figure. Paragraph (a) would become negative when the amounts allowed under Part I of Chapter II exceed the income of a person. Furthermore, Part I of Chapter II includes s 20 which deals with assessed losses. There would also have been no need to amend s 103(2) to prevent the set off of a 'tainted' capital gain against an assessed loss if such a set off was impossible in the first place.

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

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

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

‘ “[T]axable income” means the aggregate of—

- (a) the amount remaining after deducting from the income of any person all the amounts allowed under Part I of Chapter II to be deducted from or set off against such income; and
- (b) all amounts to be included or deemed to be included in the taxable income of any person in terms of this Act;’

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

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

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

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

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

Facts:

During the year ending 29 February 2020 Jackie derived the following amounts:

	R
Loss on rental of flat in London	(600 000)
Interest from a deposit with a South African bank (taxable portion)	100 000
Income from employment in South Africa	400 000
Taxable capital gain arising from sale of London flat	1 000 000

Result:

Jackie’s taxable income is determined as follows:

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

Under para (b) of the proviso to s 20(1) Jackie is not permitted to set off the foreign rental loss against her income from a South African source. The foreign assessed loss of R600 000 is therefore carried forward to 2021. The amount included in para (a) of the definition of ‘taxable income’ is therefore R500 000 [R100 000 interest income) + R400 000 (salary income)].

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

The taxable capital gain of R1 million is included in para (b) of the definition of ‘taxable income’.

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

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

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

For CGT purposes capital gains and losses can arise on foreign assets under para 43 and before the 2012 year of assessment, under Part XIII. Paragraph (b) of the proviso to s 20(1) prevents the set-off of a foreign assessed loss against domestic income (see 5.9.2). The Eighth Schedule, in contrast, contains no restriction on the set-off of foreign capital losses against domestic capital gains. Nor does it restrict the set-off of domestic capital losses against foreign capital gains. Therefore, subject to the clogged loss rule in para 39 and the anti-avoidance provisions of s 103/Part IIA, there is nothing to prevent the set-off of a foreign capital loss against a local capital gain. Similarly, apart from capital gains of CFCs (see 5.9.6), there is no bar on the set-off of a foreign capital gain against a local capital loss.

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

Section 20A provides for the ring-fencing of an assessed loss arising from specified 'suspect' trades. The question arises whether a ring-fenced assessed loss can be set off against a taxable capital gain arising from the disposal of an asset used in the course of the 'suspect' trade. The answer depends on whether the asset is disposed of during the course of or after cessation of the trade. No set-off is permitted if an asset is disposed of during the course of the trade. But once trade has ceased and an asset that was used in carrying on the suspect trade is disposed of, s 20A(6)(b) permits a set-off of the ring-fenced assessed loss. It provides as follows:

'(6) For the purposes of this section and section 20, the income derived from any trade referred to in subsections (1) or (5), includes any amount—

- (a) [not relevant – deals with recoupments]; or
- (b) derived from the disposal after cessation of that trade of any assets used in carrying on that trade.'

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

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

Facts:

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

Result:

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

5.9.5 Set-off of assessed capital loss against taxable income

An assessed capital loss determined under para 9 sustained by a person for a year of assessment 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 increases a person's assessed loss of a revenue nature. Such an assessed capital loss is therefore ring-fenced and can be set off only against capital gains arising during future years of assessment.

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

5.9.6 Set-off of capital gains and losses of controlled foreign companies

Despite it generally being possible to set off a foreign capital gain against a local capital loss, there is an exception in relation to CFCs. Section 9D(2) requires that there shall be included in the income of a resident holder of participation rights (other than a headquarter company) 'an amount equal to' the proportional amount of the 'net income' of a CFC. Section 9D(2A) defines 'net income' as 'an amount equal to' the taxable income of the CFC. A capital gain or loss of a CFC is determined as if the CFC had been a resident, and for this purpose the opening words of s 9D(2A) make paras 2(1)(a), 24, 70, 71, 72 and 80 of the Eighth Schedule applicable in determining the CFC's taxable income. The inclusion rate in determining a taxable capital gain is reduced to 40% when the resident shareholder is an individual, special trust or insurer's individual policyholder fund [s 9D(2A)(f)]. The effect of the words 'an amount equal to' mean that what is included in the resident's income is not a taxable capital gain but an amount equal to such a taxable capital gain. The separate character of a CFC's capital gains is thus lost with the result that any local capital loss cannot be set off against the amount included in the resident's income. There can be no question of the income inclusion retaining its component parts under a conduit-pipe principle in order to achieve a set-off.

A capital loss arising in a CFC can, subject to para 39, be set off only against capital gains arising in the CFC and is not attributed to the resident holder of the CFC's shares. Under s 9D(2A) what is attributed to the resident holder of the CFC's shares is an amount equal to the taxable income of the CFC ('net income'). Section 9D does not make provision for the attribution to a resident of a capital loss or assessed capital loss of a CFC. Subject to para 39, the CFC must set off such a capital loss or assessed capital loss against other capital gains arising in the CFC in determining the CFC's net income.

Chapter 6 – Disposal and acquisition of assets

PART III: DISPOSAL AND ACQUISITION OF ASSETS

6.1 Disposals

Paragraph 11

6.1.1 Disposal events

The disposal of an asset triggers the liability for CGT and it is, therefore, a core rule that is fundamental to the application of CGT. It is for this reason that a wide meaning has been given to 'disposal'.¹⁹⁹

A *disposal* is any

- event
- act
- forbearance,²⁰⁰ or
- operation of law

which results in the

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

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

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

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

¹⁹⁹ The Australian approach of having a restricted list of numbered events was not followed because of the danger that certain events may be unintentionally omitted.

²⁰⁰ The term was borrowed from the Value-Added Tax Act 89 of 1991.

6.1.1.1 Forbearance

According to the *Shorter Oxford English Dictionary on Historical Principles*²⁰¹ 'forbearance' means

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

6.1.1.2 Conversion

6.1.1.2.1 Meaning of 'conversion'

The word 'conversion' is not defined in the Act. It has a number of dictionary meanings, many of which are inapplicable in the context of a disposal. The following meaning seems to be appropriate:²⁰²

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

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

- a company to a share block company and *vice versa*; and
- a preference share to an ordinary share and *vice versa* (except when the rights are acquired up front).

6.1.1.2.2 Conversions that do not give rise to a capital gain or loss

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

- The conversion of a close corporation to a company under s 40A or the conversion of a co-operative to a company under s 40B will not give rise to a capital gain or loss in the hands of a holder of shares under para 11(2)(f). From the corporate entity's perspective such conversions will also not trigger a disposal.
- The conversion of an interest of a holder of shares in a share block company to an interest in immovable property (for example, as part of a conversion to sectional title) will not give rise to a capital gain or loss under para 67B.
- The conversion of old mineral, mining, prospecting, exploration and production rights held before the introduction of the Mineral and Petroleum Resources Development Act 28 of 2002 to new rights under that Act will not give rise to a capital gain or loss under para 67C (roll-over relief is granted).

6.1.1.2.3 Conversions dealt with in para 12

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

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

²⁰¹ A Stevenson 6 ed (2007) Oxford University Press.

²⁰² *The Free Dictionary* [online] available at <<http://www.thefreedictionary.com/conversion>> [Accessed 2 November 2020].

6.1.1.2.4 Convertible preference shares

The view is held that no disposal will occur at the time of conversion of a convertible preference share if its time and terms of conversion are fixed up front and those terms are not subject to any uncertain future events. The details pertaining to the preference share (date of acquisition and cost) will simply be carried over to the ordinary share.²⁰³

But if the option to convert is left to the whim of the shareholder or company, is subject to an uncertain future event, or the company makes a unilateral offer of conversion, the rights cannot be said to be acquired up front because the right of conversion is either subject to a suspensive condition, or did not exist at the time the preference share was acquired. In these instances, a disposal will be triggered at the time of conversion. Under para 13(1)(a)(v) the time of disposal in the case of a conversion is the date of conversion.

Example 1 – Conversion of an asset

Facts:

Muriel acquired a preference share on 1 March of year 1 at a cost of R100. On 28 February of year 6 the company unilaterally offered Muriel the opportunity to convert her preference share into an ordinary share. Muriel surrendered her preference share and received an ordinary share with a value of R150.

Result:

Under para 13(1)(a)(v) the time of disposal in the case of the conversion of an asset is the date on which the asset is converted. The proceeds in respect of the disposal are equal to the value of the ordinary share. Muriel will therefore have a capital gain of R150 – R100 = R50. The base cost of the ordinary share is R150. The base cost and proceeds are determined as an exchange transaction under the core rules. See the notes below and under 8.5 on barter or exchange transactions and para 20.

Example 2 – Obligation to convert fixed up front

Facts:

Muriel acquired a convertible preference share on 1 March of year 1 at a cost of R100. The share was compulsorily convertible to an ordinary share on 28 February of year 6. On 28 February of year 6 Muriel surrendered her preference share and received an ordinary share with a value of R150.

Result:

The conversion is not a disposal. The base cost of the ordinary share is R100 and is regarded as having been acquired on 1 March of year 1.

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

Facts:

Mientjie acquired a preference share on 1 March of year 1 at a cost of R100. The preference share was redeemable on 28 February of year 11 with an option granted to the holder to convert the share to an ordinary share on that date.

²⁰³ A similar view is expressed by E Mazansky in 'Share Conversions' (2003) 17 *Tax Planning* 133.

Result:

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

Example 4 – Conversion subject to an uncertain future event*Facts:*

A preference share entitles the holder to a cumulative preference dividend equal to the prime interest rate. If and when the company's ordinary shares trade on the JSE at a price not less than R2 a share for no less than five consecutive days, the preference shares automatically convert into ordinary shares on a one-for-1 basis.

Result:

Since the conversion is subject to an uncertain future event, it cannot be said that the bundle of rights making up the preference shares was disposed of on the date on which they were acquired, nor can it be said that the bundle of rights making up the ordinary shares was acquired when the preference shares were acquired.

Should the price of the ordinary shares be sustained for five consecutive days at R2 a share, a disposal will occur at the date of conversion. The proceeds on disposal of the preference shares will be equal to R2 a share and the ordinary shares will be acquired for an expenditure actually incurred under para 20 of R2 a share.

6.1.1.2.5 Convertible debentures

A debenture is 'any interest-bearing arrangement or debt' and hence falls within para (c) of the definition of 'instrument' in s 24J(1). Section 24J(1) contains definitions of an 'adjusted gain on transfer or redemption of an instrument' and an 'adjusted loss on transfer or redemption of an instrument'. Section 24J(4)(a) deems the 'adjusted gain' to accrue in the year of transfer or redemption, while s 24J(4)(b) deems an 'adjusted loss' to be incurred in the year of transfer or redemption. It follows that even if the right to convert a debenture into a share is acquired up front, a capital gain or loss will have to be determined at the time of conversion.

6.1.1.3 Creation

The notion that the creation of an asset can trigger a disposal seems counterintuitive but is valid²⁰⁴ despite suggestions to the contrary by some commentators. The confusion seems to stem from the impression that it is the party in whose hands the asset is created who has a disposal. This impression is misplaced because that party has acquired an asset, not disposed of one. The concept in fact refers to the creation of an asset by one person for the benefit of another. In creating the asset for the other person, the existing rights of the creator are

²⁰⁴ The concept is well recognised in Australian CGT legislation.

diminished and it is this diminution that represents the disposal of an asset. The following are examples of the creation of assets that give rise to disposals:

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

The bundle of rights comprising ownership was considered by Erasmus J in *Vairetti v Zardo NO & others* in which the following was stated:²⁰⁵

[17] Ownership comprises of an 'elastic' bundle of rights. It is elastic in the sense that the full exercise of ownership rights by the owner of the thing concerned (be it movable or immovable) may be suspended by granting a third party the power to exercise certain of the rights flowing from that ownership.

[18] The incidents of ownership that are relevant for present purposes are:

18.1. bare legal ownership; and

18.2. the right of use and enjoyment

[19] Servitudes, such as *usufructus* and *usus*, are limited real rights which restrict "the rights, powers or liberties of [the] owner to a greater or lesser extent in favour of either another person or the owner of another tenement".

Servitudes are in short a subtraction from the owner's *dominium*. While dominium remains with the owner, certain of the rights of use and enjoyment are placed at the disposal of a third party to the exclusion of the owner.

Servitudes are either personal or praedial in nature (*usus* and *usufruct* being personal) and are generally classified according to the nature and extent of the rights conferred on the third party (and taken away from the owner).'

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

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

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

²⁰⁵ (12423/2007) [2010] ZAWCHC 146 (12 April 2010) in [17] *et seq.*

6.1.1.4 Variation

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

- nothing has been disposed of – in fact, something additional has been acquired; and
- costs associated with such variations are included in the base cost of an asset under para 20.

Does the variation of rights attaching to shares result in a full or a part-disposal? In *Standard Bank of South Africa Ltd & another v Ocean Commodities Inc & others* Corbett JA stated the following:²⁰⁶

'A share in a company consists of a bundle, or conglomerate, of personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends.'

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

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

Based on the above it is submitted that the variation of one or more rights in a share may well result in a part-disposal of a share rather than a full disposal. Whether a full disposal has taken place will depend on whether a new share has come into existence. This question must be decided on the facts and circumstances of the particular case.

Example 1 – Variation that is not a disposal

Facts:

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

Result:

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

Example 2 – Disposal by variation of rights

Facts:

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

Result:

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

²⁰⁶ 1983 (1) SA 276 (A) at 288.

6.1.1.5 Exchange

Under para 11(1)(a) the exchange of an asset is a disposal. On the determination of the base cost of an asset acquired under an exchange transaction, see 8.5. When proceeds are determined in a form other than cash, see the notes on the meaning of the word 'amount' in para 35 in 9.1. In some instances, the corporate restructuring rules in ss 41 to 47 provide roll-over relief for barter transactions. For example, in an asset-for-share transaction, a person disposes of an asset to a company in exchange for shares in that company. The transferor is given roll-over relief provided the requirements of s 42 are met.

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

Example – Exchange of an asset

Facts:

Lammie purchased a piece of land in year 1 for R100 000. In year 3 he entered into an exchange transaction with Barry, the terms of which were as follows:

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

In year 6 Lammie sold the holiday home for R170 000.

Result:

The CGT consequences for Lammie are as follows:

Land

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

As a result of the 'exchange' with Barry, there has been a disposal of the land under para 11(1)(a). In a barter transaction, the proceeds are equal to the market value²⁰⁷ of the asset received. Although Lammie received a holiday home valued at R160 000, only R150 000 of this amount relates to the land. The remaining R10 000 relates to the cash paid to Barry. In year 3 Lammie will therefore have a capital gain of R50 000 (R150 000 (proceeds) – R100 000 (base cost)).

Holiday home

The base cost of the holiday home is equal to the amount of 'expenditure' incurred in acquiring it under para 20. Such expenditure is equal to the value by which Lammie's assets have been reduced as a result of the transaction. Lammie gave up land valued at R150 000 plus cash of R10 000. His assets therefore decreased in value by R160 000 and this amount forms the acquisition cost of the holiday home. In year 6 Lammie therefore realised a capital gain of R10 000 (R170 000 (proceeds) – R160 000 (base cost)) on disposal of the holiday home.

²⁰⁷ As to the meaning of 'amount', see the comments on para 35.

6.1.1.6 Operation of law

Sometimes a disposal can be triggered by a change in legislation. An example of such a disposal occurred when the definition of 'foreign partnership' was amended by the Taxation Laws Amendment Act 25 of 2015. The relevant requirement to be a foreign partnership currently requires that

'the partnership, association, body of persons or entity is not liable for or subject to any tax on income, other than a tax levied by a municipality, local authority or a comparable authority, in that country'.

The underlined words were inserted by the amendment described above and came into operation on 31 December 2015 and apply to years of assessment ending on or after that date. Before the amendment, if the foreign law treated the partnership as a flow-through entity but made the partnership liable for municipal taxes on income, it meant that the entity was not a foreign partnership as defined in s 1(1) and the resident partners would have comprised holders of shares in a company. However, following the amendment, the entity would have become a foreign partnership and the residents would be regarded as having disposed of their shares in the entity in exchange for a fractional interest in the partnership assets.

Other examples of disposals by operation of law include deemed disposals in the main body of the Act such as s 9H (deemed disposal as a result of change of residence, ceasing to be CFC or becoming headquarter company) and s 9HA (deemed disposal on death).

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

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

Table 1 – Non-disposals

Paragraph 11(2)	Non-disposal event
(a)	The transfer by a person of an asset as security for a debt or by a creditor who transfers that asset back to that person upon release of the security.
(b)	There is no disposal by a company in respect of <ul style="list-style-type: none"> • the issue, cancellation or extinction of a share in the company; or • the granting of an option to acquire a share in or certificate acknowledging or creating a debt owed by that company. See commentary below.
(c)	The issue by a collective investment scheme (CIS) of a participatory interest in that CIS, and the granting of an option by that CIS to acquire a participatory interest in that CIS. ²⁰⁸
(d)	The issue of any debt by or to a person.
(e)	Deleted. ²⁰⁹
(f)	Deleted – see 6.1.3.1.

²⁰⁸ A collective investment scheme (other than one in property) must in any event disregard any capital gain or loss under para 61(3). Paragraph 11(2)(c) therefore seems to be aimed at preventing a disposal by a collective investment scheme in property.

²⁰⁹ Before its deletion by s 74 of the Revenue Laws Amendment Act 60 of 2008 para 11(2)(e) stated that there was no disposal of an asset 'by a trustee in respect of the distribution of an asset of the trust to a beneficiary to the extent that that beneficiary has a vested interest in that asset'. The

Paragraph 11(2)	Non-disposal event
(g)	A disposal made to correct an error in the registration of immovable property in that person's name in the deeds registry.
(h)	The lending of any security or bond under a 'lending arrangement' as defined in s 1 of the Securities Transfer Tax Act 25 of 2007 and the return of an identical security or bond to the lender within the 12-month period contemplated in that definition. ²¹⁰
(i)	The vesting of the assets of the spouse of an insolvent in the Master of the High Court or in a trustee. Under s 21 of the Insolvency Act 24 of 1936, when a person becomes insolvent, the assets of the spouse of the insolvent also vest in the Master of the High Court or a trustee, and only when it is proved that the assets do belong to the spouse, are they released to the spouse. The vesting of the spouse's assets in the Master or trustee and the subsequent release of the assets is not a 'disposal' for CGT purposes.
(j)	Deleted for years of assessment commencing on or after 1 March 2016.
(k)	On the cession or release of a right to acquire a marketable security in whole or in part for a consideration which consists of or includes another right to acquire a marketable security in the circumstances contemplated in s 8A(5). ²¹¹
(l)	Certain share substitutions (see below)
(m)	By a person that exchanges a qualifying equity share for another qualifying equity share as contemplated in s 8B(2)
(n)	By a transferor to a transferee or by a transferee to a transferor when any share or bond ²¹² has been transferred under a collateral arrangement. ²¹³
(o)	by a person that <ul style="list-style-type: none"> • disposed of an asset to another person under an agreement; and • reacquired that asset from that other person by reason of the cancellation or termination, during the year of assessment during which that asset was so disposed of, of that agreement and the restoration of both persons to the position they were in prior to entering into that agreement.²¹⁴

deletion is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009, and was consequent on the introduction of para 13(1)(a)(iiA). The effect of the latter amendment is to backdate the distribution of the asset to the time of vesting. As a result, the distribution of the asset results in neither a capital gain nor a capital loss and there is no need to treat it as a non-disposal.

²¹⁰ Paragraph 11(2)(h) was amended with effect from 22 December 2003. Previously the provision made reference to the definition of a 'lending arrangement' under the Stamp Duties Act 77 of 1968. The reference to a bond was inserted by s 70(1)(a) of the Taxation Laws Amendment Act 15 of 2016 with effect from 1 January 2017 and applies to any securities lending arrangement entered into on or after that date.

²¹¹ Paragraph 11(2)(k) was inserted by s 66(1) of the Revenue Laws Amendment Act 31 of 2005, came into operation on 1 February 2006 and applies in respect of any disposal on or after that date.

²¹² The reference to a bond was inserted by s 70(1)(b) of the Taxation Laws Amendment Act 15 of 2016 and applies to any collateral arrangement entered into on or after that date.

²¹³ Applies to any collateral arrangement entered into on or after 1 January 2016.

²¹⁴ Applies to disposals on or after 1 January 2016.

Transfer of asset as security [para 11(2)(a)]

Paragraph 11(2)(a) provides that there is no disposal of an asset

'by a person who transfers the asset as security for a debt or by a creditor who transfers that asset back to that person upon release of the security'.

Paragraph 11(2)(a) envisages the pledge of an asset as security. Both corporeal and incorporeal assets can be pledged.

A pledge is a contract under which a debtor places an asset in the hands of another as security for debt. To be effective the subject matter of the pledge must be delivered to the pledgee, for example with a corporeal asset, through physical delivery or by handing over a key to a storeroom in which the assets are held thus giving the pledgee sole control over the pledged assets. An incorporeal asset must be delivered through a legal formality equivalent to delivery.²¹⁵

In *Cape of Good Hope Bank v Mellé*²¹⁶ De Villiers CJ noted that

'it is important to bear in mind what the exact nature of a pledge is by our law. It confers no right of ownership on the pledgee, but only what is termed a *jus in re aliena*; the ownership still remaining with the pledgor'.

An incorporeal asset is incapable of physical delivery with the result that its delivery must be effected by cession. When an incorporeal asset is ceded as security, the cession is described as being given *in securitatem debiti*.

In *National Bank of South Africa, Ltd v Cohen's Trustee*²¹⁷ a Mr Cohen ceded a fire policy to a bank as security for a mortgage bond. Following a fire at the property the proceeds from the policy were paid to the bank. Shortly before the payment Mr Cohen had been placed in sequestration and the issue was whether the policy proceeds should have been paid to his trustee rather than the bank. In deciding this question, it had to be determined whether the cession of the policy amounted to an out-and-out transfer of ownership to the bank. After examining the intention of the parties, the court concluded that the cession was in the nature of a pledge and that the rights of the bank were those of a pledgee and not those of an owner, and amounted to a "*jus in re aliena*". Innes J stated the following:²¹⁸

'If the parties intended that the bare ownership should remain in the cedent, it is not taken out of him by the cession. In the present instance, it is clear that nothing but a pledge was meant to be constituted; and I come therefore to the conclusion that the *dominium* in the policy was, at the date of insolvency, in Cohen, and not in the bank; and that, of course, is sufficient to let in the trustee's claim to administer.'

More recently, in *Grobler v Oosthuizen*²¹⁹ the court considered whether the cession of policies *in securitatem debiti* amounted to an out-and-out cession which would have involved a re-cession back to the debtor when the debt was settled or whether ownership of the policies remained with the cedent.

The court noted that there were two theories on the question. The one theory, referred to as the pledge theory was inspired by a parallel with the pledge of a corporeal asset. In accordance with this theory the effect of the cession *in securitatem debiti* is that the principal debt is 'pledged' to the cessionary while the cedent retains what has variously been described as the

²¹⁵ *Wilcocks NO v Visser and New York Life Insurance Co* 1910 OPD 99 at 102.

²¹⁶ (1893) 10 SC 280 at 288/9.

²¹⁷ 1911 AD 235.

²¹⁸ At 253.

²¹⁹ 2009 (5) SA 500 (SCA).

'bare *dominium*' or a 'reversionary interest' in the claim against the principal debtor. By contrast, under the 'out-and-out cession' theory an undertaking or *pactum fiduciae* is superimposed that the cessionary will re-cede the principal debt to the cedent on satisfaction of the secured debt. In consequence, the ceded right in all its aspects is vested in the cessionary. After the cession *in securitatem debiti* the cedent has no direct interest in the principal debt and is left only with a personal right against the cessionary, by virtue of the *pactum fiduciae*, to claim re-cession after the secured debt has been discharged.

Brand JA stated that despite the doctrinal difficulties arising from the pledge theory, the SCA had in its latest series of decisions, primarily for pragmatic reasons, accepted that theory in preference to the outright- cession/ *pactum fiduciae* construction. He concluded that the doctrinal debate must be regarded as settled in favour of the pledge theory.

The use of the words 'that asset' in para 11(2)(a) make it clear that it is the same asset that must be returned to the debtor once the debt has been settled. Had it been intended that a substantially identical asset be returned to the debtor, the legislature would have deployed specific language to achieve that outcome such as 'an asset of the same kind and of the same or equivalent quantity and quality'.²²⁰

In summary, under a cession in *securitatem debiti* the pledgor retains a reversionary interest in the asset. The creditor (cessionary) may sell the asset only if the debtor (cedent) does not settle the debt secured by the asset. The proceeds from the disposal by the creditor of the asset are those of the debtor and not of the creditor. The proceeds may be used by the creditor to settle the debt owing by the debtor but the creditor must account to the debtor for the proceeds, the debtor being entitled to any surplus remaining after the proceeds have been applied by the creditor to settle the debt.

The debtor will be entitled to the release of the security and the return of the pledged asset if the debt secured by it is settled by the debtor. The wording of para 11(2)(a) caters for the retransfer of, for example, the physical possession of a pledged asset upon release of the security.

It is clear from the underlying legal principles that a cession *in securitatem debiti* does not effect a transfer of ownership of the asset. The concern when para 11(2)(a) was drafted was that the creditor's rights under the cession *in securitatem* could be seen as the creation of an asset by the debtor and therefore as the disposal, by the debtor, of an asset separate from the asset serving as security, while the release, by the creditor, of the security could be seen as a disposal by the latter.

A securities lending arrangement involves, in contrast to a cession *in securitatem*, an outright transfer of ownership. A separate provision was needed in this regard, since para 11(2)(a) did not cater for such transfers, hence para 11(2)(h).

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

Upon entering into a contract for the issue of shares, the company acquires an asset in the form of a personal right to expect those shares to be taken up. When the company issues the shares, it disposes of that personal right in exchange for proceeds equal to the issue price. Frequently the company would have paid nothing for the personal right, resulting in a zero base cost. As a consequence, in the absence of this provision, the company would be subject to CGT on the full issue price. Clearly this would have severely discouraged company formation and the raising of capital through rights issues, hence the need to exclude the issue of shares as a disposal.

²²⁰ Similar wording to that suggested is used in s 24J(1) in the definition of 'lending arrangement' and in para 42.

When a company buys back its own shares, it acquires an asset which is held for an instant before being disposed of through cancellation or extinction. Such shares would have a base cost equal to the expenditure incurred by the company in acquiring them but there would be no proceeds resulting in a potential capital loss. Paragraph 11(2)(b) ensures that this capital loss does not arise.

On the question of cancellation or extinction of a share so bought back, under s 35(5) of the Companies Act 71 of 2008 shares of a company that have been issued and subsequently acquired by that company have the same status as shares that have been authorised but not issued. Under s 35(4) of the same Act an authorised share of a company has no rights associated with it until it has been issued. It follows that when a company acquires its own shares any rights in those shares are immediately extinguished by merger or *confusio*.

The leading case dealing with *confusio* is *Grootchwaing Salt Works Ltd v Van Tonder* in which Innes CJ stated the following:²²¹

'Now *confusio* in the sense with which we are here concerned is the concurrence of two qualities or capacities in the same person, which mutually destroy one another. In regard to contractual obligations it is the concurrence of the debtor and creditor in the same person and in respect of the same obligation. (Pothier *Verbintenissen*, par 641; Opzomer, Vol. 7, para. 1472; Van der Linden (1.18, para. 5). The typical example of *confusio* and the one mainly dealt with in the books is the case of a creditor becoming heir to his debtor or vice versa. But the same position is established whenever the creditor steps into the shoes of his debtor by any title which renders him subject to his debt (Pothier *Verb*, para. 642) and it is common cause that *confusio* takes place as between lessor and lessee when the latter acquires the leased property. As to the consequences of *confusio* there can be no doubt that speaking generally it destroys the obligations in respect of which it operates. Pothier (para. 643) is clear upon the point. A person, he says, can neither be his own creditor nor his own debtor. And if there is no other debtor then the debt is extinguished. *Non potest esse obligatio sine persona obligata*. (See also Voet, 46.3.19; Cens. For, Pt. 1.4.38, para. 1; Van der Linden, 1.18, sec. 5, etc.), but the obligation is only destroyed to the extent to which the concurrence of the opposing capacities renders it impossible to exist.'

Section 85(8) of the previous Companies Act 61 of 1973 was differently worded in that it stated that

[s]hares issued by a company and acquired under this section shall be cancelled as issued shares and restored to the status of authorized shares forthwith'.

Paragraph 11(2)(b) caters for both the cancellation and the extinction of shares bought back by a company.

In some foreign jurisdictions a company acquires its own shares and holds them as treasury shares on its balance sheet and later either cancels or sells them. However, under South African law a company cannot hold rights against itself. A company that buys back its own shares (which comprise a bundle of rights) immediately disposes of them by merger. Given that in determining its 'net income' under s 9D(2A) a CFC is treated as a resident for the purposes of the Eighth Schedule, the subsequent 'disposal' of treasury shares by a CFC must be regarded as a reissue of shares under South African law, which will not give rise to a capital gain or loss. A similar approach is followed in the United Kingdom where, under s 195 of the Finance Act, 2003, the acquisition by a company of its own shares is not recognised as an asset.

²²¹ 1920 AD 492 at 497.

Exchange of share options under s 8A(5) before 1 February 2006 [para 11(2)(k)]

Paragraph 11(2)(k) was introduced with effect from 1 February 2006. It effectively provides roll-over relief by treating as a non-disposal the cession or release by an employee of one share option for another in the circumstances contemplated in s 8A(5). SARS takes the view that a similar position prevailed before the introduction of para 11(2)(k), though for different reasons. The view is held that any consideration received in respect of the cession or release of the first option 'must be' included in gross income upon exercise of the second option. In these circumstances the amount received or accrued must be reduced to nil under para 35(3)(a). Any expenditure in respect of the first option would similarly have to be reduced under para 20(3)(a).

The above applies despite the fact that the second option may not be exercised because it is 'out of the money' at the relevant time. The intention is that s 8A should take precedence.

*Share substitutions not comprising a disposal [para 11(2)(l)]**Corporate law background*

Typically, companies subdivide their shares in order to make them more marketable by reducing the price per share while leaving the underlying rights unchanged. A consolidation of shares may occur when the price per share becomes too low. Thus, a company could consolidate existing shares (for example, by issuing 1 new ordinary share for 5 pre-existing ordinary shares) or split existing shares (for example, by issuing 10 new ordinary shares in exchange for 1 pre-existing ordinary share).

The Companies Act 71 of 2008 does not deal explicitly with the subdivision or consolidation of shares of one class into a greater or lesser number of shares of the same class. Section 114(1), which deals with schemes of arrangement, provides that the board of a company may propose, 'among others'

- a consolidation of securities of different classes [s 114(1)(a)];
- a division of securities into different classes [s 114(1)(b)]; and
- the exchange of any of its securities for other securities [s 114(1)(d)].

Section 114(1)(a) and (b) deal with variations in class rights and not with the consolidation or subdivision of the same class of shares.

It would seem that a company can subdivide or consolidate its shares provided that it is authorized to do so under its memorandum of incorporation. It is, however, unnecessary to express an opinion on the exact procedure which must be followed by a company in carrying out a subdivision or consolidation of its shares of the same class.

By contrast, s 75 of the Companies Act 61 of 1973 expressly addressed the subdivision or consolidation of shares. It provided as follows:

'75. Company may alter share capital and shares.—(1) Subject to the provisions of sections 56 and 102 a company having a share capital, if so authorized by its articles, may by special resolution—

- (c) consolidate and divide all or any part of its share capital into shares of larger amount than its existing shares or consolidate and reduce the number of the issued no par value shares;

(e) subdivide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum;

The consolidation of different classes of shares under s 114(1)(a) and the division of a class of shares into different classes under s 114(1)(b) represent a conversion and not a subdivision or consolidation of shares. In this regard, s 75(1)(i) of the Companies Act, 1973 enabled a company to

'(i) convert any of its shares, whether issued or not, into shares of another class'.

The language of s 75 was more closely aligned with the Eighth Schedule. It follows that when a company, say, splits its ordinary shares into class A and class B with the A shares being entitled to dividends out of profits from source X and the B shares being entitled to dividends out of profits from source Y, such a transaction is a conversion and does not fall within the ambit of para 11(2)(l), even if the totality of the rights held by each holder of shares remains the same. SARS's view is that in the context of para 11(2)(l), the 'subdivision' of shares should be interpreted narrowly to mean the opposite of a consolidation of shares. Accordingly, in the context of shares, a subdivision can mean only a change in the number of issued shares which are still interchangeable after the transaction. When one class of shares is exchanged for two different classes of shares, the holder holds something fundamentally different after the transaction from what the holder held before the transaction, even if the total rights are still the same. The holder thus disposes of the shares, having regard to the wide description of disposal under para 11(1), which includes, amongst others, an exchange, variation or extinction of an asset, and acquires the different classes of shares as consideration under para 35. The base cost of the newly acquired shares will be equal to the market value of the previously held shares – see **8.5**.

The conversion of a close corporation to a company is addressed in Schedule 2 of the Companies Act 71 of 2008 while the conversion of a co-operative to a company is addressed in s 161A or 161C of the Co-operatives Act 91 of 1981 and s 62 of the Co-operatives Act 14 of 2005.

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

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

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

The regulations affecting the conversion of the nominal or par value of shares are contained in reg 31 of Part D of the regulations issued under GNR 351 of 26 April 2011 in GG 34239. Under reg 31(3) it is not possible for a company to issue par value shares if no shares in that class have been issued out of the authorised shares in that class, or if they have been issued, they were all bought back. A pre-existing company that has par value shares in issue immediately before 1 May 2011 may issue further par value shares of the same class as those issued par valued shares up to the limit of its authorised par value shares, but may not increase the number of authorised par value shares [reg 31(5)]. The company may apply to convert the class of shares to shares of no par value. Such a proposal must not be designed substantially or predominantly to evade the requirements of any applicable tax legislation [reg 31(6)(a)].

Under reg 31(7) the board of directors is required to prepare a report describing amongst other things

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

The company must file a copy of the proposed resolution dealing with the conversion and report described above with the CIPC, and with SARS to **regulation31@sars.gov.za**, at the same time that the proposal is published to the shareholders [reg 31(8)(b)]. At any time before the shareholders' meeting called to consider the conversion SARS may apply to court for a declaratory order that the proposal contravenes reg 31(6)(a).

Background to share substitutions

Before 1 January 2013 para 78(2) and (3) dealt with share substitution by reason of a subdivision, consolidation or conversion contemplated in s 40A or 40B.

Before 4 July 2013 a conversion of shares of par value to shares of no par value was dealt with by applying general principles. Given that a share is a bundle of rights,²²² there is no disposal if those rights remain unchanged following a conversion from shares of par value to shares of no par value. However, if some of those rights have been lost or diminished, there would clearly be a disposal or part-disposal.

Although it was contended in the *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012* that a conversion from shares of par value to shares of no par value was addressed by s 43, this is not considered to be correct, since it was a prerequisite for s 43 that a share had to be disposed of. The view is therefore held that such conversions which did not involve a change in the underlying rights and interests in the shares had to continue to be dealt with by applying general principles during the period 1 January 2013 to 3 July 2013 (the period before the introduction of para 11(2)(l) and during which s 43 operated in its previous guise).

Paragraph 11(2)(l)

Paragraph 11(2)(l) was deemed to have come into operation on 4 July 2013 and applies in respect of transactions entered into on or after that date. It was introduced in order to address the matters that were previously dealt with in para 78(2) as well as conversions of shares of par value to no par value and *vice versa*. Arguably its introduction was unnecessary because the events it deals with would in any event under general principles not give rise to a disposal. It can therefore be viewed as a clarifying provision. It provides that there is no disposal by a person of shares held in a company when that company

- subdivides or consolidates those shares;
- converts shares of no par value to par value or of no par value to par value;
- converts shares under s 40A (conversion of a close corporation to a company) or s 40B (conversion of a co-operative to a company)

²²² *Standard Bank of South Africa Ltd & another v Ocean Commodities Inc & others* 1983 (1) SA 276 (A).

solely in substitution of the shares held by that person and

- the proportionate participation rights and interests of that person in that company remain unaltered; and
- no other consideration whatsoever passes directly or indirectly in consequence of that subdivision, consolidation or conversion.

The words 'subdivides or consolidates' refer to the situation in which a company substitutes a greater or lesser number of shares of one class for shares of the same class. They do not apply to a conversion of shares of one class into other classes, even if the totality of the rights and interests of the holder remain unchanged. This fact can be deduced from the ordinary meaning of 'subdivides or consolidates' as applied in commercial practice, which is supported by the wording of s 75(1)(i) of the Companies Act 61 of 1973 and from the use of the word 'converts' in relation to para 11(2)(i)(ii) and (iii). The latter subitems apply to a new type of share as opposed to one of the same type.

In some situations, the participation rights and interests of holders of shares may be varied by a share substitution contemplated in para 11(2)(i). Whether a reduction in rights will trigger a full or a part-disposal is a question of degree and will depend on the facts of the particular case. A part-disposal is more likely to be triggered when the loss of rights is limited and clearly identifiable. The compensation received by a holder of shares who has been adversely affected by such a substitution would usually comprise the proceeds for the disposal, although para 38 will substitute a market value consideration between connected persons if the consideration is not arm's length.

Paragraph 11(2)(i) does not stipulate how the details of previously held shares which have been subdivided or consolidated must be spread across the new number of replacement shares. Logically, the same basis that was followed in the now repealed para 78(2) should be followed. Under that basis the details of the old shares to be carried across to the new shares include

- any expenditure allowable under para 20,
- the date that expenditure was incurred,
- the date of acquisition, and
- any market value adopted or determined under para 29(4).

The aggregate expenditure or market value of the old shares should be allocated among the newly issued shares according to the relative market values of the new shares.

The carry-over of these details

- enables a person to use the time-apportionment base cost method when determining the valuation date value of pre-valuation date shares, and
- ensures that the kink tests in paras 26 and 27 can be applied to the new shares.

How must a consolidation of previously held shares acquired on different dates be dealt with? It is submitted that this problem can be addressed by splitting the proceeds on the disposal of the consolidated share between the previously held shares, performing separate time-apportionment calculations, and then combining the result.

Example 1 – Share split*Facts:*

ABC Ltd issued 10 new class A shares in exchange for the surrender of every 5 class A shares currently held by holders of its shares. The underlying rights and interests in the shares will remain unchanged and no holder will receive any additional consideration as a result of the subdivision.

Bob acquired 100 class A shares in ABC Ltd on 30 June 1990 at a cost of R500 000 which he continued to hold at the time of the share split.

Result:

There is no disposal when Bob surrenders his 100 class A shares in exchange for 200 class A shares in ABC Ltd. The 200 new class A shares are regarded as having been acquired at a cost of R500 000 on 30 June 1990.

Example 2 – Determination of time-apportionment base cost after consolidation*Facts:*

Lani acquired the following ordinary shares in Millbrew Ltd:

Date	No of shares	Cost R
1 July 1983	100	100
1 August 2000	100	150
1 June 2010	100	260

On 31 October 2019 Millbrew Ltd consolidated its issued share capital by issuing 1 new share for every 3 existing shares. On 31 December 2019 Lani sold her shares for R1 200. Determine Lani's capital gain or loss assuming that she adopts the time-apportionment base cost method.

Result:

Lani's 100 consolidated shares are made up of a mix of pre- and post-valuation date shares that were acquired on different dates at different costs. She received $R1\ 200 / 300 = R4$ a share in relation to her previously held shares. Therefore, her capital gain or loss is determined as follows:

Post-valuation date shares (acquired 1 June 2010)

Proceeds $100 \times R4$	R 400
Less: Base cost	(260)
Capital gain	<u>140</u>

Pre-valuation date shares

Shares bought on 1 July 1983

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R100 + [(R400 - R100) \times 19 / (19 + 19)] \\
 &= R100 + (R300 \times 19 / 38) \\
 &= R100 + R150 \\
 &= R250
 \end{aligned}$$

$$\begin{aligned}
 \text{Capital gain} &= R400 - R250 \\
 &= R150
 \end{aligned}$$

Shares bought on 1 August 2000

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R150 + [(R400 - R150) \times 2 / (2 + 19)] \\
 &= R150 + (R250 \times 2 / 21) \\
 &= R150 + R24 \text{ (rounded to nearest R1)} \\
 &= R174
 \end{aligned}$$

$$\begin{aligned}
 \text{Capital gain} &= R400 - R174 \\
 &= R226
 \end{aligned}$$

$$\text{Combined capital gain} = R140 + R150 + R226 = R516$$

Example 3 – Substitution of different classes of shares for pre-existing shares

Facts:

ABC (Pty) Ltd has an issued share capital of 100 ordinary shares of R1 each. Two holders of shares each own 50% of the shares. As a precursor to another transaction, the company cancelled the ordinary shares and issued 30 A class ordinary shares and 20 B class ordinary shares to each holder of shares. The company contains two discrete businesses, A and B. The class A shares entitle the holder of those shares to dividends out of the profits of business A while the class B shares entitle the holder of those shares to dividends out of the profits of business B.

Result:

The exchange of the pre-existing ordinary shares for class A and class B shares is a conversion and not a subdivision. Accordingly, para 11(2)(l) does not apply.

Exchange of one qualifying equity share for another under s 8B(2) [para 11(2)(m)]

Under s 8B(2) if a person disposes of a qualifying equity share in exchange solely for any other equity share in that person's employer or any company that is an associated institution as defined in the Seventh Schedule in relation to that employer, that other equity share acquired in exchange is deemed to be

- a qualifying equity share which was acquired by that person on the date of grant of the qualifying equity share disposed of in exchange; and
- acquired for a consideration equal to any consideration given for the qualifying equity share disposed of in exchange.

An exchange of qualifying equity shares under s 8B(2) as described above does not give rise to a disposal for CGT purposes and the dates of acquisition and expenditure of the previously held shares will simply be rolled over to the replacement shares.

Transfer of shares under a collateral arrangement [para 11(2)(n)]

There is no disposal by a transferor to a transferee or by a transferee to a transferor when any share has been transferred under a 'collateral arrangement'.

The term 'collateral arrangement' is defined in s 1(1) as follows:

‘ “[C]ollateral arrangement” means a collateral arrangement as defined in section 1 of the Securities Transfer Tax Act, 2007 (Act No. 25 of 2007);’

Under s 1 of the Securities Transfer Tax Act 25 of 2007 ‘collateral arrangement’ is defined as follows:

‘ “[C]ollateral arrangement” means any arrangement in terms of which—

- (a) a person (hereafter the transferor) transfers a listed share or any bond issued by the government of the Republic in the national or local sphere or any sphere of government of any country other than the Republic if that bond is listed on a recognised exchange as defined in paragraph 1 of the Eighth Schedule to the Income Tax Act to another person (hereafter the transferee) for the purposes of providing security in respect of an amount owed by the transferor to the transferee;
- (b) the transferor can demonstrate that the arrangement was not entered into for the purposes of the avoidance of tax and was not entered into for the purposes of keeping any position open for more than 24 months;
- (c) that transferee in return contractually agrees in writing to deliver an identical share, as defined in section 1 of the Income Tax Act, or any bond issued by the government of the Republic in the national or local sphere or any sphere of government of any country other than the Republic that is listed on a recognised exchange as defined in paragraph 1 of the Eighth Schedule to the Income Tax Act to that transferor within a period of 24 months from the date of transfer of that listed share or bond from the transferor to the transferee;
- (d) that transferee is contractually required to compensate that transferor for any distributions in respect of the listed share (or any other share that is substituted for that listed share in terms of an arrangement that is announced and released as a corporate action as contemplated in the JSE Limited Listings Requirements in the SENS (Stock Exchange News Service) as defined in the JSE Limited Listings Requirements) or a corporate action as contemplated in the listings requirements of any other exchange, licenced under the Financial Markets Act, that are substantially the same as the requirements prescribed by the JSE Limited Listings Requirements, where that corporate action complies with the applicable requirements of that exchange or any bond issued by the government of the Republic in the national or local sphere or any sphere of government of any country other than the Republic that is listed on a recognised exchange as defined in paragraph 1 of the Eighth Schedule to the Income Tax Act, which that transferor would have been entitled to receive during that period had that arrangement not been entered into; and
- (e) that arrangement does not affect the transferor’s benefits or risks arising from fluctuations in the market value of that listed share (or any other share that is substituted for that listed share in terms of an arrangement that is announced and released as a corporate action as contemplated in the JSE Limited Listings Requirements in the SENS (Stock Exchange News Service) as defined in the JSE Limited Listings Requirements) or a corporate action as contemplated in the listings requirements of any other exchange, licenced under the Financial Markets Act, that are substantially the same as the requirements prescribed by the JSE Limited Listings Requirements, where that corporate action complies with the applicable requirements of that exchange or any bond issued by the government of the Republic in the national or local sphere or any sphere of government of any country other than the Republic that is listed on a recognised exchange as defined in paragraph 1 of the Eighth Schedule to the Income Tax Act,

but does not include an arrangement where the transferee has not transferred the identical share or bond contemplated in paragraph (b) to the transferor within the period referred to in that paragraph unless such failure to return such identical share or bond is due to an arrangement that is announced and released as a corporate action as contemplated in the JSE Limited Listings Requirements in the SENS (Stock Exchange News Service) as defined in the JSE Limited Listings Requirements or a corporate action as contemplated in the listings requirements of any other exchange, licenced under the Financial Markets Act, that are substantially the same as the requirements prescribed by the JSE Limited Listings Requirements, where that corporate action complies with the applicable requirements of that exchange;

The term 'identical share' is defined in s 1(1) as follows:

‘ “[**I**]dentical share” means in respect of a share—

- (a) a share of the same class in the same company as that share; or
- (b) any other share that is substituted for a listed share in terms of an arrangement that is announced and released as a corporate action as contemplated in the JSE Limited Listings Requirements in the SENS (Stock Exchange News Service) as defined in the JSE Limited Listings Requirements or a corporate action as contemplated in the listings requirements of any other exchange, licensed under the Financial Markets Act, that are substantially the same as the requirements prescribed by the JSE Limited Listings Requirements, where that corporate action complies with the applicable requirements of that exchange;’

Paragraph 11(2)(n) was introduced on 1 January 2016 and applies to any collateral arrangement entered into on or after that date.

The rule was introduced as a result of the more stringent capital and liquidity requirements applicable to the financial sector (particularly banks and pension funds). Collateral can be given by pledge (no change in beneficial ownership and no CGT consequences) or by out-and-out cession [CGT consequences in the absence of para 11(2)(n)]. The out-and-out cession of shares facilitates compliance with the capital and liquidity requirements and has thus been made a non-disposal event.

Cancellation of agreement during the same year of assessment [para 11(2)(o)]

Under para 11(2)(o) there is no disposal when an agreement is cancelled or terminated during the same year of assessment in which the disposal occurred if

- the seller reacquires the asset; and
- both persons are restored to the position they were in before entering into the agreement.

Example – Cancellation of agreement during the same year of assessment

Facts:

In March of year 1 Brian disposed of an asset having a base cost of R20 to Bernard on credit for R100. In December of that year Brian and Bernard agreed to cancel the contract. Under the cancellation agreement Bernard returned the asset to Brian and his indebtedness of R100 to Brian fell away.

Result:

Under para 11(2)(o) Brian is treated as not having disposed of the asset to Bernard. The capital gain of R80 (R100 proceeds less R20 base cost) therefore does not arise. Going forward the base cost of Brian's asset remains R20.

Since Brian is treated as not having disposed of the asset, Bernard is treated as not having acquired it and will consequently also be unaffected by the transaction for CGT purposes.

6.1.3 Non-disposals not mentioned in the Eighth Schedule

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

6.1.3.1 Changes in appointment of executors, curators and administrators

Paragraph 11(2)(f) used to deal with this topic but it was deleted because it was considered unnecessary.

Assets held by trustees, executors, curators and administrators are not held for their own benefit. The view is held that changes in appointments do not result in the disposal of the underlying assets which are held on behalf of vested or contingent beneficiaries, heirs, legatees, and the like. A payment of an amount to a trustee to resign from his or her office and to agree to the appointment of a new trustee is likely to fall within the ambit of para (d) of the definition of 'gross income' or alternatively be a payment for the disposal of an asset.²²³

6.1.3.2 Conversion of close corporation or co-operative to company under ss 40A and 40B

If a close corporation converts to a company, the two entities are treated as one and the same company for the purposes of the Act.²²⁴ Schedule 2 of the Companies Act, 2008 similarly provides that all the assets, liabilities, rights and obligations of a close corporation that has converted to a company vest in the company.

If a co-operative is incorporated as a company under s 62 of the Co-operatives Act 14 of 2005, the co-operative and the company are deemed to be one and the same company for the purposes of the Act.²²⁵ The same treatment applies to an incorporation of a co-operative that occurred under s 161A or 161C of the now repealed Co-operatives Act 91 of 1981.

Conversions of this nature will therefore not trigger CGT in the entities concerned. A conversion under s 40A or 40B is tax neutral in the hands of the shareholder under para 11(2)(f)(iii).

6.1.3.3 Amalgamation of co-operatives

Section 27(5B)

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

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

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

- Any admissible para 20 expenditure.
- The dates of acquisition and incurral of that expenditure.
- Any valuation determined by the previous co-operative under para 29(4).

²²³ ITC 746 (1952) 18 SATC 312 (C).

²²⁴ Section 40A.

²²⁵ Section 40B.

- Any assessed loss or assessed capital loss.

The roll-over relief provided by s 27(5B) does not extend to shareholder level. Fortunately, the shares in a co-operative tend to have a nominal value (see notes on para 31 in **8.35**).

The Co-operatives Act, 1981 was repealed by s 98 of the Co-operatives Act 14 of 2005. A co-operative is a company as defined in s 1(1).²²⁶ However, it is excluded from the definition of 'group of companies' in s 41(1) which restricts the circumstances in which a co-operative can make use of the corporate restructuring rules in ss 41 to 47. In addition, in an amalgamation transaction s 44(14) provides that a resultant company may not be a co-operative.

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

The consolidation or subdivision of land will not in itself give rise to a disposal or part-disposal, since the owner retains all rights in the land. With a subdivision it will be necessary to allocate the base cost among the subdivided parts on some logical and reasonable basis, for example, by using the proportions based on the relative market values of the subdivided parts at the time of the subdivision. Paragraph 33 will not apply at the time of the subdivision, since that provision requires a part-disposal.

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

Example 1 – Subdivision of land

Facts:

On 1 March of year 1 Bob acquired a piece of land at a cost of R100 000. During year 6 he erected a wall around the property at a cost of R300 000 and two houses on the property at a cost of R2,4 million and R1,8 million respectively. On 28 February of year 10 he subdivided the property with the intention of disposing of one-half of the property together with the house that cost R1,8 million at a future date.

Result:

The expenditure on the subdivided parts may be determined as follows:

Portion containing house costing R2,4 million

	R
Land R100 000 × 1 / 2	50 000
Boundary wall R300 000 × 1 / 2	150 000
House	<u>2 400 000</u>
	<u>2 600 000</u>

Portion containing house costing R1,8 million

²²⁶ Paragraph (c) of the definition of 'company' in s 1(1).

Land R100 000 × 1 / 2	50 000
Boundary wall R300 000 × 1 / 2	150 000
House	<u>1 800 000</u>
	<u>2 000 000</u>

Note: Had the cost of the individual houses not been known, it could have been determined by valuing both houses and then apportioning the total cost with reference to the respective market values. The facts and circumstances of each case must be taken into account in determining an appropriate method of apportionment.

When pre- and post-valuation date land is consolidated and the consolidated land is later disposed of, the base cost of the consolidated land must be determined by treating the pre-valuation date and post-valuation date portions as separate assets. For this purpose, it will be necessary to allocate the proceeds across the various pieces of land according to the relative market values of each part in order to determine the valuation date values of the pre-valuation date portions.

The same approach must be followed when multiple pieces of land which were acquired before valuation date are consolidated. In other words, the selling price must be allocated across the various pieces of land before consolidation on the basis of their current market values and the capital gain or loss on disposal of each piece must be determined separately as if it were a separate asset.

Example 2 – Consolidation of pre- and post-valuation date land

Facts:

On 1 March 1983 Pieter acquired land at a cost of R100 000. On 30 June 2009 he acquired an adjacent piece of land at a cost of R500 000. On 30 September 2019 he had the two pieces of land consolidated under a single title deed. On 29 February 2020 he sold the consolidated land for R3 million. The market values of the pre-valuation and post-valuation date portions were R1 million and R2 million respectively. Pieter did not determine a market valuation for the pre-valuation date portion by 30 September 2004 under para 29(4). Assume that the sale of the land was on capital account.

Result:

Disposal of pre-valuation date portion

	R
Proceeds	1 000 000
Less: Base cost (see below)	<u>(550 000)</u>
Capital gain	<u>450 000</u>

The time-apportionment base cost of the asset is determined as follows:

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R100\,000 + [R1\,000\,000 - R100\,000] \times 19 / 38 \\
 &= R550\,000
 \end{aligned}$$

The '20% of proceeds' method gives a base cost of R1 million × 20% = R200 000 and it is therefore assumed that Pieter will adopt the time-apportionment base cost method.

Disposal of post-valuation date portion

	R
Proceeds	2 000 000
Less: Base cost [para 20(1)(a)]	<u>(500 000)</u>
Capital gain	<u>1 500 000</u>

The combined capital gain is thus R450 000 + R1 500 000 = R1 950 000.

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

This rule is in s 26 of the Taxation Laws Amendment Act 9 of 2005 and was deemed to have come into operation on 1 July 2005.²²⁷ It is aimed at enabling non-proprietary exchanges such as the former JSE Securities Exchange SA (now JSE Ltd)²²⁸ and the Bond Exchange of South Africa, to convert to companies without adverse tax consequences for their members. Under a conversion of this nature, the rights previously held and the shares acquired in the company are deemed to be one and the same asset for the purposes of the Act. This 'one and the same asset' treatment has the effect of a roll-over for CGT purposes.

The roll-over applies when

- a person acquires shares in a company that has assumed all the functions of a non-proprietary exchange;
- that exchange was exempt from tax under s 10(1)(d) before 1 July 2005; and
- the shares are issued by 1 January 2008²²⁹ in exchange for any right in the non-proprietary exchange before the conversion.

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

Some unit portfolios split their portfolios into different classes.²³⁰ The purpose of this administrative arrangement is to enable the fund manager to charge different management fees for each class. The investors in the various classes, however, have an equal undivided share per unit in the fund assets and income. In these circumstances the switch by an investor from one class to another within the same portfolio is not regarded as a disposal.

²²⁷ As per s 26A of the Taxation Laws Amendment Act 9 of 2005 which was inserted by s 97(b) of the Revenue Laws Amendment Act 20 of 2006.

²²⁸ The JSE Securities Exchange South Africa was incorporated as a public company on 1 July 2005.

²²⁹ The date was changed from 1 January 2007 to 1 January 2008 by s 97(a) of the Revenue Laws Amendment Act 20 of 2006.

²³⁰ In the late 1990's fees were deregulated, resulting in different fee classes. The Regulated Fee Class (R Class) applies to investors at the time of deregulation who have a right not to be charged more than 1% + VAT unless they agreed to pay more. Investors in other classes can be charged whatever fee they agree to pay (for example, a flat fee or one based on performance).

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

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

Result:

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

6.1.3.7 Appointment of new contingent beneficiaries by a discretionary trust

The appointment of new contingent beneficiaries by the trustee of a discretionary trust will not normally give rise to a disposal by the trust or the beneficiaries. The trust continues to hold the trust assets until the time of vesting. An existing beneficiary will continue to hold a mere *spes*. While it could be argued that the value of an existing beneficiary's contingent right could be diluted by the introduction of new beneficiaries, this is by no means certain and would be known only when the assets of the trust are finally vested in the beneficiaries. At the time of appointment of a new beneficiary it would not be possible to quantify the dilution. Accordingly, the appointment of a new contingent beneficiary is unlikely to give rise to a 'value shifting arrangement'. However, in some cases the appointment of new contingent beneficiaries can result in a complete change in the purpose for which the trust was formed. In such a situation a new trust comes into existence, and the old trust ceases to exist.²³¹ The creation of the new trust will result in a disposal of the assets from the old trust to the new trust, and in this regard para 38 must be considered. There are also likely to be simultaneous tax consequences for the old beneficiaries or trustees, particularly if they relinquish their rights in exchange for consideration. Provisions to bear in mind include para (d) of the definition of 'gross income' (relevant to a trustee relinquishing his or her office) and para 81 which stipulates that the base cost of a beneficiary's interest in a discretionary trust is nil.

6.1.3.8 Repudiation of inheritance

In *Wessels NO v De Jager & another NNO*²³² an insolvent and his wife had been married out of community of property. After his sequestration but before his rehabilitation his wife had taken out a policy on her life, nominating the insolvent as the beneficiary. Subsequently the insolvent's wife died intestate. The insolvent refused to accept the benefits of the policy and also renounced his inheritance as intestate heir. The issue was whether the right to accept the policy proceeds vested in his trustee. The court held that the insolvent did not acquire a right to the policy proceeds until he accepted the offer arising from the contract between his wife and the insurer. Regarding the inheritance, the court stated that only the competence of acquiring the inheritance had accrued to the insolvent. The right to acquire the inheritance

²³¹ ITC 1828 (2007) 70 SATC 91 (G).

²³² 2000 (4) SA 924 (SCA).

would accrue to him only if he accepted the benefit. As a result, the insolvent acquired no right to property which vested in his trustee.

In *Crookes NO & another v Watson & others*²³³ Van den Heever JA stated the following on the need for adiation:

'The oft-repeated saying that a legatee does not acquire a legacy unless he accepts it, misplaces the stress; it would be more correct to say that he acquires a right to the subject-matter of the bequest unless he repudiates it.'

The right to the subject matter referred to by Van den Heever JA is a contingent right, and the heir or legatee therefore does not have any *dominium* in the asset concerned before the liquidation and distribution account becomes final.²³⁴

Based on the above principles, it is accepted that the repudiation of an inheritance will not give rise to the disposal of an 'asset' for CGT purposes.²³⁵

6.1.3.9 Listing of a company

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

6.1.3.10 Transfer of listed shares from one securities exchange to another

The transfer of shares listed on one securities exchange to another should not give rise to a disposal because the bundle of rights making up the shares remains unchanged. This principle would be relevant to a shareholder who transfers shares listed on the *JSE* to, say, the *NYSE*.

6.1.3.11 Nominee shareholders

There is no disposal of an asset when shares are transferred from a nominee to the beneficial owner of a share or from one nominee to another. The same applies when the management of a share portfolio on behalf of a client is transferred to a new portfolio manager, since the managers are merely acting in a fiduciary capacity and do not have any beneficial interest in the shares. The Act is as a rule not concerned with amounts received by persons in a nominee capacity, but with beneficial entitlement. See, for example, *Geldenhuis v CIR*²³⁶ in which the court held in the context of the definition of 'gross income' that the word 'received' meant 'received by the taxpayer on his own behalf for his own benefit'. See too *Taxpayer v COT Botswana*²³⁷ when the court refused to impose tax on directors' fees paid to a director who had ceded them in advance to his employer.

In *SIR v Smart*²³⁸ the respondent, who was a registered shareholder and director of the M company, sold his shares to P and at the same time ceded his right to claim certain future payments from the M company to P. Under the company's articles of association, the consent of all the other shareholders was required to approve the sale of the shares. The other shareholders of the M company refused to recognise the sale of the shares to P and as a

²³³ 1956 (1) SA 277 (A) at 298.

²³⁴ ITC 816(1955) 20 SATC 496 (T).

²³⁵ See 'Renunciation and Adiation on Inheritances; Insolvency of Beneficiary' (October 2002) 51 *The Taxpayer* 181 at 184.

²³⁶ 1947 (3) SA 256 (C), 14 SATC 419 at 430.

²³⁷ (1980) 43 SATC 118.

²³⁸ 1973 (1) SA 754 (A), 35 SATC 1.

result the M company continued to pay the amounts to Smart as a registered shareholder. Smart did not pay these amounts to P but applied them in reduction of the purchase price of the shares owed to him by P. The Secretary for Inland Revenue taxed Smart on the amounts paid to him by the M company as remuneration even though Smart had already ceded them to P. Smart lodged objection and appeal against the assessments. The Special Court found in Smart's favour, holding that the amounts were in the nature of a return on investment on the shares and not remuneration. The court also confirmed that Smart had ceded the amounts to P before they had accrued to him and they accordingly accrued to P. The Appellate Division dismissed the Secretary's appeal against the decision of the Special Court and confirmed its findings.

6.1.3.12 Conversion of private company to public company

Does the conversion of a private company to a public company result in a disposal of the company's shares by its shareholders? Provided that none of the rights comprising the bundle of rights making up the company's shares is extinguished or otherwise disposed of (for example, by a substantive change in the nature of the rights), the conversion should not result in a disposal or part-disposal of the company's shares by its shareholders. If anything, the bundle of rights may be enhanced by the acquisition of a right to unrestricted transfer of the company's shares. But the reverse situation (conversion of public company to private company) may well result in a disposal or part-disposal of the company's shares because the shareholders would be surrendering the right to freely market their shares. Whether such a disposal or part-disposal will result in a capital gain or loss will depend on the facts of the particular case. Under s 8(2)(b) of the Companies Act the memorandum of incorporation of a profit company that is a private company must prohibit it from offering any of its securities to the public and restrict the transferability of its shares.

In particular, it will have to be determined whether the loss of the right to freely market the shares has resulted in a decrease in the market value of the shares, since this will be relevant in applying para 33(1). In BCR 033²³⁹ a public company having two equal shareholders converted to a private company. It was ruled that there was a part-disposal, but that no capital gain or loss arose under para 33(1).

6.1.3.13 Assets acquired by heirs or legatees

An heir or legatee who has not repudiated an inheritance acquires certain personal rights against the executor of a deceased estate for no consideration such as the right to claim delivery of an inherited asset when the liquidation and distribution account becomes final. Such a right would be disposed of by extinction when the asset is distributed to the heir or legatee. The question then arises whether this disposal gives rise to proceeds equal to the market value of the asset received and hence a capital gain. The Eighth Schedule does not contain a specific non-disposal rule for the acquisition of an inherited asset. Under s 25(3)(b) the heir or legatee is treated as having acquired the inherited asset for an amount of expenditure equal to the expenditure of the asset to the deceased estate. Had the normal barter or exchange principles applied, the asset would be acquired for an amount equal to the market value of the personal right that was extinguished (see **8.5A**). It can therefore be inferred that the legislature intended that any exchange of personal rights for an inherited asset should be disregarded and that a capital gain or loss will not arise in the hands of an heir or legatee upon acquisition of the inherited asset.

6.1.3.14 Shares acquired for no consideration

Upon approval by the board of directors of the issue of capitalisation shares under s 47 of the Companies Act, a shareholder acquires a personal right against the company for delivery of

²³⁹ BCR 033 dated 14 March 2012 'Conversion of a Public Company to a Private Company'.

the shares at a future date. When the shares are issued, the personal right is extinguished in exchange for the shares. The question arises whether this disposal will trigger proceeds equal to market value, thus resulting in a capital gain at the time of acquisition of the shares. Had barter or exchange principles applied, the shares would be acquired for an amount equal to the market value of the personal right given up (see 8.5). However, s 40C modifies this position by providing that shares issued to a person for no consideration are deemed to be acquired for an expenditure of nil. It is implicit in this treatment that the exchange of rights preceding the acquisition of the shares must be disregarded. There is also a necessary implication against double taxation in the Act and if a capital gain were to arise on acquisition of a capitalisation share, double taxation would result when the share is ultimately disposed of. For these reasons it is considered that the exchange of personal rights as described above must be disregarded, thus avoiding any capital gain on acquisition of capitalisation shares.

6.1.3.15 Deregistration and reinstatement of a company

Deregistration puts an end to the existence of a company. It brings an end to its corporate personality 'in the same way that a natural person ceases to exist at death'.²⁴⁰ All subsequent actions purportedly taken on behalf of the deregistered company are consequently void and of no effect. Its property passes automatically – that is, without any form of delivery – into the ownership of the state as *bona vacantia*.²⁴¹

In *Newlands Surgical Clinic (Pty) Ltd v Peninsula Eye Clinic (Pty) Ltd*²⁴² the court held that reinstatement of a deregistered company under s 82(4) of the Companies Act 71 of 2008 had complete and automatic retrospective effect to the date of deregistration, not only in revesting the company with its property but also in validating its corporate activities during the period of its deregistration. A party prejudiced by such reinstatement could seek relief under s 83(4) of that Act.

For CGT purposes, the effect of reinstatement of a deregistered company is to nullify retrospectively the disposal of the company's assets to the state and their subsequent repatriation to the company.

Example – Effect of deregistration and re-registration of a company

Facts:

During April 2017 Company A was deregistered by CIPC as a result of failing to submit annual returns for more than two successive years. At the time it owned an office block which it had acquired in 2008 at a cost of R5 million. The market value of the building at the time of deregistration was R10 million. In October 2019 the company's auditors discovered that it had been deregistered and the company requested reinstatement under s 82(4) of the Companies Act. On 17 February 2020 the company's registration was restored. The market value of the property at the time of reinstatement was R12 million.

Result:

Since Company A's reinstatement takes place with retrospective effect, there is no disposal of its assets at the time of deregistration, nor does it reacquire its assets at the time of reinstatement.

²⁴⁰ *Miller & others v Nafcoc Investment Holding Co Ltd & others* 2010 (6) SA 390 (SCA) at 395.

²⁴¹ *Rainbow Diamonds (Edms) Bpk & andere v Suid-Afrikaanse Nasionale Lewensassuransiematskappy* 1984 (3) SA 1 (A) at 1011. The term *bona vacantia* means 'vacant goods', that is, ownerless property.

²⁴² 2015 (4) SA 34 (SCA).

6.1.3.16 Liquidation and reinstatement of a company that has been dissolved

The Companies Act 61 of 1973 was repealed by the Companies Act 71 of 2008 subject to the transitional arrangements set out in Schedule 5 to the 2008 Act. Item 9(1) of Schedule 5 provides that Chapter 14 of the 1973 Act continues to apply to the winding-up and liquidation of companies, as if not repealed, until a date to be determined. Chapter 14 comprises ss 337 to 426. Section 339 of the Act provides for the application of the laws relating to insolvency in the winding-up of a company that is unable to pay its debts. Section 420 provides as follows:

'When a company has been dissolved, the Court may at any time on an application by the liquidator of the company, or by any other person who appears to the Court to have an interest, make an order, upon such terms as the Court thinks fit, declaring the dissolution to have been void, and thereupon any proceedings may be taken against the company as might have been taken if the company had not been dissolved.'

In *De Villiers & others v GJN Trust & others* the court contrasted the position of a dissolved company and a deregistered company when it stated the following:²⁴³

'[14] The effect of an order under s 420 is to revive the company and to restore the position that existed immediately prior to its dissolution. Thus, the company is recreated as a company in liquidation, with the rights and obligations that existed upon its dissolution. Property of the company that passed to the state as *bona vacantia* is automatically revested in the company by operation of law. An order under s 420 is only retrospective in this sense and does not validate any corporate activity of the company which may have taken place during the period of its dissolution. The effect of an order in terms of s 420 must therefore be contrasted with the effect of the reinstatement of a company in terms of s 82(4) of the new Act after its deregistration by the Companies and Intellectual Property Commission in terms of s 82(3) thereof. See *Newlands Surgical Clinic (Pty) Ltd v Peninsula Eye Clinic (Pty) Ltd* 2015 (4) SA 34 (SCA) ([2015] ZASCA 25). The abovementioned principles appear from *Henochsberg* above [11] at 900(1) – 902; and Blackman *et al Commentary on the Companies Act* vol 3 at 14 – 506 to 14 – 507. See also *Pieterse v Kramer* 1977 (1) SA 589 (A) at 600 – 601. The findings of the court *quo*, that the aim of s 420 is to set aside the entire liquidation process of a corporation for purposes of commencing the liquidation anew, were therefore clearly wrong. The steps taken during the prior liquidation, up to the time of dissolution, stand.'

The court noted that further assets of the company recovered by the liquidators must be dealt with in a further liquidation and distribution account under s 403, while s 44(1) of the Insolvency Act provided for late proof of claims.

The effect of reinstating the dissolved company would be to retrospectively restore it with ownership of any hidden assets previously forfeited to the state, thus preventing the original disposal to the state.

6.2 Events treated as disposals and acquisitions

Paragraph 12

6.2.1 Disposal and reacquisition [para 12(1)]

Paragraph 12 deals with a number of events that are treated as disposals for the purposes of the Eighth Schedule. If an event described in para 12(2) occurs, the person will be treated as having

- disposed of the asset for an amount received or accrued equal to the market value of the asset at the time of the relevant event, and

²⁴³ 2019 (1) SA 120 (SCA) at 125.

- to have immediately reacquired the asset for an expenditure actually incurred for the purposes of para 20(1)(a) equal to that market value.

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

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

The deemed disposal and reacquisition rule in para 12(1) is subject to para 24.²⁴⁴ Paragraph 24 contains special 'kink tests' which, when applicable, have the effect of substituting a different value for the market value base cost established under para 12(1) or (4) in order to prevent 'phantom' losses.

Under para 13(1)(g)(i) the time of the events in para 12(2)(a), (b), (c), (d) or (e), 12(3) or 12(4) is the date immediately before the day that the event occurs. Paragraph 13(1)(g)(ii) provides that in the case of transfers between the five funds of an insurer, which are a deemed disposal under para 12(2)(f), the time of disposal is the date that the event occurs.

²⁴⁴ These conditions were inserted by s 50(1)(a) of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation on 21 February 2008 and apply in respect of an asset disposed of on or after that date, unless that disposal is the subject of an application for an advance tax ruling accepted by the Commissioner before that date.

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

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

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

Paragraph 12(2)	Event treated as disposal	Comment
(a)(i) and (ii)	<p>A person</p> <ul style="list-style-type: none"> • commences to be a resident; or • that is a foreign company commences to be a CFC. <p>This rule applies to all assets, except</p> <ul style="list-style-type: none"> • immovable property situated in South Africa held by that person or any interest or right of whatever nature of that person to or in immovable property situated in South Africa including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources [para 2(1)(b)(i)]; • any asset effectively connected with a permanent establishment of that person in South Africa [para 2(1)(b)(ii)]; • any right to acquire any marketable security contemplated in s 8A. 	<p>The term 'resident' is defined in s 1(1). <i>Individuals</i> commence to be resident when they</p> <ul style="list-style-type: none"> • become ordinarily resident, or • are not ordinarily resident, but are physically present in South Africa for the number of days specified in the definition of 'resident'. <p><i>Companies and trusts</i> commence to be resident when</p> <ul style="list-style-type: none"> • they are incorporated, established or formed in South Africa; or • their place of effective management changes to South Africa. <p>A person can also become a resident when a tax treaty deems that person to be exclusively a resident of South Africa.</p>
(b)	<p>An asset of a person who is not a resident that</p> <ul style="list-style-type: none"> • becomes an asset of the person's permanent establishment in South Africa other than by acquisition, or • ceases to be an asset of the person's permanent establishment in South Africa otherwise than by a disposal under para 11. 	<p>For example, a person's asset in another country is brought to South Africa for use in the permanent establishment.</p> <p>For example, the person withdraws the asset from the permanent establishment for personal or other use.</p>

Paragraph 12(2)	Event treated as disposal	Comment
(c)	Non-trading stock that becomes trading stock. ²⁴⁵	Under s 22(3)(a)(ii) the person will be treated as having acquired the trading stock at market value for ordinary income tax purposes. For CGT purposes the person is treated as having disposed of the asset at market value which brings symmetry to the transaction. For allowance assets a recoupment of capital allowances is triggered under s 8(4)(k)(iv), which will have the effect of decreasing the deemed proceeds under para 12(1) by virtue of para 35(3)(a). ²⁴⁶
(d)	A personal-use asset that becomes a non-personal-use asset (excludes disposals under para 11)	For example, a personal-use asset that becomes a capital asset used in a person's trade.
(e)	A non-personal-use asset that becomes a personal-use asset.	For example, a capital asset used in a person's trade that becomes a personal-use asset.
(f)	An asset transferred by an insurer from one fund to another under s 29A(4).	The activities of insurers are treated as being conducted in five separate funds for income tax purposes. Transfers of assets by insurers between these funds are treated as disposals at market value.

The case of *C: SARS v Tradehold Ltd*²⁴⁷ involved the application of the exit charge previously in para 12(2)(a) which applied when a person ceased to be a resident. With effect from 1 April 2012 the exit charge was moved to s 9H.

Tradehold's year of assessment ended on 28 February 2003. The company was an investment holding company, incorporated in South Africa, with its registered office at 36 Stellenberg Road, Parow Industria, and was listed on the JSE. During the 2003 year of assessment Tradehold's only relevant asset was its 100% shareholding in Tradegro Holdings which, in turn, owned 100% of the shares in Tradegro Limited, a company incorporated in Guernsey which owned approximately 65 per cent of the issued share capital in the United Kingdom-based company, Brown & Jackson plc.

On 2 July 2002, at a meeting of Tradehold's board of directors in Luxembourg, it was resolved that all further board meetings would be held in that country. This resolution had the effect that, as from 2 July 2002, Tradehold became effectively managed in Luxembourg. Under the tax treaty Tradehold became exclusively a resident of Luxembourg and thus ceased to be a resident of South Africa.

²⁴⁵ See, for example, *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A), 37 SATC 193.

²⁴⁶ Effective in respect of transactions on or after 15 January 2020.

²⁴⁷ 2013 (4) SA 184 (SCA), 74 SATC 263.

After the change of effective management one of Tradehold's directors remained in South Africa until 29 January 2003. It was contended by Tradehold that the office maintained by this director constituted a permanent establishment to which the shares in Tradehold Holdings were attributable, but this point was disputed by SARS and no finding was made on the issue by either the tax court or SCA.

On 26 February 2003 the definition of 'resident' in s 1 was amended to include the words

'but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation'.

As a result of the change of residence on 2 July 2002 (when the change in the place of effective management occurred) or 26 February 2003 (when the definition of resident in section 1 was amended) SARS deemed Tradehold to have disposed of all its shares at market value in Tradehold Holdings under para 12(1) read with para 12(2)(a), giving rise to a capital gain of R405 039 083. Tradehold's objection to the assessment having been disallowed, it appealed to the Tax Court. The tax court in ITC 1848²⁴⁸ found in favour of Tradehold. SARS then appealed to the SCA which upheld the decision of the tax court.

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

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

In the tax court Griesel J held that under article 13(4) of the tax treaty Tradehold was taxable only in the contracting state of which it was a resident. Since it was exclusively a resident of Luxembourg on or after 2 July 2002, the court held that SARS was unable to tax the capital gain. The judgment makes no mention of the time of disposal rule in para 13(1)(g)(i) which deemed the date of disposal to be the date immediately before the day on which Tradehold ceased to be a resident. The significance of this point is that on 1 July 2002 Tradehold was effectively managed in South Africa and hence fell outside the tax treaty.

In the SCA, Counsel for SARS's principal submission was that the word 'alienation' as used in article 13(4) did not include a deemed disposal under paragraph 12(1). The implications of para 13(1)(g)(i) were once again not argued before the court.

The SCA dismissed SARS's argument that the word 'alienation' as used in article 13(4) did not include a deemed disposal.

On the overriding effect of a tax treaty the court stated the following:

'Double tax agreements effectively allocate taxing rights between the contracting states where broadly similar taxes are involved in both countries. They achieve the objective of s 108, generally, by stating in which contracting state taxes of a particular kind may be levied or that such taxes shall be taxable only in a particular contracting state or, in some cases, by stating that a particular contracting state may not impose the tax in specified circumstances. A double tax agreement thus modifies the domestic law and will apply in preference to the domestic law to the extent that there is any conflict.'

Boruchowitz AJA concluded as follows:

'Consequently, Art 13(4) of the DTA applies to capital gains that arise from both actual and deemed alienations or disposals of property. It follows therefore that from 2 July 2002, when Tradehold relocated its seat of effective management to Luxembourg, the provisions of the DTA became applicable and that country had exclusive taxing rights in respect of all of Tradehold's capital gains. This conclusion renders it unnecessary to deal with the Commissioner's other contentions.'

²⁴⁸ (2010) 73 SATC 170 (C).

The SCA made no mention of para 13(1)(g)(i) in its judgment nor did it make any finding on whether Tradehold continued to maintain a permanent establishment in South Africa.

SARS accepts the SCA's finding that the word 'alienation' includes a deemed disposal. Importantly, however, the question of the time of disposal under para 13(1)(g)(i) which was the crux of the matter was not argued before the SCA and neither the tax court nor SCA made any finding on the point. The Tradehold case is therefore no authority for the view that SARS is unable to impose an exit charge when a company ceases to be a resident.

The validity of similar exit charges has been considered and upheld in a number of foreign jurisdictions.

In *Holbrook R Davis v Her Majesty. The Queen*,²⁴⁹ the Canadian Federal Court of Appeal had to decide whether an exit charge was contrary to the tax treaty with the United States. The appellant, Davis, ceased to be a resident of Canada on 31 December 1972. Under subsection 48(1) of the Canadian Federal Income Tax Act as amended in 1973 he was deemed to have disposed of his property immediately before ceasing to be a resident. The court held that the tax treaty did not apply because the capital gains were deemed to have been made while he was a resident in Canada and not after he became a resident of the United States. On the question of the retrospective amendment to the legislation the court found that the appellant did not have the right to be protected against a retroactive change in the legislation. The appellant's appeal was dismissed.

The validity of exit taxes has also been considered in a number of European court cases some of which have gone in favour of the taxpayer on the basis that the exit charge undermines the principle of freedom of movement within the European Union.²⁵⁰ Since the latter principle is inapplicable in a South African context, these cases cannot be taken as supporting the view that an exit charge is contrary to general tax treaty principles. In fact, the European Court of Justice has not ruled that an exit tax cannot be levied. Rather it has indicated that it must be implemented in such a way that it does not inhibit freedom of movement within the EU. A decision of the Netherlands Supreme Court in the so-called 'N' case found in favour of the imposition of the Dutch exit tax on unrealised capital gains by an individual who ceased to be resident in the Netherlands.²⁵¹ On 22 January 1997, N transferred his residence from the Netherlands to the United Kingdom. At the time he left the Netherlands, he was the sole shareholder of three limited liability Netherlands companies the management of which was moved to the Netherlands Antilles after that date. Under the Netherlands income tax legislation N was regarded as a 'substantial shareholder' because he held more than 5% of the companies' shares and as a result fell within the ambit of the exit charge.

²⁴⁹ 80 DTC 6056 (1980), [1980] 2 FC 250, 1980 FC LEXIS 465.

²⁵⁰ *de Lasteyrie du Saillant* Case C-9/02 [2004] ECR I-2409. Article 49 of the Treaty for the Functioning of the European Union (TFEU) deals with freedom of establishment within the European Union.

²⁵¹ *N* Case 07/12314, 20 February 2009 (Hoge Raad).

For the 1997 tax year the Dutch tax authorities issued a so-called ‘preserving assessment’ in which they imposed the exit charge on N’s substantial shareholding with the proceeds being equal to the market value of the shares at the time of exit. N applied for a deferral of the tax charge under the relevant tax legislation under which the tax would be payable when the shares were subsequently actually disposed of. Under the relevant law N was required to provide security for the tax. The European Court of Justice (ECJ) held that the Netherlands could impose its exit tax but was not permitted to call for security and it also had to take account of any decline in value which may arise on a later actual disposal of the shares. The ECJ held that the problem of security could not be resolved by merely lifting the security but could be resolved by a claim for damages.²⁵² Following on the ECJ decision the Netherlands Supreme Court confirmed that the Netherlands system of issuing preserving assessments was in accordance with European Community law but held that the demanding of security and the failure to take into account a subsequent decrease in value in the shares was not. The court found that the exit charge was in accordance with the principle of territoriality combined with a temporal component, namely, the residence on a territory during which the taxable profit arises. The exit tax was a matter of public interest. In addition, the exit charge was not contrary to the ‘good faith’ principle under the tax treaty and the Vienna Convention. The court noted that the issue of a preserving assessment may make a change in residence less attractive but it is not disproportionate to the legitimate objective of allocating taxing rights between member states in order to avoid double taxation.

More recently, the ECJ considered the validity of a Dutch exit charge in the case of *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond / kantoor Rotterdam*.²⁵³ Unlike the *N* case which involved an individual, this case involved a company. The facts were that National Grid Indus was incorporated in the Netherlands and up until 15 December 2000 was effectively managed in that country. Since 10 June 1996 the company was owed an amount that was denominated in British pound sterling by a United Kingdom company. On 15 December 2000 there was an unrealised currency gain on this loan. On the same date the company transferred its place of effective management to the United Kingdom after which the United Kingdom had an exclusive right to tax the company’s profits under the Netherlands – United Kingdom tax treaty. The company did not retain a permanent establishment in the Netherlands. The Dutch tax authorities subjected the unrealised currency gain to tax. At issue was whether the Netherlands was entitled to impose the exit tax under the equivalent of article 49 of the Treaty for the Functioning of the European Union (the freedom of establishment article). The ECJ held that article 49 did not preclude the imposition of an exit tax on unrealised capital gains and stated that no account need be taken of a subsequent decline in value of the assets or the fact that they may realise a lower value. However, article 49 precluded the immediate collection of the tax.

On the question of preserving the Netherlands’ taxing rights the court noted that it was permissible to restrict the freedom of establishment if it is justified by overriding reasons in the public interest. It also noted that it was a legitimate objective to preserve the powers of allocation of taxation between the Member States. It stated that the ECJ had previously held that, in accordance with the principle of fiscal territoriality linked to a temporal component, namely the taxpayer’s residence for tax purposes within national territory during the period in which the capital gains arise, a Member State is entitled to charge tax on those gains at the time when the taxpayer leaves the country. Such a measure is intended to prevent situations capable of jeopardising the right of the Member State of origin to exercise its powers of taxation in relation to activities carried on in its territory, and may therefore be justified on grounds

²⁵² *N v Inspecteur van de Belastingdienst Oost/kantoor Almelo Case C-470/04 [2006] ECR I-740.*

²⁵³ *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond / kantoor Rotterdam Case C-371/10 (29 November 2011)*, available at <<http://curia.europa.eu/juris/document/document.jsf?docid=115461&doclang=EN&mode=&part=1>> [Accessed 2 November 2020].

connected with the preservation of the allocation of powers of taxation between the Member States.

Some commentators have suggested that it is unconstitutional to impose an exit charge on the grounds that it infringes a person's rights under the Bill of Rights in Chapter 2 of the Constitution of the Republic of South Africa, 1996 [sections 18 (freedom of association), 21 (freedom of movement and residence) and 22 (freedom of trade, occupation and profession)]. However, under s 36 of the Constitution the rights in the Bill of Rights may be limited by a law of general application to the extent that the limitation is reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom.²⁵⁴ The imposition of an exit charge protects the tax base and is therefore in the wider public interest. Were South Africa not to impose an exit charge on movable property not forming part of a permanent establishment when a taxpayer ceases to be a resident it would be very difficult for SARS to collect the tax due when the assets concerned are actually disposed of. Exit charges are common in many open and democratic countries²⁵⁵ and are not contrary to international law. The argument that it is unconstitutional to impose an exit charge is therefore without merit.

Following the *Tradehold* case, a number of amendments have been introduced to further entrench and clarify South Africa's taxing rights. The exit charge has been moved to s 9H and a taxpayer's year of assessment is deemed to end on the day before the person ceases to be a resident.

Persons becoming resident before valuation date

Paragraph 12(2)(a) applies only to persons who became residents of South Africa on or after 1 October 2001 for the following reasons:

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

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

Asset transferred to a foreign permanent establishment

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

²⁵⁴ *Metcash Trading Ltd v C: SARS & another* 2001 (1) SA 1109 (CC), 63 SATC 13 at 42.

²⁵⁵ For example, in Australia, Canada, France, the Netherlands and the United Kingdom.

6.2.2A Change of residence, ceasing to be controlled foreign company or becoming headquarter company

Section 9H

Background

Section 9H was inserted by the Taxation Laws Amendment Act 24 of 2011 and came into effect on 1 April 2012. It deals with situations in which

- an individual or trust ceases to be a resident;
- a company ceases to be a resident;
- a resident company becomes a headquarter company; or
- a CFC ceases, otherwise than by becoming a resident, to be a CFC. The CGT consequences for a foreign company that ceases to be a CFC by reason of becoming a resident are addressed in para 12(4).

Generally, when any of these events occurs, the taxpayer is deemed to dispose of the assets held by that person at market value on the day immediately preceding the date of the event and to have reacquired them at the same market value on the date of the event. This deemed disposal could trigger ordinary income or CGT consequences. For example,

- trading stock that has a market value on the day before the date of the event that differs from its cost price or written-down value will result in an effective inclusion or reduction in income;
- an allowance asset held on the date of the event could result in a recoupment of capital allowances under s 8(4)(a) or a revenue loss under s 11(o) as well as a capital gain, in the latter case depending on whether the proceeds exceed the cost price of the asset; and
- a capital asset held on the date of the event could result in a capital gain or loss.

The deemed disposal rules for ceasing to be a resident or CFC were previously contained in para 12(2)(a). One impact of moving the rules to the main body of the Act is to bring trading stock and allowance assets within the ambit of the exit charge.

Definitions [s 9H(1)]

The following definitions apply for the purposes of s 9H:

‘ “[A]sset” means an asset as defined in paragraph 1 of the Eighth Schedule;’

and

‘ “market value”, in relation to an asset, means the price which could be obtained upon a sale of that asset between a willing buyer and a willing seller dealing at arm’s length in an open market.’

Cessation of residence of persons other than companies [s 9H(2)]

An individual or trust that ceases to be a resident during any year of assessment must be treated as having

- disposed of each of that individual or trust's assets to a person that is a resident on the date immediately before the day on which that individual or trust ceases to be a resident for an amount received or accrued equal to the market value of the asset on that date; and
- reacquired each of those assets on the day on which that individual or trust ceases to be a resident at an expenditure equal to that market value.

The individual or trust's year of assessment is deemed to

- end on the date immediately before the day on which the individual or trust ceases to be a resident; and
- commence on the day on which the individual or trust ceases to be a resident.

The above rule does not apply to specified South African-source assets listed in s 9H(4) such as immovable property in South Africa.

The question arises whether a capital gain or loss will be triggered when a person becomes a non-resident while holding an investment in a retirement annuity fund. The deemed inclusion under s 9H is not a 'lump sum benefit' contemplated in the definition of that term in the Second Schedule and the amount cannot therefore be disregarded under para 54. However, para 35(3)(a) provides that proceeds must be reduced by 'any amount of the proceeds that must be ... included in the gross income of that person or that must be ... taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain'. The words 'must be' look to the future and it is clear that any amount derived from a retirement annuity fund will be included in a person's taxable income as a lump sum benefit and any balance paid by way of annuity will be included in gross income. Similarly, para 20(3)(a)(i) provides that the expenditure in respect of an asset must be reduced by any amount that 'is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of that person ... before the inclusion of any taxable capital gain'. Premiums which qualified as a deduction under s 11(k) or (n) (both repealed) or s 11F must be reduced to nil under para 20(3)(a). Thus, while there is a disposal on cessation of residence, it should not give rise to a capital gain or loss.

Example 1 – Individual ceasing to be resident*Facts:*

Dorothy, a resident, emigrated to Australia on 30 June 2019. On 29 June 2019 she held the following assets:

	Market value On 29 June 2019	Base cost
	R	R
Primary residence	5 000 000	1 000 000
Shares in ABC Ltd (JSE-listed)	500 000	100 000
Shares in Propco CC	1 200 000	300 000

The sole asset of Propco CC was a holiday home at Scottburgh on the KZN south coast.

Result:

Dorothy is deemed to have disposed of all her assets at market value on 29 June 2019 except the primary residence which is excluded by s 9H(4)(a). Although the member's interest in Propco CC represents an interest in immovable property referred to in para 2(2), it does not constitute immovable property for the purposes of s 9H and any capital gain or loss on its deemed disposal on the date of exit must be brought to account.

She must therefore include the following capital gains arising on the deemed disposal on the date of exit in her return of income for the period covering 1 March 2019 to 28 June 2019:

Shares in ABC Ltd	R400 000 (R500 000 – R100 000)
Member's interest in Propco CC	R900 000 (R1,2 million – R300 000)

After Dorothy has become a non-resident, she will have to account for any capital gain or loss when she ultimately disposes of the primary residence and the member's interest in Propco CC, since these assets remain within the South African tax net under para 2(1)(b). Assuming she does not incur any further expenditure under para 20 on these assets, the base cost of the primary residence will be R1 million and the base cost of the member's interest in Propco CC will be R1,2 million [stepped-up when she ceased to be a resident by virtue of the 'deemed reacquisition at market value' rule under s 9H(2)(a)(ii)].

Events affecting companies [s 9H(3)]

Section 9H(3) applies when

- a resident company ceases to be a resident during any year of assessment of that company;
- a resident company becomes a headquarter company during any year of assessment of that company; or
- a CFC ceases, otherwise than by way of becoming a resident, to be a CFC during any foreign tax year of that CFC.

A company to which the above events applies is deemed to

- dispose of each of its assets to a person that is a resident on the date immediately before the day on which the event occurred for an amount received or accrued equal to the market value of the asset on that date; and
- reacquire each of those assets on the day on which the event occurred at an expenditure equal to that market value.

The year of assessment of a resident company that ceases to be a resident or becomes a headquarter company is deemed to

- end on the date immediately before the day on which it ceased to be a resident or became a headquarter company; and
- recommence on the day on which that company ceased to be a resident or became a headquarter company.

For the purposes of dividends tax, the company is deemed to have declared and paid a dividend *in specie* on the day before it ceased to be a resident or became a headquarter company (see s 9H(3)(c)(iii) for more details).

Reversal of participation exemption [s 9H(3)(e) and (f)]

[Effective 5 June 2015]

A company that ceases to be a resident and which disregarded a capital gain on the disposal of equity shares under para 64B during the three years immediately preceding the date on which it ceased to be a resident must treat such capital gain as a net capital gain in the year of assessment in which it ceases to be a resident [s 9H(3)(e)].

A company that ceases to be a resident and which was exempt from tax on a foreign dividend only under s 10B(2)(a) during the three years immediately preceding the year of assessment in which it ceased to be a resident must treat such amount as a foreign dividend that is not exempt under s 10B(2) in the year of assessment in which it ceases to be a resident [s 9H(3)(f)].

Example 2 – Company ceasing to be a resident*Facts:*

South African Parent owns all the shares in South African Subsidiary. On 1 July 2019 South African Subsidiary moved its place of effective management to a foreign jurisdiction, thus ceasing to be a resident under the applicable tax treaty. South African Subsidiary had an asset with a market value of R10 million and a base cost of R2 million. Its liabilities amounted to R4 million and its CTC R500 000. For the purposes of determining the market value of South African Subsidiary's shares, assume that the net-asset-value basis is used.

Result:

On 30 June 2019, the day before it ceased to be a resident, South African Subsidiary is deemed to have sold all its assets resulting in a capital gain of R8 million (proceeds of R10 million less base cost of R2 million). The year of assessment for South African Subsidiary ends on that day and a new year of assessment begins on 1 July 2019.

While a dividend *in specie* is deemed to have been declared and paid for dividends tax purposes to South African Parent, it is exempt because it is paid to a resident company. However, had South African Parent been a non-resident, dividends tax on a dividend of R5,5 million (R10 million of assets less R4 million of liabilities less CTC of R500 000) would have been payable.

The foreign tax year of a CFC which ceased to be a CFC is deemed to

- end on the date immediately before the day on which that CFC ceased to be a CFC; and
- recommence on the day on which that CFC ceased to be a CFC.

Example 3 – Company ceasing to be a CFC*Facts:*

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

Result:

The issue of ordinary shares eliminates CFC status because South African Company no longer holds more than 50% of the ordinary shares. Under s 9H(3) this loss of CFC status triggers a deemed disposal on the day before the event with the exit charge applying to all the portfolio shares and generating a capital gain of R4 million (R5 million proceeds less R1 million base cost).

Excluded assets [s 9H(4)]

The deemed disposal rules in s 9H(2) and (3) do not apply to an asset constituting

- immovable property situated in South Africa that is held by that person;
- any asset which is, after the person ceases to be a resident or a CFC, attributable to a permanent establishment of that person in South Africa;
- any qualifying equity share contemplated in s 8B that was granted to that person less than five years before the date on which that person ceases to be a resident as contemplated in s 9H(2) or (3);
- any equity instrument contemplated in s 8C that had not yet vested as contemplated in that section at the time that the person ceases to be a resident; or
- any right of that person to acquire any marketable security contemplated in s 8A.

Under para 2(1)(b)(i) a non-resident must account for any capital gain or loss on disposal of immovable property situated in South Africa or any interest or right of whatever nature to or in such property including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources.

Paragraph 2(2) deems certain indirect interests in immovable property to constitute an interest in immovable property for the purposes of para 2(1)(b)(i). For example, a person who holds at least 20% of the equity shares in a company when 80% or more of the market value of those shares is directly or indirectly attributable to immovable property in South Africa would fall within para 2(2). However, the exclusion of immovable property from the ambit of s 9H does not extend to these indirect interests. As a result the exit charge will be triggered on exit on such interests but they will still remain within the South African tax net and a capital gain or loss will have to be brought to account, with the base cost having been stepped up under s 9H at the time of exit, when the non-resident eventually disposes of them.

Exclusion of certain foreign companies [s 9H(5)]

A CFC that ceases to be a CFC will not be subject to s 9H(3) when it loses its CFC status

- directly or indirectly as a result of a person disposing of an equity share in a CFC; and
- the capital gain or loss determined in respect of that disposal is disregarded under para 64B.

Example 4 – Non-application of s 9H when para 64B applies*Facts:*

South African Parent owns all the shares in CFC 1, which in turn owns all the shares in CFC 2, and CFC 2 owns all the shares in CFC 3. This ownership structure has been in place for more than five years. CFC 1 has a net value of R50 million, taking into account its direct and indirect ownership in CFC 2 and CFC 3. South African Parent sells CFC 1 to an independent foreign company. Foreign Company provides R20 million cash and issues a R30 million note in exchange.

Result:

The disposal will qualify for the participation exclusion in para 64B. South African Parent held at least 10% of the equity shares of CFC 1, and held these shares for more than 18 months. The sale of CFC 1 was to an independent foreign person, and the consideration received equals the value transferred. Although the sale will trigger a loss of CFC status for CFC 1, CFC 2 and CFC 3, the exit charges for these CFCs will be waived because the loss of CFC status was a direct or indirect result of a disposal eligible for the participation exclusion.

Other exclusions [s 9H(6)]

Section 9H does not apply to a CFC that ceases to be a CFC as a result of

- an amalgamation transaction as defined in s 44(1) to which s 44 applies; or
- a liquidation distribution as defined in s 47(1) to which s 47 applies.

These events may be a technical cessation of CFC status but the assets are merely moving to a different company falling within the same tax paradigm.

Assets acquired in foreign currency [s 9H(7)]

For the purposes of s 9H(2) and (3) the market value of an asset must be determined in the currency of expenditure incurred to acquire the asset. This rule is of relevance when applying para 43. By ensuring that the proceeds and expenditure are in the same foreign currency, individuals and non-trading trusts will translate the capital gain or loss in foreign currency to the local currency in the year of disposal under para 43(1). Had the proceeds been determined in rand, individuals and non-trading trusts would have fallen into para 43(1A) with potentially adverse consequences. Under para 43(1A) the expenditure is translated to rand at the rate ruling in the year in which it was incurred as opposed to para 43(1) which uses the exchange rate in the year of disposal. A similar rule is contained in para 43(5) for the events in s 9HA and 25 and paras 12, 38 and 40, all of which result in deemed proceeds (see **19.5**).

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

Paragraph 12(3) deals with the situation in which trading stock of a person ceases to be trading stock of that person, otherwise than by way of disposal under para 11. In such event that person will be treated as having

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

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

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

Conventional disposals of trading stock

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

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

Type of disposal	Value included in income under s 22(8)	Base cost of acquirer
Donation	Market value	Market value – para 38
Disposal other than in the ordinary course of trade, for a consideration less than the market value	Market value	Market value – para 38
Distribution by a company <i>in specie</i> on or after 21 June 1993 to a holder of shares in the company	Market value	Market value – para 38 or 75(1)(b)

Changes in usage of trading stock

Trading stock may cease to be trading stock without a conventional disposal under para 11. Typically, such situations involve a mere change of usage. Examples of such changes in usage include

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

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

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

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

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

Type of use	Amount to be included in income under s 22(8) / Amount treated as base cost in hands of acquirer
Private or domestic use or consumption	<ul style="list-style-type: none"> • Cost, less any provision for obsolescence, or • if the cost price cannot be readily determined, the market value
Application for any other purpose other than the disposal of the trading stock in the ordinary course of trade	Market value
Assets which cease to be held as trading stock	Market value

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

Sight should, of course, not be lost of the following *dictum* of Centlivres CJ in *CIR v Richmond Estates (Pty) Ltd*:²⁵⁶

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

"Equity shares" as defined in s 9C(1) held for at least three years

Section 9C replaced s 9B and applies to the disposal of any 'equity share' on or after 1 October 2007.²⁵⁷

Section 9C(2) provides as follows:

'Any amount received or accrued (other than a dividend or foreign dividend) or any expenditure incurred in respect of an equity share must be deemed to be of a capital nature if that equity share had, at the time of the receipt or accrual of that amount or incurral of that expenditure, been held for a period of at least three years.'

While any amount received or accrued in respect of an equity share as defined in s 9C(1) will be of a capital nature once the share has been held for at least three years, that does not mean that the share will necessarily cease to be held as trading stock at the end of the three-year period. Paragraph (a) of the definition of 'trading stock' includes 'anything ... purchased or in any other manner acquired by a taxpayer for the purposes of ... sale or exchange by the taxpayer or on behalf of the taxpayer'. If the shares were originally purchased with the intention of resale, this fact will not change merely because any amount received or accrued in respect of the shares will be of a capital nature after three years. The shares will thus remain trading stock and there will be no automatic deemed disposal and reacquisition under para 12(3) at the end of the three-year period.

²⁵⁶ 1956 (1) SA 602 (A), 20 SATC 355 at 361.

²⁵⁷ See Interpretation Note 43 (Issue 7) dated 8 February 2019 'Circumstances in which Certain Amounts Received or Accrued from the Disposal of Shares are Deemed to be of a Capital Nature'.

For more on s 9C see **2.4.3.1.6** and Interpretation Note 43 (Issue 7) dated 8 February 2019 'Circumstances in which Certain Amounts Received or Accrued from the Disposal of Shares are Deemed to be of a Capital Nature'.

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

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

- immovable property situated in South Africa held by that person or any interest or right of whatever nature of that person to or in immovable property situated in South Africa including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources;
- any asset effectively connected with a permanent establishment of that person in South Africa; and
- assets held by the CFC if any amount received or accrued from their disposal would have been taken into account for purposes of determining the net income of that CFC under s 9D.

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

Paragraph 12(4) is aimed at assets of a CFC which qualify for the 'foreign business establishment' exemption under s 9D(9)(b). Since these assets did not fall within the South African tax net while the company was a CFC, it is appropriate that any pre-residence unrealised capital gains and losses be excluded from the South African tax system by the 'deemed acquisition at market value' rule.²⁵⁸

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

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

Facts:

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

²⁵⁸ Paragraph 12(4) was substituted by s 75(1) of the Revenue Laws Amendment Act 60 of 2008 deemed to have come into operation on 21 February 2008 and applies in respect of an asset disposed of on or after that date, unless that disposal is the subject of an application for an advance tax ruling accepted by the Commissioner before that date.

Result:

The conversion of CFC 1 to South African residence status is a para 12(4) event. Paragraph 12(4) triggers a deemed disposal of the foreign business establishment assets. The deemed disposal does not give rise to any capital gains by virtue of the foreign business establishment exemption in s 9D(9)(b). The deemed disposal results in a market value base cost step-up for the foreign business establishment assets. The portfolio passive assets and the shares of CFC 2 are not subject to deemed-disposal treatment, meaning that those assets retain their historical base cost [they are excluded from the foreign business establishment exemption under s 9D(9A)(a)(iii)].

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

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

Paragraph 12(5) was deleted with effect from years of assessment commencing on or after 1 January 2013.²⁵⁹ The provisions dealing with reduction of debt are now largely contained in para 12A read with s 19. For the commentary on para 12(5), see issue 7 of this guide.

6.2.6 Concession or compromise in respect of a debt

Paragraph 12A

6.2.6.1. Background

Debt relief occurs in a variety of situations, including insolvency, business rescue, similar statutory proceedings, informal workouts²⁶⁰ and within and outside a group of companies.

A brief history of the debt relief rules

Years of assessment commencing before 1 January 2013

For years of assessment commencing before 1 January 2013 the debt reduction rules in the Eighth Schedule were mainly contained in para 12(5) with other provisions in paras 3(b)(ii) and 20(3)(b). At that time the principal provisions in the main body of the Act were s 8(4)(m) and para (ii) of the proviso to s 20(1)(a).

Years of assessment commencing on or after 1 January 2013 but before 1 January 2018

Paragraph 12A 'Reduction or cancellation of debt' was inserted by the Taxation Laws Amendment Act 22 of 2012 and applied to years of assessment commencing on or after 1 January 2013 and replaced para 12(5). At the same time s 8(4)(m) and the relevant portion of the proviso to s 20 were deleted and replaced with s 19. For a comprehensive commentary on the debt reduction provisions before years of assessment commencing on or after 1 January 2018, see Interpretation Note 91 dated 21 October 2016 'Reduction of Debt' and issue 6 of this guide.

²⁵⁹ Section 107(1)(c) of the Taxation Laws Amendment Act 22 of 2012.

²⁶⁰ An informal process of debt restructuring undertaken by a financially distressed person with creditors outside any formal insolvency proceedings.

Years of assessment commencing on or after 1 January 2018

Paragraph 12A and s 19 were substituted by the Taxation Laws Amendment Act 17 of 2017. The heading of para 12A was changed to ‘Concession or compromise in respect of a debt’. Further amendments were made by the Taxation Laws Amendment Act 23 of 2018 most of which, barring two mentioned below, were backdated to 1 January 2018. These backdated amendments were largely aimed at lessening the impact of the debt reduction rules which could have had harsh consequences, for example, as a result of the terms of a loan being changed.

Years of assessment commencing on or after 1 January 2019

The amendments to para 12A(4) and para 12A(6)(b) by the Taxation Laws Amendment Act 23 of 2018 came into effect for years of assessment commencing on or after 1 January 2019. These amendments relate to debt waived in a year of assessment subsequent to that in which the asset was disposed of and the exemption relating to debt waived by donation. Previously, when debt was waived in a subsequent year with the asset being disposed of in an earlier year the only consequence for the debtor was a reduction in any assessed capital loss. Now a capital gain will result in the year of waiver. The exemption for waiver of debt by donation now applies only in respect of the portion of the donation on which donations tax is payable. For example, there will now be consequences under para 12A for the annual donations tax exemption of R100 000.

The Taxation Laws Amendment Act 34 of 2019 deleted the obsolete definitions of ‘allowance asset’ and ‘capital asset’ from para 12A(1) but made no other amendments to para 12A.

Purpose of the rules

The rules under para 12A and s 19 are aimed at ensuring that a debt benefit is appropriately taxed but not subject to more than one of the following taxes:

- Estate duty²⁶¹
- Donations tax
- Income tax on a fringe benefit received by an employee
- Income tax on income
- CGT

Paragraph 12A must be read with s 19 and para 56(2). Paragraph 56 prevents capital losses on disposal of debt owed by a connected person unless the debtor suffers a consequence under, for example, s 19 or para 12A(3) or (4).

Generally, s 19 is not considered in this guide but in view of the interaction of para 12A and s 19 it would be useful to provide an overview of s 19 and para 12A before delving into the detail of para 12A.

²⁶¹ The value of any debts owed to a deceased person are included in that person’s estate for estate duty purposes under s 3 of the Estate Duty Act.

Section 19 and para 12A contain ordering rules for dealing with debt relief. These ordering rules apply to trading stock, other deductible expenditure, allowance assets and capital assets financed by debt which is the subject of a 'concession or compromise'. Briefly the rules provide as follows upon a 'debt benefit' arising as a result of such a 'concession or compromise':

- Trading stock still on hand – Any s 11(a) deduction or the value of opening stock as well as any closing stock is reduced by the debt benefit under s 19(3). Any excess is treated as a recoupment under s 19(4) read with s 8(4)(a).
- Trading stock disposed of and other deductible expenditure excluding capital allowances – The debt benefit is treated as a recoupment under s 19(5) read with s 8(4)(a) to the extent that the expenditure was allowed as a deduction.
- Assets not disposed of in a year of assessment before that in which the debt benefit arises – The base cost of the asset is reduced under para 12A(3) by the debt benefit. For an allowance asset, after the base cost (tax value) has been reduced to nil under para 12A(3), any excess is treated as a recoupment of previous allowances claimed under s 19(6) read with s 8(4)(a). Future capital allowances will be limited to the cost of the asset less the debt benefit and any previous allowances claimed on the asset under s 19(7).
- Assets disposed of in a year of assessment before that in which the debt benefit arises – under para 12A(4) the debt benefit triggers a redetermination of the capital gain or loss recognised in the prior year of assessment, with the absolute difference between the redetermined capital gain or loss and the prior year capital gain or loss being treated as a capital gain in the year of assessment in which the debt benefit arises. Section 19(6A) deals with the situation in which an allowance asset is disposed of in a year of assessment prior to that in which the debt benefit arises. Under these circumstances, the taxpayer must redetermine the recoupment in the earlier year as if the debt benefit arose in that year, and if there is an increase, it must be brought to account as a recoupment under s 8(4)(a) in the year of assessment in which the debt benefit arises.

A special rule in para 12A(5) applies to debt that financed the acquisition of a pre-valuation date asset. The effect of the rule is to convert the asset to a post-valuation date asset by establishing its base cost as expenditure which can be reduced by the debt benefit.

Exclusions from the ordering rules

Tax debt is excluded from the definition of 'debt' and its waiver cannot therefore give rise to any consequences under para 12A.

Paragraph 12A(6) contains seven exclusions from the ordering rules which cover debt reduced by bequest, debt reduced by donation in respect of which donations tax is payable, debt reduced by an employer, reduction in intra-group debt of a dormant company, debt reduced in the course or in anticipation of liquidation or deregistration of a company when the debtor company and the creditor are connected persons in relation to each other, intra-group debt settled through the issue of shares by the debtor company and debt, excluding interest debt, settled through the issue of shares by a debtor company.

While the exclusions in para 12A(6) are largely mirrored in s 19(8), there is one important difference, namely, that s 19(8) does not contain the exemption for a liquidating company.

Consequential amendments to prevent double taxation are contained in ss 8(4)(a), 9C(5), 24J(4A)(b) and paras 3(b)(ii), 20(3)(b)(iii) and 56(2)(a). These consequential amendments apply to years of assessment commencing on or after 1 January 2013.

6.2.6.2 Definitions

Definition – ‘concession or compromise’

<p>‘[C]oncession or compromise’ means any arrangement in terms of which—</p> <p>(a) a debt is—</p> <p style="padding-left: 20px;">(i) cancelled or waived; or</p> <p style="padding-left: 20px;">(ii) extinguished by—</p> <p style="padding-left: 40px;">(aa) redemption of the claim in respect of that debt by the person owing that debt or by any person that is a connected person in relation to that person; or</p> <p style="padding-left: 40px;">(bb) merger by reason of the acquisition, by the person owing that debt, of the claim in respect of that debt,</p> <p style="padding-left: 20px;">otherwise than as the result or by reason of the implementation of an arrangement described in paragraph (b);</p> <p>(b) a debt owed by a company to a person is settled, directly or indirectly—</p> <p style="padding-left: 20px;">(i) by being converted to or exchanged for shares in that company; or</p> <p style="padding-left: 20px;">(ii) by applying the proceeds from shares issued by that company;’</p>
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Not every ‘concession or compromise’ will result in a reduction in the base cost of an asset under para 12A(3) or a redetermination of a capital gain or loss giving rise to a capital gain under para 12A(4). A prerequisite for such a reduction is that there must be a ‘debt benefit’ and the definition of concession or compromise must therefore be read with that definition.

Paragraph (a) of the definition of ‘concession or compromise’ applies when a debt is

- cancelled
- waived
- extinguished by redemption
- extinguished by merger

otherwise than as the result or by reason of the implementation of an arrangement described in para (b).

Cancellation

*Lexico.com*²⁶² defines ‘cancel’ as follows:

‘1.2 Abolish or make void (a financial obligation)

“I intend to cancel your debt to me”.’

²⁶² <<https://www.lexico.com/en/definition/cancel>> [Accessed 2 November 2020].

Waiver

Waiver is a form of contract in which one party deliberately surrenders that party's rights. There is a presumption against waiver and the onus is on the party asserting it and it is not an onus easily discharged. The intention to waive must be communicated to the debtor and until then the creditor may change his or her mind.

In *Union Free State Mining and Finance Corporation Ltd v Union Free State Gold and Diamond Corporation Ltd*²⁶³ Munnik AJ stated the following on the question of whether waiver amounted to a donation:

'I do not think that a creditor can by the mere exercise of his will terminate the obligation without the concurrence of the debtor because as both Wessels and Pothier point out a release, waiver or abandonment is tantamount to making a donation to the debtor of the obligation from which he is to be released and until that donation has been accepted it has not been perfected. There may conceivably be circumstances in which a debtor does not wish to be released from his obligation. It may for a variety of reasons not suit him to be released. To allow the release, waiver or abandonment and the consequent making of a donation dependent solely on the will or action of the creditor would be tantamount to creating a contract at the will of one party which is a concept foreign to our jurisprudence.'

The gratuitous waiver of a debt is recognized as a donation in para 12A(6)(b). However, not every waiver of a debt will be motivated by gratuitousness. Debts can be waived for sound commercial reasons and in fact there may be a *quid pro quo* involved. For example, the waiver by a shareholder of a shareholder's loan may result in the value of the shares in the company increasing.

The impairment of a debt in a creditor's accounting records cannot be equated with the waiver of a debt. Such an impairment does not amount to the extinction of the creditor's rights against the debtor.

In *Malone & another v FX Africa Foreign Exchange (Pty) Ltd & others*²⁶⁴ the applicant argued that a respondent creditor had abandoned a debt because it had written the debt off in its financial statements. A Chartered Accountant submitted an affidavit to the court that 'impairment' or 'writing-off' of a loan receivable does not, in accounting terms, amount to its abandonment (that is, discharge). The accountant explained that the management of FX Africa can and often does continue to try and recover a debt subsequent to treating it as being fully impaired. If any portion of the debt is recovered, the amount recovered is written back and recognised as profit or income in the year in which the recovery is made. After weighing up the evidence, the court concluded that the relevant debt was still valid and had not been abandoned (discharged).

Redemption

*Lexico.com*²⁶⁵ defines 'redemption' as follows:

'2 The action of regaining or gaining possession of something in exchange for payment, or clearing a debt.'

²⁶³ 1960 (4) SA 547 (W) at 549.

²⁶⁴ Case 1056/2014, Western Cape Division, 27 June 2014, unreported. See also N van Vuuren "Impairment is not Abandonment" (November 2014) *Werksmans Legal Brief* 042009.

²⁶⁵ <<https://www.lexico.com/definition/redemption>> [Accessed 2 November 2020].

Merger

Merger or *confusio* is the union in the same person of the characters of creditor and debtor in respect of the same debt. The leading case dealing with *confusio* is *Grootchwaing Salt Works Ltd v Van Tonder* in which Innes CJ stated the following:²⁶⁶

‘Now *confusio* in the sense with which we are here concerned is the concurrence of two qualities or capacities in the same person, which mutually destroy one another. In regard to contractual obligations it is the concurrence of the debtor and creditor in the same person and in respect of the same obligation. (Pothier *Verbintenissen*, par 641; Opzomer, Vol. 7, para. 1472; Van der Linden (1.18, para. 5)). The typical example of *confusio* and the one mainly dealt with in the books is the case of a creditor becoming heir to his debtor or vice versa. But the same position is established whenever the creditor steps into the shoes of his debtor by any title which renders him subject to his debt (Pothier *Verb*, para. 642) and it is common cause that *confusio* takes place as between lessor and lessee when the latter acquires the leased property. As to the consequences of *confusio* there can be no doubt that speaking generally it destroys the obligations in respect of which it operates. Pothier (para. 643) is clear upon the point. A person, he says, can neither be his own creditor nor his own debtor. And if there is no other debtor then the debt is extinguished. *Non potest esse obligatio sine persona obligata*. (See also Voet, 46.3.19; Cens. For, Pt. 1.4.38, para. 1; Van der Linden, 1.18, sec. 5, etc.), but the obligation is only destroyed to the extent to which the concurrence of the opposing capacities renders it impossible to exist.’

Examples of how merger may occur include the purchase on the open market of a listed debenture by the issuer, the distribution to a beneficiary by a trust of an amount owed by the beneficiary, or the distribution *in specie* by a subsidiary to its holding company of a debt owed by its holding company.

Paragraph (b) of the definition of ‘concession or compromise’ deals with circumstances in which debt is discharged through the issue of shares. Such a discharge can take place in the form of

- conversion (for example, a convertible debenture);
- exchange (for example, giving up a loan in return for shares); or
- by using the proceeds from the issue of shares (for example, through set-off of the debt claim in respect of the subscription price against a pre-existing shareholder’s loan or by using the cash proceeds from the share issue to repay the debt).

Definition – ‘debt’

‘ “[D]ebt” means any amount that is owed by a person in respect of—

(a) expenditure incurred by that person; or

(b) a loan, advance or credit that was used, directly or indirectly, to fund any expenditure incurred by that person,

but does not include a tax debt as defined in section 1 of the Tax Administration Act;’

Paragraph (a) of the definition refers to an amount owing in respect of expenditure incurred by a person. This situation would occur, for example, when an asset is acquired on credit from a supplier.

²⁶⁶ 1920 AD 492 at 497.

Paragraph (b) of the definition refers to an amount owing in respect of a loan, advance or credit that was used, directly or indirectly, to fund any expenditure incurred by a person. This situation would apply, for example, if a person borrowed money from a bank and used those funds to purchase an asset from a supplier.

In *CIR v Datakor Engineering (Pty) Ltd*²⁶⁷ the court distinguished the characteristics of debt and shares. Harms JA held that with debt the debtor had an enforceable obligation to effect payment of the debt, while with a share the right of redemption rests with the company. He highlighted a further distinction when noting that in the case of debt all the assets of the company were available to satisfy the claims of creditors while shares could be redeemed only if the requirements specified in, at that time, the Companies Act 61 of 1973 were met.

Under the Companies Act a company may redeem its shares only if it meets the solvency and liquidity requirements in that Act.

For accounting purposes dividends payable on preference shares meeting specified criteria may be required to be treated as interest.²⁶⁸ However, in the absence of a statutory provision giving effect to such treatment they remain dividends for tax purposes. As was stated by Watermeyer CJ in *Joffe & Co (Pty) Ltd v CIR*²⁶⁹

‘the Court is not concerned with deductions which may be considered proper from an accountant’s point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the statute’.

The term ‘tax debt’ is defined in s 1 of the Tax Administration Act and means

‘an amount referred to in section 169(1);’.

Section 169(1) of the Tax Administration Act provides that an amount of tax due or payable in terms of a tax Act is a tax debt due to SARS for the benefit of the National Revenue Fund.

As a result of the exclusion of a tax debt from the definition of ‘debt’ in para 12A(1), the reduction of a tax debt will not have any CGT implications. Under specified circumstances a tax debt owed by a person can be permanently reduced by SARS as a result of a business rescue plan, the liquidation of a company, insolvency of a person, prescription or a compromise.

Definition – ‘debt benefit’

‘ “[D]ebt benefit”, in respect of a debt owed by a person to another person, means—

- (a) in the case of an arrangement described in paragraph (a) (i) of the definition of “concession or compromise”, the amount cancelled or waived;
- (b) in the case of the extinction of that debt by means of an arrangement described in paragraph (a) (ii) of the definition of “concession or compromise”, the amount by which the face value of the claim in respect of that debt held by the person to whom the debt is owed prior to the entering into of that arrangement exceeds the expenditure incurred in respect of—
 - (i) the redemption of that debt; or
 - (ii) the acquisition of the claim in respect of that debt;

²⁶⁷ 1998 (4) SA 1050 (SCA), 60 SATC 503.

²⁶⁸ IAS 32.

²⁶⁹ 1946 AD 157, 13 SATC 354 at 359.

- (c) in the case of the settling of that debt by means of an arrangement described in paragraph (b) of the definition of “concession or compromise”, where the person who acquired shares in a company in terms of that arrangement held no effective interest in the shares of that company prior to the entering into of that arrangement, the amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the market value of the shares acquired by reason or as a result of the implementation of that arrangement; or
- (d) in the case of the settling of that debt by means of an arrangement described in paragraph (b) of the definition of “concession or compromise”, where the person who acquired shares in a company in terms of that arrangement held an effective interest in the shares of that company prior to the entering into of that arrangement, the amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the amount by which the market value of the effective interest held by that person in the shares of that company immediately after the implementation of that arrangement exceeds, solely as a result of the implementation of that arrangement, the market value of the effective interest held by that person in the shares of that company immediately prior to the entering into of that arrangement;’

The definition of ‘debt benefit’ contains separate rules for a concession or compromise arising from

- cancellation, waiver, extinction through redemption or merger; and
- conversion or exchange for shares or issue of shares by the debtor.

Table 1 – Types of debt benefit and methods for their determination

Paragraph of definition of ‘debt benefit’	Event	Debt benefit
(a)	Cancellation or waiver	The amount cancelled or waived.
(b)	Redemption or merger	The amount by which the face value of the claim in respect of that debt held by the person to whom the debt is owed prior to the entering into of that arrangement exceeds the expenditure incurred in respect of <ul style="list-style-type: none"> • the redemption of that debt; or • the acquisition of the claim in respect of that debt.
(c)	Conversion, exchange for shares or application of proceeds from share issue when creditor does not hold an effective interest in the company prior to the arrangement	The amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the market value of the shares acquired by reason or as a result of the implementation of that arrangement.
(d)	Conversion, exchange for shares or application of proceeds from share issue when creditor holds an effective interest in the	The amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the amount by which the market value of the effective interest held by that person in the

	company prior to the arrangement	shares of that company immediately after the implementation of that arrangement exceeds, solely as a result of the implementation of that arrangement, the market value of the effective interest held by that person in the shares of that company immediately prior to the entering into of that arrangement.
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With a redemption or merger, a comparison is required between

- The face value of the debt; and
- the expenditure incurred in respect of the redemption of the debt or the acquisition of the claim in respect of the debt.

The word ‘expenditure’ is not used here in the usual sense of determining expenditure for the purposes of s 11(a) or para 20 because such expenditure would already have been incurred when the debt was undertaken. Nevertheless, the same principles apply for determining whether expenditure has been incurred when the debt is settled. The use of the word ‘expenditure’ requires that the debtor give up cash or assets in discharging the debt. Harms AP stated the following in *C: SARS v Labat Africa Ltd* on the meaning of ‘expenditure’:²⁷⁰

‘The term “expenditure” is not defined in the Act and since it is an ordinary English word and, unless the context indicates otherwise, this meaning must be attributed to it. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent.

‘The Afrikaans text, in using the term “onkoste”, endorses this reading. In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended.’

Example 1 – Debt benefit arising from cancellation or waiver of debt

Facts:

Company X lent Company Y R100 at an interest rate of 10% a year, repayable in five years’ time. As a result of cash-flow difficulties experienced by Company Y, Company X agreed to waive R30 of the loan.

Result:

Company Y has derived a debt benefit of R30, being equal to the amount waived.

Example 2 – Debt benefit arising from redemption of debt

Facts:

On 1 March 2013 Company X issued 100 7% debentures at face value of R100 000 each. The debentures were redeemable at the option of the company after five years based on their market value at the time of redemption. On 30 April 2019 Company X redeemed one of the debentures at its market value of R90 000. The market value of the debentures had fallen as a result of an increase in prevailing interest rates.

²⁷⁰ 2013 (2) SA 33 (SCA), 74 SATC 1 at 6.

Result:

Company X has derived a debt benefit of R10 000, being the difference between the face value of the debenture (R100 000) and the expenditure in respect of the redemption of the debt (R90 000).

Example 3 – Debt benefit arising from merger*Facts:*

Company X issued 7% debentures on the JSE at an issue price of R10 000 each. On 30 April 2019 Company X purchased 100 of those debentures on the open market when the listed price was R8 000 each owing to an increase in prevailing interest rates.

Result:

Upon acquisition the debentures acquired by Company X will be extinguished by merger because Company X cannot be both debtor and creditor in respect of the same debentures.

Company X has a debt benefit equal to the difference between the face value of the debentures (R10 000 each) and the expenditure incurred in acquiring them (R8 000 each). The debt benefit is thus $R10\,000 - R8\,000 = R2\,000 \times 100 = R200\,000$.

Example 4 – Debt benefit arising from merger*Facts:*

Holdco owns 60% of the equity shares in Subco. Holdco owed Subco R100 000 on loan account. Subco subsequently distributed the loan to Holdco. The market value of the loan on the date of distribution was R60 000.

Result:

Under para 75(1) Subco is deemed to have disposed of the loan account for proceeds of R60 000 and Holdco is deemed to have acquired it on the date of distribution for expenditure for purposes of para 20 of the same amount. Holdco has therefore derived a debt benefit of R40 000, being equal to the difference between the face value of the loan (R100 000) and the expenditure deemed to have been incurred on its acquisition (R60 000).

Example 5 – Debt benefit arising from merger*Facts:*

Discretionary Trust has several beneficiaries. Over the years the trust had advanced R100 000 to Beneficiary X on loan account. Beneficiary X was in a dire financial position and the trustees estimated that no more than R10 000 of the loan was recoverable. They accordingly resolved to distribute it to Beneficiary X out of the trust capital.

Result:

Under para 38 the distribution of the loan is deemed to be made at market value and Beneficiary X is deemed to have acquired it at an expenditure for the purposes of para 20 equal to that same market value. A debt benefit of R90 000 has therefore arisen in the hands of Beneficiary X's, being equal to the difference between the face value of the loan account (R100 000) and the expenditure deemed to have been incurred in acquiring it (R10 000).

Settlement of debt through the conversion, exchange or application of proceeds from a share issue

While a debt benefit can arise when debt is settled through the issue of shares, this will have a practical effect only when the debt includes accumulated interest as a result of the exemption in para 12A(6)(g) and the debtor and creditor are not part of the same group of companies as defined in s 41 [para 12A(6)(f)].

Creditor not previously holding effective interest in shares [para (c) of the definition of 'debt benefit']

When the creditor that acquired shares in the debtor company through conversion, exchange or issue did not hold a pre-existing effective interest in the shares of the debtor company, the debt benefit is equal to the amount by which the face value of the debt exceeds the market value of the shares held or acquired by reason or as a result of the implementation of the arrangement.

The face value of the debt being referred to is not the whole debt but only the part that is the subject of a concession or compromise. The principle is that to the extent that the creditor does not derive value from the share issue in comparison to the face value of the debt reduction, there will be a debt benefit to the debtor company.

Example 6 – Debt benefit arising from issue of shares by debtor company and creditor not holding pre-existing shares

Facts:

Lelanie is the sole holder of shares in Company L, holding 100 000 shares which she acquired on formation of the company at a subscription price of R100 000. Her sister Talita lent R1 million to the company interest free some years ago. As a result of accumulated losses, it was decided to recapitalise the company by issuing 200 000 shares to Talita in partial discharge of R200 000 of her loan. The balance sheet of the company before and after the arrangement appeared as follows:

	Before R	After R
Share capital	100 000	300 000
Accumulated losses	(200 000)	(200 000)
Loan from Talita	<u>1 000 000</u>	<u>800 000</u>
	<u>900 000</u>	<u>900 000</u>
 Represented by:		
Land at cost (same as market value)	1 000 000	1 000 000
Less: Current liabilities	<u>(100 000)</u>	<u>(100 000)</u>
	<u>900 000</u>	<u>900 000</u>

Assume that it is appropriate to value Talita's shares on the 'net asset value' basis and that the market value of the land at the time the debt benefit arose was still equal to its cost price.

Result:

Applying the net asset value basis of valuation, Talita's shares have a market value of 33,33 cents a share (R100 000 / 300 000) which is equal to R66 667 (200 000 × 33,33 cents a share).

Company L has been the subject of a 'concession or compromise' as defined in para 12A(1), since it has partly settled a debt by issuing shares to Talita.

The debt benefit derived by Company L is equal to the difference between R200 000 (the face value of the claim subject to concession or compromise) and the market value of Talita's shares (R66 667) = R133 333. There will, however, be no impact on Company L under para 12A because of the exemption in para 12A(6)(g), since no portion of the loan included accumulated interest and even if it had, the base cost of the land would not include accumulated interest by virtue of para 20(2)(a), which, as a general rule, excludes borrowing costs from base cost. For an example illustrating a debt benefit involving the waiver of accumulated interest and the impact on the base cost of an asset including such interest, see **6.2.6.8 (g)**.

Creditor previously holding effective interest in shares [para d) of the definition of 'debt benefit']

When the creditor that acquired shares in the debtor company through conversion, exchange or issue holds a pre-existing effective interest in the shares in the debtor company, the debt benefit is equal to

- the amount by which the face value of the claim held by that creditor in respect of that debt, before the entering into of any arrangement in respect of that debt, exceeds
 - the amount by which the market value of the effective interest in the shares held by that creditor in that company after the implementation of the arrangement exceeds, solely as a result of the implementation of that arrangement,
 - the market value of the effective interest in the shares held by that creditor in that company before the entering into of that arrangement.

The face value of the debt being referred to is not the whole debt but only the part that is the subject of a concession or compromise. The principle is that to the extent that the creditor does not derive value from the share issue in comparison to the face value of the debt reduction, there will be a debt benefit to the debtor company.

Example 7 – Debt benefit arising from issue of shares by debtor company and creditor holding pre-existing shares

Facts:

Bradley holds 100% of the equity shares in Company S. Company S purchased land from Bradley interest free on loan account for R1 million on 1 March 2013. On 30 April 2019 Company S and Bradley agreed that Company S could settle R200 000 of the loan, which still stood at R1 million, through the issue of equity shares of R200 000 because Company S had accumulated losses and needed to be recapitalised. Company S has a financial year ending on the last day of February. The balance sheet of Company S appeared as follows before and after the issue of the new shares:

	Before R	After R
Share capital	100 000	300 000
Accumulated losses	(200 000)	(200 000)
Loan from Bradley	<u>1 000 000</u>	<u>800 000</u>
	<u>900 000</u>	<u>900 000</u>
Represented by:		
Land at cost (same as market value)	1 000 000	1 000 000
Less: Current liabilities	<u>(100 000)</u>	<u>(100 000)</u>
	<u>900 000</u>	<u>900 000</u>

Assume that it is appropriate to value Bradley's shares on the 'net asset value' basis and that the market value of the land at the time the debt benefit arose was still equal to its cost price.

Result:

Applying the 'net asset value' basis of valuation, the market value of Bradley's shares in Company S before the issue of the shares in discharge of the debt was nil and after the issue was R100 000.

Company S has been the subject of a 'concession or compromise' as defined in para 12A(1), since it has partly settled a debt by issuing shares to Bradley. The amount of the debt benefit is equal to the amount by which the face value of the debt subject to concession or compromise before the share issue (R200 000) exceeds the difference between the market value of all the shares held after the arrangement (R100 000) and the market value of all the shares previously held (nil). Company S will, however, not have to reduce the base cost of its land by the amount of the debt benefit of R100 000 because the loan was interest free and the exemption in para 12A(6)(g) applies.

Creditor holding an effective interest in shares

Paragraphs (c) and (d) of the definition of 'debt benefit' refer to the creditor having an effective interest in the debtor company. A person can have an effective interest in a company either directly or indirectly. For example, if A owns 60% of the shares in B and B owns 40% of the shares in C, A has a direct interest of 60% in B and B has a direct interest of 40% in C. But A also has an indirect (effective) interest of $60\% \times 40\% = 24\%$ in C. If A also held 5% of the shares in C directly, A's effective interest in C would be $24\% + 5\% = 29\%$.

The settlement of a debt can cause an increase in the market value of the shares in another company that also owns shares in the debtor company. For example, this situation could occur when the creditor also holds shares in a company that holds shares in the debtor company.

Example 8 – Reduction of debt benefit when market value of shares in another company increases as a result of a concession or compromise

Facts:

Hennie holds 10% of the equity shares in Company S. He also owns 100% of the equity shares in Company H which owns the remaining 90% of the equity shares in Company S. Company H and Company S are both residents and have financial years that end on the last day of February. Company S purchased land from Hennie on loan account for R50 000 on 1 March 2013. On 30 April 2019 Company S and Hennie agreed that Company S could settle R20 000 of the loan, which still stood at R50 000, through the issue of 20 000 equity shares of R20 000 because Company S had accumulated losses and needed to be recapitalised. The balance sheet of Company S appeared as follows before and after the issue of the new shares:

	Before R	After R
Share capital		
Held by Company H	90 000	90 000
Held by Hennie	<u>10 000</u>	<u>30 000</u>
Total share capital	100 000	120 000
Accumulated losses	<u>(20 000)</u>	<u>(20 000)</u>
Total equity	80 000	100 000
Loan from Hennie	<u>50 000</u>	<u>30 000</u>
	<u>130 000</u>	<u>130 000</u>

Represented by:

Land at cost (same as market value)	50 000	50 000
Other net assets	<u>80 000</u>	<u>80 000</u>
	<u>130 000</u>	<u>130 000</u>

Assume that it is appropriate to value Hennie's effective interest in the shares in Company S on the 'net asset value' basis and that the market value of the land at the time the debt benefit arose was still equal to its cost price. Also assume that any increase in the value of Company H's holding in Company S as a result of the arrangement is fully reflected in Company H's share price.

Result:

Before the arrangement Hennie held 10% of the shares in Company S directly. He also had an indirect interest of 90% in Company S through Company H. Therefore, Hennie's effective interest in Company S was $10\% + 90\% = 100\%$.

The market value of a 100% effective interest in Company S before the arrangement on a net asset value basis was R80 000 and after the arrangement was R100 000. The debt benefit is therefore nil, being equal to the difference between the face value of the debt before the arrangement (R20 000) and the difference between the market value of the effective interest before and after the arrangement ($R100\ 000 - R80\ 000 = R20\ 000$).

Definition – 'group of companies'

' "[G]roup of companies" means a group of companies as defined in section 41.'

The definition of 'group of companies' in s 41 begins with the wider definition of the term in s 1(1) but then excludes, among others, a company incorporated under foreign law which is not effectively managed in South Africa, a company effectively managed outside South Africa and a variety of exempt or partially exempt bodies such as a public benefit organisation and a recreational club.

This definition is used in the exemptions in para 12A(6)(d) and (f) which apply to the waiver of intra-group debt and the settlement of such debt through the issue of shares respectively.

Definition – 'market value'

“**[M]arket value**” in relation to shares acquired or held by reason or as a result of implementing a concession or compromise in respect of a debt means the market value of those shares immediately after the implementation of that concession or compromise.’

This definition modifies the definition of 'market value' in para 1 which in turn refers to para 31 which contains the detailed rules for determining market value. This definition is used in paras (c) and (d) of the definition of 'debt benefit' which apply when debt is settled through the issue of shares. The term is also used in para 12A(5) which applies when debt is used to finance the acquisition of a pre-valuation date asset but the term is not used in the sense defined in para 12A(1) in that context.

For shares listed on a recognised exchange and for which a price was quoted on that exchange, para 31(1)(a) provides that the market value is the ruling price in respect of that share on that recognised exchange at close of business on the last business day *before* the specified date. That rule is in conflict with the definition of 'market value' in para 12A(1) which requires the market value to be determined immediately after the concession or compromise. Therefore, depending on the facts, it may be appropriate to use the ruling price at close of business on the date of the concession or compromise.

For unlisted shares, para 31(3) provides that the market value is 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, disregarding any provision restricting the transferability of the shares or which specifies how the value of the shares is to be determined. A special rule applies when a company is being wound up. Again, this market value must be determined immediately after the concession or compromise.

6.2.6.3 Application [para 12A(2)]

Except for the circumstances listed in para 12A(6), para 12A applies when

- a debt benefit in respect of a debt owed by a person arises in respect of a year of assessment by reason or as a result of a concession or compromise in respect of that debt during that year of assessment; and
- the amount of that debt is owed by that person in respect of or was used by that person to fund, directly or indirectly, any expenditure, other than expenditure in respect of trading stock in respect of which a deduction or allowance was granted under the Act.

The type of expenditure covered by para 12A would exclude the cost of trading stock which is allowable as a deduction under s 11(a) or s 22(2) (opening stock). An example of expenditure in respect of trading stock that is not allowable as a deduction can be found in s 23F, that is, trading stock neither disposed of during the year of assessment nor held at the end of that

year of assessment – so-called trading stock ‘on the water’ (FOB destination under which ownership passes upon delivery).

Paragraph 12A applies to expenditure in respect of all assets other than trading stock for which a deduction or allowance was granted under the Act. Examples include

- goodwill;
- land and buildings;
- financial instruments such as shares and participatory interests in collective investment schemes;
- plant and machinery and other assets qualifying for capital allowances;
- debt assets such as loans and bank accounts; and
- trading stock for which no deduction is allowable by virtue of s 23F.

On the meaning of expenditure, Harms AP stated the following in *C: SARS v Labat Africa Ltd*:²⁷¹

‘The term “expenditure” is not defined in the Act and since it is an ordinary English word and, unless the context indicates otherwise, this meaning must be attributed to it. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent.

‘The Afrikaans text, in using the term “onkoste”, endorses this reading. In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended.’

In *Ackermans Ltd v C: SARS*²⁷² it was held that the words ‘expenditure incurred’ mean the undertaking of an obligation to pay or the actual incurring of a liability.

The valuation date value of an asset does not comprise ‘expenditure’, hence the need to establish the base cost of an asset before the debt benefit arises under para 12A(5) – see **6.2.6.7**.

Direct v indirect funding

A sufficiently close connection must exist between the debt and the expenditure incurred. Expenditure or an asset is directly funded by an amount if, for example, an asset is purchased on credit from the creditor. Expenditure or an asset is indirectly funded by an amount if, for example, a creditor advances an amount to a debtor and the debtor uses the amount to finance expenditure or an asset purchased from a third party. Another example would be when the debtor makes use of a bank overdraft to acquire an asset. In these situations, debt substitution occurs because the debt initially incurred with the supplier is extinguished and replaced with other debt in the form of a bank overdraft. Since the overdraft is one step removed from the initial incurring of the expenditure, the financing of the expenditure becomes indirect.

²⁷¹ 2013 (2) SA 33 (SCA), 74 SATC 1 at 6.

²⁷² 2011 (1) SA 1 (SCA), 73 SATC 8 at 5.

6.2.6.4 Time when a debt benefit arises under some specific circumstances

For purposes of para 12A the time when a debt benefit arises will depend on the facts and circumstances of each case. A debt benefit will generally arise when the event giving rise to the concession or compromise takes place, for example, when a creditor decides not to enforce payment of a debt and informs the debtor accordingly. However, specific rules apply in the circumstances described below.

(a) *Business Rescue*

Under business rescue proceedings, creditors may vote to accept less than the face value of the debts owing to them as part of the business rescue plan. The actual amount of a debt that is reduced will in most instances be determined only once the assets of the debtor have been disposed of, the agreed costs paid and the final distribution made to the creditors. While the creditors are bound under s 152(4) of the Companies Act by the adopted business rescue plan, the actual amount reduced by a creditor in these circumstances is dependent on the amount of the final distribution which takes place subsequent to the approval and adoption of the business rescue plan. A debt will accordingly be regarded as having been reduced for purposes of para 12A only at the time the actual amount of the debt that is reduced is determined, being the date upon which the final distribution is determined and the creditor concerned is notified.

If, however, the amount of debt forgiven is certain at the time the business rescue plan is adopted at the meeting convened under s 151 of the Companies Act, the relevant debt will have been reduced as contemplated in para 12A at that time, since the adopted business rescue plan is binding on the company and its creditors.

(b) *Compromise*

A compromise between a company and its creditors must be supported by a majority in number representing at least 75% in value of the creditors or class of creditors under s 155(6) of the Companies Act. After the compromise proposal has been so approved, it must be sanctioned by the court under s 155(7) of that Act. The time when a debt benefit arises in respect of a compromised debt will occur when the order of the court sanctioning the compromise is filed under s 155(8)(c) of the same Act.

(c) *Insolvency*

The time when a debt benefit arises as a result of the insolvency of a debtor depends on the facts and circumstances of the case. It will, however, generally occur on the date on which the final liquidation and distribution account is confirmed by the Master of the High Court under s 112 of the Insolvency Act 24 of 1936.

(d) *Liquidation*

The time when a debt benefit arises as a result of the liquidation of a company will generally occur on the date on which the liquidator commences with the distribution, which will be after the final liquidation and distribution account has been confirmed by the Master of the High Court under s 408 of the Companies Act 61 of 1973.

6.2.6.5 Assets held during the year of assessment in which the debt benefit arises [para 12A(3)]

A person must reduce the expenditure contemplated in para 20 in respect of an asset by the amount of any debt benefit when

- that debt benefit in respect of a debt owed by a person arises in respect of a year of assessment by reason or as a result of a concession or compromise in respect of that debt during that year of assessment; and
- the amount of that debt is owed by that person in respect of or was used by that person to fund, directly or indirectly, any expenditure, other than expenditure in respect of trading stock in respect of which a deduction or allowance was granted under the Act, in respect of an asset that was not disposed of by that person in a year of assessment prior to that in which that debt benefit arises.

Example 1 – Debt benefit arising while asset still held

Facts:

In year 1 Company A acquired land on loan account from Company B for R1 million. During year 4 Company B waived R600 000 of the debt because of Company A's inability to pay. In year 5 Company A disposed of the land for R1,2 million. None of the exemptions in para 12A(6) applies.

Result:

Year 4

Company A must reduce the base cost of the land by R600 000 under para 12A(3). In year 5 Company A will realize a capital gain as follows:

	R
Proceeds	1 200 000
Less: Base cost (R1 million – R600 000)	<u>(400 000)</u>
Capital gain	<u>800 000</u>

Example 2 – Debt benefit involving allowance asset

Facts:

Company A acquired second-hand machinery at a cost of R1 million on loan account from Company B on 1 March 2018. Company A and Company B form part of the same group of companies as defined in s 41(1) and both traded during the 2019 and 2020 years of assessment. Company A and Company B had agreed in writing under s 45(6)(g) that s 45 would not apply to the acquisition. Company A is entitled to an allowance of 20% a year on the cost price of the machinery under s 12C(1). On 30 April 2019 Company B waived the outstanding balance on the loan account which at that stage stood at R700 000, because of Company A's adverse economic position. Company A's year of assessment ends on 28 February. Company A held the asset throughout the 2020 year of assessment.

Result:

Company A was granted allowances under s 12C(1) of R200 000 a year for the 2019 and 2020 years of assessment. At the time when the debt benefit arose, the base cost of the machinery for purposes of para 20 was accordingly R600 000 (R1 million – R400 000).

The base cost of the machinery must be reduced to nil under para 12A(3) because para 12A(6)(d) does not apply. In the latter regard, Company A traded during the 2019 and 2020 years of assessment which disqualified it from the exemption in para 12A(6)(d).

Under s 19(6) the debt that funded the expenditure incurred in respect of the second-hand machinery and which was the subject of a debt benefit, is deemed, for the purposes of s 8(4)(a), to be an amount that has been recovered or recouped in the 2020 year of assessment, but only to the extent that para 12A has not been applied and limited to any allowances previously granted under the Act. The recoupment under s 19(6) is accordingly restricted to R100 000:

	R
Debt benefit (amount of loan waived)	700 000
Less: Base cost reduction under para 12A(3)	<u>(600 000)</u>
Amount recouped under s 8(4)(a) (limited to R400 000)	<u>100 000</u>

6.2.6.6 Asset disposed of in year of assessment prior to the year in which the debt benefit arises [para 12A(4)]

Paragraph 12A(4) was completely revised for years of assessment commencing on or after 1 January 2019. Before this amendment, para 12A(4) merely required the reduction of any assessed capital loss when an asset was disposed of in a prior year of assessment and the debt was waived in a subsequent year of assessment. If there was no assessed capital loss to be reduced, para 12A had no impact on the debtor. Under the current dispensation the debt benefit is brought to account as a capital gain in the year of assessment in which the debt benefit arises.

Paragraph 12A(4) applies when

- a debt benefit in respect of a debt owed by a person arises in respect of a year of assessment by reason or as a result of a concession or compromise in respect of that debt during that year of assessment; and
- the amount of that debt is owed in respect of or was used by that person to fund, directly or indirectly, any expenditure, other than expenditure in respect of trading stock in respect of which a deduction or allowance was granted under the Act to fund expenditure incurred in respect of an asset that was disposed of in a year of assessment prior to that in which that debt benefit arises. The type of asset envisaged is a capital asset, allowance asset or trading stock in respect of which a deduction was not granted (see **6.2.6.3** for an example of such non-deductible trading stock).

Next, it is necessary to determine whether the capital gain or loss that arose in the prior year of assessment on disposal of the asset would have differed from the capital gain or loss determined assuming that the debt benefit was taken into account in that prior year of assessment.

The difference between the prior year capital gain or loss and the redetermined capital gain or loss must be determined based on an absolute difference. The absolute difference is the distance between two real numbers (negative, zero or positive) on the 'real line'.²⁷³ For example, the absolute difference between -2 and +3 is $2 + 3 = 5$, while the absolute difference between two negative or two positive numbers is the difference between their absolute values (for example, the absolute difference between -2 and -5 is 3 and between 3 and 7 is 4).

²⁷³ <https://en.wikipedia.org/wiki/Absolute_difference> [Accessed 2 November 2020].

Thus, for example, if a capital loss of R20 arose on disposal of the asset in the prior year and the redetermined amount is a capital gain of R80, the absolute difference is $R20 + R80 = R100$.

The absolute difference must be treated as a capital gain in the year of assessment in which the debt benefit arises.

When multiple debt benefits have arisen in respect of an asset over more than one prior year of assessment, any duplication in the amount of the capital gain to be brought to account must be eliminated.

A similar rule to para 12A(4) applies under s 19(6A) when an allowance asset is disposed of in an earlier year of assessment and the debt benefit arises in the current year of assessment. Any recoupment of allowances that arose in the earlier year of assessment must be redetermined as if the debt benefit arose in that year and any increase must be brought to account as a recoupment under s 8(4)(a) in the current year.

Example 1 – Asset disposed of in prior year and debt waived in subsequent year

Facts:

On 1 March 2010 Gerrie lent R1 million to Company X. Company X immediately used the funds to acquire vacant land at a cost of R1 million. On 28 February 2019 Company X sold the land for R1,2 million and reflected a capital gain of R200 000 in its return of income for the 2019 year of assessment. On 30 April 2019 Gerrie waived the loan because of Company X's inability to pay.

Result:

A debt benefit has arisen in the 2020 year of assessment as a result of Gerrie having waived the loan account. The debt was used to fund an asset disposed of in a prior year of assessment. The capital gain of R200 000 which arose in the 2019 year of assessment must therefore be redetermined as if the debt benefit had arisen in that year of assessment.

As a result of the debt waiver, the base cost of the vacant land must be reduced to nil under para 12A(3). The redetermined capital gain will therefore be R1,2 million (proceeds) – nil (base cost) = R1,2 million. The capital gain to be brought to account in the 2020 year of assessment is the absolute difference between R1,2 million (redetermined capital gain) and R200 000 (previous capital gain) = R1 million.

Example 2 – Asset disposed of in prior year and multiple year debt waivers

Facts:

Company X acquired vacant land in year 1 for R1 million and disposed of it in year 5 for R1,2 million.

The purchase of the land was financed through a loan from the bank. From year 6 Company X began to experience cash-flow difficulties and the bank began waiving portions of the loan over the next three years: R100 000 in year 6, R300 000 in year 7 and R600 000 in year 8. No interest was charged on the loan.

*Result:**Year 5*

	R
Proceeds	1 200 000
Less: Base cost	<u>(1 000 000)</u>
Capital gain	<u>200 000</u>

A debt benefit arises in years 6, 7 and 8 and a capital gain must be redetermined in each of those years as if the debt benefit had arisen in year 5.

Year 6

Proceeds	1 200 000
Less: Base cost (R1 million – R100 000 [para 12A(3)])	<u>(900 000)</u>
Redetermined capital gain	300 000
Less: Capital gain determined in year 5	<u>(200 000)</u>
Capital gain to be accounted for in year 6	<u>100 000</u>

Year 7

Proceeds	1 200 000
Less: Base cost (R1 million – R100 000 – R300 000 [para 12A(3)])	<u>(600 000)</u>
Redetermined capital gain	600 000
Less:	
Capital gain determined in year 5	(200 000)
Capital gain determined in year 6	<u>(100 000)</u>
Capital gain to be accounted for in year 7	<u>300 000</u>

Year 8

Proceeds	1 200 000
Less: Base cost (R1 million – R100 000 – R300 000 – R600 000 [para 12A(3)])	<u>_____</u>
Capital gain	1 200 000
Less:	
Capital gain determined in year 5	(200 000)
Capital gain determined in year 6	(100 000)
Capital gain determined in year 7	<u>(300 000)</u>
Capital gain to be accounted for in year 8	<u>600 000</u>

Example 3 – Absolute difference between capital loss and capital gain*Facts:*

Company X acquired a piece of vacant land in year 1 for R1 million and sold it in year 5 for R800 000. The purchase of the land was funded by an interest-free loan from Company Z. In year 6 Company Z waived the loan because of Company X's inability to pay.

Result:

In year 5 Company X determined a capital loss as follows:

	R
Proceeds	800 000
Less: Base cost	<u>(1 000 000)</u>
Capital loss	<u>(200 000)</u>

In year 6 a debt benefit of R1 million arises as a result of the waiver of the loan. Consequently, the capital loss of R200 000 determined in year 5 must be redetermined as if the debt benefit had arisen in year 5. The base cost of the land must be reduced by the amount of the debt benefit and will therefore be nil (R1 million – R1 million). The redetermined capital gain is therefore R800 000 (proceeds) – RNil = R800 000.

The capital gain to be accounted for in year 6 is equal to the absolute difference between the capital loss of R200 000 determined in year 5 and the capital gain of R800 000 redetermined in year 6, namely, R200 000 + R800 000 = R1 million.

Example 4 – Absolute difference between larger capital loss and smaller capital loss

Facts:

Company X acquired a piece of vacant land in year 1 for R1 million and sold it in year 5 for R300 000. The purchase of the land was funded by an interest-free loan from Company Z. In year 6 Company Z waived R100 000 of the loan because Company X was experiencing cash-flow difficulties.

Result:

In year 5 Company X determined a capital loss as follows:

	R
Proceeds	300 000
Less: Base cost	<u>(1 000 000)</u>
Capital loss	<u>(700 000)</u>

In year 6 a debt benefit of R100 000 arises as a result of the partial waiver of the loan. Consequently, the capital loss of R700 000 determined in year 5 must be redetermined as if the debt benefit had arisen in year 5. The base cost of the land must be reduced by the amount of the debt benefit and will therefore be R900 000 (R1 million – R100 000). The redetermined capital loss is therefore as follows:

	R
Proceeds	300 000
Less: Base cost (R1 000 000 – R100 000 [para 12A(3)])	<u>(900 000)</u>
Redetermined capital loss	<u>(600 000)</u>

The capital gain to be accounted for in year 6 is equal to the absolute difference between the capital loss of R700 000 determined in year 5 and the capital loss of R600 000 redetermined in year 6, namely, R700 000 – R600 000 = R100 000.

6.2.6.7 Pre-valuation date assets [para 12A(5)]

In applying para 12A(3) or (4), special rules prescribed in para 12A(5) are required to determine the base cost of a pre-valuation date asset. A pre-valuation date asset is defined in para 1 and means an asset acquired before valuation date by a person and which has not been disposed of by that person before valuation date.

Paragraph 12A(5) provides that, for purposes of determining the date of acquisition of a pre-valuation date asset of a person and the expenditure incurred in respect of that asset, that person must be treated as having

- disposed of that asset at a time immediately before that debt benefit arose as contemplated in para 12A(3)(a) or (4)(a) for an amount equal to the market value of the asset at the time; and

- immediately reacquired the asset at that time at an expenditure equal to that market value
 - less any capital gain; and
 - increased by any capital loss,

that would have been determined had the asset been disposed of at market value at that time.

The market value of an asset on a specified date is determined under para 31.

The expenditure determined under para 12A(5) must be treated as an amount of expenditure actually incurred for purposes of para 20(1)(a).

The purpose of this rule is to establish the base cost of the asset as an amount of expenditure which can be reduced by the amount of the debt benefit. The base cost of a pre-valuation date asset is made up of its valuation date value plus any post-valuation date expenditure. The valuation date value may comprise the market value of the asset on valuation date (generally 1 October 2001 or a later date if the person ceased to be an exempt person under para 63 such as a PBO or recreational club), the time-apportionment base cost, or 20% of the proceeds after first deducting any post-valuation date expenditure. Since the valuation date value can be determined only on the date of disposal when the time-apportionment and '20% of proceeds' methods are adopted, it would not be possible under such methods to reduce the base cost of the asset at the time of any debt benefit without first establishing the base cost of the asset as an amount of "expenditure", hence the need for this rule.

Example – Determination of the base cost of a pre-valuation date asset

Facts:

Company X acquired land in 1995 at a cost of R500 000. Under para 29 Company X determined the market value of the land on valuation date at R900 000. Improvements of R2 million, funded with a loan from Company Y, were affected to the land in 2003. On 1 June 2019 R1,8 million of the loan of R2 million was waived because of Company X's inability to pay. None of the exemptions in para 12A(6) applies. Company X adopted the market value on valuation date as the valuation date value of the land. Immediately before the debt cancellation the market value of the land and improvements was R5 million. The year of assessment of Company X ends on 31 March.

Result:

The land and buildings are deemed to be disposed of at market value for the purposes of establishing their base cost.

	R	R
Deemed proceeds		5 000 000
Less: Base cost (para 25)		
Valuation date value	(900 000)	
Post-CGT improvements	(2 000 000)	(2 900 000)
Capital gain		<u>2 100 000</u>

The above capital gain is not taken into account for the purposes of determining Company X's aggregate capital gain or loss but is merely part of the calculation for establishing the base cost of the land and buildings as 'expenditure'.

The expenditure actually incurred on the asset (land and improvements) is calculated as follows for purposes of para 20(1)(a):

	R
Asset treated as being reacquired at market value	5 000 000
Less: Capital gain (as determined above)	<u>(2 100 000)</u>
Expenditure actually incurred for purposes of para 20(1)(a)	<u>2 900 000</u>

Paragraph 12A(3) is applied to reduce the base cost of the land and buildings to R1,1 million (R2,9 million – R1,8 million) because of the debt benefit.

6.2.6.8 Exclusions [para 12A(6)]

(a) Debt owed by heir or legatee [para 12A(6)(a)]

Paragraph 12A does not apply to any debt owed by a person that is an heir or legatee of a deceased estate, to the extent that

- the debt is owed to that deceased estate;
- the debt is reduced by the deceased estate; and
- the amount by which the debt is reduced by the deceased estate forms part of the property of the deceased estate for the purposes of the Estate Duty Act 45 of 1955.

Property of a deceased estate may not be liable to estate duty because of deductions allowed under ss 4 and 4A of the Estate Duty Act. However, the exclusion will still apply even if the estate is not liable to estate duty. The key question is whether the debt forms part of the property of the deceased estate for estate duty purposes.

Section 3(1) of the Estate Duty Act provides that the estate of a person shall consist of all property and property which is deemed to be property of that person as at the date of death of the person. Section 3(2) of that Act provides that 'property' means any right in or to property, movable or immovable, corporeal or incorporeal and lists items which are specifically included in and excluded from 'property'. Property which is deemed to be property of a deceased person is identified in s 3(3) of the Estate Duty Act. A debt owed to the deceased as at the date of death will generally form part of the property of the deceased for estate duty purposes even when it is subsequently reduced by the deceased estate.

Example – Non-application of para 12A – Debt forming part of the property of a deceased estate

Facts:

Anne sold shares to a family trust on loan account in 2015. The shares were acquired by the family trust as a capital investment. Anne passed away on 30 April 2019 with her last will providing that the loan be bequeathed to the trust. The loan was awarded to the trust when the liquidation and distribution account became final on 15 February 2020.

Result:

The loan was discharged for no consideration upon being awarded to the trust and a debt benefit therefore arises. Under para 12A(6)(a) no reduction in the base cost of the shares must be made by the trust because the debt was owed to and reduced by the deceased estate and the amount of the debt formed part of the property of the deceased estate for purposes of the Estate Duty Act. The reduction of the debt is, therefore, not subject to the application of para 12A.

(b) Debt reduced by donation [para 12A(6)(b)]

Paragraph 12A does not apply to a debt benefit in respect of a debt owed by any person to the extent that the debt is reduced by

- a donation as defined in s 55(1); or
- any transaction to which s 58 applies,

in respect of which donations tax is payable.

The requirement that donations tax be payable came into operation on 1 January 2019 and applies to years of assessment commencing on or after that date.²⁷⁴ The implication is that if the donation is exempt from donations tax under s 56, the exclusion under para 12A(6)(b) will not apply.

Example 1 – Debt benefit comprising a donation*Facts:*

Lizette formed a discretionary trust for the benefit of her husband and two children. She advanced a loan of R1 million to the trust which bore interest at the official rate. The trust used the funds to acquire a property at a cost of R1 million from which it derived rental income. During the 2020 year of assessment Lizette waived R150 000 of the loan account. She did not make any other donations during the 2020 year of assessment.

Result:

Under s 56(2)(b) R100 000 of the donation will be exempt from donations tax, while donations tax will be payable on the balance of the donation of R50 000. Paragraph 12A(6)(b) will therefore apply only to the extent of R50 000 with the result that the trust must reduce the base cost of the property by R100 000.

The definitions of ‘donation’ and ‘property’ in s 55(1) read as follows:

‘“**[D]onation**” means any gratuitous disposal of property including any gratuitous waiver or renunciation of a right;’

‘“**[P]roperty**” means any right in or to property movable or immovable, corporeal or incorporeal, wheresoever situated.’

²⁷⁴ Section 77(1)(h) of the Taxation Laws Amendment Act 23 of 2018.

In *Welch's Estate v C*: SARS Marais JA stated the following on the meaning of a donation:²⁷⁵

'The test to be applied at common law to determine whether the disposition of an asset amounts to a donation properly so called (as opposed to a remuneratory donation) is so well-settled that it hardly needs repetition. The test is of course that the disposition must have been motivated by 'pure liberality' or 'disinterested benevolence'.

...

'In my opinion the legislature has not eliminated from the statutory definition the element which the common law regards as essential to a donation, namely, that the disposition be motivated by pure liberality or disinterested benevolence and not by self-interest or the expectation of a *quid pro quo* of some kind from whatever source it may come.

'If one were to scour the dictionaries to find a single word apt to convey that the disposition should be motivated by pure liberality and not in expectation of any *quid pro quo* of whatever kind, one would not find a better or more appropriate word than "gratuitous". The *Shorter OED* gives the following meaning to the word:

"1. Freely bestowed or obtained; granted without claim or merit; costing nothing to the recipient; free.

2. Done, made, adopted or assumed without any good ground or reason; uncalled for; unjustifiable."

In *Estate Sayle v CIR* the court stated the following:²⁷⁶

'In short, liberality at the expense of another is not a "donation"; to be a "donation" the gift must be liberality at the expense of the donor, an act whereby the donee is enriched and the donor correspondingly impoverished.'

In *The Master v Thompson's Estate* the court confirmed that a transaction will not be a donation when something is received in return or when there is some consideration.²⁷⁷

Only a debt benefit motivated by pure liberality or disinterested benevolence will be a debt reduced by way of a 'donation' as defined in s 55(1). Under para 12A(6)(b) the reduction of a debt by way of a 'donation' as defined in s 55(1) will not be subject to the application of para 12A to the extent that donations tax is payable.

Any transaction to which s 58 applies

Under para 12A(6)(b) a debt reduced by way of a transaction to which s 58 applies is not subject to the application of para 12A to the extent that donations tax is payable.

Section 58(1) provides as follows:

'58. Property disposed of under certain transactions deemed to have been disposed of under a donation.—(1) Where any property has been disposed of for a consideration which, in the opinion of the Commissioner, is not an adequate consideration that property shall for the purposes of this Part be deemed to have been disposed of under a donation: Provided that in the determination of the value of such property a reduction shall be made of an amount equal to the value of the said consideration.'

²⁷⁵ 2005 (4) SA 173 (SCA), 66 SATC 303 at 312 and 314.

²⁷⁶ 1945 AD 388, 13 SATC 170 at 173.

²⁷⁷ 1961 (2) SA 20 (FC), 24 SATC 157 at 165.

In *Welch's Estate v C: SARS*²⁷⁸ Marais JA held²⁷⁹ that the definition of 'donation' in s 55(1) plays no role in interpreting or giving effect to the provision in s 58. He held further that it is clear that in applying s 58 the motive for the disposal is irrelevant; it is simply a question of whether the consideration given for a disposal of property (whatever the motive) was, in the opinion of the Commissioner, adequate.

In ITC 1599²⁸⁰ Wunsh J explained the history and object of donations tax by quoting the following statement from Boshoff WRP in *Ogus v SIR*:²⁸¹

‘“At the outset it is necessary to draw attention to the fact that the donations tax was introduced to make up for loss of revenue by way of income tax and estate duty when certain types of donations are made. The mischief aimed at was that practice by taxpayers of reducing their assets by making donations and thereby reducing the income on which income tax is payable, reducing their assets on which estate duty would be payable at their death, and spreading the assets and the income derived therefrom over several taxpayers.”’

Wunsh J stated further that the purpose of s 58 is to combat tax avoidance.²⁸² He emphasised that the Commissioner's satisfaction that the consideration is inadequate is only a condition for the coming into force of s 58. When this condition is fulfilled, the fair market value of the property that is disposed of must be compared with the consideration and the difference will be subject to tax.²⁸³

Wunsh J confirmed that although the discretion exercised by the Commissioner under s 58(1) is not subject to objection and appeal, his determination of the valuation of the property and the consideration given is subject to objection and appeal.²⁸⁴

In SARS's view the term 'adequate consideration' does not necessarily mean 'fair market value'. In deciding whether a particular consideration is adequate, regard must be had to the circumstances of the case and the objectives of donations tax. One of the objectives of donations tax is to prevent estate duty avoidance. If a donor's estate is not impoverished by a transaction, SARS is less likely to regard a consideration as being inadequate. This situation could occur when a sole shareholder of a company partially waives a shareholder's loan account. Such a waiver may not result in the shareholder's estate being impoverished because the value of the shares may increase by a corresponding amount. A similar situation arises when loans between wholly owned group companies are partially waived. While such a transaction may fall outside the scope of s 58 it may well fall within the ambit of para 12A.

Example 2 – Debt discharged partly by donation and partly for consideration

Facts:

Maretha lent her brother Gary R100 000 which Gary used to buy vacant land. Some years later Gary had not repaid the loan because of cash-flow difficulties. In an act motivated by affection for her brother, Maretha agreed to accept R10 000 in full and final settlement of her claim of R100 000. Maretha did not make any other donations during the year of assessment in which the debt was discharged.

²⁷⁸ 2005 (4) SA 173 (SCA), 66 SATC 303.

²⁷⁹ 66 SATC at 315.

²⁸⁰ (1995) 58 SATC 88 (T) at 97.

²⁸¹ 1978 (3) SA 67 (T), 40 SATC 100 at 107.

²⁸² At SATC 98.

²⁸³ At SATC 99.

²⁸⁴ At SATC 96.

Result:

Since the waiver of the debt was partly gratuitous and partly for consideration, s 58 applies. However, Maretha will not pay donations tax because the donation of R90 000 (R100 000 – R10 000) is covered by the annual donations tax exemption of R100 000 under s 56(2)(b). Gary must accordingly reduce the base cost of his land by R90 000 under para 12A(3).

(c) Employee debt [para 12A(6)(c)]

Paragraph 12A does not apply to any debt owed by a person to an employer of that person to the extent that the debt is reduced in the circumstances contemplated in para 2(h) of the Seventh Schedule.

Paragraph 2 of the Seventh Schedule provides that, for the purposes of the Seventh Schedule and para (i) of the definition of “gross income” in s 1(1),²⁸⁵ a taxable benefit shall be deemed to have been granted by an employer to the employer’s employee in respect of the employee’s employment with the employer if

- as a benefit or advantage of;
- by virtue of such employment; or
- as a reward for services rendered or to be rendered by the employee to the employer,

a benefit listed in para 2 of the Seventh Schedule is granted.

Under para 2(h) of the Seventh Schedule a taxable benefit shall be deemed to have been granted if the employer has

- directly or indirectly paid any debt owing by an employee to a third person, excluding
 - contributions or payments made to a medical scheme registered under the Medical Schemes Act 131 of 1998; or
 - an amount in respect of medical, dental and similar services, hospital services, nursing services or medicines provided to the employee or the employee’s spouse, child, relative or dependant,
 without requiring the employee to reimburse the employer for the amount paid; or
- released the employee from an obligation to pay any debt owing by the employee to the employer.

Under the proviso to para 2(h) of the Seventh Schedule, if any debt owing by an employee to an employer has been extinguished by prescription,²⁸⁶ the employer shall be deemed to have released the employee from the employee’s obligation to pay the amount of the debt if the employer could have recovered the amount owing or caused the running of the prescription to be interrupted. This proviso will not apply if the employer’s failure to recover the amount owing or to cause the running of prescription to be interrupted was not due to any intention of the employer to confer a benefit on the employee.

²⁸⁵ Under para (i) of the definition of ‘gross income’, the cash equivalent of the value of a benefit or advantage granted in respect of employment or to the holder of any office, being a “taxable benefit” as defined in the Seventh Schedule is to be included in the gross income of a person.

²⁸⁶ Section 11(d) of the Prescription Act 68 of 1969 provides that the period of prescription of any debt, other than debt mentioned in section 11(a) to (c) of that Act, is three years.

Example – Non-application of para 12A – Debt reduced by an employer that resulted in a fringe benefit*Facts:*

Employer ABC granted a loan of R10 000 to Employee A on 1 April 2016 which funded the acquisition of a computer from Employer ABC. Employee A used the computer to carry on a business after hours and claimed a wear-and-tear allowance of 15% a year on the computer. On 1 April 2019 Employer ABC waived the loan.

Result:

Under para 2(h) of the Seventh Schedule a taxable benefit is deemed to have been granted by Employer ABC to Employee A because of the waiver of the loan.

Employee A will accordingly not be subject to para 12A.

(d) Group of companies [para 12A(6)(d)]

Paragraph 12A does not apply to a debt benefit in respect of any debt owed by a company to another company when during the year of assessment during which that debt benefit arises and the immediately preceding year of assessment

- both the debtor and creditor form part of the same group of companies as defined in s 41(1); and
- the debtor company has not carried on any trade.

For years of assessment commencing on or after 1 January 2018 the scope of this exclusion was considerably narrowed and now applies only when the debtor company has not traded in both the current and preceding years of assessment. The benefit for taxpayers of this restriction is that a debtor company which has traded will be able to first reduce the base cost of an allowance asset before any excess is subject to recoupment under s 19(6) read with s 8(4)(a). Previously para 12A(6)(d) precluded para 12A from applying when the debtor and creditor formed part of the same group of companies as defined in s 41, subject to an exception for debt incurred outside the group. While it might be expected that a provision excluding the application of para 12A would be beneficial for a debtor, that was not so in this instance because it had the effect of shifting the full recoupment to income account under s 19(6) read with s 8(4)(a). For example, assume an allowance asset costing R100 was funded with intra-group debt and allowances of R60 were claimed on the asset leaving it with a base cost of R40. The creditor then waived the loan of R100. Under the previous para 12A(6)(d), the full amount of the allowances of R60 would be recouped under s 19(6) because any possibility of base cost reduction was precluded by para 12A(6)(d). However, under the amended para 12A(6)(d), R40 would be applied in reduction of the base cost of the asset while the remaining R20 would be recouped under s 19(6) as long as the debtor had traded in the current or previous years of assessment.

The exclusion uses the definition of 'group of companies' in para 12A(1), which in turn refers to the restrictive definition of the same term in s 41(1) rather than the wider definition in s 1(1). The relief under para 12A(6)(d) is therefore limited to situations in which both the debtor company and the creditor company are fully within the tax system. In other words, not reducing the base cost of an asset under para 12A(3) or redetermining the capital gain or loss under para 12A(4) and bringing the debt benefit to account in the year in which it arises is matched by the denial of a capital loss on disposal of the debt for a creditor under para 56(1).

Example – Debt benefit when debtor and creditor form part of the same group of companies as defined in s 41(1)*Facts:*

Holdco owns 100% of the equity shares in Subco and both companies are residents with financial years ending on the last day of February. Subco's balance sheet appears as follows on 31 January of year 5:

	R
Share capital	100
Accumulated loss	(100)
Loan from Holdco	<u>1 000 000</u>
	<u>1 000 000</u>
Vacant land	1 000 000

The vacant land had been used as a parking lot and its acquisition on 1 March of year 1 was financed by the loan from Holdco. Subco ceased trading on 28 February of year 3 and on 28 February of year 5 Holdco waived its loan of R1 million.

Result:

Under para 12A(6)(d) Subco is not required to reduce the base cost of its land as a result of the debt benefit it derived from the loan waiver because Holdco and Subco are part of the same group of companies as defined in s 1(1) and Subco has not traded in the current or previous year of assessment. Consequently, Subco's base cost of the land remains intact at R1 million and Holdco will not be permitted to claim a capital loss by virtue of para 56(1).

The exclusion in para 12A(6)(d) does not apply in respect of any debt

- incurred, directly or indirectly, by that company to fund expenditure incurred in respect of any asset that was subsequently disposed of by that company by way of an asset-for-share, intra-group or amalgamation transaction or a liquidation distribution in respect of which s 42, 44, 45 or 47, as the case may be, applied; or
- incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by
 - any other company that forms part of the same group of companies; or
 - any company that is a controlled foreign company in relation to any company that forms part of the same group of companies.

(e) Companies in liquidation [para 12A(6)(e) and (7)]

Paragraph 12A does not apply to a debt owed by a company to a connected person²⁸⁷ in relation to that company if the debt is reduced in the course, or in anticipation of the liquidation, winding up, deregistration or final termination of the existence of that company to the extent that the debt benefit does not, at the time that the debt benefit arises, exceed the base cost²⁸⁸ of the debt for the connected person.

²⁸⁷ See Interpretation Note 67 (Issue 4) dated 28 January 2020 'Connected Persons' for commentary on the definition of 'connected person' in s 1(1).

²⁸⁸ As determined under para 20.

The exclusion under para 12A(6)(e) does not apply if

- the debt was reduced as part of any transaction, operation or scheme entered into to avoid any tax imposed by the Act and the company became a connected person in relation to the creditor after the debt, or any debt issued in substitution of that debt, arose [para (a) of the proviso to para 12A(6)(e)]; or
- the company
 - has not within 36 months of the date on which the debt is reduced or such further period as the Commissioner may allow, taken the steps contemplated in s 41(4)²⁸⁹ to liquidate, wind up, deregister or finally terminate its existence;
 - has at any stage withdrawn any step taken to liquidate, wind up, deregister or finally terminate its corporate existence; or
 - does anything to invalidate any step contemplated in s 41(4), with the result that the company is or will not be liquidated, wound up, deregistered or finally terminate its existence [para (b) of the proviso to para 12A(6)(e)].

Paragraph 12A(7) provides that any tax which becomes payable as a result of the application of para (b) of the proviso to para 12A(6)(e) must be recovered from the company and the connected person who must be jointly and severally liable for the tax.

Section 19 will, however, apply to a debt owed by a company to a connected person in relation to that company if the debt is reduced in the course, or in anticipation of the liquidation, winding up, deregistration or final termination of the existence of that company because there is no equivalent exclusion for the winding up of a company under s 19(8). It follows that under s 19 the waiver of loans that funded deductible expenditure of a liquidating company can result in a recoupment under s 8(4)(a) or a reduction in the value of trading stock for such a company.

Example 1 – Non-application of para 12A – Debt reduced in anticipation of the liquidation of a company

Facts:

Company Y holds 20% of the shares in Company X. Company X and Company Y are connected persons²⁹⁰ in relation to each other but do not form part of the same group of companies. Company Y advanced a loan of R10 million to Company X on 1 April 2014. This loan indirectly funded the acquisition of a fixed property by Company X. On 1 April 2019 Company Y cancelled the debt of R10 million in anticipation of the liquidation of Company X. The year of assessment of Company X ends on 31 March.

Result:

The base cost of the fixed property of Company X is not reduced by the amount of the debt benefit of R10 million because para 12A(6)(e) provides that para 12A must not apply if the debt owed by a company to a connected person is reduced in anticipation of the liquidation of that company.

²⁸⁹ Specific steps are listed in s 41(4) for the liquidation or winding-up of a company and for the deregistration of a company.

²⁹⁰ Under para (d)(v) of the definition of 'connected person' in s 1(1).

Note:

Under para 56(1) Company Y cannot claim the capital loss on disposal of the debt of R10 million because Company X and Company Y are connected persons in relation to each other and para 56(2) does not apply.

Example 2 – Non-application of para 12A – Debt reduced in anticipation of the liquidation of a company*Facts:*

Company Y holds 20% of the shares in Company X. Company X and Company Y are connected persons²⁹¹ in relation to each other but do not form part of the same group of companies. Company Y advanced a loan of R10 million to Company X on 1 April 2014. This loan indirectly funded the acquisition of a fixed property by Company X. On 1 April 2019 Company Y cancelled the debt of R10 million in anticipation of the liquidation of Company X. Company Y is a moneylender and is entitled to claim the loss on cancellation of the loan as a deduction under s 11(a) read with section 23(g). The year of assessment of Company X ends on 31 March.

Result:

Paragraph 12A(6)(e) provides that para 12A must not apply if the debt owed by a company to a connected person is reduced in anticipation of the liquidation of that company *to the extent* that the amount of the debt benefit does not, at the time of the reduction of the debt, exceed the base cost of the debt of the connected person. The base cost of the debt of Company Y is nil (R10 million – R10 million)²⁹² at the time that the debt is reduced because the loss on disposal of the debt is allowable as a deduction under s 11(a) read with s 23(g). The amount of the debt benefit of R10 million therefore exceeds the base cost of the debt of Company Y of nil.

The relief under para 12A(6)(e) therefore does not apply which means that the base cost of the fixed property of Company X must, for purposes of para 20, be reduced to nil (R10 million – R10 million) under para 12A(3).

Example 3 – Non-application of para 12A – Debt reduced in anticipation of the deregistration of a company*Facts:*

On 1 July 2015 Individual Y acquired all the shares and a loan account with a face value of R100 000 in Company X from a former holder of shares in Company X. The loan account of R100 000 indirectly financed the acquisition of vacant land by Company X at a cost of R100 000 and was acquired by Individual Y at a discounted value of R80 000. On 28 February 2019 Company X disposed of the vacant land for proceeds of R130 000. On 1 April 2019 Individual Y waived the loan account in anticipation of the deregistration of Company X. The year of assessment of Company X ends on 28 February.

Result:

Individual Y and Company X are connected persons in relation to each other.²⁹³

²⁹¹ Under para (d)(v) of the definition of “connected person” in s 1(1).

²⁹² Under para 20(3)(a)(i) the expenditure incurred by a person on an asset must be reduced by any amount which is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of that person.

²⁹³ Under paras (d)(iv) and (e) of the definition of “connected person” in s 1(1).

Paragraph 12A(6)(e) provides that para 12A must not apply if the debt owed by a company to a connected person is reduced in anticipation of the deregistration of that company *to the extent* that the amount of the debt benefit does not, at the time the debt benefit arose, exceed the base cost of the debt of the connected person. The base cost of the debt of Individual Y is R80 000 at the time that the debt is reduced. The reduction amount of the debt of R100 000 therefore exceeds the base cost of the debt of Individual Y by R20 000.

The relief under para 12A(6)(e) applies only to the amount of the debt benefit of R80 000. Under para 12A(4) the original capital gain was R30 000 (R130 000 proceeds – R100 000 base cost). The redetermined capital gain is R50 000 (R130 000 proceeds – R80 000 base cost). In redetermining the capital gain, the base cost of R100 000 must be reduced under para 12A(3) to the extent of R20 000, being the portion of the debt benefit not shielded by para 12A(6)(e). The absolute difference between the original capital gain of R30 000 and the redetermined capital gain of R50 000 is R20 000 and this must be recognised as a capital gain by Company X in the 2020 year of assessment under para 12A(4).

Note:

Individual Y acquired the loan at a cost of R80 000 and disposed of it for no proceeds, which resulted in a capital loss of R80 000. Paragraph 56(1) provides that this amount must be disregarded because Individual Y and Company X are connected persons in relation to each other. For para 56(2)(a)(i) to apply, the amount of the debt disposed of must represent an amount which is applied to reduce the expenditure in respect of an asset of the debtor under para 12A. In the context it is considered that the amount of the debt should be taken as a reference to the expenditure incurred by the creditor, that is, the amount of R80 000. Since no part of the R80 000 was used to reduce the base cost of an asset of Company X, the exclusion from para 56(1) will not apply and Individual Y will not be allowed a capital loss in respect of the waiver of the debt. The previous owner of the debt (assuming that owner was a resident) would have incurred a capital loss of R20 000 and this is matched by the R20 000 reduction in the base cost of Company X's asset under para 12A.

(f) *Debtor company issuing shares to creditor company and both companies forming part of the same group of companies [para 12A(6)(f)]*

Paragraph 12A does not apply to a debt benefit in respect of any debt owed by a company to another company when

- the debtor and creditor companies form part of the same group of companies as defined in s 41(1); and
- the debtor company reduces or settles that debt, directly or indirectly, by means of shares issued by it.

However, the exclusion in para 12A(6)(f) does not apply in respect of any debt that was incurred or assumed by that company in order to settle, take over, refinance or renew, directly or indirectly, any debt incurred by another company which

- did not form part of that same group of companies at the time that that other company incurred that debt; or
- does not form part of that same group of companies at the time that company reduces or settles that debt, directly or indirectly, by means of shares issued by that company.

Example – Debt benefit arising from issue of shares by debtor company and debtor and creditor forming part of the same group of companies

Facts:

Company H holds 100% of the equity shares in Company S. Company S purchased listed shares from Company H on loan account for R900 000 on 1 March 2013. The loan had since increased by R100 000 as a result of accumulated interest. On 30 April 2019 Company S and Company H agreed that Company S could settle R200 000 of the loan (including all accumulated interest) through the issue of equity shares of R200 000 because Company S had accumulated losses and needed to be recapitalised. Assume that it is appropriate to value the shares on the 'net asset value' basis and that the value of the listed shares was still equal to their cost price at the time when the debt benefit arose. Both companies have financial years ending on the last day of February. The balance sheet of Company S appeared as follows before and after the issue of the new shares:

	Before R	After R
Share capital	100 000	300 000
Accumulated losses	(200 000)	(200 000)
Loan from Company H	<u>1 000 000</u>	<u>800 000</u>
	<u>900 000</u>	<u>900 000</u>
Represented by:		
Listed shares at cost (same as market value)	<u>900 000</u>	<u>900 000</u>

Result:

The base cost of the listed shares is R933 333 (acquisition cost of R900 000 plus one-third of interest of R100 000). The balance of the accumulated interest of R66 667 would not have qualified as a deduction under s 11(a) by reason of s 23(f) and is therefore not subject to recoupment under s 8(4)(a) read with s 19 as a result of the debt benefit.

On the 'net asset value' basis the market value of the shares held by Company H in Company S before the issue of the shares in discharge of the debt was nil and after the issue was R100 000.

Company S has been the subject of a 'concession or compromise' as defined in para 12A(1), since it has partly settled a debt by issuing shares to Company H. The amount of the debt benefit is equal to the amount by which the face value of the debt before the share issue exceeds the difference between the market value of all the shares previously held and the market value of all the shares after the current share issue [R200 000 – (R100 000 – RNil)]. Under para 12A(6)(f) Company S is not required to reduce the base cost of the listed shares by the debt benefit of R100 000 because it and Company H are members of the same group of companies as defined in s 41(1). Note that the exclusion under para 12A(6)(f) includes accumulated interest, unlike para 12A(6)(g).

Under para 56(1) Company H will not be entitled to a capital loss in respect of the disposal of the loan in exchange for the shares, since Company S has not suffered any of the consequences listed in para 56(2).

(g) Debt not including interest discharged through issue of shares

Paragraph 12A(6)(g) was inserted by s 77(1)(i) of the Taxation Laws Amendment Act 23 of 2018 and is deemed to have come into operation on 1 January 2018 and applicable in respect of years of assessment commencing on or after that date.

Paragraph 12A does not apply to a debt benefit in respect of any debt owed by a person to the extent that the debt so owed

- is settled by means of an arrangement described in para (b) of the definition of 'concession or compromise'; and
- does not consist of or represent an amount owed by that person in respect of any interest incurred by that person during any year of assessment.

Paragraph (b) of the definition of 'concession or compromise' deals with the situation in which a debt owed by a company is settled directly or indirectly

- by being converted to or exchanged for shares in that company; or
- by applying the proceeds from shares issued by that company.

From a CGT perspective, even when a debt benefit arises in respect of accumulated interest, there are relatively few situations in which it will result in the reduction in the base cost of an asset. This outcome follows from para 20(2)(a) which prohibits the inclusion in the base cost of an asset any borrowing costs, including any interest as contemplated in s 24J or raising fees. The only exception to this rule is in para 20(1)(g) which allows one-third of the interest on money borrowed to finance the cost of acquisition or improvement or enhancement in the value of a share listed on a recognised exchange or a participatory interest in a portfolio of a collective investment scheme (including money borrowed to refinance those borrowings).

In a partial debt reduction of an interest-bearing loan, the issue may arise whether it is the interest or the capital element of the loan that is being reduced. In *Standard Bank of South Africa Ltd v Oneanate Investments (Pty) Ltd (In Liquidation)*²⁹⁴ it was held that debt repayments must first be allocated against interest and then against capital. It would therefore be appropriate to apply this principle in determining in the first instance how the outstanding loan balance is made up and secondly, whether it is the capital or interest that is being reduced.

Example 1 – Debt discharged through issue of shares*Facts:*

Company X, which has a financial year ending on the last day of February, is wholly owned by Rene. Its balance sheet appeared as follows at 29 February 2020:

	R
Share capital	100
Accumulated loss	(100 000)
Shareholder's loan account	<u>200 000</u>
	<u>100 100</u>
Assets	<u>100 100</u>

²⁹⁴ 1998 (1) SA 811 (SCA).

In order to return Company X to solvency, Rene agreed to the issue of shares in discharge of R100 000 of her loan account. No portion of the loan account represented accumulated interest. After the transaction the balance sheet appeared as follows:

	R
Share capital	100 100
Accumulated loss	(100 000)
Shareholder's loan	<u>100 000</u>
	<u>100 100</u>
Assets	<u>100 100</u>

Before the issue of the additional shares the previously held shares had a market value of nil and after the share issue all the shares are worth R100.

Result:

There has been a 'concession or compromise' because a debt owed by a company has been settled by being converted to or exchanged for shares in that company.²⁹⁵

There is a debt benefit determined as follows:

		R
Face value of loan settled through issue of shares		100 000
<i>Less:</i>		
Market value of shares after arrangement	100	
Market value of previously issued shares	(0)	(100)
Debt benefit		<u>99 900</u>

There are, however, no consequences under para 12A by virtue of para 12A(6)(g), since no portion of the loan comprises interest.

Example 2 – Debt including capitalised interest discharged through issue of shares

Facts:

Company X, which has a financial year ending on the last day of February, is wholly owned by Audrey. Its balance sheet appeared as follows at 29 February 2020:

	R
Share capital	100
Accumulated loss	(100 000)
Shareholder's loan account (R140 000 capital; R60 000 interest)	<u>200 000</u>
	<u>100 100</u>
Listed shares	<u>100 100</u>

In order to return Company X to solvency, Audrey agreed to the issue of shares in discharge of R100 000 of her loan account. The portion of the loan account so waived included accumulated interest of R60 000 which had been expensed for accounting purposes. The portion of the loan waived was used to fund accumulated interest of R60 000 with the remaining R40 000 being used to fund the acquisition of listed shares.

²⁹⁵ Paragraph (b)(i) of the definition of 'concession or compromise' in para 12A(1).

After the transaction the balance sheet appeared as follows:

	R
Share capital	100 100
Accumulated loss	(100 000)
Shareholder's loan	<u>100 000</u>
	<u>100 100</u>
Listed shares at cost	<u>100 100</u>

Before the issue of the additional shares the previously held shares had a market value of nil and after the share issue all the shares are worth R100.

Result:

There has been a 'concession or compromise' because a debt owed by a company has been settled by being converted to or exchanged for shares in that company.²⁹⁶

There is a debt benefit determined as follows:

		R
Face value of loan settled through issue of shares		100 000
Less:		
Market value of shares after arrangement	100	
Market value of previously issued shares	(0)	(100)
Debt benefit		<u>99 900</u>

Of this amount, R60 000, representing accrued interest, will not be excluded from potential para 12A(3) consequences, while the remaining R39 900 will be excluded under para 12A(6)(g).

The base cost of the listed shares is made up as follows:

	R
Original cost [para 20(1)(a)]	100 100
Interest [para 20(1)(g)] R60 000 × 1 / 3	<u>20 000</u>
	<u>120 100</u>

Company X must therefore reduce the base cost of its listed shares by R20 000. The balance of the debt benefit relating to accumulated interest of R40 000 (R60 000 – R20 000) will not have any consequences under s 19, since it would not have qualified as a deduction under s 11(a) read with s 23(f), being in the production of exempt dividend income.

6.3 Time of disposal and acquisition

Paragraph 13

6.3.1 Introduction

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

²⁹⁶ Paragraph (b)(i) of the definition of 'concession or compromise' in para 12A(1).

Paragraph 13 contains three categories of timing rules covering

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

However, not all the time of disposal rules are contained in para 13. Some of them are in standalone provisions in the Eighth Schedule and the main body of the Act:

Table 1 – Time of disposal rules other than in para 13

Provision	Disposal	Time of disposal
Paragraph 77(1)	Disposal of shares in liquidating company	Earlier of: <ul style="list-style-type: none"> • the date of dissolution or deregistration; or • with the liquidation or winding-up, the date when the liquidator declares in writing that no reasonable grounds exist to believe that the holder of shares in the company (or holders of shares holding the same class of shares) will receive any further distributions in the course of the liquidation or winding-up of that company. See 18.10.
Section 9H(2)	Person other than a company ceases to be a resident	The date immediately before the day on which that person so ceases to be a resident. See 6.2.2A .
Section 9H(3)(a)	A company ceases to be a resident or becomes a headquarter company	On the date immediately before the day on which that company so ceased to be a resident or became a headquarter company. See 6.2.2A .
Section 9H(3)(b)	A CFC ceases, otherwise than by becoming a resident, to be a CFC during any foreign tax year of that CFC	On the date immediately before the day on which that CFC so ceased to be a CFC. See 6.2.2A
Section 9HA(1)	Death	At the date of the person's death. See 16.2.1 .

Section 24J(4)	Adjusted gain or loss on transfer or redemption of an instrument	Year of assessment in which transfer or redemption of the instrument occurs. See 24.4.
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The table below summarises the time of disposal rules under para 13.

Table 2 – Time of disposal under para 13

Paragraph 13(1)	Disposal	Time of disposal
(a)	Disposal of an asset by means of a change of ownership effected or to be effected from one person to another because of an event, act, forbearance or by operation of law	
(i)	Agreement subject to a suspensive condition (see below for meaning of 'suspensive condition')	Date on which the condition is satisfied.
(ii)	Agreement not subject to a suspensive condition	Date on which agreement is concluded.
(iiA) ²⁹⁷	The distribution of an asset of a trust by a trustee to a beneficiary to the extent that the beneficiary has a vested interest in the asset	Date on which the interest vests.
(iiB) ²⁹⁸	The granting by a trust to a beneficiary of an equity instrument contemplated in s 8C.	Time when the equity instrument vests in the beneficiary as contemplated in s 8C.
(iii)	Donation of an asset	Date of compliance with all legal requirements for a valid donation – see 6.3.7.
(iv)	Expropriation of an asset	Date on which the person receives the full compensation agreed to or finally determined by a competent tribunal or court. The word 'receives' is used here in the sense of 'actually receives'. Thus, a person whose property is expropriated and in return becomes entitled to a lump sum payable in instalments (whether through agreement or by order of court) must bring the disposal and proceeds to account when the final instalment is actually received. The purpose of this deferral is to prevent a cash-flow problem for the taxpayer that might otherwise have resulted from the determination of an up-front capital gain, particularly because the compensation may be paid over

²⁹⁷ Paragraph 13(1)(a)(iiA) inserted by s 76(a) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

²⁹⁸ Paragraph 13(1)(a)(iiB) inserted by s 107(1) of the Taxation Laws Amendment Act 25 of 2015 and applicable to years of assessment commencing on or after 1 March 2016.

Paragraph 13(1)	Disposal	Time of disposal
		several years and be outside the control of the taxpayer.
(v)	Conversion of an asset	Date on which that asset is converted
(vi)	Granting, renewal or extension of an option	Date on which the option is granted, renewed or extended
(vii)	Exercise of an option	Date on which the option is exercised
(viii)	Termination of an option granted by a company to a person to acquire a share, participatory interest ²⁹⁹ or debenture of that company	Date on which that option terminates
(ix)	Any other case	Date of change of ownership
(b)	Extinction of an asset including by way of forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment	Date of the extinction of the asset
(c)	Scrapping, loss or destruction of an asset	Date (i) when the full compensation in respect of that scrapping, loss or destruction is received; or (ii) if no compensation is payable, the later of the date when the scrapping, loss or destruction is discovered or the date on which it is established that no compensation will be payable
(d)	Deleted ³⁰⁰	
(e)	Distribution of an asset by a company to a holder of shares	Date on which that asset is so distributed as contemplated in para 75
(f)	Decrease of a person's interest in a company, trust or partnership as a result of a 'value shifting arrangement',	Date on which the value of that person's interest decreases
(g)(i)	The following events referred to in para 12: (2)(a)(i) person that commences to be a resident;	Date immediately before the day that the event occurs

²⁹⁹ The previous reference to a unit was substituted by a reference to a participatory interest by the Revenue Laws Amendment Act 32 of 2004, effective as from the date that the Collective Investment Schemes Control Act 45 of 2002 came into operation, namely, 3 March 2003.

³⁰⁰ Paragraph 13(1)(d) was deleted by s 76(b) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009. The provision stated that the time of disposal in the case of 'the vesting of an interest in an asset of a trust in a beneficiary is the date on which that interest vests'. Although the vesting of an interest in an asset of a trust in a beneficiary remains a disposal event under para 11(1)(d), the time of such a disposal must now be inferred from para 13(1)(a)(iiA) as being the date on which the interest vests. This would in any event be the date under general principles, since the date on which the beneficiary becomes unconditionally entitled to the asset is the date of vesting.

Paragraph 13(1)	Disposal	Time of disposal
	<p>(ii) foreign company that commences to be a CFC;</p> <p>in respect of all assets of that person other than</p> <ul style="list-style-type: none"> • assets in South Africa listed in para 2(1)(b)(i) and (ii) (South African immovable property or assets effectively connected with a permanent establishment in South Africa); and • any right to acquire any marketable security contemplated in s 8A. <p>(b)(i) asset of a non-resident becoming part of that non-resident's permanent establishment in South Africa otherwise than by way of acquisition; or</p> <p>(ii) asset of a non-resident ceasing to be part of that non-resident's permanent establishment in South Africa otherwise than by way of a disposal contemplated in para 11.</p> <p>(c) assets that commence to be held as trading stock</p> <p>(d) asset which ceases to be held as a personal-use asset otherwise than by way of a disposal contemplated in para 11</p> <p>(e) asset which commences to be held as a personal-use asset</p> <p>12(3) assets which cease to be held as trading stock otherwise than by way of a disposal contemplated in para 11.</p> <p>12(4)³⁰¹ person ceasing to be a CFC as a result of becoming a resident</p>	
(g)(ii)	Paragraph 12(2)(f) transfer of assets between funds of an insurer	Date that the event occurs

Application of para 13 to pre-CGT disposals

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

‘ “[P]re-valuation date asset” means an asset acquired prior to valuation date by a person and which has not been disposed of by that person before valuation date.’

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

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

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

Beneficial ownership of immovable property

It sometimes happens that a person (A) will register immovable property in the name of another person (B), for example, a relative, boyfriend or girlfriend, on the understanding that A will remain the true owner despite registration in B's name. This ill-advised arrangement may be done in an effort to conceal assets from creditors or to obtain bond finance from a bank because A is not creditworthy. For CGT purposes however, registration of immovable property in a person's name is evidence of a transfer of ownership and any private arrangement between the parties would not prevent that transfer of ownership. This outcome follows from s 16 of the Deeds Registries Act 47 of 1937, which reads as follows:

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

In these circumstances the CGT consequences for both parties will have to be considered because the registered owner of the property holds an asset in the form of a real right while the beneficial owner holds a personal right of use and occupation. The outcome will depend on the terms of the agreement entered into between the parties. Taxpayers need to be mindful of s 102 of the Tax Administration Act which places the burden on them to prove the terms of any agreement. The position with an asset such as a share is different since in that case it is possible for a person to act as a nominee of a beneficial owner.

³⁰¹ The reference to para 12(4) was inserted by s 68(1) of the Taxation Laws Amendment Act 17 of 2009 and deemed to have come into operation on 21 February 2008 and applies in respect of an asset disposed of on or after that date, unless that disposal is the subject of an application for an advance tax ruling accepted by the Commissioner for SARS before that date.

Example – Primary residence registered in the name of another person*Facts:*

Adele wished to purchase a primary residence but lacked the credit standing required in order to obtain a bond. Her sister Sandy agreed to acquire the residence on Adele's behalf and to register a bond in her name on condition that Adele would pay all the necessary expenses and bond repayments. Under their agreement Sandy also agreed that she would account to Adele for any proceeds when the residence was disposed of. Under the agreement Adele was given full use and occupation of the residence, which she used as her primary residence. Sandy did not occupy the residence.

The residence cost R500 000, including transfer fees. Adele paid a deposit of R100 000 and her sister took out a bond for the balance of R400 000. Over the next seven years Adele paid the rates, water and electricity. She also paid the bond instalments which comprised capital of R100 000 and interest of R50 000. After seven years the property was sold for R2,5 million. Sandy used R300 000 to settle the balance of the bond (R400 000 original debt less R100 000 paid by Adele over the seven-year period) and paid the remaining R2,2 million to Adele.

*Result:**Adele*

Under para (c) of the definition of 'an interest' in para 44 Adele has a right of use and occupation which comprises her primary residence. The base cost of that right comprises the expenditure actually incurred by her under para 20(1)(a), that is, the amount for which she is unconditionally liable to Sandy, namely, the purchase price of the residence of R500 000. Adele is unconditionally entitled to the proceeds of R2,5 million, leaving her with a capital gain of R2 million which she must disregard under para 45.

Sandy

Sandy owns a real right in the residence because it is registered in her name at the deeds registry. While she is indebted to the bank for the bond of R400 000 she has a right of recovery against Adele for a like amount. While she owed R100 000 to the purchaser for the deposit, this amount was paid by Adele.

Under para 20(3)(b) the base cost of an asset must be reduced by any amount which has been recovered or become recoverable or paid by any other person. Sandy's base cost in the residence must therefore be reduced to nil.

Since she antecedently divested herself of the future proceeds, no proceeds will accrue to her. She will therefore realise neither a capital gain nor a loss on the disposal.

Disposal of immovable property with right to reacquire a portion of it after subdivision

It can happen that immovable property is disposed of on condition that the seller is granted a right to reacquire a portion of it at nominal value following subdivision of the property by the buyer. Such a transaction is not a part-disposal and must be dealt with according to barter or exchange principles, which are examined in more detail in **8.5**.

Example – Disposal of immovable property with reacquisition of portion of it after subdivision*Facts:*

X Ltd held immovable property as a capital asset. The company was approached by a developer with a view to acquiring a portion of the property. X Ltd applied for the property to be subdivided but the process was proving to be very time consuming and the developer was keen to proceed with the development. It was therefore agreed that X Ltd would transfer the entire property to the developer on condition that it would be entitled to take transfer of the portion of the property that it wished to retain after the developer had completed the subdivision process. The developer would not pay anything for this 'take back' portion and neither would X Ltd pay the developer when the 'take back' portion was transferred back to X Ltd. X Ltd had acquired the entire property in 2002 at a cost of R4 million. The market value of the entire property at the time of sale to the developer was R12 million. The portion of the property to be reacquired represented 75% of the market value of the property. This market value did not change between the time of disposal of the full property and the reacquisition of the 'take back' portion a few months later. On transfer of the full property to the developer, the developer paid X Ltd R3 million (R12 million × 25%). The sale agreement conferred on X Ltd a right to reacquire a designated 75% portion of the property after subdivision and the title deeds were endorsed accordingly. The sale agreement was concluded on 29 February 2020 and the property was transferred to the developer on 31 May 2020. The take-back portion was transferred to X Ltd on 30 November 2020.

Result:

The transfer of the entire property on 29 February 2020 comprises a full disposal and triggers a capital gain for X Ltd of R8 million (R12 million proceeds less R4 million base cost. The proceeds comprise the portion of the purchase price to be paid in cash on transfer of R3 million plus the market value of the right to reacquire 75% of the property of R9 million.

The base cost of the amount deposited into X Ltd's bank account is R3 million and the base cost of the right to reacquire 75% of the property is R9 million. These amounts represent expenditure in the form of the amount by which X Ltd was impoverished in giving up the full property worth R12 million.

When the 75% portion is returned to X Ltd, it will have a base cost of R9 million, being equal to the market value of the right to reacquire the property which was given up in exchange for a real right in the property.

6.3.2 Dates of disposal not covered by para 13 and the main body of the Act

While para 13 sets out time of disposal rules for many of the disposal events contained in para 11, it is not an exhaustive provision. For example, the creation of an asset is a disposal event in para 11(1), but para 13 does not specify a time of disposal for the creation of an asset. If para 13 is silent, the time of disposal (and the corresponding time of acquisition) must be deduced from the disposal event itself. Thus, the time of disposal for the vesting of an interest in an asset of a trust in a beneficiary is the date on which the asset vests. This date would under general principles also be the date on which the beneficiary became unconditionally entitled to the asset. The date can also be inferred from para 13(1)(a)(iiA) which takes the time of distribution of an asset back to the time of vesting.

As noted in 6.3.1, some time of disposal rules are contained in the main body of the Act (for example, s 9H and 9HA). But even here the rules are not exhaustive. Section 25(3)(b) is silent on the date on which an heir or legatee acquires an asset. It is considered that an heir or legatee will become unconditionally entitled to an asset from the deceased estate when the liquidation and distribution account becomes final. See 16.4.2. Special rules apply to a resident surviving spouse under s 25(4).

The time of disposal for the creation of an asset is the date when the asset is created. This rule is best illustrated by the disposal of certain personal rights. Paragraph 13(1)(a) provides times of disposal when a change of ownership has been effected or is to be effected. While a person can own a personal right and in certain circumstances transfer such a right to another person (for example, by cession), many personal rights do not involve a transfer of ownership from one person to another. Personal rights are frequently ‘created’ rather than transferred.

Example – Personal right created through obligation

Facts:

Beverly agreed not to trade within a five-kilometre radius of Agatha’s business for two years in exchange for a payment of R100 000,

Result:

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

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

6.3.3 Suspensive v resolutive conditions

A *suspensive condition* suspends the full operation of the obligation under a contract and renders it dependent on an uncertain future event.³⁰² A clause which states that a sale will be confirmed only if a mortgage bond of a specified amount is obtained by a specified future date or which states that the sale is subject to the buyer being able to dispose of an existing residence by a future date are typical suspensive conditions.

A suspensive condition must be distinguished from a term of a contract. In *Design & Planning Service v Kruger*³⁰³ Botha J distinguished a suspensive condition from a term of a contract as follows:

‘In the case of a suspensive condition, the operation of the obligations flowing from the contract is suspended, in whole or in part, pending the occurrence or non-occurrence of a particular specified event (cf *Thiart v Kraukamp*, 1967 (3) SA 219 (T) at p 225). A term of the contract, on the other hand, imposes a contractual obligation on a party to act, or to refrain from acting, in a particular manner. A contractual obligation flowing from a term of the contract can be enforced, but no action will lie to compel the performance of a condition (*Scott & another v Poupard & another*, 1971 (2) SA 373 (A) at p 378 in fin).’

³⁰² W A Joubert *et al* ‘Suspensive Conditions’ Volume 9 (Third Edition Volume) *LAWSA* [online] (My LexisNexis: 31 October 2014) in para 362.

³⁰³ 1974 (1) SA 689 (T) at 695.

Example 1 – Disposal subject to a suspensive condition*Facts:*

Lindsay disposed of his luxury townhouse at Ballito to Kevin on 28 February 2019, subject to Kevin obtaining a bond of at least R2 million by 30 June 2019. On 15 June 2019 Kevin obtained a bond of R2,1 million, and on 15 August 2019 the property was transferred into his name.

Result:

The date of disposal is 15 June 2019 when the suspensive condition was fulfilled.

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

Example 2 – Disposal subject to resolutive condition*Facts:*

On 15 January 2020 the Acorn Trust disposed of its investment in Oak Tree (Pty) Ltd to an empowerment consortium. The sale agreement provided that the sale would be cancelled and any monies paid by the purchasers would be forfeited to the seller if the company did not produce a turnover of R100 million by 30 June 2022.

Result:

The date of disposal is 15 January 2020 because the sale is not subject to a suspensive condition. The clause in the contract is resolutive in nature.

6.3.4 Time of conclusion of contract

The time of disposal for an unconditional agreement is the date on which the agreement is concluded [para 13(1)(a)(ii)]. The date of conclusion of an agreement is a matter to be determined in accordance with the law of contract, and will depend on the facts of the particular case. It is beyond the scope of this guide to provide a full exposition of the law in this regard. The courts have laid down some general rules for determining the date of conclusion of a contract, and these are as follows:³⁰⁴

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

There are exceptions to these rules. For example:

- A contract negotiated through the post is concluded by the posting of the letter of acceptance, and not when the letter is received by the offeror.³⁰⁵

³⁰⁴ GB Bradfield *The Law of Contract in South Africa* 7 ed (2016) [online] (My LexisNexis: 31 December 2015) in para 2.3.

³⁰⁵ *Dunlop v Higgins* (1848) 9 ER 805; *Cape Explosives Works Ltd v SA Oil & Fat Industries Ltd* 1921 CPD 244 and *Kergeulen Sealing & Whaling Co Ltd v CIR* 1939 AD 487, 10 SATC 363.

- The general rule can be varied by the offeror stipulating the method of acceptance.³⁰⁶

Effective dates

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

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

A contract of sale not subject to any suspensive conditions in which the transfer of ownership occurs after the conclusion of the agreement of sale involves two disposals, namely,

- The disposal of a personal right to the buyer, being the right to claim transfer or delivery; and
- The transfer or delivery of the thing sold.

Each of these rights comprises an asset for CGT purposes and each of these assets is disposed of under para 11. The creation of a personal right to claim delivery in favour of the buyer is a disposal through the creation of an asset. In the process of creation, the seller's asset is encumbered by an obligation to effect delivery and in the process the rights in the asset are diminished. The buyer acquires a valuable asset in the form of the right to claim delivery and should the seller fail to perform, would be entitled to various remedies against the seller.

The second disposal occurs through the change of ownership when the real right in the asset is transferred to the buyer through delivery (for example, through registration in the deeds registry).

Under para 13(1)(a)(ii) the time of disposal of an asset by a change of ownership effected or to be effected is in the case of an agreement which is not subject to a suspensive condition the date on which the agreement is concluded. The effect of this rule is to create a legal fiction that the assets described above have been transferred or delivered on the date on which the agreement is concluded. By taking both disposals back to the time at which the agreement was concluded any change in the value of the asset between the time of conclusion of the agreement and the time of delivery will be disregarded thus resulting in neither a capital gain nor a capital loss.

In the absence of para 13(1)(a)(ii), a buyer of an asset could have faced a capital gain or loss at the time of delivery as illustrated in the example below.

Example 1 – Exchange of rights

Facts:

Under an agreement not subject to any suspensive conditions, X sold land with a base cost of R40 to Y for R100 on 1 March. On 31 May X transferred the land to Y in exchange for the purchase price of R100. On 31 May the land had increased in value to R120. What would the consequences have been for Y in the absence of para 13(1)(a)(ii)?

³⁰⁶ *Driftwood Properties (Pty) Ltd v McLean* 1971 (3) SA 591 (A) and *Laws v Rutherford* 1924 AD 261.

Result:

On 1 March Y acquired a personal right to claim delivery of the land at a cost of R100. In the absence of para 13(1)(a)(ii), Y's personal right would have been extinguished on 31 May in exchange for a real right in the land. The proceeds on disposal of the personal right would have been equal to the market value of the real right on 31 May, resulting in a capital gain of R20 (R120 proceeds less R100 base cost). The base cost of the real right in the land on 31 May would have been equal to the market value of the personal right given up immediately before the exchange of R120.

The effect of para 13(1)(a) is to take the exchange of the personal right for the real right back to 1 March when the real right was also worth R100. The personal right is thus deemed to be disposed of for proceeds equal to the market value of the real right on 1 March of R100 resulting in neither a capital gain nor a capital loss. Y's base cost in the land going forward is equal to the market value on 1 March of the personal right given up of R100.

X has a capital gain of R60 (R100 proceeds less R40 base cost). The proceeds of R100 accrue to X on 1 March because that is when delivery is deemed to occur.

In the absence of para 13(1)(a)(ii) a change in value of the asset between the date of the agreement and the date of delivery would not usually have been an issue for the seller with a fixed purchase price, but it could have been an issue under a barter transaction.

Prof Gerrie Swart comments on this rule as follows:³⁰⁷

'A legal fiction is created, in other words, that the asset involved is transferred or delivered to the person entitled thereto on the date on which the unconditional right to claim such transfer or delivery arises, even though the actual transfer or delivery may be effected only at a later date (including a date falling in a later tax year, or which might, due to unforeseen circumstances, never occur). This artificial rule is of profound importance. By treating the transfer or change of ownership of an asset as having taken place on the date on which and during the tax year in which the contract is concluded or becomes unconditional, the fictional change of ownership precedes the actual change of ownership. The rule therefore operates prospectively, with the result that the change of ownership is drawn back and recognized in the tax year in which the initial contractual right arises. The actual transfer or delivery of the asset in a later tax year is ignored as it does not qualify as a disposal in that year.'

The effect of para 13(1)(a) is thus to take the time of disposal of the real right back to the time when the agreement was concluded. The provisions of the Eighth Schedule must be read as a whole and for this reason it is no defence to argue that an accrual for the purposes of para 35 must be determined independently of para 13 on the basis of alleged common law principles.

While it has been held in the tax court that there is no accrual when the right to claim payment is dependent on the seller's obligation to perform under an agreement³⁰⁸ it is by no means clear that this principle extends to something which is merely an administrative term of a contract, such as the obligation to effect transfer of immovable property in the deeds registry. But as noted above since para 13(1)(a)(ii) deems delivery to have occurred on conclusion of the agreement, any delay in actual delivery will not delay an accrual of proceeds or the incurral of expenditure because fulfilment of the term is deemed to have occurred. This principle is consistent with a similar rule in s 24(1) which applies 'for the purposes of the Act'. However,

³⁰⁷ Gerard Swart 'The Taxation of Trusts – Superimposing New Rules on Old Principles' (July 2002) 17 *Acta Juridica* 102 at 128.

³⁰⁸ *WH Lategan v CIR* 1926 CPD 203, 2 SATC 16; *ITC 424* (1938) 10 SATC 338 (U). See also AP de Koker & RC Williams *Silke on South African Income Tax* [online] (My LexisNexis: October 2019) in § 2.8, and *ITC 316* (1934) 8 SATC 166 (U).

on the basis that specific provisions override general ones, para 13 will take precedence over s 24(1).³⁰⁹

The fact that delivery is deferred and requires performance on the part of the seller does not make delivery a suspensive condition. Delivery is merely a term of the contract. A breach of the contract by failing to deliver gives rise to ordinary contractual remedies of a compensatory nature, that is, (depending on the circumstances) specific performance, damages, cancellation or certain combinations of these.³¹⁰

In ITC 1900³¹¹ the issue was whether the amounts received or accrued in respect of the disposal of 25 immovable properties had to be included in the appellant's gross income in the 2013 or 2014 years of assessment. The court stated that a right to payment in respect of immovable property under the *Lategan* principle vested in the Appellant, and had a value in its hands, as soon as it was in a position to be able to tender transfer to the purchasers under the agreements. The court refused to accept that the accrual took place only upon transfer when payment occurred.

Binns-Ward J stated that³¹²

'the timing of the transfers and actual making of the payments, and the order in which they happen do not, in my judgment, determine when the taxpayer became "entitled to payment" within the meaning of the *Lategan* principle. The taxpayer's entitlement to payment vested at the date of the fulfilment (including fictitious fulfilment in a case in which the purchaser frustrated the actual fulfilment of the condition) of any suspensive conditions to which the agreement was subject, or the date upon which the taxpayer obtained (or, acting reasonably, could have obtained) the statutory permissions necessary to enable it to tender transfer, whichever occurred later. In other words, the entitlement to payment vested in the taxpayer as soon as the contract became enforceable at the instance of either party'.

In the result, however, the actual date of accrual under the *Lategan* principle was academic because the court found that the proceeds were deemed to accrue under s 24 on the date of entering into the agreements.

On appeal in *Milnerton Estates Ltd v C: SARS*³¹³ the SCA found it unnecessary to canvass the potentially complicated question of whether there was an accrual in accordance with ordinary principles. In the result the court dismissed the appeal, holding that the income was deemed to accrue in the 2013 year of assessment under s 24(1). During argument counsel for the appellant raised the concern that there was potential for the sale to give rise to a capital gain in the first year and a capital loss in the second in circumstances in which the taxpayer might have no corresponding gain against which to offset the loss. In this regard Wallis JA observed that³¹⁴

'the determination of the amount of any capital gain falling to be included in the taxpayer's taxable income is a matter dealt with in the eighth schedule to the Act. It is not apparent to me that the provisions of s 24(1) apply in determining when an accrual occurs for the purpose of para 3 of the eighth schedule. There is no reference back to s 24(1) and on its face the schedule seems to provide a self-contained method for determining whether a capital gain or loss has arisen. Again I refrain from any definitive decision on the point, but it may be an answer to the concern expressed by counsel'.

³⁰⁹ C Divaris 'Income Tax Act: delayed-transfer transactions—I' (January 2015) 142 *TSH* at 9.

³¹⁰ *R v Katz* 1959 (3) SA 408 (C) at 417.

³¹¹ ITC 1900 (2017) 79 SATC 341 (WC).

³¹² At 348.

³¹³ 2019 (2) SA 386 (SCA), 81 SATC 193.

³¹⁴ At SATC 203 in [20].

It therefore remains a moot point whether s 24(1) applies for CGT purposes. As explained earlier, the preferred view is that the proceeds are deemed to accrue on the date of disposal under para 13.

Example 2 – Time of accrual of proceeds under a deferred delivery arrangement

Facts:

On 20 February 2020 Ipeleng concluded an agreement with Johannes under which she disposed of her holiday flat to him for R800 000. The sale was not subject to any suspensive conditions. Under a term of the agreement Johannes was required to pay R800 000 into the trust account of Ipeleng's attorney after which the attorney would effect transfer and make payment to Ipeleng. Johannes duly transferred the funds on 11 March 2020 and Ipeleng's attorney effected transfer of ownership in the deeds registry on 20 March 2020. He paid the funds over to Ipeleng on 2 April 2020. The base cost of the property in Ipeleng's hands was R200 000.

Result:

Ipeleng is deemed to have disposed of the property on 20 February 2020 and Johannes is deemed to have acquired it on the same date. The proceeds of R800 000 accrue to Ipeleng on 20 February 2020 because she is deemed under para 13(1)(a)(ii) to have transferred ownership on 20 February 2020 even though the actual transfer of ownership took place on 20 March 2020.

In the 2020 year of assessment Ipeleng will have a capital gain of R600 000 (R800 000 proceeds less R200 000 base cost). Johannes is deemed to have incurred expenditure of R800 000 for the purposes of para 20(1)(a) on 20 February 2020.

Suspensive sale v suspensive condition

A suspensive sale agreement, which is simply a sale by instalments, must not be confused with a sale subject to a suspensive condition. Under the typical suspensive sale agreement involving residential immovable property, the parties enter into a sale agreement under which the buyer pays a small deposit followed by instalments. Once the last instalment is paid the property is transferred into the name of the buyer. The buyer is also entitled to demand transfer of the property once 50% of the purchase price has been paid by settling the balance of the amount owing through registration of a mortgage bond. The agreement is recorded against the title deeds in the deeds registry.³¹⁵ The mere fact that transfer is delayed until the last instalment is paid does not mean that the sale is subject to a suspensive condition. The sale will usually be *perfecta* when entered into and in such event that is when the disposal will occur. The SCA remarked on one such agreement that '[i]t was labelled a "suspensive sale agreement", although I fail to see what was suspensive about it'.³¹⁶

6.3.6 Cancellation of contracts

6.3.6.1 Retrospective adjustments not permitted

The accrual of proceeds is not prevented in a contract subject to cancellation as a result of a resolutive condition. For example, it might be provided that the contract will be cancelled should payment not take place by a certain date. The view is held that at the time of disposal the contract is *perfecta*, and the seller is entitled to either the return of the asset (money's

³¹⁵ Section 20 of the Alienation of Land Act 68 of 1981.

³¹⁶ *Tsung & another v Industrial Development Corporation of South Africa Limited & another* 2013 (3) SA 468 (SCA) at 471.

worth) or payment (money). In either case the proceeds can be unconditionally determined and the seller has a definite right *in praesenti*.

With a contract subject to a resolutive condition, the disposal takes place when the agreement is concluded [para 13(1)(a)(ii)]. The common law consequences flowing from the cancellation of a contract as a result of the fulfilment of a resolutive condition were described by Coetzee J in *Amoretti v Tuckers Land & Development Corporation (Pty) Ltd*³¹⁷ in which he cited with approval the following extract from *Wessels on Contract*.³¹⁸

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

(Emphasis added by Coetzee J.)

But from a tax perspective the matter cannot be dealt with retrospectively.³¹⁹ Tax is an annual event and assessments cannot be held open indefinitely for conditions to be fulfilled; nor can they be reopened to give effect to subsequent events (unless this is explicitly provided for). In *Caltex Oil (SA) Ltd v SIR Botha JA* stated that³²⁰

'income tax is assessed on an annual basis in respect of the taxable income received by or accrued to any person during the period of assessment, and determined in accordance with the provisions of the Act. ... It is only at the end of the year of assessment that it is possible, and then it is imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment'.

He continued:³²¹

'What is clear, I think, is that events which may have an effect upon a taxpayer's liability to normal tax are relevant only in determining his tax liability in respect of the fiscal year in which they occur, and cannot be relied upon to redetermine such liability in respect of a fiscal year in the past.'

Generally, the Eighth Schedule has been formulated so as to avoid reopening assessments, and it is for this reason that the rules in paras 3 and 4 exist.

While s 93(1)(d) of the Tax Administration Act enables SARS to issue a reduced assessment when a taxpayer has submitted a return containing a readily apparent undisputed error, this provision cannot be used to retrospectively undo the consequences of a valid disposal when a contract is cancelled. The cancellation of the contract does not mean that there was an undisputed error and the consequences must be brought to account in the year of cancellation. See *New Adventure Shelf 122 (Pty) Ltd v C: SARS*³²² which is considered in **9.1.3.3**.

The Eighth Schedule was amended with effect from 1 January 2016 to deal with cancellation of contracts and these amendments are summarised in **6.3.6.3**.

³¹⁷ 1980 (2) SA 330 (W) at 332.

³¹⁸ JW Wessels (edited by AA Roberts) Vol 1 *The Law of Contract in South Africa* 2 ed (1951) Butterworth & Company (Africa) Ltd in paras 1409–1411. See also AJ Kerr 'Resolutively Conditioned Sales' 24 (Second Edition Volume) *LAWSA* [online] (My LexisNexis: 31 May 2010) in para 113.

³¹⁹ See, for example, ITC 1346 (1981) 44 SATC 31 (C) in which a lecturer who received a salary while on study leave was required to repay it if he did not resume his post at the conclusion of his leave. The court held that the amount had to be included in gross income despite being subject to a contingency.

³²⁰ 1975 (1) SA 665 (A), 37 SATC 1 at 11.

³²¹ At SATC 15.

³²² [2017] 2 All SA 784 (SCA), 79 SATC 233.

The position before 1 January 2016, and for the situation on or after that date when an agreement is cancelled and the parties are not restored to their pre-sale position is addressed in **6.3.6.2**.

6.3.6.2 Contracts cancelled before 1 January 2016

For contracts cancelled before 1 January 2016 it is submitted that the ‘adjustment rules’ in paras 3(b) and 4(b) deal with circumstances other than those in which a contract is cancelled and the asset is reacquired by the seller. The basis for this submission is that one of the core rules of the Eighth Schedule in para 11(1)(b) recognizes cancellation as a disposal event. If the cancellation of a contract results in a disposal by the original buyer and a reacquisition by the original seller, that transaction will have its own base cost and proceeds and there is no need to tamper with the proceeds or base cost relating to the original disposal. Also, attempting to conflate the core disposal rules and the adjustment rules can give rise to absurd results. In *Natal Joint Municipal Pension Fund v Endumeni Municipality* the court stated the following:³²³

‘An interpretation will not be given that leads to impractical, unbusinesslike or oppressive consequences or that will stultify the broader operation of the legislation or contract under consideration.’

The absurd consequences that flow from applying the adjustment rules can be illustrated with a simple example.

Example 1 – Absurd results when the adjustment rules are applied to cancellation of a contract that results in the reacquisition of an asset

Facts:

In year 1 Abe sells land having a base cost of R20 to Bart for R100 on credit. During the same year of assessment Abe and Bart agree to cancel the contract with Bart returning the land and being relieved of having to pay the purchase price. The land is still worth R100 at the time of cancellation.

Result:

Abe has a capital gain on the initial disposal of the land of R80 (proceeds of R100 less base cost of R20). Following the disposal Abe has given up land with a market value of R100 in exchange for a new asset, being the debt claim against Bart. The base cost of the debt claim is equal to the market value of the land given up since that represents the expenditure on its acquisition (see **8.5** on the application of barter or exchange principles for establishing expenditure). However, if the proceeds on disposal of the land are reduced under para 35(3)(c), Abe is left with a capital loss of R20 since there is no adjustment rule to reduce his base cost to nil. There is also no adjustment rule to re-establish Abe’s base cost at R20. If the core rules are applied to re-establish the base cost of the asset, it would have a base cost equal to R100, being equal to the value of the debt claim given up. It would clearly be absurd to provide Abe with a capital loss of R20 and a step-up in base cost to R100.

By contrast, if the core rules are applied, a sensible result ensues. Abe will have a capital gain of R80 on the first disposal and will then reacquire the asset at a stepped-up base cost of R100.

³²³ 2012 (4) SA 593 (SCA) at 610.

A similar absurdity would arise if the sale were cancelled in a subsequent year of assessment. For example, assume that the sale is cancelled in year 3 on the same basis and that the land is still worth R100 at the time of cancellation. If para 4(b)(i)(aa) were to be applied, Abe would have a capital loss in year 3 of R100 being equal to the proceeds taken into account in year 1 that he is no longer entitled to as a result of the cancellation of the agreement. However, as noted above there is no rule to restore Abe's base cost to R20 and if the core rules are applied, the base cost of the reacquired land would be R100, equal to the value of the debt claim given up. Applying the core rules to both the initial sale and the subsequent cancellation avoids this absurdity. There will be a capital gain of R80 in year 1 and a step-up in base cost in year 3 on the reacquired land to R100 which is a reasonable result.

Any increase in value of the asset originally disposed of from the time of disposal to the time of cancellation must be dealt with as a claim for damages which will give rise to a further capital gain. Any instalments that are refunded to the buyer represent expenditure actually incurred for the purposes of para 20 in reacquiring the asset.

Example 2 – Simple cancellation of contract during the same year of assessment [pre-1 January 2016 disposal]

Facts:

In year 1 Althea sold land having a base cost of R20 to Bongani on loan account for proceeds of R100. In the same year of assessment, the parties cancelled the contract. Bongani returned the land to Althea and was relieved of having to settle the debt of R100. The asset has the same value at the time of cancellation.

Result:

The initial disposal of the land gives rise to a capital gain for Althea of R80 (proceeds of R100 less base cost of R20). Althea has given up the land in exchange for a debt claim having a base cost of R100. When the sale is cancelled, Althea disposes of the debt claim in return for the land. The proceeds on disposal of the debt claim are equal to the market value of the land received (R100) and the base cost of the debt claim is R100 resulting in neither a capital gain nor a capital loss. The base cost of the reacquired land is R100, being equal to the market value of the debt claim given up.

Bongani has incurred expenditure of R100 under para 20(1)(a) in acquiring the land which is equal to the liability incurred at the time of its acquisition. When the sale is cancelled, Bongani disposes of the land to Althea for proceeds of R100 under para 35(1)(a), equal to the liability discharged resulting in neither a capital gain nor a capital loss.

Example 3– Cancellation of contract and refund of purchase price [pre-1 January 2016 disposal]

Facts:

Aki sold an asset having a base cost of R20 to Jenny for proceeds of R100. The sale was settled with an initial instalment of R10 and the balance on loan account. During the same year of assessment, the sale was cancelled. Jenny returned the asset and was relieved of having to pay the balance of the loan account of R90. Aki refunded Jenny the instalment of R10.

Result:

Aki has a capital gain of R80 (proceeds of R100 less base cost of R20). When the sale was cancelled, Aki paid Jenny R10 and gave up the debt claim of R90. These two amounts constitute the expenditure on the reacquired asset which has a base cost of R100.

Jenny's base cost upon acquiring the asset is R100 (R90 debt claim plus R10 cash payment). When the sale was cancelled, Jenny disposed of the asset to Aki. Her proceeds are R100 comprising R90 under para 35(1)(a) in respect of the discharge of the debt claim and R10 received in cash from Aki resulting in neither a capital gain nor a capital loss.

Example 4 – Cancellation of contract when seller retains instalments received and value of asset increases [pre-1 January 2016 cancellation]

Facts:

In year 1 Tom sold an asset having a base cost of R20 to Ivan for proceeds of R100. The selling price was settled by an initial instalment of R10 and the balance on loan account.

In year 3 the sale was cancelled at which time the asset had a market value of R125. Ivan returns the asset to Tom, is relieved of having to pay the balance of the purchase price and forfeits the initial instalment and any growth in the value of the asset as compensation to Tom. The balance on the loan account at the time of cancellation, which included accrued interest of R30, was R120.

Result:

In year 1 Tom has a capital gain of R80 (proceeds of R100 less base cost of R20). In year 3 as a result of the cancellation of the contract Tom acquires a claim for compensation against Ivan amounting to R5. The claim has a base cost of nil. When Ivan returns the asset, Tom's debt claim against Ivan of R120 is disposed of for an equivalent amount reflected in the value of the asset resulting in neither a capital gain nor a capital loss. The balance of the value received of R5 (R125 – R120) represents proceeds on disposal of the claim for compensation resulting in a capital gain of R5 (R5 proceeds – RNil base cost).

Cancellation of illegal contracts

Under some circumstances the cancellation of a contract can result in the original disposal being disregarded. This situation could arise when the initial disposal is incapable of performance because it is illegal. Examples include a verbal contract to sell immovable property which is contrary to s 2 of the Alienation of Land Act 68 of 1981 or a sale of farm land to more than one person when such action is prohibited by the Subdivision of Agricultural Land Act 70 of 1970.

Example 5 – Invalid disposal and reopening of assessment

Facts:

John entered into a written deed of sale under which he disposed of his farm to Jack and Jill in equal shares. John reflected the sale in his 2018 return of income and was assessed on a capital gain of R2 million. During the 2020 year of assessment John was informed that the sale was null and void because it contravened the Subdivision of Agricultural Land Act. The sale was accordingly cancelled and a new contract entered into with a company owned by Jack and Jill.

Result:

John would be entitled to request SARS to reduce his 2018 assessment under s 93(1)(d) of the Tax Administration Act to the extent of the inclusion of the incorrect capital gain on the basis that the return he had submitted contained a readily apparent undisputed error.

6.3.6.3 Contracts cancelled on or after 1 January 2016

The Taxation Laws Amendment Act 25 of 2015 introduced a number of amendments which go some way towards addressing the difficulties described above. In essence the following amendments have been made:

- A non-disposal event was introduced in the form of para 11(2)(o) which applies when a sale is cancelled in the same year of assessment (see **6.1.2**).
- Paragraph 20(4) was introduced to reinstate the base cost when the sale is cancelled in a subsequent year of assessment. It also permits the seller to add the cost of compensation paid by the seller to the buyer for improvements effected by the buyer (see **8.20**).
- Paragraphs 3(c) and 4(c) reverse the original capital gain or loss in the year of cancellation (see **5.1.3** and **5.2.3**).

Thus, for example, if an asset with a base cost of R20 is sold for R100 in year 1, and the contract is cancelled in year 5 and the asset returned to the seller, the seller will have a capital gain of R80 in year 1 and a capital loss of R80 in year 5. The base cost of the reacquired asset will be R20. But if the sale is cancelled in year 1, the original disposal is disregarded with the result that the base cost of the seller's asset remains R20 and there is no capital gain or loss. It is a requirement that both parties be restored to the position they were in before entering into the agreement. The amendments inserting paras 3(c), 4(c), and 20(4) came into operation on 1 January 2016 and apply to any asset reacquired as a result of the cancellation or termination of an agreement during any year of assessment commencing on or after that date. Paragraph 11(2)(o) was inserted with effect from 1 January 2016 and applies to disposals on or after that date.

A further amendment which came into effect on 15 January 2020 was made to para 35(3)(c) (see **9.1.3.3**) by the Taxation Laws Amendment Act 34 of 2019 to prevent proceeds from being reduced when a contract is cancelled and the asset is reacquired in the same year of assessment. This amendment has no relevance when the parties are restored to their pre-sale position because para 11(2)(o) ensures that the original disposal is disregarded. However, it ensures that proceeds are not reduced when the parties are not so restored, and in that event the matter must be addressed in line with the commentary in **6.3.6.2**.

6.3.7 Donations

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

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

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

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

Table 1 – Time of disposal of asset by donation

Type of donation	Date legal formalities complied with
Donation subject to a suspensive condition	Not valid until condition fulfilled, even if condition accepted by donee
Donation subject to resolutive condition	Effective immediately
Illegal donation	Not valid even if property transferred to donee.
Oral donation without delivery	Not valid.
Oral donation with delivery	Date delivery of asset accepted by donee.
Executory contract of donation (no delivery)	Date of acceptance of the offer by the donee, the terms of which are contained in a deed of donation signed by the donor.
<i>Donatio mortis causa</i>	Date of death (see below)
Section 56(1)(d) donation	Date of acceptance by donee.

In *The Law of Contract in South Africa* the following is stated on the need for acceptance:³²⁴

‘An unaccepted offer obviously cannot create a contract, since it emanates from the offeror alone and the necessary agreement cannot be held to exist without some evidence of the state of mind of the offeree. Hence the general rule that no contract can come into existence unless the offer is accepted.

‘The general rule applies to donations in the same way as to other contracts. If this were not so there would be a legal obligation to receive even such unwanted and burdensome donations as the white elephants which the King of Siam is said to have donated to courtiers who offended him.³²⁵ This has never been our law, as is made clear by Paul D 50 17 69: “*Invito beneficium non datur*.”’

(Footnotes suppressed.)

Donatio mortis causa

A *donatio mortis causa* is a donation made in contemplation of death. In order to be valid, it must be executed with the formalities required for a will.³²⁶ It vests only on the donor’s death and may be revoked by the donor at any time before that date even if it has been delivered to the donee.³²⁷

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

³²⁴ GB Bradfield *The Law of Contract in South Africa* 7 ed (2016) [online] (My LexisNexis: 31 December 2015) in para 2.3.1.

³²⁵ Since a white elephant was regarded as a sacred animal, it could not be put to work and the unfortunate recipient would derive no benefit from it but would have the burden of feeding it.

³²⁶ Voet 39.6.4.

³²⁷ *Meyer & others v Rudolph’s Executors* 1918 AD 70 at 84.

Section 56(1)(d) donations

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

The application of s 56(1)(d) was considered in ITC 1192³²⁸ and more recently in *C: SARS v Marx NO*.³²⁹ According to the *Marx* case the executory contract of donation comes into force upon acceptance by the donee. The act of donation and the delivery of the asset are two separate legal events. It is therefore submitted that the donation comes into effect when the donee accepts the terms of the donation.

6.3.8 Time of disposal = day before the specified event

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

A similar rule applies in s 9H when a person ceases to be a resident, a CFC ceases to be a CFC otherwise than by becoming a resident and when a company becomes a headquarter company. See in this regard the commentary on the *Tradehold* case in 6.2.2 in which the SCA failed to take cognizance of this rule after a company ceased to be a resident. The court held that South Africa had no jurisdiction to tax the capital gain arising on exit because the taxpayer had become a resident of Luxembourg at that time and hence fell under the tax treaty which gave Luxembourg an exclusive taxing right. However, since the taxpayer was deemed to dispose of its assets on the day before it ceased to be a resident, it was still a resident of South Africa at that time and should have been subject to CGT.

6.3.9 When does a person become a resident?

The term 'resident' is defined in s 1. An individual will become a resident upon becoming 'ordinarily resident'³³⁰ or when satisfying the physical- presence test.³³¹ The latter test is satisfied when the individual has been physically present in South Africa for more than

- 91 days in the current year of assessment,
- 91 days in each of the immediately preceding five³³² years of assessment, and
- 915³³³ days in total during the immediately preceding five³³⁴ years of assessment.

³²⁸ (1965) 35 SATC 213 (T) at 219.

³²⁹ (2006 (4) SA 195 (C), 68 SATC 219.

³³⁰ See Interpretation Note 3 (Issue 2) dated 20 June 2018 'Resident: Definition in Relation to a Natural Person – Ordinarily Resident'.

³³¹ See Interpretation Note 4 (Issue 5) dated 3 August 2018 'Resident: Definition in Relation to a Natural Person – Physical Presence Test'.

³³² Five years substituted for three years by s 3(1)(i) of the Revenue Laws Second Amendment Act 32 of 2005 and shall (i) in respect of any person who by virtue of para (a)(ii) of the definition of 'resident' was a resident on 28 February 2005, come into operation on 1 March 2006 and applies in respect of any year of assessment commencing on or after that date; and (ii) in respect of any other person, is deemed to have come into operation on 1 March 2005 and applies in respect of any year of assessment commencing on or after that date.

³³³ 915 days substituted for 549 days by s 3(1)(i) of the Revenue Laws Second Amendment Act 32 of 2005. See previous footnote for commencement date of the amendment.

³³⁴ Five years substituted for three years by the Revenue Laws Second Amendment Act 32 of 2005 (see previous footnote).

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

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

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

Paragraph 13(2) provides that when an asset is disposed of, the acquirer is treated as having acquired it at the time of disposal contemplated in para 13(1). This time of acquisition rule applies only when an asset has been disposed of. Under para 11(2) certain events are deemed to be non-disposals, such as the issue of a share or debenture. In such instances para 13(2) will not operate and reliance will have to be placed on common law principles for determining the date of acquisition.

Section 41(1) contains a definition of 'date of acquisition' that applies for the purposes of the corporate restructuring rules in ss 41 to 47. Under this definition the date of acquisition is

- the date of acquisition determined in accordance with para 13; or
- when the corporate restructuring rules specify a deemed date of acquisition for a transaction, that date. Under s 41(2) this rule will take precedence over para 13.

6.4 Disposal by spouses married in community of property

Paragraph 14

Paragraph 14 deals with the disposal of an asset by a spouse married in community of property. The applicable rules are set out in the table below.

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

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

There is no equivalent of s 7(2A) in the Eighth Schedule. Section 7(2A) provides that when spouses are married in community of property and a trade is carried on by one spouse, the income from that trade, other than income from the letting of fixed property, must be accounted for by that spouse. Thus, even though the income from a particular asset may have been declared by only one of the spouses, any capital gain arising on disposal of that asset must be split between the spouses unless it is excluded from the joint estate. The types of assets excluded from a joint estate include gifts or bequests excluded under an exclusion clause by the donor or testator, assets excluded by antenuptial contract, Fideicommissary property and right of usufruct, non-patrimonial³³⁵ loss, property which cannot legally be acquired by both spouses, costs in matrimonial proceedings, benefits under the Friendly Societies Act 25 of 1956 and wedding gifts.

³³⁵ Non-patrimonial means non-pecuniary, in other words, something which does not have a money value. Examples of non-patrimonial loss are pain and suffering, emotional shock, disfigurement, loss of amenities of life and shortened life expectancy. Claims for non-patrimonial loss are excluded from the joint estate under s 18 of the Matrimonial Property Act 88 of 1984. Capital gains arising from damages claimed for such losses are likely to be excluded under para 59.

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

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

6.5 The accrual system and marriage out of community of property

The Matrimonial Property Act 88 of 1984 makes the accrual system automatically applicable to a marriage out of community of property unless its application is specifically excluded in the antenuptial contract.³³⁶ Under the accrual system a claim will arise on death or divorce in the hands of one spouse against the other for the difference in growth of the estates of the spouses,³³⁷ For example, if the growth in value of spouse A's estate during the marriage is R100, and the growth in value of spouse B's estate is R50, spouse B will have a claim of R25 against spouse A on dissolution of the marriage.

The accrual system does not result in a splitting of capital gains and losses between spouses. A capital gain or loss on disposal of an asset by a person married out of community of property must be accounted for by the spouse that owns the asset. A claim under the accrual system arises only on death or divorce of a spouse³³⁸ or under an order of court.³³⁹ It does not affect the tax treatment of the spouses during the subsistence of the marriage or even on its termination. It is a claim for a sum of money, not a pre-existing entitlement to specific assets or income of the other spouse. The accrual claim is thus contingent on death or divorce and its quantum also depends on the value of the estates of the spouses at the time of those events. It might happen, for example, that gains accumulated earlier in a marriage are later lost or expended. It does not therefore have any impact on the incidence of an accrual of an amount of gross income or proceeds on disposal of an asset. On death of a spouse, s 9HA(2)(a) provides roll-over treatment to the deceased spouse who disposes of an asset in settlement of a claim under s 3 of the Matrimonial Property Act. Section 9HB(2)(a) grants relief in the other direction, that is, when the surviving spouse has to dispose of an asset to the deceased estate in order to settle a claim under s 3 of the Matrimonial Property Act. It deems the disposal to be to the person's deceased spouse immediately before the date of death.

³³⁶ Section 2 of the Matrimonial Property Act 88 of 1984.

³³⁷ Section 3 of the Matrimonial Property Act 88 of 1984.

³³⁸ Section 3 of the Matrimonial Property Act 88 of 1984.

³³⁹ Under s 8 of the Matrimonial Property Act 88 of 1984 the court can order the division of the accrual of the estate of a spouse if that spouse's conduct is seriously prejudicial to the other spouse's ultimate accrual claim on dissolution of the marriage [s 8(1)]. The court can also exclude the accrual system completely [s 8(2)].

Chapter 7 – Limitation of losses

PART IV: LIMITATION OF LOSSES

7.1 Personal-use aircraft, boats and certain rights and interests

Paragraph 15

Capital gains and losses on the disposal of personal-use assets are generally disregarded under para 53(1) but specified assets are excluded from this rule under para 53(3). Examples of such excluded assets include financial instruments, gold and platinum coins deriving their value mainly from their metal content, immovable property, large boats and aircraft and usufructs. While capital gains on excluded personal-use assets must be brought to account, capital losses on specified excluded assets must be disregarded under para 15. The rationale for the exclusion of such losses is that they are likely to be attributable to personal consumption.

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

Capital losses on the following assets must be disregarded to the extent that they are not used for the purposes of trade:

- An aircraft with an empty mass exceeding 450kg. A hang glider or microlight aircraft would thus be excluded. It is understood that aircraft with an unladen mass in excess of 450kg have to be licensed as aircraft. The word 'aircraft' is not defined and hence will bear its ordinary meaning.
- A boat exceeding 10 metres in length. See in this regard the wide definition of 'boat' in para 1. The purpose of the 10-metre cut-off is simply to exclude small pleasure craft such as rowing boats, ski boats, small yachts, rubber dinghies and the like which are unlikely to yield capital gains on disposal.
- Fiduciary, usufructuary or similar interests whose value decreases over time. For example, a husband dies and leaves the bare *dominium* in his holiday home to his son and the right of use to his wife for the rest of her life. Under para 15(c) the wife will not be entitled to any capital loss when the usufruct ceases on her death to the extent that the holiday home was not used for the purposes of trade. See **24.1.1** for more on usufructs.
- A lease of immovable property. For example, a holiday home acquired under a 99-year lease.
- Time-share and share block interests with a fixed life whose value decreases over time.
- Rights or interests in the above assets

An apportionment on a fair and reasonable basis will be required if an asset of this nature is used for both trade and private purposes. Only the trade portion of any capital loss will be allowable.

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

Tielman purchased a light aircraft for R1 million, which he used for visits to his holiday home in Plettenburg Bay. He disposed of the aircraft for R900 000 six months later when he disposed of the holiday home.

Result:

	R
Proceeds	900 000
Less: Base cost	<u>(1 000 000)</u>
Capital loss	<u>(100 000)</u>

The capital loss of R100 000 must be disregarded by Tielman under para 15(a).

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

Example 2 – Disregarding of capital loss – business and private usage*Facts:*

Duncan paid R1 million for his aircraft which he used 50% of the time in his air-charter business, and 50% for private purposes. Two years after acquiring the aircraft he crashed it during a night flight and thankfully escaped unscathed. He was uninsured and sold the wreck as spares for R100 000. The aircraft had an empty mass in excess of 450 kg.

Result:

Capital allowances	Total R	Allowed R
Cost	1 000 000	
Less: Allowances under s 12C	<u>(400 000)</u>	200 000
Tax value	600 000	
Less: Proceeds	<u>(100 000)</u>	
Allowance under s 11(o)	<u>(500 000)</u>	(250 000)

Note: The allowance under s 11(o) is determined with reference to the original cost and total wear-and-tear allowances ignoring any private element. Once the allowance under s 11(o) has been established, it is apportioned to disallow the portion relating to private use.³⁴⁰

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

³⁴⁰ Interpretation Note 60 (Issue 2) dated 29 September 2017 'Loss on Disposal of Qualifying Depreciable Assets' in 4.1.2; ITC 322 (1935) 8 SATC 243 (U).

Capital gain or loss

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

Note: The aircraft is not a personal-use asset, since it has an empty mass in excess of 450 kg [para 53(3)(c)].

7.2 Intangible assets acquired before valuation date

Paragraph 16

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

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

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

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

Example – Pre-1 October 2001 intangible asset acquired from connected person

Facts:

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

Result:

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

- Double Ewe (Pty) Ltd is a connected person in relation to Vee Ltd, and
- the intellectual property acquired is associated with a business taken over by Vee Ltd.

7.3 Forfeited deposits

Paragraph 17

A capital loss must be disregarded

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

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

- Gold or platinum coins, of which the market value is mainly attributable to the material from which they are minted (for example, Krugerrands).
- Immovable property, excluding a primary residence (for example, a holiday home).
- Financial instruments³⁴¹ (for example, a share and a participatory interest in a portfolio of a collective investment scheme).
- Any right or interest in these assets.

7.4 Disposal of options

Paragraph 18

Paragraph 18 imposes a restriction on the capital losses determined in respect of the abandonment, expiry or disposal of options on most personal-use assets. These assets are not subject to CGT, since the reduction in their value can be mainly attributed to personal use.

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

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

7.5 Losses on the disposal of certain shares

Paragraph 19

See 21.4.

³⁴¹ As defined in s 1(1).

Chapter 8 – Base cost

PART V: BASE COST

8.1 Base cost – allowable expenditure

Paragraph 20, s 23C

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

Paragraph 20 is the primary method for determining the base cost of post-valuation date assets, although there are exceptions when a method such as market value is prescribed, for example, when a person becomes a resident (para 12), assets acquired by donation, or at a non-arm's length price from a connected person (para 38), assets acquired by heirs and legatees [s 9HA(3) and s 25(3)(b) and s 40CA (acquisitions of assets in exchange for shares or debt issued)].

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

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

8.2 Base cost – domestic and unproductive expenditure

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

8.3 Base cost – direct costs of acquisition and disposal [para 20(1)(a) to (c)]

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

Table 1 – Direct costs of acquisition and disposal

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

Paragraph 20(1)	Qualifying expenditure
(b)	Expenditure actually incurred in respect of the valuation of the asset for the purpose of determining a capital gain or capital loss in respect of the asset. It is not a qualifying requirement that the market value of the asset that has been valued be adopted as the valuation date value of that asset. The result is that valuation costs will constitute post-valuation date expenditure for the purposes of determining the time-apportionment base cost of an asset under para 30. As a consequence, the proceeds formula in para 30(2) will have to be used.
(c)	
(i)	Remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor, for services rendered. A conveyancing attorney's FICA verification and identification fee when transferring immovable property qualifies under this category. Liquidator's remuneration or Master's fees incurred by an insolvent estate or company in liquidation are not provided for.
(ii)	<p>Transfer costs. Transfer costs of immovable property include the cost of obtaining a certificate of compliance for electrical installation as required by the Electrical Installation Regulation under the Occupational Health and Safety Act 85 of 1993, an electric fence system compliance certificate under the regulations in GG 34154 of 25 March 2011 under the same Act, a Gas certificate of conformity under s 43 of the same Act read with the Pressure Equipment Regulations in GN R 734 GG 22439 of 15 July 2009, a certificate of compliance of water installation under the City of Cape Town's by-laws, and an entomologist's certificate (required in KwaZulu-Natal and the Cape) for the purposes of effecting transfer. However, repairs necessitated by such inspections will not qualify.</p> <p>Bond registration costs and bond cancellation costs do not qualify by virtue of para 20(2) which prohibits their inclusion. Depending on the facts, a fee for early termination of a loan agreement may comprise interest as defined in s 24J. In such event it would need to be determined whether the interest qualifies for deduction against income under s 24J(2) or failing which it qualifies to be added to the base cost of listed shares or participatory interests in collective investment schemes under para 20(1)(g).</p>
(iii)	Stamp duty, ³⁴² transfer duty, securities transfer tax or similar duty or tax. The amnesty levies imposed under the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003 are not regarded as being similar to stamp duty or transfer duty. The latter are transaction taxes, usually imposed as a result of the transfer of ownership in an asset from one person to another. By contrast, the amnesty levies were imposed once-off by reason of an amnesty application relating to an underlying criminal offence, and are thus not directly related to the acquisition or disposal of an asset. To allow such levies to form part of base cost would be contrary to public policy, frustrate the legislative intent, and allow a punishment imposed to be diminished or lightened – see ITC 1490. ³⁴³

³⁴² The Stamp Duties Act 77 of 1968 was repealed by s 103(1) of the Revenue Laws Amendment Act 60 of 2008 with effect from 1 April 2009.

³⁴³ (1990) 53 SATC 108 (T).

Paragraph 20(1)	Qualifying expenditure
	<p>Securities transfer tax (STT) was introduced by the Securities Transfer Tax Act 25 of 2007 with effect from 1 July 2008. It replaced stamp duty and uncertificated securities tax on marketable securities. STT is levied on any transfer of a security (whether listed or unlisted) based on the taxable amount of the security. The term 'security' means any</p> <ul style="list-style-type: none"> • share or depository receipt in a company; or • member's interest in a close corporation, <p>excluding the debt portion in respect of a share linked to a debenture.</p>
(iv)	Advertising costs to find a seller or to find a buyer
(v)	<p>Cost of moving the asset from one location to another. The allowable costs relate only to those incurred in acquiring or disposing of an asset. The costs incurred by a company of moving assets to a new branch would therefore be excluded. Certain moving costs may, however, qualify for a deduction by way of a capital allowance such as those referred to in s 11(e)(v), 12C(6) or 12E(3). Such costs would in any event be excluded from base cost by para 20(3)(a). Any moving costs incurred by a seller will form part of the seller's base cost. Such costs will not form part of base cost when the asset constitutes trading stock in the seller's hands, since the moving costs would be claimed under s 11(a) and would thus be excluded from base cost by virtue of para 20(3)(a).</p>
(vi)	<p>Cost of installation of the asset, including the cost of foundations and supporting structures. Again, this subitem would not apply to the cost of installing an asset when the asset is not being acquired or disposed of – such as when it is relocated from one branch to another. Installation costs borne by a seller under a sale that is not on revenue account will form part of the seller's base cost.</p>
(vii)	<p>A portion of the donations tax payable by a donor of an asset as determined in accordance with the formula in para 22 (see 8.7). The donations tax may be added to base cost despite s 23(d), which prohibits the deduction of any tax imposed under the Act.³⁴⁴</p>
(viii)	<p>A portion of the donations tax payable by a donee of an asset in accordance with a formula (see 8.8). The portion of the donations tax may be added to base cost despite s 23(d).</p>
(ix)	<p>If the asset was acquired or disposed of by the exercise of an option (other than the exercise of an option after valuation date which was acquired before valuation date), the expenditure actually incurred in respect of the acquisition of the option. This subitem merges the cost of the option with the cost of the asset acquired or disposed of. Under para 58 a person must disregard any gain or loss on the exercise of an option.</p>

³⁴⁴ Section 23(d) prohibits the deduction of any tax imposed under the Act or interest or penalty imposed under any other Act administered by the Commissioner.

8.4 Base cost – composite acquisitions

Assets are sometimes acquired with other assets as part of a composite acquisition. For example, a single contract of purchase may be entered into at an inclusive price embracing multiple assets. In these circumstances the purchase price must be apportioned to the respective assets broadly by reference to their market values at the date of acquisition.³⁴⁵ The onus rests on the taxpayer under s 102 of the Tax Administration Act to justify any allocation. The court will not accept a fictitious allocation of the purchase price. In ITC 1235³⁴⁶ the parties allocated R1 to a plantation. The court held that the agreement was fictitious and not a real agreement and accepted the Commissioner's valuation.

8.5 Base cost – assets acquired by barter or exchange

Paragraph 20(1)(a) refers to

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

The word 'expenditure' includes expenditure in cash or in kind. In ITC 1783³⁴⁷ Goldblatt J stated the following on the meaning of the word 'expenditure':

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

The learned judge cited the following extract from *Silke* with approval:³⁴⁸

'It is submitted that the word "expenditure" is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash.⁴¹ For example, if a merchant were required to pay for his goods by tendering land or shares in a company, the value of the land or shares would constitute expenditure in terms of s 11(a) and would be deductible.'

⁴¹ *Caltex Oil (SA) Ltd v SIR* 1975 (1) SA 665 (A), 37 SATC 1.

Silke continues:³⁴⁹

'In accordance with the principle of the decision in *Caltex Oil (SA) Ltd v SIR*²⁹⁹ a case dealing with expenditure incurred in a foreign currency, it would appear that in a transaction of barter the commodity promised in satisfaction of the obligation incurred would have to be valued in rands, and its value would constitute the amount of the expenditure incurred.'

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

In *C: SARS v Labat Africa Ltd*³⁵⁰ the court stated that expenditure

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

³⁴⁵ See ITC 108 (1928) 3 SATC 343 (U) in which the court made an allocation of the purchase price, and ITC 429 (1939) 10 SATC 355 (SR) in which the appellants were entitled to apportion the purchase price.

³⁴⁶ (1975) 37 SATC 233 (T) at 236.

³⁴⁷ (2004) 66 SATC 373 (G) at 376.

³⁴⁸ AP de Koker & RC Williams *Silke on South African Income Tax* [online] (My LexisNexis: October 2019) in § 24.54.

³⁴⁹ In § 7.24.

³⁵⁰ 2013 (2) SA 33 (SCA), 74 SATC 1. The SCA judgment overturned the decisions in ITC 1801 (2005) 68 SATC 57 (G) and *C: SARS v Labat Africa Ltd* (2009) 72 SATC 75 (North Gauteng High Court).

This principle confirms that the expenditure in a barter transaction is the amount by which each party's assets are diminished. For more on the *Labat* case see **8.40**.

In *South Atlantic Jazz Festival (Pty) Ltd v C: SARS*³⁵¹ the taxpayer staged annual international jazz festivals during the period in question. In the course of that enterprise it concluded sponsorship agreements with various suppliers under which the sponsors paid money towards and provided goods and services for the festivals, in return for which the taxpayer provided goods and services to the sponsors in the form of branding and marketing. Binns-Ward J noted that the transactions under the sponsorship agreements were essentially barter transactions despite their part-cash components. The judge stated the following:³⁵²

'In consequence, and accepting, as one may, that the transactions were at arms' length, the value of the goods and services provided by the appellant to the sponsors in each case falls to be taken as the same as that of the counter performance by the relevant sponsor.

...

'In an ordinary arms' length barter transaction the value that the parties to it have attributed to the goods or supplies that are exchanged seems to me, in the absence of any contrary indication, to be a reliable indicator of their market value.'

In general, therefore, it can be accepted that when assets or services are exchanged for assets or services under a barter transaction, the market value of the assets or services will, absent any contrary indication, be the market value of the assets or services as agreed between the parties and would be of equal value. In most instances the market value of the assets or services to be exchanged between the parties is reflected in the relevant agreement.

If asset A plus an amount of cash is given in exchange for asset B, the expenditure in respect of asset B is the market value of asset A plus the cash consideration. For an example showing the determination of both proceeds and base cost in an asset exchange, see **6.1.1.5**.

The base cost of an asset acquired in exchange for the rendering of services would generally be established under para 20(1)(h)(ii)(bb) (fringe benefit included in gross income) or (dd) (amount of services rendered included in gross income).

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

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

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

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

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

³⁵¹ 2015 (6) SA 78 (WCC), 77 SATC 254.

³⁵² At SATC 260/1.

- the accrued right of a holder of shares to claim delivery of an asset to be distributed as a dividend *in specie*.³⁵³

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

Applying this principle to an asset acquired by donation, inheritance or distribution *in specie*, the sequence of events is as follows:

First, upon accrual, the person acquires a right to claim delivery of the asset for no consideration.

Next, the personal right to claim delivery of the asset is extinguished upon acquisition of the ultimate asset. The proceeds from the disposal of the personal right to claim delivery are equal to the market value of the ultimate asset, while the cost of the personal right is nil. This will give rise to a pre-CGT gain, but it is irrelevant for purposes of the Eighth Schedule, since the disposal occurs before valuation date.

Finally, the expenditure actually incurred for the purposes of para 20(1)(a) on the acquisition of the ultimate asset is equal to the market value of the personal right to claim delivery immediately before it is disposed of through extinction.

The disposal of a personal right to claim delivery in return for the actual asset is well recognised in the time of disposal rules in para 13. For example, under para 13(1)(a)(iiA) the time of disposal of an asset distributed to a beneficiary who has a pre-existing vested interest in the asset is taken back to the time of vesting. This is done in order to prevent any capital gain or loss from arising at the time of transfer of ownership of the asset.

Example – Acquisition of asset by inheritance before the valuation date

Facts:

On 15 May 1990 Darryl passed away. In his last will and testament he bequeathed his holiday home to his daughter Leigh. On 10 June 1991 the estate became distributable after the liquidation and distribution account had lain for inspection for the prescribed period and no objection had been lodged against it. On 15 November 1991 the executor transferred the property into Leigh's name. The value of the property on 10 June 1994 was R100 000. Leigh sold the property for R700 000 on 1 October 2019. Leigh determined the valuation date value of the holiday home using the time-apportionment base cost method.

Result:

$$\begin{aligned} Y &= B + [(P - B) \times N / (N + T)] \\ &= R100\,000 + [(R700\,000 - R100\,000) \times 11 / 30] \\ &= R320\,000 \end{aligned}$$

$$\begin{aligned} \text{Capital gain} &= \text{Proceeds} - \text{base cost} \\ &= R700\,000 - R320\,000 \\ &= R380\,000 \end{aligned}$$

Note: The property is regarded as having been acquired on the date when Leigh acquired a personal right to claim delivery of it, that is, 10 June 1991.

³⁵³ The time of accrual of a dividend depends on the terms specified in the resolution of the company dealing with the declaration of the dividend. For example, unconditional entitlement may arise on the date of declaration, or if payable to shareholders registered on a later date, on that date.

8.5B Base cost of debt assets acquired through services rendered or as a result of interest or dividends received or accrued

The principles considered in **8.5A** also apply to debt assets arising from services rendered, accrued interest and declared dividends. These principles apply both before and on or after the valuation date, except to the extent that they are dealt with explicitly in para 20(1)(h).

The pre-existing personal rights which are given up in exchange for the debt asset are

- a service provider's contractual right to claim payment once the service has been rendered to the satisfaction of the customer;
- a right to claim payment of interest on a loan or bank deposit; and
- a right to claim payment of a declared dividend.

The establishment of the base cost of a debt asset arising from services rendered has been specifically addressed in para 20(1)(h)(ii)(dd). That provision applies to any disposal on or after 8 November 2005, and thus covers debt assets arising before valuation date which are repaid on or after that date. The general principle illustrated in **Example 1** below applies to debt assets disposed of before 8 November 2005.

The principle that a right to claim a declared dividend is an asset was recognised in *Defy Ltd v C: SARS*.³⁵⁴

Example 1 – Base cost of debt arising from the rendering of a service

Facts:

Ernest called Joe the plumber to repair a water leak at his home. After inspecting the site Joe told Ernest that it would cost R1 000 to repair the broken pipe. Ernest agreed, and Joe proceeded to do the repair. Joe had to purchase some replacement pipes and other materials and claimed these costs under s 11(a). Once the job was complete, Ernest expressed his satisfaction with the work and asked Joe if he could pay the amount of R1 000 in 10 days' time as he was experiencing a cash-flow problem. Joe agreed, and 10 days' later Ernest duly paid Joe the amount of R1 000. What is the base cost of the debt that arose when Joe completed the job?

Result:

Upon entering into the contract, Joe acquired a personal right against Ernest to undertake the repair work. That personal right is an asset, the base cost of which is nil, because all Joe's expenditure was claimed under s 11(a) and is hence excluded from base cost under para 20(3)(a). When the job was completed and Ernest was satisfied with it, an amount of R1 000 accrued to Joe which was included in his gross income. The amount of R1 000 was therefore excluded from proceeds under para 35(3)(a). The disposal of the personal contractual right through extinction in order to acquire a right to claim R1 000 (being the debt asset) accordingly gives rise to neither a capital gain nor a capital loss. The base cost of the debt asset is equal to the market value of the personal right given up, determined immediately before its disposal (R1 000). When Ernest settles the debt, Joe receives proceeds of R1 000 and there is also no gain or loss.

³⁵⁴ 2010 (5) SA 416 (SCA), 72 SATC 99 at 110 in [44].

Example 2 – Interest accrued on bank account before valuation date*Facts:*

Nathi invested R100 000 in a deposit account with the ABC bank on 1 September 2001. At the end of the first month the bank credited Nathi's account with R1 000. What is the base cost of the bank deposit on valuation date?

Result:

On 30 September 2001 Nathi acquired a right to claim accrued interest of R1 000 from the bank. When the bank deposited the amount of R1 000 into his bank account, Nathi gave up that right in return for the bank deposit of R1 000. The expenditure incurred on the amount deposited into his bank account is equal to the market value of the right to claim a cash payment which was extinguished on 30 September 2001, and which had a value of R1 000 at that time. This principle applies equally in establishing a base cost for accrued interest on or after the valuation date.

Example 3 – Dividend credited to shareholder's loan account*Facts:*

ABC (Pty) Ltd declared a dividend to Yasmeen on 1 March of R1 000. The resolution passed by the directors indicated that Yasmeen had agreed to receive payment of the dividend by crediting her loan account in the company. Immediately before the declaration of the dividend Yasmeen's loan account stood at R100 000.

Result:

Upon declaration of the dividend Yasmeen acquired a right to claim payment of the dividend. When her loan account was credited, her right to claim the dividend was extinguished and it is that extinction that establishes the expenditure on the loan account of R1 000 under para 20. Yasmeen's loan account thus has a base cost of R101 000 after it was credited with the dividend.

No capital gain or loss arises on the disposal of the right to claim the dividend because Yasmeen incurred no expenditure in acquiring the right and the amount of the dividend received is excluded from proceeds under para 35(3)(a) because the dividend was included in Yasmeen's gross income under para (k) of the definition of 'gross income'.

8.5C Assets acquired by acquisitive prescription

Acquisitive prescription occurs when a person acquires ownership of a thing by uninterrupted possession of it for the period of prescription. Under s 1 of the Prescription Act 68 of 1969

'a person shall by prescription become the owner of a thing which he has possessed openly and as if he were the owner thereof for an uninterrupted period of thirty years or for a period which, together with any periods for which such thing was so possessed by his predecessors in title, constitutes an uninterrupted period of thirty years'.

Acquisitive prescription is one of the modes of original acquisition as opposed to derivative acquisition. *LAWSA* states the following in this regard:³⁵⁵

‘The acquisition of ownership is said to be original if it is acquired independently and not derived from the ownership of a predecessor. In some cases of original acquisition of ownership there may be a predecessor, as in the case of expropriation. However, in such a case there is no transfer of rights of a predecessor to a successor. The ownership is acquired by a fresh unilateral act and is free of the characteristics, obligations and benefits pertaining to the right of a predecessor. A totally new right is created with regard to the thing.’

The implication of original acquisition is that para 38 will not apply, since that provision requires a disposal of an asset by one person to another. Thus, a person who acquires a property on or after the valuation date by acquisitive prescription will have a cost of nil. But if a property is acquired through acquisitive prescription before the valuation date, the valuation date value could be established using one of the three available methods, namely, time apportionment, market value on 1 October 2001 (assuming that the property was valued on or before 30 September 2004) and 20% of proceeds.

8.5D Acquisition of mining assets

Section 37 applies when a taxpayer sells, transfers, leases or cedes any mining property together with any capital assets contemplated in s 36(11).

Under s 37 the purchase price of capital assets qualifying for deduction under s 36(11) and any mining property (defined to include land on which mining is carried on and mineral rights) must be allocated in proportion to a valuation conducted by the Director General for Minerals and Energy. Any allocation specified in the sale agreement will thus be overridden. This requirement applies for the purposes of the Act and thus includes para 20. The assets qualifying under s 36(11) would have a base cost of nil by virtue of para 20(3)(a) but the mining property should have a positive base cost because the land and mineral rights do not qualify for deduction under s 36.

8.6 Base cost – assets acquired through deferred delivery

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

When does the buyer incur expenditure? Under the common law the expenditure will usually be incurred only when delivery is taken (ITC 1444³⁵⁶ and ITC 1725).³⁵⁷ But for CGT purposes the common law position is varied by the time of disposal rule in para 13(1)(a)(ii) and the time of acquisition rule in para 13(2). See **6.3.5**.

³⁵⁵ CG van der Merwe *Things/Ownership/Original acquisition/Introduction/Original and derivative acquisition* Volume 27 (second edition volume) [online] (My LexisNexis: 31 January 2014) in para 169.

³⁵⁶ (1987) 51 SATC 35 (T).

³⁵⁷ (2000) 64 SATC 223 (C).

8.7 Base cost – donations tax paid by donor [para 20(1)(c)(vii)]

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

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

In this formula:

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

The purpose of the formula is to achieve the same result that would have prevailed had the person died while still holding the asset. It ensures that the donations tax plus CGT is the same as the estate duty plus CGT on death. The net value of an estate for estate duty purposes is reduced under s 4(b) of the Estate Duty Act 45 of 1955 by the deceased's normal tax liability (including CGT) on death. Yet, there is no similar reduction of donations tax in respect of the CGT arising on the donation of an asset. It is thus apparent that without an uplift of the base cost of a donated asset under para 22 the donations tax plus CGT would exceed the estate duty plus CGT on death.

For example, assume a person on the maximum marginal rate of 45% dies holding an asset with a base cost of R100 and a market value of R200. On death there would be CGT under s 9HA of $(R200 - R100) \times 40\% \times 45\% = R18$ and estate duty of $(R200 - R18) \times 20\% = R36,40$, giving a total of R54,40. Without allowing the CGT as an addition to base cost, the total taxes payable on donation would comprise donations tax of $R200 \times 20\% = R40$ plus CGT of R18 ($R100$ capital gain $\times 40\% \times 45\%$) = R58. By allowing a portion of the donations tax to be added to base cost, parity is achieved. The base cost is increased by $R100 / R200 \times R40 = R20$. The CGT is thus $(R200 - R120) \times 40\% \times 45\% = R14,40$. The donations tax plus CGT is thus reduced to $R40 + R14,40 = R54,40$ which achieves parity with the taxes payable on death. The formula disregards the estate duty abatement of R3,5 million, the donations tax exemption of R100 000 a year and the time value of money.

The formula has the effect that no amount of any donations tax paid will qualify for inclusion in base cost should an asset be disposed of at a capital loss. No adjustment is made in this situation because no CGT is payable and hence parity is achieved on death (estate duty of 20% of the market value of the asset) and on donation (20% of the market value of the asset).

The type of donation envisaged by para 20(1)(c)(vii) is one 'contemplated in para 38'. Paragraph 38 does not define the word 'donation' and it must therefore be given its common law meaning. It follows that unlike a donation for donations tax purposes, if the donee gives any consideration, the disposal will not be a donation.³⁵⁸ In *Estate Welch v C: SARS*³⁵⁹ it was confirmed by Marais JA that the common law test for a donation was as follows:

'[T]he disposition [must] be motivated by pure liberality or disinterested benevolence and not by self-interest or the expectation of a *quid pro quo* of some kind from whatever source it may come.'

³⁵⁸ *The Master v Thompson's Estate* 1961 (2) SA 20 (FC), 24 SATC 157 at 24F–26C, 48F–49C.

³⁵⁹ 2005 (4) SA 173 (SCA), 66 SATC 303 at 183.

Example – Donations tax paid by donor of asset*Facts:*

Gerrie donated a yacht to his son at a time when its market value was R1 300 000. The base cost of the yacht before taking into account any donations tax paid was R750 000.

Gerrie paid donations tax of R240 000, calculated as follows:

	R
Market value of asset donated	1 300 000
Less: Section 56(2)(b) abatement	<u>(100 000)</u>
	<u>1 200 000</u>
Donations tax @ 20%	240 000

Result:

$$\begin{aligned} \text{Allowable addition to base cost} &= \frac{(\text{Market value of asset} - \text{base cost})}{\text{Market value of asset}} \times \text{Donations tax} \\ &= \frac{\text{R1 300 000} - \text{R750 000}}{\text{R1 300 000}} \times 240\,000 \\ &= \text{R550 000} / \text{R1 300 000} \times \text{R240 000} \\ &= \text{R101 538} \\ \text{Base cost of yacht} &= \text{R750 000} + \text{R101 538} \\ &= \text{R851 538} \end{aligned}$$

The purpose of this provision is to achieve parity with the estate duty that would have become payable on the capital gain had the donor died on the date of donation. The formula ignores the effect of the R100 000 donations tax abatement, the R3,5 million³⁶⁰ estate duty abatement and the time value of money.

The effect is illustrated as follows. Assume that the donor of the yacht in the above example died on the date of donation and that the R3,5 million estate duty abatement has been used against other assets. Also assume that the taxpayer was on the maximum marginal rate of 45%.

	R
Value of yacht (includes gain of R550 000)	1 300 000
Less: CGT paid (R550 000 × 18%)	<u>(99 000)</u>
	<u>1 201 000</u>
Estate duty at 20%	R240 200
Estate duty levied on gain	= (R550 000 – R99 000) × 20%
	= R451 000 × 20%
	= R90 200

Total tax collected on gain = R99 000 + R90 200 = R189 200

³⁶⁰ The abatement was increased from R2,5 million to R3,5 million by s 1(1) of the Taxation Laws Amendment Act 8 of 2007. The increased abatement came into operation on 1 March 2007 and applies in respect of the estate of any person who dies on or after that date. Earlier abatements: 1 March 2006 to 28 February 2007: R2,5 million; 1 March 2002 to 28 February 2006: R1,5 million; 16 March 1988 to 28 February 2002: R1 million.

Comparing this with the donation of the yacht, and assuming that the R100 000 abatement has been used against other donations, the tax collected will be as follows:

Donations tax = R1 300 000 × 20%
= R260 000

(Includes donations tax on gain of R550 000 × 20% = R110 000)

Capital gain = R1 300 000 – (R750 000 + R110 000)
= R440 000

Capital gains tax = R440 000 × 18%
= R79 200

Total tax collected on gain = R110 000 + R79 200 = R189 200

8.8 Base cost – donations tax paid by donee [para 20(1)(c)(viii)]

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

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

As with para 20(1)(c)(vii), the word ‘donation’ is not defined for the purposes of para 20, and it must therefore be given its ordinary meaning. It follows that unlike a donation for donations tax purposes, if the donee gives any consideration the disposal will not be a donation (see 8.7).³⁶¹ Donations tax may also not be added to the base cost of the donee’s asset should the donor have disposed of the asset at a capital loss.

Example – Donations tax paid by donee acquiring asset

Facts:

Hannalie acquired a yacht by donation from her father at a time when its market value was R1 300 000. The yacht had a base cost of R750 000 in her father’s hands. The donations tax due by her father was R240 000, calculated as follows:

Market value of asset donated	R 1 300 000
Less: Section 56(2)(b) abatement	<u>(100 000)</u>
	<u>1 200 000</u>
Donations tax @ 20%	240 000

Since her father failed to pay the donations tax to SARS within the prescribed period, Hannalie was held liable for the sum of R240 000 under s 59 of the Income Tax Act.

³⁶¹ *The Master v Thompson’s Estate* 1961 (2) SA 20 (FC), 24 SATC 157 at 24F–26C, 48F–49C and *Welch’s Estate v C: SARS* 2005 (4) SA 173 (SCA), 66 SATC 303.

Result:

Hannalie's father was liable for CGT on a capital gain of R550 000 as a result of the donation (R1 300 000 – R750 000), Hannalie may add the following amount to the base cost of her yacht:

$$\begin{aligned}
 \text{Allowable addition to base cost} &= \frac{\text{Capital gain of donor}}{\text{Market value of asset}} \times \text{Donations tax} \\
 &= \frac{\text{R550 000}}{\text{R1 300 000}} \times \text{R240 000} \\
 &= \text{R101 538}
 \end{aligned}$$

8.9 Base cost – costs of establishing, maintaining or defending a legal title or right in an asset [para 20(1)(d)]

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

- ITC 1677³⁶² – legal expenses incurred in resisting competing publisher's claim for an interdict against a new work on the ground of an infringement of its copyright.
- ITC 1648³⁶³ – legal costs incurred by a farmer in opposing an application to force him to eliminate certain boreholes on his farm.

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

This provision is very similar to the equivalent rule in the Australian Income Tax Assessment Act, 1997, namely, s 110-5(6).

Example – Costs incurred in defending legal title

Facts:

Ignatius operates a nightclub in an up market area. The city council wishes to expropriate the nightclub's premises. Ignatius incurred legal fees in resisting the attempt by the city council to expropriate his property.

Result:

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

³⁶² (1999) 62 SATC 276 (N).

³⁶³ (1998) 61 SATC 58 (C).

8.10 Cost of improvements or enhancements to the value of an asset [para 20(1)(e)]

The cost of improving or enhancing an asset may also be added to its base cost.

Prior to 15 January 2020 it was a requirement that the improvement or enhancement still be reflected in the state or nature of the asset at the time of its disposal but this was deleted by the Taxation Laws Amendment Act 34 of 2019. The amendment came into effect on 15 January 2020. It is considered that these words were unnecessary because the part-disposal rules in para 33 will in any event result in the base cost of an asset being reduced if a part of it is disposed of. The words may also have unintended adverse consequences for a taxpayer that makes a non-scrip capital contribution to a company which is wiped out by subsequent losses (see below). From a policy perspective such an outcome runs contrary to the way in which the base cost of shares is treated (the cost of acquisition of shares is not reduced because the value of the shares subsequently decreases) and also runs counter to the principle that a disposal should not be triggered merely because there is a reduction in the value of an asset.

A holder of shares in a company may be required under an agreement for the disposal of those shares to first discharge the debts of the company without creating or increasing the holder's loan account. Such a holder would be able to add the cost of discharging the debts of the company to the base cost of the shares, provided it can be shown that the value of the shares was enhanced. For example, if a company had share capital of R100, accumulated losses of R200 and third-party debts of R300, discharging the debts of the company would not result in a corresponding enhancement in the value of the shares. Before the settlement of the debts, the shares were worth nothing and after settlement they would be worth $R100 - R200 + R300 = R200$. The enhancement will therefore be only R200 and not R300 because R100 was absorbed by accumulated losses. The holder would therefore be able to add only R200 to the base cost of the shares under para 20(1)(e).

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

The payment by a bare *dominium* holder to a usufructuary for the termination of the usufruct will qualify as an addition to the base cost of the asset, provided that the restoration of full title results in an enhancement in the value of the asset.

Non-scrip capital contributions

Under the company law of some foreign jurisdictions, holders of shares are permitted to inject capital into a company without the issue of shares. If the value of the existing shares held by the holder is correspondingly enhanced, the amount expended can be added to the base cost of the shares under para 20(1)(e).

An issue arises whether, prior to 15 January 2020, the amount could still be added to base cost when the company had made subsequent losses, since one of the conditions of para 20(1)(e) was that the enhancement must be reflected in the state or nature of the asset at the time of its disposal. In *National Mutual Life Association of Australia Ltd v Commissioner of Taxation*³⁶⁴ the court confirmed that a non-scrip capital contribution qualified to be added to the base cost of the shares in the target company because it resulted in the enhancement of the value of the shares. However, the court also observed that if the contribution was wiped out by reason of subsequent losses, it would no longer be reflected in the state or nature of the shares at the time of their disposal. The court stated the following:³⁶⁵

‘Whether an increase in value is reflected in the state or nature of an asset at the later point will depend upon its particular attributes. Shares have attributes that are measurable by reference to the shareholder’s funds to which they relate.’

In commenting on another case in which the capital contribution had been absorbed by subsequent losses, the court stated that in its opinion

‘the Special Commissioners should have dismissed the trustees’ appeal on the ground that the capital contributions totalling £1,530,546 made to the company had evidently wasted away by the time of sale. The shares were disposed of for US\$1.’

SARS has not taken a view on the issue, since the manner of reporting and accounting for the contribution may be case-specific and the enabling foreign legislation will need to be considered.

The ‘state or nature’ requirement in para 20(1)(e) finds its provenance in s 110-25(5) of the Australian Income Tax Assessment Act, 1997 which dealt with the fourth element of the reduced cost base. However, with effect from 1 July 2005 s 110-25(5) was amended to delete the ‘state or nature’ requirement, presumably on the basis that it created so-called ‘black hole’ expenditure.

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

Facts:

Jeannee acquired a second property at a cost of R900 000 in 2008 from which she derived rental income. Jeannee replaced the kitchen, which was in disrepair, at a cost of R30 000 and installed a security system costing R10 000. In 2011 she installed a jacuzzi in one of the bedrooms at a cost of R25 000. In February 2020 the jacuzzi cracked and all the water leaked out. It was not worth repairing, so she had it removed.

Result:

Jeannee’s base cost is R900 000 + R10 000 = R910 000. The replacement of the kitchen is not added to the base cost of the property, since it is considered to be a repair. The jacuzzi is also not added to the base cost of the property, since it no longer exists as part of the property. Jeannee would have had a part-disposal when she scrapped the jacuzzi and any capital loss should have been determined at that point.

³⁶⁴ [2009] FCAFC 96,76 ATR 608.

³⁶⁵ In para 42.

8.11 Base cost – option acquired before, asset acquired or disposed of after valuation date [para 20(1)(f)]

As noted in 8.3, the cost of an option that is exercised will form part of the base cost of the underlying asset [para 20(1)(c)(ix)]. An exception to this rule applies when the asset is acquired on or after 1 October 2001 as a result of the exercise of an option acquired before that date. In such a case, the valuation date value of the option must be included in base cost. This treatment applies to options to acquire or dispose of assets.

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

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

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

Example 1 – Option acquired before valuation date; asset acquired or disposed of on or after that date

Facts:

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

Result:

The base cost of Kosie's cottage will be $R300\,000 + R5\,000 = R305\,000$.

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

Facts:

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

Result:

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

Time-apportionment base cost

Cost of option R10 000

Proceeds on disposal of option R380 000 – R300 000 = R80 000

$$\begin{aligned} Y &= B + [(P - B) \times N / (N + T)] \\ &= R10\,000 + [R80\,000 - R10\,000] \times 1 / 2 \\ &= R10\,000 + R35\,000 \\ &= R45\,000 \end{aligned}$$

Note: For the purpose of determining 'N' and 'T' a part of a year is treated as a full year [proviso to para 30(1)].

Market value

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

20% of proceeds

Proceeds on disposal of option = R80 000

R80 000 × 20% = R16 000.

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

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

Facts:

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

Result:

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

8.12 Interest incurred to finance the cost of listed shares and participatory interests in collective investment schemes [para 20(1)(g)]

These notes apply to disposals on or after 1 January 2014. For the position before that date see Issue 4 of this guide.

Paragraph 20(1)(g) permits one third of certain interest on borrowed monies to be added to the base cost of listed shares and participatory interests in collective investment schemes. The addition is subject to the following conditions:

- Only interest contemplated in s 24J will qualify excluding any interest contemplated in s 24O. Section 24O relates to interest incurred by a controlling company in acquiring a share in an operating company. It deems such interest to be incurred in the production of income.

- The borrowed monies must relate to the expenditure contemplated in para 20(1)(a) or (e). In other words, the borrowed monies must have been used to acquire the shares or participatory interests or to enhance their value.
- Interest on monies borrowed to refinance such borrowings will also qualify – see ITC 1020³⁶⁶ and ITC 1553.³⁶⁷
- Any shares must be listed on a recognized exchange. It follows that interest on borrowed monies used to finance the acquisition of shares in private companies and close corporations as well as shares listed on an unrecognized foreign stock exchange will not qualify. Should a share be delisted, only interest incurred up to the date of delisting will qualify.
- The interest expense must not have been deducted from income – see para 20(3)(a).

The limitation of the interest to one-third reflects the fact that when such assets are held on capital account the bulk of the interest expense is incurred in order to earn dividend income. Since the dividend income generated by a portfolio of a collective investment scheme in property which qualifies as a REIT is fully taxable, the holding costs associated with an investment of this nature may be deductible under s 11(a) provided it is incurred in the production of income in carrying on a trade and if so, it will be excluded from base cost by para 20(3)(a).

From a policy perspective interest on unlisted shares is not allowable for at least two reasons. First, there is the possibility that the expenditure could relate indirectly to private consumption. taxpayers could acquire shares using loan finance in a private company holding non-business assets. Secondly, the addition of interest to the base cost of an asset amounts to a disguised form of inflation indexing, a policy that has not been adopted in the Eighth Schedule.

Example – Interest incurred in financing the cost of shares

Facts:

Quintin acquired 2 000 shares in Ess Limited, a company listed on the JSE, after the valuation date at a cost of R100 000 which he financed with a bank loan. During the year of assessment he incurred interest on the loan of R9 000.

Result:

Interest of R9 000 × 1 / 3 = R3 000 must be added to the base cost of the shares.

³⁶⁶ (1962) 25 SATC 414 (T).

³⁶⁷ (1989) 55 SATC 105 (T).

8.13 Base cost – asset resulting in an inclusion in gross income upon acquisition [para 20(1)(h)(i) to (iii)]

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

Table 2 – Base cost of assets that resulted in an inclusion in income when acquired

Paragraph 20(1)(h)	Type of asset	Amount included in base cost
(i)	A marketable security or equity instrument the acquisition or vesting of which resulted in the determination of any gain or loss to be included in or deducted from any person's income under s 8A or 8C.	The <ul style="list-style-type: none"> • market value of the marketable security or equity instrument, or • amount received or accrued from its disposal, that was taken into account in determining the amount of the gain or loss (including when the gain and loss so determined was nil). ³⁶⁸ (Note 1)
(ii)(aa)	Assets acquired by a lessee from a lessor when there has been a recoupment under s 8(5)	Amount included in lessee's income under s 8(5), which reduced the purchase price of the asset. (Note 2)
(ii)(bb)	Assets the acquisition of which results in a taxable benefit under para (i) of the definition of 'gross income'	The value placed on the asset under the Seventh Schedule for purposes of determining the amount included in the person's gross income. (Note 1)
(ii)(cc)	Obligatory improvements effected by a lessee under a lease which constitute gross income in the lessor's hands under para (h) of the definition of 'gross income'	Amount included in gross income Less: Amount of any allowance granted under s 11(h).
(ii)(dd) ³⁶⁹	Assets the acquisition of which results in an amount being included in the person's gross income under para (c) of the definition of 'gross income' in s 1(1). This provision also establishes a base cost for any debt asset arising in the hands of the person rendering the service. For example, A renders a service to B for R100. A agrees to accept payment after 30 days. The base cost of A's debt asset is R100.	The value placed on the asset for the purposes of determining the amount so included in the person's gross income.

³⁶⁸ The reference to an amount received or accrued was added by s 68(1) of the Revenue Laws Amendment Act 31 of 2005. The amendment came into operation on 8 November 2005 and applies in respect of any disposal on or after that date.

³⁶⁹ Sub-subitem (dd) added by s 68(1)(c) of the Revenue Laws Amendment Act 31 of 2005, and comes into operation on 8 November 2005 and applies in respect of any disposal on or after that date.

Paragraph 20(1)(h)	Type of asset	Amount included in base cost
(iii)(aa)	Right in a controlled foreign company (CFC 1) held directly by a resident	<p>The proportional amount of</p> <ul style="list-style-type: none"> • the net income of CFC 1 included in the resident's income under s 9D during any tax year, and • the net income of any other CFC in which CFC 1 and the resident directly or indirectly have an interest that was included in the resident's income under s 9D during any tax year • <i>Reduced by:</i> Foreign dividends distributed by CFC 1 that are exempt under s 10B(2)(a) or (c). <p>Note: In determining the proportional amount of the net income of a CFC no regard must be had to the inclusion rate in para 10. (Note 3)</p>
(iii)(bb)	A right in a CFC (CFC 2) held directly by another CFC (CFC 1)	<p>An amount equal to</p> <ul style="list-style-type: none"> • the proportional amount of the net income of <ul style="list-style-type: none"> ➤ CFC 2, and ➤ any other CFC in which both CFC 2 and CFC 1 directly or indirectly have an interest, • which during any year of assessment would have been included in the income of CFC 1 under s 9D had it been a resident, • <i>Reduced by:</i> • The amount of any foreign dividend distributed by CFC 2 to CFC 1 if that dividend would have been exempt from tax under s 10B(2)(a) or (c) had CFC 1 been a resident. See 23.7.11. <p>Note: In determining the proportional amount of the net income of a CFC, no regard must be had to the inclusion rate in para 10. (Note 4)</p>

On the currency translation rules for determining

- The market value of shares in a CFC on valuation date, see para 43(6);
- The net income to be added to the base cost of the shares, see s 9D(6); and
- The exempt dividends declared that reduce base cost, see s 25D(1) and (3).

The proviso to item (h)³⁷⁰

The purpose of this proviso is to prevent the effective duplication of expenditure forming part of the base cost of assets referred to in para 20(1)

- (h)(i) – marketable security or equity instrument acquired under s 8A or 8C,
- (h)(ii)(bb) – assets acquired by employees / directors that have been subject to fringe benefits tax under the Seventh Schedule, and
- (h)(ii)(dd) – assets acquired in exchange for services rendered (for example, by an independent contractor) that have been included in para (c) of the definition of ‘gross income’.

In these instances, any expenditure actually incurred by that person in respect of the asset must be disregarded when it is incurred before the date

- on which the market value or value placed on the asset under the Seventh Schedule was determined, or
- on which the asset was disposed of, when the amount received or accrued from the disposal is taken into account in determining the gain or loss under s 8C (see note 1).³⁷¹

Examples of the type of expenditure excluded by this proviso are

- the cost of an option contemplated under para 20(1)(c)(ix) when that option is to be used to acquire a s 8A marketable security or s 8C equity instrument, and
- the strike price paid for that marketable security or equity instrument that would otherwise have been allowable under para 20(1)(a) when the option is exercised.

These costs are excluded because they are effectively reflected in the value of the asset included under para 20(1)(h).

Note:

1. The reference to an amount received or accrued was inserted following an amendment to s 8C. In certain circumstances the market value of the instruments is not used to determine the s 8C gain or loss, but rather the amount actually received or accrued from the disposal. For example, an employee who resigns may be obliged to sell the equity instruments back to the employer at cost. In these instances, the s 8C gain or loss is determined using the actual amount received or accrued [see s 8C(2)(a)(i)]. The step-up in base cost to market value will occur even when the s 8C gain is exempt under s 10(1)(o)(ii). The reason is that a gain or loss has been determined under s 8C and included in income. The fact that it is subsequently removed from income through the exemption does not nullify its initial inclusion.

³⁷⁰ The proviso was inserted by the Revenue Laws Amendment Act 31 of 2005, came into operation on 8 November 2005 and applies in respect of any disposal on or after that date. For disposals before this date, the view is held that the actual acquisition costs would in any event have been eliminated by para 20(3)(a), since they were allowed in determining the income gain or loss. Alternatively, the specific provisions of para 20(1)(h)(i) and (ii)(bb) take precedence over the general provisions of para 20.

³⁷¹ Paragraph (b) of the proviso to para 20(1)(h) was inserted by the Revenue Laws Amendment Act 20 of 2006 and is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

2. A lessee who acquires an asset from a lessor at less than market value must include the difference between the market value and the amount paid for the asset in gross income under s 8(5). This recoupment of lease rentals previously 'overpaid' is treated as part of the base cost of the asset.
3. The purpose of these adjustments is to fully reflect capital gains and losses arising in the CFC in the base cost of the interest of a resident in a CFC and to avoid double taxation.
4. This adjustment applies when a lower-tier CFC is disposed of by a higher-tier CFC. When this happens, it is necessary to determine the base cost of the shares in that lower-tier CFC so that the capital gain or loss arising in the higher-tier CFC can be determined and imputed to the resident under s 9D. As in note 3 above this provision prevents double taxation.

Base cost of restricted equity instruments disposed of to connected persons

In some instances, an employee will dispose of shares to a connected person such as a relative or family trust while the shares are restricted under s 8C. When the equity instrument 'vests' (that is, the restriction is lifted), s 8C(5) deems the income gain or loss to arise in the hands of the employee. From a CGT perspective the wording of para 20(1)(h)(i) is wide enough to ensure that the connected person will receive a step-up in base cost equal to the market value of the share on which the employee was subjected to normal tax. The opening words of para 20(1) refer to an asset acquired by 'a person' – which would apply to the employee's trust or relative, while the base cost step-up under para 20(1)(h)(i) is granted if the gain or loss is taxed in the hands of 'any person' (that is, the employee). Therefore, the person acquiring the asset can add an amount to base cost under para 20(1)(h)(i) as long as some other person (the employee) is taxed under s 8A or 8C. In this way economic double taxation of the employee and the family trust or relative is averted.

Base cost of assets subject to fringe benefits tax

Under para 16(1)(b) of the Seventh Schedule an employee will be liable to income tax on the value of an asset transferred to say, a relative of the employee or the employee's family trust. With effect from the commencement of years of assessment ending on or after 1 January 2008, the relative or family trust will be able to secure a step-up in base cost under para 20(1)(h)(ii) for the asset acquired.³⁷² Before this date no step-up under this provision was possible because the provision covered only the situation in which the employee acquired the asset.

Example 1 – Base cost of shares acquired under s 8A

Facts:

On 1 October 2001 Trevor was granted an option to acquire 1 000 shares in his employer, ComWorld Ltd at a price of R1 a share when the market price was R1,50 a share. He paid 10 cents a share for the options. On 28 February 2003 he exercised the options when the market price was R5 a share, and on 30 June 2006 he sold his shares at R8 a share.

Result:

The following gains will arise in Trevor's hands:

- 2003 year of assessment – an ordinary income gain under s 8A

³⁷² The reference in para 20(1)(h)(ii)(bb) to 'that' person's gross income was replaced by a reference to 'any' person's gross income by s 73(a) of the Revenue Laws Amendment Act 35 of 2007.

- 2007 year of assessment – a capital gain.

These gains are determined as follows:

Section 8A gain

	R
Market value of shares at date option exercised (1 000 × R5)	5 000
Less: Cost of options 1 000 × 10 cents	(100)
Cost of shares 1 000 × R1	<u>(1 000)</u>
Section 8A gain included in income	<u>3 900</u>

Capital gain

Proceeds 1 000 × R8	8 000
Less: Base cost 1 000 × R5	<u>(5 000)</u>
Capital gain	<u>3 000</u>

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

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

Facts:

Trevor is employed by Xenon Ltd and is not a share-dealer. In 2016 he acquired a restricted Xenon Ltd share from the company in exchange for a R100 loan when that restricted share had a value of R100. In February 2020 the restrictions on the share were lifted when the share had a market value of R250. Trevor sold the share for R400 in September 2020.

Result:

The share vested in the 2020 year of assessment when all the restrictions were lifted. Under s 8C(2) Trevor must include R150 in his income in that year (R250 less the R100 cost of the share). Trevor obtained a base cost of R250 (based on market value) in the share on that date. He will have a capital gain of R150 on the sale (R400 proceeds less R250 base cost) in the 2021 year of assessment.

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

Facts:

In 2016 Jeremy acquired a restricted share of Zenon Ltd while employed by that company. The share was provided at no cost to him.

Under the restriction, Jeremy must surrender the share to Zenon Ltd at no cost if he resigns before 2020. In 2018 he sold the share to his wife, Anne, for R55. In 2019 Anne transferred the share to the Jeremy Family Trust in exchange for a R110 loan with the Trust, being a connected person in relation to Jeremy. In 2020 the restriction was lifted when the share had a market value of R100. In 2021 the Trust sold the share for R150 with all parties settling their related loans.

Result:

Under s 8C(2) read with s 8C(5)(a) the share vested in 2020 when the restriction was lifted, triggering an income inclusion of R100 in Jeremy's hands. Under para 20(1)(h)(i) the Trust's base cost of the shares was R100 because the 'vesting . . . resulted in the determination of any gain or loss to be included in or deducted from . . . any person's income in terms of section . . . 8C'. The Trust has a capital gain of R50 on the sale (R150 proceeds less R100 base cost). The disposal by Jeremy to Anne and by Anne to the Trust must be disregarded under para 64C read with s 8C(5)(a). See **12.20**.

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

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

<i>Year of assessment ended</i>	R
29 February 2016	10 000
28 February 2017	10 000
28 February 2018	10 000
28 February 2019	10 000
29 February 2020	<u>10 000</u>
	<u>50 000</u>

At the end of the 2020 year of assessment Andrew acquired the property from Franz at a price of R2 000 even though its market value was R50 000. The lower price paid by Andrew was in recognition of the fact that most of the rentals paid by him were excessive and really in part payment of the purchase price. Under s 8(5) R48 000 (R50 000 – R2 000) was included in Andrew's income for the 2020 year of assessment. In 2021 Andrew sold the property for R65 000.

Result:

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

	R
Amount paid [para 20(1)(a)]	2 000
Amount included in income under s 8(5) [para 20(1)(h)(ii)]	<u>48 000</u>
Base cost	<u>50 000</u>

Andrew's capital gain is therefore R65 000 – R50 000 = R15 000

Example 5 – Determination of base cost of CFC [para 20(1)(h)(iii)(aa)]*Facts:*

A South African resident individual owns all the shares in a foreign company, which qualifies as a CFC. The shares were acquired for R200 000 on 19 December 2001. The receipts and accruals of the foreign company consist of the following:

	R
Taxable portion of foreign dividends	200 000
Capital gain on disposal of shares	400 000
Capital loss on disposal of shares	(100 000)

Result:

The net income of the CFC (disregarding the CGT inclusion rate applicable to individuals) as contemplated in s 9D is R200 000 + R400 000 – R100 000 = R500 000. The base cost of the shares is determined as follows:

	R
Cost of shares [para 20(1)(a)]	200 000
Net income as above [para 20(1)(h)(iii)(aa)]	<u>500 000</u>
Base cost	<u>700 000</u>

Example 6 – Base cost of shares in multi-tier CFC structure [para 20(1)(h)(iii)(bb)]*Facts:*

Sam, a resident, owns all the shares in CFC 1 which owns all the shares in CFC 2 which owns all the shares in CFC 3. Sam acquired all the shares in CFC 1 at a cost of R300 000 on 1 March 2018. At that date each CFC owned a portfolio of foreign listed shares valued at R100 000. On 28 February 2019 CFC 3 sold its portfolio of shares for R150 000 and reinvested the proceeds in other foreign listed shares. On 30 June 2019 CFC 3 declared a dividend of R25 000 to CFC 2 which on-declared it to CFC 1 which on-declared it to Sam. On 31 December 2019 CFC 1 disposed of its interest in CFC 2 for R275 000.

Result:

The disposal of listed shares by CFC 3 gives rise to a capital gain of R50 000 which is taxed in Sam's hands under s 9D in the 2019 year of assessment. The portion of the capital gain included in Sam's taxable income for that year is R50 000 × 40% = R20 000. The base cost of CFC 1's shares in CFC 2 is determined as follows:

	R
Market value of shares on date CFC 2 became a CFC [para 12(2)]	200 000
Net income of CFC 3 (disregarding inclusion rate under para 10)	50 000
Less: Exempt dividend [s 10B(2)(c)]	<u>(25 000)</u>
	<u>225 000</u>
Capital gain = R275 000 – R225 000	
= R50 000	

Check: The value of the listed investments in CFC 2 and CFC 3 increased by R100 000 from the date CFC 1 became a CFC until it disposed of CFC 2. Of this, R50 000 was taxed in Sam's hands on 28 February 2019. The remaining R50 000 capital gain arises on 31 December 2019 when CFC 1 disposes of the shares in CFC 2 (R275 000 proceeds less R225 000 base cost).

8.14 Base cost – asset acquired as a result of a 'value shifting arrangement' [para 20(1)(h)(iv)]

A person who acquires or disposes of an asset as a result of a 'value shifting arrangement' must make specified adjustments to the base cost of the asset. These adjustments are contained in para 23 (see **8.25**).

8.15 Base cost – asset acquired by heirs or legatees from non-resident estate [para 20(1)(h)(v)]

The base cost of an asset inherited by a person from a non-resident estate is determined as follows:

8.15.1 Paragraph 2(1)(b) assets [proviso to para 20(1)(h)(v)]

This category applies to

- immovable property situated in South Africa held by that person or any interest or right of whatever nature of that person to or in immovable property situated in South Africa including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources; and
- any asset effectively connected with a permanent establishment of that person in South Africa.

The base cost of these assets must be determined by both residents and non-residents under s 25(3)(b). Under that provision, the heir or legatee acquires the asset at the expenditure to the deceased estate (market value on date of death plus any further para 20 expenditure incurred by the executor).

8.15.2 All other assets [para 20(1)(h)(v)]³⁷³

The base cost of all other assets (for example, listed shares) is determined under para 20(1)(h)(v), which follows the same treatment as in s 25(3)(b). The asset is deemed to be acquired for an amount equal to

- the market value determined immediately before the death of the deceased person, and
- any further expenditure incurred by the executor of the estate under para 20 in the process of winding up the estate.

8.15A Base cost – asset acquired from a non-resident by way of donation, consideration not measurable in money or connected person transaction at a non-arm's length price [para 20(1)(h)(vi)]

An asset is deemed to be acquired at market value on the date of acquisition when

- it is acquired on or after the valuation date,
- from a person who at the time of that acquisition was not a resident,

³⁷³ Under s 107(2) of the Revenue Laws Amendment Act 20 of 2006 para 20(1)(h)(v) comes into operation as from the commencement of years of assessment ending on or after 1 January 2007. Before that date such assets will have a base cost of nil.

- by way of donation, consideration not measurable in money, or transaction between a connected person not at an arm's length price.³⁷⁴

This provision was introduced because of concern that para 38(1) did not apply to disposals of non-South African source assets by non-residents. As with para 38, it does not apply to assets acquired before the valuation date. Except when the transitional rules in para 97 apply, the actual cost of acquisition (if any) of assets acquired under these circumstances must be used for pre-valuation date assets when the time-apportionment base cost method is adopted. For years of assessment commencing before 1 January 2013 para 12(5) overrides this provision, with the result, for example, that if a non-resident waives a debt owed by a resident, the resident will have a capital gain equal to the amount discharged. In other words, the debt will be deemed to be acquired at a base cost of nil under para 12(5) instead of at a base cost equal to market value under this provision.

Amounts excluded from base cost

Paragraph 20(2) and (3)

8.16 Exclusions – specified current costs [para 20(2)]

Except to the extent permitted under para 20(1)(g) (see **8.12**), the following expenses do not form part of base cost:

- borrowing costs, including any interest as contemplated in s 24J, raising fees, bond registration costs or bond cancellation costs;³⁷⁵
- repairs, maintenance, protection, insurance, rates and taxes, or similar expenditure
- the valuation date value of any option or right to acquire any marketable security contemplated in s 8A(1). The purpose of this exclusion is to prevent an employee claiming the valuation date value of the option as well as pre-1 October 2001 expenditure under para 20(1)(f).

Example – Interest not forming part of base cost

Facts:

Petro purchased her primary residence at a cost of R1 million after the valuation date with the assistance of a mortgage bond of R800 000. She disposed of the residence ten years later for R3,5 million. The interest on the bond over the ten year holding period was R720 000.

³⁷⁴ Paragraph 20(1)(h)(vi) was introduced by s 77(1)(c) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009. It was amended by s 84 of the Taxation Laws Amendment Act 43 of 2014 to replace the words 'by way of a disposal contemplated in paragraph 38(1)' with the words in the bullet point. The previous wording was potentially problematic because it could have been argued that a non-resident seller does not have a disposal under para 2(1)(b) although the intention with the reference to para 38(1) was to refer to the manner in which the asset was transferred rather than to a disposal as defined.

³⁷⁵ Bond registration costs and bond cancellation costs were included by the Taxation Laws Amendment Act 34 of 2019 with effect from 15 January 2020. It is considered that such costs would in any event have fallen within the rubric 'borrowing costs', and that this was a clarifying amendment.

Result:

Petro may not claim the interest on the bond as part of the base cost of the residence. The capital gain is thus R3,5 million (proceeds) – R1 million (base cost) – R2 million (primary residence exclusion) = R500 000.

Reductions in base cost

Paragraph 20(3)

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

8.17 Reduction – expenditure already allowed [para 20(3)(a)]

The expenditure in para 20(1)(a) to (g) must be reduced by any amount that

- is or was allowable or is deemed to have been allowed in determining taxable income [para 20(3)(a)(i)], and
- is not included in the taxable income of that person under s 9C(5) [para 20(3)(a)(ii)],³⁷⁶

before the inclusion of any taxable capital gain.

This provision prevents the double deduction of expenditure.

The words ‘or is deemed to have been allowed’ were inserted to deal with assets of a micro business referred to in the Sixth Schedule.³⁷⁷ Under ss 11(e)(ix), 12C(4A), 12D(3A), 12DA(4), 12F(3A) and 37B(4) a taxpayer is deemed to have been allowed the applicable capital allowances granted under those sections during years of assessment when the asset has been used in the taxpayer’s trade but the receipts or accruals from that trade were not included in the taxpayer’s income during those years of assessment. This treatment will be relevant in determining the base cost of an asset that was used in a micro business but is subsequently moved out of such a business, say, because the person’s turnover exceeds the threshold required in order to remain within the presumptive turnover tax regime.

Section 9C(5) provides for a recoupment of expenditure claimed under section 11 by a share-dealer when qualifying equity shares are disposed of after having been owned by the seller for at least three years. Were it not for para 20(3)(a)(ii), the recouped expenditure could arguably not be added to the base cost of the shares because it was originally ‘allowable’ even though it was later recouped. Nevertheless, in order to qualify as part of the base cost of the shares, such recouped expenditure must still satisfy the requirements of para 20. Not all such expenditure will qualify under para 20; for example, only one-third of the interest incurred on funds borrowed to acquire listed shares or participatory interests in collective investment schemes will qualify as part of base cost, while no portion of interest on funds borrowed to acquire unlisted shares will qualify [para 20(1)(g)].

³⁷⁶ Paragraph 20(3)(a)(ii) inserted by s 95 of the Taxation Laws Amendment Act 7 of 2010 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2011.

³⁷⁷ Introduced by s 77(1)(d) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

A provision for doubtful debts under s 11(j) should not be applied in reduction of the base cost of a debt owing to a person under para 20(3)(a) because s 11(j) requires that such an allowance be included in the taxpayer's income in the following year of assessment. The allowance is thus effectively always cancelled by the subsequent recoupment which is automatically required by s 11(j). Accordingly, the allowance is not regarded as having been allowable for the purposes of determining the base cost of the asset.

Paragraph 20(3)(a) does not apply to amounts included in base cost by para 20(1)(h). However, the proviso to para 20(1)(h) prevents any double deduction of expenditure.

Example 1 – Application of para 20(3)(a)

Facts:

Hazel bought a bakkie at a cost of R100 000. She disposed of it three years later by which time she had claimed wear-and-tear allowances of R60 000 under s 11(e).

Result:

Under para 20(3)(a) the base cost of Hazel's bakkie is R100 000 – R60 000 = R40 000.

Example 2 – Exclusion of expenditure recouped under s 9C(5) from the application of para 20(3)(a)

Facts:

Mark, a share-dealer, purchased shares in X Ltd, a JSE-listed company on 1 March of year 1 for R100 000 and funded the acquisition with a loan from the bank. For the first three years he claimed interest of R10 000 × 3 = R30 000 on the loan as a deduction under s 11(a). He sold the shares on 28 February of year 5 for R120 000.

Result:

From 1 March of year 4 no further interest would have been allowable under s 11(a) because the shares had been held for three years and any proceeds on their disposal would be of a capital nature under s 9C(2).

For the year ended 28 February of year 5 Mark had opening stock of R100 000. This amount, together with the interest of R30 000 claimed as a deduction under s 11(a) is subject to recoupment on disposal under s 9C(5).

Ordinary income

	R
Recoupment of opening stock and interest under s 9C(5)	130 000
Less: Opening stock	(100 000)
Net inclusion in taxable income	30 000

Capital gain

Proceeds	120 000
Less: Base cost (see below)	<u>(110 000)</u>
Capital gain	<u>10 000</u>

The base cost of the shares is determined as follows:

	R
Cost of acquisition [para 20(1)(a)]	100 000
Interest R30 000 × 1 / 3 [para 20(1)(g)]	<u>10 000</u>
Total	<u>110 000</u>

Despite the original cost of the shares and the interest incurred during the first three years having been allowed as a deduction, para 20(3)(a)(ii) does not require these costs to be excluded, since they were recouped under s 9C(5).

8.18 Reduction – expenditure recovered or recouped [para 20(3)(b)]

The expenditure contemplated in para 20(1)(a) to (g) must be reduced when an expense has for any reason been

- reduced,
- recovered,
- become recoverable from any other person, or
- been paid by any other person.

It does not matter whether the reduction, recovery or payment takes place before or after the expense is incurred. This requirement was specifically inserted to counter the argument that expenditure cannot be recouped in advance. For example, X intends to buy an asset from a third party. By arrangement, Y deposits the purchase price in the supplier's bank account and X then takes delivery of the asset without becoming indebted to Y. X's base cost must be reduced to nil despite the recovery taking place in advance of the incurral of the expenditure.

It can happen that, say, a group company (X) acquires an asset on credit from a third party supplier. By arrangement, another group company (Y) pays the supplier after which X owes Y the same amount. It is not intended that para 20(3)(b) should apply in these circumstances, since debt substitution has simply occurred, and in substance X has paid the supplier by using Y as an intermediary. But when Y pays the supplier and does not recover the money from X, para 20(3)(b) will apply.

In *C: SARS v Pinestone Properties CC*³⁷⁸ the court held that the onus was on SARS to show that an amount previously allowed to be deducted had been recovered or recouped by the taxpayer.

Exclusions from para 20(3)(b)

No reduction is required to the extent that the amount is

- taken into account as a recoupment under section 8(4)(a);
- taken into account as a recoupment under para (j) of the definition of 'gross income' (which deals with the recoupment of certain mining capital expenditure);
- reduced under s 12P (Exemption of amounts received or accrued in respect of government grants); or
- applied to reduce an amount of expenditure incurred in respect of
 - trading stock as contemplated in s 19(3); or
 - any other asset as contemplated in para 12A(3).³⁷⁹

³⁷⁸ *C: SARS v Pinestone Properties CC* 2002 (4) SA 202 (N), 63 SATC 421 at 426.

³⁷⁹ As amended by s 56(1)(c) of the Taxation Laws Amendment Act 34 of 2019, deemed to come into operation on 1 January 2018 and applies to years of assessment commencing on or after that date.

Exclusion – Government grants dealt with under s 12P

The Taxation Laws Amendment Act 22 of 2012 introduced a new system for dealing with government grants in the form of s 12P and the Eleventh Schedule. The latter Schedule contains a list of tax-exempt government grants. This system applies to years of assessment commencing on or after 1 January 2013. Section 12P contains its own base cost reduction rules dealing with trading stock, allowance assets and capital assets. In order to prevent duplication, a government grant accounted for under s 12P will not give rise to a reduction in expenditure under para 20(3)(b).

Exclusion – Reduction of debt funding trading stock

Paragraph 20(3)(b)(iii)(aa) ensures that para 20(3)(b) does not apply if the expenditure in respect of trading stock has been reduced under s 19(3). Such a reduction would occur under s 19(3) when the debt reduction occurs while the trading stock is still on hand. The purpose of this rule is to prevent a potential double reduction in expenditure. Such a double reduction would otherwise have occurred through the application of both para 20(3)(a)(i) and para 20(3)(b). Despite the subsequent reduction in the expenditure originally incurred under s 11(a) or s 22(2) (opening stock) as a result of the application of s 19(3), the original expenditure incurred in acquiring the trading stock 'was allowable' (capable of being allowed) at the time it was incurred and hence para 20(3)(a)(i) would apply.

Example 1 – Reduction of expenditure funding trading stock*Facts:*

Company A acquired trading stock at a cost of R100 000 during its 2020 year of assessment from Company B on loan account. During the same year of assessment Company B cancelled the debt of R100 000 because of Company A's inability to pay. The trading stock was subsequently sold for R120 000. The year of assessment of Company A ends on 31 March.

Result:

Under s 19(3) the deduction for the acquisition of trading stock under s 11(a) is reduced to nil. The amount received or accrued on disposal of the trading stock of R120 000 is included in Company A's gross income.

Trading stock is an 'asset' as defined in para 1 and accordingly falls to be dealt with under the Eighth Schedule. The capital gain or loss on its disposal is calculated as follows:

Proceeds (R120 000 – R120 000 [para 35(3)(a)]) ³⁸⁰	R Nil
Less: Base Cost (R100 000 – R100 000 [para 20(3)(a)])	(Nil)
Capital gain	<u>Nil</u>

Under para 20(3)(a) the base cost of the trading stock is reduced by the amount that was allowable as a deduction under s 11(a). Potentially a further reduction in the base cost of the trading stock could occur under para 20(3)(b), which applies when expenditure is reduced or becomes recoverable. However, this reduction is prevented by para 20(3)(b)(iii)(aa) which excludes any such reduction when the expenditure in respect of trading stock has been reduced under s 19(3).

³⁸⁰ Paragraph 35(3)(a) provides that the proceeds from the disposal of an asset must be reduced by any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain.

Exclusion – Reduction of base cost of asset under para 12A(3)

Paragraph 20(3)(b)(iii)(bb) ensures that para 20(3)(b) does not apply if the expenditure in respect of an asset other than trading stock contemplated in s 19(3) has been reduced under para 12A(3). Such a reduction would occur under para 12A(3) in respect of an asset not disposed of in a prior year of assessment which was funded directly or indirectly by debt which is the subject of a concession or compromise during the current year of assessment. Such an asset could be disposed of during the current year of assessment or could be still held at the end of that year.

Example 2 – Reduction of expenditure funding asset other than trading stock*Facts:*

Company A acquired vacant land as a capital asset at a cost of R100 000 during its 2016 year of assessment from Company B on loan account. During the 2020 year of assessment Company B cancelled the debt of R100 000 because of Company A's inability to pay.

The year of assessment of Company A ends on 31 March.

Result:

Under para 12A(3) Company A must reduce the base cost of its vacant land by R100 000 during the 2020 year of assessment. However, para 20(3)(b) will not apply by virtue of the exclusion in para 20(3)(b)(iii)(bb).

*Some general observations on debt reduction and para 20(3)(b)**Alignment of para 12A(3) and para 20(3)(b)*

The suspension from operation of para 20(3)(b) when s 19(3) or para 12A(3) applies means that para 20(3)(b) is unlikely to apply to the cancellation of debt. Before years of assessment commencing on or after 1 January 2018 both para 12A(3) and para 20(3)(b) could have applied during the year of assessment in which an asset was disposed of. During that time para 12A(3) applied only during the period that the asset was held and not disposed of, which meant that para 20(3)(b) could have applied to the cancellation of debt after the date of disposal but before the end of the relevant year of assessment. In the latter regard, a taxpayer's capital gain or capital loss is determined for a year of assessment and not at the time of disposal of an asset. Accordingly, adjustments to the base cost of the asset under para 20(3)(b) can be made up to the last day of the year of assessment in which the asset is disposed of. The latter point is relevant not only to debt cancellation but other forms of base cost recovery such as a refund of part of the purchase price.

This situation no longer prevails because para 12A(3) now applies at any time during the year of assessment, as long as the asset was held at the beginning of the year of assessment in which the debt was cancelled.

Potential application of para 20(3)(b) to debt cancellation

But for the exclusion in para 20(3)(b)(iii), para 20(3)(b) would have applied to the cancellation of debt. In ITC 1634 Wunsh J noted that³⁸¹

‘to recoup is to recover or get back what has been expended or lost or to compensate’.

Recognising that a recoupment can occur when debt that financed deductible expenditure is reduced, he summed up the position as follows:³⁸²

‘The cancellation or reduction of a liability which has been incurred by a taxpayer in the production of its income, is not of a capital nature and has been allowed as a deduction in computing its taxable income is an amount which accrues to the taxpayer and, in any event, whether or not it is of a capital nature, represents a recoupment by it of the deduction for the purpose of s 8(4)(a) of the Act. There is no difficulty in identifying the “amount” – it is the face value of the liability which is cancelled or the amount by which it is reduced.’

Expenditure must be directly incurred

Paragraph 20(3)(b) applies when the expenditure contemplated in para 20(1)(a) to (g) ‘has for any reason been reduced or recovered or become recoverable from or has been paid by any other person’. Given that it is the relevant expenditure, and not the debt relating to such expenditure that must be reduced or recovered, the view is held that para 20(3)(b) applies only when the debt is incurred with the person from whom the asset is acquired, that is, when the amount of the debt was used ‘directly’ to fund the relevant expenditure. It is submitted that para 20(3)(b) does not apply when the person borrows the necessary funds to acquire the asset from a third party, such as a bank, and the third party waives the related debt. The reference to ‘other person’ is interpreted as a reference to someone other than the person who incurred the expenditure that formed part of the base cost of the asset acquired by that person.

Specific provisions override general ones

Paragraph 12A(6) contains a number of exemptions which make para 12A inapplicable to specified debt cancellation transactions, for example, when the debt cancellation results in donations tax becoming payable. Under the legal maxim *generalia specialibus non derogant* para 12A is the more specific provision and takes precedence in these situations and it would therefore not be proper to apply para 20(3)(b) to reduce the base cost of the asset funded by the cancelled debt.

Example 3 – Paragraph 12A taking precedence over para 20(3)(b)*Facts:*

Lizette acquired immovable property from her father on loan account for a market-related consideration of R2,1 million. Two years later her father decided to waive the value of the loan. He paid donations tax of $(R2,1 \text{ million} - R100\,000) \times 20\% = R400\,000$.

³⁸¹ ITC 1634 (1997) 60 SATC 235 (T) at 242.

³⁸² At 258.

Result:

The waiver of the loan falls to be dealt with under para 12A(3) as a reduction in expenditure. However, the exemption in para 12A(6)(b) applies to R2 million of the loan because the waiver of that part of the loan constitutes a donation as defined in s 55(1) in respect of which donations tax is payable. Paragraph 20(3)(b) will not apply to the R2 million because para 12A takes precedence. Lizette is therefore not required to reduce the base cost of the property except to the extent of R100 000 under para 12A(3) (the portion exempt from donations tax). Paragraph 20(3)(b) does not apply to the R100 000 by virtue of the exclusion in para 20(3)(b)(iii)(bb).

Shares acquired cum div

A dividend received shortly after the acquisition of a share, the price of which includes the value of the dividend, is not regarded as a recovery of cost under para 20(3)(b). There is no guarantee that the price of a share will drop after the declaration of a dividend (see *Tod's case*).³⁸³ Also, given that the major part of the value of a share usually comprises the right to receive dividends, there does not seem to be any justification for treating a dividend received soon after acquisition of the share as a recovery of cost, while treating other dividends as receipts or accruals of gross income. Paragraph 19 addresses the disregarding of a capital loss arising on disposal of a share as a result of the receipt or accrual of a pre-acquisition dividend. In ITC 1859³⁸⁴ redeemable preference shares were redeemed at a capital loss which was partly attributable to the fact that a part of the consideration comprised a dividend. The court rejected the argument that the dividend and redemption premium portion of the purchase price represented a recovery of the cost of the shares under para 20(3)(b), noting that the dividend and redemption premium represented the fruit from the share and the fact that these benefits may have been taken into account in determining the price the appellant paid for the shares did not convert them into the recoveries envisaged in para 20(3)(b).

Purchased annuities under s 10A

Generally, a purchased annuity contemplated in s 10A involves an individual investing a lump sum with an insurer in return for an annuity. Each annuity instalment is divided into capital and income elements with the income element being included in the annuitant's gross income. The amount paid for the annuity comprises expenditure actually incurred in acquiring an asset for purposes of para 20(1)(a).

The capital element of a purchased annuity referred to in s 10A is regarded as a return of the expenditure incurred under para 20 in acquiring the annuity.

Loan repayments

See **24.4** on the treatment of loan repayments as a cost recovery.

³⁸³ *CIR v Tod* 1983 (2) SA 364 (N), 45 SATC 1.

³⁸⁴ (2012) 74 SATC 213 (J).

8.18A Reduction of base cost of assets of small, medium or micro-sized enterprises

Section 230

Background

Section 230 came into operation on 1 March 2015 and applies to amounts received on or after that date.

It applies when a small, medium or micro-sized enterprise as defined in s 1(1) receives an amount from a small business funding entity and uses that amount to fund deductible expenditure or expenditure forming part of the base cost of an asset.

The term 'small business funding entity' is defined in s 1(1) as follows:

' "[S]mall business funding entity" means any entity, approved by the Commissioner in terms of section 30C;'

The purpose of a small business funding entity is to provide funding to small, medium or micro-sized enterprises. For more on such entities, see **12.18**.

The term 'small, medium or micro-sized enterprise' is defined in s 1(1) as follows:

' "[S]mall, medium or micro-sized enterprise" means any—

(a) person that qualifies as a micro business as defined in paragraph 1 of the Sixth Schedule; or

(b) any person that is a small business corporation as defined in section 12E(4);'

Qualifying criteria to be a micro business

A person will qualify as a small, medium or micro-sized enterprise if that person qualifies as a micro business under the Sixth Schedule. It is merely a requirement that the person meet the qualifying criteria laid down in the Sixth Schedule. It is not required that the person be registered as a micro business, since if the person were so registered, that person's business receipts would be excluded from normal tax under s 10(1)(zJ) and would disregard any capital gain or loss on disposal of micro business assets under para 57A.

Part II of the Sixth Schedule sets out positively (para 2) and negatively (para 3) who qualifies and who does not qualify as a micro business. Under para 2 of the Sixth Schedule a natural person or company with a qualifying turnover not exceeding R1 million for the year of assessment will potentially qualify as a micro business. Paragraph 3 of the Sixth Schedule excludes as a micro business

- a person who holds shares in another company apart from certain permissible holdings;
- a natural person if more than 20% of that person's total receipts during the year of assessment comprises income from the rendering of a professional service;
- a company if more than 20% of its total receipts during a year of assessment comprises investment income and income from rendering a professional service;
- personal service providers, and labour brokers without an exemption certificate;

- a person whose receipts from the disposal of immovable property mainly used for business purposes and from the disposal of any other asset of a capital nature used mainly for business purposes (excluding financial instruments) exceeds R1,5 million during the current and previous two years of assessment;
- a company whose year of assessment ends on a date other than the last day of February;
- a company if any of the holders of its shares are not natural persons or the deceased or insolvent estates of natural persons;
- a company if a holder of its shares holds shares in another company (other than permissible holdings);
- a public benefit organisation approved by the Commissioner under s 30;
- a recreational club approved by the Commissioner under s 30A;
- an association approved by the Commissioner under s 30B;
- a small business funding entity approved by the Commissioner under s 30C;
- members of a partnership if any one of them is not a natural person or if the qualifying turnover of the partnership exceeds R1 million; and
- a person who is a member of more than one partnership.

Qualifying criteria to be a small business corporation

A person will qualify as a small, medium or micro-sized enterprise if it qualifies as a small business corporation under s 12E(4). Under s 12E(4) a small business corporation can comprise a close corporation, co-operative, private company as defined in the Companies Act or personal liability company as contemplated in s 8(2)(c) of the Companies Act when all the holders of its shares are natural persons and its gross income for a year of assessment does not exceed R20 million (pro-rated when the small business corporation traded for a period of less than 12 months with part of a month treated as a full month). A person will be excluded as a small business corporation if

- a holder of its shares holds shares in another company (other than permissible holdings);
- more than 20% of the total of all its receipts and accruals (other than those of a capital nature) and all its capital gains consists collectively of investment income and income from the rendering of a personal service; or
- the person comprises a personal service provider as defined in the Fourth Schedule.

Exemption from normal tax

A small, medium or micro-sized enterprise is exempt from normal tax on any amount received by or accrued to or in favour of it from a small business funding entity under s 10(1)(zK). The CGT consequences of such funding are not addressed in the Eighth Schedule but rather in s 23O.

Funding of trading stock [s 230(2)]

Section 230(2) applies when during any year of assessment

- any amount is received by or accrues to a small, medium or micro-sized enterprise from a small business funding entity; and
- the amount is for the acquisition, creation or improvement of trading stock; or
- is a reimbursement for expenditure outlaid for such purpose.

A small, medium or micro-sized enterprise must reduce any s 11(a) expenditure allowed as a deduction in respect of the trading stock as well as any amounts taken into account under s 22(1) as closing stock or 22(2) as opening stock to the extent that the amount received or accrued from the small business funding entity is applied for the purpose described above.

The reduction of the amounts will apply regardless of whether the funding is received before or after the incurral of the expenditure. An amount received in advance would be for the acquisition, creation or improvement of the trading stock while an amount received after the expenditure has been incurred would represent a reimbursement.

Example 1 – Funding of trading stock*Facts:*

On 1 March 2019 ABC CC, which qualifies as a micro business, received a non-refundable grant of R20 000 from XYZ (Pty) Ltd, an approved small business funding entity for the purpose of subsidising the cost of trading stock. On 1 April 2019 ABC purchased trading stock at a cost of R50 000. All this trading stock was disposed of by 29 February 2020.

Result:

ABC CC is entitled to a deduction of R50 000 under s 11(a) but this amount must be reduced under s 230(2) by the amount of the grant of R20 000. ABC CC will therefore be entitled to a net deduction under s 11 of R30 000 during the 2020 year of assessment.

For CGT purposes the base cost of the trading stock is reduced to nil under para 20(3)(a)³⁸⁵ and no adjustments are therefore required under s 230.

Funding of allowance assets [s 230(3)]

The term ‘allowance asset’ is defined in s 230(1) as follows:

‘ “[A]llowance asset” means an asset as defined in paragraph 1 of the Eighth Schedule, other than trading stock, in respect of which a deduction or allowance is allowable in terms of this Act for purposes other than the determination of any capital gain or capital loss.’

Typical examples would include assets qualifying for the wear-and-tear or depreciation allowance under s 11(e) or assets qualifying for the 40/20/20/20 allowance under s 12C. Also included would be assets of a small business corporation qualifying for accelerated write-off under s 12E.

³⁸⁵ Paragraph 20(3)(a) would apply to the full amount of R50 000 on the basis that it was ‘allowable’ under s 11(a) even though it was subsequently reduced under s 230(2). This view is supported by the fact that s 230(2) refers to ‘any expenditure incurred in respect of that trading stock *allowed* as a deduction in terms of section 11(a) ...’.

Section 23O(3) applies when during any year of assessment

- any amount is received by or accrues to a small, medium or micro-sized enterprise from a small business funding entity; and
- the amount is for the acquisition, creation or improvement of an allowance asset; or
- is a reimbursement for expenditure outlaid for such purpose.

A small, medium or micro-sized enterprise must reduce the base cost of the allowance asset to the extent that the amount received or accrued from the small business funding entity is applied for the purpose described above.

The term 'base cost' is defined in s 23O(1) as follows:

‘ “[B]ase cost” means base cost as defined in paragraph 1 of the Eighth Schedule.’

Example 2 – Reduction in base cost of allowance asset

Facts:

On 1 March 2019 XYZ CC, which qualifies as a micro business, received a non-refundable grant of R20 000 from DEF (Pty) Ltd, an approved small business funding entity for the purpose of subsidising the cost of machinery. On 1 April 2019 XYZ purchased a machine at a cost of R100 000.

Result:

The base cost of the machine for CGT purposes must be reduced to R80 000 (R100 000 – R20 000) under s 23O(3).

Limitation on allowances [s 23O(4)]

The aggregate amount of the deductions or allowances allowable to the person in respect of the allowance asset may not exceed an amount equal to the aggregate of the expenditure incurred in the acquisition, creation or improvement of that allowance asset, reduced by an amount equal to the sum of

- the amount so received or accrued from the small business funding entity applied for the purpose described in s 23O(3); and
- the aggregate amount of all deductions and allowances previously allowed to that person in respect of the allowance asset.

Example 3 – Limitation of allowances

Facts:

JHK (Pty) Ltd qualifies as a small business corporation and has a financial year ending on the last day of February. On 1 March 2019 it received a non-refundable grant of R10 000 from DEF (Pty) Ltd, an approved small business funding entity, for the purpose of subsidising the cost of machinery to be used in its trade as a food retailer. On 1 April 2019 JHK (Pty) Ltd purchased a machine at a cost of R100 000.

Result:

Since it does not carry on a process of manufacture or similar process, JHK (Pty) Ltd will be entitled to write off the machine over three years in the ratio 50/30/20 under s 12E.

However, under s 23O(4) the allowances claimable by JHK (Pty) Ltd will be limited to the cost of the machine less the grant received from the small business funding entity, that is, R100 000 – R10 000 = R90 000. Since the allowances for the first two years amount to R80 000 (R50 000 + R30 000), there will be no limitation in those years. The allowance of R20 000 claimable in the third year will, however, be limited to R10 000 in order to limit the overall allowances to R90 000.

Year of assessment

		R
2020	R100 000 × 50%	50 000
2021	R100 000 × 30%	30 000
2022	R100 000 × 20% = R20 000 limited to R10 000	<u>10 000</u>
Total capital allowances		<u>90 000</u>

Funding of capital assets other than allowance assets [s 23O(5)]

References under this heading to a capital asset are to an asset other than trading stock or an allowance asset.

Section 23O(5) applies when during any year of assessment

- any amount is received by or accrues to a small, medium or micro-sized enterprise from a small business funding entity; and
- the amount is for the acquisition, creation or improvement of a capital asset; or
- is a reimbursement for expenditure outlaid for such purpose.

A small, medium or micro-sized enterprise must reduce the base cost of the capital asset for CGT purposes to the extent that the amount received or accrued from the small business funding entity is applied for the purpose described above.

Example 4 – Funding of capital asset*Facts:*

MNO (Pty) Ltd qualifies as a small business corporation under s 12E(4). On 1 March 2019 it acquired a piece of land at a cost of R500 000 for the purpose of erecting a retail store. On 30 June 2019 the company received a non-refundable grant of R50 000 from a small business funding entity for the purpose of subsidising the cost of the land it had acquired.

Result:

Under s 23O(5) MNO (Pty) Ltd must reduce the base cost of its land by the amount of the grant received. The base cost of the land will therefore be R500 000 – R50 000 = R450 000.

Reduction in other expenditure and carry-forward of excess [s 23O(6)]

Section 23O(6) applies when during any year of assessment

- any amount is received by or accrues to a small, medium or micro-sized enterprise from a small business funding entity; and
- section 23O(2) (reduction of trading stock), (3) (reduction of base cost of allowance asset), (4) (limitation of allowances on an allowance asset) or (5) (funding of capital assets other than allowance assets) does not apply.

Any amount allowed to be deducted from the income of that small, medium or micro-sized enterprise under s 11 for that year of assessment must be reduced to the extent of the amount received or accrued from a small business funding entity.

To the extent that the amount so received or accrued exceeds the amount allowed to be deducted under s 11, the excess is deemed to be an amount received or accrued from a small business funding entity during the following year of assessment for the purposes of reducing any expenditure under s 11.

Example 5 – Reduction of s 11 expenditure and carry-forward of excess*Facts:*

RST (Pty) Ltd qualifies as a small business corporation and its financial year ends on the last day of February. On 1 February 2020 the company acquired trading stock at a cost of R100 000, all of which was included in closing stock at the end of the 2020 year of assessment. Besides the cost of the trading stock, the company incurred other deductible expenditure during the 2020 year of assessment under s 11 of R50 000. On 15 February 2020 the company received a non-refundable grant of R175 000 for the purpose of subsidising the cost of trading stock. During the 2021 year of assessment the company incurred expenditure under s 11 of R40 000.

Result:

2020 year of assessment

The cost of the trading stock allowable under s 11(a) and the closing stock included in income under s 22(1) of R100 000 must be reduced to nil under s 23O(2). The other expenditure allowable under s 11 of R50 000 must also be reduced by the balance of the funding remaining after reducing the cost of trading stock. An amount of R175 000 – R100 000 – R50 000 = R25 000 must be carried forward to the 2021 year of assessment.

2021 year of assessment

Under s 23O(6) the s 11 expenditure of R40 000 must be reduced by the excess funding brought forward from the 2020 year of assessment of R25 000. The company's s 11 deductions will thus be limited to R15 000.

8.19 Reduction – para 20(3)(c)

Paragraph 20(3)(c) in its original form was deleted and later reinserted. The current version, however, fulfils an entirely different purpose to the initial version. The table below summarises the changes to para 20(3)(c) since it was first introduced into the Eighth Schedule. For the sake of completeness the commentary on the old version is retained in **8.19.1**, while the current version is dealt with in **8.19.2**.

Table 1 – Amendments to para 20(3)(c)

Amending Act	Commencement date	Purpose
Taxation Laws Amendment Act 5 of 2001	Any disposal on or after 1 October 2001	Reduces base cost by any amount included therein by para 20(1) and (2) which has not been paid and is not due and payable in a year of assessment.
Revenue Laws Amendment Act 32 of 2004	The deletion came into operation on 24 January 2005 and applies in respect of any disposal during a year of assessment commencing on or after that date.	Deletes para 20(3)(c)
Revenue Laws Amendment Act 20 of 2006	The reinsertion is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.	Reduces expenditure in para 20(1)(a) to (g) in respect of any amount which is <ul style="list-style-type: none"> • exempt from tax under s 10(1)(y) or (yA), • is granted or paid for purposes of the acquisition of an asset, and • not identified for exclusion from para 20(3)(c) by the Minister by notice in the Gazette. <p>This provision relates to Government grants, scrapping payments and ODA assistance amounts.</p>
Taxation Laws Amendment Act 22 of 2012	Years of assessment commencing on or after 1 January 2013.	To delete the reference to s 10(1)(y) which was deleted from the same date

8.19.1 Reduction – expenditure unpaid and not due and payable [old para 20(3)(c)]

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

Before the deletion of para 20(3)(c), the expenditure in para 20(1)(a) to (g) incurred by a person had to be reduced by any amount

‘which has not been paid and is not due and payable in a year of assessment’.

This rule was essentially an anti-avoidance measure. In order to apply, both requirements had to be met. It is therefore important to determine when a debt has been paid and when it is due and payable.

Paid

When a debt is paid by cash or cheque, it will be regarded as paid.³⁸⁶ The more difficult question arises when the amount owed is replaced by a new loan. It is impossible to lay down hard and fast rules in this regard as the answer will depend on the facts of the particular case. In many cases the issue will be irrelevant for the purposes of para 20(3)(c) because the debt may well be due and payable at the time it is replaced by the new loan. Novation occurs when an existing obligation is discharged and replaced by a new one, but it has been held that novation is not a form of payment.³⁸⁷

Due and payable

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

Example 1 – Expenditure unpaid, not due and payable

Facts:

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

Result:

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

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

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

Example 2 – Expenditure unpaid, not due and payable

Facts:

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

Result:

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

³⁸⁶ ITC 1688 (1999) 62 SATC 478 (N).

³⁸⁷ *Market Furnishers v Reddy* 1966 (3) SA 550 (N) at 553D .

8.19.2 Reduction – Government grants, scrapping payments and ODA assistance amounts [current para 20(3)(c)]

Paragraph 20(3)(c) was reinserted by the Revenue Laws Amendment Act 20 of 2006, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007. The reference in para 20(3)(c) to s 10(1)(y) was deleted with effect from years of assessment commencing on or after 1 January 2013 and was consequent on the introduction of s 12P which came into operation on the same date.

The expenditure incurred by a person in respect of an asset in para 20(1)(a) to (g) must be reduced by any amount which is exempt from tax under s 10(1)(yA) and is granted or paid for purposes of the acquisition of an asset.

Section 10(1)(yA) exempts from normal tax any amount received by or accrued to any person (for example, a foreign donor or multinational company) in respect of goods or services provided to beneficiaries under an official development assistance (ODA) agreement. The amount must be received or accrued in relation to projects approved by the Minister and the agreement must provide that those receipts and accruals of that person must be exempt.

The purpose of this provision is to prevent so-called 'double-dipping'. Double-dipping occurs when a recipient of exempt income uses that exempt amount to purchase an asset, and then claims that amount as part of the base cost of the asset.

8.20 Re-establishment of base cost after cancellation or termination of agreement in a subsequent year [para 20(4)]

Paragraph 20(4) was inserted with effect from 1 January 2016 and applies to any asset reacquired as a result of the cancellation or termination of an agreement during any year of assessment commencing on or after that date.

It applies when a person

- disposed of an asset to another person under an agreement; and
- reacquired that asset from that other person by reason of the cancellation or termination of that agreement

and both persons are restored to the position they were in before entering into that agreement.

The person who disposed of the asset must be treated as having acquired that asset for an amount equal to

- the base cost of that asset before that disposal; and
- so much of any expenditure incurred on that asset by that other person (buyer) that has been recovered from that person (seller) as would have constituted expenditure contemplated in para 20(1)(e) had it been incurred by that person (seller).

Paragraph 20(4) came into operation on 1 January 2016 and applies to any asset reacquired as a result of the cancellation or termination of an agreement during any year of assessment commencing on or after that date. It must be read with para 3(c) and 4(c).

Since the disposal of an asset under an agreement which is cancelled or terminated during the same year of assessment is treated as a non-disposal under para 11(2)(o), para 20(4) applies only when the agreement is cancelled or terminated in a subsequent year of assessment.

As noted above, it is a condition for the application of para 20(4) that both parties be restored to their pre-sale position. Sometimes contracts include a penalty or damages clause which results in para 20(4) becoming inapplicable. Under such circumstances the transaction must be dealt with under the core rules.

Example 1 – Re-establishment of base cost following cancellation or termination of an agreement

Facts:

On 1 March 2015 Dave disposed of immovable property having a base cost of R200 000 to Monica for R1 million. Monica paid Dave a deposit of R100 000 with the balance of the purchase price being payable on loan account over five years. As a result of financial difficulties, Monica was unable to meet any of the instalments. On 30 June 2019 Dave and Monica agreed to cancel the contract. Dave refunded Monica her deposit of R100 000 and Monica transferred the property to Dave. She was relieved of having to repay the balance of the purchase price.

Monica had effected various improvements to the property which cost her R50 000. Dave paid Monica R50 000 for the value of these improvements.

Result:

For the 2016 year of assessment Dave realised a capital gain of R800 000 (proceeds of R1 million less R200 000 base cost). Monica acquired the property at a base cost of R1 million.

For the 2020 year of assessment Dave is treated under para 20(4) as having reacquired the property at the original base cost of R200 000 plus the amount paid to Monica for the improvements she effected. Under para 4(c) Dave has a capital loss of R800 000, representing the reversal of the capital gain recognised in the 2016 year of assessment.

Monica is in a tax-neutral position. The base cost of the property in her hands before cancellation of the agreement is R1 050 000 (original cost plus cost of improvements). When she disposes of the property back to Dave, she has proceeds of R1 050 000 (refund of deposit of R100 000, discharge of loan account balance of R900 000 [para 35(1)(a)] and receipt of compensation for improvements of R50 000). She will thus make neither a capital gain nor a capital loss when she disposes of the property back to Dave.

Example 2 – Cancellation of contract and parties not restored to their pre-sale positions

Facts:

Patrick disposed of shares in ABC (Pty) Ltd having a base cost of R20 000 to Refiloe for R100 000. Refiloe paid R10 000 in cash and owed the balance of the purchase price of R90 000 on loan account.

Five years later the sale was cancelled under a resolutive condition relating to the market value of the shares and Refiloe was obliged to return the shares. In return her obligation to settle the outstanding balance on the loan account was discharged but she forfeited the R10 000 paid in cash under a penalty clause in the agreement. The market value of the shares at the time of the cancellation of the contract was R120 000.

Result:

Paragraph 20(4) does not apply because Patrick and Refiloe have not been restored to their pre-sale positions as a result of the penalty clause. The cancellation must therefore be dealt with under the core rules applying barter or exchange principles.

When the sale was cancelled, Patrick acquired a right to shares worth R120 000. That amount constitutes proceeds in discharge of the loan (R90 000) and R30 000 in discharge of a penalty / damages claim. The disposal of the loan account gives rise to neither a capital gain nor a capital loss since the base cost of the loan (R90 000) is equal to the proceeds on its disposal (R90 000). The disposal of the damages claim results in a capital gain of R30 000 (R120 000 less value of loan account of R90 000), since the claim has a base cost of nil. The base cost of the shares reacquired by Patrick is R120 000, being the amount by which he was impoverished as a result of giving up the loan and damages claims.

8.20 Base cost – adjustment for currency gain or loss exclusion under s 24I(11A) [para 20(4)]³⁸⁸

Paragraph 20(4) in its previous guise was deleted with effect from years of assessment commencing on or after 1 April 2014. The notes below therefore relate to years of assessment commencing before that date.

This provision must be read with s 24I(11A) which was deleted with effect from years of assessment commencing on or after 1 January 2014. Section 24I(11A) dealt with the situation in which a resident entered into a forward exchange contract or foreign currency option contract for the purpose of acquiring the equity shares in a foreign company. For s 24I(11A) to apply the resident

- must have acquired at least 20% of the equity shares in the foreign company under the transaction,
- the acquired company must have been a CFC after the transaction, and
- under IFRS the exchange gain or loss in respect of the hedge must not have been reflected in the resident's income statement (IAS 39 refers).

In these circumstances the currency hedge gain or loss is excluded for normal tax purposes. However, the *quid pro quo* for this exclusion is that the base cost of the equity shares must, under para 20(4), be

- reduced by any excluded currency gain or premium received, or
- increased by any excluded currency loss or premium paid.³⁸⁹

³⁸⁸ Paragraph 20(4) was inserted by s 45(1)(e) of the Revenue Laws Amendment Act 20 of 2006 and deemed to have come into operation on 31 December 2006 and applies in respect of any year of assessment ending on or after that date.

³⁸⁹ The reference to a premium received or paid was inserted by s 60(1)(b) of the Taxation Laws Amendment Act 8 of 2007, and deemed to have come into operation on 31 December 2006 and applicable in respect of any year of assessment ending on or after that date.

Section 24I(11A) also applies when the shares in the foreign company are acquired by a member of a group of companies as defined in s 1, but the hedge is taken out by another member of the same group. In this scenario the hedge exchange gain or loss may be excluded by the hedging company only if it is not reflected in the consolidated income statement of the group for the purposes of IFRS (when both the acquiring company and the hedging company are part of that group). The acquiring company must reduce the base cost of the equity shares by the amount of any exchange gain and increase it by the amount of any exchange loss that was excluded in the hands of the hedging group company.

Example – Adjustment of base cost as a result of the application of s 24I(11A)

Facts:

On 1 March 2007 resident Holdco entered into negotiations to acquire 51% of the equity shares in foreign Subco at a price of \$100 000. On the same date Holdco took out a forward exchange contract of \$100 000 at R7,10 = \$1 to cover the expected purchase. At the time the expected acquisition was considered to be a 'highly probable forecast transaction' that qualified as a 'cash flow hedge' under IAS 39.³⁹⁰ On 31 July 2007 the contract for the acquisition of the shares was concluded and the purchase price was settled on the same date. Holdco elected to reduce the initial cost of the shares by the exchange gain on the FEC (that is, the gain was not reflected in its income statement).³⁹¹

The spot rates were as follows:

1 March 2007	R7,09 = \$1
31 July 2007	R7,20 = \$1

Result:

Holdco has the following exchange gain in respect of the FEC:

	R
Proceeds \$100 000 × R7,20	720 000
Less: Cost \$100 000 × R7,10	<u>(710 000)</u>
Exchange gain	<u>10 000</u>

The exchange gain on the FEC is disregarded under s 24I(11A). The base cost of the Subco shares is determined as follows:

	R
Expenditure actually incurred [para 20(1)(a)] ³⁹²	720 000
Less: Exchange gain on FEC disregarded under s 24I(11A) [para 20(4)]	<u>(10 000)</u>
Base cost	<u>710 000</u>

8.21 Base cost – exclusion of value-added tax allowed as input tax deduction (s 23C)

Section 23C ensures that value-added tax cannot be claimed as a deduction under the Act when it has been allowed as an input tax deduction under s 16(3) of the Value-Added Tax Act 89 of 1991. See also the remarks on VAT in the determination of market value under para 31.

³⁹⁰ See definition of 'hedged item' in para 9 of IAS 39 'Financial Instruments: Recognition and Measurement'.

³⁹¹ Under para 98(b) of IAS 39.

³⁹² Incurred at the spot rate on 31 July 2007.

8.22 Base cost – farming development expenditure (para 20A)

Paragraph 20A

Paragraph 20A was inserted by the Revenue Laws Amendment Act 45 of 2003 and applies to any disposal on or after 22 December 2003.

8.22.1 The position before 22 December 2003

Farmers are entitled to claim specified capital development expenditure (CDE) in the year of incurral under para 12(1)(a) to (j) of the First Schedule. These deductions are allowed in full but are in effect limited to the taxable income derived from farming operations [para 12(3)], with the exception of the amounts referred to in para 12(1)(a) and (b). These two exceptions relate to the eradication of noxious plants and the prevention of soil erosion.

The limitation of the deduction is effected by deeming the amount by which the expenditure exceeds the taxable income from farming operations to be income in the current year of assessment. This excess is then deemed to be a para 12(1) deduction in the following year of assessment.

Furthermore, the recoupment provisions of s 8(4)(a) do not apply to the deductions under para 12. Paragraph 12, however, contains its own special recoupment provisions in respect of the following assets:

- Housing used for domestic purposes by a person who is not an employee [para 12(6)].
- Movable assets [para 12(1B) and (1C)].

Thus, for example, expenditure in respect of the building of a dam will never be subject to recoupment, while expenditure on a movable dipping tank can be recouped in the special manner explained below.

While recoupments of CDE in respect of movable assets may not be included in taxable income under s 8(4)(a), they are dealt with by first reducing any qualifying balance of CDE brought forward from the previous year under para 12(3B). To the extent that the qualifying balance is insufficient, the excess is included in farming income.

8.22.2 The CGT implications

An asset arising from CDE is also an asset for CGT purposes. The CGT implications largely revolve around what has been allowed or recouped for normal tax purposes under the First Schedule.

The base cost of an asset must be reduced under para 20(3)(a) to the extent that the farmer has had a deduction against farming income in respect of CDE under para 12(1) of the First Schedule. The fact that there may have been insufficient farming income to absorb the deduction, which resulted in the excess being deemed to be income in the relevant year, is irrelevant. The unutilised portion of CDE is allowed as a deduction in the following year and will be carried forward until there is sufficient farming income.

The amount received or accrued on disposal of the asset will constitute proceeds on disposal under para 35, except to the extent it has been recouped under para 12 of the First Schedule.

Under para 35(3)(a) the proceeds from the disposal of an asset by a person, as contemplated in para 35(1) must be reduced by

‘any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain’.

Must proceeds be reduced by an amount that was included in income as a result of farming income being insufficient to absorb CDE? Paragraph 35(3) refers to proceeds ‘from the disposal of an asset’. Proceeds should not be reduced, since the amount has nothing to do with the disposal of the asset.

The result is that when a farmer disposes of a CDE asset it will more than likely have a zero base cost with the consideration received or accrued comprising the capital gain (except to the extent it represents a recoupment). A farmer who discontinues farming operations during a year of assessment and does not recommence those operations during the following year of assessment will forfeit any unutilised balance of CDE.³⁹³ Before the introduction of para 20A the Act did not allow for any portion of this forfeited balance to be claimed as a capital loss.

Example 1 – Capital development expenditure and CDE assets that become movable

Facts:

	R
Year 1	
Expenditure on movables	20 000
Farming income	<u>12 000</u>
Qualifying balance carried forward to year 2	8 000
Year 2	
Farming income	30 000
Amount received on disposal of movables	12 000
Cost of movables disposed of	10 000
Capital development expenditure	15 000

Result:

Farming income for year 2 will be calculated as follows:

Qualifying balance brought forward	(8 000)
Recoupment (restricted to qualifying balance)	<u>8 000</u>
Qualifying balance	Nil
Farming income before any CDE	30 000
Balance of recoupment (R10 000 – R8 000)	<u>2 000</u>
	32 000
Less: Current expenditure on items (c) to (j)	<u>(15 000)</u>
Taxable income before taxable capital gains	<u>17 000</u>
Consideration received on disposal of movables	12 000
Less: Recoupment [para 35(3)(a)]	<u>(10 000)</u>
Proceeds	<u>2 000</u>

Note: For the purposes of para 35(3)(a) R10 000 was ‘taken into account when determining the taxable income’ of the farmer: R8 000 was accounted for by reducing the qualifying balance brought forward from year 1, and R2 000 was included in income.

³⁹³ This follows from s 26 of the Act. See ‘Farming – Expenditure on Improvements – Cessation of Farming Operations’ *Income Tax Practice Manual* [online] (My LexisNexis: 31 March 2014) at [A:F13].

	R
Cost of movables	10 000
Less: Amount allowed as CDE under para 12(1)	<u>(10 000)</u>
Base cost (para 20)	<u>Nil</u>
Proceeds	2 000
Less: Base cost	<u>-</u>
Capital gain	<u>2 000</u>

Example 2 – Capital development expenditure and immovable assets

Facts:

In year 1 Mr Brown purchased some farmland adjacent to his existing farm at a cost of R500 000. In year 5 he built a dam on this land at a cost of R100 000. The dam qualified as a deduction under para 12(1)(d) of the First Schedule. In year 10 he disposed of the land on which the dam was built to a neighbouring farmer for R800 000.

Mr Brown has had farming losses in years 5 to 10.

Result:

Mr Brown's capital gain on disposal of the land will be as follows:

	R
Proceeds	800 000
Less: Base cost	<u>(500 000)</u>
Capital gain	<u>300 000</u>

Note: In this instance the base cost comprises only the cost of the land as the cost of the dam had been allowed against taxable income and hence must be excluded from base cost under para 20(3)(a). The unutilised CDE of R100 000 will be carried forward to the following year and will be available for set-off against future farming taxable income.

8.22.3 The position on or after 22 December 2003

Paragraph 20A was inserted by s 96 of the Revenue Laws Amendment Act 45 of 2003, came into operation on 22 December 2003 and applies to any disposal on or after that date.

8.22.3.1 To whom does para 20A apply?

It applies to persons carrying on pastoral, agricultural or other farming operations as contemplated in s 26 who have an unutilised balance of capital development expenditure.

8.22.3.2 What is CDE?

For the purpose of para 20A, capital development expenditure ('CDE') refers to the expenditure in para 12(1)(c) to (i) of the First Schedule. The latter expenditure is set out in the table below:

Table 1 – CDE in respect of which an election can be made

Paragraph 12(1) of First Schedule	Description of expenditure
(c)	Dipping tanks.
(d)	Dams, irrigation schemes, boreholes and pumping plants.
(e)	Fences.

Paragraph 12(1) of First Schedule	Description of expenditure
(f)	The erection of, or extensions, additions or improvements (other than repairs) to, buildings used in connection with farming operations, other than those used for domestic purposes.
(g)	The planting of trees, shrubs or perennial plants for the production of grapes or other fruit, nuts, tea, coffee, hops, sugar, vegetable oils or fibres, and the establishment of any area used for the planting of such trees, shrubs or plants.
(h)	The building of roads and bridges used in connection with farming operations.
(i)	The carrying of electric power from the main transmission lines to the farm apparatus or under an agreement concluded with Eskom under which the farmer has undertaken to bear a portion of the cost incurred by Eskom in connection with the supply of electric power consumed by the farmer wholly or mainly for farming purposes.

Paragraph 12(1A) of the First Schedule deems expenditure contemplated in para 12(1)(a), (b), (d) or (e) of that Schedule on conserving and maintaining land to be incurred in carrying on farming operations. The work must be undertaken under an agreement entered into under s 44 of the National Environmental Management: Biodiversity Act 10 of 2004.

8.22.3.3 Purpose

The purpose of para 20A is to allow a person to add the cost of unutilised CDE to the base cost of a farm property on which farming operations have ceased. Such a situation could arise upon the death of a farmer or when the farmer discontinues farming operations. Without para 20A, any unutilised CDE will be forfeited unless farming operations are recommenced in the next year of assessment.

8.22.3.4 The problem created by the wording of the First Schedule

Normally capital expenditure that has not been allowed against ordinary income can be added to the base cost of the relevant asset under para 20. CDE qualifying under para 12(1)(c) to (i) of the First Schedule is limited to income from farming operations. The result is that when the farming income is insufficient to absorb the CDE, the unutilised balance is carried forward to the next succeeding year. One might expect that the unutilised CDE could be added to base cost under the core rules. However, because of the structure of para 12 of the First Schedule this is not so. Under that provision, if the CDE exceeds the income from farming, the full CDE is allowed as a deduction and an amount equal to the excess expenditure is added to the income so that they cancel each other out. The excess expenditure is carried forward to the next year of assessment and deemed to be expenditure incurred in that next year. The result is that para 20(3)(a) prevents the addition of unutilised CDE to the base cost of the farm property, even though the farmer has for all intents and purposes not enjoyed the benefit of a deduction of the CDE.

8.22.3.5 Why is CDE forfeited on cessation of farming operations?

As a rule, the First Schedule applies only to a person who carries on farming operations. This consequence follows from the wording of s 26(1) which provides that the taxable income of farmers must be determined in accordance with the First Schedule. A person who ceases to carry on farming operations during a year of assessment may not carry forward any unutilised CDE to the next succeeding year of assessment if the person does not carry on farming operations in that succeeding year.³⁹⁴ A fatal interruption occurs because the First Schedule ceases to apply and there is no other mechanism in the Act under which the CDE can be carried forward. In short, the unutilised CDE is forfeited. Even if the person recommences farming operations after such a fatal interruption, that person will not be entitled to the unutilised CDE forfeited in a previous year.³⁹⁵ Instead of consigning such expenditure to a black hole, para 20A allows it to be added to the base cost of the farm property. This treatment is logical because such expenditure would in all likelihood have contributed to the value of the farm property and the amount realised on its disposal.

8.22.3.6 Key requirements for CDE to be added to base cost

The person must have

- unutilised CDE;
- ceased farming operations during the current or a previous year of assessment;
- disposed of the farm property in the current year of assessment; and
- made an election as to how much of the CDE is to be added to the base cost of the ex-farm property disposed of.

8.22.3.7 The election

The election may be made in respect of the whole or a part of the CDE. There is no requirement that the elected CDE must actually relate to the ex-farm property disposed of, since the provision contains no cost identification rules. For example, if a farmer has ceased farming and has two farms, and sells one of them, he can elect that all or part of the CDE (including CDE relating to the second farm) be allocated to the base cost of the first farm. The provision is not specific as to when the election must be made and in what form it must be made. However, the view is held that the election must be made in the return of income covering the earlier of

- the year of assessment in which the farm property is disposed of; and
- when farming operations have recommenced in the same or the immediately succeeding year of assessment, in that year.

In the first case, the election needs to be made in order that the capital gain on disposal of the farm can be computed. In the second case, the election needs to be made in order that the taxable income from farming can be computed – in other words the farmer must choose between adding the CDE to base cost and using it against farming income.

The amount of CDE in respect of which an election can be made is subject to two limitation rules that are considered below.

³⁹⁴ 'Farming – Expenditure on Improvements – Cessation of Farming Operations' *Income Tax Practice Manual* [online] (My LexisNexis: June 2015) at [A:F13].

³⁹⁵ See AP de Koker & RC Williams *Silke on South African Income Tax* [online] (My LexisNexis: October 2019) in §15.30.

Why is the amount of CDE that can be added to base cost subject to an election? It is possible that a person may cease farming operations in one year of assessment, dispose of the farm property and then commence farming operations in the current or immediately succeeding year of assessment. In these circumstances a farmer may wish to use the remaining CDE against any taxable capital gain arising on the disposal of the farm property rather than carry it forward for utilisation against any farming income that may be generated in future years. In making the election the farmer must consider

- whether farming operations will be recommenced before the end of the succeeding year of assessment, and
- if the farmer should recommence farming operations, whether sufficient farming income will be generated in the foreseeable future to absorb the CDE.

Should the farmer fail to recommence farming operations in the succeeding year, any unutilised CDE will be lost forever. Even if farming operations are recommenced in the next year, it may be many years before the farmer will have sufficient farming income against which the CDE can be utilised. Another factor to bear in mind is that a farmer is likely to incur further CDE in starting up a new farming operation. From a cash flow point of view a farmer may wish to save CGT now rather than normal tax at a much later date.

Another reason for the election relates to the loss limitation rule in para 20A(2). The election would, for example, be required when a person dies holding two farm properties. If the executor allocated all the CDE to the first farm, a loss may result which would trigger para 20A(2) thereby resulting in a limitation on the amount of the CDE that can be allocated to that farm. The executor may wish to ensure that the CDE is allocated in a manner that will not result in a capital gain on one property and a capital loss on the other.

8.22.3.8 The selection of a cost-identification method

For the purpose of the loss limitation rules in para 20A(2) and (3) it is necessary for a farmer to maintain a separate record of pre- and post-valuation date unutilised CDE. If a portion of CDE has been utilised against farming income on or after 1 October 2001, what identification method must be used to determine whether the unutilised CDE on the date of cessation of farming operations relates to pre- or post-valuation date expenditure?

Paragraph 20A does not contain any cost identification rules for determining what constitutes pre- and post-valuation date expenditure. In the absence of a specific rule, the *contra fiscum* rule must be applied, and a person is free to choose the method that will yield the best result.

8.22.3.9 The loss-limitation rule [para 20A(2)]

The amount of CDE in respect of which an election can be made is limited to the amounts reflected in the table below.

Table 2 – Limitation of CDE in respect of which election can be made

When immovable property acquired	CDE limited to
Before valuation date	<p>Proceeds reduced by any other amount allowable under para 25, namely, the</p> <ul style="list-style-type: none"> • valuation date value under para 26 or 27, • plus any para 20 expenditure incurred on or after the valuation date.

When immovable property acquired	CDE limited to
On or after valuation date	Proceeds reduced by allowable para 20 expenditure.

Example 1 – Limitation on CDE when market value adopted as valuation date value

Facts:

Frikkie purchased a sugar cane farm in the Pongola area in 1995 at a cost of R80 000. On 28 February 2019 he decided to discontinue farming operations and converted his farm into a tourist resort. At the end of the 2019 year of assessment, Frikkie had unutilised CDE of R200 000, all incurred after the valuation date. On 29 February 2020 he sold the property for R1 million after the resort had proved unsuccessful. The market value of the property on valuation date was R800 000. Improvements to the property during the 2019 year of assessment amounted to R30 000.

Result:

The amount of CDE that can be added to the base cost of the property is limited to the following:

	R	R
Proceeds		1 000 000
Less: Valuation date value	800 000	
Post-1 October 2001 improvements	<u>30 000</u>	<u>(830 000)</u>
CDE qualifying to be added to base cost		<u>170 000</u>

Frikkie can therefore elect to add only R170 000 of the unutilised CDE of R200 000 to the base cost of the property. He must make the election in his 2020 return of income. Should he make the election, it will result in neither a capital gain nor a capital loss on disposal of the property, determined as follows:

	R	R
Proceeds		1 000 000
Less: Market value on 1 October 2001	800 000	
Unutilised CDE (limited)	170 000	
Improvements – 2019	<u>30 000</u>	<u>(1 000 000)</u>
Capital gain or loss		<u> -</u>

Example 2 – Limitation on CDE when time-apportionment is adopted as valuation date value

Facts:

John paid R100 000 for his farm on 1 July 1983. He passed away on 30 June 2019 at which stage the market value of the farm was R150 000. At the date of his death he had unutilised CDE made up as follows:

Tax year	CDE incurred R	Farming income R	Unutilised CDE c/f R
1999	50 000	20 000	30 000
2000	80 000	30 000	80 000
2003	50 000	50 000	80 000
2004	-	10 000	70 000

Result:

Applying the FIFO principle, the unutilised CDE of R70 000 is made up as follows:

	R
On or after valuation date	50 000
Before valuation date	20 000

Time-apportionment base cost disregarding CDE [para 20A(2)]

$$\begin{aligned} Y &= B + [(P - B) \times N / (N + T)] \\ &= R100\,000 + [(R150\,000 - R100\,000) \times 18 / 36] \\ &= R125\,000 \end{aligned}$$

Limitation:

Proceeds	150 000
Less: Time-apportionment base cost	<u>(125 000)</u>
Maximum allowable CDE	<u>25 000</u>

Applying FIFO, the entire R25 000 relates to the post-valuation date period.

Time-apportionment base cost including CDE

$$\begin{aligned} P &= R100\,000 / R125\,000 \times R150\,000 \\ &= R120\,000 \end{aligned}$$

$$\begin{aligned} Y &= B + [(P - B) \times N / (N + T)] \\ &= R100\,000 + [(R120\,000 - R100\,000) \times 18 / 36] \\ &= R100\,000 + R10\,000 \\ &= R110\,000 \end{aligned}$$

$$\begin{aligned} \text{Capital gain} &= R150\,000 - (R110\,000 + R25\,000) \\ &= R15\,000 \end{aligned}$$

What if John uses LIFO? In that case, the entire R25 000 would be regarded as having been incurred in 1999. Therefore, $B = R100\,000 + R25\,000 = R125\,000$.

$$\begin{aligned} Y &= B + [(P - B) \times N / (N + T)] \\ &= R125\,000 + [(R150\,000 - R125\,000) \times 18 / 36] \\ &= R125\,000 + R12\,500 \\ &= R137\,500 \end{aligned}$$

$$\begin{aligned} \text{Capital gain} &= R150\,000 - R137\,500 \\ &= R12\,500 \end{aligned}$$

John would therefore use LIFO.

8.22.3.10 Restriction when market value adopted as valuation date value [para 20A(3)]

A further restriction on the range of expenditure in respect of which an election can be made applies when a person adopts the market value as the valuation date value of the immovable property. In this case, CDE incurred only on or after valuation date can be taken into account. In these circumstances the FIFO method of cost identification will ensure that the maximum amount of CDE is treated as post-valuation date expenditure.

Example – Inadmissibility of pre-valuation date CDE when market value adopted as valuation date value*Facts:*

Diana passed away on 30 June 2019 leaving behind a wine farm in Paarl.

She had incurred CDE under para 12(1)(c) to (i) of the First Schedule as follows:

Tax year	CDE incurred R	Farming income R	Unutilised CDE c/f R
1999	50 000	20 000	30 000
2000	80 000	30 000	80 000
2003	50 000	50 000	80 000
2014	-	10 000	70 000

The market value of the farm was as follows:

	R
On 1 October 2001	1 000 000
On 30 June 2019	1 500 000

Result:

In this instance it is assumed that the unutilised CDE of R70 000 was incurred as follows using the FIFO basis:

	R
After valuation date	50 000
Before valuation date	20 000

The base cost of the property is R1 000 000 + R50 000 = R1 050 000, resulting in a capital gain of R450 000. No election may be made in respect of the CDE incurred before the valuation date, since the market value basis has been adopted.

8.23 Base cost – prevention of double deductions (para 21)

Paragraph 21

Paragraph 21 embodies more or less the same principles contained in s 23B (prohibition of double deductions). Its purpose is twofold.

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

Secondly, no expenditure shall be allowed under para 20(1)(a) or (e) when it has in fact qualified under any other provision of the Eighth Schedule but has been limited under that other provision. (An 'anti-carry forward' provision.) As an example, in the case of a disposal of an asset by way of donation, when the donor pays donations tax, under para 20(1)(c)(vii), the donations tax allowable as expenditure for purposes of determining base cost is calculated under para 22. Any balance that is not allowable as expenditure under this paragraph may not then qualify as 'expenditure actually incurred' under para 20(1)(a).

8.24 Base cost – amount of donations tax to be included (para 22)

Paragraph 22

Paragraph 20(1)(c)(vii) entitles a donor to add a portion of the donations tax paid to the base cost of a donated asset. This paragraph contains the formula to be used in calculating the allowable portion of such tax. See 8.7.

8.25 Base cost – ‘value shifting arrangement’ (para 23)

Paragraph 23

Paragraph 23 sets out the formulae to be applied to the parties to a ‘value shifting arrangement’. For a full explanation of value shifting, the formulae and illustrative examples see 21.3.

8.26 Base cost – asset of a person who becomes a resident (para 24)

Paragraph 24

Paragraph 24 applies when

- a person becomes a resident on or after 1 October 2001, and
- disposes of an asset acquired before that person became a resident.

Persons that become resident are deemed to dispose of and reacquire their assets (except specified assets that were subject to tax in South Africa before they became resident) at market value under para 12(1). Paragraph 24 contains rules which limit the base cost so arrived at in order to prevent phantom losses.

There are various circumstances under which a person can become a resident but from para 24(2) and (3) it can be inferred that para 24 will apply when

- A person commences to be a resident [para 12(2)(a)(i)];
- A foreign company becomes a CFC [para 12(2)(a)(ii)]; and
- A foreign company ceases to be a CFC as a result of becoming a resident [para 12(4).

As regards the second bullet point, under s 9D(2A) a foreign company that becomes a CFC is treated as a resident when determining its net income for purposes, amongst others, of para 2(1)(a) and 24.

When the circumstances in para 24(2) and (3) apply, those provisions will substitute a different base cost for the market value-based one determined under para 12(1) as a result of the events in para 12(2)(a) and (4). In essence para 24 is a gain and loss limitation rule known as a ‘kink test’.

The term ‘resident’ is defined in s 1(1). A natural person can become resident if he or she becomes ordinarily resident in South Africa or becomes physically present in South Africa for the number of days specified in the definition.

A company or trust can become resident if it becomes effectively managed in South Africa.

A person can also become resident if that person is deemed exclusively to be a resident under a tax treaty.

Paragraph 24(1) determines that the base cost of assets falling within its ambit is equal to the sum of

- the value of the asset determined under para 24(2) or (3), and
- the expenditure allowable under para 20 incurred in respect of the asset on or after the date on which the person became a resident.

Specified assets of a person are excluded from para 24, namely,

- immovable property situated in South Africa held by that person or any interest or right of whatever nature of that person to or in immovable property situated in South Africa including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources [para 2(1)(b)(i)],
- any asset effectively connected with a permanent establishment of that person in South Africa [para 2(1)(b)(i)], and
- any asset held by a person if any amount received or accrued from the disposal of the asset would be taken into account for purposes of determining the net income as contemplated in s 9D of that person, acquired by a person before the date on which that person became a resident.³⁹⁶

The assets referred to in the first two bullet points above are taxed on a source basis and are not influenced by any change in the residence status of the owner. The third bullet point relates to the situation in which a CFC ceases to be a CFC as a result of becoming a resident. The s 9D passive assets referred to in the third bullet point are excluded from para 24 because under para 12(1) read with para 12(4) they are not subject to deemed disposal and reacquisition treatment when a CFC becomes a resident. In other words, these assets were subject to CGT while the foreign company was a CFC in determining its net income and remain subject to CGT when the foreign company ceases to be a CFC as a result of becoming a resident.

The exclusion of these assets under para 24(1) seems superfluous, since they (together with other assets) are in any event excluded from para 12(2)(a) and (4) and hence are not subject to deemed disposal and reacquisition treatment at market value under para 12(1).

This paragraph does not apply to persons who became residents before 1 October 2001 [para 24(4)]. Such residents will be subject to the normal rules and would have to determine the valuation date value of their assets under paras 25, 26, 27 and 28.

Under para 12(2)(a) read with para 13(1)(g) persons becoming resident in South Africa are deemed to have disposed of and re-acquired their assets (other than the South African-source assets listed below) at market value on the date immediately before the day on which they become resident. The South African-source assets that need not be valued at the time of taking up residence are

- any immovable property or an interest or right in immovable property situated in South Africa [para 12(2)(a)(aa)];
- an asset of a permanent establishment through which that person carries on a trade in South Africa during the year of assessment [para 12(2)(a)(aa)]; and

³⁹⁶ These words were inserted into para 24(1) by s 78(1)(a) of the Revenue Laws Amendment Act 60 of 2008, and deemed to have come into operation on 21 February 2008 and applicable in respect of an asset disposed of on or after that date, unless that disposal is the subject of an application for an advance tax ruling accepted by the Commissioner before that date.

- any right to acquire any marketable security contemplated in s 8A [para 12(2)(a)(bb)].

Under para 12(4) a CFC that becomes a resident is deemed to dispose of and reacquire each of its assets at market value immediately before it ceases to be a CFC. This provision excludes the assets listed in para 2(1)(b) (immovable property in South Africa, including specified related rights and interests, and assets effectively connected with a permanent establishment in South Africa), and any asset the capital gain or loss from the disposal of which would have been included in the net income of the CFC under s 9D. It follows that by a process of elimination, the deemed disposal and reacquisition rule under para 12(4) applies to foreign business establishment assets of the CFC which would have been exempt from CGT when disposed of. Such foreign business establishment assets will therefore be subject to the gain and loss limitation rules in para 24(2) and (3).

There is no time limit for the determination of the market values established under para 12(2)(a) or (4) – see notes at the end of this paragraph.

Paragraph 24 envisages two distinct cases.

Scenario 1 – Proceeds and pre-residence expenditure are each lower than market value on day before becoming resident [para 24(2)]

The first scenario deals with the situation in which both the proceeds and the allowable expenditure, as contemplated in para 20, incurred before becoming a resident are less than the market value determined on the day immediately before becoming resident. In this case the person who becomes a resident or CFC is treated as having acquired the pre-residence asset at a cost equal to the higher of

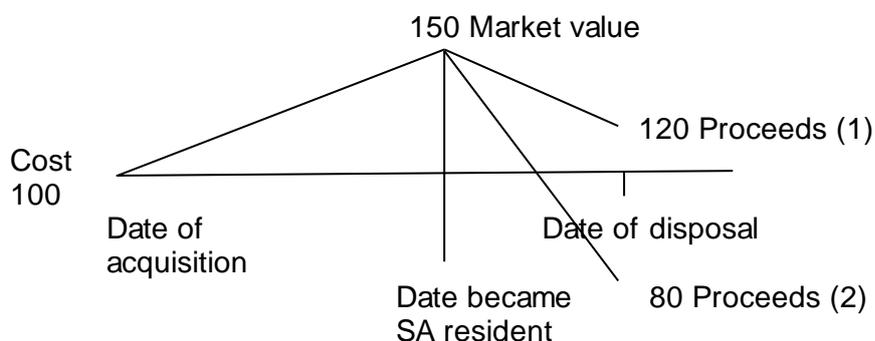
- the expenditure allowable under para 20 incurred in respect of that asset before the date of becoming a resident; or
- those proceeds less the expenditure allowable under para 20 incurred on or after that date in respect of that asset.

The expenditure allowable under para 20 actually incurred before becoming resident for the above purpose refers to the actual pre-residence expenditure. It is not the market value determined under para 12(2)(a) or (4) on the day before becoming resident, which is deemed to be para 20 expenditure under para 12(2)(a)³⁹⁷ or (4).

Two permutations are possible under the first scenario:

- Proceeds may be higher than expenditure before residence, or
- proceeds may be lower than expenditure before residence.

³⁹⁷ This was clarified by amendments to para 24(2) and (3) effected by s 69 of the Revenue Laws Amendment Act 31 of 2005, which were deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2006.

Example 1 – Proceeds and cost less than market value

In case (1) proceeds must be used thus eliminating the loss of R30 (R150 – R120). In case (2) historical cost must be used resulting in a loss of R20 rather than R70 had the market value been allowed as the base cost.

Example 2 – Proceeds and cost less than market value

	Permutation 1 R	Permutation 2 R
Proceeds	100 000	75 000
Market value	200 000	200 000
Expenditure before residence	50 000	100 000
Expenditure after residence	25 000	25 000
Deemed acquisition cost is the higher of:		
Expenditure before residence; or	50 000	100 000
Proceeds less expenditure after residence	75 000	50 000
Therefore, deemed acquisition cost equals	75 000	100 000
Proceeds	100 000	75 000
Less: Base cost	(100 000)	(125 000)
Capital gain / (loss)	Nil	(50 000)

Note:

1. The base cost under permutation 1 is R75 000 + R25 000 and under permutation 2 is R100 000 + R25 000.
2. In both permutations, the market value is not considered and the actual capital gain or loss allowable is determined in relation to historic cost.

Scenario 2 – Proceeds and market value on day before becoming resident are each lower than pre-residence expenditure [para 24(3)]

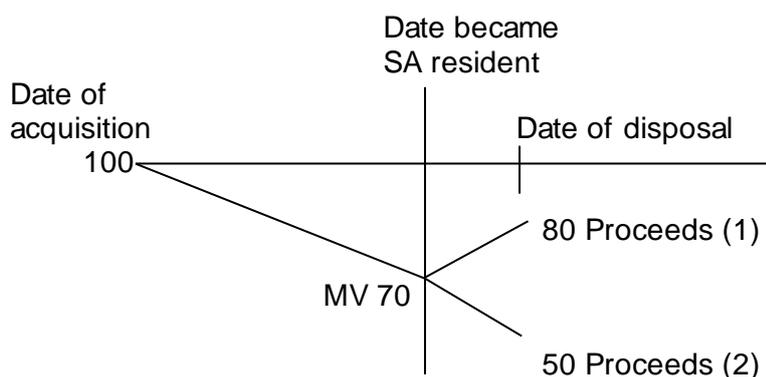
The second scenario occurs when both the proceeds and the market value on the day before becoming resident are lower than the allowable expenditure, as contemplated in para 20, incurred before becoming a resident. In this instance the person who becomes a resident is treated as having acquired that asset at a cost equal to the higher of

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

Again, two permutations are possible under the second scenario. The proceeds may be

- higher than market value, or
- lower than market value.

Example 3 – Proceeds and market value less than cost



In case (1), proceeds must be used which results in neither a capital gain nor a capital loss compared to the gain of R10 that would have arisen had market value been used.

In case (2), market value must be used resulting in a loss of R20 (R50 – R70) compared to the loss of R50 that would have resulted had historical cost been used.

Example 4 – Proceeds and market value less than cost

	Permutation 1 R	Permutation 2 R
Proceeds	100 000	75 000
Market value	50 000	100 000
Expenditure before residence	200 000	200 000
Expenditure after residence	25 000	25 000
Deemed acquisition cost is the higher of:		
Market value; or	50 000	100 000
Proceeds less expenditure after residence	75 000	50 000
Therefore, deemed acquisition cost equals	75 000	100 000
Proceeds	100 000	75 000
Less: Base cost	(100 000)	(125 000)
Capital gain / (loss)	<u>Nil</u>	<u>(50 000)</u>

Note: The base cost under permutation 1 is R75 000 + R25 000 and under permutation 2 is R100 000 + R25 000.

Since the expenditure in respect of the asset must be known in order to apply the above gain and loss limitation rules, the rules cannot be applied when the pre-valuation date expenditure on the asset cannot be determined.

Time period for performing valuations

Under para 12(2)(a) a person that

- commences to be a resident; or
- that is a foreign company that commences to be a CFC,

must be treated under para 12(1) as having disposed of that person's assets at market value and to have reacquired them at a cost equal to that market value. The cost is treated as expenditure incurred for the purposes of para 20(1)(a). A similar rule under para 12(4) applies to the foreign business establishment assets of a CFC that becomes a resident.

These persons are responsible for valuing their assets. If a person fails to value an asset, the Commissioner can estimate its value under s 95 of the Tax Administration Act.

Unlike para 29(4) which requires that pre-valuation date assets be valued within three years of valuation date, para 12(2)(a) and (4) set no time limit within which new residents must value their assets after taking up residence. In theory these persons could value their assets at date of disposal, though this carries with it the problem of securing sufficient evidence to support the valuation long after the event. The onus of proving the correctness of a valuation rests on the resident under s 102(1)(e) of the Tax Administration Act. Regardless of when the valuation is done, the fact remains that a valuation is mandatory.

8.27 Base cost – pre-valuation date assets (para 25)

Paragraph 25

8.27.1 The general formula [para 25(1)]

The base cost of a pre-valuation date asset is the sum of the valuation date value of that asset, as determined under para 26, 27 or 28, and the expenditure allowable under para 20 incurred on or after the valuation date in respect of that asset. This paragraph enables expenditure incurred after the valuation date to be added to base cost. Expressed as a formula the base cost of a pre-1 October 2001 asset is

$$\text{Base cost} = \text{valuation date value} + \text{expenditure incurred on or after valuation date}$$

The term 'valuation date' is defined in para 1 and for most persons is 1 October 2001. A later date applies to a person that ceases to be a fully exempt person under para 63 on or after 1 October 2001. For such persons the valuation date is the date on which the person so ceased to be an exempt person. Typically, this situation applies to PBOs and recreational clubs which lost their fully exempt status with the introduction of the partial taxation system for taxing such entities.

Paragraph 25 does not apply to a person who has adopted the weighted-average method for valuing specified categories of identical assets under para 32(3A). The reason for the exclusion of such assets from the weighted average method is that pre-valuation date assets cannot be separately identified once they have been merged in a pool with post-valuation date assets.

As will be seen in paras 26, 27 and 28 the valuation date value of an asset could be one of the following:

- Market value on valuation date
- Time-apportionment base cost
- 20% of proceeds after first deducting expenditure incurred on or after valuation date
- Proceeds less expenditure incurred on or after valuation date

8.27.2 Redetermination of capital gains and losses on disposal of pre-valuation date assets [para 25(2) and (3)]

Effective date

This provision came into operation on the date of promulgation of the Revenue Laws Amendment Act 32 of 2004, namely, 24 January 2005, and applies in respect of any disposal during any year of assessment commencing on or after that date.

Paragraph 25(2) and (3) deal with the redetermination of capital gains and losses in respect of pre-valuation date assets. Such redeterminations are required when any of the events in the following table occur:

Table 1 – Circumstances in which capital gains and losses must be redetermined

Paragraph 25(2)	Event during current year triggering redetermination
(a)	Additional proceeds received or accrued.
(b)	Proceeds were previously taken into account, and <ul style="list-style-type: none"> • they have become irrecoverable, • they have become repayable, or • the person is no longer entitled to those proceeds as a result of the <ul style="list-style-type: none"> ➤ cancellation, termination or variation of any agreement or ➤ due to the prescription or waiver of a claim or a release from an obligation or any other event.
(c)	Additional expenditure forming part of base cost is incurred.
(d)	Expenditure previously taken into account as part of base cost has been recovered or recouped.

When a redetermination is required, it simply means that the capital gain or loss on disposal of the asset must be redetermined from scratch, taking into account all amounts of proceeds and expenditure from the date on which the asset was first acquired. Redetermination is necessary for the following reasons:

- Any capital gain or loss determined under the first disposal may have been eliminated by the kink tests in paras 26 and 27. In the absence of redetermination this could cause hardship or confer an undue benefit on a taxpayer.
- If the time-apportionment base cost method was used with the first disposal, any subsequent capital gain or loss would otherwise not be time-apportioned. For example, additional proceeds received or accrued in a year subsequent to the year of disposal would comprise a full capital gain in the year received or accrued. Note in this regard that the values of 'N' and 'T' in the time-apportionment formula (period before and after valuation date) remain unchanged. In other words, these periods are determined by the date of disposal, and not by the date of receipt or accrual of subsequent proceeds or the incurral of subsequent expenditure.

While para 25(2)(b) refers to proceeds being refunded owing to the cancellation or termination of an agreement, this does not apply when the asset is reacquired, since there are specific rules for dealing with the reacquisition of an asset under para 3(c), 4(c) and 20(4).

Adjustment of capital gain or loss [para 25(3)]

The redetermined capital gain or loss must be taken into account in the current year under para 3(b)(iii)(aa) (capital gain) or para 4(b)(iii)(aa) (capital loss). There is no requirement that a person must consistently apply the same valuation method. For example, a person may have elected time-apportionment for the first disposal and market value for the redetermination. Redetermination is not required when the weighted-average method is adopted under para 32(3A).

Any capital gain or loss that was previously determined is reversed as a capital loss or gain as the case may be, under para 3(b)(iii)(bb) (previous capital loss treated as capital gain) or para 4(b)(iii)(bb) (previous capital gain treated as capital loss).

Example 1 – Redetermination of capital gain or loss when the kink tests applied to the initial disposal*Facts:*

In 1995 Ruzanne purchased land at a cost of R100 000. She determined a market value for the land on 1 October 2001 of R150 000. On 28 February 2018 she sold the land for R120 000 plus a further sum of R35 000 to be paid on 29 February 2020 if the purchaser was able to attain a required level of profitability from the use of the land. The purchaser was able to attain the required level of profitability and Ruzanne duly received the additional proceeds of R35 000 on 29 February 2020. In determining the valuation date value of the land, she adopted the market-value method

*Result:**2018 year of assessment*

During the 2018 year of assessment Ruzanne's capital loss of R30 000 was disregarded under para 26(3). Under that provision the valuation date value of the land was deemed to be R120 000.

2020 year of assessment

The receipt of the additional proceeds of R35 000 triggers a redetermination of the capital gain or loss in respect of the disposal of the land under para 25(2). The revised capital gain is determined as follows:

	R
Proceeds R120 000 + R35 000	155 000
Less: Base cost	<u>(150 000)</u>
Capital gain	<u>5 000</u>

Example 2 – Redetermination of capital gain upon accrual of further proceeds when a capital gain was determined in the year of disposal*Facts:*

In 1995 Ruzanne purchased land at a cost of R100 000. She determined a market value for the land on 1 October 2001 of R150 000. On 28 February 2018 she sold the land for R155 000 plus a further sum of R35 000 to be paid on 29 February 2020 if the purchaser was able to attain a required level of profitability from the use of the land. The purchaser was able to attain the required level of profitability and Ruzanne duly received the additional proceeds of R35 000 on 29 February 2020. In determining the valuation date value of the land, she adopted the market-value method

*Result:**2018 year of assessment*

In the 2018 year of assessment Ruzanne had a capital gain of R5 000 (R155 000 proceeds less R150 000 base cost).

2020 year of assessment

In the 2020 year of assessment Ruzanne has a redetermined capital gain of R40 000, determined as follows.

	R
Proceeds R155 000 + R35 000	190 000
Less: Base cost	<u>(150 000)</u>
Capital gain	<u>40 000</u>

The redetermined capital gain of R40 000 is treated as a capital gain in the 2020 year of assessment under para 3(b)(iii)(aa). The capital gain of R5 000 that arose during the 2018 year of assessment is treated as a capital loss in the 2020 year of assessment under para 4(b)(iii)(bb). The net effect in the 2020 year of assessment is that an amount of R35 000 is subject to CGT.

Example 3 – Redetermination of capital gain when time-apportionment adopted in respect of initial disposal

Facts:

On 1 June 1985 Natasha acquired 100 Alpha Ltd shares at a cost of R200 000. On 1 March 2018 she sold them for R500 000 plus a further amount of R100 000 payable on 29 February 2020 depending on whether the shares produced a dividend yield of at least 5% during the 2019 and 2020 years of assessment. Natasha elected to use time-apportionment to determine the valuation date value of her shares.

*Result:**2019 year of assessment*

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R200\,000 + [(R500\,000 - R200\,000) \times 17 / 34] \\
 &= R200\,000 + R150\,000 \\
 &= R350\,000
 \end{aligned}$$

	R
Proceeds	500 000
Less: Base cost	<u>(350 000)</u>
Capital gain	<u>150 000</u>

2020 year of assessment

$$\begin{aligned}
 P &= R500\,000 + R100\,000 \\
 &= R600\,000
 \end{aligned}$$

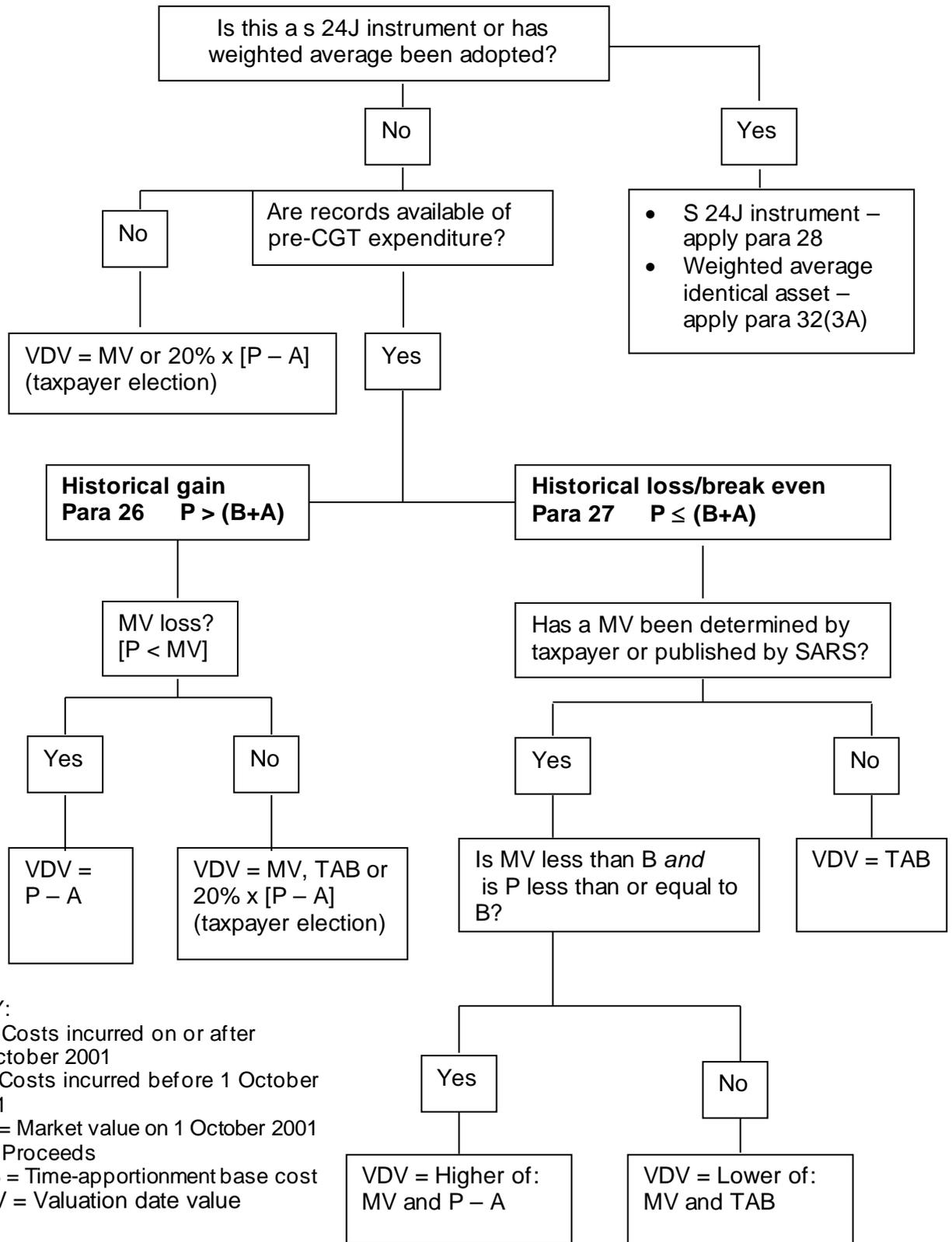
$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R200\,000 + [(R600\,000 - R200\,000) \times 17 / 34] \\
 &= R200\,000 + R200\,000 \\
 &= R400\,000
 \end{aligned}$$

	R
Proceeds	600 000
Less: Base cost	<u>(400 000)</u>
Capital gain	<u>200 000</u>

The earlier year capital gain of R150 000 is treated as a capital loss under para 4(b)(iii)(bb) while the redetermined capital gain of R200 000 is treated as a capital gain under para 3(b)(iii)(aa). The net result is that an amount of R50 000 will be subject to CGT in the 2020 year of assessment.

Note: The number of years after valuation date ('T' in the time-apportionment formula) remains unchanged at 17 years despite the additional proceeds being received 19 years after valuation date.

Overview of paras 26 and 27



KEY:
 A = Costs incurred on or after 1 October 2001
 B = Costs incurred before 1 October 2001
 MV = Market value on 1 October 2001
 P = Proceeds
 TAB = Time-apportionment base cost
 VDV = Valuation date value

8.28 Valuation date value – when proceeds exceed expenditure or expenditure in respect of an asset cannot be determined (para 26)

Paragraph 26

8.28.1 Introduction

The base cost of a pre-valuation date asset is equal to its valuation date value plus any allowable para 20 expenditure incurred on or after the valuation date [para 25(1)]. The 'valuation date value' is therefore a key component making up the base cost of a pre-valuation date asset, its purpose being to provide a base cost starting point that will eliminate pre-CGT gains and losses when the asset is disposed of. The rules for determining the valuation date value of an asset are contained in paras 26 and 27. These provisions also contain anti-avoidance measures that limit losses under specified conditions. Two categories of asset fall outside these rules, namely, certain classes of identical asset in respect of which the weighted-average method has been adopted under para 32(3A), and s 24J instruments which are addressed under para 28.

Paragraph 26 determines the valuation date value of an asset for which

- the pre-valuation date expenditure is known, and the asset is disposed of at an historical gain, that is, the proceeds from its disposal exceed the allowable para 20 expenditure incurred before, on and after the valuation date [para 26(1)], and
- the pre-valuation date expenditure is unknown (para 26(2)).

Paragraph 26(3) contains a loss limitation rule that applies when the market-value method is adopted.

Paragraph 27 on the other hand deals with the situation when the pre-valuation date expenditure is known and the disposal of the asset results in an historical loss or break-even situation.

Unlike para 27 which is prescriptive in the methods that must be used in determining a valuation date value, a person disposing of an asset falling under para 26 has the freedom to choose the method that gives the most favourable result. This freedom of choice may, however, be restricted in two respects. First, para 26(3) will substitute a no gain or loss rule when the market-value method is adopted under para 26(1)(a) and a capital loss results. Secondly, the option to adopt the market-value method depends on compliance with para 29.

8.28.2 Valuation date value methods when proceeds exceed allowable para 20 expenditure [para 26(1)]

This paragraph sets out the method for determining the valuation date value of a pre-valuation date asset disposed of on or after the valuation date if

- the pre-valuation date expenditure in respect of the asset is known,
- proceeds exceed expenditure allowable under para 20 incurred before, on and after the valuation date (an historical gain);
- that asset is not an instrument as defined in s 24J of the Act (these assets are dealt with under para 28), and
- the asset is not part of a class of identical assets to which para 32(3A) applies. Under para 32(3A) a person can elect to determine the base cost of certain classes of identical asset using the weighted-average method. The classes of asset are listed financial instruments, participatory interests in collective investment schemes, gold

and platinum coins and listed interest-bearing instruments. A person who elects to use the weighted-average method for a class of identical assets is not permitted to use the time-apportionment or '20% of proceeds' method for determining the valuation date value of an asset forming part of that class. However, the person will also not be subject to the loss limitation rule in para 26(3).

A person who meets the above criteria may, subject to the overriding loss limitation rule in para 26(3), determine the valuation date value of a pre-valuation date asset using

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

The choice of method is made in the return of income reflecting the disposal of the asset.

8.28.3 Limitation on 'phantom' losses [para 26(3)]

Paragraph 26(3) contains a loss-limitation rule known colloquially as a 'kink test'. The label originates from the United Kingdom and describes the shape of the graph that results when the pre-valuation date expenditure, market value on valuation date and proceeds are plotted. There are three prerequisites for the application of this rule:

First, the asset must be one contemplated in para 26(1). In other words, it must have been disposed of at an historical gain.

Secondly, the person disposing of the asset must adopt the market value of the asset as its valuation date value under para 26(1)(a). This adoption will usually take place in the year of assessment in which the asset is disposed of. Merely because a person has determined the market value of an asset does not mean that the person has adopted it. Before adoption is possible several requirements must be met:

- A person must have a record of pre-valuation date expenditure. This requirement follows from para 26(1), which applies when the proceeds from the disposal of an asset exceed the expenditure allowable under para 20 incurred *before*, on and after the valuation date. A person who does not have a record of pre-valuation date expenditure would adopt market value under para 26(2)(a), not para 26(1)(a).
- The asset must have been valued within the time limit prescribed by para 29(4). For example, if the valuation date is 1 October 2001 the asset must have been valued by 30 September 2004 unless it was an asset such as a JSE-listed share whose price was published in the *Gazette*, in which case there is no time limit.
- The person must have complied with the valuation form submission requirements for certain high-value assets under para 29(5).
- Persons who have adopted the weighted-average method under para 32(3A) may not adopt market value under para 26, since they must apply the weighted-average method consistently [para 32(6)]. The kink test also does not apply to pre-valuation date s 24J instruments. These are dealt with under para 28.

Thirdly, the asset must have been disposed of at a loss, that is, the proceeds must not exceed the market value of the asset on valuation date.

When the above conditions are met, the rule substitutes as the valuation date value an amount equal to the proceeds less the expenditure allowable under para 20 incurred on or after the valuation date in respect of the asset. This substituted valuation date value will result in neither a capital gain nor a capital loss.

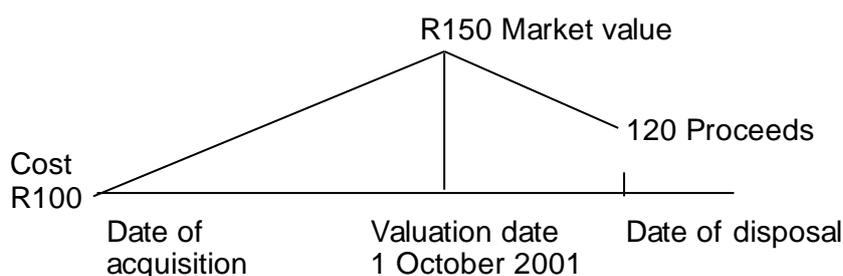
The rule thus eliminates 'phantom' capital losses when the market value has been adopted as the valuation date value and proceeds exceed actual or historic cost. Any capital gain with reference to the actual or historic cost is, however, also disregarded.

Example 1 – Paragraph 26(3) – Historical gain, market value loss ('kink test')

Facts:

Vicky acquired an asset before the valuation date at a cost of R100, which was allowable under para 20. She determined its market value on 1 October 2001 at R150 and adopted that value as the valuation date value. She sold the asset for R120 after the valuation date.

Result:



Step 1: Is there an historical gain? Yes, $R120 - R100 = R20$ and para 26 therefore applies.

Step 2: Is there a market value loss? Yes, $R120 - R150 = -R30$

Since both conditions are satisfied, the loss limitation rule in para 26(3) applies. Therefore, $VDV = \text{Proceeds (R120)} - \text{post-1 October 2001 expenditure (RNil)} = R120$.

Capital gain / loss = Proceeds – base cost

Capital gain / loss = Proceeds – [VDV + post-1 October 2001 expenditure]

Capital gain / loss = $R120 - [R120 + R0] = RNil$

Example 2 – Paragraph 26 – Historical gain and market value loss with post-CGT expenditure

Facts:

Werner disposed of a pre-valuation date asset after the valuation date. Details of the asset are as follows:

	R
Expenditure before valuation date	100 000
Expenditure after valuation date	25 000
Market value at valuation date	200 000
Proceeds upon disposal	150 000

Werner adopted the market value of the asset as its valuation date value.

Result:

Paragraph 26(3) applies because

- the asset has been disposed of at an historical gain (R150 000 – R100 000 – R25 000 = R25 000); and
- the proceeds do not exceed market value on valuation date (R150 000 < R200 000)

Valuation date value = Proceeds less expenditure on or after valuation date

	R
Proceeds	150 000
Less: Post-valuation date expenditure	<u>(25 000)</u>
Proceeds less post-valuation date expenditure	<u>125 000</u>
Valuation date value (as above)	125 000
Post-valuation date expenditure	<u>25 000</u>
Base cost	<u>150 000</u>
Proceeds	150 000
Less: Base cost	<u>(150 000)</u>
Capital gain / (loss)	<u>Nil</u>

What range of proceeds fall within para 26(3)?

Paragraph 26(1) contains two broad requirements. The first – whether there is a gain based on historical cost – determines whether the paragraph is applicable (the entry requirement). Once that test is satisfied the next step is to determine whether the loss limitation rule applies (market value loss).

In Example 1 the loss limitation rule will apply when proceeds fall within the range 101 – 149 (ignoring cents). Proceeds falling within this range will always give rise to an historical cost gain and a market value loss.

What if proceeds were, say R160? The loss-limiting rule would not apply because there would be a market value gain. In fact, any proceeds of R150 or more will give rise either to a break-even situation (proceeds = market value) or a market value gain (proceeds > market value). In this situation the taxpayer would still fall within para 26(1), having a gain based on historical cost, and would have the freedom to choose the higher of market value, time-apportionment base cost or 20% of [proceeds less post-valuation date expenditure] as the valuation date value.

What if proceeds were R80? The paragraph would not apply in its entirety because the person would have failed to pass the entry requirement, having an historical loss of R80 – R100 = R20. A key requirement for entry into para 26(1) is an historical gain. In this instance the matter would be dealt with under para 27, which deals with the historical loss and break-even situations.

Understanding ‘proceeds less post-1 October 2001 expenditure’

The loss-limiting formula ‘proceeds less post-valuation date expenditure’ will always result in neither a capital gain nor a capital loss. This formula is applied elsewhere in the Eighth Schedule, such as in paras 24 and 27. In order to understand this formula it is necessary to begin with the core base cost formula in para 25:

Base cost = valuation date value (VDV) + post-valuation date expenditure

A person will determine neither a capital gain nor a capital loss when:

$$\text{Base cost} = \text{Proceeds.}$$

This equation can be restated as:

$$\text{VDV} + \text{post-valuation date expenditure} = \text{Proceeds}$$

And then rearranged as:

$$\text{VDV} = \text{Proceeds} - \text{post-valuation date expenditure.}$$

Essentially the 'proceeds less post-valuation date expenditure' formula works backwards to arrive at a VDV that will yield neither a gain nor a loss after the post-1 October 2001 expenditure is added to it.

8.28.4 Expenditure unknown [para 26(2)]

If neither the person who disposed of an asset nor the Commissioner can determine the expenditure incurred before the valuation date, the person must determine the valuation date value of the asset using

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

Time limit for valuing assets for which there is no record of expenditure

Under para 29(4), for the purposes of paras 26(1)(a) and 27(3), a person may adopt or determine the market value as the valuation date value of an asset on 1 October 2001 only if that person has valued that asset on or before 30 September 2004. Since this provision is for the purposes of paras 26(1)(a) and 27(3), it does not apply to a market value adopted under para 26(2)(a).

However, para 29(5) imposes a restriction on the ability of a person to adopt a market value on valuation date for three categories of high-value assets by requiring the valuation to be submitted by a cut-off date. In order to be able to adopt the market value of the asset as the valuation date value on valuation date, the person who valued the asset concerned must have furnished proof of that valuation to the Commissioner in the form as the Commissioner may prescribe, with the first return submitted by that person after the date or period contemplated in para 29 (4).

It follows that a person who does not have a record of pre-valuation date expenditure in respect of an asset

- Will not be subject to a time limit for valuing the asset if it falls outside para 29(5); and
- Will be subject to a time limit for determining a market value and hence be prevented from adopting such value if the asset is one referred to in para 29(5) and the valuation was not submitted within the required period.

Therefore, for an asset falling within para 29(5) the person will be able to adopt the market value of the asset as its valuation date value only if that person has furnished proof of that valuation to the Commissioner in the form as the Commissioner may prescribe with the first return submitted by that person after the date or period contemplated in para 29(4). For a person with a valuation date of 1 October 2001, para 29(4)(a)(i) contemplates the date of 30 September 2004. In other words, the valuation form must have been submitted with the first return submitted on or after 30 September 2004. Paragraph 29(5) does not apply to a

person with a valuation date after 1 October 2001, such as a recreational club or PBO – see para 29(8).

When adopting the ‘20% of proceeds’ method, post-valuation date expenditure must first be deducted from proceeds before multiplying the result by 20%.

A person who does not have a record of pre-valuation date expenditure may not adopt the time-apportionment base cost method by assuming that the pre-valuation date expenditure is nil. Persons finding themselves in this position are obliged to use the market-value or ‘20% of proceeds’ method unless the Commissioner can determine the relevant expenditure.

8.29 ‘20% of proceeds’ method

One of the options available to a person for determining the valuation date value of a pre-valuation date asset is the so-called ‘20% of proceeds’ method. This method is available when a person

- has a record of pre-valuation date expenditure and is in the historical gain situation [para 26(1)(b)], or
- does not have a record of pre-valuation date expenditure [para 26(2)(b)].

It is unavailable when the pre-valuation date expenditure is known and there is an historical loss or break-even situation under para 27.

For persons who do not have a record of pre-valuation date expenditure and who did not perform a valuation by 30 September 2004, this method will be one of last resort because the time apportionment and market value methods will be unavailable.

The method also deserves consideration by those who are able to use the time-apportionment or market-value method. With the rise in asset prices since 2001, the ‘20% of proceeds’ method may yield a higher valuation date value than time apportionment or market value, depending on the extent of the post-valuation date growth. It may also yield a better result than time apportionment when the asset has a nil or relatively low pre-CGT cost but has been improved on or after valuation date. In these circumstances the proceeds formula in para 30(2) will cause a greater percentage of the overall gain to comprise a capital gain.

Errors in the application of the method are not uncommon, owing in part to it being informally (and misleadingly) referred to as the ‘20% of proceeds method’. In fact, the method is not always applied by multiplying the proceeds by 20%. Any allowable para 20 expenditure incurred on or after the valuation date must first be deducted from the proceeds before multiplying the result by 20%. Once this has been done the base cost of the asset must be determined under para 25 by adding the post-valuation date expenditure to the valuation date value so determined. In some situations, the valuation date value produced under this method can be a negative figure which will result in a capital loss. This result would occur when the post-valuation date expenditure exceeds the proceeds.

Example 1 – ‘20% of proceeds’ method

Facts:

Waheeda acquired an asset many years before the valuation date and neither she nor the Commissioner could establish its original cost. She effected improvements to the asset after valuation date at a cost of R15 000 for which she has purchase invoices. The asset was sold after the valuation date for R115 000. Determine the capital gain using the ‘20% of proceeds’ method.

Result:

	R
Proceeds	115 000
Less: Post-1 October 2001 expenditure	<u>(15 000)</u>
Subtotal	<u>100 000</u>
Valuation date value R100 000 × 20%	20 000
Post-1 October 2001 expenditure	<u>15 000</u>
Base cost	<u>35 000</u>
Proceeds	115 000
Less: Base cost	<u>(35 000)</u>
Capital gain	<u>80 000</u>

Example 2 – ‘20% of proceeds’ method resulting in capital loss*Facts:*

Susan acquired an asset many years before the valuation date. Unfortunately, she had lost all her records of the cost of the asset in a fire that occurred before 1 October 2001. After the valuation date she improved the asset at a cost of R100 000, all of which qualified as allowable expenditure under para 20. She subsequently disposed of it for proceeds of R60 000. She was unable to determine a market value on 1 October 2001.

Result:

Susan’s only alternative is to use the ‘20% of proceeds’ method to determine the valuation date value of the asset. The time-apportionment method is unavailable as she does not have a record of pre-valuation date expenditure, and the market-value method is unavailable because she failed to perform a valuation by 30 September 2004 as required by para 29(4).

	R
Proceeds	60 000
Less: Post-1 October 2001 expenditure	<u>(100 000)</u>
Subtotal	<u>(40 000)</u>
Valuation date value R40 000 × 20%	(8 000)
Post-1 October 2001 expenditure	<u>100 000</u>
Base cost	<u>92 000</u>
Proceeds	60 000
Less: Base cost	<u>(92 000)</u>
Capital loss	<u>(32 000)</u>

8.30 Valuation date value – when proceeds do not exceed expenditure (para 27)

Paragraph 27

8.30.1 Application [para 27(1) and (2)]

Paragraph 27 sets out a method to determine the valuation date value of an asset disposed of on or after the valuation date when

- that asset was acquired before the valuation date,
- proceeds do not exceed expenditure, allowable under para 20, incurred before, on and after that date (an historical cost loss or break-even situation),

- that asset is not an instrument as defined in s 24J (these assets are dealt with under para 28), and
- the asset is not part of a class of identical assets to which para 32(3A) applies. Under para 32(3A) a person can elect to determine the base cost of specified classes of identical assets using the weighted-average method, namely, listed financial instruments, participatory interests in collective investment schemes, gold and platinum coins and listed interest-bearing instruments. The gain and loss limitation rules in para 27 will not apply to the identical assets falling within the particular class of asset in respect of which an election to use the weighted-average method has been made.

The paragraph also does not apply to a person who does not have a record of expenditure. The valuation date value of such an asset must be determined under para 26(2).

Paragraph 27 deals with three separate scenarios. These rules – also known as ‘kink tests’³⁹⁸ – are designed to protect the *fiscus* from ‘phantom’ losses that would otherwise arise if taxpayers were given free rein to adopt either the time-apportionment base cost or market-value methods.

When a disposal falls within para 27 (that is, the proceeds do not exceed the expenditure), the valuation date value of the asset is fixed by para 27. In other words, a person has no freedom to choose another method for determining the valuation date value of the asset. This result differs from the situation in which there is an historical gain. In that case para 26 applies and a person has freedom to choose the method that gives the highest base cost, subject to the para 26(3) kink test which eliminates a capital loss when the market-value method is adopted.

8.30.2 Assets whose market value has been determined or published [para 27(3)]

The first two scenarios are contained in para 27(3) and apply when

- a person has determined the market value of an asset on the valuation date, as contemplated in para 29, or
- the market value of an asset has been published under that paragraph.

Assets whose value has been determined under para 31 must also be included, since para 29(1)(c) includes such assets.

8.30.2.1 Assets in respect of which a market value has been determined

There has been much confusion among taxpayers as to when they will be regarded as having ‘determined’ a market value and hence subject to the kink tests in para 27. The word ‘determined’ must be distinguished from the word ‘adopted’. ‘Adopted’ implies an election (in other words a freedom of choice), while ‘determined’ refers to a factual situation when there is no right of election.

A person will have ‘determined’ a value if that person has performed or obtained a valuation as at 1 October 2001 during the three years ending 30 September 2004, regardless of whether that person intends using that valuation.

SARS takes the view that just as para 26 allows the taxpayer to select the method that gives the smallest gain, so it is appropriate that para 27 requires that the taxpayer select the method that gives the smallest loss.

³⁹⁸ A term borrowed from the United Kingdom. The kink refers to the shape of the graph that results when plotting the cost, market value and proceeds.

Before the amendment of para 27 by the Second Revenue Laws Amendment Act 60 of 2001, there was some uncertainty over the treatment of listed shares and participatory interests in portfolios of collective investment schemes. It could have been argued that it was not the taxpayer who 'determined' the market value, but rather SARS. As a result, para 27 was rewritten to make it quite clear that a taxpayer did not have freedom of choice between the time-apportionment base cost method and the market-value method when that taxpayer had determined a market value or it was a published instrument and the taxpayer was in the situation in which there was

- an historical loss / break-even situation, and
- market value was less than pre-valuation date expenditure.

In these circumstances the choice is simply the higher of market value or proceeds less post-valuation date costs, and the time-apportionment base cost method is NOT an option.

The position of local listed shares and participatory interests in portfolios of collective investment schemes is now quite unambiguous.

But how are other assets to be treated? Taxpayers will be bound by this test if they have 'determined' a market value. The intention of this expression was that if taxpayers had performed or obtained a valuation date valuation (either personally or by making use of a valuer), they would be brought within the confines of the provision.

How would SARS know if the taxpayer had 'determined' a market value? With the high-value assets referred to in para 29(5) SARS will have the prescribed form in its possession. With other assets SARS could request a taxpayer to confirm whether a valuation had been done or may discover evidence of such valuation during an audit.

A taxpayer's submission of a valuation to SARS does not commit the taxpayer to using the valuation when para 26 applies.

8.30.2.2 Assets with published values

Paragraph 27(3) refers to assets whose market values have been published under para 29. These are assets whose prices were published by the Commissioner in the *Government Gazette*.³⁹⁹ See commentary on para 29(4) in **8.33.8**.

8.30.2.3 The first scenario [para 27(3)(a)]

The first scenario arises when

- proceeds are less than or equal to pre-1 October 2001 expenditure (in other words a loss or break-even situation), and
- market value is less than pre-1 October 2001 expenditure.

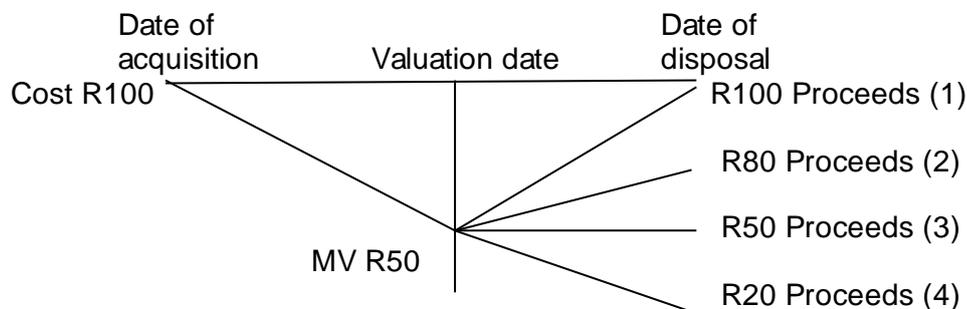
Under these circumstances the valuation date value is the **higher** of

- market value, and
- proceeds less expenditure incurred on or after 1 October 2001. As explained in the commentary on para 26, this valuation date value will result in neither a capital gain nor a capital loss.

³⁹⁹ GN 65 GG 23037 of 25 January 2002. The prices are also available from the SARS website under Types of tax / Capital gains tax / Market values.

This situation can be graphically illustrated as follows:

Example – Scenario 1: $MV < B \geq P$



P = Proceeds, B = Pre-1 October 2001 costs, MV = Market value on valuation date

Within these parameters there are only four possible permutations:

1. Proceeds = cost
2. Proceeds < cost
3. Proceeds = MV
4. Proceeds < MV

The rule states that a person must use the **higher** of

- proceeds less post-1 October 2001 expenditure, and
- market value.

Applying the rule, the valuation date value (VDV) in the four permutations shown in the graph will be as follows (the higher option is highlighted):

1. Proceeds = **R100**, MV = R50, VDV = R100, no gain, no loss
2. Proceeds = **R80**, MV = R50, VDV = R80, no gain, no loss
3. Proceeds = R50, MV = R50, VDV = R50, no gain/no loss (interestingly, the legislation does not make provision for this possibility, but logic dictates that either proceeds or market value could be used since they are identical)
4. Proceeds = R20, MV = **R50**, VDV = R50, loss = R20 – R50 = –R30

The use of the time-apportionment base cost method in these circumstances is not permitted. Had it been permitted, it would have resulted in pre-CGT losses being spread into the post-CGT period when it is known for a fact that those losses are wholly attributable to the pre-CGT period. This result is the case in situations 1, 2 and 3.

What is the effect of the rule? While the use of time-apportionment is denied, the taxpayer is not subjected to CGT on the actual gain based on market value, and is treated as making neither a capital gain nor a capital loss (situations 1 – 3). This rule thus prevents hardship to taxpayers. In situation 4 the taxpayer is allowed the actual market value loss. Whether or not this market value loss would be higher or lower than a time-apportioned loss will depend on the facts of each case. The question is, however, academic since time-apportionment is not an option.

8.30.2.4 The second scenario [para 27(3)(b)]

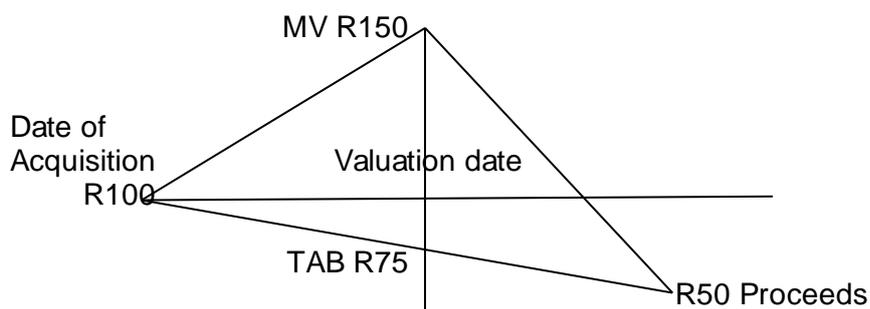
The second scenario also applies when a market value has been determined or published and deals with any situation not covered by the first scenario.

The valuation date value of an asset in these circumstances must be determined as the **lower** of

- market value; and
- time-apportionment base cost under para 30.

The interrelationship between the four variables: market value, pre- and post-CGT expenditure, and proceeds gives rise to many complex permutations under this scenario, and it is not intended to explore all of them. It suffices to say that the intention of these rules is to protect the *fiscus* against phantom losses and this is achieved by compelling the adoption of the lower of market value and time-apportionment base cost.

Two of the many possibilities are graphically illustrated below.

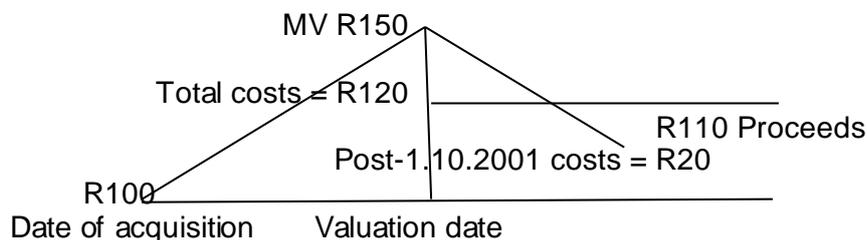
Example 1 – Scenario 2: $P \leq B < mv$ 

P = Proceeds, B = Pre-1 October 2001 costs, MV = Market value on valuation date

Assume that the asset in this instance was purchased 19 years before valuation date and sold 19 years after that date.

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \text{ (see para 30(1) for details of the time-apportionment formula)} \\
 &= R100 + [(R50 - R100) \times 19 / 38] \\
 &= R75
 \end{aligned}$$

Since the time-apportionment base cost is lower than market value, time-apportionment base cost must be used. The taxpayer would be entitled to claim the lower time-apportionment base cost capital loss of R25 (R50 - R75). As can be seen, this is a great deal less than the 'phantom' market value loss of R50 - R150 = R100 against which the *fiscus* is protected.

Example 2 – Scenario 2: $P \leq [A + B] < MV$ 

P = Proceeds, A = Post-1 October 2001 costs, B = pre-1 October 2001 costs, MV = Market value on valuation date

Assuming an equal 19-year period before and after 1 October 2001, the time-apportionment base cost would be calculated as follows:

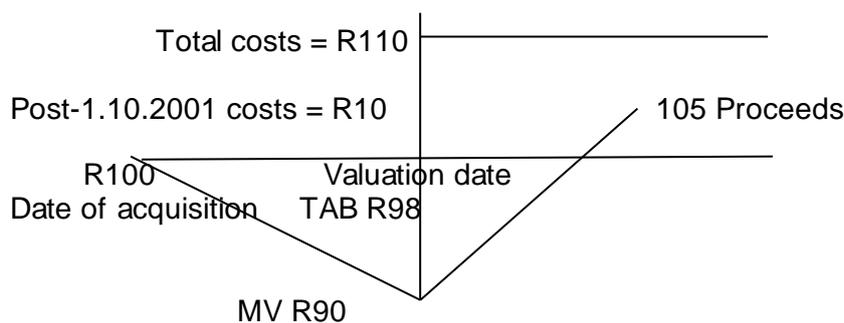
$$P = R100 / R120 \times R110$$

$$P = R92$$

$$\begin{aligned} Y &= B + [(P - B) \times N / (N + T)] \\ &= R100 + [(R92 - R100) \times 19 / 38] \\ &= R96 \end{aligned}$$

In this instance the time-apportionment base cost is lower than market value so the time-apportionment base cost will prevail thus shielding the *fiscus* from the higher market value loss of $R110 - [R150 + R20] = -R60$. The allowable time-apportioned capital loss is

$$R110 - [R96 + R20] = -R6$$

Example 3 – Scenario 2: $MV < P \leq [A + B]$ 

P = Proceeds, A = Post-1 October 2001 costs, B = Pre-1 October 2001 costs, MV = Market value on valuation date

Time-apportionment base cost:

Assume the asset was acquired 19 years before and disposed of 19 years after valuation date.

$$\begin{aligned} P &= R100 / R110 \times R105 = R95,45 \\ Y &= B + [(P - B) \times N / (N + T)] \\ &= R100 + [(R95,45 - R100) \times 19 / 38] \\ &= R100 - [R4,55 \times 19 / 38] \\ &= R100 - R2,28 \\ &= R97,72 \end{aligned}$$

MV = R90

Lower of MV and TAB = R90

Capital gain = R105 – R90 – R10
= R5

(Had time-apportionment been permitted, a capital loss of R105 – R97,72 – R10 = –R2,72 would have been allowed).

8.30.3 The third scenario [para 27(4)]

If the person has not determined a market value or the price of the asset is not one published in the *Government Gazette*, para 27(4) provides that the valuation date value of the asset is its time-apportionment base cost.

Example 1 – Scenario 3: $P \leq [A + B]$ and no MV determined or published

Facts:

An asset was acquired on 5 July 1984 at a cost of R200. On 30 June 2019 the asset was sold for R50. No market value was determined for the asset on 1 October 2001 and its price was not published in the *Government Gazette*.

Result:

The asset has been disposed of at an historical loss of R50 – R200 = –R150 and para 27 therefore applies. Since no market value on valuation date has been determined or published for the asset, its valuation date value must be determined under para 27(4) using the time-apportionment base cost method.

$$\begin{aligned} Y &= B + [(P - B) \times N / (N + T)] \\ &= R200 + [(R50 - R200) \times 18 / 36] \\ &= R200 + [-R150 \times 18 / 36] \\ &= R200 - R75 \\ &= R125 \end{aligned}$$

$$\begin{aligned} \text{Capital loss} &= R50 - R125 \\ &= -R75 \end{aligned}$$

Some further examples of the application of para 27 are set out below.

Example 2 – Historical loss and market value loss when MV > pre-1 October 2001 costs

Facts:

Xerxes acquired an asset in July 1971 for R100 000 and disposed of it in February 2020 for R80 000. The market value of the asset at valuation date had been determined as R120 000.

Result:

	R
Expenditure before valuation date	100 000
Market value at valuation date	120 000
Proceeds upon disposal	80 000

Since a market value has been determined, the valuation date value of the asset is the lower of

- market value, or
- time-apportionment base cost,

of that asset.

Therefore, the lower of

- R120 000, or
- Y = $R100\,000 + [(R80\,000 - R100\,000) \times (33 / (33+17))]$
 = $R100\,000 + (-R20\,000 \times 31 / 50)$
 = $R100\,000 - R12\,400$
 = R87 600

	R
Proceeds	80 000
Less: Base cost	<u>(87 600)</u>
Capital loss	<u>(7 600)</u>

In this example para 27 applies, since proceeds do not exceed expenditure allowable under para 20 incurred both before and after the valuation date. Since the market value has been determined and it exceeds expenditure allowable under para 20 (para 27(3)(a) is inapplicable), the lower of market value or time-apportionment base cost must be used as the valuation date value [para 27(3)(b)]. The effect is to limit the capital loss to the loss that would be allowable on a time-apportionment basis.

Example 3 – Historical loss and MV loss when MV < pre-1 October 2001 expenditure

Facts:

The facts are the same as in Example 2 but the expenditure allowable under para 20 incurred *before* the valuation date also exceeds the market value (para 27(3)(a) applies). A market value of R90 000 was determined at valuation date.

	R
Expenditure before valuation date	100 000
Market value at valuation date	90 000
Proceeds upon disposal	80 000

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

- market value, or
- those proceeds less the expenditure allowable under para 20 incurred after the valuation date.

Therefore, the higher of

- R90 000, or
- R80 000 (R80 000 – R0),

equals R90 000.

	R
Proceeds	80 000
Less: Base cost	<u>(90 000)</u>
Capital loss	<u>(10 000)</u>

In this example para 27 applies, since proceeds do not exceed expenditure allowable under para 20 incurred both before and after the valuation date. Since the market value has been determined and it does not exceed expenditure allowable under para 20 incurred before the valuation date, the higher of market value or proceeds less expenditure after valuation date must be used as the valuation date value.

8.31 Valuation date value – instrument [para 28]

Paragraph 28

8.31.1 Some common bond terms

Bond – A bond is debt issued for a period of more than one year. Typically, bonds are sold by governments, local governments, electricity and water authorities (for example, ESKOM) and companies. A person who buys a bond is lending money. From a CGT perspective the lender acquires an asset, being the right to claim the amount advanced from the borrower at a future specified date. Interest-bearing bonds usually pay interest twice a year. The market price of bonds fluctuates with prevailing interest rates. When prevailing interest rates fall, the price of bonds rises, and when interest rates rise, the price of bonds falls. For example, if a bond yielding 10% a year is bought for R100, and a year later the prevailing interest rate falls to 5%, a prospective purchaser of the bond would be prepared to pay R200 for it because the interest produced by the bond (R10) would produce a yield of 5% on a sum of R200.

Clean price – Bond price excluding accrued interest.

Coupon – the periodic interest paid to bondholders during the period of the bond.

Coupon rate – The stated percentage rate of interest usually paid twice a year.

Mark-to-market – Adjustment of the book or collateral value of a bond to reflect its market value.

'T + 3' – This indicator means that settlement must take place within three business days of the trade date.

8.31.2 The purpose of para 28

Paragraph 28 provides the rules for determining the *valuation date value* of a s 24J 'instrument'. It does not deal with instruments acquired on or after valuation date – these are dealt with under the core rules (more on this below).

8.31.3 What is an 'instrument'?

The term '**instrument**' is defined in s 24J(1) as follows:

'**[I]nstrument**' means—

- (a)
- (b)
- (c) any interest-bearing arrangement or debt;
- (d) any acquisition or disposal of any right to receive interest or the obligation to pay any interest, as the case may be, in terms of any other interest-bearing arrangement; or
- (e) any repurchase agreement or resale agreement,

which was—

- (i) issued or deemed to have been issued after 15 March 1995;
- (ii) issued on or before 15 March 1995 and transferred on or after 19 July 1995; or
- (iii) in so far as it relates to the holder thereof, issued on or before 15 March 1995 and was unredeemed on 14 March 1996 (excluding any arrangement contemplated in subparagraphs (i) and (ii)),

but excluding any lease agreement (other than a sale and leaseback arrangement as contemplated in section 23G) or any policy issued by an insurer as defined in section 29A;'

Since an interest-free loan is not an instrument as defined in s 24J, a loan of this nature must be dealt with under the core rules and not under para 28.

8.31.4 Methods for determining the valuation date value of an instrument

The two alternative methods that may be used to determine the valuation date value of an instrument are set out in the table below. Unlisted instruments are in addition subject to a loss limitation rule ('kink test').

Table 1 – Methods for determining the valuation date value of an instrument

Method	How determined	
'Adjusted initial amount' on 1 October 2001	The 'adjusted initial amount' is a term defined in s 24J(1). In essence it is the initial amount paid for the instrument, plus the cumulative amount of all interest accrued and amounts paid less all amounts received from date of acquisition to 1 October 2001.	
Market value on 1 October 2001	The price that could have been obtained upon a sale of the instrument between a willing buyer and a willing seller dealing at arm's length in an open market.	
	Type of instrument	Date market value determined
	<ul style="list-style-type: none"> • Listed on a recognised exchange • Other instruments 	Last trading day before 1 October 2001 Valuation date

The term 'instrument' as defined in s 24J(1) and used in para 28 must be distinguished from a 'financial instrument', a much wider term defined in s 1(1). A financial instrument includes not only an instrument, but also other securities such as shares and participatory interests in collective investment schemes. The distinction is important because para 28 overrides the general rules contained in para 29 for determining the market value on valuation date of financial instruments.

Just like para 29, para 28 also uses different dates for determining the price of listed and unlisted instruments (see Table 1 above). As far as the listed instruments are concerned, it was unnecessary to use a five-day average. The prices of these instruments are determined by prevailing interest rates and it would not have been possible for a single player to manipulate the entire interest-rate market in South Africa before valuation date. The market value of listed instruments must be determined on the last trading day before Monday, 1 October 2001. With instruments listed in South Africa, the last trading day before that date was Friday 28 September 2001. The prices of bonds listed on the Bond Exchange of South Africa (BESA) were not published in the *Government Gazette* but are available on the SARS website.⁴⁰⁰ SARS accepts BESA's T + 3 mark-to-market valuation on 28 September 2001 as the valuation date value of these instruments. In order to determine the market value of a

⁴⁰⁰ Available Under Types of tax / Capital gains tax / Market values/BESA listed bond prices. Select the MTM Excel worksheet at the bottom of the page.

s 24J instrument from the BESA prices on the SARS website, the following formula should be used:

$$\text{Nominal value of instrument} \times \frac{\text{All-in price}}{100}$$

Example 1 – Determination of market value of s 24J instrument on valuation date

Facts:

An RSA R150 bond has a nominal value of R14 000 000. Determine the market value on valuation date of the bond.

Result:

According to the BESA schedule, the All-in Price of an R150 bond is 106,84896. Therefore, the market value of the bond is R14 000 000 × 106,84896 / 100 = R14 958 854,40.

Example 2 – Determination of adjusted initial amount

Facts:

On 31 December 2000 Argh (Pty) Ltd, a company with a financial year end of 30 June, acquired a financial instrument listed on the Bond Exchange of South Africa with a term of two years at a discount of R1,2 million to the face value of R10 million. Interest is receivable six-monthly, calculated at 3% of the face value of the instrument. At maturity date, 31 December 2002, the instrument will be redeemed at par.

Result:

Step 1 – Calculation of the yield to maturity

The cash flows may be summarised as follows:

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

The accrual period is six months, and the resultant yield to maturity is 6,50308% for each accrual period. The method for determining the yield to maturity is explained in **8.32.3**. The yield to maturity can be proved as follows:

Period	1	2	3	4	Total
Cash flow	300 000	300 000	300 000	10 300 000	
Factor	0,93894	0,88161	0,82778	0,777233	
PV	281 682	264 483	248 333	8 005 502	8 800 000

The present value (PV) discount factor is $1/(1+r)^n$ in which r = percentage interest rate and n = period. The discount factor for the first period is $1/(1+0,0650308)^1$, for the second period $1/(1,0650308 \times 1,0650308)$ and so on.

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

Interest accrued calculated as follows:

$$R8\ 800\ 000 \times 6,50308\% = R572\ 271$$

Step 3 – Calculation of interest accrued up to valuation date

Interest accrued calculated as follows:

$$(R8\,800\,000 + R572\,271 - R300\,000) \times 6,50308\% \times 3 / 6 = R294\,988$$

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

	R
Initial amount paid	8 800 000
Total cash inflows resulting from transactions	(300 000)
Total interest accrued to 30 September 2001	<u>867 260</u>
Adjusted initial amount	<u>9 367 260</u>

Step 5 – Determine capital gain or loss

Period	Opening balance R	Interest at 0.0650308 R	Receipts R	Closing balance R
31.12.2000 to 30.06.2000	8 800 000	572 271	(300 000)	9 072 271
01.07.2001 to 31.12.2001	9 072 271	589 977	(300 000)	9 362 248
01.01.2002 to 30.06.2002	9 362 248	608 834	(300 000)	9 671 082
01.07.2002 to 31.12.2002	9 671 082	<u>628 918</u>	<u>(10 300 000)</u>	-
		<u>2 400 000</u>	<u>(11 200 000)</u>	

Interest earned before 1 October 2001 = R572 271 + (R589 977 × 3 / 6) = R862 260

Interest earned on or after 1 October 2001 = R2 400 000 – R862 260 = R1 532 740

The base cost of the instrument is determined as follows:

	R
Initial amount (valuation date value under para 28)	9 367 260
Interest accrued on or after valuation date	1 532 740
Less: Coupons received or accrued on or after valuation date [para 20(3)(b)]	<u>(900 000)</u>
Base cost	<u>10 000 000</u>

The interest accruing on the instrument on or after the valuation date is added to the base cost on the basis that the right to the income is given up in return for it being credited to the instrument (see **8.5B**). The coupons are treated as a recovery of cost under para 20(3)(b).

The capital gain or loss is determined as follows:

	R
Proceeds	10 000 000
Less: Base cost (as above)	<u>(10 000 000)</u>
Capital gain or loss	<u>-</u>

No capital gain or loss has arisen in this example, since the adjusted initial amount has been adopted as the valuation date value of the instrument and it was held until maturity.

Impact of choice of method

A person who adopts the adjusted initial amount as the valuation date value and holds the instrument to maturity will not realise a capital gain or loss. However, if there has been a change in prevailing interest rates and the instrument is disposed of before maturity, a capital gain or loss might result.

Under the market-value method, a capital gain or loss will arise if the prevailing interest rates differ

- at the date of acquisition and the valuation date, or

- at the valuation date and the date of disposal.

In the first instance a change in interest rates would result in the market value on valuation date differing from the adjusted initial amount on that date. In the second instance a capital gain or loss should arise even if the instrument is held to maturity.

8.31.5 Identification methods

A person will be entitled to use specific identification or FIFO for the purpose of identifying listed s 24J instruments that have been disposed of. The weighted-average method may also be used but only for listed s 24J instruments. These listed instruments are treated as a separate class of asset under para 32(3A)(d). Once weighted average has been adopted, it will have to be applied to all the holder's listed instruments.

8.31.6 The unlisted instrument kink test [para 28(2)]

Paragraph 28(2) contains its own 'kink' test similar to that contained in para 27 designed to protect the *fiscus* against 'phantom' losses. This loss-limitation provision is, however, applicable only to instruments that are not listed on a recognised exchange. It is considered that the potential for abuse exists mainly with unlisted instruments. The time-apportionment base cost must be substituted as the valuation date value of an instrument when

- a person has adopted the adjusted initial amount of the instrument as its valuation date value; and
- the proceeds from disposal of the instrument are less than that amount.

The effect of this rule is to prevent the full amount of a loss incurred before valuation date from being claimed after that date.

Without this provision a person would effectively be entitled to a deduction against income as well as the expenditure being included in base cost in the determination of a capital gain or capital loss. For example, a person could claim the unpaid interest portion as a deduction under s 24J(4A) and the same amount would be included in base cost. Alternatively, a person would be allowed a deduction for expenditure that has been recovered. Such a recovery would apply, for example, to interest that had accrued before valuation date that is received on or after valuation date.

Example – Application of the 'kink' test to unlisted instruments

Facts:

On 31 December 2000 Bargh (Pty) Ltd, a company with a financial year end of 30 June, acquired an unsecured debenture in Shady Dealings (Pty) Ltd with a term of two years at a discount of R1,2 million to the face value of R10 million. Interest is receivable six-monthly, calculated at 3% of the face value of the instrument. At maturity date, 31 December 2002, the instrument will be redeemed at par.

On 12 September 2001 Shady Dealings informed Bargh that it had lost a major customer as a result of the World Trade Centre tragedy and would be suspending all interest and capital repayments until further notice. On 30 April 2002 Shady Dealings was placed in compulsory liquidation, and Bargh was informed that concurrent creditors would not receive a dividend.

Result:

Date of investment	31 December 2000
Date of disposal	30 April 2002
Expenditure before valuation date	R8 800 000
No of years (including part years) before valuation date:	1
No of years (including part years) after valuation date:	1

Proceeds = RNil

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R8\,800\,000 + [(R0 - R8\,800\,000) \times 1 / (1 + 1)] \\
 &= R8\,800\,000 - R4\,400\,000 \\
 &= R4\,400\,000
 \end{aligned}$$

Capital loss = R0 (proceeds) – R4 400 000 (time-apportionment base cost) = R4 400 000

8.32 Base cost – instruments acquired on or after valuation date

8.32.1 Base cost

The determination of the base cost of an instrument acquired on or *after* valuation date falls completely outside para 28 and must be determined in accordance with para 20 or 31. The amount paid for the instrument (including any accrued interest at the date of acquisition) will constitute the expenditure actually incurred for the purposes of para 20. With inheritance [s 25(3)(b)] or donation (para 38), the market value of the instrument acquired must be determined under para 31.

8.32.2 Proceeds

When an instrument is disposed of, the proceeds will comprise the total receipts over the period that the instrument was held, reduced under para 35(3)(a) by the accrued interest.

8.32.3 Determination of accrued interest

A common misconception exists that the regular coupons received, usually six-monthly, constitute 'interest'. The coupons could equal interest if the instrument were acquired at face value on date of issue. But when it is purchased on the bond exchange at a later date, the chances are that its value will differ from the face value because of fluctuations in prevailing interest rates. The interest on such instruments must be determined using the 'yield to maturity' method set out in s 24J. The yield to maturity is determined by calculating the Internal Rate of Return (IRR) based on all cash flows up to the date of maturity (*not* date of disposal). The IRR is determined mathematically by an iterative (trial and error) process using a financial calculator or Excel spreadsheet. This calculation is illustrated in the example in **8.32.4**.

8.32.4 Accrued interest included in acquisition price

The purchase price of a post-valuation date instrument may frequently include accrued interest. In these circumstances the initial accrual period will be shorter than the remaining accrual periods based on the regular intervals at which the coupons are received. In determining the IRR, s 24J requires that all accrual periods must be equal. In the example below this problem has been addressed by making all the accrual periods equal to the initial accrual period.

Determining the base cost of a post-valuation date instrument

The base cost of a post-valuation date instrument comprises three elements, namely, the original cost (including the value of accrued interest), the coupons, and the interest accruing at the end of each accrual period.

Purchase price

The purchase price represents the 'expenditure actually incurred in respect of the cost of acquisition or creation of that asset' contemplated in para 20(1)(a). This amount would include the value of any interest accruing up to the date of purchase, assuming that the instrument was acquired after issue from a previous holder between accrual periods.

Coupons

As its name suggests, the yield-to-maturity method assumes that the instrument will be held to maturity. The instrument would therefore not give rise to a capital gain or loss if held to maturity. Under this assumption it is appropriate to treat the coupons as a recovery of cost of the instrument under para 20(3)(b).

Interest accrued

While the instrument is held, the holder has a personal right to claim interest. At the end of the accrual period the right is extinguished in return for the interest being credited to the instrument. It is the giving up of the right to interest which establishes the expenditure which is added to the base cost of the instrument under para 20(1)(e).

Example – Disposal of s 24J instrument acquired on or after valuation date*Facts:*

On 1 April 2017 Johan purchased ESKOM stock for R9 100. The face value of the bond was R10 000 with a coupon rate of 5% payable every six months on 30 June and 31 December. The bond is redeemable at face value on 31 December 2022. Johan sold the bond on 29 February 2020 for R10 200. Determine Johan's capital gain or loss on disposal of the bond.

*Result:**Step 1 – Determine the accrual period*

For the purposes of this example an accrual period of three months has been elected [see para (b) of the definition of 'accrual period' in s 24J(1)]. This accrual period accounts for the three-month gap between the date of acquisition and the first receipt (1 April 2017 to 30 June 2017).

Step 2 – Determine yield to maturity

Cash flows to maturity:

	R
01.04.2017	(9 100)
30.06.2017	500
30.09.2017	0
31.12.2017	500
31.03.2018	0
30.06.2018	500
30.09.2018	0
31.12.2018	500
31.03.2019	0
30.06.2019	500

30.09.2019	0
31.12.2019	500
31.03.2020	0
30.06.2020	500
30.09.2020	0
31.12.2020	500
31.03.2021	0
30.06.2021	500
30.09.2021	0
31.12.2021	500
31.03.2022	0
30.06.2022	500
30.09.2022	0
31.12.2022	10 500
IRR	3,1704%

Using an Excel spreadsheet, the cash flows are listed in a column with the first cell (A1) containing -9100, second cell (A2) 500, third cell (A3) 0 and so on and the last cell (A24) 10500. In cell A25 the following formula is entered:
=IRR(A1:A24)

This result may give a rounded figure of 3%, but the decimal point can be expanded using the increase/decrease button on the toolbar or for keyboard users ALT, H, 0 (increase) or ALT, H, 9 (decrease).

Step 3: Determine interest accrued using IRR

Period	Opening balance	Interest at 3,1704%	Receipts	Closing balance
01.04.2017 - 30.06.2017	9 100,00	288,51	-500	8 888,51
01.07.2017 - 30.09.2017	8 888,51	281,80	0	9 170,31
01.10.2017 - 31.12.2017	9 170,31	290,73	-500	8 961,04
01.01.2018 - 31.03.2018	8 961,04	284,10	0	9 245,14
01.04.2018 - 31.06.2018	9 245,14	293,11	-500	9 038,25
01.07.2018 - 30.09.2018	9 038,25	286,55	0	9 324,80
01.10.2018 - 31.12.2018	9 324,80	295,63	-500	9 120,43
01.01.2019 – 31.03.2019	9 120,43	289,15	0	9 409,58
01.04.2019 – 30.06.2019	9 409,58	298,32	-500	9 207,90
01.07.2019 – 30.09.2019	9 207,90	291,93	0	9 499,83
1.10.2019 – 31.12.2019	9 499,83	301,18	-500	9 301,01
01.01.2020 - 29.02.2020	9 301,01	193,31	-10 200	-705,68
		3 394,32	-12 200	

Step 4 – Determine base cost

	R
Original cost	9 100
Interest credited to instrument	3 394
Less: Coupons received to 29.02.2020 [para 20(3)(b)]	(3 000)
Base cost	<u>9 494</u>

Step 5 – Determine capital gain or loss

Proceeds	10 200
Less: Base cost (para 20)	(9 494)
Capital gain	<u>706</u>

Note: As illustrated below, had the bond been held to maturity, no gain or loss would have arisen.

	R
Opening balance	9 100
Interest accrued	6 900
Less: Coupons (R500 × 12 = R6 000) and final repayment (R10 000)	(16 000)
Closing balance	=

8.33 Market value on valuation date

Paragraph 29

8.33.1 Introduction

Paragraph 29 is a transitional measure and deals with the requirements for the valuation of assets on valuation date. (Paragraph 31 contains the permanent market value rules.)

8.33.2 Market value of financial instruments listed in South Africa [para 29(1)(a)(i)]

Shares and other financial instruments listed on a recognised exchange in South Africa must be valued on the basis of the volume-weighted average price (VWAP). This valuation is achieved by dividing

- the aggregate transaction value (that is, total selling price) of each financial instrument for the last five business days preceding valuation date, by
- the total quantity of instruments traded during the same period.

Since Monday 24 September was a public holiday and 29 and 30 September 2001 fell on a weekend, the prices of instruments traded from Friday 21 September 2001 to Friday 28 September 2001 were used. The averaging of prices in this way was necessary to ensure that shares were fairly valued on 1 October 2001. This averaging method was adopted to prevent the upward manipulation of share prices (known as ‘ramping’) by substantial players in the market for the purpose of inflating the base cost of their shares. Share prices can also be distorted, upwards or downwards, at a single moment in time as a result of a thinly traded market.

The necessary calculations were performed and the prices are available to taxpayers in the *Government Gazette*⁴⁰¹ and on the CGT page of the SARS website (Types of Tax / Capital Gains Tax / Market values). These values must be used to determine the market value of these instruments.

Paragraph 29(1)(a) requires that a price be quoted for the financial instrument both before and after the valuation date, thus ensuring that para 29 applies only to pre-valuation date financial instruments. For example, a share that listed on 1 October 2001 would not meet the requirement because it was unlisted before 1 October 2001. The intention is not to exclude shares that become unlisted some years after valuation date. For example, assume a company's shares were listed on the JSE for many years before 1 October 2001 but became unlisted in 2020. A person who held such shares before and after valuation date must use the

⁴⁰¹ GN 65 GG 23037 of 25 January 2002.

price quoted in the *Government Gazette* for the purposes of determining the market value of the shares even though the shares are unlisted at the time of disposal.

The weighted-average identification method is, however, unavailable for shares that were not listed from valuation date until the time of disposal – see **8.36.2.3**.

Circumstances in which the Commissioner can determine the valuation date value of a financial instrument [para 29(2A)]

The Commissioner, after consultation with the recognised exchange in South Africa and the Financial Services Board, must determine the market value of a financial instrument when

- an instrument was not traded during the last five business days preceding valuation date,
- an instrument is suspended for any period during September 2001, or
- the market value of the instrument for the five days preceding valuation date, as determined using the method described in the previous paragraph, exceeds the average of the ruling price of that instrument determined for the first fourteen business days of September 2001 by 5% or more.

In determining the market value, the Commissioner must have regard to

- the actual value of the instrument,
- if suspended, the reason for the suspension, and
- if there has been an increase in value above 5%, the Commissioner must consider the reason for the increase.

Any decision of the Commissioner in this regard is subject to objection and appeal.

A committee consisting of officials from the former JSE Securities Exchange SA (now JSE Ltd), the former Financial Services Board (now the Financial Sector Conduct Authority) and SARS reviewed the prices and only one adjustment was made before the final prices were published in the *Government Gazette*⁴⁰² ('Indeqty' was decreased from 219 to 135). Suspended listings are regarded as having a value of zero unless subsequently revised by the Commissioner for SARS upon receipt of a properly motivated representation.

The term 'ruling price' is defined in para 1. It is used in relation to listed financial instruments in a number of subparagraphs of para 29 instead of the phrase 'last price quoted'.

Kumba and Iscor

The price of Kumba shares is not reflected in the *Gazette* as it was listed only on 26 November 2001. Iscor distributed the Kumba shares to its shareholders as a dividend *in specie* under a pre-valuation date unbundling transaction. SARS and Iscor have agreed on a price for Kumba at 1 October 2001 of R28,04,⁴⁰³ and it is suggested that taxpayers use this figure. The price for Iscor is R25,22, as reflected in the *Gazette*. For the purposes of para 76, the Kumba distribution constituted a dividend, and hence was not a capital distribution as then defined in para 74. If the time-apportionment base cost method is adopted in valuing the Iscor shares on valuation date, there is no means by which the pre-CGT expenditure in respect of the Iscor shares can be proportionately reduced to account for the Kumba unbundling. Although such a reduction must be made in respect of a post-valuation date unbundling transaction, no adjustment is required for a pre-CGT unbundling transaction. See commentary in **18.2**.

⁴⁰² GN 65 GG 23037 of 25 January 2002.

⁴⁰³ This agreement was advertised in *Business Day* of 29 January 2002.

8.33.3 Financial instruments listed outside South Africa [para 29(1)(a)(ii)]

The valuation date values of financial instruments listed on a recognised exchange outside South Africa are determined on a different basis to financial instruments listed in South Africa for the following reasons:

- First, it would have been impractical for SARS to publish all the prices in the Gazette.
- Secondly, SARS did not have access to the data needed to determine a five-day volume weighted-average price.
- Thirdly, the risk of a South African resident being able to influence the price during the five days preceding 1 October 2001 was considered minimal.

Financial instruments listed on a recognised exchange outside South Africa must be valued at the 'ruling price' on the last business day preceding 1 October 2001. With a dual listing, for example, a share listed on both the JSE and London Stock Exchanges, the price as computed in **8.33.2** must be used.

The term 'ruling price' is defined in para 1. In the case of financial instruments listed on a recognised exchange outside South Africa it means the **last sale price** of that financial instrument at close of business of the exchange, subject to the following:

- If there is a higher bid or a lower offer on the day subsequent to the last sale, the price of that higher bid or lower offer will prevail.
- If the ruling price is not determined in this manner by that exchange, the **last price quoted** in respect of that financial instrument at close of business of that exchange.

For the meaning of 'bid' and 'offer' see **4.1.6**.

8.33.4 South African collective investment schemes in securities and property shares [para 29(1)(b)(i)]

These units must be valued according to the price published by the Commissioner in the *Government Gazette*, which is

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

Units of South African property unit trusts are listed on the JSE and the value of their units are included with the financial instruments referred to in (a) above.

8.33.5 Foreign collective investment schemes [para 29(1)(b)(ii)]

These units must be valued according to

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

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

8.33.6 Other assets [para 29(1)(c)]

All other assets must be valued at market value under para 31.

8.33.7 Valuation of controlling interest in listed shares [para 29(2)]

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

For para 29(3) to apply, the controlling interest must

- be held in a listed company,
- exceed 35% [para 29(3)],
- be disposed of in its entirety,

and the buyer and seller must not be connected persons.

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

Example – Valuation of controlling interest in listed shares

Facts:

Sweet Pea Ltd holds 51% of the issued shares of Pea Ltd, a company listed on the JSE since 1990 when Sweet Pea Ltd acquired its holding. Sweet Pea Ltd disposed of its entire holding in Pea Ltd to Oh (Pty) Ltd for cash on 1 October 2019.

Total number of Pea Ltd shares held by Sweet Pea Ltd	3 000 000
Last buying price for each Pea Ltd share on 30 September 2019 (per JSE)	R1,95
Last selling price for each Pea Ltd share on 30 September 2019 (per JSE)	R2,05
Price for each share under sale agreement	R2,20
Average price for each Pea Ltd share under para 29(1)(a)(i)	R1,50

Result:

Step 1 – Calculate market value on valuation date

Valuation date market value (3 000 000 × R1,50)	R 4 500 000
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Step 2 – Calculate control premium or discount

Average last price quoted = $(R1,95 + R2,05) / 2$
= R2,00

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

= $\frac{(R2,20 - R2,00)}{R2,00}$

= 10%

Step 3 – Determine base cost

Valuation date market value (3 000 000 × R1,50)	4 500 000
Control premium R4 500 000 × 10%	<u>450 000</u>
Base cost	<u>4 950 000</u>

Step 4 – Determine capital gain

Proceeds R3 000 000 × R2,20	6 600 000
Less: Base cost	<u>(4 950 000)</u>
Capital gain	<u>1 650 000</u>

The market value of a controlling interest in an unlisted company must be determined in accordance with para 31(3), namely, the price a willing buyer would pay a willing seller with both parties dealing at arm's length in an open market, but disregarding any transferability restrictions or valuation method stipulations, and taking into account any preferential entitlement upon winding-up. For more information on valuation methods, see the SARS guide entitled *Valuation of Assets for Capital Gains Tax Purposes*.⁴⁰⁴

It is not a requirement of para 29(2) that the shareholder must hold the controlling interest on valuation date. For example, a person may hold an interest of 25% on valuation date and acquire a further 11% interest after that date. In such event the adjustment to the valuation date market value must be applied to the pre-valuation date interest of 25%. The base cost of the post-valuation date interest of 11% remains unaffected by this adjustment, being determined under para 20 or 38.

8.33.8 Time limit on obtaining valuations [para 29(4)]

For the purposes of paras 26(1)(a) and 27(3), a person may adopt or determine the market value as the valuation date value of an asset only if the person satisfies the requirements set out below.

8.33.8.1 Valuation date – 1 October 2001

A person having a valuation date of 1 October 2001 may adopt or determine a market value for the purposes of paras 26(1)(a) and 27(3) only if

- that person has valued the asset on or before 30 September 2004,

⁴⁰⁴ Available under Types of tax / Capital gains tax / Valuation values.

- the price of that asset has been published by the Commissioner under para 29 in the Gazette, or
- the person has acquired that asset from that person's spouse under s 9HB⁴⁰⁵ and the transferor spouse had adopted or determined a market value under para 29. For this purpose, the transferee spouse is treated as having adopted or determined the market value adopted or determined by the transferor spouse.

Paragraph 29(4) originally provided that valuations had to be completed by 30 September 2003 (two years after 1 October 2001) but this period was extended by a year.⁴⁰⁶

There is no valuation time limit for assets whose prices were published in the *Government Gazette*,⁴⁰⁷ namely,

- JSE-listed financial instruments
 - Equities
 - Warrants
 - Financial futures.
 - Agricultural futures
- South African unit trusts

The use of these prices is mandatory and taxpayers are accordingly relieved from having to value these assets. The prices are also available on the SARS website under Types of Tax / Capital Gains Tax / Market values.

Although Krugerrand prices appear on the SARS website, they were not published in the *Government Gazette*. A person who uses the applicable Krugerrand prices on the SARS website will be regarded as having valued these assets within the prescribed period.

The prices of shares listed on a recognised exchange outside South Africa have not been published by SARS. Nevertheless, a person who uses the listed price in appropriate circumstances (for example, to value a minority holding) on valuation date will be regarded as having valued the relevant share within the prescribed period. As with Krugerrands the values of these assets were determined by the market on valuation date and it is not expected that independent valuations be performed.

Since para 29(4) requires valuations only for the purposes of paras 26(1)(a) and 27(3), there is no requirement to determine a market value in respect of s 24J interest-bearing instruments within the three-year limit. These assets are dealt with under para 28, which contains no time limit. The prices of listed s 24J instruments are nevertheless available on the SARS website under Types of Tax / Capital Gains Tax / Market values.

⁴⁰⁵ The reference to para 67 was replaced with a reference to s 9HB by s 57 of the Taxation Laws Amendment Act 34 of 2019.

⁴⁰⁶ The initial period of two years was extended to 30 September 2004 by the Minister. See GN 207 GG 26026 of 20 February 2004.

⁴⁰⁷ GN 65 GG 23037 of 25 January 2002.

The opening words of para 29(4) state that the subparagraph applies for the purposes of paras 26(1)(a) and 27(3). No reference is made to para 26(2)(a) which applies when neither the person nor the Commissioner can determine the expenditure in respect of the asset. It follows that there is no time limit for determining a market value on valuation date in such instances. However, persons falling into para 26(2)(a) will be unable to adopt the market value basis in respect of the high-value assets contemplated in para 29(5) unless they have complied with the submission deadline (that is, submitted the CGT 2L form with the first return after 30 September 2004).

Valuation of business v valuation of individual assets

In some instances, taxpayers have valued the shares in a company but have neglected to value the assets within the company. They then seek to use the share valuation when the underlying business is disposed of as a going concern. In other instances, taxpayers have simply valued the company's business as a whole. These practices are unacceptable for, amongst others, the following reasons:

- A company and its shareholders are separate taxpayers, each with their own tax obligations. If one taxpayer has performed a valuation, this cannot simply be imputed to another. The opening words of para 29(4) state that a person may only adopt or determine market value as the valuation date value 'if that person has valued that asset'
- The valuation of shares in a company may differ significantly from the valuation of the company's assets. For example, in valuing the shares on a net asset basis, the assets must be reduced by the liabilities, including the contingent liability for dividends tax. Liabilities are not taken into account when valuing individual assets. Furthermore, the method for valuing shares (for example, earnings yield or dividend yield) may be completely different to the method used to value individual assets in the company.
- Valuations must be performed for each asset. The business is not an asset, but rather a collection of assets. The fact that this was envisaged by the legislature can be seen in para 29(5)(c) in which it is recognised that a single share is an asset, but for the purposes of the submission-requirement limit the value of all the shares held in the company must be taken into account.
- The kink tests in paras 26 and 27 must be applied to each asset. By grouping assets together for valuation purposes, the kink tests will be averaged and this will not always give the same result that would ensue if the tests are applied on an asset-by-asset basis.

8.33.8.2 Valuation date after 1 October 2001

A person who ceases to be an exempt person under para 63 will have a valuation date after 1 October 2001.⁴⁰⁸ The valuation date of such a person will be the date on which it ceases to be an exempt person. Currently this rule applies to PBOs and recreational clubs.

A person having a valuation date after 1 October 2001 may adopt or determine a market value for the purposes of paras 26(1)(a) and 27(3) only if

- that person has valued the asset within two years of the valuation date, or
- the asset is one contemplated in para 31(1)(a) or (c)(i) and the market value of that asset on valuation date is determined under one of those paragraphs.

⁴⁰⁸ See para (a) of the definition of 'valuation date' in para 1.

Table 1 – Assets which do not have to be valued within two years by persons with a valuation date after 1 October 2001

Paragraph 31(1)	Description	Market value on valuation date
(a)	Financial instrument listed on a recognised exchange for which a price was quoted on that exchange	Ruling price on last business day before valuation date
(c)(i)	A participatory interest in a local collective investment scheme in <ul style="list-style-type: none"> • securities, or • property 	Price at which a participatory interest can be sold to the management company of the scheme on valuation date.

Participatory interests in foreign collective investment schemes that are listed fall under para 31(1)(a) in the above table. However, when they are unlisted the person must establish their market value within two years of the person's valuation date under para 29(1)(b)(ii), namely,

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

A capital gain or loss arising from the disposal by a PBO of an unlisted participatory interest in a foreign collective investment scheme is likely to be excluded by para 63A(a). The failure by a PBO to value such an interest is therefore unlikely to have any adverse CGT consequences while the PBO remains approved by the Commissioner under s 30(3).

8.33.9 Early submission of valuation forms [para 29(5)]

The CGT 2L valuation form in respect of the high-value assets summarised in the table below must be furnished to SARS with the first return of income submitted after 30 September 2004. A person who fails to meet this requirement may not adopt market value as the valuation date value of the asset and will be compelled to resort to the time-apportionment base cost or '20% of proceeds' method. Before 20 January 2015, if the form was not submitted with that return the Commissioner was permitted to allow an extension for the lodging of the form. On or after 20 January 2015 the Commissioner's discretion to extend the period for lodging the form has been removed.⁴⁰⁹ For the pre-20 January 2015 period the person would have had to provide SARS with proof that the valuation was performed on or before 30 September 2004.⁴¹⁰ That proof could have taken the form of

- a copy of a valuation by an independent third party signed and dated on or before 30 September 2004,
- a copy of the invoice from the valuer dated on or before 30 September 2004, or
- proof of payment of the valuer on or before 30 September 2004.

⁴⁰⁹ The Commissioner's discretion was removed by s 13(a) of the Tax Administration Laws Amendment Act 44 of 2014 and came into operation on 20 January 2015, the date of promulgation of that Act.

⁴¹⁰ This discretion was inserted in para 29(5) by s 47(1)(c) of the Revenue Laws Amendment Act 20 of 2006. The amendment did not carry a specific effective date. However, it is accepted that the amendment applies to any request submitted to the Commissioner on or after the date of promulgation of the Act, namely, 7 February 2007.

Paragraph 29(5) applies regardless of whether a person has a record of pre-valuation date expenditure incurred in respect of an asset.

Paragraph 29(5) does not apply to persons having a valuation date after 1 October 2001, such as PBOs and recreational clubs [para 29(8)].

Table 1 – High-value assets in respect of which proof of valuation must be submitted

Type of asset	Applies	When market value exceeds
Any asset	Individual asset ⁴¹¹	R10 million
Intangible asset	Individual asset	R 1 million
Unlisted shares	All shares held by the shareholder in the company	R10 million

‘Intangible asset’

The words ‘intangible asset’ are not defined for the purposes of para 29(5) and must therefore be given their ordinary meaning. Intangible assets include goodwill, debts, patents, copyrights, trade marks, designs and mineral rights.

Partial interests in assets

A person owning a fractional interest in an asset must take the value of that interest and not the full value of the asset into account in determining whether the R1 million and R10 million limits have been exceeded. For example, if A owns one-third and B two-thirds of land with a market value of R18 million, A does not need to comply with para 29(5), since the value of A’s interest is R6 million. However, B will have to submit a valuation form with the first return lodged after 30 September 2004, since the value of B’s interest is R12 million.

Assets denominated in foreign currency

For the purpose of deciding whether the applicable R1 million and R10 million limits have been exceeded, it will be acceptable if the market value is translated into rand at the ruling exchange rate on valuation date. The valuation form should be completed in the currency of expenditure and this fact should be indicated on the form. When the asset is disposed of, the appropriate exchange rate under para 43(6) should be used in the return of income reflecting the disposal.

Non-residents

A non-resident who is not required to submit a tax return because of an absence of South African-source income, and who holds South African immovable property will be required to submit a return (and the CGT 2L form) only when the property is disposed of, and provided that the capital gain or loss exceeds the threshold set by the Commissioner in the annual notice to furnish returns.

Residents falling below the tax threshold

In a few instances a resident who holds high-value assets may not have to submit a return. This situation could arise if the resident’s income is below the threshold set by the Commissioner. In such event the valuation form must be lodged when the person has to lodge a return. That could occur when the person’s income exceeds the submission threshold or when the asset is disposed of.

⁴¹¹ With listed shares, each share is a separate asset. It is therefore very unlikely that para 29(5)(a) will apply to listed shares.

Adopt v determine

The earlier submission of the prescribed valuation form for these high-value assets will not necessarily bind a person to using market value as a method in the year of disposal of an asset. In other words, in the historical gain situation of para 26, the time-apportionment and '20% of proceeds' methods remain alternatives for determining the valuation date value of an asset. However, by completing the form the person will have 'determined' a market value for the purposes of the kink tests in paras 26 and 27. More specifically, under para 27 a person's freedom to choose time-apportionment may be precluded when an historical loss has been incurred. For example, if the asset cost R100m in 1980, had a market value of R50m on valuation date, and was sold for R70m in 2018, the valuation date value of the asset under para 27 would be R70m (proceeds less post-CGT expenditure). The person would therefore not be permitted to use the time-apportionment base cost method to generate a capital loss.

Example – Submission date for valuation of high-value assets*Facts:*

Andrew owns 10 shares in Enne (Pty) Ltd, a company with a 31 August financial year-end. His accountant carried out a valuation of his shares on 31 August 2003 and valued them at R1,5 million each as at 1 October 2001. The accountant's valuation of the assets in the company was as follows:

	R
Fixtures and fittings	10 000 000
Goodwill	2 500 000
Trade marks	1 700 000
Liquor licence	800 000

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

Enne (Pty) Ltd submitted its return for the year ending 31 August 2003 on 31 August 2004 and obtained an extension to submit its 2004 return by 31 August 2005.

Andrew submitted his return for the year ending 29 February 2004 on 28 February 2005.

Result:

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

Asset	Reason	Proof to be submitted with return for year ending:
Shares in Enne (Pty) Ltd	MV > R10 million	28 February 2004
Intangible assets		
• Goodwill	MV > R1 million	31 August 2004
• Trademark	MV > R1 million	31 August 2004

8.33.10 Submission of proof of valuation upon disposal [para 29(6)]

8.33.10.1 The general rule

As noted above, para 29(5) contains early valuation form submission requirements in respect of three categories of high-value assets. Paragraph 29(6) contains the submission requirements for the following categories of assets:

- High-value assets referred to in para 29(5) that have been disposed of before the submission date provided for in para 29(5). For example, an individual sold all his shares in a private company in January 2003. The shares were valued at R11 million on 1 October 2001. The individual must have submitted the valuation form with the 2003 return of income.
- Any other asset that has been disposed of and has been valued.

Paragraph 29(6) requires that a person with assets falling in the above categories⁴¹²

‘must retain proof of that valuation’.

The above amended wording was introduced in consequence of the e-filing system under which taxpayers are not required to lodge supporting documents with their electronically filed returns unless called upon by SARS to do so.

Before 20 January 2015 para 29(6) provided that the person

‘must submit proof of that valuation in a form prescribed by the Commissioner with the return for the year of assessment during which that asset was disposed of’.

Before 13 December 2002 para 29(6) did not stipulate in what form the proof of valuation had to be submitted. This shortcoming was rectified retrospectively to 1 October 2001 by the Revenue Laws Amendment Act 74 of 2002. If a person disposed of an asset and submitted the actual valuation report instead of the prescribed form with a return of income before 13 December 2002, SARS will accept that para 29(6) has been complied with.

Three forms have been prescribed by the Commissioner since 1 October 2001. The first form was entitled ‘Annexure’ and was released before 1 October 2001. This was replaced by the CGT 2(e) [English] or CGT 2(a) [Afrikaans] form. The only difference between Annexure and CGT 2(e) or (a) was the number, which was inserted for ease of identification. Either of these forms will be acceptable to SARS if completed and signed by 30 September 2004. Persons who had completed and signed the Annexure form are not expected to have transcribed the information onto the CGT 2(e) or (a) form.

⁴¹² The wording was amended by s 13(b) of the Tax Administration Laws Amendment Act 44 of 2014 and came into operation on 20 January 2015, the date of promulgation of that Act.

The meaning of the phrase ‘in the form prescribed by’ was considered in the United Kingdom case of *Osborne (deceased) v Dickinson (Inspector of Taxes)*.⁴¹³ In that case a taxpayer had completed certain capital gains tax pages, but had not completed the required return. The Special Commissioners held that the taxpayer had not submitted the information in the form prescribed.

The intention was that persons should complete and sign either Annexure or CGT 2(e) or (a) before 30 September 2004. There has been some uncertainty whether these forms must have been signed by the taxpayer on or before 30 September 2004. Paragraph 29(4) requires that the person must have valued the asset within the prescribed period, but does not state that the prescribed form must be used for this purpose. In the light of this uncertainty the CGT 2L form was introduced. A person who failed to complete and sign the Annexure or CGT 2(e) or (a) form on or before 30 September 2004 in respect of a valuation done by that date must complete the CGT 2L form. The person must declare that the valuation was performed by 30 September 2004 and that any third party valuation was accepted by that date.

The completion of the prescribed form does not mean that a person has elected in advance to adopt the market-value method, although the person will be regarded as having ‘determined’ a market value for the purposes of para 27.

Taxpayers who backdate or inflate valuations expose themselves to the imposition of an understatement penalty under s 222 of the Tax Administration Act, interest under s 89 *quat* and criminal prosecution. SARS reserves the right to call for valuations before the disposal of the relevant assets.

8.33.10.2 Valuer’s signature

The use of a valuer is optional and the lack of a valuer’s signature on the CGT 2(e) form will not invalidate the valuation. It will be acceptable if a person cross-references the CGT 2(e) form to a signed valuation report.

The CGT 2L form makes provision for the insertion of the date of the valuer’s report.

The credibility of a valuation will be brought into question if the valuer refuses to sign either the CGT 2(e) form or the valuation report.

The CGT 2(e) form will also not be invalidated if a person has not inserted details of the original cost of the asset by the deadline date.

8.33.10.3 Self-generated forms

Some persons have produced their own forms and captured the information electronically. Such self-generated forms will also be regarded as being in the prescribed form provided that they contain the same details as the CGT 2 form.

When numerous assets have been valued, it will be acceptable if a single covering form is signed. The total of the market value of the relevant assets must be inserted on the form and this must agree to a schedule containing the details on the CGT 2 form. The assets on the schedule should be described in sufficient detail to allow for correct identification when individual assets on the list are disposed of.

8.33.10.4 Assets denominated in foreign currency

The valuation of an asset denominated in a foreign currency must be done in the currency of expenditure under para 43(6) and translated to the local currency by applying the spot rate on valuation date. The term ‘local currency’ is defined in para 43(7) (see **19.2.2**).

⁴¹³ SpC 393, [2004] STC (SCD) 104.

The relevant foreign currency values must accordingly be reflected on the form.

8.33.10.5 Identical assets

Only one CGT 2 form need be completed for a particular group of identical assets such as unlisted shares or foreign listed shares. Thus, if a person owned 100 shares in ABC (Pty) Ltd on valuation date, that person need complete only one form and not 100 forms.

8.33.10.6 CFCs and valuations

Under s 9D(2A) a CFC is treated as a resident for the purposes of para 2(1)(a). It follows that it must have complied with para 29 should it wish to adopt the market-value method for determining the base cost of its pre-valuation date assets. Any valuation would have had to have been completed by 30 September 2004 if it was a CFC on 1 October 2001.

A company that becomes a CFC after 1 October 2001 is deemed to have acquired all its assets at market value under para 12(2)(a) on the day before it becomes a CFC. Such a CFC falls within para 24 and is not subject to a time limit for determining a valuation. On the interaction between s 9D(2A)(e) and para 12(2)(a), see **23.7.8**.

A CFC will be required to submit proof of the valuation in the form prescribed under para 29(5) or (6) only when it is obliged to submit a return of income. Such an obligation could occur, for example, when it has a branch in South Africa or disposes of immovable property in South Africa). But if it is not required to submit a return, the submission requirements in para 29(5) or (6) will not apply to it.

Although s 72A requires a resident shareholder of a CFC to submit a return, there is no requirement that the resident lodge the prescribed valuation form as a prerequisite to the CFC being permitted to adopt the market-value method for determining the base cost of its assets.

8.33.11 The impact of para 29 on the determination of STC on liquidation or deregistration of a company

For the commentary on this topic, see issue 7 of this guide. It is relevant only to distributions before 1 January 2011 because s 64B(5)(c) was deleted with effect from 1 January 2011.

8.33.12 Right of Commissioner to amend valuation or call for further particulars [para 29(7)]

If not satisfied with a valuation, the Commissioner may

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

The right to adjust the valuation has been made subject to objection and appeal.⁴¹⁴ On the subject of erroneous valuations, see the articles cited in the footnote below.⁴¹⁵

In *C: SARS v Stepney Investments (Pty) Ltd*⁴¹⁶ the taxpayer company had disposed of a 4,37% interest in a company in two tranches during the 2002 and 2003 years of assessment. The taxpayer had used the market-value method to determine the valuation date value of the shares. Since the proceeds on disposal of the shares were less than the market value

⁴¹⁴ Section 3(4)(h).

⁴¹⁵ Charles Hattingh 'Deceit, Carelessness or Ignorance?' (November/December 2003) *Accountancy SA* 26 and Charles Hattingh 'The Valuation Volcano is about to Erupt' (January 2005) *Accountancy SA* 38.

⁴¹⁶ 2016 (2) SA 608 (SCA), 78 SATC 86.

established by the taxpayer, a capital loss had arisen which was eliminated by para 26(3). All shares in the company had been valued by the taxpayer using the 'discounted cash flow' basis with the market value of its holding being determined by multiplying the total value by the percentage holding. The Commissioner adjusted the market value of the shares disposed of under para 29(7)(b) to nil. The memorandum of incorporation of the company in which the shares were held described its main object as developing, owning, operating and conducting the business of casinos, hotels and related leisure ancillary activities. The company was awarded a casino licence on 21 October 2000 by the KZN Gambling Board which gave it an exclusive right to operate a casino for 15 years in the Richards Bay area. After the licence was awarded, a religious group objected to the proposed location of the casino and the company obtained an alternative temporary venue in Empangeni for which it was granted a temporary licence on 4 October 2001. The objection brought by the religious group did not succeed after valuation date. The Commissioner valued the shares on the net asset value basis, arguing that the shares had a value of nil. The Commissioner's valuation took into account the various uncertainties that existed on valuation date. Having lost in the tax court the Commissioner took the matter on appeal to the SCA. In the SCA the Commissioner conceded that the net asset value method was inappropriate but challenged the taxpayer's valuation as being defective on a number of grounds. It then fell to the SCA to evaluate the conflicting opinions of the experts called by SARS and the taxpayer. On the question of relying on the evidence of experts the court cited the following *dictum* of Wessels JA in *Coopers (SA) (Pty) Ltd v Deutsche Gesellschaft Für Schädlingsbekämpfung MBH*:⁴¹⁷

'As I see it, an expert's opinion represents his reasoned conclusion based on certain facts [or] on data, which are either common cause, or established by his own evidence or that of some other competent witness. Except possibly where it is not controverted, an expert's bald statement of his opinion is not of any real assistance. Proper evaluation of the opinion can only be undertaken if the process of reasoning which led to the conclusion, including the premises from which the reasoning proceeds, are disclosed by the expert.'

The court also cited Addleson J in *Menday v Protea Assurance Co Ltd* thus:⁴¹⁸

'It is not the mere opinion of the witness which is decisive but his ability to satisfy the Court that, because of his special skill, training or experience, the reasons for the opinion which he expresses are acceptable . . . the Court, while exercising due caution, must be guided by the views of an expert when it is satisfied of his qualification to speak with authority and with the reasons given for his opinion.'

Next, the court proceeded to examine the various assumptions underpinning the valuation.

- The future forecast free cash flows – The valuation was performed in 2004 but the taxpayer had relied on estimates submitted to the Gambling Board around 2001 despite being aware that the earlier estimates were substantially overstated. The valuer also disregarded a letter dated 20 March 2003 submitted to the Gambling Board which painted a bleak picture of the company's profitability. The court rejected the taxpayer's argument that to take into account subsequent events would have amounted to valuing the shares with hindsight. It noted that a valuer cannot just blindly accept figures presented to him or her and has a duty to assess their reasonableness and correctness. The valuer was duty bound to evaluate the soundness of management's projections and it was wrong not to take the later information into account.
- Starting date for valuation – The valuer used 1 March 2002 instead of 1 October 2001 which had an adverse impact on the valuation.
- Tax estimates – Incorrect figures had been used by the valuer.

⁴¹⁷ 1976 (3) SA 352 (A) at 371 F–H.

⁴¹⁸ 1976 (1) SA 565 (E) at 569B–E.

- Projected capital expenditure – The projected capital expenditure was significantly understated.
- Terminal value – The terminal value had been based on discounting into perpetuity while the licence had a lifespan of 15 years. The risk of non-renewal or the costs of submitting a renewal application should have been taken into account.
- Discount factor – The discount rate used of 20,86% was used in valuing all the entities in the group and did not take into account the specific circumstances of the casino in question which was a start-up and not an established business.

In the result the court found that the valuation was fatally flawed in respect of the matters listed above. It noted that a court is entitled to reject a valuation if it is not satisfied with the investigations underpinning it and cited the following words of Denning LJ in *Dean v Prince*:⁴¹⁹

‘For instance, if the expert added up his figures wrongly, or took something into account which he ought not to have taken into account, or conversely, or interpreted the agreement wrongly, or proceeded on some erroneous principle – in all these cases, the court will interfere.’

The court upheld SARS’s appeal and referred the matter back to SARS for further investigation and assessment.

In Tax Board Case 0110⁴²⁰ the appellant had disposed of a residence for proceeds of R3,2 million in 2003. The valuation date value of the residence had been determined at R4 million on the market-value basis by a professional valuer using the comparable sales method in which three comparable sales were selected. The valuation of R4 million was actually done for mortgage bond purposes at the instance of a bank and therefore carried out conservatively. A larger property was sold in the same road by public auction for only R2,3 million a month after valuation date but was in poor condition and disposed of under a forced sale. It was therefore not accepted by the chairman as a comparable property for valuation purposes. The chairman noted that 4 non-expert criticism to be accepted as evidence above the testimony of experts is not easy. In summing up the evidence he noted that

‘[w]e are left with a valuation done by an [impartial valuator with many years’ experience who valued the property conservatively. No evidence was produced to counter either his valuation or his methodology. The evidence produced by cross-examination, which was the only actual evidence adduced by the respondent, did not assist the respondent in any way’.

In the result the chairman found in favour of the appellant.

In *C: SARS v Executors Estate Late Sidney Ellerine*⁴²¹ the court had to consider the valuation of preference shares held by the deceased on the date of death under para 40(1).⁴²²

The deceased held 112 000 7% redeemable non-cumulative preference shares of R1 each on date of death in Sidney Ellerine Trust (Pty) Ltd. The company’s share capital also included 600 ordinary shares held by a number of trusts. Each of the preference and ordinary shares carried one vote with the result that the deceased held 99,5% of the voting rights in the company (112 000 / 112 600 × 100).

In the deceased’s return of income up to date of death the proceeds on the deemed disposal of the shares were shown as R112 000, being their par value, which was the same as their redemption value. By contrast, SARS had assessed the deceased on proceeds of R563 million on the basis that the deceased could have converted the preference shares to

⁴¹⁹ *Dean v Prince* 1954 (1) All ER 749 at 758.

⁴²⁰ Case 0110, Durban Tax Board, 23 August 2007, unreported.

⁴²¹ 2019 (1) SA 111 (SCA), 80 SATC 389.

⁴²² Paragraph 40(1) provided for a deemed disposal of the deceased’s assets at market value on the date of death. For persons dying on or after 1 March 2016 this deemed disposal is now in s 9H.

ordinary shares. The preference shares should therefore have been valued as if they were ordinary shares. The issue before the court was whether the right to convert the preference shares to ordinary shares should be taken into account when valuing the preference shares. The crux of the matter was whether the consent of the ordinary shareholders was required before the preference shares could be converted to ordinary shares. The articles of association of the company provided that any variation in the rights of shares of a particular class required the consent of 75% of the shareholders in that class. The respondent argued that the conversion of the preference shares to ordinary shares would result in the variation of the rights in the ordinary shares because it would result in a drastic decrease in their value, and hence the consent of 75% of the ordinary shareholders would have been required. The court noted that English law supported the view that a variation of rights occurs when the rights which attach to shares are varied and not when they become commercially less valuable. The court cited various authorities which confirmed that this principle applied equally in South Africa. In the result the court held that the deceased could have converted the preference shares to ordinary shares without the consent of the ordinary shareholders. The appeal was accordingly upheld, with the court finding that the shares should have been valued at R563 million.

8.33.13 Period for performing valuations may be extended by Minister [old para 29(8)]

Before its amendment by s 47(1)(b) of the Revenue Laws Amendment Act 20 of 2006, para 29(8) provided the Minister of Finance with the power to extend the then two-year period within which valuations had to be performed (that is, by 30 September 2003) by notice in the *Government Gazette*. The period was extended to 30 September 2004.⁴²³ That date has now been entrenched in para 29(4)(a)(i) and the Minister's power to extend the period has been removed.

8.33.14 Non-applicability of certain provisions to persons with a valuation date after 1 October 2001 [para 29(8)]

The provisions set out in the table below do not apply to a person whose valuation date is after 1 October 2001 (as with PBOs and recreational clubs).

Table 1 – Provisions of para 29 that do not apply to persons with a valuation date after 1 October 2001

Paragraph 29	Description
(1)(a)	Prices of financial instruments listed on a recognised exchange in South Africa that were published in the <i>Gazette</i> . These prices were determined using the volume-weighted average price during the five business days before 1 October 2001.
(1)(b)(i)	Prices of units in South African equity or property unit trusts whose prices were published in the <i>Gazette</i> . These prices were based on the average price that a unit could be sold to the management company during the five trading days before 1 October 2001.
(2)	Determination of the market value of a controlling interest in a listed company.
(2A)	Listed financial instruments that <ul style="list-style-type: none"> • were not traded during the five business days preceding 1 October 2001, • were suspended during September 2001, or

⁴²³ GN 207 GG 26026 of 20 February 2004.

Paragraph 29	Description
	<ul style="list-style-type: none"> when the market value exceeds the average of the ruling price during the first 14 days of September 2001 by 5% or more.
(3)	Definition of 'controlling interest'.
(5)	Early submission requirements for certain high-value assets.
(6)(a)	Disposal of high-value assets before submission of proof with first return after 30 September 2004.

8.33.15 Pre-valuation date depreciable assets and the market-value method

A capital gain on a depreciable asset will arise only when the asset is disposed of for proceeds that exceed its original cost. In theory depreciable assets should not yield a capital gain because they deteriorate with use and as a result the proceeds on their disposal should be less than the original cost. Likewise, their disposal should not give rise to a capital loss because any loss on disposal would normally be accounted for as an allowance under s 11(o). A person may, however, not always qualify for an ordinary loss under s 11(o). Such a situation could happen, for example, with an asset that was not 'scrapped' under s 11(o) before its amendment on 22 December 2003, or with an asset disposed of on or after that date when that asset has a write-off period for tax purposes of 10 years or more.

For the purpose of determining the valuation date value of no gain or loss depreciable assets, time-apportionment is likely to be the method of choice for most persons. Time-apportionment will usually be an option because apart from certain s 11(e) assets, the cost of the asset has to be known to qualify for the capital allowances.

Depreciable assets are, however, sometimes sold above cost. This situation may apply to imported assets whose replacement cost has increased because of the depreciation in the value of the rand. It may also apply to certain buildings qualifying for capital allowances. The use of market value as the valuation date value of such assets then becomes worth considering for these 'gain' assets. No capital gain or loss should arise with an asset sold below original cost, since the proceeds and the expenditure should be reduced to nil by any recoupments under para 35(3)(a) or capital allowances under para 20(3)(a).

Under para 35(3)(a) a person who adopts the market-value method must reduce any consideration received on disposal of the asset by any recoupment of capital allowances. However, the market value cannot be reduced under para 20(3)(a) by the capital allowances claimed, since that provision applies only to expenditure. Market value is not expenditure, but rather a 'valuation date value' under para 26 or 27. In the absence of any reduction to account for the capital allowances claimed, an artificial capital loss will invariably result. However, this should be limited to nil by the kink tests in paras 26 and 27.

Example – Depreciable assets in respect of which market value has been adopted as the valuation date value

Facts:

A machine cost R100 five years before valuation date and was fully written off for normal tax purposes by 1 October 2001. The market value of the asset was R100 on valuation date and it was disposed of for a consideration of R120. Determine the capital gain or loss using market value as the valuation date value.

Result:

Proceeds = R120 – R100 (recoupment) = R20
 Expenditure = R100 – R100 (capital allowances) = R0

Market value = R100

Before applying para 26 a capital loss of $R20 - R100 = -R80$ would have resulted. However, para 26(3) applies to limit the valuation date value to the proceeds of R20, thus resulting in neither a capital gain nor a capital loss.

8.34 Time-apportionment base cost

Paragraph 30

8.34.1 Introduction

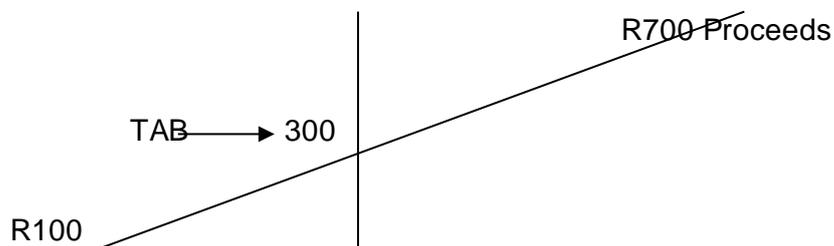
The time-apportionment base cost method is one of four methods that may be used for determining the valuation date values of assets acquired before valuation date, the other three being the market-value method (paras 29 and 31), the weighted-average method [para 32(3A)] and the '20% of proceeds' method (para 26). Under the time-apportionment method the growth or decline that occurred before 1 October 2001 is added to or subtracted from the pre-CGT expenditure to arrive at the time-apportionment base cost, which constitutes the valuation date value (VDV). The expenditure incurred after the valuation date is added to the time-apportionment base cost to arrive at the base cost under para 25.

The time-apportionment base cost method involves two types of apportionment, namely,

- time apportionment (applicable in all circumstances), and
- expenditure apportionment (applicable when expenditure is incurred on or after valuation date).

Time apportionment

Time-apportionment involves a linear spread of the historical gain or loss between the pre- and post-CGT periods. The basic principle is illustrated in the simple example below.

Example 1 – Time-apportionment Base Cost (TAB)

Date of acquisition 10 years 20 years

In the above example the asset has been sold for a profit based on historical cost of R600 (R700 – R100). The period before 1 October 2001 is 10 years and the period after 20 years. It follows that two-thirds of the profit relates to the post-CGT period, that is, $R600 \times 2 / 3 = R400$. This method is a shortcut way of determining the gain. The other way is to determine the valuation date value and to subtract this from the proceeds. The valuation date value is determined by adding the gain relating to the pre-CGT period to the original cost, that is, $R100 + (R600 \times 1 / 3) = R300$. The capital gain is then determined as follows:

	R
Proceeds	700
Less: Base cost (VDV)	<u>(300)</u>
Capital gain	<u>400</u>

Expenditure apportionment

As illustrated above, the time-apportionment method involves apportionment of the overall gain or loss based on time. However, the method also involves apportionment of the overall gain or loss by expenditure when expenditure is incurred on or after the valuation date. This result is illustrated in the simple example below. In order to keep things simple, the period before and after valuation date has been made the same.

Example 2 – Time and expenditure apportionment*Facts:*

An asset was acquired at a cost of R100 ten years before valuation date and disposed of ten years after valuation date for R900. A further amount of R200 was spent in improving the asset during 2008.

Result:

There is an overall gain of R600 (proceeds of R900 less expenditure of R300). The time-apportionment base cost method assumes that this gain was produced by both the pre- and post-valuation date expenditure on a proportional basis. Pre-CGT expenditure produces gain or loss both before and after valuation date, while post-valuation date expenditure can produce gain or loss only after the valuation date. Since R200 of the total expenditure of R300 was incurred on or after valuation date, $2 / 3$ of the overall gain of R600 will be subject to CGT ($2 / 3 \times R600 = R400$).

One-third of the overall gain was produced by the pre-valuation date expenditure ($R600 \times 1 / 3 = R200$). This gain was derived over the pre- and post-CGT periods and must be time-apportioned. In other words, $R200 \times 10 / 20$ years = R100.

The total capital gain is therefore made up as follows:

	R
Gain produced by post-CGT expenditure	400
Time-apportioned gain produced by pre-CGT expenditure	<u>100</u>
Capital gain	<u>500</u>

The method for arriving at this capital gain under para 30 is different to that adopted in this example in that it involves the determination of the time-apportionment base cost through the use of two formulae, but the result is the same. The example illustrates the principle that the higher the post-CGT expenditure, the greater the proportion of the overall gain or loss that will comprise a capital gain or loss.

8.34.2 Theoretical correctness v simplicity

It needs to be emphasised that the formulae used for determining the time-apportionment base cost reflect a trade-off between theoretical correctness and administrative simplicity. In many ways the time-apportionment method is a departure from reality that lacks theoretical correctness and this can lead to some distorted results, some in favour of the *fiscus* and others in favour of the taxpayer. The reasons for this departure from reality include the following:

- The formulae do not take account of the time value of money and compound growth.
- A part of a year is treated as a full year. One day could be treated as a year.
- Improvements to an asset incurred before valuation date are assumed to have taken place at the date of acquisition of the asset
- The date of acquisition is limited to a period 20 years before valuation date when expenditure is incurred in more than one year of assessment before valuation date.

Earlier drafts of the legislation and the first guide dated 23 February 2000 attempted to address some of these issues by separating the original cost and improvements into segments and applying an inflation factor to each segment. This proposal was discarded after public consultation for reasons of complexity.

Time-apportionment can be determined only once an asset has been disposed of. The longer the asset is held the greater the proportion of the gain or loss that will be spread into the post-CGT period. Similarly, the more improvements that take place to an asset after valuation date, the greater the proportion of the proceeds and hence gain that will be allocated to the post-CGT period. These factors can make it difficult to predict how time-apportionment will compare with the market value of an asset on 1 October 2001.

A taxpayer who has made a loss based on historical cost may either be prevented from adopting time-apportionment or may be obliged to use it depending on the circumstances. For example, a person falling within para 27(3)(a) who has made a loss based on cost but a gain based on market value after 1 October 2001, may not use time-apportionment but at the same time will not be subject to CGT on the market value gain. In other situations, para 27(3)(b) will compel a taxpayer to use time-apportionment instead of market value. This situation could typically occur when a market value loss is substantially greater than a time-apportioned loss. For more information on the operation of the gain and loss limitation rules see **8.28** and **8.30**.

8.34.3 The formulae

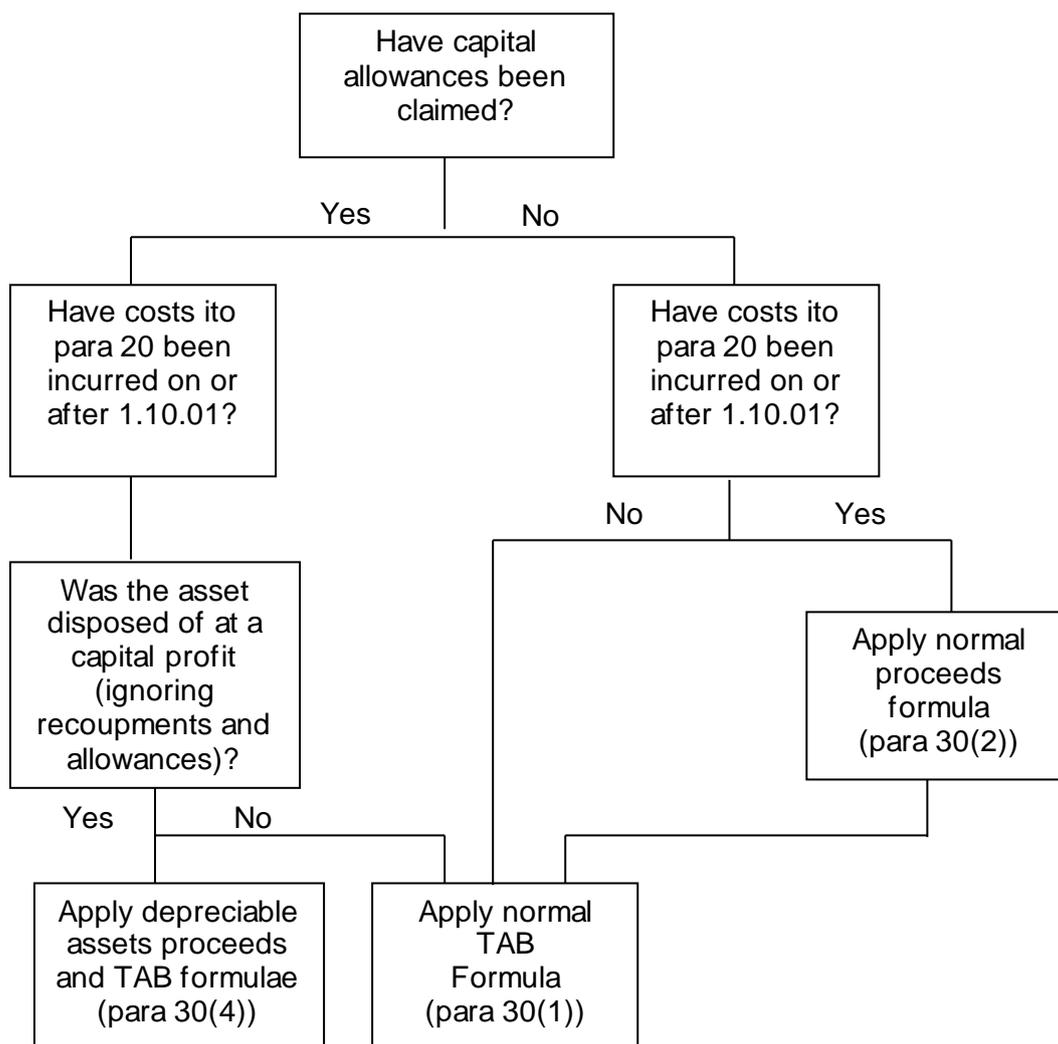
Paragraph 30 contains two sets of formulae, namely,

- the standard time-apportionment and proceeds formulae – para 30(1) and (2), and

- the depreciable assets time-apportionment and proceeds formulae – para 30(3) and (4).

The diagram below shows how the applicable formulae must be selected to fit the appropriate circumstances.

Selecting the appropriate formula



8.34.4 The standard time-apportionment formula [para 30(1)]

$$Y = \frac{B + [(P - B) \times N]}{T + N},$$

in which

'Y' = Time-apportionment base cost

'B' = The amount of expenditure incurred before the valuation date in respect of the asset that is allowable before, on or after the valuation date under para 20. Pre-CGT expenditure must be reduced by capital allowances allowable as a deduction for income tax purposes in respect of that expenditure up to the date of disposal (para 20(3)(a) – see **8.34.4.1**).

'P' = Proceeds on disposal of the asset as determined in para 35.

Note:

- The amount received or accrued on disposal of assets subject to capital allowances must be reduced by any recoupments included in gross income [para 35(3)(a)].
- 'P' must be determined in accordance with the proceeds formula in para 30(2) (see **8.34.5**) when allowable para 20 expenditure is incurred on or after the valuation date.
- 'P' must be reduced by selling expenses contemplated in para 30(5)(c) when the proceeds formula does not apply (see para 30(5)(a)(ii) and **8.34.10**).⁴²⁴

'N' = Number of years determined from the date that the asset was acquired to the day before valuation date.

Note:

- 'N' is limited to a maximum of 20 when expenditure has been incurred in more than one year of assessment before valuation date (see **8.34.4.2**).
- A part of a year is treated as a full year (see **8.34.4.3**).

'T' = Number of years determined from valuation date until the date the asset was disposed of after valuation date. Again, a part of a year is treated as a full year.

8.34.4.1 Determining 'B' for depreciable assets not falling into para 30(3) and (4)

In determining pre-valuation date expenditure in respect of a depreciable asset, para 20(3)(a) must be applied so as to take into account all capital allowances up to the date of disposal, and not merely those allowable up to valuation date.⁴²⁵

Example – Determination of 'B' in the case of depreciable assets falling under para 30(1)

Facts:

Tony acquired an asset on 1 October 1998 at a cost of R100 000 and claimed capital allowances under s 11(e) at the rate of 10% a year on a straight line basis. On 30 September 2005 he sold the asset for R120 000. As at 1 October 2001 he had claimed capital allowances of R30 000 and by the date of sale he had claimed a further R40 000, making a total claim of R70 000.

Result:

'B' in the time-apportionment formula is determined as follows:

	R
Cost of acquisition [para 20(1)(a)]	100 000
Less: Capital allowances R10 000 × 7 [para 20(3)(a)] (1 October 1998 – 30 September 2005)	(70 000)
Allowable expenditure under para 20 ('B')	<u>30 000</u>

All capital allowances up to date of disposal are taken into account and not only those allowable up to valuation date.

⁴²⁴ Applicable to disposals during years of assessment ending on or after 8 November 2005. Before that date selling expenses triggered the proceeds formula, since they were treated as post-CGT expenditure rather than as a reduction of proceeds.

⁴²⁵ Clarified by the amendment of para 30(1)(b) by s 70(1)(a) of the Revenue Laws Amendment Act 31 of 2005.

The proceeds are determined as follows:

	R
Consideration received or accrued	120 000
Less: Recoupment [para 35(3)(a)]	<u>(70 000)</u>
Proceeds	<u>50 000</u>

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R30\,000 + [(R50\,000 - R30\,000) \times 3 / (3 + 4)] \\
 &= R30\,000 + [R20\,000 \times 3 / 7] \\
 &= R30\,000 + 8\,571 = R38\,571
 \end{aligned}$$

$$\begin{aligned}
 \text{Capital gain} &= \text{Proceeds} - \text{Time-apportionment base cost} - A \\
 &= R50\,000 - R38\,571 - R0 \\
 &= R11\,429
 \end{aligned}$$

8.34.4.2 The twenty-year limit

The number of years before valuation date ('N') is limited to 20 when expenditure has been incurred in more than one year of assessment before the valuation date.

Improvements to an asset before valuation date are 'thrown back' to the date of acquisition. This measure was introduced in preference to the slice method explained earlier under which improvements would have been inflation-weighted. As a result of this concession, it was necessary to place a cap on how far back these improvements could be taken. If this were not done, one could arrive at the situation in which, say, a piece of land was acquired 100 years before valuation date, a shopping centre was erected on it shortly before valuation date, and then sold say five years after valuation date at a substantial gain. Without the 20-year limit only 5/105 of the gain would be subject to CGT. With the limit 5/25 will be taxable – still a substantial benefit though not nearly as generous. There is no limit when all pre-valuation date expenditure is incurred in a single year. So, if the 100-year-old land were sold five years after CGT was introduced without improvement, only 5/105 of the gain would attract CGT. The 20-year limit will also not be triggered when improvements take place after valuation date, though in such event the proceeds formula in para 30(2) will be triggered (see below) and will result in a greater proportion of the overall gain or loss becoming a capital gain or loss.

8.34.4.3 Parts of a year

As noted above, parts of a year are treated as a full year. For example, if an asset was acquired three years and one day before valuation date, 'N' will be treated as four years. Likewise, if the asset was disposed of three years and one day after valuation date, 'T' will be treated as four years. This treatment is intended to eliminate the need for complex fractions, and assists when the exact day on which an asset was purchased is unknown (that is, only the month and year of acquisition or disposal need be known).

In determining whether expenditure has been incurred in more than one year for the purpose of limiting 'N' to 20, regard must be had to *years of assessment*. However, in determining the number of years before and after valuation date (N and T in the formula) the years are determined as follows:

- Pre-1 October 2001 – begin at date of acquisition and count completed years up to and including 30 September 2001. The final part year up to and including 30 September 2001 is counted as a full year;
- Post-1 October 2001 – begin at 1 October 2001 and count number of completed years ended 30 September up to and including the date of disposal. The final part year immediately preceding the date of disposal is counted as a full year.

Example – Determination of ‘N’ and ‘T’

The following examples illustrate the determination of ‘N’ and ‘T’:

<i>Date of acquisition</i>	‘N’
1 October 1981	20
30 September 1981	21
30 June 1999	3
30 September 2000	2
30 September 2001	1
<i>Date of disposal</i>	‘T’
1 October 2001	1
30 June 2002	1
30 September 2002	1
1 October 2002	2
30 June 2003	2

8.34.5 The standard proceeds formula [para 30(2)]

The symbol ‘P’ in the formula $Y = B + [(P - B) \times N / (N + T)]$ must be determined in accordance with the proceeds formula set out below when expenditure is incurred both before and on or after the valuation date. This formula was amended with effect from years of assessment ending on or after 8 November 2005. Under the amendment, ‘R’ and ‘A’ must be reduced by selling expenses contemplated in para 30(5) (see **8.34.10**).

$$P = R \times \frac{B}{(A + B)},$$

in which

‘P’ = Proceeds to be used in the time-apportionment formula.

‘R’ = Proceeds as determined under para 35, less any selling expenses contemplated in para 20(1)(c)(i) to (iv) [see para 30(5)(a)(i)]. In arriving at proceeds under para 35, the amount received or accrued in respect of the disposal of the asset must be reduced by any recoupments (for example, of capital allowances) under para 35(3)(a).

‘A’ = Expenditure allowable under para 20 incurred on or after the valuation date, excluding any selling expenses referred to in para 20(1)(c)(i) to (iv) [see para 30(5)(b)].

‘B’ = The amount of expenditure incurred before the valuation date in respect of the asset that is allowable before, on or after the valuation date under para 20.

Note: For depreciable assets not falling into para 30(3) and (4) the allowable expenditure under para 20 (‘A’ and ‘B’) is arrived at by reducing the relevant pre- or post-valuation date expenditure by any applicable capital allowances under para 20(3)(a). In determining ‘B’ all capital allowances allowable up to the date of disposal in respect of the pre-valuation date expenditure must be taken into account and not merely those allowable up to valuation date (see **8.34.4.1**).⁴²⁶

⁴²⁶ Clarified by the amendment of para 30(2)(d) by s 70(1)(b) of the Revenue Laws Amendment Act 31 of 2005.

The proceeds formula is based on the premise that

- post-valuation date expenditure generates post-valuation date gain or loss, and
- pre-valuation date expenditure generates gain or loss both before and on or after valuation date.

For assets in which

- the expenditure before the valuation date is nil, and
- allowable para 20 expenditure has been incurred on or after the valuation date [excluding selling expenses – see para 30(5)].

the entire gain or loss will comprise a capital gain or loss as a result of the proceeds formula. An example is capitalisation shares [particularly those disposed of during years of assessment ending before 8 November 2005 and the introduction of para 30(5)]. When a capital gain results under these circumstances, one of the other valuation methods (market value, '20% of proceeds' or weighted average) should be considered as an alternative to time-apportionment.

Assets acquired by donation, inheritance or as a distribution *in specie* before the valuation date may well have a base cost as a result of the extinction of the personal rights preceding the acquisition of such assets – see **8.5A**.

8.34.5.1 No right of election to omit post-valuation date expenditure

The proceeds formula has the effect that the higher the post-valuation date expenditure in relation to the pre-valuation date expenditure, the higher the capital gain or loss. Some have suggested that a person can achieve a lower capital gain by simply omitting the post-valuation date expenditure from the formula. The view is held that a person does not have the right to omit post-valuation date expenditure from the proceeds formula in para 30(2), nor from the general formula in para 25 for determining a capital gain or loss in respect of a pre-valuation date asset. The reasons for this are as follows:

- The formulae and their variables are prescribed by statute. There is nothing in the Act that confers a right of election upon a taxpayer to pick and choose what to include or exclude from the variables. It would defeat the purpose of the legislature if SARS were to allow cherry picking.
- The variable 'A' in the formula refers to expenditure 'allowable' under para 20 incurred on or after the valuation date. The word 'allowable' refers to qualifying expenditure. If expenditure has been incurred and it qualifies then it must be brought to account.
- Taxpayers are obliged to keep a record of post-valuation date expenditure under s 29 of the Tax Administration Act. Under s 234(e) of that Act a person who wilfully and without just cause fails or neglects to retain records as required under the Act is guilty of an offence and, upon conviction, is subject to a fine or to imprisonment for a period not exceeding two years.
- Finally, a taxpayer who deliberately omits post-valuation date expenditure from the formulae with the object of understating a capital gain will be open to the imposition of an understatement penalty under s 222 of the Tax Administration Act and interest under s 89*quat*. A person who has lost records of post-valuation date expenditure may agree in writing with a senior SARS official under s 95(3) of the Tax Administration Act on the amount to be taken into account. The assessment so agreed upon is not subject to objection and appeal.

8.34.5.2 Payment of commission by buyer

Before the introduction of para 30(5) which treats selling expenses as a reduction of proceeds, it was suggested by some tax practitioners that with a sale of immovable property, the transaction should be restructured so that the buyer pays the estate agent's commission. Such arrangements may fall foul of s 103 (as it then read) when they are carried out solely or mainly for the purposes of avoiding CGT. This outcome could well be the case when the seller's original mandate to the agent was on the basis that the seller would pay the commission. For the purposes of transfer duty, the commission must be added back to the consideration payable in determining the amount of the duty.⁴²⁷

8.34.6 When to apply the standard formulae

Table 1 – Summary of application of time-apportionment formulae

How expenditure incurred	Application
During a single year of assessment before 1 October 2001	Use formula in para 30(1). No limit on period before 1 October 2001
In more than one year of assessment before 1 October 2001	Use formula in para 30(1). Period before 1 October 2001 limited to 20 years
Before, and on or after 1 October 2001	Use proceeds formula in para 30(2) and then formula in para 30(1)

8.34.7 Calculations must be made for each asset

The formulae must be applied to each asset separately. It is unacceptable to perform a calculation lumping different assets together. For example, a factory may be disposed of for a lump sum, but the proceeds will have to be allocated across the buildings, plant and machinery and so on and separate calculations will have to be determined for each of the assets concerned.

Each share in a company is a separate asset. Thus, if a person bought 100 shares in a company before the valuation date and another 50 shares in the same company after the valuation date, the 100 shares are pre-valuation date assets to which time-apportionment may be applied, while the 50 shares are post-valuation date assets whose base cost must be determined under para 20 based on actual cost. Assuming all the shares are disposed of at the same time, the proceeds on disposal of the 150 shares must be split 100 / 150 for the pre-valuation date shares and 50 / 150 for the post-valuation date shares.

Similarly, a member's interest in a close corporation that is acquired in separate tranches before and after the valuation date must be treated as being comprised of separate assets represented by each tranche.

A separate time-apportionment calculation for each asset is unnecessary when identical pre-valuation date assets are acquired on the same date at the same cost per asset. In such event the assets can be combined for the purposes of performing a single calculation.

Example – Member's interest acquired before and after valuation date*Facts:*

On formation of ABC CC on 1 November 1983, Magda acquired a 20% member's interest in the close corporation at a cost of R200. On 30 June 2008 she acquired a further member's interest of 30% at a cost of R70 000.

⁴²⁷ Section 6(a) of the Transfer Duty Act 40 of 1949.

On 1 April 2019 Magda passed away and was deemed to dispose of her 50% interest at its market value of R150 000 under s 9HA. Magda did not determine a market value for any of her assets on the valuation date. Her executor has elected to use the time-apportionment base cost method.

Result:

20% interest

The valuation date value of the 20% interest is determined using the time-apportionment base cost method as follows:

Proceeds R150 000 × 20 / 50 = R60 000

$$\begin{aligned} Y &= B + [(P - B) \times N / (N + T)] \\ &= R200 + [(R60\,000 - R200) \times 18 / 36] \\ &= R200 + R29\,900 \\ &= 30\,100 \end{aligned}$$

	R
Proceeds R150 000 × 20 / 50	60 000
Less: Base cost	<u>(30 100)</u>
Capital gain	<u>29 900</u>
30% interest	
Proceeds R150 000 × 30 / 50	90 000
Less: Base cost (para 20)	<u>(70 000)</u>
Capital gain	<u>20 000</u>

8.34.8 Time-apportionment base cost calculator

The following calculators for determining the time-apportionment base cost of an asset are available on the SARS website:

- TAB Calculator. This calculator applies to persons with a valuation date of 1 October 2001.
- TAB Calculator for PBOs and recreational clubs. This calculator makes provision for the valuation dates of PBOs and clubs which vary depending on their financial year-ends. It can also handle a valuation date of 1 October 2001.

Both calculators can be found on the SARS website under Types of tax / Capital Gains Tax / Calculators.

The calculators use an Excel worksheet and apply the time-apportionment and proceeds formulae in para 30(1) and (2). They also apply the kink tests in paras 26(3) and 27(3), and in the historical gain situation inform the user whether there is an alternative method that provides a better result.

The calculators cannot be used to determine the time-apportionment base cost under the special depreciable assets formulae in para 30(3) and (4).

Example 1 – Time-apportionment: No improvements made before valuation date

Facts:

Barbara acquired a piece of land in Johannesburg on 1 October 1971 for R2 000 and disposed of it on 30 November 2019 for R2 million. Barbara incurred no other expenditure allowable

under para 20 during her ownership of the land. Since she had not valued the land at valuation date, she adopted the time-apportionment base cost method to determine its valuation date value.

Result:

The capital gain that arises in Barbara's hands is determined as follows.

Applying para 30(1) the time-apportionment base cost of the land is determined as follows:

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R2\,000 + [(R2\,000\,000 - R2\,000) \times (30 / (19 + 30))] \\
 &= R2\,000 + (R1\,998\,000 \times 30 / 49) \\
 &= R2\,000 + R1\,223\,265 \\
 &= R1\,225\,265
 \end{aligned}$$

The capital gain is determined as follows:

Proceeds	R 2 000 000
Less: Base cost	<u>(1 225 265)</u>
Capital gain	<u>774 735</u>

Since Barbara did not incur expenditure in more than one year of assessment before the valuation date, 'N' in the above formula is not limited to 20 years.

Example 2 – Time-apportionment: Improvements made in more than one year before 1 October 2001 and after that date

Facts:

Tammy acquired a piece of land in Pretoria on 1 October 1975 at a cost of R600 000. She erected a shopping centre on the land two years before the valuation date at a cost of R3 million. One year after the valuation date she effected improvements to the shopping centre at a cost of R1 million. She disposed of the shopping centre along with the land on 30 November 2019 for R12 million.

Result:

Since a portion of the expenditure allowable under para 20 was incurred both before and on or after the valuation date, the proceeds formula in para 30(2) applies. Furthermore, since Tammy incurred expenditure in more than one year before valuation date, 'N' must be limited to 20.

$$\begin{aligned}
 P &= R \times (B / (A + B)) \\
 &= R12\,000\,000 \times [(R600\,000 + R3\,000\,000) / (R1\,000\,000 + (R600\,000 + R3\,000\,000))] \\
 &= R12\,000\,000 \times (R3\,600\,000 / R4\,600\,000) \\
 &= R9\,391\,304
 \end{aligned}$$

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

Paragraph 30(1) is then applied as follows:

$$B = R600\,000 + R3\,000\,000 = R3\,600\,000$$

$$N = 20 \text{ (limited – see note below)}$$

$$T = 19$$

$$\begin{aligned} Y &= B + [(P - B) \times N / (N + T)] \\ &= R3\,600\,000 + [(R9\,391\,304 - (R3\,600\,000)) \times (20 / (19 + 20))] \\ &= R3\,600\,000 + [R5\,791\,304 \times 20 / 39] \\ &= R3\,600\,000 + R2\,969\,900 \\ &= R6\,569\,900 \end{aligned}$$

Base cost = time-apportionment base cost + post-CGT expenditure

$$= R6\,569\,900 + R1\,000\,000$$

$$= R7\,569\,900$$

	R
Proceeds	12 000 000
Less: Base cost	(7 569 900)
Capital gain	<u>4 430 100</u>

Note: 'N' in the above formula is limited to 20 years when expenditure is incurred in more than one year of assessment before the valuation date. In this example, N was limited from 26 to 20 (October 1975 to September 2001 = 26 full years). Tammy loses six years on her piece of land. However, a point in Tammy's favour is that the improvements effected only two years before valuation date will be treated as being incurred 20 years before valuation date.

Example 3 – Treatment of selling expenses as a reduction of proceeds for the purposes of determining the time-apportionment formulae [para 30(5)]

Facts:

Zelda bought her holiday home on 1 June 1984 at a cost of R25 000. She sold it on 1 June 2019 for R1 million. She incurred the following selling expenses:

	R
Estate agent's commission	48 000
Cost of obtaining electrical compliance and entomologist's certificates	<u>2 000</u>
	<u>50 000</u>

Result:

The proceeds formula is not triggered because the selling expenses must be deducted from the proceeds as represented by the symbol 'P'.

$$P = R1\,000\,000 - R50\,000 = R950\,000$$

$$\begin{aligned} Y &= B + [(P - B) \times N / (N + T)] \\ &= R25\,000 + [(R950\,000 - R25\,000) \times 18 / 36] \\ &= R25\,000 + R462\,500 = R487\,500 \end{aligned}$$

$$\begin{aligned} \text{Capital gain} &= \text{Proceeds} - \text{valuation date value} - \text{post-valuation date expenditure} \\ &= 1\,000\,000 - R487\,500 - R50\,000 = R462\,500 \end{aligned}$$

Example 4 – Determination of time-apportionment base cost when selling expenses plus other post-valuation date expenditure is incurred

Facts:

Zelda bought her holiday home on 1 June 1984 at a cost of R25 000. She sold it on 1 June 2019 for R1 million. She incurred the following selling expenses:

	R
Estate agent's commission	48 000
Cost of obtaining electrical compliance and entomologist's certificates	<u>2 000</u>
	<u>50 000</u>

Zelda spent R15 000 on 31 July 2003 on installing an electric fence around her property.

Result:

$$\begin{aligned}
 R &= R1\,000\,000 - R50\,000 = R950\,000 \\
 &= R \times B / (A + B) \\
 &= R950\,000 \times R25\,000 / (R15\,000 + R25\,000) \\
 &= R593\,750
 \end{aligned}$$

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R25\,000 + [(R593\,750 - R25\,000) \times 18 / 36] \\
 &= R25\,000 + R284\,375 \\
 &= R309\,375
 \end{aligned}$$

$$\begin{aligned}
 \text{Capital gain} &= \text{Proceeds} - \text{valuation date value} - \text{post-valuation date expenditure} \\
 &= R1\,000\,000 - R309\,375 - (R50\,000 + R15\,000) \\
 &= R625\,625
 \end{aligned}$$

8.34.9 The depreciable assets time-apportionment and proceeds formulae [para 30(3) and (4)]

If expenditure has been incurred both before, and on or after the valuation date, and the asset qualifies for capital allowances, the portion of the capital gain to be allocated to the post-valuation date period can be influenced by the speed with which the expenditure has been written off against income. As a result, for example, when the entire amount of the expenditure incurred before valuation date has been written off against income, the entire gain will be allocated to the post-valuation date period. This outcome results in an inequitable apportionment of the gain. In order to rectify this problem an additional formula was introduced to cater for such circumstances.⁴²⁸ Under this formula the apportionment of the gain is determined by excluding recouplements and capital allowances from specified variables in the time-apportionment formula. Paragraph 30(3) sets out the conditions under which the 'depreciable asset formula' applies.

8.34.9.1 Conditions under which the depreciable assets time-apportionment and proceeds formulae apply [para 30(3)]

Three conditions must be met:⁴²⁹

- Expenditure under para 20(1)(a), (c) or (e) must have been incurred on or after the valuation date.

⁴²⁸ Introduced by the Revenue Laws Amendment Act 74 of 2002, effective as from 1 October 2001.

⁴²⁹ Paragraph 30(3) was amended by s 70(1)(c) of the Revenue Laws Amendment Act 31 of 2005 with effect from years of assessment ending on or after 8 November 2005.

- A part of the expenditure referred to in para 20(1)(a), (c) or (e) incurred before, on or after the valuation date is or was allowable as a deduction in determining the taxable income of the person before the inclusion of any taxable capital gain (for example, the asset qualified for a capital allowance).
- The proceeds on disposal of the asset must exceed the allowable para 20 expenditure incurred before, on and after the valuation date in respect of the asset. In other words, the asset must have been disposed of at an overall capital profit.

The expenditure referred to in para 20(1)(a), (c) and (e) is summarised in the table below.

Table 1 – Expenditure contemplated in para 20(1)(a), (c) and (e)

Paragraph 20(1)	Expenditure
(a)	Expenditure actually incurred in respect of the cost of acquisition or creation of the asset.
(c)(i) to (ix)	Various items of expenditure directly related to the acquisition or disposal of the asset (for example, estate agent's commission, transfer duty, securities transfer tax, and so on)
(e)	The expenditure actually incurred in effecting an improvement to or enhancement of the value of that asset.

8.34.9.2 The formulae

The formulae, which appear in para 30(4), are as follows:

$$Y = B \times \frac{[(P_1 - B_1) \times N]}{T + N},$$

and

$$P_1 = \frac{R_1 \times B_1}{(A_1 + B_1)}$$

In which

'P₁' = The proceeds attributable to the expenditure in B₁.

'A₁' = The sum of

- the expenditure allowable under para 20 in respect of the asset that is incurred on or after valuation date, and
- any amount of that expenditure that has been recovered or recouped as contemplated in para 35(3)(a),

less:

- any selling expenses contemplated in para 20(1)(c)(i) to (iv) [see para 30(5)(b)].

'B₁' = The sum of

- the expenditure allowable under para 20 in respect of the asset that is incurred before valuation date, and
- any amount of that expenditure that has been recovered or recouped as contemplated in para 35(3)(a).

'B', 'N' and 'T' = These symbols bear the same meanings ascribed to them in para 30(1).

'R₁' = The sum of

- the proceeds, and
- any amount contemplated in para 35(3)(a) in respect of the asset,

less:

- any selling expenses contemplated in para 20(1)(c)(i) to (iv).

The gain applicable to the pre-CGT period is determined by a two-step process.

Step 1 – Apply the depreciable assets proceeds formula

First, the portion of the 'receipts' (proceeds not reduced by recoupments) generated by the expenditure incurred before valuation date is determined. This determination is done by multiplying those 'receipts' by the costs incurred before valuation date, divided by the total cost of the asset. The costs used in this calculation are not reduced by capital allowances.

Next, the gain generated by those pre-CGT expenses is apportioned between the pre- and post-valuation date periods on a time basis. This apportionment gives the gain applicable to the pre-CGT period, which is then added to 'B' in the formula (pre-valuation date expenditure reduced by capital allowances) to give the time-apportionment base cost of the asset.

Finally, para 25 is applied in the normal way in determining a capital gain, taking recoupments and capital allowances into account. The example below illustrates the application of the formula.

Example – Determination of time-apportionment base cost using the depreciable assets time-apportionment and proceeds formulae

Facts:

The following facts pertain to an asset subject to capital allowances:

	Pre- 1 October 2001	Post- 1 October 2001	Total
	R	R	R
Cost	100	200	300
Less: Capital allowances	<u>(100)</u>	<u>(20)</u>	<u>(120)</u>
Expenditure under para 20	<u>-</u>	<u>180</u>	<u>180</u>
Period (years)	10	5	15
	R		
Received on disposal	321		
Recouped under s 8(4)(a)	<u>120</u>		
Proceeds under para 35	<u>201</u>		

Result:

The capital gain is determined as follows:

Step 1 – Determine whether the depreciable asset time-apportionment and proceeds formulae apply

The asset in the example meets all the necessary requirements:

- Expenditure before 1 October 2001 = R100; and on or after 1 October 2001 = R200;
- Capital allowances of R100 were claimed;
- There is an overall gain of R321 – R300 = R21

Step 2 – Determine the receipts generated by pre-CGT costs

$$\begin{aligned}
 P_1 &= R_1 \times \frac{B_1}{(A_1 + B_1)} \\
 &= R321 \times R100 / (R100 + R200) \\
 &= R321 \times R100 / R300 \\
 &= R107
 \end{aligned}$$

Step 3 – Apply the depreciable assets time-apportionment formula

$$\begin{aligned}
 Y &= B + \frac{[(P_1 - B_1) \times N]}{T + N}, \\
 &= R0 + [(R107 - R100) \times 10 / (10 + 5)] \\
 &= R0 + R7 \times 10 / 15 \\
 &= R4,6667
 \end{aligned}$$

Step 4 – Determine the capital gain

$$\begin{aligned}
 \text{Capital gain} &= \text{Proceeds} - (\text{time-apportionment base cost} + \text{expenditure incurred on or after 1 October 2001}) \\
 &= R201 - (R4,6667 + R180) \\
 &= R201 - R184,6667 \\
 &= R16,3333
 \end{aligned}$$

Note: The normal rules are applied under step 3 so proceeds are reduced by recoupments and expenditure on or after 1 October 2001 is reduced by capital allowances.

In summary, had the gain been worked out under the standard formulae, the entire gain would have been allocated to the post-valuation date period and the person would have paid CGT on a gain of R21. The depreciable assets time-apportionment and proceeds formulae therefore provide a far more equitable spread of the gain.

8.34.10 Time-apportionment and selling expenses [para 30(5)]

8.34.10.1 Rationale

When a person has incurred expenditure on or after the valuation date, the proceeds formulae in para 30(2) and (4) will apply. The effect of these formulae is that the greater the expenditure incurred after the valuation date, the greater the proportion of the overall gain or loss that will comprise a capital gain or loss. Since selling expenses comprise post-valuation date expenditure under para 20, they would, before the introduction of para 30(5), have triggered the application of the proceeds formulae. In the absence of para 30(5) this could have had a marked effect on the proportion of the gain or loss that was subject to CGT, especially when the historical cost of the asset was low in relation to the selling costs. This situation particularly holds true for immovable property which tends to be held for a long time and is associated with relatively high selling costs (for example, estate agent's commission). In other instances, such as the sale of shares, brokers often simply pay their clients a net amount of proceeds, and these taxpayers are unaware that the proceeds formula applies.

8.34.10.2 Exclusion of selling expenses from proceeds [para 30(5)(a)]

In order to assist taxpayers, para 30(5) was introduced. It applies to disposals made during years of assessment ending on or after 8 November 2005. Under para 30(5) selling expenses must be deducted from

- when para 30(2) and (3) apply, the amounts represented by the symbols 'R' and 'R₁' respectively, and
- in any other case, the amount represented by the symbol 'P'.

The first bullet point applies when the person has incurred qualifying para 20 expenditure on or after the valuation date (for example, expenditure on improvements or in obtaining a CGT valuation). In such event, the proceeds formulae are triggered in the normal way by that expenditure (not by the selling expenses).

The second bullet point applies when there is no post-valuation date expenditure, and the proceeds formulae do not apply.

The reduction, when applicable, of the amounts represented by the symbols 'R', 'R₁' and 'P' by the selling expenses applies solely for the purposes of applying the time-apportionment and proceeds formulae. Selling expenses remain post-valuation date expenditure for the purposes of the kink tests in paras 26 and 27, and for the purposes of determining a capital gain or loss under para 25.

8.34.10.3 Exclusion of selling expenses from allowable para 20 expenditure [para 30(5)(b)]

Except for para 30(3)(c) any reference in para 30 to expenditure allowable under para 20 must exclude selling expenses. This treatment prevents the same amounts from being taken into account twice. For example, in the absence of para 30(5)(b), selling expenses would be deducted from proceeds and would also have been included in 'A' and 'A₁' in the proceeds formulae (expenditure on or after the valuation date).

However, para 30(3)(c) is an exception to the above rule. Paragraph 30(3) contains the entry requirements for the use of the special depreciable assets formulae. One of those requirements, contained in para 30(3)(c), is that there must be an overall gain. In making this determination, selling expenses must be taken into account, otherwise what appears to be an overall gain might in fact be an overall loss.

8.34.10.4 Definition – ‘selling expenses’ [para 30(5)(c)]

The term ‘selling expenses’ is defined in para 30(5)(c). It means qualifying expenditure referred to in para 20(1)(c)(i) to (iv) incurred directly for the purposes of disposing of an asset. Those expenses are

- the remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor, for services rendered,
- transfer costs;
- stamp duty, transfer duty, securities transfer tax or similar duty or tax; and
- advertising costs to find a seller or to find a buyer.

‘Selling expenses’ do not include any expenditure described above that relates to the *acquisition* of an asset.

8.34.11 Proof of expenditure

The question arises as to the level of proof of expenditure that is required in respect of pre-valuation date assets. The records that are required to be kept are set out in s 29 of the Tax Administration Act and these requirements must be adhered to for post-valuation date acquisitions or improvements.

It is accepted that persons may no longer have copies of original purchase invoices and paid cheques in respect of pre-valuation date expenditure, particularly when the expenditure in question was incurred many years before the introduction of CGT. In such event, alternative forms of proof can be considered. It is impossible to lay down hard and fast rules as to the type of proof that will be acceptable and each case will have to be judged on its own merits. If, for example, a company has submitted annual financial statements with its tax returns and the cost of assets can be tied up to a fixed assets register that contains sufficient detail (for example, date of acquisition, description and cost) that should suffice as proof of expenditure.

8.34.12 Asset acquired for no consideration before valuation date

See **8.5A**.

8.34.13 Self-generated goodwill and time-apportionment

Goodwill is often not purchased, but is self-generated by the business.

The use of time-apportionment for determining the valuation date value of self-generated goodwill may be possible in appropriate circumstances. Two issues, however, arise in this regard.

First, what costs should be allocated to self-generated goodwill for the purpose of determining ‘A’ and ‘B’ in the time-apportionment and proceeds formulae? Much of the expenditure contributing to goodwill (for example, salaries and wages and advertising costs) will have been allowed against income and will be excluded from base cost under para 20(3)(a). Costs relating to other identifiable assets (for example, an advertising sign of a capital nature⁴³⁰ or the cost of a building) should be allocated to those assets, rather than to goodwill. While these other assets may contribute to the existence and value of goodwill, they are considered to be separate from goodwill which is taken as an asset in its own right. Also, while goodwill may comprise different elements or arise from different sources, for example, a person, monopoly, site or name, it is treated as one asset inseparable from the business. However, a word of

⁴³⁰ ITC 469 (1940) 11 SATC 261 (U).

caution needs to be sounded in cases in which there is no pre-valuation date expenditure. The entire capital gain will be subject to CGT if there is even the slightest amount of qualifying post-valuation date expenditure because of the effect of the proceeds formula in para 30(2).

Secondly, at what point before the valuation date is the goodwill created? This information is needed to determine 'N' in the time-apportionment formula (number of years including part of a year before valuation date). The following extract from the United Kingdom Inland Revenue and Customs *Capital Gains Manual* sets out when self-generated goodwill is acquired:⁴³¹

'Where an asset was not acquired but was created by the person making the disposal, for example goodwill, the date of acquisition is the date the asset was created. The date the asset was created is determined as a question of fact on the basis of the evidence available.'

In the Australian case of *FCT v Murry*⁴³² it was said that the general rule is that only established businesses could have goodwill. But how long after establishment does goodwill arise? This issue has arisen in a number of United States tax cases dealing with the distinction between short-term and long-term capital gains. In *Erwin D Friedlaender v Commissioner of Internal Revenue*⁴³³ the court noted that essentially, the goodwill of a business is the potential of that business to realise earnings in excess of the amount that might be considered a normal return from the investment in the tangible assets. Until such time as those excess earnings are produced, goodwill does not exist as an asset of the business. It is only in unusual circumstances that a value can be determined for goodwill after a relatively short period of operation.⁴³⁴

In the Australian case of *Hepples v FCT*⁴³⁵ McHugh J stated the following:

'Although goodwill is commonly valued by capitalizing the expected future net profits or by estimating the worth of purchasing several years of the past profits of a business, it may exist even though the business has not made any profits and is unlikely to do so for some time.'

The situation in which there is goodwill but an absence of profits could arise, for example, when a person is operating an unprofitable business, and a new development is announced in the area that has the effect of substantially increasing the potential future turnover of the business.

With site and monopoly goodwill it was pointed out in the *Murry* case above that goodwill may well be present at the time business operations commence.

The onus will be on the taxpayer to justify the values assigned to "A", "B" and "N".

⁴³¹ In CG17900.

⁴³² (1996) 622 FCA 1, available online at <<http://www.austlii.edu.au/cgi-bin/disp.pl/au/cases/cth/federal%5fct/1996/622.html?query=%7e+murry>> [Accessed 2 November 2020].

⁴³³ 26 TC 1005 1956 US Tax Ct LEXIS 97.

⁴³⁴ In the US case of *Sidney v LeVine* 24 TC 147 the court found that goodwill existed in a partnership after a mere 28 months of operation as a result of having highly skilled employees who developed specially designed equipment.

⁴³⁵ (1991) ALR 497.

8.34.14 Pre-CGT rationalisation schemes and time-apportionment

Section 39 of the Taxation Laws Amendment Act 20 of 1994 provided roll-over relief for normal tax purposes for certain rationalisation schemes. The type of scheme envisaged by s 39 was one in which

- on or after 4 November 1994,
- the whole or a part of any business undertaking of one company (the transferor company)
- was disposed of by way of sale, donation, cession, dividend or in any other form to any other company (the transferee company), and
- both such companies are at the time of that disposal members of the same group of companies.

Under s 39(6)(c) the Commissioner and the controlling company could agree that

‘the transferor company and the transferee company shall, subject to such adjustments as may be necessary, be deemed to be one and the same company: Provided that [the proviso is not relevant for present purposes] . . .’.

The effect of s 39(6)(c) for the purposes of time-apportionment base cost is to ensure that the details (cost, date of acquisition and date of incurral of expenditure) are carried across from the transferor company to the transferee company. Although the ‘one and the same person’ principle was subject to agreement between the Commissioner and the controlling company, it is likely that it was a standard feature of most of the rationalisation schemes that were entered into. The final date by which an application could be submitted to the Commissioner under s 39 was 1 March 2002. These rules were replaced by the corporate restructuring rules in ss 41 to 47 of the Income Tax Act.

8.35 Market value

Paragraphs 1 and 31, s 23C

8.35.1 Introduction

Paragraph 29 contains special rules for determining the market value of specified assets on valuation date. These special rules do not cover all assets and are essentially an anti-avoidance measure aimed at selected assets whose values are susceptible to manipulation.

The term ‘market value’ is defined in para 1 and means

‘market value as contemplated in paragraph 31’.

Paragraph 31 provides the general rules on how ‘market value’ as defined in para 1 is to be determined in respect of those assets not covered by para 29 as well as in other situations. The defined term is used throughout the Eighth Schedule in a wide variety of circumstances, such as on valuation date (base cost), donation, commencement of residence and non-arm's length transactions between connected persons. Section 9HA, which deals with the deemed disposal on death, also contains cross-references to market value as defined in para 1. These general rules are summarised in the table below. In determining market value, s 23C provides that no account must be taken of value-added tax when the vendor was entitled to an input tax credit under s 16(3) of the Value-Added Tax Act, 1991. A vendor who is not entitled to claim an input credit or a non-vendor may include VAT when determining market value. A vendor who was entitled to but failed to claim an input credit in any previous year must

nevertheless exclude that amount from the market value of the asset. This result follows from s 23C(1)(b), which is concerned only with entitlement and not the actual amount claimed.

8.35.2 Prescribed valuation methods

Table 1 – Prescribed methods for determining market value (para 31)

Paragraph 31	Type of asset	Market value
(1)(a)	Financial instrument listed on a recognised exchange for which a price is quoted	Ruling price ⁴³⁶ at close of business on last business day before the specified date.
(1)(b)	Long-term insurance policy with a South African insurer	Greater of: <ul style="list-style-type: none"> • Surrender value • Insurer's market value (assume policy runs to maturity).
(1)(c)(i)	Portfolio comprised in any collective investment scheme in securities ⁴³⁷ or property. ⁴³⁸	Management company's repurchase price.
(1)(c)(ii)	Portfolio comprised in any investment scheme carried on outside South Africa that is comparable to a portfolio of a collective investment scheme in participation bonds or a portfolio of a collective investment scheme in securities in pursuance of any arrangement under which members of the public (as defined in s 1 of the Collective Investment Schemes Control Act) are invited or permitted to contribute to and hold participatory interests in that portfolio through shares, units or any other form of participatory interest. ⁴³⁹	Management company's repurchase price or if not available, the selling price based on the price a willing buyer would pay a willing seller acting at arm's length in an open market.
(1)(d)	Fiduciary, usufructuary and other like interests	Present value of future benefits discounted at 12% a year over life expectancy of person to whom interest granted or lesser period of enjoyment. Commissioner may, on application by the taxpayer, fix another rate when satisfied that 12% cannot reasonably be achieved. Life expectancy is determined as follows:

⁴³⁶ As defined in para 1 of the Eighth Schedule.

⁴³⁷ As defined in s 1(1).

⁴³⁸ As defined in s 1(1).

⁴³⁹ As defined in para (e)(ii) of the definition of 'company' in s 1(1).

Paragraph 31	Type of asset	Market value
		<ul style="list-style-type: none"> • Individuals – in accordance with tables used for estate duty purposes.⁴⁴⁰ • Other persons (for example, companies or trusts) – 50 years.
(1)(e) and (2)	Asset subject to fiduciary, usufructuary or other like interest	Market value of full ownership, less value of <i>fideicommissum</i> , usufruct or other like interest as determined above.
(1)(f) and (4)	Immovable farming property	<ul style="list-style-type: none"> • Market value less 30% (defined in the Estate Duty Act) or • price based on a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market. <p>On disposal by death, donation or non-arm's length transaction, the 'market value less 30%' may be used only if it is used in determining the base cost of the disposer on</p> <ul style="list-style-type: none"> • valuation date, or, when applicable, • date acquired by inheritance, donation or non-arm's length transaction at market value less 30%. See 8.35.5.
(1)(g)	Any other asset	Price based on willing buyer, willing seller at arm's length in an open market.
(3)	Unlisted shares	<p>Price based on willing buyer, willing seller at arm's length in an open market, ignoring any</p> <ul style="list-style-type: none"> • restrictions on transferability; • stipulated method of valuation;⁴⁴¹ or <p>if a holder of shares is entitled to a share of assets on winding-up disproportionate to the holder's holding of shares, the value must not be less than the amount the shareholder would have received had the company been wound up on valuation date.⁴⁴²</p>

⁴⁴⁰ See regulations issued under s 29 of the Estate Duty Act 45 of 1955.

⁴⁴¹ This provision is similar to that found in s 5(1)(f)*bis* of the Estate Duty Act 45 of 1955.

⁴⁴² The rule is based on a similar rule in s 5(1)(f)*bis*(iii) of the Estate Duty Act. It is aimed at preventing capital losses in respect of the disposal of pre-valuation date unlisted shares.

8.35.3 What is 'market value'?

The market value of an asset is the best price at which an interest in the asset would have been sold unconditionally for a cash consideration on the date of valuation assuming

- a willing seller (under no duress at all)
- that, before the date of valuation, there had been a reasonable period (having regard to the nature of the asset and the state of the market) for the proper marketing of the interest and for the sale to be concluded;
- that no account is taken of any additional bid by a prospective purchaser with a special interest;
- a sale either
 - of the asset as a whole for use in its working place; or
 - of the asset as a whole for removal from the premises of the seller at the expense of the purchaser; or
 - of individual items for removal from the premises of the seller at the expense of the purchaser; and
- that both parties to the transaction had acted knowledgeably, prudently and without compulsion.

8.35.4 Valuation of foreign insurance policies

Paragraph 31(1)(b) deals with long-term policies issued by a South African insurer. A foreign policy is not a 'long-term policy' as defined in the Long-term Insurance Act because it is not issued by a registered insurer or a licensed insurer. See **12.4.1**. A foreign policy falls outside the Long-term Insurance Act and must therefore be valued in accordance with the general rule in para 31(1)(g).

For more on the exclusion of foreign policies from the exclusion in para 55, see **12.4.4.5**.

8.35.5 'Market value less 30%' and farming properties

Under para 31(1)(f), immovable property on which *bona fide* farming operations is carried on may be valued at

- the value contemplated in para (b) of the definition of 'fair market value' in s 1 of the Estate Duty Act 45 of 1955, or
- the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market [para 31(1)(g)].

Paragraph (b) of the definition of 'fair market value' in the Estate Duty Act was amended by s 1(1)(a) of the Revenue Laws Second Amendment Act 32 of 2005 with effect from the date of promulgation of that Act, 1 February 2006, and applicable in respect of the estate of any person who dies on or after that date. For the purposes of para 31(1)(f) the amendment should be regarded as applying to disposals or acquisitions on or after 1 February 2006.

Before 1 February 2006

Before 1 February 2006 the definition of 'fair market value' in s 1 of the Estate Duty Act read as follows:

‘ “[F]air market value”, means—

- (a) [not applicable]; or
- (b) an amount to be determined in accordance with the provisions of subsection (2) as representing the aggregate of the fair agricultural or pastoral value of the land and the value which any improvements situated thereon may be expected to add to such value of the land (which aggregate is hereinafter referred to as the surface value), together with the fair market value of any mineral rights attaching to the land, as at the date of the death of the deceased person.’

Subsection (2), which was deleted at the same time that para (b) of the above definition was substituted, read as follows:

‘(2)(a) In the case of any property in respect of which the executor elects the value determined in accordance with paragraph (b) of the definition of "fair market value" in subsection (1), the executor shall lodge an application in the prescribed form in duplicate for a determination of the surface value of that property with the magistrate of the district in which any such property is situate.

- (b)(i) Any magistrate with whom any such application has been lodged shall forward both copies thereof to any land Bank valuator selected by him who has been appointed in terms of section seventy of the Land Bank Act, 1944 (Act No. 13 of 1944), with instructions to make a valuation of the surface value of the property in question.
- (ii) The provisions of the Land Bank Act, 1944, applicable to valutors appointed under the said Act, and any instructions issued from time to time by the Land Bank to such valutors in connection with the exercise of their duties, shall apply to any such valuator instructed to make a valuation of the surface value of any such property as though he were making a valuation for land Bank purposes.
- (iii) Fees and travelling expenses shall be paid by the estate of the deceased to any such valuator in accordance with the tariffs applicable to the valuations of property by appraisers appointed under the Administration of Estates Act, 1965.

(c) Any land bank valuator to whom any such application in duplicate has been referred, shall cause the particulars of his valuation of the surface value of the property in question to be inserted on both copies of the application and shall within three days from the date on which his valuation was made forward one copy to the executor of the estate and the remaining copy to the magistrate for transmission to the Commissioner.

- (d)(i) The Commissioner shall thereupon determine the surface value of the property in question, which determination shall be subject to the provisions of paragraph (e), or may refer the matter to the Board of the Land Bank as constituted under section four of the Land Bank Act, 1944 (in this section referred to as the Board), for its determination of such value.
- (ii) The Commissioner shall at the same time determine the fair market value of the mineral rights attaching to the property in question and shall advise the executor of the values determined by him under this paragraph and shall indicate in such advice whether the determination of the surface value of the property was made by him or by the Board.

(e) If the executor considers himself aggrieved by the Commissioner's determination of the surface value of any property in terms of paragraph (d), he shall notify the Commissioner thereof in writing within twenty-one days or such further period as the Commissioner may allow from the date of the advice referred to in the said paragraph and the Commissioner shall thereupon cause the matter to be referred to the Board for review.'

The application of the above so-called Land Bank value is explained below.

On or after 1 February 2006

On or after 1 February 2006 para (b) of the definition of 'fair market value' in the Estate Duty Act reads as follows:

' "[F]air market value", means—

- (a) [not relevant]; or
- (b) in relation to immovable property on which a *bona fide* farming undertaking is being carried on in the Republic, the amount determined by reducing the price which could be obtained upon a sale of the property between a willing buyer and a willing seller dealing at arm's length in an open market by 30 per cent.'

The requirement is that a *bona fide* farming undertaking must be conducted on the land. The farming undertaking could be undertaken personally by the taxpayer or by the taxpayer's lessee. It is not a requirement that the farming undertaking be carried on by the taxpayer personally.

Under para 31(4) the use of the alternative value under para (b) of the definition of 'fair market value' is restricted when the farming property is disposed of by death, donation, or non-arm's length transaction (that is, when the para (b) value is used to determine the proceeds on disposal). Under the restriction the para (b) method may not be used on disposal unless

- for pre-valuation date farming property, it is used to determine the valuation date value [para 31(4)(a)], or
- for a farming property acquired on or after the valuation date by way of inheritance, donation or non-arm's length transaction, the property was acquired at a para (b) value [para 31(4)(b)].

The purpose of para 31(4) is to match like with like by ensuring that the method used for determining the consideration received or accrued on disposal under para 38 or s 9HA is the same as the method used in determining the base cost under para 26, 27 or 38, or s 25.

Pre-valuation date farming property [para 31(4)(a)]

Valuation date value: Market value less 30% cannot be used to determine the valuation date value of a farm property. Under para 29(4) all valuations had to be completed by 30 September 2004 and the amendment was not given retrospective effect. In other words, Land Bank value must be used as the valuation date value when para 31(1)(f)(i) is adopted.

Proceeds: The Land Bank value (disposal before 1 February 2006) or market value less 30% (disposal on or after 1 February 2006) can be used for determining the consideration received or accrued on disposal by way of death, donation or non-arm's length transaction only if Land Bank value is used in determining the valuation date value [para 31(4)(a)].

Thus, in the case of a farm acquired before valuation date and disposed of by way of death, donation or non-arm's length transaction on or after 1 February 2006, the Land Bank value on 1 October 2001 must be used as the valuation date value if the market value less 30% is used to determine the proceeds.

Under para 31(1)(f) a person has a choice of either market value or the para (b) value. It is accepted that a person who has determined both values by 30 September 2004 would be entitled to choose the value that gives the more favourable result in the circumstances. For example, if the property were sold to a third party, market value may give a higher base cost than the para (b) value. On the other hand, if a farmer dies or donates the farm, the para (b) value may result in lower proceeds but Land Bank value will have to be adopted as the valuation date value.

A person who adopts the time-apportionment base cost method or '20% of proceeds' method for determining the valuation date value of the property or who failed to obtain a Land Bank valuation by 30 September 2004 will not be permitted to use 'market value less 30%' for determining the proceeds on death under s 9HA or when para 38 applies to the disposal.

Post-valuation date farming property [para 31(4)(b)]

Paragraph 31(4)(b) applies to farming property acquired on or after valuation date which is disposed of by way of death, donation or non-arm's length transaction. In such instances market value less 30% may be used to determine the consideration received or accrued under para 38 or s 9HA only if the property was acquired by way of inheritance, donation or non-arm's length transaction at a para (b) value (pre-1 February 2006: Land Bank value; on or after 1 February 2006: market value less 30%).

Sales to third parties

Under an arm's length sale to a third party the proceeds will be the actual amount received or accrued under para 35. The valuation date value of property acquired before valuation date will be either Land Bank value or market value, depending on which value the person has determined and adopted. The base cost of farming property acquired on or after valuation date will be the actual cost under para 20, or when para 38 or s 25 applies, the value determined under those provisions in accordance with para 31(1)(f). That could be market value, Land Bank value (pre-1 February 2006 acquisition) or market value less 30% (acquisition on or after 1 February 2006), depending on the method adopted by the person from whom the property was acquired.

Non-applicability to valuation of shares in company carrying on farming operations

The 'market value less 30%' method does not apply to the valuation of shares in a company carrying on farming operations on immovable property in South Africa. Unlike s 5(1A) of the Estate Duty Act 45 of 1955, the Eighth Schedule does not contain an equivalent valuation rule. Shares in an unlisted company of this nature must be valued under para 31(1)(g) read with para 31(3).

Example 1 – Proceeds and base cost of pre-valuation date farming property

Facts:

Eddie acquired a farm in 1980 by inheritance from his late father. The Land Bank value of the property on 1 October 2001 was R1 million and the market value R1,3 million. Eddie complied fully with para 29(4).

On 30 June 2019 Eddie passed away. The market value of the property at that stage was R1,5 million. The executor determined the proceeds on death under s 9HA using market value less 30% [para 31(1)(f)(i)].

Result:

Eddie will have a capital gain determined as follows:

	R
Proceeds R1 500 000 – R450 000 (30%)	1 050 000
Less: Base cost (Land Bank value)	<u>(1 000 000)</u>
Capital gain	<u>50 000</u>

The executor is not permitted to use market value on 1 October 2001 as the base cost because market value less 30% has been used to determine the proceeds on death [para 31(4)(a)].

Example 2 – Base cost of pre-valuation date farming property sold to third party

Facts:

Eddie acquired a farm in 1980 by inheritance from his late father. The Land Bank value of the property on 1 October 2001 was R1 million and the market value R1,3 million. Eddie complied fully with para 29(4).

Eddie sold the property on 30 June 2019 to a third party for R1,5 million.

Result:

Eddie is entitled to use either Land Bank value or market value to determine the valuation date value of the property. Since market value gives the higher base cost, he will choose that value (R1,2 million). He will therefore have a capital gain of R1,5 million less R1,2 million = R300 000. In these circumstances the actual proceeds of R1,5 million must be accounted for under para 35.

Example 3 – Post-valuation date farming property disposed of by donation (1)

Facts:

Rita acquired a farm by inheritance from her late father, Bob, in 2002. Bob's executor had adopted Land Bank value of R1 million for determining the proceeds on disposal of the farm under para 40(1)(a) as it then read. On 30 September 2019 Rita donated the farm to her son Dirk when the market value of the farm was R1,5 million. Rita decided to determine her proceeds under para 38 using market value less 30%.

Result:

Rita will have proceeds of R1,5 million less 30% (R450 000) = R1 050 000. Her base cost will be equal to the base cost of Bob's deceased estate which was equal to Land Bank value [R1 million under para 40(2)(b)]. She will therefore have a capital gain of R50 000.

Example 4 – Post-valuation date farming property disposed of by donation (2)

Facts:

Rita acquired a farm by inheritance from her late father, Bob, in 2002. Bob's executor had adopted market value of R1,2 million for determining the proceeds on disposal of the farm under para 40(1)(a) as it then read. On 30 September 2019 Rita donated the farm to her son Dirk when the market value of the farm was R1,5 million.

Result:

Rita is not permitted to use market value less 30% in determining proceeds under para 38 in respect of her disposal to Dirk. She will therefore have proceeds equal to market value of R1,5 million. Her capital gain is R1,5 million (proceeds) less R1,2 million [base cost under para 40(2)(b) as it read in 2002] = R300 000.

8.35.6 Market value – valuation of shares held in co-operatives

The Co-operatives Act 91 of 1981 (the Co-op Act) governs the activities of co-operatives. Should a member of a co-operative die, be sequestrated, resign, be expelled or cease to qualify as a member, that member will be entitled to a return only of the nominal value of the shares.⁴⁴³ This limited entitlement raises the question as to how para 31(3)(a) is to be applied, given that any provision relating to the restriction of transferability of shares and the determination of value must be disregarded.

A member's entitlement to the profits is not linked to the shares held but rather to the volume of business done through or with the co-operative (referred to as the 'patronage proportion'⁴⁴⁴). See In this regard s 84 (members' entitlement to bonuses) and s 224(4)(a) (members' entitlement to the free residue on liquidation). It is therefore considered inappropriate to look at the underlying assets to determine the value of a member's shares in a co-operative, and they must be valued on the same basis used for estate duty purposes, namely, at nominal value.

8.35.7 Life expectancy tables

GNR. 1942 of 23 September 1977: Valuation of annuities or of fiduciary, usufructuary or other limited interests in property in the estates of deceased persons (R)

Note: These regulations were published in the *Government Gazette*.⁴⁴⁵

Calculations for the purposes of the valuation of annuities or of fiduciary, usufructuary or other limited interests in property in the estate of any person who died or dies on or after 1 April 1977 shall be made in accordance with the Tables subjoined hereto:

(The regulations promulgated under Government Notice 641 of 13 April 1956 shall continue to apply in relation to the estate of any person who died before 1 April 1977.)

Table A

The Expectation of Life and the Present Value of R1 per Annum for Life Capitalised at 12 per cent over the Expectation of Life of Males and Females of Various Ages

Age	Expectation of Life		Present value of R1 Per Annum for Life		Age
	Males	Females	Males	Females	
0	64,74	72,36	8,327 91	8,331 05	0
1	65,37	72,74	8,328 28	8,331 14	1
2	64,50	71,87	8,327 76	8,330 91	2
3	63,57	70,93	8,327 14	8,330 64	3
4	62,63	69,97	8,326 44	8,330 33	4
5	61,69	69,02	8,325 67	8,329 99	5
6	60,74	68,06	8,324 80	8,329 61	6

⁴⁴³ Section 81(1)(a) to (f) of the Co-operatives Act 91 of 1981.

⁴⁴⁴ As defined in s 1 of the Co-operatives Act 91 of 1981.

⁴⁴⁵ GNR 1942 GG 2533 of 23 September 1977.

Age	Expectation of Life		Present value of R1 Per Annum for Life		Age
	Males	Females	Males	Females	
7	59,78	67,09	8,323 81	8,329 18	7
8	58,81	66,11	8,322 71	8,328 69	8
9	57,83	65,14	8,321 46	8,328 15	9
10	56,85	64,15	8,320 07	8,327 53	10
11	55,86	63,16	8,318 49	8,326 84	11
12	54,87	62,18	8,316 73	8,326 08	12
13	53,90	61,19	8,314 80	8,325 22	13
14	52,93	60,21	8,312 65	8,324 27	14
15	51,98	59,23	8,310 29	8,323 20	15
16	51,04	58,26	8,307 70	8,322 03	16
17	50,12	57,29	8,304 89	8,320 71	17
18	49,21	56,33	8,301 80	8,319 26	18
19	48,31	55,37	8,298 41	8,317 64	19
20	47,42	54,41	8,294 71	8,315 84	20
21	46,53	53,45	8,290 61	8,313 83	21
22	45,65	52,50	8,286 13	8,311 61	22
23	44,77	51,54	8,281 17	8,309 12	23
24	43,88	50,58	8,275 64	8,306 33	24
25	43,00	49,63	8,269 59	8,303 26	25
26	42,10	48,67	8,262 74	8,299 81	26
27	41,20	47,71	8,255 16	8,295 95	27
28	40,30	46,76	8,246 77	8,291 71	28
29	39,39	45,81	8,237 37	8,286 97	29
30	38,48	44,86	8,226 94	8,281 70	30
31	37,57	43,91	8,215 38	8,275 83	31
32	36,66	42,96	8,202 57	8,269 30	32
33	35,75	42,02	8,188 36	8,262 10	33
34	34,84	41,07	8,172 62	8,254 00	34
35	33,94	40,13	8,155 36	8,245 09	35
36	33,05	39,19	8,136 47	8,235 17	36
37	32,16	38,26	8,115 58	8,224 26	37
38	31,28	37,32	8,092 74	8,211 99	38
39	30,41	36,40	8,067 81	8,198 66	39
40	29,54	35,48	8,040 30	8,183 86	40
41	28,69	34,57	8,010 67	8,167 62	41
42	27,85	33,67	7,978 44	8,149 83	42
43	27,02	32,77	7,943 44	8,130 12	43
44	26,20	31,89	7,905 47	8,108 81	44
45	25,38	31,01	7,863 80	8,085 27	45
46	24,58	30,14	7,819 24	8,059 56	46
47	23,79	29,27	7,771 09	8,031 19	47
48	23,00	28,41	7,718 43	8,000 26	48

Age	Expectation of Life		Present value of R1 Per Annum for Life		Age
	Males	Females	Males	Females	
49	22,23	27,55	7,662 36	7,966 17	49
50	21,47	26,71	7,602 01	7,929 50	50
51	20,72	25,88	7,537 13	7,889 67	51
52	19,98	25,06	7,467 48	7,846 46	52
53	19,26	24,25	7,393 87	7,799 65	53
54	18,56	23,44	7,316 31	7,748 34	54
55	17,86	22,65	7,232 34	7,693 55	55
56	17,18	21,86	7,144 14	7,633 63	56
57	16,52	21,08	7,051 78	7,568 96	57
58	15,86	20,31	6,952 25	7,499 27	58
59	15,23	19,54	6,850 04	7,423 21	59
60	14,61	18,78	6,742 06	7,341 35	60
61	14,01	18,04	6,630 10	7,254 57	61
62	13,42	17,30	6,512 32	7,160 20	62
63	12,86	16,58	6,393 01	7,060 46	63
64	12,31	15,88	6,268 22	6,955 37	64
65	11,77	15,18	6,137 89	6,841 61	65
66	11,26	14,51	6,007 26	6,723 93	66
67	10,76	13,85	5,871 65	6,598 93	67
68	10,28	13,20	5,734 03	6,466 35	68
69	9,81	12,57	5,591 82	6,328 18	69
70	9,37	11,96	5,451 65	6,184 66	70
71	8,94	11,37	5,307 75	6,036 07	71
72	8,54	10,80	5,167 44	5,882 78	72
73	8,15	10,24	5,024 37	5,722 22	73
74	7,77	9,70	4,878 76	5,557 43	74
75	7,41	9,18	4,734 90	5,388 93	75
76	7,07	8,68	4,593 54	5,217 27	76
77	6,73	8,21	4,446 63	5,046 79	77
78	6,41	7,75	4,303 09	4,870 92	78
79	6,10	7,31	4,158 98	4,693 89	79
80	5,82	6,89	4,024 40	4,516 47	80
81	5,55	6,50	3,890 51	4,343 99	81
82	5,31	6,13	3,768 02	4,173 15	82
83	5,09	5,78	3,652 76	4,004 82	83
84	4,89	5,45	3,545 46	3,839 88	84
85	4,72	5,14	3,452 32	3,679 21	85
86	4,57	4,85	3,368 64	3,523 71	86
87	4,45	4,58	3,300 66	3,374 26	87
88	4,36	4,33	3,249 07	3,231 75	88
89	4,32	4,11	3,225 97	3,102 96	89
90*	4,30	3,92	3,214 38	2,989 12	90

* **NB** The age is to be taken as at the next birthday after the date when the right was acquired.

Example.—Find the present value of an annuity or usufruct of R100 per year for life of:
(A) a female who becomes entitled thereto at the age of 42 years 3 months, or
(B) a male who becomes entitled thereto at the age of 65 years 9 months.

	(A)	(B)
Age when acquired	42 years 3 months	65 years 9 months
Age next birthday	43 years	66 years
Present value of R1 a year for life	R8,130 12	R6,007 26
Therefore, present value of R100 a year for life equals	R813,01	R600,73

Table B

Present Value of R1 per Annum Capitalised at 12 per cent over Fixed Periods.

Years.	Amount.	Years.	Amount.	Years.	Amount.	Years.	Amount.
	R		R		R		R
1	0,892 9	26	7,895 7	51	8,307 6	76	8,331 8
2	1,690 0	27	7,942 6	52	8,310 4	77	8,332 0
3	2,401 8	28	7,984 4	53	8,312 8	78	8,332 1
4	3,037 4	29	8,021 8	54	8,315 0	79	8,332 3
5	3,604 8	30	8,055 2	55	8,317 0	80	8,332 4
6	4,111 4	31	8,085 0	56	8,318 7	81	8,332 5
7	4,563 8	32	8,111 6	57	8,320 3	82	8,332 6
8	4,967 6	33	8,135 4	58	8,321 7	83	8,332 6
9	5,328 2	34	8,156 6	59	8,322 9	84	8,332 7
10	5,650 2	35	8,175 5	60	8,324 0	85	8,332 8
11	5,937 7	36	8,192 4	61	8,325 0	86	8,332 8
12	6,194 4	37	8,207 5	62	8,325 9	87	8,332 9
13	6,423 6	38	8,221 0	63	8,326 7	88	8,333 0
14	6,628 2	39	8,233 0	64	8,327 4	89	8,333 0
15	6,810 9	40	8,243 8	65	8,328 1	90	8,333 0
16	6,974 0	41	8,253 4	66	8,328 6	91	8,333 1
17	7,119 6	42	8,261 9	67	8,329 1	92	8,333 1
18	7,249 7	43	8,269 6	68	8,329 6	93	8,333 1
19	7,365 8	44	8,276 4	69	8,330 0	94	8,333 1
20	7,469 4	45	8,282 5	70	8,330 3	95	8,333 2
21	7,562 0	46	8,288 0	71	8,330 7	96	8,333 2
22	7,644 6	47	8,292 8	72	8,331 0	97	8,333 2
23	7,718 4	48	8,297 2	73	8,331 2	98	8,333 2
24	7,784 3	49	8,301 0	74	8,331 4	99	8,333 2
25	7,843 1	50	8,304 5	75	8,331 6	100	8,333 2

NB. Fractions of a year are to be disregarded when using this table.

Example.—Testator, who died on 1 April 1977 left to (A) an annuity or usufruct value R100 a year, to terminate when (A) attains majority, which will occur, say, at 30 September 1987. This period is found to be 10 years 6 months, but is taken as 10 years.

Present value of R1 a year for 10 years R5,650.2
 Therefore, present value of R100 a year for 10 years R565,02

Using Excel

The present value of an annuity can also be determined using a Microsoft Excel spreadsheet. For example, the formula for determining the present value of R100 per year for 10 years at 12% is

=PV(0.12,10,-100)

which gives a result of R565,02

8.36 Base cost – identical assets (para 32)

Paragraph 32

8.36.1 What are identical assets?

Paragraph 32 contains the rules for the determination of the base cost of assets that form part of a group of similar assets. Such assets are sometimes referred to as fungible assets. When an asset of this nature is sold, it may not be possible to physically identify the particular asset that is being disposed of. Hence, it is necessary to lay down identification rules. Examples include Krugerrands, participatory interests in portfolios of collective investment schemes, and shares.

A dual test has been devised in para 32(2) to identify these assets:

- First, if any one of the assets in a particular holding were to be sold, it would realise the same amount as any one of the other assets in that holding.
- Secondly, all the assets in the group must share the same characteristics.

Example – Separate holdings of identical assets

Each of the following assets constitute a separate holding of identical assets:

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

Unique identifying numbers such as share certificate numbers must be ignored for the purpose of determining whether an asset is part of a holding of identical assets.

8.36.2 Permissible methods for determining base cost of identical assets

Taxpayers must adopt one of three alternative methods:

- Specific identification
- First-in-first-out
- Weighted average

There are no restrictions on the use of the specific identification and first-in-first-out methods, which may be used for any identical asset. However, the weighted-average method may be used only for certain classes of asset. The three methods are explained below:

8.36.2.1 Specific identification

Under the specific identification method, the cost of each asset disposed of is discretely identified. Such an identification could be done, for example, by reference to share certificate numbers. The question arises how shares that have been dematerialised under the STRATE system can be identified, since there are no longer share certificate numbers in existence. Such shares can be identified by the date of acquisition and cost.

8.36.2.2 First-in-first-out (FIFO)

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

8.36.2.3 Weighted-average method

Application

The weighted-average method may be used only for the classes of assets set out in Table 1 below. Separate rules contained in para 32(3B) apply to long-term insurers.

Table 1 – Classes of assets for which weighted-average method may be used

Paragraph 32(3A) item	Class of asset
(a)	<p>Local and foreign financial instruments listed on a recognised exchange (for example, shares)</p> <ul style="list-style-type: none"> • that comprised such financial instruments from the date of acquisition to the date of disposal, and • for which a price was quoted on that exchange, <p>but excluding any listed s 24J instruments (these are dealt with in item (d) below).</p>
(b)	<p>Participatory interests in</p> <p><i>Subitem (i)</i></p> <ul style="list-style-type: none"> • a collective investment scheme in securities or property, and • a foreign collective investment scheme carried on outside South Africa, whose price is regularly published in a national or international newspaper;

Paragraph 32(3A) item	Class of asset
	<p><i>Subitem (ii)</i></p> <ul style="list-style-type: none"> • a collective investment scheme in securities or property whose price is not published in a newspaper but the management company is registered under s 42 of the Collective Investment Schemes Control Act 45 of 2002.* <p><i>Subitem (iii)</i></p> <ul style="list-style-type: none"> • a foreign collective investment scheme approved by the Registrar under s 65 of the Collective Investment Schemes Control Act 45 of 2002 to solicit investments from the public in South Africa.
(c)	Gold and platinum coins, whose prices are regularly published in a national or international newspaper
(d)	<p>Section 24J instruments</p> <ul style="list-style-type: none"> • that comprised such instruments from the date of acquisition to the date of disposal, • that were listed on a recognised exchange, and • for which a price was quoted on that exchange.

*These are high-entry-level, specialist schemes that operate as ‘wholesalers’ and are generally invested in by other collective investment schemes and organisations.

Assets in items (a) and (d) must remain in this class from the date of acquisition to the date of disposal. For example, if the weighted-average method had been used in respect of ABC Limited, a listed share, and that share became unlisted, the weighted-average method would no longer be permissible in respect of those shares and the taxpayer would be forced to switch to specific identification or FIFO.

It is evident from the above table that the weighted-average method may *not* be used for determining the base cost of the following types of identical asset:

- Financial instruments not listed on a recognised exchange (for example, private company shares and listed shares on an unrecognised exchange).
- Gold and platinum coins whose prices are not published in a newspaper for example, a collection of identical old Roman coins displayed in the boardroom of a company.
- Other hard assets.

The specific identification and FIFO methods will have to be adopted for these assets.

The weighted-average method and long-term insurers [para 32(3B)]

Under s 29A(4) long-term insurers are obliged to maintain five funds, namely,

- an untaxed policyholder fund;
- an individual policyholder fund;
- a company policyholder fund;
- a corporate fund; and

- a risk policy fund.⁴⁴⁶

A long-term insurer is obliged to use the weighted-average method for all the identical assets allocated to its various policyholder funds excluding

- an instrument as defined in s 24J(1);
- an interest rate agreement as defined in s 24K(1);
- a contractual right or obligation the value of which is determined directly or indirectly with reference to
 - an instrument as defined in s 24J(1);
 - an interest rate agreement as defined in s 24K(1); or
 - any specified rate of interest;
- trading stock; or
- a policy of reinsurance; or
- an asset held by an insurer that is a Category III Financial Services Provider as defined in s 29B(1) when that asset is held by that insurer in its capacity as a Category III Financial Services Provider.

Paragraph 32(3B) was introduced as a result of the change in the inclusion rates which applied to years of assessment commencing on or after 1 March 2012. The increase in the inclusion rates brought about the need for a once-off deemed disposal and reacquisition of financial instruments held in the policyholder funds of long-term insurers under s 29B in order to lock in the benefits of the lower inclusion rate and to prevent new policyholders from having to bear the increased inclusion rate on gains accruing to earlier policyholders. Under s 29B(2) an insurer is deemed to have disposed of each asset held by that insurer on 29 February 2012, at the close of the day, in respect of all its policyholder funds, other than certain specified assets. The assets excluded under s 29B(2) are also excluded for purposes of para 32(3B). Section 29B(6) excludes from the once-off disposal event any asset held by an insurer if the asset is administered by a Category III Financial Services Provider and that asset is held by that insurer solely for the purpose of providing a linked policy as defined in the Long-term Insurance Act. By contrast, para 32(3B) has wider application and excludes all assets held by a Category III service provider in its capacity as such a provider.

Trading stock was excluded from the weighted-average method, since the rates of normal tax remained unchanged. Debt instruments and interest rate swaps (as well as derivatives of these assets) were excluded from the weighted-average method because capital gains from their disposal are largely insignificant. Domestic policies of reinsurance are similarly excluded because the underlying assets are subject to the deemed disposal event under s 29B in the domestic reinsurer. Assets of a Category III Financial Services Provider operate differently from other assets held by long-term insurer policyholder funds. Assets of this nature are closely connected to the policyholder so gains and losses associated with them (for example, typically units in a collective investment scheme in securities or property) are connected to the policyholder with the policyholder fully bearing gain or loss upon disposal of the underlying assets.

⁴⁴⁶ The risk policy fund was added with effect from years of assessment commencing on or after 1 January 2016.

*How the weighted average is determined**Moving-average method*

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

Determination of weighted average on valuation date and on or after that date

The weighted average must be determined as follows:

- On valuation date – the aggregate market value determined under para 29 of the pre-valuation date identical assets divided by the number of pre-valuation date identical assets.
- After valuation date – after each acquisition of an identical asset or incurral of allowable expenditure after valuation date, the expenditure incurred must be added to the base cost of the identical assets on hand and divided by the number of identical assets on hand.

Paragraph 32(4) is silent on the effect that a disposal of an identical asset has on the base cost pool of identical assets. Common sense, however, indicates that the pool must be proportionately reduced by the units and base cost of assets sold. The practical application of this is illustrated in the example below.

Example – Determination of weighted average after consecutive purchases and sales

Date	Description	Number of shares	Price per share R	Base cost R	Comment
01.10.2001	Opening balance	100		5,0000	500,00 Market
					Gazette
30.09.2002	Purchase	400	<u>300</u> 5,3750	<u>5,5000</u> 2 150,00	<u>1 650,00</u> R2 150 / 400
30.06.2003	Sell	(50)		<u>5,3750</u>	<u>(268,75)</u>
		350	5,3750	1 881,25	
28.02.2004	Purchase	150	<u>150</u>	<u>6,0000</u>	<u>900,00</u>
		500	5,5625	2 781,25	R2 781,25 / 500
30.06.2005	Sell	(100)	<u>(100)</u>	<u>5,5625</u>	<u>(556,25)</u>
		400	<u>5,5625</u>	<u>2 225,00</u>	

8.36.3 Consistency

Paragraph 32 contains two provisions aimed at ensuring the consistent use of the three asset-identification methods (that is, FIFO, specific identification and weighted average). These rules are aimed at preventing base cost manipulation. The rules apply only to the four classes of identical assets referred to in para 32(3A), and do not cover groups of identical assets falling outside those classes, such as unlisted shares. It would, therefore, be possible to use specific identification for one group of unlisted shares, and FIFO for another such group. Under para 32(3A) it would not be possible to use the weighted-average method for unlisted shares.

8.36.3.1 The weighted average consistency rule [para 32(3A)]

A person using the weighted-average method for a group of identical assets falling into one of the four classes of asset referred to in para 32(3A) must use it for all other groups of identical assets falling into that class.

Example – Consistent use of weighted-average method

Facts:

Geoff buys shares listed on recognised exchanges only. His entire holding on valuation date consisted of 1000 ABC Limited shares. In 2002 he purchased a further 500 ABC Ltd shares. In 2003 he sold 500 ABC shares and decided to use the weighted-average method. In 2004 he acquired 200 XYZ Limited listed shares.

Result:

Geoff must use the weighted-average method in respect of the XYZ shares. Only once he has disposed of his entire holding of listed shares can he adopt specific identification or FIFO in respect of any future purchases.

The Act is silent as to when the election of the weighted-average method must be made. It follows that a taxpayer will be bound by the weighted-average method only once the first disposal of a class of asset takes place and evidence of the method adopted is reflected in the relevant return of income.

If a group of identical assets falling into item (a) or (d), that is, listed shares or listed s 24J instruments, becomes unlisted, the weighted-average method can no longer be used for that group, and the specific identification or FIFO method will have to be adopted for the unlisted assets. After delisting, the view is held that the base cost of the unlisted assets will continue to be their weighted-average base cost. However, if further identical assets are acquired, they will have a base cost determined under para 20. Also, the kink tests in paras 26 and 27 will not apply to any previously listed identical assets.

The removal of those assets from the particular class will have no impact on the use of the weighted-average method for any remaining listed shares or s 24J instruments falling in items (a) or (d).

8.36.3.2 The general consistency rule [para 32(6)]

Under para 32(6), once a person has adopted the specific identification, FIFO or weighted-average method for one of the four classes of identical asset referred to in para 32(3A), that person must continue to use that method until all the assets in the class have been disposed of. This rule is primarily aimed at the specific identification and FIFO methods, as consistency of use of the weighted-average method is assured in para 32(3A) as explained in **8.36.3.1**.

It is implicit in para 32(6) that a person may adopt only one asset identification method (that is, specific identification, FIFO or weighted average) for each of the four classes of asset referred to in para 32(3A). Only once all the assets in that class have been disposed of can a different method be adopted in respect of that class.

Paragraph 32(6) states that ‘once a person has adopted one of the methods . . . that method *must* be used . . .’. It follows that once a particular method has been adopted it is not open to a person to request a reopening of assessments in earlier years in order to achieve a more favourable result with hindsight using another method. This restriction applies despite the fact that such a revision would result in a consistent application of a particular method. The evidence of adoption of a particular method can usually be deduced from the return of income reflecting the first disposal on or after valuation date of an identical asset falling within a particular class,

8.36.4 Time-apportionment and the kink tests

Under para 25 the weighted-average method may not be used when the base cost of an asset is determined using the time-apportionment base cost method. Under the time-apportionment method it is necessary to know the date of acquisition of each asset, which would not be an easy task if the assets were pooled. Several different pools of assets at different values would have to be maintained, creating unnecessary complexity.

For the same reason the kink tests in paras 26 and 27 are inapplicable when the weighted-average method is adopted.

8.36.5 Third party reporting requirements

Section 26 of the Tax Administration Act authorizes the Commissioner to issue a public notice requiring a person who, amongst other things, has control over assets of another person, to submit a return by the date specified in the notice. The notice must be in the prescribed form and set out the information required by the Commissioner.

The Commissioner has prescribed the use of the weighted-average method for reporting of share transactions, that is, starting with market value on 1 October 2001 and adding subsequent purchases at cost. See **22.2**.

8.36.6 Relationship between the identification methods and valuation date value methods

As far as pre-valuation date assets are concerned, some taxpayers seem to have had difficulty in understanding the relationship between para 32 asset identification methods and the methods prescribed for determining valuation date values in paras 26, 27 and 28. Some of the confusion may be caused by the fact that para 32 apart from specifying identification methods

also prescribes a valuation date value method, namely, weighted average. The relationship can be summarised as follows:

Table 1 – Asset identification methods that can be used with selected valuation date value methods

Valuation date value method	Permissible Identification method
Market value	Specific identification or FIFO
Time-apportionment base cost	Specific identification or FIFO
20% of proceeds after first deducting post-valuation date expenditure	Not applicable – identification of pre-CGT costs is not required for this method
Weighted average	Weighted average. On valuation date the result is the same as the market-value method. Once additions take place after valuation date, the two methods yield different results.

Example – Comparison of use of specific identification, FIFO and weighted average

Facts:

Daphne holds the following units in a portfolio of a collective investment scheme:

Date purchased	No. of units	Cost per unit R	Cost R
1 October 2001	100	1,50	150
1 November 2001	50	1,60	80
1 December 2001	150	1,70	255
1 January 2002	<u>100</u>	1,35	<u>135</u>
	<u>400</u>		<u>620</u>

On 28 February 2002 Daphne sold 125 units.

Result:

Specific identification method

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

Details of units sold	Quantity sold	Cost per unit R	Base Cost R
Acquired 1 November 2001	50	1,60	80,00
Acquired 1 December 2001	<u>75</u>	1,70	<u>127,50</u>
	<u>125</u>		<u>207,50</u>

First-in-first-out method

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

Details of units sold	Quantity sold	Cost per unit R	Base Cost R
Acquired 1 October 2001	100	1,50	150
Acquired 1 November 2001	<u>25</u>	1,60	<u>40</u>
	<u>125</u>		<u>190</u>

Weighted-average method

The weighted average unit cost is $R620 / R400 = R1,55$

The base cost of 125 units is therefore $125 \times R1,55 = R193,75$

8.37 Part-disposals

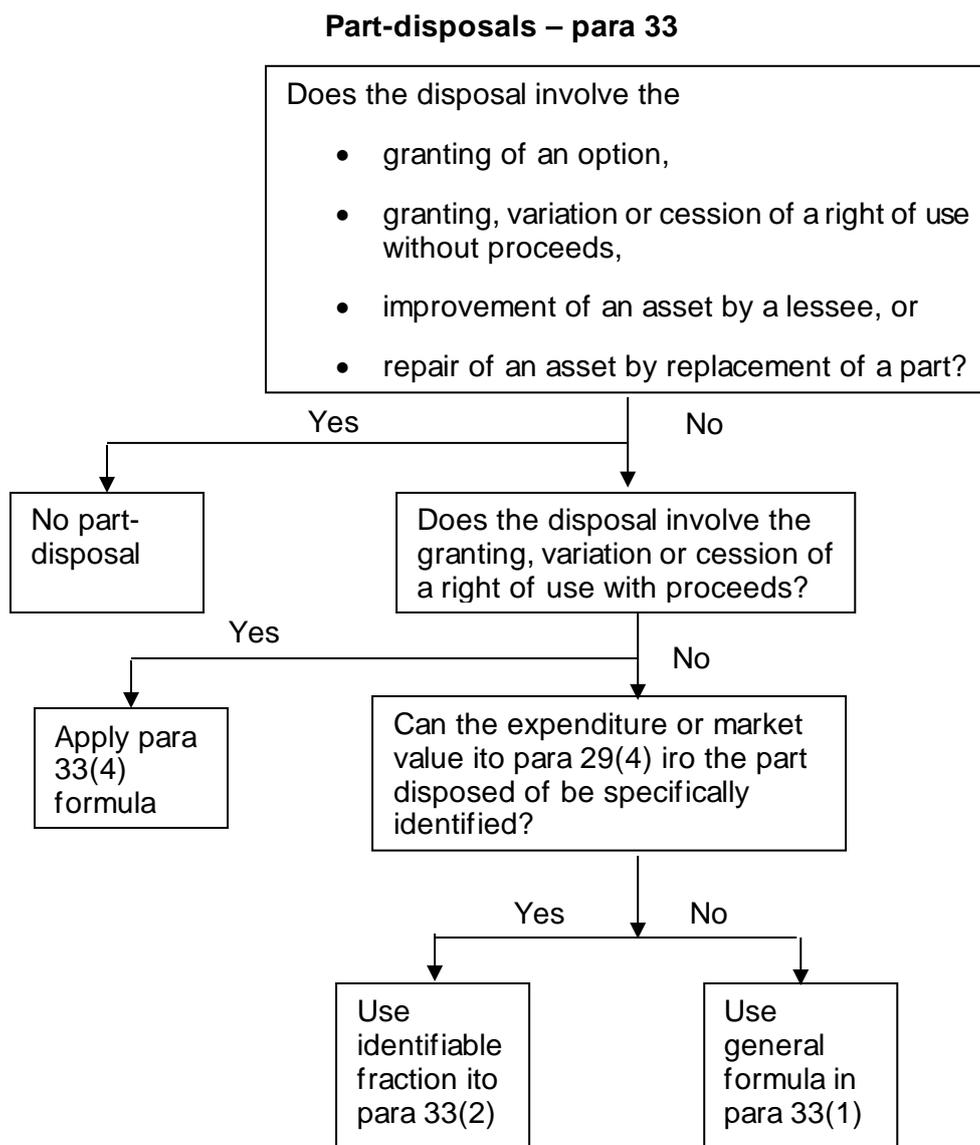
Paragraph 33

8.37.1 Purpose and application

When part of an asset is disposed of, it is necessary to allocate part of the base cost of the asset to the part disposed of in order to determine the capital gain or loss in respect of that part. Paragraph 33 contains rules that

- determine the base cost attributable to the part disposed of; and
- prevent the allocation of a portion of the base cost for certain part-disposals.

The flowchart below sets out the various formulae/methods that must be used to determine the part disposed of.



8.37.2 The standard part-disposal formula [para 33(1)]

The portion of the expenditure allowable under para 20 and any valuation date market value adopted or determined under para 29(4) attributable to the part disposed of is determined in accordance with the following formula:

$$\frac{\text{Market value of part disposed of}}{\text{Market value of entire asset immediately before disposal}} \times \text{Expenditure under para 20 or market value under para 29(4) in respect of entire asset}^{447}$$

The remainder of the expenditure or market value under para 29(4) would be allowable on a future disposal of the part retained.

⁴⁴⁷ Paragraph 33 was substituted by s 99 of the Revenue Laws Amendment Act 45 of 2003 with effect from the commencement of years of assessment ending on or after 1 January 2004. Before its amendment, para 33 contained a number of references to the 'base cost' of an asset. These were replaced with references to allowable expenditure in terms of para 20 or market value adopted or determined in terms of para 29(4). The purpose of the amendment was to facilitate the use of the time-apportionment base cost method when part of a pre-valuation date asset is disposed of.

Example 1 – Part-disposal: Apportionment of base cost*Facts:*

Eric acquired a piece of vacant land at Hermanus before the valuation date. A developer approached him with an offer to purchase half the property for R400 000. An estate agent valued the entire property at R1 million. The market value of the property on 1 October 2001 was R700 000, and Eric elected to use the market-value method to determine the base cost of the property on valuation date.

Result:

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

$$\begin{aligned} \text{Base cost of part sold} &= \frac{\text{R400 000}}{\text{R1 000 000}} \times \text{R700 000} \\ &= \text{R280 000} \end{aligned}$$

Eric would realise a capital gain of R120 000 (R400 000 – R280 000) if he were to dispose of portion of the vacant land to the developer.

Example 2 – Part-disposals and time-apportionment base cost*Facts:*

Wayne paid R100 000 for a piece of vacant land on 30 June 1984. He erected a fence around the property at a cost of R20 000 during the period after valuation date. On 30 September 2019 he subdivided the land and disposed of part of it for proceeds of R16 000. The market value of the land immediately before the disposal was R160 000. Wayne decided to use the time-apportionment base cost method to determine the valuation date value of the asset.

Result:

The capital gain on the part disposed of is determined as follows:

$$\begin{aligned} \text{Percentage disposed of} &= \text{R16 000} / \text{R160 000} \times 100 = 10\% \\ \text{Portion of pre-valuation date expenditure disposed of} &= \text{R100 000} \times 10\% = \text{R10 000} \\ \text{Portion of post-valuation date expenditure disposed of} &= \text{R20 000} \times 10\% = \text{R2 000} \\ \text{Apply proceeds formula} &= \text{R10 000} / (\text{R10 000} + \text{R2 000}) \times \text{R16 000} = \text{R13 333} \end{aligned}$$

$$\begin{aligned} Y &= \text{R10 000} + [(\text{R13 333} - \text{R10 000}) \times 18 / 36] \\ &= \text{R11 667} \end{aligned}$$

$$\begin{aligned} \text{Capital gain} &= \text{R16 000} - [\text{R11 667} + \text{R2 000}] \\ &= \text{R2 333} \end{aligned}$$

For the purpose of any subsequent disposal the expenditure remaining will be as follows:

$$\begin{aligned} \text{Pre-valuation date expenditure} &= \text{R100 000} - \text{R10 000} = \text{R90 000} \\ \text{Post-valuation date expenditure} &= \text{R20 000} - \text{R2 000} = \text{R18 000} \end{aligned}$$

8.37.3 Identifiable fraction method [para 33(2)]

The formula described above does not apply when a part of the allowable expenditure under para 20 or market value adopted or determined under para 29(4) can be directly attributed to

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

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

Example – Part-disposal: Identifiable fraction*Facts:*

In June 1997 Fiona purchased two adjoining pieces of land. She paid R50 000 for the first piece and R75 000 for the other and then had them consolidated. In January 2020 she decided to re-subdivide the property and sell the piece that cost her R50 000. She has elected to use the time-apportionment base cost method to determine the valuation date value of the property disposed of. She sold the piece for R170 000.

Result:

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R50\,000 + [(R170\,000 - R50\,000) \times 5 / (5 + 19)] \\
 &= R50\,000 + [R120\,000 \times 5 / 24] \\
 &= R50\,000 + R25\,000 \\
 &= R75\,000
 \end{aligned}$$

	R
Proceeds	170 000
Less: Time-apportionment base cost	<u>(75 000)</u>
Capital gain	<u>95 000</u>

Some practical issues are addressed below.

8.37.4 Record-keeping

Taxpayers should keep a permanent record of the balance of the cost allocated to the part of the asset retained, for use in computing the gain or loss on any subsequent disposal or part-disposal.

8.37.5 Disposal of usufructs and similar interests and subsequent enhancements

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

8.37.6 Events not treated as part-disposals [para 33(3)]

The four events in the table below do not trigger an allocation of part of the allowable para 20 expenditure or market value under para 29(4) when a part of an asset is disposed of. This treatment prevents the triggering of premature capital losses and was also introduced for administrative reasons when it would be impracticable to compute capital losses arising from numerous small part-disposal events. These events do not prevent the part-disposal itself from taking place but merely prevent an allocation of part of the base cost of the asset to the part-disposal. Any proceeds received in these circumstances will therefore comprise a capital gain in respect of the part-disposal without a base cost deduction.

Table 1 – Events not treated as part-disposals

Paragraph 33(3)	Event not treated as part-disposal
(a)	Granting of an option in respect of an asset
(b)	Granting, variation or cession of a right of use or occupation of an asset without the receipt or accrual of any proceeds.
(c)	Improvement or enhancement of immovable property which a lessee leases from a lessor (see Table 1 in 8.37.6.3 for effective dates)
(d)	Replacement of part of an asset if that replacement comprises a repair.

8.37.6.1 Granting of an option [para 33(3)(a)]

Under para 11(1)(a) the granting of an option is a disposal. An amount received by or accrued to a person for the granting of an option will therefore comprise proceeds. The grantor is likely to have a nil base cost⁴⁴⁸ and in such event a capital gain equal to the proceeds will result. The base cost of the underlying asset in respect of which the option is granted will be brought to account only when the option is exercised and the asset itself is disposed of. An option created after the valuation date in respect of a pre-valuation date asset is not in itself a pre-valuation date asset, since it is 'created' on or after the valuation date.

8.37.6.2 Granting, variation or cession of a right of use or occupation without proceeds [para 33(3)(b)]

Paragraph 33(3)(b) was introduced with effect from the commencement of years of assessment ending on or after 1 January 2003 to prevent the creation of artificial losses. The grant, variation or cession of a right of use or occupation of an asset comprises the disposal of part of an asset, the base cost of which can be determined under para 33(1) and (2). The consideration the person receives for the use or occupation of the asset is normally rental or a lease premium that forms part of the person's gross income and therefore does not constitute 'proceeds' for CGT purposes. In the absence of this provision, the person would have a base cost but no proceeds thus creating an artificial capital loss. The amount of the base cost claimed in these circumstances would reduce the base cost of the asset and if the asset is subsequently disposed of, only a reduced amount of base cost will be deductible from the proceeds on disposal. Under this provision, however, the full base cost will be allowed when the whole asset is disposed of.

The words 'use or occupation' contemplate a right of physical usage or occupation. A typical example is the granting of a lease over movable or immovable property. The granting of a right to the future dividend income from a share will not fall within para 33(3)(b), since it involves neither use nor occupation.

⁴⁴⁸ The base cost of the option could, however, include expenses such as legal fees which are directly related to the cost of creating the option.

The sale of a future dividend stream (being a quasi-usufruct) results in a disposal of a portion of the bundle of rights attaching to the underlying shares. Such a sale must be accounted for as a part-disposal of the shares. The amount received or accrued from the part-disposal is not a 'dividend', but rather an amount of proceeds, assuming that the sale is on capital account. The amount paid by the buyer of the dividend stream is expenditure actually incurred for the purposes of para 20(1) in arriving at the buyer's base cost of the right to the future dividends. The dividends when received or accrued will comprise gross income in the buyer's hands under para (k) of the definition of 'gross income', which may be exempt under s 10(1)(k).

Example – Granting of a lease without proceeds

Facts:

XYZ (Pty) Ltd acquired a warehouse on 1 October 2001 at a cost of R100 000. It immediately advertised for tenants, and on 1 November 2002 entered into a 5-year lease agreement with another company. The agreement provided for a rental of R1 000 payable monthly in advance. It is estimated that the present value of the rental contract is R40 000. Immediately before signing the lease, the property had a market value of R120 000.

Determine the capital gain or loss assuming that XYZ (Pty) Ltd has a year-end of

- 30 November 2002
- 28 February 2003

Result:

Years of assessment ended before 1 January 2003

Under para 11(1)(a) the act of granting a lease over the property is a disposal and the portion of the base cost disposed of would have to be determined under para 33. The market value of the part disposed of is R40 000. Therefore, under para 33 the portion of the base cost disposed of is as follows:

$$R40\ 000 / R120\ 000 \times R100\ 000 = R33\ 333.$$

Since the future rental income will be included in gross income, it will be excluded from proceeds under para 35(3)(a). The result is a capital loss of R33 333.

Years of assessment ending on or after 1 January 2003

The act of entering into the lease is not regarded as a part-disposal under para 33 and as a result no gain or loss results. The base cost of R100 000 will remain intact and available for use when the full property is disposed of.

8.37.6.3 Improvement or enhancement of immovable property by lessee [para 33(3)(c)]

After it was introduced by the Revenue Laws Amendment Act 45 of 2003, para 33(3)(c) was deleted in the following year⁴⁴⁹ and then reinstated with more focused wording in the following year. The table below sets out the periods during which the rule applies and does not apply and the relevant wording of the provision.

⁴⁴⁹ The deletion seems to have been made in error.

Table 1 – Effective dates of amendments to para 33(3)(c)

Amending Act	Effective date		Effect	Wording ‘[T]here is no part- disposal of an asset in respect of— ,’
	From	To		
Section 38 of the Taxation Laws Amendment Act 5 of 2001 (inserts Eighth Schedule)	1 October 2001	Years of assessment ending on or before 31 December 2003	No rule (para 33(3)(c) not yet introduced).	
Section 99 of the Revenue Laws Amendment Act 45 of 2003 (substituted para 33)	Commencement of years of assessment ending on or after 1 January 2004	23 January 2005	Paragraph 33(3)(c) introduced.	‘the improving or enhancing of that asset which is leased to that person’
Section 61(1)(b) of the Revenue Laws Amendment Act 32 of 2004	Paragraph 33(3)(c) deleted with effect from 24 January 2005	31 January 2006	No rule.	
Section 71(1)(b) of the Revenue Laws Amendment Act 31 of 2005	Applies in respect of any improvement or enhancement effected on or after 1 February 2006	To date	Rule reintroduced.	‘the improvement or enhancement of immovable property which that person leases from a lessor’

Under the common law, improvements made to immovable property of a lessor by a lessee accede to the property under the principle of *accessio* (see **24.2**). Although the lessee will continue to enjoy the use of the improvements until the termination of the lease, the lessee loses the ownership of the asset when it is affixed to the property. This common law principle results in a disposal of the bare *dominium* in the asset.

In order to prevent the premature triggering of capital losses, para 33(3)(c) provides that there is no part-disposal in these circumstances. Accordingly, with effect from 1 February 2006 (and during the earlier period reflected in Table 1 above), the lessee may not allocate any portion of the base cost of the asset to the disposal. The cost of improvements to the leased asset qualifies as part of the base cost under para 20 and will be brought into account for capital gains tax purposes on the termination of the lease.

Example – Leasehold improvements by lessee*Facts:*

Grocer (Pty) Ltd entered into a ten-year lease for a shop and spent R100 000 on the shop front and fixtures on which no income tax allowances could be claimed. The value of the bare *dominium* disposed of is equal to the total value of the improvements (R100 000) less the value of the right of use for the next 10 years [para 31(1)(e)]. The bare *dominium* of the improvements calculated over the remaining term of the lease is R32 198. Grocer (Pty) Ltd's financial year ends on 31 March.

What is the CGT position of the lessee if the improvements were effected on

- 31 March 2005, or
- 31 March 2006?

Result:

When effecting the improvements to the land and buildings, the company disposed of the bare *dominium* in the improvements, and retained the right of use.

Improvements effected 31 March 2006

Under para 33(3)(c) the expenditure will form part of the base cost of the asset, that is, the lease, and if on termination of the lease no compensation for the improvements is received the capital loss of R100 000 will be allowed at the time of the expiry of the lease.

Improvements effected 31 March 2005

Grocer (Pty) Ltd will have a capital loss of R32 198 on 31 March 2005. The company will have a further capital loss of R67 802 (R100 000 – R32 198) on termination of the lease in 10 years' time.

8.37.6.4 Replacement of part of an asset comprising a repair [para 33(3)(d)]

[Effective as from the commencement of years of assessment ending on or after 1 January 2004]

A person who replaces part of an asset in the course of repairing it, disposes of part of the main asset by removing the worn out or damaged part. For example, the replacement of a broken window in a building will constitute the disposal of a part of the building.

In order to prevent the triggering of numerous small capital losses, para 33(3)(d) prevents the allocation of any part of the base cost of the main asset to the part-disposal when the replacement of part of the asset is a repair. This provision does not affect those persons who are entitled to claim repairs under s 11(d), since their base cost allocation would have been eliminated by para 20(3)(a). Any proceeds derived from the disposal of the worn out part will be recognised as a capital gain at the time of its disposal with no base cost deduction.

As to what comprises a repair, see the following extract from ITC 617:⁴⁵⁰

(1) Repair is restoration by renewal or replacement of subsidiary parts of the whole. Renewal as distinguished from repair is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject matter under discussion.

(2) In the case of repairs effected by renewal it is not necessary that the materials used should be identical with the materials replaced.

(3) Repairs are to be distinguished from improvements. The test for this purpose is – has a new asset been created resulting in an increase in the income-earning capacity or does the work undertaken merely represent the cost of restoring the asset to a state in which it will continue to earn income as before?

See also Interpretation Note 74 (Issue 2) dated 14 December 2015 ‘Deduction and Recoupment of Expenditure Incurred on Repairs’.

Example – Replacement of part of asset comprising a repair

Facts:

John purchased a country cottage for investment and letting purposes at a cost of R150 000. At the time of purchase the cottage was in a poor state of repair. During the first year of assessment during which he held the cottage, John replaced a rusty geyser at a cost of R6 000, which he claimed against rental income under s 11(d). He managed to sell the old geyser to a scrap metal merchant for R100.

Result:

When he removed the old geyser, John disposed of a part of the cottage. However, under para 33(3)(d) he does not have to determine the portion of the cost of the cottage attributable to the old geyser. The proceeds of R100 constitute a capital gain that must be recognised in the year of assessment in which the old geyser is disposed of.

8.37.6.5 Acquisition of shares cum div

No part-disposal is triggered when a shareholder acquires a share cum div and subsequently receives the dividend. The dividend comprises gross income and does not represent a recovery of cost for purposes of para 20(3)(b).

8.37.7 Granting, variation or cession of a right of use or occupation when proceeds received or accrued [para 33(4)]

Despite para 33(3)(b), para 33(4) triggers a part-disposal when proceeds are received or accrued in respect of the granting, variation or cession of a right of use or occupation of an asset. The intention of this provision was to prevent hardship by allowing a base cost deduction for a lessor who receives proceeds. In practice most receipts or accruals received by or accruing to a lessor would fall within the definition of ‘gross income’ (for example, rental income), while lease premiums will fall within para (g) of that definition. Deemed proceeds may also arise under para 38 when a lessor who is a connected person in relation to a lessee charges a rental or royalty that is not market-related.

⁴⁵⁰ ITC 617 (1946) 14 SATC 474 (U) at 476.

In these circumstances, the portion of the base cost attributable to the part of the asset in respect of which those proceeds were received or accrued is determined in accordance with the following formula:

$$\frac{\text{Proceeds}}{\text{Market value of entire asset}} \times \text{Expenditure under para 20 or market value under para 29(4) in respect of entire asset immediately before disposal}$$

Proceeds are used in the numerator of the above formula instead of market value in order to arrive at a fair apportionment of the base cost. Take, for example, the case of a lessor who enters into a long lease that provides for the payment of an up-front lease premium of R1. Had market value been used in the numerator, a large portion of the base cost would be allocated to the disposal (the market value of the part disposed of would be high because of the length of the lease). The use of proceeds in the numerator prevents the creation of abnormal capital losses.

Example 1 – Part-disposal when lease granted and proceeds received

Facts:

Errol purchased 'Speedy Boy', a racehorse, for R100 000 on 1 October 2001. On 31 August 2002 after Speedy Boy had won a number of races, Errol agreed to lease the steed to Andrew for a market-related rental of R50 000 a year for five years. Immediately before entering into the lease the market value of the racehorse was R200 000. Since Andrew was desperate to impress his friends and reverse his flagging fortunes on the race track, he agreed to pay Errol an up-front premium (see note at end of this example) of R25 000 for the right of use of Speedy Boy. This payment was in addition to, and over and above the market-related rental that Errol could have obtained from other interested lessees. For the purposes of this example it is assumed that Errol did not claim depreciation on Speedy Boy.

Result:

Under para 33(4), since Errol has received proceeds of R25 000, he will have triggered a part-disposal. The base cost of the part disposed of is determined as follows:

	R
Base cost	100 000
Proceeds (lease premium)	25 000
Market value of Speedy Boy	200 000

Part of base cost disposed of = R100 000 × R25 000 / R200 000 = R12 500

Capital gain = R25 000 – R12 500
= R12 500.

Note:

For the purpose of this example, it has been assumed that a horse is not 'plant' and hence that the lease premium does not fall within para (g) of the definition of 'gross income'. In reality, however, a horse may well constitute plant. In the United Kingdom case of *Yarmouth v France*⁴⁵¹ Lindley LJ held that a vicious horse constituted plant for the purpose of the Employer's Liability Act, 1880. He stated that in its ordinary sense plant

'includes whatever apparatus is used by a businessman for carrying on his business – not his stock-in-trade which he buys or makes for sale; but all goods and chattels, fixed or movable, live or dead, which he keeps for permanent employment in his business'

⁴⁵¹ (1887) 19 QBD 647 at 658.

The above quote was cited with approval in *Blue Circle Cement Ltd v CIR*,⁴⁵² a landmark case that dealt with the meaning of the word 'plant'.

A somewhat more restrictive view of the word 'plant' can be found in ITC 1046⁴⁵³ in which the court held that bins that were not used in a manufacturing process did not constitute plant. In that case the court relied on the *Shorter Oxford English Dictionary* meaning, which at the time read as follows:

'[T]he fixtures, implements, machinery and apparatus used in carrying on any industrial process.'

Example 2 – Part-disposal involving deemed proceeds under para 38

Facts:

Holdco owns all the shares in Subco 1 and Subco 2. Subco 1 owns a factory building, while Subco 2 carries on a manufacturing operation. Subco 1's property has a market value of R1 million and a base cost of R200 000. Subco 1 entered into a ten-year lease with Subco 2 under which Subco 2 paid an annual rental of R1. A fair rate of return on the property would have been 12% a year. Determine Subco 1's capital gain or loss.

Result:

Subco 1 and Subco 2 are connected persons in relation to each other. Since the rental consideration of R1 a year is not market-related, para 38 applies. A fair rental would be $R1\ 000\ 000 \times 12\% = R120\ 000$ a year.

The present value of R120 000 a year for 10 years using an Excel spreadsheet is as follows:

$$\begin{aligned} &=PV(0.12,10,-120000) \\ &= R678\ 027 \end{aligned}$$

The present value of the actual rental is

$$\begin{aligned} &=PV(0.12,10,-1) \\ &= R6 \end{aligned}$$

The deemed proceeds under para 38 are $R678\ 027 - R6 = R678\ 021$.

Alternatively, this same result can be arrived at by discounting R119 999 ($R120\ 000 - R1$) a year at 12% over 10 years.

Under para 35(3)(a) the actual consideration of R1 a year is excluded from proceeds as it 'must be' included in gross income in future. Under para 33(4) the portion of the base cost disposed of is as follows:

$$\begin{aligned} &\text{Proceeds / market value} \times \text{base cost} \\ &R678\ 021 / R1\ 000\ 000 \times R200\ 000 \\ &= R135\ 604 \end{aligned}$$

	R
Proceeds	678 021
Less: Base cost	<u>(135 604)</u>
Capital gain	<u>542 417</u>

⁴⁵² 1984 (2) SA 764 (A), 46 SATC 21.

⁴⁵³ (1964) 26 SATC 217 (F).

Concern has been expressed that the outcome of Example 2 implies the imposition of transfer pricing on all connected-person leases, including informal leases between relatives of individuals. Most connected-person leases tend to be informal arrangements that are renewed on a day-to-day basis. Such arrangements arguably do not have a market value, since a third party would not be prepared to pay anything for the cession of a lease that can be cancelled at a moment's notice. These informal arrangements should accordingly not result in deemed proceeds under para 38. The facts of Example 2 deal with a long-term lease which clearly creates a valuable leasehold right for the lessee.

8.37.8 Consistent adoption of the '20% of proceeds' method [para 33(5)]

[Effective 22 December 2003]

A person who has adopted the '20% of proceeds' method in respect of a part-disposal of a pre-valuation date asset must continue to use that method for all subsequent disposals of that asset.

A person who adopts this method does not need to allocate part of the expenditure or market value to the part disposed of and, therefore, falls outside s 33(1).

The '20% of proceeds' method determines the base cost of the part disposed of but does not determine the part of the expenditure allowable under para 20 or the part of the market value disposed of. It is therefore unclear how much of these components remain behind after a part-disposal effected using this method. For this reason, it is desirable that consistency be prescribed.

Example – Consistent application of '20% of proceeds' method under a part-disposal

Facts:

Louise purchased a piece of land at a cost of R5 000 in 1999. In 2017 she disposed of half the land for proceeds of R100 000. The market value on valuation date of the property was R20 000. She decided to adopt the '20% of proceeds' method, which gave her a base cost of R20 000 and a capital gain of R80 000. In 2020 she disposed of the remaining land for proceeds of R50 000.

Result:

Under para 33(5) Louise must adopt the '20% of proceeds' method for the disposal in 2019 and will have a base cost of R10 000 and a capital gain of R40 000. Had she been permitted to switch to the time-apportionment base cost or market-value method for the second disposal, it would have been unclear how much of the expenditure and market value remained after the first disposal.

8.37.9 Part-disposal of goodwill

The goodwill of a business is a single asset, separate and distinct from the other assets of the business. It does not attach to the identifiable assets of the business. On the other hand, goodwill has no existence independently of the conduct of a business and cannot be severed from the business that created it. See in this regard the leading Australian case of *FCT v Murry*⁴⁵⁴ and the subsequent rulings issued by the Australian Tax Office.⁴⁵⁵

It follows that goodwill as a general rule cannot be partly disposed of. It is, however, accepted that it is possible to own and operate separate and distinct businesses, each with its own goodwill.

When a taxpayer sells a distinct and separate business and the goodwill attaching to that business was not separately valued at the valuation date, SARS accepts that certain difficulties may arise.

The following approach will be adopted:

If only one business is being carried on and a part of it is disposed of, it is a question of fact whether a discrete business, to which goodwill attaches, has been disposed of. This question is determined having regard to all the facts and circumstances, including whether

- sufficient relevant assets are sold to enable the purchaser to continue with the business,
- the assets sold are accompanied or carry with them the legal right, privilege or entitlement to conduct the business, and
- what is sold is sold as a self-contained business.

If part of a business is disposed of, an important consideration is whether the effect of the transaction is to put the purchaser in possession of a going concern, the activities of which the purchaser could carry on without interruption.

The disposal of pre-valuation date goodwill

Paragraph 33 provides for the apportionment of the base cost of an asset when there is a part-disposal of that asset. In applying para 33, and bearing the above principles in mind, the following should be noted:

- The discrete business disposed of must have been in existence in its present form on 1 October 2001. In other words, a portion of the goodwill in existence on 1 October 2001 cannot be allocated to the disposal of a business that commenced after that date. This requirement means, amongst other things, that a portion of the goodwill in existence on 1 October 2001 cannot be allocated to the disposal of a group of assets that did not, in themselves, constitute a discrete business on 1 October 2001, even though the assets were assets of the business on that date.

⁴⁵⁴ (1996) 622 FCA 1, available online at <<http://www.austlii.edu.au/cgi-bin/disp.pl/au/cases/cth/federal%5fct/1996/622.html?query=%7e+murry>> [Accessed 2 November 2020].

⁴⁵⁵ Taxation Rulings TR 1999/16 and TR 1999/16A available at <<https://www.ato.gov.au/law/view/document?Docid=TXR/TR199916/NAT/ATO/00001&PiT=99991231235958>> [Accessed 2 November 2020].

- It follows that all discrete businesses that formed part of the whole business on the valuation date should be identified, even if the goodwill attached to them was not determined. It is suggested that a list of discrete businesses in existence on valuation date be compiled and retained with the valuation of the goodwill of the whole business. Such record-keeping will assist the taxpayer in proving which of the businesses at the date of disposal existed at the valuation date.
- Expenditure incurred in developing pre-valuation date self-generated goodwill will invariably have been allowed against income. Paragraph 20(3)(a) eliminates such expenditure from base cost. Paragraph 26(3) will eliminate any capital loss on a part-disposal of self-generated goodwill when market value is adopted as the valuation date value.
- On disposal of a discrete business, which was in existence on 1 October 2001, para 33 requires that the market value of the discrete business disposed of and the market value of the entire business be determined immediately before that disposal. This determination is done in order to establish the proportion of the goodwill to be allocated to the discrete business disposed of.

8.38 Debt substitution

Paragraph 34

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

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

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

The base cost, for the creditor, of the asset acquired from the debtor would in the absence of the debt substitution rule be equal to the consideration given by the creditor, namely, the amount of the claim given up by the creditor. Under this paragraph, however, the asset must be treated as one acquired by the creditor at a base cost equal to its market value at the time. The market value of the asset is treated as an amount of expenditure actually incurred and paid for the purposes of para 20(1)(a). This treatment prevents any double counting in the creditor's hands of an amount equal to the gain or loss determined in respect of the exchange of the creditor's claim for the asset.

Example – Discharge of debt by disposal of asset*Facts:*

Gerrie owes Helen R1 000. Helen agrees to release Gerrie from the debt in return for the transfer, by Gerrie to Helen, of an asset to the value of R900 that Gerrie originally acquired for R400.

*Result:**Gerrie*

	R
Proceeds [para 35(1)(a)]	1 000
Less: Base cost	<u>(400)</u>
Capital gain	<u>600</u>

Helen

Proceeds (market value of asset acquired from Gerrie)	900
Less: Base cost of debt	<u>(1 000)</u>
Capital loss	<u>(100)</u>

Under para 34 the base cost of Helen's asset acquired from Gerrie is deemed to be R900.

8.39 Exchange control and related tax amnesty assets

8.39.1 Introduction

Between 1 June 2003 and 29 February 2004 South African-resident individuals, deceased estates, trusts and close corporations were able to apply for amnesty for specified exchange control and related tax offences. A pre-requisite for amnesty was that the applicant had to hold a foreign asset at 28 February 2003 which had been tainted by a tax or exchange control offence. The relevant legislation is contained in the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003 ('the Amnesty Act') and in Regulations issued under s 30 of that Act.⁴⁵⁶

A successful applicant is not liable to tax on any undeclared capital gain arising during any year of assessment ending on or before 28 February 2002 (s 15 of the Amnesty Act).

It follows that persons holding amnesty assets in their own names are required to make full disclosure of any capital gains and losses arising during the 2003 and subsequent years of assessment.

Section 4 of the Amnesty Act provided a special procedure under which a person (being a donor, deceased estate of a donor or beneficiary) could elect to treat foreign assets held by a non-resident discretionary trust as that person's own assets for the purposes of the Act, other than Parts V (donations tax) and VII (STC). The election did not apply for estate duty purposes.

The base cost of assets held by persons in their own names is determined in the same way as non-amnesty assets. A successful applicant must use market value on 1 October 2001, time-apportionment or 20% of proceeds to determine the valuation date value of pre-valuation date assets. The amnesty legislation did not make provision for the exclusion of any unrealised growth or decline in value of amnesty assets arising between 1 October 2001 and say, 1 March 2002. The base cost of foreign amnesty assets acquired on or after 1 October 2001 is determined under para 20 or, when applicable, para 38.

⁴⁵⁶ GN R 1368, GG 25511 of 29 September 2003.

However, any growth or decline in the value of offshore trust assets before 1 March 2002 in respect of which an election was made under s 4 of the Amnesty Act is disregarded. These special rules are addressed in **8.39.2**.

The table below summarises the rules applicable to amnesty assets.

Table 1 – Base cost of amnesty assets

Applicant	Date of acquisition for CGT purposes	Base cost
<p>Person directly holding foreign assets in own name</p>	<p><i>Direct assets</i></p> <p>Normal rules determine date of acquisition (e.g. para 13(2) or general principles).</p> <p><i>Assets of CFC</i></p> <p>If foreign company was a CFC before 1 October 2001, the CFC will acquire its assets in the same way as any resident and its valuation date is 1 October 2001.</p> <p>If the foreign company became a CFC after 1 October 2001, its date of acquisition is the date it became a CFC⁴⁵⁷</p>	<p>Determined in accordance with the core rules:</p> <p>Pre-valuation date assets – under paras 25 to 28.</p> <p>Post-valuation date assets – under para 20 or 38.</p> <p>Before the 2012 year of assessment, foreign currency assets – under the now repealed Part XIII of the Eighth Schedule (valuation date = 1 March 2003 – para 84)</p> <p>Other foreign assets – para 43.</p> <p>If the person applied for exchange control amnesty for the assets in question, whatever base cost is arrived at under the core rules is subject to the base cost limitation rule in s 28(2) of the Amnesty Act</p> <p>Market value on valuation date, time-apportionment or 20% of proceeds.</p>
<p>Donor, deceased estate of donor or beneficiary making an election in respect of foreign assets of a non-resident discretionary trust under s 4 of Amnesty Act</p>	<p>General rule</p> <p>The first day of the last year of assessment ending on or before 28 February 2003.⁴⁵⁸</p>	<p>Market value on 1 March 2002 plus subsequent expenditure incurred.⁴⁵⁹ The market value of assets (other than Part XIII foreign currency assets) must be determined in foreign currency and translated to rand under para 43.</p>

⁴⁵⁷ Section 9D(2A)(e).

⁴⁵⁸ Under s 4(3)(a)(ii) of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003.

⁴⁵⁹ Regulation 4(a) of GN R 1368, GG 25511 of 29 September 2003.

Applicant	Date of acquisition for CGT purposes	Base cost
	<p><i>Assets of CFC</i> Under para 12(2)(a) read with para 12(1) the foreign company is deemed to have disposed of and reacquired its assets on the date it became a CFC. It became a CFC when its shares were deemed under s 4(3)(a)(ii) of the Amnesty Act to be acquired by the electing party, namely, on the first day of the last year of assessment ending on or before 28 February 2003.</p>	<p>If the person applied for exchange control amnesty in respect of the assets in question, this value is subject to the base cost limitation rule in s 28(2) of the Amnesty Act.</p> <p>Market value on date the foreign company became a CFC [para 12(2)(a)]. This rule is subject to the 'kink test' in para 24, which may substitute a different value.</p>

8.39.2 Election in respect of assets held by foreign discretionary trust under amnesty provisions

The exchange control and related tax measures apply only to residents of South Africa. Since a foreign trust is unlikely to be a resident, such trusts would in the absence of s 4 of the Amnesty Act have been unable to apply for amnesty. Section 4 enabled a donor, deceased estate of a donor or beneficiary to elect that the discretionary trust's assets be treated as being held by that electing party. For the purpose of the provision a donation includes a donation contemplated in s 58 of the Act.⁴⁶⁰ This rule ensures that an asset that is disposed of for an inadequate consideration will also be treated as a donation. The reference to a deceased estate of a donor is unclear. It would seem to have limited application to deceased estates that are in the process of being wound up during the amnesty period, for once the estate has been wound up it ceases to exist.

Assets affected by the election include the donated asset, and any asset whose value is wholly or partly derived from a donation made by the donor.⁴⁶¹ This treatment means that the election extends to assets acquired out of the proceeds of donated assets.

The electing party is treated as having

- acquired the foreign asset for an amount equal to the market value on 1 March 2002 plus any post-1 March 2002 expenditure incurred by the trust, and
- dealt with the foreign asset in the same manner as the trust deals with it from 28 February 2003.⁴⁶²

It follows that any pre-1 March 2002 capital gain or loss is disregarded. In addition, if the trust, for example, held the asset as trading stock on 28 February 2003, the electing party is treated as holding the asset as trading stock on that date. Should the trust subsequently convert the trading stock into a capital asset, an inclusion in income will be triggered under s 22(8) and an

⁴⁶⁰ Regulation 2(b).

⁴⁶¹ Regulation 3.

⁴⁶² Regulation 4.

acquisition under para 12(3) in the electing party's hands. Likewise, if the trust converts a capital asset in respect of which an election has been made into trading stock, a disposal at market value will be triggered for CGT purposes in the electing party's hands under para 12(2)(c) and an acquisition of trading stock at that same market value under s 22(3)(a)(ii).

For the purposes of determining the base cost of assets which are the subject of the s 4 election, the market-value method is the only one open to an electing party. Time-based apportionment and the '20% of proceeds' methods are not available options. There is no time limit for the determination of the market value.

For purposes of determining any income or any capital gain or loss from the disposal of a foreign asset in respect of which an election was made, the electing party is deemed to hold the asset until

- the foreign asset is disposed of by the trust to a person other than the electing party;⁴⁶³
- the electing party dies or ceases to be a resident;⁴⁶⁴ or
- a deceased estate, close corporation or trust ceases to exist by operation of law. Such an event includes the termination of a deceased estate once wound up, the termination of a trust by reason of insolvency, destruction of trust property or realisation of trust purpose and the dissolution of a close corporation as a result of liquidation.⁴⁶⁵

The vesting of an asset in the electing party by the trustees in respect of which an election has been made does not trigger a disposal of that asset by the electing party. The electing party will simply switch from being a deemed owner to an actual owner, and since there is no change in ownership there can be no disposal. Note that s 4(3) triggers a disposal only when the asset is disposed of 'to any other person', that is, to a person other than the electing party. An asset so vested will, however, commence to form part of the electing party's estate for estate duty purposes.

When the electing party ceases to hold the assets in respect of which an election has been made as a result of one of the events described above, the electing party is deemed to dispose of the assets for a consideration equal to their market value on the date of disposal.⁴⁶⁶ The disposal is to no one in particular and the deemed proceeds are unrelated to any actual consideration received by the trust. The electing party is not treated as having acquired any replacement asset acquired by the trust with the actual proceeds. For example, if the trust disposes of asset X in exchange for asset Y, asset Y will belong to the trust for CGT purposes and not to the electing party.

If the electing party is deemed to be the owner of shares, and the company concerned makes a distribution in specie to the trust, it is considered that the *in specie* asset will belong to the electing party, since it was derived from the shares which the electing party is deemed to own. Such an interpretation gives full effect to the legal fiction. The electing party will be deemed to dispose of the asset so derived when the trust disposes of it to a third party.

The attribution rules in paras 70, 72 and 80 do not apply to any capital gain arising in the trust during the period that a person has made an election under s 4.⁴⁶⁷ See **15.9**.

⁴⁶³ Section 4(3)(a)(ii) of the Amnesty Act. Although Regulation 4(c)(i) states that the person must be deemed to hold the asset until it is disposed of by the trust (that is, unlike s 4(3)(a) it does not exclude a disposal to the electing party), it is considered that s 4(3)(a) must prevail.

⁴⁶⁴ Regulation 4(c)(ii).

⁴⁶⁵ Regulation 4(c)(iii).

⁴⁶⁶ This outcome follows from s 4(3) of the Amnesty Act read with reg 4.

⁴⁶⁷ Regulation 7.

When the trust becomes a South African resident after the election (for example, because new South African-based trustees are appointed to manage the trust), para 12(2)(a) will not trigger a disposal in the electing party's hands. This follows from the fact that while under para 12(2)(a) the trust is deemed to dispose of its assets at market value and to reacquire them at that same value upon the change of residence, the assets in question are deemed to be held by the electing party, and not the trust. Since the electing party would already be a South African resident, para 12(2)(a) cannot apply. Furthermore, s 4(3) refers to the disposal by the trust of the assets to 'any other person'. This wording envisages an actual disposal to a person, not a deemed disposal to no one in particular as is the case under para 12(2)(a).

When an election has been made in respect of a controlling interest in a foreign company (a CFC), s 9D will apply as if the resident electing shareholder held the shares directly. Thus, the 'net income' (that is, an amount equal to the taxable income) of the CFC must be attributed to the electing party unless an exemption applies. Part XIII, which dealt with foreign currency gains and losses before the 2012 year of assessment, did not apply to companies. The exchange gains and losses of the CFC must be determined under s 24I and will form part of the CFC's 'net income'.

8.39.3 Limitation of base cost of amnesty assets

Section 28(2) of the Amnesty Act

The Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003 provided amnesty for certain exchange control and tax violations relating to foreign assets held on 28 February 2003. An exchange control amnesty levy of 5% or 10% was payable in respect of amounts taken offshore illegally in excess of the permissible limits. In order to prevent understatement of the value of the foreign assets disclosed for the purpose of determining the levy, a limitation was placed on the base cost of those assets under s 28(2) of that Act.

Under this rule a disclosed foreign asset is deemed to have a base cost that does not exceed that asset's disclosed market value on 28 February 2003 plus para 20 expenditure incurred after that date. As a result of this rule, persons who applied for exchange control amnesty who undervalued a disclosed foreign asset (to reduce the amnesty levy) will be forced to incur additional tax upon eventual sale of that asset. Stated differently, under-valuations will result only in deferral as against outright exemption.

This limitation applies only when the relevant asset was held on 28 February 2003 and the person was an exchange control amnesty applicant. Persons who applied for tax amnesty only are not affected by the rule. The normal rules apply in determining the base cost of an asset disposed of during the year preceding that date. For example, with pre-valuation date assets the rules in paras 25, 26, 27, 28, 29 and 32 will apply. Section 28(2) also applies to the base cost of assets held by a foreign discretionary trust in respect of which an election has been made under s 4 of the Amnesty Act. Such assets are deemed to have been acquired by the electing party at market value on 1 March 2002.

Under s 28(2) the base cost of the asset may not exceed

- the value in foreign currency of the asset on 28 February 2003 as disclosed for the purpose of determining the amnesty levy, plus
- any post-28 February 2003 para 20 expenditure.

In summary, a person must use the lower of two possible base costs:

- The 'normal' base cost determined under the Eighth Schedule (with pre-valuation date assets, using time-apportionment, market value on 1 October 2001 or 20% of proceeds), and

- The ‘limited’ base cost determined under s 28(2).

Section 28(2) envisages a comparison between two foreign currency amounts. The normal base cost of the asset must accordingly be determined in foreign currency rather than rand in order to achieve a comparison with the limited base cost. The lower of the two foreign currency base costs must be adopted.

Translation of the lower base cost

Neither para 43, Part XIII (repealed from 1 March 2011) nor s 25D address the issue of how the ‘value in foreign currency’ on 28 February 2003 is to be translated, since they refer to expenditure or market value on valuation date. The amount under consideration is a ‘value’, not expenditure.

The method of translation should as far as possible follow the translation rules in para 43 and Part XIII (repealed). With para 43(1) assets (expenditure and proceeds in same foreign currency), the capital gain or loss should be determined in the foreign currency and translated to rand at the spot rate at the time of disposal or by using the average exchange rate in the year of disposal. With para 43(1A) assets the market value on 28 February 2003 should be translated at the spot rate ruling on that date, while expenditure incurred after 28 February 2003 must be translated at the spot rate when the expenditure was incurred or by using the average rate in the year of incurral.

Example 1 – Understatement of market value of foreign asset on 28 February 2003

Facts:

Des owned a block of flats in London from which he derived rental income. He initially acquired the flats in contravention of Exchange Control for £18 million on 1 July 1984. The flats had an actual value of £25 million on 28 February 2003, but Des provided a sworn valuation from a friendly valuer that the flats were worth only £15 million. This £15 million value was accepted as true by the amnesty unit. Since he had already used his R750 000 permissible foreign capital allowance, Des paid an exchange control amnesty levy of £1,5 million (10% × £15 million) instead of a £2,5 million levy (10% × £25 million). He sold the flats for £30 million on 15 September 2019, and wishes to use time-apportionment to determine the base cost of the flats. No improvements have been made to the flats since Des acquired them.

Result:

Des’ base cost is determined as follows:

The time-apportionment base cost of the flats is £24 million, arrived at as follows:

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= £18\,000\,000 + [(£30\,000\,000 - £18\,000\,000) \times 18 / 36] \\
 &= £18\,000\,000 + £6\,000\,000 \\
 &= £24\,000\,000
 \end{aligned}$$

However, the base cost of Des’ flats may not exceed the amount declared to the amnesty unit as the value on 28 February 2003 (£15 000 000) plus any post-28 February 2003 para 20 expenditure (£nil). He is therefore not permitted to use the higher time-apportionment base cost as his base cost and is restricted to the value declared to the amnesty unit of £15 million. His capital gain is therefore £15 million (£30 million proceeds – £15 million base cost) as opposed to what it could have been, namely, £6 million (£30 million proceeds – £24 million base cost) had he disclosed the true value to the unit.

Example 2 – Irrelevance of use of permissible foreign exchange allowance in determining base cost limitation

Facts:

The facts are the same as Example 1, except that Des has never used any of his permissible foreign capital allowance of R750 000 (and the amnesty levy is reduced accordingly).

Result:

The result is the same as Example 1. The use of the permissible foreign capital allowance to reduce the amnesty levy has no impact on tax cost.

Example 3 – Translation of lower base cost

Facts:

Matthew applied for exchange control amnesty for a foreign endowment policy he acquired in France at a cost of €100 000 on 1 October 1996. He completed a CGT 2 form by 30 September 2004 indicating that the valuation date market value was €200 000. At the time of applying for amnesty he engaged a friendly valuer who supplied him with an understated valuation as at 28 February 2003 of €150 000. He disposed of the policy on 31 January 2019 for €500 000. In 2004 he invested an additional amount of €20 000 in the policy. The average exchange rate for the 2020 year of assessment was R16,2475 = €1. Matthew decided to use market value as the valuation date value.

Result:

Compare normal base cost and limited base cost

Normal base cost = €200 000 (VDV) + €20 000 = €220 000

Limited base cost = €150 000 + €20 000 = €170 000

Since limited base cost is the lower base cost, Matthew must use €170 000 as his base cost.

Under para 43(1) Matthew must determine a capital gain or loss as follows:

Proceeds	€ 500 000
Less: Base cost	(170 000)
Capital gain	<u>330 000</u>
Capital gain in rand	€330 000 × R16,2475 R5 361 675

8.39.4 Disposal of shares at cost by trust to resident under Circular D 405

Some residents placed shares in South African companies in offshore trusts for the purpose of exporting foreign currency illegally by way of dividends (the so-called '74/26' or 'loop' scheme).

The South African Reserve Bank established rules in Circular D 405 dated 30 September 2003⁴⁶⁸ for the unwinding of these loop structures. One of the requirements of Circular D 405 is that the offshore trust must dispose of the shares in the South African company to a resident before 29 February 2004, and this sale must take place at original cost. Circular D 405 does not address the CGT consequences of unwinding loop structures. These must be deducted from s 4 of the Amnesty Act (when an election was made), or para 20 or 38 (when no election was made). The Amnesty Unit accepted that the shares in the South African company were a

⁴⁶⁸ Available at <<http://www.ftomasek.com/archive/ExchangeControlD405.pdf>> [Accessed 2 November 2020]. This circular must be read with circular D 417.

'foreign asset' as defined in the Amnesty Act on the basis that the rights of ownership in the shares were transferred offshore. Without this acceptance it would not have been possible for an applicant to make an election in respect of the shares held by the trust. Clearly, the acquisition of the shares at a cost which is considerably less than market value will be of concern to persons in establishing the base cost to be taken into account in any future disposal of the shares.

If an election was made under s 4 and the electing party acquires the shares in the resident company at cost, the disposal by the trust and corresponding acquisition by the electing party must be disregarded under s 4(3)(a)(ii) of the Amnesty Act. Under that provision, the electing party is deemed to have held the shares

'from the first day of the last year of assessment ending on or before 28 February 2003 . . . until that foreign asset is disposed of by that discretionary trust to *any other person*'.

(Emphasis added.)

The italicised words make it clear that the electing party remains the deemed owner of the shares for CGT purposes even though that party may in reality have acquired the shares from the trust. Any amount paid by the party in acquiring the shares must accordingly be disregarded, since it does not relate to the cost of acquiring the asset (the asset was already deemed to be acquired). The resident must simply account for any capital gain or loss when the shares are disposed of to a third party (see example below).

If an election was not made, the base cost of the shares in the hands of the resident acquirer will have to be determined either under para 20 or 38. If the resident is not a connected person in relation to the trust, the price paid for the shares under Circular D 405 will constitute the expenditure actually incurred in acquiring the shares for the purposes of para 20(1)(a). Even though the price paid may be far less than the market value, para 38 would not apply, since the price paid would not constitute a donation. For there to be a donation the transaction must be wholly gratuitous. A resident who is a connected person in relation to a trust will receive a step-up in base cost under para 38 equal to market value. This situation would apply to a resident beneficiary, since beneficiaries of a trust are connected persons in relation to the trust under para (b) of the definition of 'connected person' in s 1(1). The facts and circumstances of structures unwound under Circular D 405 vary considerably and each situation must be considered on its merits in determining the base cost of the shares.

Example – Shares in South African Company acquired at original cost by resident under Circular D 405

Facts:

Jurgen, a resident, set up a discretionary trust in Jersey. The trust acquired a 74% interest in his South African manufacturing company at cost of R740. Jurgen acquired the other 26% interest at a cost of R260 and funded the company's assets by way of a large interest-free loan. Under s 4 of the Amnesty Act, Jurgen made an election in respect of the trust's assets. The market value of the shares on 1 March 2002 was R1 million. He decided to take advantage of the Reserve Bank's offer to unwind the loop structure under Circular D 405, and purchased the shares from the trust at a cost of R740 on 29 February 2004. On 29 February 2020 he disposed of the shares to a third party for R3 million. The market value of the shares on 29 February 2004 was R1 100 000.

Result:

Under s 4(3) of the Amnesty Act, the acquisition of the shares by Jurgen must be disregarded, since the trustees did not dispose of the shares to 'any other person'. The R740 paid by Jurgen for the shares must likewise be excluded from base cost. When he sold the shares to the third party, he made a capital gain of R2 million (R3 million proceeds less R1 million base cost).

8.39A Additional voluntary disclosure relief

The Special Voluntary Disclosure Programme (SVDP), as it was colloquially known, ran from 1 October 2016 to 31 August 2017 and enabled taxpayers to regularise their tax and exchange control affairs in respect of undisclosed offshore assets. The legislation is in ss 14 to 18 of the Rates and Monetary Amounts and Amendment of Revenue Laws Act 13 of 2016 (the Rates Act). This commentary deals only with the provisions affecting the base cost of assets disclosed under the SVDP which were held and not disposed of on the last day of the year of assessment ending on or before 28 February 2015. References in this commentary to sections are to sections of the Rates Act.

Under s 17 the asset is deemed to have been acquired on that day at a cost equal to the value of the asset under s 16, in the relevant foreign currency, for the purposes of determining a capital gain or capital loss on the disposal of the asset. The value referred to in s 16 is the market value determined in the relevant foreign currency. By retaining the expenditure in the foreign currency, an individual will be able to take advantage of para 43(1) provided that the asset is disposed of in the same foreign currency.

The deemed acquisition cost is, however, limited to the proceeds on the disposal of the asset less the expenditure allowable under para 20 incurred on or after that day in respect of the asset. This rule prevents a capital loss from arising and is designed to protect the *fiscus* from inflated market values.

Example 1 – Base cost of SVDP assets*Facts:*

Barry held 100 shares in X Inc, a company listed on the NYSE. He had derived the shares from undisclosed income and his application under the SVDP was successfully approved. The market value of the shares on the last business day before Saturday 28 February 2015 was \$1 million. Barry sold the shares a few years later for \$900 000 and incurred selling expenses of \$13 500.

Result:

Barry must determine a capital gain or loss under para 43(1) read with s 17 of the Rates Act. Since he disposed of the shares at less than their market value as determined on 27 February 2015, his base cost is limited to the proceeds (\$900 000) less expenditure incurred on or after that date (\$13 500) = \$886 500. The base cost of Barry's shares is thus as follows:

	\$
Deemed acquisition cost limited under s 17	886 500
Allowable para 20 expenditure incurred after acquisition	<u>13 500</u>
Base cost	<u>900 000</u>

His capital gain or loss is thus determined as follows:

\$

Proceeds	900 000
Less: Base cost (as above)	(900 000)
Capital gain or loss	_____ -

Election in respect of trusts

For ease of reference, s 18 of the Rates Act is reproduced below.

'18. (1) For the purposes of sections 15, 16 and 17, a person who is a donor (or the deceased estate of a donor) or a beneficiary in relation to a discretionary trust which is not a resident may elect that any asset situated outside the Republic contemplated in subsection (2), which was held by the discretionary trust during the period 1 March 2010 to 28 February 2015, be deemed to have been held by that person for the purposes of all tax Acts.

(2) Subsection (1) applies in respect of an asset situated outside the Republic held by a discretionary trust, if that asset—

- (a) had been acquired by the trust by way of a donation or is derived from such a donation;
- (b) has been wholly or partly derived from any amount not declared to the Commissioner as required by the Estate Duty Act or the Income Tax Act; and
- (c) has not vested in any beneficiary of that trust at the time that election is made.

(3) (a) Subject to paragraph (b), where a person makes an election as contemplated in subsection (1), that person must be deemed to have—

- (i) held the asset contemplated in that subsection from the date on which the discretionary trust acquired the asset;
- (ii) received or accrued the same income and incurred the same expenditure in respect of that asset as the trust received, accrued or incurred; and
- (iii) dealt with the asset in the same manner as the trust dealt with that asset.

(b) Paragraph (a) must apply until—

- (i) the asset is disposed of by the trust;
- (ii) the person would be treated as having disposed of the asset in terms of the Income Tax Act; or
- (iii) in the case of a deceased estate, company or other juristic person, the day before that person ceases to exist by operation of law.

(c) When paragraph (b) applies, the person must be treated as having disposed of that asset for consideration equal to the market value of that asset on the date of disposal.

(4) Sections 7(5), 7(8) and 25B of the Income Tax Act and paragraphs 70, 72 and 80 of the Eighth Schedule to that Act, must not apply in respect of any income, expenditure or capital gain relating to that asset, during the time an asset is deemed to be held by the person as contemplated in subsection (1).'

An election under s 18 is possible only if the non-resident trust is a discretionary trust, that is, the beneficiary does not have a vested right in the asset in question.

An electing party must determine the base cost of the asset in respect of which the election has been made under s 17, that is, at market value determined in foreign currency on the last day ending on or before 28 February 2015. The electing party is deemed to have dealt with the asset in the same way that the trust dealt with it. For example, if the asset was held as trading stock by the trust, the electing party will be deemed to have held it as trading stock.

The attribution rules which deem income and a capital gain back to a resident donor are inapplicable while the electing party remains the deemed owner but will resume once the electing party ceases to be a deemed owner.

Cessation of deemed ownership occurs under three circumstances set out in s 18(3)(b).

First, the electing party will be deemed to dispose of the asset at market value when the trust disposes of the asset. Section 18 is silent on whether a disposal will be triggered if the trust distributes the asset to the electing party. Under such a situation the electing party will cease to be a deemed owner and become an actual owner. Since the period of ownership is uninterrupted, it is considered that no disposal will be triggered under these circumstances.

Secondly, the electing party will be deemed to dispose of the asset at market value if the asset is deemed to be disposed of under the Act. Examples of such deemed disposals include cessation of residence (s 9H), death (s 9HA) and para 12 (for example, conversion of trading stock to a capital asset and vice versa).

Thirdly, if the electing party is a deceased estate, company or other juristic person, the asset is deemed to be disposed of on the day before the person ceases to exist by operation of law. For example, a company would cease to exist when it is dissolved. Upon the death of the electing party the view is held that the assets in respect of which the election was made do not have to be taken into account for estate duty purposes because the electing party is deemed to dispose of them at the date of death under s 9HA(1) which will trigger s 18(3)(b)(ii).

8.40 Base cost of assets acquired through the issue of shares or debt

Section 40CA

Section 40CA determines the amount of expenditure that is deemed to be actually incurred by a company when it acquires an asset as defined in para 1 by issuing its shares or debt.

Section 40CA was introduced with effect from 1 January 2013 and applies to acquisitions on or after that date.⁴⁶⁹ For the period 1 October 2001 to 31 December 2012 the base cost of assets acquired through an issue of shares or debt was dealt with under s 24B. From 1 January 2013 until its repeal with effect from 1 April 2013 the ambit of s 24B was restricted to determining the base cost of shares acquired through a cross issue of shares. During the latter period s 24B took precedence over s 40CA, with s 40CA being subject to s 24B. Shares acquired by a cross issue before 1 April 2013 were given an expenditure of nil under s 24B(2) which differed from the treatment afforded to other assets under s 40CA.

From a CGT perspective, the common law position set out below applies to assets acquired before 1 October 2001 and is one of the reasons why it was initially necessary to introduce s 24B and later, s 40CA. For example, it will be relevant to a person adopting the time-apportionment base cost method.

In ITC 703⁴⁷⁰ a company that paid a firm of technical consultants through the issue of shares was allowed to claim a deduction for a portion of the fees (the non-allowable portion related to the establishment of a factory and was of a capital nature) This case cannot, however, be seen as authority for the view that expenditure is incurred when an asset is acquired through the issue of shares, since the court did not consider this aspect.

⁴⁶⁹ Section 40CA was inserted by s 71(1) of the Taxation Laws Amendment Act 22 of 2012 with effect from 1 January 2013.

⁴⁷⁰ (1950) 17 SATC 208 (N).

In ITC 1783⁴⁷¹ a company acquired a business licence through the issue of its own shares and sought to claim an allowance under s 11(gA) on the ‘cost’ of the licence. The court held that when a company issues its own shares in exchange for an asset, it has not incurred any expenditure in respect of the acquisition of the asset, since it has not lost or expended anything.⁴⁷²

In *C: SARS v Labat Africa Ltd*⁴⁷³ the taxpayer company had sought to claim a deduction under s 11(gA) for a trade mark which it had acquired in exchange for an issue of its shares. At issue was whether the company had incurred ‘expenditure’ in acquiring the trade mark. The court rejected the taxpayer’s argument that it had incurred ‘expenditure’. On the meaning of the word ‘expenditure’ Harms AP stated the following:⁴⁷⁴

‘The term “expenditure” is not defined in the Act and since it is an ordinary English word and, unless context indicates otherwise, this meaning must be attributed to it. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. The Afrikaans text, in using the term “onkoste”, endorses this reading. In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended.’

The court noted that the words ‘obligation’ or ‘liability’ and ‘expenditure’ are not synonymous. The allotment of shares does not reduce the assets of the company and can therefore not comprise expenditure.

Paragraph 38 was largely ineffective in establishing a base cost equal to market value for the asset acquired. Unless the value of the shares issued does not represent an arm’s length consideration for the asset disposed of, para 38 cannot be applied. The recipient of the shares issued would also have to be a connected person in relation to the company before the transaction.

In some circumstances an acquiring company will be able to secure a deduction under the corporate restructuring rules, for example, under s 42(2) (asset-for-share transactions) and s 44(2) (amalgamation transactions). Under s 41(2) these rules will override s 40CA.

Under s 40CA the expenditure actually incurred in respect of the asset is deemed to be in the case of

- an issue of shares, the sum of
 - the market value of the shares so issued immediately after the acquisition; and
 - any deemed capital gain determined under s 24BA(3)(a) in respect of the acquisition of that asset;⁴⁷⁵ or
- debt issued by the company, equal to the amount of debt so issued.

The exclusion in para 38(2)(e) ensures that para 38 does not apply to any asset to which s 40CA applies.

⁴⁷¹ (2004) 66 SATC 373 (G) at 376.

⁴⁷² See *Silke* in § 7.4 which was cited with approval in ITC 1783.

⁴⁷³ 2013 (2) SA 33 (SCA), 74 SATC 1. The SCA judgment overturned the decisions in ITC 1801 (2005) 68 SATC 57 (G) and *C: SARS v Labat Africa Ltd* (2009) 72 SATC 75 (North Gauteng High Court).

⁴⁷⁴ In para 12 at 5.

⁴⁷⁵ Inserted by s 38(1) of the Taxation Laws Amendment Act 34 of 2019 and came into operation on 1 January 2020 and applies in respect of acquisitions on or after that date.

Section 40CA applies to an asset as defined in para 1 which includes trading stock. It also applies regardless of whether the parties to the transaction are connected persons in relation to each other. It does not, however, provide a deduction to a company that issues its shares in return for services rendered.

There are additional CGT and dividends tax consequences for the company and the shareholder under s 24BA if a value mismatch involving the issue of shares occurs (see **8.41**).

Section 40CA(a)(ii) includes any capital gain arising under s 24BA(3). This addition is necessary in order to avoid double taxation.

Example 1 – Inclusion of capital gain arising from s 24BA(3) when market value of asset exceeds market value of shares issued [amendment effective 1 January 2020]

Facts:

Company A issued 100 shares having a market value of R100 immediately after issue to Lizelle in exchange for an asset with a market value of R150 immediately before the share issue.

Result:

Under s 24BA(3) Company A is deemed to have a capital gain on issue of the shares equal to the difference between the market value of the asset (R150) and the market value of the shares issued in exchange for it (R100), that is, $R150 - R100 = R50$ because the value of the asset exceeds the value of the shares.

Under s 40CA the base cost of the asset is equal to the sum of the market value of the shares immediately after issue (R100) and the capital gain determined under s 24BA(3)(a) on the share issue of R50, namely, R150.

Were it not for the addition of the capital gain to the base cost of the asset under s 40CA(a)(ii), double taxation would arise if Company A immediately sold the asset for its market value of R150. In other words, Company A would have been taxed on a capital gain of R50 under s 24BA(3)(a) and a capital gain on disposal of the asset of R50 [R150 proceeds less R100 base cost under s 40CA(a)(i)].

8.41 Value mismatches arising when assets are acquired through the issue of shares

Section 24BA

8.41.1 Application

Under s 40(1) of the Companies Act 71 of 2008 the board of a company must issue shares for 'adequate consideration to the company as determined by the board'. Despite this injunctive the legislature was clearly concerned from a fiscal standpoint that the words 'adequate consideration' could mean something other than market value, and hence the need for s 24BA.

Section 24BA applies when

- under any transaction, a company, for consideration, acquires an asset from a person in exchange for the issue by that company to that person of shares in that company; and

- the consideration contemplated in the above bullet point is (before taking into account any other transaction, operation, scheme, agreement or understanding that directly or indirectly affects that consideration) different from the consideration that would have applied had that asset been acquired in exchange for the issue of those shares under a transaction between independent persons dealing at arm's length.

For the purposes of s 24BA 'asset' is defined in s 24BA(1) to mean an asset as defined in para 1 or a number of such assets.

When there is a value mismatch (that is, the value of the asset immediately before the transaction is more or less than the value of the shares immediately after the transaction), there will be consequences for the company and the shareholder.

Normally under s 41(2) the corporate restructuring rules in ss 41 to 47 take precedence over the rest of the Act. However, s 41(2) specifically excludes s 24BA which means that s 24BA will take precedence over the corporate restructuring rules. The primacy of s 24BA means that despite any roll-over relief under the corporate restructuring rules the relevant transaction must still represent value for value otherwise s 24BA will apply.

8.41.2 Value of asset exceeds value of shares

If the market value of the asset immediately before the disposal exceeds the market value of the shares immediately after the disposal, the consequences will be as follows:

The company

The excess is deemed to be a capital gain of the company in respect of the disposal of the shares. Normally the issue by a company of its own shares is not a disposal under para 11(2)(b) but s 24BA applies notwithstanding para 11(2)(b). While a company's own shares are not an asset of the company, when a person subscribes for shares the company acquires a right to claim payment of the subscription price and it is this asset that is disposed of when the right is extinguished through payment by the subscriber.

For acquisitions of assets on or after 1 January 2020, s 40CA(a) has been amended to provide that the company be deemed to incur expenditure on the asset equal to the sum of the value of the shares issued and any capital gain determined under s 24BA(3)(a). Prior to this amendment the company would have had a base cost that was lower than the market value of the asset and additionally did not receive a step-up in base cost despite suffering a capital gain on the value mismatch under s 24BA.

Section 24BA is not overridden by the corporate restructuring rules in ss 41 to 47.⁴⁷⁶ Concern has been expressed that s 24BA(3) can be triggered as a result of a deferred tax liability that may arise in the transferee company after an asset-for-share transaction under s 42. Such a contingent liability would have the effect of depressing the value of the shares in relation to the market value of the asset, resulting in a value mismatch. For example, assume that an asset with a base cost of R150 and a market value of R500 is transferred to a company under s 42 in exchange for equity shares in the company. The transferor would be deemed to dispose of the asset for proceeds of R150 while the company would acquire it at a base cost of R150. The company now has a potential unrealised capital gain of R350 (R500 market value – R150 base cost). This capital gain would trigger a potential CGT liability of $R350 \times 22,4\%$ (80% inclusion rate \times 28% statutory rate) = R78,40. Arguably the liability would need to be discounted by estimating its present value based on the date on which the asset is expected to be disposed of. For example, if the asset is estimated to be sold after 15 years, the present value of R78,40 at a discount rate of 12% a year using Excel would be

⁴⁷⁶ Section 41(2).

$$=78.4/(1+12\%)^{15}$$

which gives a result of R14,32. An alternative formula which gives the same result is:

$$=PV(0.12,15,0,-78.4)$$

The shares would therefore be worth R500 – R14,32 = R485,68, resulting in a value mismatch.

It is, however, not the intention to trigger s 24BA in these circumstances, since such a mismatch is one that would ordinarily arise between independent persons acting at arm's length [s 24BA(2)(b)].

The shareholder

The person acquiring the shares must, in the case of shares acquired as

- a capital asset, reduce the expenditure actually incurred in acquiring the shares under para 20 by the amount of the value mismatch; and
- trading stock, reduce any amount that must be taken into account under s 11(a) or 22(1) or (2) by the amount of the value mismatch.

Under general barter or exchange principles the shareholder would incur expenditure on the shares equal to the market value of the asset given up. The base cost of the shares would therefore be higher than their market value. By reducing the base cost of the shares by the amount of the value mismatch, the base cost of the shares is brought in line with their market value.

8.41.3 Value of shares exceeds value of asset

If the market value of the shares immediately after the disposal exceeds the market value of the asset immediately before the disposal, the consequences will be as follows:

The company

The excess must, for the purposes of dividends tax, be deemed to be a dividend as defined in s 64D that

- consists of a distribution of an asset *in specie*; and
- is paid by the company on the date on which the shares were issued.

Under s 40CA the company is deemed to acquire the asset at a value that exceeds its market value. Nevertheless, this benefit comes at the cost to the company of having to pay the dividends tax on the amount of the value mismatch.

The shareholder

Assuming that para 38 does not apply, under general principles the shareholder will acquire the shares for an expenditure equal to the lower market value of the asset disposed of and will also have to take the higher value of the shares into account as proceeds when determining the capital gain or loss on disposal of the asset. Assuming that the market value of the shares remains unchanged, the shareholder will realise the excess as a capital gain when the shares are disposed of. Section 24BA does not regulate the base cost of the shares in these circumstances.

8.41.4 Exclusions

Section 24BA(4) provides that s 24BA will not apply in three circumstances discussed below.

The group of companies exclusion

Section 24BA will not apply when the person transferring the asset and the company acquiring it form part of the same group of companies as defined in s 1(1) immediately after the company acquires the asset.

The wholly owned company exclusion

Section 24BA will not apply when the person who disposed of the asset to the company holds all the shares in the company immediately after the company acquires the asset. The person could be an individual, a trust or a company.

The para 38 exclusion

Section 24BA will not apply when para 38 applies to the transaction.

Example 1 – Market value of asset acquired by company exceeds market value of shares issued*Facts:*

Julian sold a capital asset with a market value of R2 million and a base cost of R1 350 000 to ABC (Pty) Ltd. As consideration for the asset, ABC (Pty) Ltd issued shares with a market value of R1 400 000 to Julian. The asset was acquired as a capital asset by ABC (Pty) Ltd. The transaction would not have occurred in isolation between independent parties acting at arm's length (for example, it was motivated by tax considerations).

*Result:**ABC (Pty) Ltd*

Since the market value of the asset disposed of by Julian (R2 million) exceeds the market value of the shares issued by ABC (Pty) Ltd (R1,4 million), ABC (Pty) Ltd is deemed to have a capital gain of R600 000 under s 24BA(3)(a)(i) equal to the difference between the market value of the asset immediately before the disposal and the market value of the shares immediately after their issue. Under s 40CA ABC (Pty) Ltd is deemed to have incurred expenditure on the acquisition of the asset of R1,4 million, being the lower of the market value of the asset and the market value of the shares issued.

Note: ABC (Pty) Ltd is not given a step-up in expenditure for the capital gain of R600 000.

Julian

Julian has a capital gain of R1 400 000 (proceeds) less R1 350 000 (base cost) = R50 000 on disposal of the asset assuming that he is not a connected person in relation to ABC (Pty) Ltd and that he is not using s 42.⁴⁷⁷

Under general principles Julian acquires the shares for an amount equal to the market value of the asset given up (R2 million). Under s 24BA(3)(a)(ii)(aa) Julian must reduce his expenditure on the shares by the amount of the value mismatch of R600 000. Julian's shares accordingly have a base cost of R2 000 000 – R600 000 = R1 400 000.

⁴⁷⁷ Under s 42(8A) a qualifying transferor and transferee can agree in writing that s 42 must not apply to an asset-for-share transaction.

Impact of s 42

Should s 42 apply, ABC (Pty) Ltd will acquire the asset for an expenditure of R1 350 000. As a result of the value mismatch, this figure must be reduced by R600 000 leaving the company with a base cost of R750 000.

Under s 42 Julian would make neither a capital gain nor a capital loss on disposal of the asset. He would acquire the shares at a base cost of R1 350 000 and must reduce this figure by the value mismatch of R600 000 leaving him with a base cost of R750 000.

Example 2 – Market value of shares issued exceeds market value of asset acquired by company*Facts:*

Anita transferred a capital asset with a market value of R1 million to DEF (Pty) Ltd. As consideration for the asset DEF (Pty) Ltd issued shares with a total market value of R1,2 million to Anita. The asset will be held as a capital asset by DEF (Pty) Ltd. The transaction would not have occurred in isolation between independent persons acting at arm's length (for example, it was motivated by tax considerations).

Result:

The market value of the asset disposed of by Anita (R1 million) is lower than the market value of the shares issued by DEF (Pty) Ltd (R1,2 million). Under s 24BA(3)(b)(i) DEF (Pty) Ltd is deemed to distribute a dividend *in specie* of R200 000 equal to the difference between the market value of the shares and the market value of the asset. It will therefore be liable for dividends tax of $R200\ 000 \times 20\% = R40\ 000$.

Under s 40CA DEF (Pty) Ltd is deemed to have acquired the asset at a base cost of R1,2 million.

Under general principles the base cost of the shares received by Anita is equal to the market value of the asset given up (R1 million). No adjustment is made to this figure under s 24BA.

8.42 Cross issues of shares

Section 24B

Section 24B was repealed with effect from 1 April 2013. The repeal applies in respect of shares acquired, issued or disposed of on or after that date. For the commentary on s 24B, see issue 7 of this guide.

Chapter 9 – Proceeds

PART VI: PROCEEDS

9.1 Proceeds from disposal

Paragraph 35

9.1.1 Inclusions in proceeds [para 35(1)]

The proceeds from the disposal of an asset by a person are equal to

- the amount
- received by, or accrued to, or which is treated as having been received by or accrued to or in favour of, that person
- in respect of that disposal.

These words are explored in more detail below. The above is subject to

- para 35(2) – deemed proceeds under a ‘value shifting arrangement’,
- para 35(3) – certain reductions in proceeds, and
- para 35(4) – an anti-discounting to present value provision.

Paragraph 35(1) also includes two special inclusions.

9.1.1.1 ‘Amount’

The meaning of ‘amount’ was judicially considered in *WH Lategan v CIR*⁴⁷⁸ in relation to its use in the definition of ‘gross income’ and the following *dictum* of Watermeyer J has been cited with approval in a number of other cases:⁴⁷⁹

‘In my opinion, the word ‘amount’ must be given a wider meaning, and must include not only money but the *value* of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value.’

(Emphasis added.)

In *Cactus Investments (Pty) Ltd v CIR*⁴⁸⁰ the court held that in order to comprise an ‘amount’, rights of a non-capital nature must be ‘capable of being valued in money’. Similarly, in the *People’s Stores* case⁴⁸¹ the court held that in order to be included in gross income an amount must be of such a nature that a value can be attached to it in money. In *Stander v CIR*⁴⁸² the court held that an amount must be capable of being turned into money or money’s worth. But this view was soundly rejected in the landmark case of *C: SARS v Brummeria Renaissance (Pty) Ltd & others*.⁴⁸³ In that case it was held that it did not follow that if a receipt or accrual cannot be turned into money, it had no money value. The ‘turn into money’ test was merely one of the tests for determining whether an accrual had a money value. The court confirmed that the test was objective, not subjective.

⁴⁷⁸ 1926 CPD 203, 2 SATC 16 at 19.

⁴⁷⁹ See also *CIR v Butcher Bros (Pty) Ltd* 1945 AD 301, 13 SATC 21 at 34 and *CIR v People’s Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9 at 21.

⁴⁸⁰ 1999 (1) SA 315 (SCA), 61 SATC 43.

⁴⁸¹ *CIR v People’s Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9.

⁴⁸² 1997 (3) SA 617 (C), 59 SATC 212 at 218/9.

⁴⁸³ *C: SARS v Brummeria Renaissance (Pty) Ltd & others* 2007 (6) SA 601 (SCA), 69 SATC 205.

The word 'amount' bears the same meaning in relation to proceeds.

9.1.1.2 'Received by or accrued to'

The words 'received by or accrued to' have also received judicial consideration in relation to the definition of 'gross income' and bear a similar meaning in the context of para 35. In *Geldenhuys v CIR* the words 'received by' were held by Steyn J to mean⁴⁸⁴

'received by the taxpayer on his own behalf for his own benefit'.

In *CIR v Genn & Co (Pty) Ltd* Schreiner JA noted that not all amounts constituted receipts for the purposes of the definition of 'gross income' when he stated the following:⁴⁸⁵

'It certainly is not every obtaining of physical control over money or money's worth that constitutes a receipt for the purposes of these provisions. If, for instance, money is obtained and banked by someone as agent or trustee for another, the former has not received it as his income. At the same moment that the borrower is given possession he falls under an obligation to repay.'

The word 'accrued' means⁴⁸⁶

'to which he has become entitled'.

In *Mooi v SIR*⁴⁸⁷ the court held that there was no accrual in respect of a contingent right to income, and that such a right merely 'set up the machinery for creating a benefit'.

Since value-added tax does not accrue to or in favour of a vendor, it is not included in proceeds.

9.1.1.3 'In respect of'

The words 'in respect of' make it clear that a receipt or accrual causally connected to a disposal will qualify as part of the proceeds from that disposal even if such receipt or accrual preceded the disposal or was received or accrued in an earlier year of assessment. This situation could happen, for example, when an asset is expropriated, scrapped, lost or destroyed, as the time of disposal rules in para 13 provide in such instances that the disposal is delayed until the full compensation is determined.⁴⁸⁸ An amount could also be received or accrued in an earlier year of assessment when a sale is subject to a suspensive condition, since the time of disposal will be deferred until the last of any suspensive conditions is fulfilled.

9.1.1.4 Specific inclusion – Reduction or discharge of debt [para 35(1)(a)]

The proceeds from the disposal of an asset include the amount by which any debt owed by that person has been reduced or discharged.

While the definition of 'gross income' does not contain an equivalent rule to para 35(1)(a), the issue was addressed in ITC 1634⁴⁸⁹ in which it was held that for the purposes of gross income the benefit derived from the discharge of a debt was both an 'amount' and an 'accrual'. Wunsh J stated the following:⁴⁹⁰

⁴⁸⁴ 1947 (3) SA 256 (C), 14 SATC 419 at 430.

⁴⁸⁵ 1955 (3) SA 293 (A), 20 SATC 113 at 123.

⁴⁸⁶ *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9 at 19.

⁴⁸⁷ 1972 (1) SA 674 (A), 34 SATC 1 at 11.

⁴⁸⁸ See para 13(1)(a)(iv) (expropriation) and para 13(1)(c) (scrapping, loss or destruction).

⁴⁸⁹ (1997) 60 SATC 235 (T).

⁴⁹⁰ At 258.

'The cancellation or reduction of a liability which has been incurred by a taxpayer in the production of its income, is not of a capital nature and has been allowed as a deduction in computing its taxable income is an amount which accrues to the taxpayer and, in any event, whether or not it is of a capital nature, represents a recoupment by it of the deduction for the purpose of s 8(4)(a) of the Act. There is no difficulty in identifying the 'amount' – it is the face value of the liability which is cancelled or the amount by which it is reduced. Amounts of reduced or extinguished liabilities of which the taxpayer derives the benefit in the course of carrying on its business and arise from the business or are incidents of it accrue to it.'

Example 1 – Proceeds equal to amount of debt discharged

Facts:

Jack owes Jill R100. Jack sells an asset to Jane for an amount of R150. He requests Jane to settle his debt with Jill and to give him R50 in cash.

Result:

The amount of R100 paid by Jane to Jill will constitute part of the proceeds on disposal of Jack's asset under para 35(1)(a).

Proceeds on withdrawal of funds from bank account

A bank account is an asset, being a debt claim against the bank.

Withdrawals from a bank account constitute proceeds for the reasons explained below.

It is clear that a withdrawal of cash in the form of notes and coins over the counter or through an ATM constitutes the amount received by the account holder in respect of a full or part-disposal of the bank account. But what of an electronic funds transfer? The proceeds in such an instance may be equal to the amount of a liability discharged by the bank on the taxpayer's behalf [para 35(1)(a)] or the value of an asset acquired as a result of the payment by the bank on the taxpayer's behalf (for example, when the bank transfers funds from one account of the taxpayer to another).

9.1.1.5 Specific inclusion – Compensation to lessee from lessor for improvements to property [para 35(1)(b)]

The proceeds from the disposal of an asset include any amount received by or accrued to a lessee from a lessor for improvements effected to the leased property.

Under the principle of *accessio*, improvements by a lessee to land accede to the land of the lessor when they are affixed to the lessor's land. But for para 33(3)(c), this common-law rule would have the effect of triggering a part-disposal because the lessor would acquire the bare *dominium* in the property while the lessee would retain a right of use until the end of the lease. The effect of para 33(3)(c) is to defer the disposal until the time when the improvements are fully disposed of (that is, at the end of the lease) and it is at that time that the lessee must account for the proceeds determined under para 35(1)(b). Paragraph 35(1)(b) clarifies that the compensation received from the lessor is treated as proceeds and not as a base cost reduction.

9.1.2 Proceeds from ‘value shifting arrangement’ [para 35(2)]

The proceeds from a disposal by way of a ‘value shifting arrangement’ are dealt with specifically in para 35(2). The proceeds are the difference between the market value of the interest in the company, trust or partnership before the value-shifting event takes place and the market value of that interest after the event has occurred. The proceeds are the amount by which the market value has decreased. (See **21.3** for further details and examples on value shifting)

9.1.3 Reduction in proceeds [para 35(3)]

Proceeds must be reduced by the amounts shown in the table below.

Table 1 – Reduction in proceeds

Paragraph 35(3)	Proceeds from the disposal of an asset during a year of assessment must be reduced by
(a)	<ul style="list-style-type: none"> • Any amount of the proceeds • that must be or was • included in the gross income of that person, or • taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain.
(b)	Any amount of the proceeds that has during that year of assessment been repaid or has become repayable to the person to whom that asset was disposed of.
(c)	Any reduction, as a result of the cancellation, termination or variation of an agreement, other than any cancellation or termination of an agreement that results in the asset being reacquired by the person that disposed of it, or due to the prescription or waiver of a claim or release from an obligation or any other event during that year, of an accrued amount forming part of the proceeds of that disposal.

9.1.3.1 Amounts included in gross income / taxable income [para 35(3)(a)]

The use of the words ‘must be’ in para 35(3)(a) require a person to determine whether an amount will be taxed as income at some point in the future. This treatment emphasises the point that as a general rule, sections of the main body of the Act will take precedence over the Eighth Schedule (see **4.4**).

Recoupments

Any depreciation allowances recovered or recouped on disposal of an asset under s 8(4)(a) are included in gross income under para (n) of the definition of ‘gross income’. The amount received or accrued on disposal of the asset must accordingly be reduced by the amount so recovered or recouped in order to arrive at the proceeds under para 35.

Dividends

Paragraph (k) of the definition of ‘gross income’ includes in the definition

‘any amount received or accrued by way of a dividend or a foreign dividend’.

The amount received by or accrued to a holder of shares upon a share buy-back must therefore be reduced by any portion of that amount which constitutes a dividend – see **18.11**.

Sale of shares cum dividend

A sale of listed shares cum div occurs when shares are sold after the announcement of a dividend but on or before the 'last day to trade [*cum div*]' (LDT). During the three business days following the last day to trade up to and including the record date the shares trade ex div. In other words, on or before LDT the buyer of the shares pays a price which includes the value of the dividend and receives the right to the dividend. With a sale during the period LDT + 3 the seller receives the dividend and the buyer pays a price that excludes the value of the dividend.

Under a cum div sale the amount received or accrued from the sale of the share comprises the proceeds, which must not be reduced by the value of the future dividend.

Example – Sale of shares cum div*Facts:*

On 26 February 2020 XYZ Ltd announced that it would be paying a dividend of R5 a share to shareholders registered in its share register on Friday 3 April 2020 (record date). The dividend was payable on Monday 6 April 2020.

On Tuesday 31 March 2020 (last day to trade cum div) Gary sold a share in XYZ Ltd to Shaun cum div for R105.

*Result:**Gary (seller)*

Gary is regarded as having received proceeds of R105 in respect of the disposal. Although the selling price takes into account the forthcoming dividend, that portion (R5) is not a dividend in Gary's hands. Had it been a dividend it would have been excluded from proceeds under para 35(3)(a).

Shaun (buyer)

Shaun is regarded as having incurred para 20 expenditure of R105 in respect of the acquisition of the share. The dividend does not constitute proceeds in Shaun's hands, since it is not received in respect of the disposal of the share. The receipt of the dividend is also not regarded as a recovery of expenditure in Shaun's hands under para 20(3)(b), since it has not been recovered and is merely the receipt of an amount of gross income (that is, it forms part of the income stream generated by the asset).

9.1.3.2 Proceeds repaid or repayable [para 35(3)(b)]

The proceeds from the disposal, during the year of assessment, of an asset must be reduced by any amount of such proceeds that has during that year of assessment been repaid or has become repayable to the person to whom an asset was disposed of. This rule applies only when the repayment takes place in the year of assessment in which the asset is disposed of or in a year of assessment before the year of disposal. An amount repaid in a year subsequent to the year of assessment in which an asset is disposed of is treated as a capital loss under para 4(b)(i)(cc) which contains an equivalent provision.

9.1.3.3 Amounts reduced as a result of cancellation, termination, variation, prescription, waiver or release from obligation [para 35(3)(c)]

Any accrued amount forming part of the proceeds from a disposal during a year of assessment must be reduced when that amount is reduced as the result of the

- cancellation,
- termination,
- other than any cancellation or termination of an agreement that results in the asset being reacquired by the person that disposed of it,⁴⁹¹ or
- variation

of an agreement,

- or due to the
- prescription or waiver of a claim,
- release from an obligation, or
- any other event

during that year.

As with para 35(3)(b) this provision applies only when the reduction takes place in the year of assessment in which an asset is disposed of or in advance of that year of assessment. A reduction in a year of assessment subsequent to the year of assessment in which an asset is disposed of must be treated as a capital loss under para 4(b)(i)(aa), which contains an equivalent provision.

The reference to prescription could apply, for example, when a seller receives the proceeds in the form of debt claims. Thus, such a debt claim could prescribe in the year of assessment in which an asset is disposed of if it becomes older than three years during that year and the necessary legal measures to prevent prescription such as serving a summons have not been taken.

The facts in ITC 1880⁴⁹² were that in 2003 the appellant, Z, represented A Ltd (A) in the sale of its entire 47,3% shareholding in B (Pty) Ltd (B) to F. In 2007 Z and X, in an unrelated transaction, sold shares representing a 30% interest in B to F. Z's proceeds were approximately R842 million. This amount together with X's share was deposited into Z's bank account by F.

In 2007 A instituted a damages claim against Z in the amount of R925 million for withholding information while representing it during the negotiations for the sale of its shares in B in 2003. Z paid A approximately R695 million in settlement of the damages claim. Z then sought to reduce the proceeds of R842 million received from F on disposal of his B shares by approximately R625 million. This reduction amount was a portion of the amount of R695 million paid in damages to A. SARS refused to allow the reduction and issued an assessment restoring the proceeds to R842 million.

On appeal Z argued that the reduction amount did not represent an amount received by or accrued to him or alternatively that the proceeds should be reduced under para 35(3)(c).

⁴⁹¹ This exclusion was inserted by the Taxation Laws Amendment Act 34 of 2019 and came into operation on 15 January 2020.

⁴⁹² (2014) 78 SATC 103 (J).

The court found that Z's sale of the shares to F was unrelated to the damages claim brought by A and that the amount of R842 million had been received by the appellant. The court further rejected the appellant's contention that the damages claim fell into the category of 'any other event' in para 35(3)(c). The words 'any other event' are not used in isolation but appear in conjunction with a list of events which could be relied on so as to include any other event which is related to the disposal but not mentioned in the paragraph. The events described in para 35(3)(c) fell into two groups, namely,

- changes to the disposing agreement comprising cancellation, termination or variation of an agreement; and
- release from an obligation or waiver of a claim.

The court was of the view that a 'cancellation' terminates the relationship between the parties and restores to the seller his full rights of disposal over the property concerned, while under the second group the purchaser of the disposed asset no longer has an obligation to pay the proceeds of the disposal.

Wepener J held that the term 'any other event' must be understood within the context of these two groups. Under the *ejusdem generis* rule the ordinarily broad and unlimited term 'any' was limited by the two categories referred to above.

Despite the *obiter* view of the meaning of 'cancellation' expressed in ITC 1880, the view is held that the reference to 'cancellation' refers to a cancellation of a portion of the proceeds receivable under the agreement and not to the cancellation of the entire agreement which results in the reacquisition of the asset originally disposed of – see **6.3.6**. This issue has now been clarified by the Taxation Laws Amendment Act 34 of 2019 which excludes from para 35(3)(c) any cancellation or termination of an agreement that results in the asset being reacquired by the person that disposed of it. The amendment came into operation on 15 January 2020.

Paragraph 11(2)(o) provides that there is no disposal of an asset when an asset is disposed of and reacquired during the same year of assessment as a result of the cancellation or termination of the agreement, provided both parties are restored to their pre-sale position. Therefore, the exclusion of the reduction in proceeds under para 35(3)(c) when a seller reacquires an asset as a result of the cancellation or termination of the agreement will be irrelevant when para 11(2)(o) applies. But it will be relevant when the parties are not restored to their pre-sale position, and under such circumstances the original disposal is left untouched and the CGT consequences of the disposal of any debt claim in exchange for the return of the asset must be brought to account. By applying the core disposal rules dealt with in **6.3.6.2**.

In *New Adventure Shelf 122 (Pty) Ltd v C: SARS*⁴⁹³ the taxpayer had purchased immovable property in June 1999 at a cost of R185 000. Further expenditure of R1,1 million was incurred on the property before valuation date. On 20 September 2006 during the 2007 year of assessment the taxpayer disposed of the property to a third party under an agreement not subject to any suspensive conditions for R17 720 000. This amount was reduced by a rebate of R840 000 during the 2007 year of assessment as a result of the taxpayer having made an advance payment in accordance with the contract. The taxpayer adopted the time-apportionment base cost method in determining the valuation date value of the property. The capital gain was R9 746 875 (proceeds of R16 880 000 less base cost of R7 133 125).

The contract was cancelled in the 2012 year of assessment and the property returned to the taxpayer. The purchaser forfeited R4 549 082 already paid to the taxpayer as damages for cancelling the contract.

⁴⁹³ [2017] 2 All SA 784 (SCA), 79 SATC 233.

The taxpayer argued that under para 35(3)(c) read with para 25 and paras 3 and 4 SARS was required to reopen the 2007 assessment to reduce the proceeds by the amount that was no longer recoverable. The court rejected this contention, finding that any adjustments must be made in the year of cancellation.

The SCA noted that the court *a quo*⁴⁹⁴ had endorsed a calculation of the net capital loss of R7 706 824 to which the appellant would be entitled in the year of cancellation.

That figure was arrived at on the assumption that the redetermination rules, applicable to pre-valuation date assets, apply to the reacquisition of an asset as a result of the cancellation of a contract, something which has not been conceded by SARS. Under the purported calculation, the previous capital gain of R9 746 875 would be reversed as a capital loss of the same amount in 2012 under para 4(b)(iii). The redetermined base cost of the property using the time-apportionment method amounted to R2 509 031. This amount was determined using reduced proceeds of R4 549 082 (the amount retained by the taxpayer), with the same expenditure before valuation date of R1 285 000 and the same dates of acquisition and disposal (June 1999 and September 2006). The result was a revised capital gain of R2 040 051 under para 3(b)(iii). The aggregate capital loss in 2012 was thus R9 746 875 (2007 capital gain reversed as capital loss) less R2 040 051 (redetermined capital gain) = R7 706 824. The Western Cape High Court did not comment on what the base cost of the property would be going forward.

The SCA steered clear of the arithmetic involved in a redetermination calculation and did not express any opinion either on how it should be performed or the resultant outcome.

The preferred view in relation to cases of this nature before the 2016 amendments (discussed below) is that the redetermination rules did not apply when an asset was reacquired as a result of the cancellation of a contract. When the asset was originally disposed of, it was replaced by a post-valuation date asset in the form of a debt claim against the purchaser. As a result of the cancellation of the contract, that debt asset is disposed of in exchange for the return of the asset which becomes a post-valuation date asset, and its base cost is equal to the market value of the debt claim given up plus any further compensation paid to the purchaser for post-sale improvements. To contend that the proceeds to be taken into account in the redetermination comprise only the forfeited payments ignores the fact that the taxpayer was additionally compensated through the reacquisition of the property. It is also considered that para 25 cannot apply to a post-valuation date asset, which the property became on reacquisition.

Subsequent to this case, the Eighth Schedule was amended with effect from 1 January 2016 and under the current rules the previous capital gain would be reversed as a capital loss in the year of cancellation with the base cost being reset to its former position under para 20(4).

The case reaffirms the principle laid down in the *Caltex* case⁴⁹⁵ that income tax is an annual event and that events occurring after a year of assessment cannot be relied upon to reopen an assessment for a prior year. It is also clear from the judgment that para 35(3)(c) applies only to adjustments to proceeds in the year of assessment in which an asset is disposed of. Any adjustments as a result of cancellation in a later year of assessment are made in that later year under paras 3(b) and 4(b).

⁴⁹⁴ *New Adventure Shelf 122 (Pty) Ltd v C: SARS [2016] 2 All SA 179 (WCC), 78 SATC 190.*

⁴⁹⁵ *Caltex Oil (SA) Ltd v SIR 1975 (1) SA 665 (A), 37 SATC 1.*

In ITC 1898⁴⁹⁶ the appellant trust had sold some shares on the open market through its stockbrokers in August 2010. The purchasers paid the full purchase price to the stockbrokers. During October 2010 on instruction from the appellant the stockbrokers transferred the funds to a Netherlands bank on the taxpayer's behalf. In December 2010 these funds were allegedly fraudulently transferred to a bank account in the United Arab Emirates. The appellant sought to reduce the proceeds from the sale of the shares under para 35(3)(c) on the basis that the theft of the funds represented 'any other event'. The court rejected the appellant's contention that para 35(3)(c) applied to the embezzlement of the funds. In the first instance the appellant had received the funds and in that regard the court stated the following:⁴⁹⁷

'Unlike para 35(1) which refers specifically to money "received or accrued to," a plain reading of para 35(3) reveals that it applies to money that accrued to the taxpayer.

'Accordingly, it must be inferred that the legislature intended to exclude from the ambit of para 35(3), money that was "received" and not accrued.'

In relation to the words 'any other event' the court went on to state the following:⁴⁹⁸

'Having regard to the context in which the words are used and their clear purpose, it is sufficient to establish that the words apply to situations where the purchaser of an asset is partially or wholly released from the obligation to pay for the asset disposed of. Ultimately, the words were not intended to apply to an embezzlement of the nature alleged in this case, for the reasons stated herein.

'The set-off or deduction contemplated is one which flows as a consequence of extinguishing the taxpayer's right to receive payment and the payee's obligation to pay.

'The relevant nexus is to the event that causes such extinguishing not to a subsequent unrelated event caused by a person who held no obligation to pay for the asset disposed of and who acted outside the agreement to dispose of the asset.

'The *nexus* cannot be a broad and vague one between the accrual and the deduction's event, irrespective of how remotely it is connected to the failure to actually retain/receive the funds.

'If the legislature intended a deduction to be available for any unrelated reason, that would have the consequence of a reduced payment, it would have expressed itself in words conveying that meaning.'

9.1.4 Disregarding of present value [para 35(4)]

An amount payable after the end of the year of assessment must be treated as having accrued to a person in the year of assessment in which that person becomes entitled to it. This provision mirrors the first proviso to the definition of 'gross income' in s 1(1) which was introduced following the *People's Stores* case⁴⁹⁹ in which it was held that the amount to be included in gross income was the discounted future value. Paragraph 35(4) ensures that it is the face value of an amount of proceeds payable in the future that is brought to account, rather than the present value.

⁴⁹⁶ (2016) 79 SATC 266 (WC).

⁴⁹⁷ At 274.

⁴⁹⁸ At 275.

⁴⁹⁹ *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9.

9.1.5 Proceeds – composite disposals

Assets are sometimes disposed of as part of the sale of a business as a going concern. A selling price expressed as a lump sum will have to be allocated across the various assets in accordance with their relative market values at the time of disposal.⁵⁰⁰ Such an allocation is necessary because the 'business' is not an asset and CGT is imposed on an asset-by-asset basis. The onus rests on the taxpayer under s 102 of the Tax Administration Act to justify any allocation. The court will not accept a fictitious allocation of the selling price. In ITC 1235⁵⁰¹ the parties allocated R1 to a plantation. The court held that the agreement was fictitious and not a real agreement and accepted the Commissioner's valuation.

In order to arrive at the total proceeds to be allocated amongst the assets, any lump sum which is net of liabilities taken over by the buyer must be increased by the amount of those liabilities, including contingent liabilities.

In the Canadian case of *Daishowa-Marubeni International Ltd v Canada*⁵⁰² the appellant company owned certain timber rights which carried with them a reforestation obligation. The company disposed of its forestry business with the purchaser assuming the reforestation obligation. The business was valued at \$180 million while the reforestation obligation was valued at \$11 million by the parties. The sale agreement showed the purchase price as \$169 million for the business and \$11 million for the reforestation obligation. At issue was whether the proceeds on sale of the business were \$169 million or \$169 million plus the reforestation obligation.

The Supreme Court of Canada distinguished between future costs which depress the value of an asset and an obligation which is a distinct existing liability. The court held that the reforestation obligation was simply a future cost tied to the forest tenures that depressed the value of the asset and was not a separate obligation. The reforestation obligation did not represent proceeds on disposal. In appropriate circumstances the principle enunciated in this case may find application in a South African context. SARS accepts that a distinction must be drawn between an embedded statutory obligation that depresses the value of an asset and a separately identifiable contingent liability.⁵⁰³

Example – Disposal of business

Facts:

Company A disposed of its business to Company B. The sale agreement provided that the purchase price was made up as follows:

	R
Market value of assets (itemised)	1 100 000
Less: Trade creditors	(300 000)
Contingent liabilities	(20 000)
Amount payable in cash	<u>780 000</u>

The contingent liabilities comprise obligations of Company A to meet the cost of

- post-retirement medical aid benefits for its employees;
- employee bonuses under a long-term bonus scheme; and

⁵⁰⁰ See ITC 108 (1928) 3 SATC 343 (U) in which the court made an allocation of the purchase price, and ITC 429 (1939) 10 SATC 355 (SR) in which the appellants were entitled to apportion the purchase price.

⁵⁰¹ (1975) 37 SATC 233 (T) at 236.

⁵⁰² 2013 SCC 29.

⁵⁰³ See Interpretation Note 94 dated 19 December 2016 'Contingent Liabilities Assumed in the Acquisition of a Going Concern'.

- repairs under property leases.

None of the assets disposed of comprise trading stock or depreciable assets.

Determine the proceeds on disposal of the assets

Result:

Company A is entitled to R1,1 million for the disposal of the assets. Thus, R1 100 000 has accrued to Company A, which comprises the proceeds under the opening words of para 35. This amount is settled by a cash payment of R780 000 and by the delegation of the trade creditors and contingent liabilities to Company B of R320 000.

Note: Under the principle established in *Ackermans Ltd v C: SARS*⁵⁰⁴ Company A is not entitled to a deduction under s 11(a) for the contingent liabilities, since the amounts have not been actually incurred.

9.1.6 CGT of seller payable by purchaser

It sometimes happens that a seller will insist on a purchaser paying any CGT arising from a disposal. The amount equal to the CGT received by the seller forms part of the proceeds on the disposal. In order to determine the amount of the CGT in these circumstances which must be added to the proceeds, follow these steps for a taxpayer with a flat rate of tax such as a company or trust:

Step 1 Determine the CGT payable using the proceeds excluding the CGT and multiply it by the effective CGT rate.

Step 2 Multiply the tax determined in step 1 by $100 \div (100 - \text{effective CGT rate applicable to the person})$.

Step 3 Add the figure determined in step 2 to the proceeds to obtain the grossed-up proceeds after iteration.

For persons subject to a sliding scale (natural persons, deceased and insolvent estates and special trusts) it will be necessary to perform the calculation at the taxpayer's effective marginal CGT rate. Should the taxable capital gain span more than one band, it will be necessary to perform separate calculations for each band and then aggregate the results.

Example – CGT of seller payable by purchaser

Facts:

Company A agreed to sell land with a base cost of R20 000 and market value of R120 000 to Company B on condition that Company B reimburse Company A for any CGT that becomes payable.

Result:

The CGT that becomes payable must be added to the proceeds on disposal of the land, since it forms part of the selling price.

Step 1: Determine CGT ignoring reimbursement

	R
Proceeds	120 000
Less: Base cost	<u>(20 000)</u>
Capital gain	<u>100 000</u>

⁵⁰⁴ 2011 (1) SA 1 (SCA), 73 SATC 1.

Inclusion rate	80%
Taxable capital gain R100 000 × 80%	<u>80 000</u>
CGT R80 000 × 28%	<u>22 400</u>
Step 2: Apply the iterative formula to determine the actual CGT	
The effective CGT rate for a company is 22,4% (80% inclusion rate × 28% corporate rate)	
= R22 400 × 100 / (100 – 22,4)	
= R28 866	
Step 3: Perform the final CGT calculation	
	R
Proceeds R120 000 + R28 866	148 866
Less: Base cost	<u>(20 000)</u>
Capital gain	<u>128 866</u>
Taxable capital gain R128 866 × 80%	<u>103 093</u>
CGT R103 093 × 28%	<u>28 866</u>

9.1.7 Proceeds from short-term insurance

Unlike a long-term policy under para 55 (see **12.4**), there is no specific exclusion applicable when a person disposes of an asset and, as a result, derives proceeds from a short-term insurance policy, except when the policy relates to a personal-use asset. Depending on the facts, the disposal of the underlying asset may, however, qualify for roll-over relief under para 65 or 66. Under para 53(3)(g) a personal-use asset excludes any contract under which a person, in return for payment of a premium, is entitled to policy benefits upon the happening of a certain event and includes a reinsurance policy in respect of such a contract. However, this provision excludes any short-term policy contemplated in the Short-term Insurance Act. Thus, for example, if an insured asset such as a private motor vehicle was involved in an accident, the amount received from the insurer would be treated as being derived from the disposal of a personal use asset and the resulting capital gain or loss would be disregarded under para 53(1) (see **12.2**). But if the same asset were used mainly in carrying on a trade, the capital gain or loss on its disposal would have to be accounted for unless roll-over relief applied.

A question may arise whether the right to receive the proceeds under a short-term policy is an asset in its own right or whether it should be accounted for as part of the disposal of the insured asset. The view is held that it will generally relate to the insured asset, but if an underlying asset cannot be identified, the right to receive the proceeds will be the asset that must be accounted for (see **4.1.2.5**).

The time of disposal of an asset disposed of by scrapping, loss or destruction is when⁵⁰⁵

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

⁵⁰⁵ Paragraph 13(1)(c).

Example – Proceeds from short-term policy*Facts:*

Company X owns a building which it uses for the purposes of trade. The building was insured against fire and Company A had claimed the insurance premiums as a deduction under s 11(a). During the current year of assessment, the building was completely destroyed by fire. The base cost of the building was R1 million and the short-term insurer paid Company X R3 million in settlement of the insurance claim during the same year of assessment. Company A did not replace the building, and hence did not qualify for roll-over relief under para 65. The building did not qualify for any capital allowances.

Result:

Company X has a capital gain of R2 million (R3 million proceeds less R1 million base cost).

9.2 Disposal of partnership asset

Paragraph 36

9.2.1 Date of accrual of proceeds

Under para 36 the proceeds from the disposal of a partner's interest in a partnership asset is treated as having accrued to the partner at the time of the disposal. This rule is intended to provide certainty as to when capital gains or losses accrue.⁵⁰⁶

9.2.2 Guidelines for the treatment of partnerships

The core rules of the Eighth Schedule apply to partners who are persons for tax purposes. Also applicable to partners are the existing provisions of the Act dealing with the submission of returns and the issue of assessments.

A partnership⁵⁰⁷ is not a separate legal entity⁵⁰⁸ and is not a taxpayer.⁵⁰⁹ It is therefore the individual partners who must bear the consequences of CGT.

The taxation of partnerships poses a number of practical difficulties. Every time a new partner joins or a partner leaves, the existing partnership is dissolved and a new partnership comes into existence.⁵¹⁰ Were this common law principle to be applied, the effect would be to trigger a disposal of the entire interest of each partner each time a partner joined or left.

Since CGT is concerned with the disposal of rights, it is not intended that partners be regarded as disposing of their entire interests in the partnership assets every time a new partner is admitted or an existing partner leaves. Instead, each partner must be regarded as having a

⁵⁰⁶ In *Sacks v CIR* 1946 AD 31, 13 SATC 343 it was held that the profits accrue on the date on which the partners agree to take account of the profits. This common law position is superseded by para 36 for CGT purposes and by s 24H(5) for income.

⁵⁰⁷ As to the requirements for a valid partnership see *Joubert v Tarry & Co Ltd* 1915 TPD 277.

⁵⁰⁸ *Michalow, NO v Premier Milling Co Ltd* 1960 (2) SA 59 (W) at 61.

⁵⁰⁹ *Chipkin (Natal) (Pty) Ltd v C: SARS* 2005 (5) SA 566 (SCA), 67 SATC 243 at 249.

⁵¹⁰ *Executors of Paterson v Webster, Steel & Co* (1880 – 1882) 1 SC 350 at 355; *Whitlock v Rolfes, Nebel & Co* 1911 WLD 35; *Wagstaff & Elston v Carter & Talbot* 1909 TS 121; *Standard Bank v Wentzel & Lombard* 1904 TS 828 833–834 and *Kirsh Industries Ltd v Vosloo & Lindeque* 1982 (3) SA 479 (W).

fractional interest in each of the partnership assets.⁵¹¹ To the extent that a partner's fractional interest in the partnership assets remains unchanged following the introduction of a new partner or the withdrawal of an existing partner, there will be no disposal. A disposal should occur only when a partner's fractional interest in an asset of the partnership is diminished.

9.2.2.1 Introduction of new partner

When a new partner joins the partnership and contributes an asset or cash to the partnership, each pre-existing partner must be treated as having disposed of a part of his or her share in the pre-existing partnership assets in exchange for a fractional interest in the assets or cash contributed by the incoming partner. A capital gain or loss must accordingly be determined in respect of the part disposed of by the pre-existing partners. The base cost of the part disposed of must be determined under para 33.

The new partner will acquire a corresponding interest in the pre-existing partnership assets in exchange for that partner's contribution and retain a fractional interest in the cash and assets contributed to the partnership.

9.2.2.2 Assets contributed to the partnership

The introduction of an asset to the partnership by a partner will trigger a part-disposal of a portion of that partner's interest in the asset, while the other partners will acquire a corresponding interest in the part disposed of.

In *GB Mining and Exploration SA (Pty) Ltd v C: SARS*⁵¹² the appellant contributed 50% of a chrome tailings mine dump ('the Kroondal dump') to a joint venture. The appellant contended that the dump had not been disposed of but merely made available for use to the joint venture. The SCA disagreed based on the evidence and held that the dump was an asset that had been disposed of for CGT purposes.

9.2.2.3 Withdrawal of partner

A partner leaving a partnership will have disposed of his or her interest and a capital gain or loss must be determined. The remaining partners who acquire that partner's interest will reflect an increase in base cost.

In *GB Mining and Exploration SA (Pty) Ltd v C: SARS*⁵¹³ the appellant disposed of a 38% interest in a 25% interest in the RK1 joint venture in exchange for a 62% interest in the RK2 joint venture. The court confirmed that the exchange of the interest in the RK1 joint venture represented the disposal of an asset for CGT purposes.

9.2.2.4 Assets disposed of by the partnership

When an asset is disposed of to a third party, the proceeds must be allocated between the partners according to the partnership agreement, or if one does not exist, according to partnership law.

⁵¹¹ This approach is followed by the United Kingdom and Australia. On the United Kingdom practice, see Partnerships: Statement of Practice D12 (17 January 1975) <<https://www.gov.uk/government/publications/statement-of-practice-d12/statement-of-practice-d12>> [Accessed 2 November 2020]. For the United Kingdom HM Revenue & Customs *Capital Gains Manual* on partnerships generally, see <<http://www.hmrc.gov.uk/manuals/cgmanual/cg27000c.htm>> [Accessed 2 November 2020]. For the Australian treatment see Chapter 3, Part 3-1, Division 106, Subdivision 106-A, s 106-5 of the Income Tax Assessment Act, 1997.

⁵¹² (2015 (4) SA 605 (SCA), 76 SATC 347.

⁵¹³ (2015 (4) SA 605 (SCA), 76 SATC 347.

In *Isaacs v Isaacs*⁵¹⁴ the court said the following:

'It is clear law that on dissolution each party gets a proportionate share of the assets according to his or her contribution, and it is only when their respective contributions were equal or it is impossible to say that one has contributed more than the other that they share equally – *vide Fink v Fink* (1945 WLD 226).'

In the absence of a specific asset-surplus sharing ratio, the proceeds will normally be allocated according to the profit-sharing ratio.

For the purposes of para 20 the base cost of each partner's interest in the asset will comprise the amount paid for that interest less any part of the interest in the asset that has been disposed of. It is important to realise that when a partner acquires an interest in a partnership that interest is comprised of the share in the assets less the liabilities. The net interest is not an asset for CGT purposes – it is the gross cost of the assets that must be considered.

Example 1 – Acquisition of interest in assets and liabilities of partnership

Facts:

Adele acquired a half share in a partnership made up as follows:

	R
Asset	100 000
Less: Creditor	(60 000)
Amount paid	<u>40 000</u>

Result:

The expenditure actually incurred by Adele for the purposes of para 20(1)(a) in acquiring an interest in the asset is R100 000 comprising the cash payment of R40 000 and the assumption of the share in the liability of R60 000.

⁵¹⁴ 1949 (1) SA 952 (C) at 961, cited with approval in ITC 1721 (1999) 64 SATC 93 (G).

Table 1 – Consequences of change in partner's fractional interest

Change in fractional share	Consequence	Example
Increase	Acquisition	<ul style="list-style-type: none"> • New partner acquires an interest • Purchase of additional interest from retiring partner • Change in profit-sharing ratio resulting in an increase in a partner's interest
Decrease	Disposal	<ul style="list-style-type: none"> • Withdrawal of partner • Death of partner • Insolvency/liquidation of partner or partnership • Dilution of interest through introduction of new partner • Change in profit-sharing ratio resulting in a decrease in a partner's interest

Example 2 – Division of capital profits and losses*Facts:*

Jack and Jill set up a business in partnership. Jack contributed a piece of land to the partnership. Under their partnership agreement Jack has a 75% interest in the land and Jill 25%. The agreement states that profits must be shared evenly.

Result:

When the land is sold, Jack's capital gain or loss will be determined on the basis of his 75% interest. For other partnership assets, the capital gains and losses must be split equally.

Example 3 – Withdrawal of partner*Facts:*

A, B and C commenced business in partnership. They each injected R10 000 in cash into the partnership bank account which was later used to purchase a piece of land at a cost of R30 000. Five years later the land was worth R90 000 and partner B decided to leave the partnership. Partner A paid Partner B R30 000 for his share ($1 / 3 \times R90\ 000$).

*Result:**Disposal by B*

Proceeds	R 30 000
Less: Base cost	(10 000)
Capital gain	<u>20 000</u>

Acquisition by A

Base cost of interest before acquisition	10 000
Acquisition of B's interest	<u>30 000</u>
Revised base cost	<u>40 000</u>

C is unaffected by the transaction as C's percentage interest remains one-third.

Example 4 – Admission of partner*Facts:*

A, B and C commence business in partnership. They each inject R10 000 in cash into the partnership bank account which is later used to purchase a piece of land at a cost of R30 000. Five years later the land is worth R90 000, and A, B and C decide to admit D as an equal partner for a consideration of R22 500 (one-fourth of R90 000). A, B and C each receive R7 500 of the amount paid by D ($R22\,500 / 3$).

Result:

A, B and C each owned a one-third interest in the land before D joined the partnership. Their one-third interests were reduced to one-fourth resulting in a part-disposal.

	A R	B R	C R	Total R
Proceeds	7 500	7 500	7 500	22 500
Less: Base cost	<u>(2 500)</u>	<u>(2 500)</u>	<u>(2 500)</u>	<u>(7 500)</u>
Capital gain	<u>5 000</u>	<u>5 000</u>	<u>5 000</u>	<u>15 000</u>

Determination of part disposed of:

A, B and C each had a one-third share ($33\frac{1}{3}\%$).

With the admission of B this reduced to one-quarter (25%).

Reduction = $33,33\% - 25\% = 8,33\%$ ($\frac{1}{12}$)

Percentage reduction = $8,33 / 33,33 \times 100 = 25\%$

In other words, one-third minus one-twelfth = one quarter.

Part disposed of = $25\% \times R10\,000 = R2\,500$

The same result is achieved if one applies the para 33 formula:

Proceeds/Market value before disposal \times base cost

$R7\,500 / R30\,000 \times R10\,000 = \underline{R2\,500}$

D will have a base cost of R22 500.

Example 5 – Admission of new partner who introduces an asset*Facts:*

A and B enter into a partnership agreement under which they share profits 50/50. They each introduce cash of R50 which is used by the partnership to buy Asset 1 for R100. Some years later when Asset 1 is worth R200 they admit C to the partnership. C introduces an asset with a value of R100. A, B and C agree to share profits equally. The base cost of Asset 2 in C's hands before entry into the partnership was R60. Determine the CGT consequences for A, B and C in respect of the admission of C.

Result:

Upon the admission of C, the partnership profit-sharing ratio changed as follows:

	A	B	C
	%	%	%
Before	50,00	50,00	-
Decrease/Increase	<u>(16,67)</u>	<u>(16,66)</u>	<u>(33,33)</u>
After	<u>33,33</u>	<u>33,34</u>	<u>33,33</u>

A and B each dispose of 16,67 / 50 (1/3) of their former interests.

Sale of fractional interest in Asset 1 by A and B to C

	A	B
Proceeds	33,33	33,33
Less: Base cost	<u>(16,67)</u>	<u>(16,67)</u>
Capital gain	<u>16,66</u>	<u>16,66</u>

The proceeds are equal to the market value of the fractional interest acquired by each partner in Asset 2 (R100 × 1 / 3).

A and B each disposed of 1/3 of their base cost in Asset 1, namely, 1 / 3 × R50 = R16,67.

Sale of fractional interest in Asset 2 by C to A and B

The base cost of Asset 2 in C's hands before admission was R60. Upon admission, C disposes of 2/3 of the interest in Asset 2 in exchange for a 1/3 stake in Asset 1. Thus, C has a disposal of Asset 2 on entry as follows:

Proceeds 1 / 3 × R200	R
	66,67
Less: Base cost 2 / 3 × R60	<u>(40,00)</u>
Capital gain	<u>26,67</u>

C's remaining base cost in respect of Asset 2 is R60 – R40 = R20. C's base cost in respect of Asset 1 is the amount by which C has been impoverished as a result of the disposal of the 2/3 interest in Asset 2, namely, 2 / 3 × R100 = R66,67.

Summary – Base cost of A, B and C's interests after admission of C

	A	B	C
Asset 1	33,33	33,33	66,67
Asset 2	33,33	33,33	20,00

Example 6 – Change in profit-sharing ratio

Facts:

A and B enter into a partnership agreement under which they share profits 50/50. A introduces Asset X worth R5 000 and B introduces Asset Y worth R5 000. The base cost of each asset in the hands of A and B before entry into the partnership is R5 000.

Some years later Asset X is sold for R10 000. The amount realised is paid to the partners in equal shares and deposited into their personal bank accounts. A then reintroduces R5 000 and B R1 000 and they agree to change their profit-sharing ratios in accordance with their revised capital contributions. Asset Y is worth R10 000 at the time of the change in ratios.

What are the CGT implications for A and B of the change in profit-sharing ratios?

Result:

Step 1 – Introduce assets into partnership

	R
Capital account – A	5 000
Capital account – B	<u>5 000</u>
	<u>10 000</u>
Asset – X	5 000
Asset – Y	<u>5 000</u>
	<u>10 000</u>

Base cost after entry

	A	B
	R	R
Asset X	2 500	2 500
Asset Y	<u>2 500</u>	<u>2 500</u>
	<u>5 000</u>	<u>5 000</u>

Upon entry A disposed of a 50% interest in Asset X in return for a 50% interest in Asset Y. Similarly, B disposed of a 50% interest in Asset Y in return for a 50% interest in Asset X. In this example these disposals resulted in neither a capital gain nor a capital loss because the value received was equal to the base cost of the part disposed of.

Step 2 – Sell Asset X

	R
Capital account – A (R5 000 + R2 500)	7 500
Capital account – B (R5 000 + R2 500)	<u>7 500</u>
	<u>15 000</u>
Bank account	10 000
Asset Y	<u>5 000</u>
	<u>15 000</u>

	A	B	Total
Proceeds	5 000	5 000	10 000
Less: Base cost	<u>(2 500)</u>	<u>(2 500)</u>	
Capital gain	<u>2 500</u>	<u>2 500</u>	

Step 3 – Distribute bank balance to A and B

Capital account – A (R7 500 – R5 000)	2 500
Capital account – B (R7 500 – R5 000)	<u>2 500</u>
	<u>5 000</u>
Asset Y (MV = R10 000)	<u>5 000</u>

Step 4 – Revalue existing assets, reintroduce funds into partnership bank account and change ratios (A introduces R5 000, B R1 000)

	R
Capital account – A (62,5%) (R2 500 + R2 500 ⁵¹⁵ + R5 000 ⁵¹⁶)	10 000
Capital account – B (37,5%) R2 500 + R2 500 + R1 000)	<u>6 000</u>
	<u>16 000</u>
	R

⁵¹⁵ This is the revaluation surplus (50% × increase in market value of Asset Y).

⁵¹⁶ Additional contribution.

Asset Y (at market value)	10 000
Bank account (R5 000 + R1 000)	<u>6 000</u>
	<u>16 000</u>

*A's position**A's interest in the partnership bank account*

A has withdrawn an amount of R5 000 from A's personal bank account thereby triggering a part-disposal of that bank account. The proceeds from this disposal are represented by the following partnership assets acquired in exchange:

Partnership bank account	R
Interest in amount introduced by A $R5\,000 \times 62,5\%$	3 125
Interest in amount introduced by B $R1\,000 \times 62,5\%$	<u>625</u>
Total interest in bank account (Check: $R6\,000 \times 62,5\%$)	3 750
Additional interest in Asset Y $R10\,000 (MV) \times 12,5\%$	<u>1 250</u>
	<u>5 000</u>

Since the base cost of the portion of A's personal bank account disposed of is equal to R5 000, the disposal will result in neither a capital gain nor a capital loss.

A's interest in Asset Y

As noted above, A acquires an additional 12,5% (62,5% less 50%) interest in Asset Y at a cost of R1 250. The revised base cost of A's interest in Asset Y is made up as follows:

	R
Initial cost	2 500
Cost of additional interest	<u>1 250</u>
Total base cost	<u>3 750</u>

B's position

B has made two disposals. First, B disposed of a portion of his personal bank account by withdrawing R1 000 from it. Secondly, B disposed of a 12,5% interest in Asset Y which was worth R10 000 at the time of disposal. The amount given up by B is $R10\,000 \times 12,5\% = R1\,250$. In return for these two disposals B gained an increased interest in the partnership bank account. B acquired 37,5% of the amount introduced by A ($37,5\% \times R5\,000 = R1\,875$) and retained an interest of 37,5% of the amount he introduced ($37,5\% \times R1\,000 = R375$). The position can be summarised as follows:

	Disposed of R	Acquired R
Decrease in value of interest in Asset Y	1 250	-
Withdrawal from personal bank account	1 000	-
Bank account – acquired from A	-	1 875
Bank account – own investment retained	<u>-</u>	<u>375</u>
	<u>2 250</u>	<u>2 250</u>

The part-disposal of B's personal bank account does not give rise to a capital gain or loss, since the base cost of R1 000 is equal to the proceeds of R1 000 (part of the amount acquired of R2 250).

The proceeds from the disposal of B's interest in Asset Y are equal to the interest acquired in the partnership bank account (R2 250 less R1 000 relating to the disposal of the personal bank account = R1 250).

B's base cost in respect of Asset Y comprises the following:

	R
Original base cost	2 500
Less: Revised base cost 37,5% / 50% × R2 500	<u>(1 875)</u>
Part disposed of	<u>625</u>
Proceeds	1 250
Less: Base cost	<u>(625)</u>
Capital gain	<u>625</u>

Example 7 – Disposal of partnership asset

Facts:

A, B and C commenced business in partnership. They each injected R10 000 in cash into the partnership bank account which was later used to purchase a piece of land at a cost of R30 000. Five years later the land was worth R90 000 and partner B decided to leave the partnership. Partner A paid Partner B R30 000 for Partner B's share ($1/3 \times R90\,000$) (see Example 3 for the consequences up to this point).

Partners A and C sold the land for R120 000 two years later.

Result:

	A	C	Total
	R	R	R
Proceeds	80 000	40 000	120 000
Less: Base cost	<u>(40 000)</u>	<u>(10 000)</u>	
Capital gain	<u>40 000</u>	<u>30 000</u>	

Example 8 – Unequal initial contributions, equal profit sharing

Facts:

Duncan and Lorraine entered into a partnership agreement under which

- the capital account of a partner must be credited with the market value of any assets contributed by that partner, and
- profits on the disposal of any partnership assets were shared equally.

For the purposes of this example, capital allowances and other income and expenses are ignored.

The partners' respective contributions at the date of formation of the partnership were as follows:

	Market value	Base cost
	R	R
Duncan – land and buildings	200 000	100 000
Lorraine – plant and machinery	300 000	150 000

Three years later the partnership was dissolved and the assets sold for the following amounts:

	R
Land and buildings	350 000
Plant and machinery	<u>400 000</u>
Total proceeds	<u>750 000</u>

*Result:**Accounting consequences*

Balance sheet as at date of formation

Capital employed

Capital accounts

Duncan	200 000
Lorraine	<u>300 000</u>
	<u>500 000</u>

Represented by:

Land and buildings	200 000
Plant and machinery	<u>300 000</u>
	<u>500 000</u>

Income statement for the year ending on date of dissolution

Profit on sale of partnership assets

Land and buildings	150 000
(R350 000 – R200 000)	
Plant and machinery	100 000
(R400 000 – 300 000)	
Net income for the year	<u>250 000</u>

Distributed as follows:

Duncan 50% × R250 000	125 000
Lorraine 50% × R250 000	<u>125 000</u>
	<u>250 000</u>

Each partner's share is credited to his/her capital account.

Balance sheet – as at date of dissolution

Capital employed

Capital accounts

Duncan R200 000 + R125 000	325 000
Lorraine R300 000 + R125 000	<u>425 000</u>
	<u>750 000</u>

Represented by:

Cash	<u>750 000</u>
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The CGT consequences

On entry into the partnership

Duncan has disposed of 50% of his interest in the land and buildings in exchange for a 50% interest in Lorraine's plant and machinery. In determining what has been acquired and disposed of by each partner, it is best not to have regard to the partners' capital accounts, as this can cause confusion. For example, one may be tempted to say that Duncan has a 2/5 interest in the partnership assets because of the ratio that the balance on his capital account bears to the combined capital accounts, but the correct interest is 50%.

Duncan and Lorraine are connected persons in relation to each other. Paragraph 38 requires that transactions between connected persons must take place at market value. Therefore, the capital gains of the partners must be determined as follows:

Duncan

Disposal of fractional interest in land and buildings on date of entry

	R
Proceeds (50% × 200 000)	100 000
Less: Base cost (50% × 100 000)	<u>(50 000)</u>
Capital gain	<u>50 000</u>

He has acquired a base cost in the plant and machinery of $R300\,000 \times 50\% = R150\,000$ and has retained a base cost of $50\% \times R100\,000 = R50\,000$ in the land and buildings.

Disposal of fractional interest in partnership assets on dissolution

	R
Proceeds – land and buildings (R350 000 × 50%)	175 000
Less: Base cost	<u>(50 000)</u>
Capital gain	<u>125 000</u>

Proceeds – plant and machinery (R400 000 × 50%)	200 000
Less: Base cost	<u>(150 000)</u>
Capital gain	<u>50 000</u>

Total capital gains:

On entry	
– Land and buildings	50 000
On dissolution	
– Land and buildings	125 000
– Plant and machinery	<u>50 000</u>
	<u>225 000</u>

Proof:

Balance on capital account (represented by cash)	325 000
Less: Base cost of land and buildings before entry	<u>(100 000)</u>
Increase in net wealth	<u>225 000</u>

Lorraine

Disposal of fractional interest in plant and machinery on date of entry

Lorraine has disposed of 50% of her interest in the plant and machinery in exchange for a 50% interest in Duncan's land and buildings.

	R
Proceeds (50% × R300 000)	150 000
Less: Base cost (50% × R150 000)	<u>(75 000)</u>
Capital gain	<u>75 000</u>

Disposal of fractional interest in partnership assets on dissolution

Land and buildings

Proceeds (R350 000 × 50%)	175 000
Less: Base cost	<u>(100 000)</u>
Capital gain	<u>75 000</u>

Plant and machinery

Proceeds (R400 000 × 50%)	200 000
Less: Base cost	<u>(75 000)</u>
Capital gain	<u>125 000</u>

Total capital gains:

On entry	
- Plant and machinery	75 000
On dissolution	
- Land and buildings	75 000
- Plant and machinery	<u>125 000</u>
	<u>275 000</u>

Proof:

Balance on capital account (represented by cash)	425 000
Less: Base cost of plant and machinery before entry	<u>(150 000)</u>
Increase in net wealth	<u>275 000</u>

Example 9 – Partner contributing labour, the other contributing an asset*Facts:*

Paul and Simon, both musicians, enter into a partnership. Paul contributes a guitar worth R20 000 while Simon contributes his exceptional musical talent. They agree to share profits and assets equally. The base cost of Paul's guitar is R5 000. Some years later, following flagging album sales they decide to end the partnership and sell the guitar for R36 000, each partner receiving R18 000.

*Result:**Consequences on entry into partnership*

By entering into the partnership, Paul disposes of 50% of his interest in the guitar. Although he does not physically receive any proceeds, he is deemed under para 38 to have disposed of his 50% share in the guitar at market value. He realises a capital gain of R10 000 – R2 500 = R7 500. Simon acquires a base cost in the guitar of R10 000.

Consequences on dissolution

Paul's capital gain is R18 000 – R2 500 = R15 500, while Simon's is R18 000 – R10 000 = R8 000.

Proof: Paul's capital account was credited with R20 000 + [50% × (R36 000 – R20 000)] = R28 000. His guitar cost him R5 000 originally, so his increase in wealth is R23 000. His capital gains total R7 500 + R15 500 = R23 000. Simon started with nothing and his capital account was credited with R8 000 [50% × (R36 000 – R20 000)]. His capital gain is R8 000.

Example 10 – Depreciable asset*Facts:*

Five individuals purchased a helicopter in partnership at a cost of R5 million during the 2019 year of assessment. They each contributed R1 million to the partnership for this purpose and share in profits and losses equally. In their 2019 and 2020 returns of income they each claimed an allowance under s 12C of R200 000 a year ($R1\ 000\ 000 \times 20\% = R200\ 000$).

In the 2020 year of assessment a partner's share in the helicopter was sold to the other partners for R1 050 000.

Result:

The withdrawing partner's capital gain will be calculated as follows:

	R
Consideration received	1 050 000
Less: Recoupment	<u>(400 000)</u> ⁵¹⁷
Proceeds	<u>650 000</u>
Cost	1 000 000
Less: Allowances under s 12C	<u>(400 000)</u>
Base cost	<u>600 000</u>

Capital gain R650 000 – R600 000 = R50 000

9.2.2.5 Partners as connected persons and goodwill

Partners are connected persons in relation to one another under the definition of 'connected person' in s 1(1), which reads as follows:

‘ “[C]on~~ne~~cted person” means—

...

(c) in relation to a member of any partnership or foreign partnership—

(i) any other member; and

(ii) any connected person in relation to any member of such partnership or foreign partnership;

...’

Paragraph 38 provides that transactions between connected persons that are not at an arm's length price must be treated as taking place at market value. It frequently happens in large partnerships that new partners are not required to pay for goodwill on entry nor are retiring partners paid for goodwill by the remaining partners. An amount would be received for goodwill only if the partnership were dissolved or sold as a going concern. SARS accepts that in these circumstances the partners are acting at arm's length and that the proceeds derived by a retiring partner should not be artificially increased to include goodwill for which no consideration has been received. Likewise, a retiring partner who has not paid for goodwill on entry must not include goodwill in market value on 1 October 2001 unless it is disposed of for a consideration. Paragraph 27 would in any event preclude the claiming of a market value loss

⁵¹⁷ In *Chipkin (Natal) (Pty) Ltd v C: SARS 2005 (5) SA 566 (SCA)*, 67 SATC 243 Cloete JA upheld the earlier decision in ITC 1784 (2004) 67 SATC 40 (G), namely, that a company that disposed of 99% of its interest in an aircraft partnership was subject to recoupment under s 8(4)(a) in respect of the s 14bis allowances it had claimed on its undivided share in the aircraft.

on disposal of an asset acquired and disposed of for no consideration. Paragraph 16 also precludes the claiming of a loss in respect of goodwill acquired before valuation date from a connected person.

9.2.2.6 Dissolution of partnership

Upon dissolution of a partnership it needs to be determined whether a disposal will result when the partnership assets are divided among the partners.

For example, assume that the partnership assets comprise 100 shares in a single company and there are two partners A and B sharing profits equally. On dissolution partner A takes 50 shares and partner B takes 50 shares. Before dissolution each partner had a fractional interest in 50 shares and after dissolution each partner still holds 50 shares. While it could be argued that the 50 shares taken over by partner A consist of 25 shares formerly held by partner B and 25 shares formerly held by partner A it is not considered appropriate to trigger a disposal in these circumstances because each partner's bundle of rights in the shares has remained unchanged.

The position would be different if the partnership assets comprised 50 shares in Company X and 50 shares in Company Y and partner A took over the 50 shares in Company X and partner B took over the 50 shares in Company Y. In that event partner A has disposed of 25 shares in Company Y to partner B in return for 25 shares in Company X. Likewise, partner B has disposed of 25 shares in Company X in return for 25 shares in Company Y.

9.2.2.7 Foreign partnerships

For some years controversy existed whether a LLP (United Kingdom) or LLC (United States) comprised a company or a partnership. This issue has been addressed by introducing a definition of 'foreign partnership' and by excluding a foreign partnership from the definition of 'company' in s 1(1).

A foreign partnership as defined in s 1(1) is a partnership for the purposes of the Act and full effect must be given to this treatment even if in reality the entity is a company. As a consequence, each partner must be regarded as holding a fractional interest in the partnership assets as with a local partnership. Thus, a partner that holds a 30% share in a LLP which holds a 50% interest in a foreign company would be entitled to the participation exclusion in para 64B since the partner would be regarded as holding an interest of $30\% \times 50\% = 15\%$ in the shares in the foreign company which exceeds the 10% threshold required for exclusion. An interest in a foreign partnership carries with it the complexity of having to account for capital gains and losses each time the partnership disposes of an asset or when other potential disposal events occur such as the introduction of a new partner, the withdrawal of an existing partner or a change in the profit-sharing ratio.

9.3 Assets of trust and company

Paragraph 37

Under the Eighth Schedule capital gains and losses determined in respect of most personal-use assets are disregarded. While capital gains are taxable, capital losses in respect of certain assets such as boats and aircraft not used for trade purposes are disregarded under para 15 (see 7.1).

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

or company, the interest in which or shares of which, are owned directly or indirectly by a natural person, and

- that trust or company owns assets such as boats or aircraft or assets which if owned by natural persons would be personal-use assets,
- there is a decrease in the value of the assets of the trust or company after that person acquired the interest in the trust or company, and
- the interest in the trust or company is then disposed of by a person.

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

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

9.4 Disposal by donation, consideration not measurable in money and transactions between connected persons not at an arm's length price

Paragraph 38

9.4.1 Application

This provision applies when a person disposes of an asset

- by donation;
- for a consideration not measurable in money; or
- to a connected person⁵¹⁸ immediately prior to or immediately after that disposal for a consideration which does not reflect an arm's length price.

The words 'immediately prior to or immediately after that disposal' were inserted by the Taxation Laws Amendment Act 34 of 2019 and came into operation on 15 January 2020. Their insertion means that the connected person relationship may be judged either immediately before or immediately after the disposal. Before this amendment, the relationship had to be determined at the time of disposal, which means that the parties would have had to be connected persons in relation to each other immediately before the disposal. Typically, a person who disposes of an asset to a company in return for shares in that company will become a connected person in relation to the company immediately after the transaction if the person acquires the required percentage of shares in the company immediately after the transaction.

Under s 41(2) the asset-for-share transaction rules in s 42 will override para 38 if they apply. In other words, under s 42(2) the transferor is deemed to dispose of a capital asset for an amount received or accrued equal to its base cost, while para 38 would potentially require the transaction to take place at market value. However, s 42 may not always apply, in which event para 38 may apply. For example, the transferor and company can elect in writing to opt out of s 42;⁵¹⁹ the asset's base cost may exceed its market value at the time of disposal;⁵²⁰ or the

⁵¹⁸ As defined in s 1(1).

⁵¹⁹ Section 42(8A).

⁵²⁰ Paragraph (a)(i) of the definition of 'asset-for-share transaction' in s 42(1).

holder of shares may not have the required qualifying interest of at least 10% of the equity shares and voting rights in the company.⁵²¹

Example – Persons who become connected persons immediately after a disposal

Facts:

Shane acquired 20% of Company A's equity shares. He did not own any pre-existing shares in the company. Immediately before the transaction, he sold an asset with a market value of R100 for R80 to the company for cash.

Result:

Prior to the disposal, Shane was not a connected person in relation to Company A under para (d)(iv) of the definition of 'connected person' in s 1(1) because he held less than 20% of the equity shares or voting rights in the company. However, after he acquired the 20% interest, he became a connected person in relation to Company A. Shane is therefore deemed to have proceeds of R100 and Company A is deemed to acquire the asset at a base cost of R100, despite the actual consideration being R80 because Shane became a connected person in relation to Company A immediately after the disposal of the asset.

9.4.2 'Not measurable in money'

The words 'not measurable in money' are not defined in the Act.⁵²² They would seem to refer to a consideration which does not have a pecuniary or economic value under Roman Dutch law being *res extra commercium*, namely, *res communes* (things common to all inhabitants such as the sea and air) and *res publicae* (State property held for the benefit of inhabitants). Also falling into this category are rights arising in the sphere of the law of persons, such as personal liberty, parental authority and rights flowing from the marital relationship (see 4.1.2).

In *GB Mining and Exploration SA (Pty) Ltd v C: SARS*⁵²³ the appellant had disposed of a 38% interest in a 25% interest it held in the RK1 joint venture to RKMSA. In return GB Mining obtained a 62% stake in the RK2 joint venture held by RKMSA. The court confirmed that the proceeds were not measurable in money and accordingly applied para 38, determining that the proceeds were equal to the market value of the RK1 interest so disposed of. It is unclear from the facts of the case why it was not possible to measure the value of the interest in the RK2 joint venture acquired in exchange but it is possible that the appellant simply failed to adduce evidence of such a value.

The words 'not measurable in money' do not include a barter transaction under which the value of the asset received can be determined.

Section 24M deals with the situation in which the consideration cannot be quantified in the current year of assessment (see 10.2.1).

⁵²¹ Paragraph (c) of the definition of 'qualifying interest' in s 42(1) read with the definition of 'asset-for-share transaction'.

⁵²² A similar term 'not measurable in terms of money' is used in s 22(4) in relation to the acquisition of trading stock.

⁵²³ (2015 (4) SA 605 (SCA), 76 SATC 347.

Example – Consideration not measurable in money

Facts (with due acknowledgements to the TV series Isidingo on SABC 3):

Cherel has been charged with the murder of her husband's son Duncan. About two years previously she had shot him and dumped his body down a mineshaft. While in prison awaiting trial, she approached Dumisani and asked him to provide her with an alibi, namely, that he was with her on the night of the murder. In exchange she would give him her shares in Deep Gold and ON-TV. He agreed. Assume that she duly transferred the shares to Dumisani upon him testifying at her trial.

Result:

Under para 38 Cherel is deemed to have sold her Deep Gold and ON-TV shares for their market value as the consideration is not measurable in money. Dumisani is deemed to have acquired them for the same market value.

9.4.3 'Acting at arm's length'

The phrase 'acting at arm's length' was considered in *Hicklin v SIR* in which Trollip JA stated the following:⁵²⁴

'It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself.'

An arm's length price cannot always be equated with market value. Situations can arise in which connected persons transact between one another at a price determined on an arm's length basis which does not reflect market value. In these circumstances para 38 will not apply. See for example, **9.2.2.5** which deals with large partnerships in which partners do not pay for goodwill on entry to or exit from the partnership, yet are acting at arm's length with one another. See also **24.13**, dealing with transactions between an employee share incentive trust and its beneficiaries. Generally, employees who are not relatives of the founder would be expected to negotiate their employment conditions at arm's length.

9.4.4 Substitution of market value for non-arm's length consideration

The consideration, which is not an arm's length price between connected persons, could be greater than or less than the market value of the asset disposed of.

The person disposing of the asset is treated as having disposed of the asset for an amount received or accrued⁵²⁵ equal to the market value of the asset so disposed of at the date of disposal. The acquirer is treated as having acquired the asset at the same market value. The market value is treated as an amount of expenditure actually incurred for the purposes of para 20(1)(a).

The market value of the asset disposed of will be substituted for any actual consideration agreed upon by the parties.

9.4.5 Acquisition of asset by resident from non-resident

There is a view that for para 38(1)(b) to apply, para 38(1)(a) must apply. Since the Eighth Schedule does not apply to the disposal of assets by a non-resident [except for the deemed

⁵²⁴ 1980 (1) SA 481 (A), 41 SATC 179 at 195.

⁵²⁵ The term 'amount received or accrued' was substituted for the word 'proceeds' by the Revenue Laws Amendment Act 32 of 2004, effective 24 January 2005.

South African-source assets mentioned in para 2(1)(b)], it is contended that para 38(1)(b) cannot apply to a resident acquirer.

In order to enable the acquirer of the asset to establish an acquisition cost equal to market value, para 20(1)(h)(vi) was inserted.⁵²⁶ See **8.15A**.

9.4.6 Asset acquired or disposed of between connected persons under option contract

The question arises whether para 38 should be applied when an option to acquire or dispose of an asset is exercised and the strike price differs from the market value of the asset at the time of exercise. In these instances, the terms of the option contract cannot be ignored and para 38 should not be invoked merely because the strike price differs from the prevailing price. Paragraph 38 needs to be considered not at the time of exercise, but at the time when the option is granted. It is necessary to determine whether the price paid for the option is market-related. If not, para 38 will operate to substitute the market-related price for the actual option price.

Example 1 – Application of para 38 when asset acquired through exercise of option

Facts:

Patrick and Liesel are brother and sister. They own 25% and 30% respectively of the shares in Ger Ltd. In year 1 Liesel granted Patrick a call option which gave him the right (but not the obligation) to acquire one-sixth of her shares (that is, a further 5% stake in the company) at a strike price of R2 a share. The option had to be exercised before the end of year 5. He paid 50 cents for the option which was determined by an independent financial analyst as being an arm's length price. The base cost of Liesel's shares was 75 cents a share. In year 5 Patrick exercised the option when the shares were trading at R3 a share.

Result:

Patrick and Liesel are connected persons in relation to each other under para (a)(i) of the definition of 'connected person' in s 1(1) because they are relatives in relation to one another. However, para 38 does not apply despite the fact that the price paid for the shares (R2 a share) is less than the price prevailing at the time of exercise of the option (R3 a share). Effect must be given to the option contract in determining whether the strike price was market-related. Since the price paid for the option was market-related, there is no need to adjust it under para 38.

Year 1

Liesel will have a capital gain in respect of the granting of the option of 50 cents a share [proceeds of 50 cents a share less base cost of nil under para 33(3)(a)].

The base cost of Patrick's option is 50 cents a share.

Year 5

Liesel will have a capital gain of R2 (strike price proceeds) less base cost of 75 cents = R1,25 a share.

The base cost of Patrick's shares will be 50 cents (cost of option) plus R2 (strike price) = R2,50.

⁵²⁶ Paragraph 20(1)(h)(vi) was introduced by s 77(1)(c) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

Example 2 – Non-arm's length option price*Facts:*

Patrick and Liesel are brother and sister. They own 25% and 30% respectively of the shares in Ger Ltd. In year 1 Liesel granted Patrick a call option which gave him the right (but not the obligation) to acquire one-sixth of her shares (that is, a further 5% stake in the company) at a strike price of R2 a share. The option had to be exercised before the end of year 5. He paid 25 cents for the option. However, an independent financial analyst determined an arm's length price for the option as 50 cents per share. The base cost of Liesel's shares was 75 cents a share. In year 5 Patrick exercised the option when the shares were trading at R3 a share.

Result:

Under para 38

- the proceeds received by Liesel will be increased from 25 to 50 cents a share. In year 1 she will have a capital gain of 50 cents a share in respect of the granting of the option [proceeds 50 cents a share less base cost of nil under para 33(3)(a)], and
- the base cost of the option in Patrick's hands will be increased from 25 to 50 cents a share. The base cost of the shares acquired by Patrick in year 5 on exercise of the option will be 50 cents (option price adjusted under para 38) + R2 (strike price) = R2,50 a share.

9.4.7 Disposals to which para 38 does not apply

Table 1 – Disposals to which para 38 does not apply

Paragraph 38	Disposals of assets to which para 38(1) does not apply	Effective date
(1)	An asset transferred between spouses under s 9HB. ⁵²⁷	1 October 2001.
(2)(a)	A right contemplated in s 8A.	1 October 2001.
(2)(b)	An asset in the circumstances contemplated in s 10(1)(nE).	1 October 2001.
(2)(c)	A qualifying equity share contemplated in s 8B by an employer, associated institution or any other person by arrangement with the employer, as contemplated in para 1 of the Seventh Schedule, to an employee.	Disposals of qualifying equity shares acquired on or after 26 October 2004.
(2)(d) ⁵²⁸	This provision was deleted because it was regarded as superfluous in view of the now repealed para 11(2)(j), which provided that there is no disposal of a s 8C equity instrument before vesting as contemplated in that section.	
(2)(e)	Any asset in respect of which s 40CA applies.	Shares acquired or disposed of on or after 1 April 2013.

⁵²⁷ Section 59 of the Taxation Laws Amendment Act 34 of 2019 replaced a reference to para 67 with a reference to s 9HB with effect from 15 January 2020.

⁵²⁸ Deleted by s 98 of the Taxation Laws Amendment Act 7 of 2010 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2011.

Paragraph 38	Disposals of assets to which para 38(1) does not apply	Effective date
(2)(f)	any land from the date on which that land becomes declared land as defined in s 37D(1). This exclusion was inserted to prevent double taxation that may otherwise have arisen between s 37D and the Eighth Schedule. Section 37D grants a person an allowance of 4% a year over 25 years for land declared as a nature reserve but this deduction is reduced by the taxable capital gain that would have arisen at the time of donation. Thus, in effect SARS is recovering the taxable capital gain over 25 years. The problem was that the granting of the rights to the government for 99 years is an actual disposal under paragraph 11 and the proceeds would be determined under paragraph 38 by virtue of the donation. A capital loss cannot result because of para 33(3)(b), since there would be no proceeds in respect of the granting of the right of use. To the extent that the donation is to the government any capital gain or loss must in any event be disregarded under para 62(a).	

Section 9HB overrides para 38(1).⁵²⁹

Under share incentive schemes and share option schemes the share trust and companies disposing of shares and options are often connected persons in relation to the employees and directors. Were it not for this exclusion, the rules of the paragraph would apply to transactions between these parties. The effect in certain circumstances would have been that the consideration between the parties would have been inflated and employees would have been taxed on gains they never made or allowed losses they did not suffer. It is for this reason that the rules do not apply to ss 8A and 8B securities in the circumstances set out in the above table. Section 10(1)(nE) deals with the so-called 'stop-loss' provisions commonly found in share incentive schemes. For example, a share purchase trust deed may provide that employees must sell their shares back to the trust at cost if they do not remain in the employer's service for a set period. At the time of repurchase the market price may be more or less than the cost price and this would trigger an artificial gain or loss under para 38(1) were it not for the exception in para 38(2)(b).

An asset acquired by a company through the issue of its own shares is deemed under s 40CA to have been acquired at the market value of the shares immediately after the acquisition. A company that acquired an asset through the issue of debt is deemed under s 40CA to have acquired the asset for the amount of the debt. To the extent that s 40CA applies, para 38 will not apply, either to the person disposing of the asset or to the company acquiring it in exchange for an issue of shares. Under such circumstances the person disposing of the asset would derive proceeds under para 35 equal to the market value of the shares acquired in exchange for the asset.

⁵²⁹ Paragraph 38(1) is 'subject to' s 9HB.

9.4.8 Pre-valuation date disposals

Paragraph 38 applies only to disposals on or after the valuation date. This follows from para 2 which states that, subject to para 97, the Eighth Schedule applies to the disposal of an asset on or after the valuation date.

Nevertheless, an asset acquired at a non-arm's length price before the valuation date may have a cost equal to market value at the time of its acquisition as a result of the extinction of personal rights leading up to its acquisition— see **8.5A**.

Example – Asset acquired for non-arm's length consideration before the valuation date

Facts:

On 10 June 1990 Albie's brother Morné offered to sell him 1 000 shares in ABC Ltd for R1 a share when the shares were valued at R10 a share. On 15 June 1990 Morné accepted Albie's offer, and at that stage the shares had increased in value to R11 a share. Morné finally took transfer of the shares on 31 July 1990 when the shares were valued at R12 each. He paid Albie R1 000 for the shares on the same date. What expenditure has Morné incurred in acquiring the shares for the purposes of para 20(1)(a)?

Result:

When Morné accepted Albie's offer, he acquired a vested right to claim delivery of the shares at a price of R1 000. The cost of this right to Morné was R1 000. Under para 13(1)(a)(ii) the time of disposal by Albie and under para 13(2) the time of acquisition by Morné is 15 June 1990 (not the date of actual transfer of ownership). When Morné took transfer of the shares, he gave up the right to claim delivery of the shares in return for the actual shares. The consideration he received for giving up that right is R11 000, being the market value of the actual shares on 15 June 1990 (1 000 × R11 = R11 000). This disposal gives rise to a pre-CGT gain of R11 000 – R1 000 = R10 000 which is irrelevant for CGT purposes.

Immediately before the acquisition of the actual shares the right to claim delivery was also worth R11 a share. Morné's expenditure in acquiring the shares is thus equal to the value of the right given up on 15 June 1990, being R11 000.

Note: Based on the definition of 'pre-valuation date asset' in para 1, the time of disposal rules in para 13 also apply to transactions before valuation date.

9.4.9 The receipt of a donation

The receipt of a donation is generally of a capital nature⁵³⁰ unless it is a payment for services rendered or is in the form of an annuity. Does the receipt of such a donation give rise to a capital gain in the hands of the donee? Upon acceptance of a donation, the donee acquires a personal right to claim payment of the donation from the donor for no consideration. So ostensibly the receipt of a donation could give rise to a capital gain. However, para 38 takes care of this problem by treating the donee as having acquired the personal right at market value. Since the proceeds would usually have the same market value as the personal right, the receipt of a donation will generally not give rise to a capital gain or loss in the donee's hands.

⁵³⁰ (1940) 11 SATC 178 (U).

Example 1 – Donation of asset*Facts:*

Johan donated a yacht exceeding 10 metres in length to Indira as a token of his affection for her. There was no marital-like union between them at the time in spite of Johan's efforts to establish one. The yacht had a base cost of R1 million and had a market value of R2,5 million at the time of the donation. For the purposes of the example ignore donations tax.

Result:

Johan and Indira do not qualify as spouses. The base cost of R1 million in the hands of Johan is therefore not transferred to Indira under para 67. Johan must treat the transaction as a disposal for a consideration of R2,5 million under para 38. He will therefore realise a capital gain of R1,5 million in respect of the donation, while Indira will be treated as having acquired the yacht at a base cost of R2,5 million.

Example 2 – Disposal of asset for consideration not measurable in money*Facts:*

Keith sold an aircraft with a base cost of R1 million and a market value of R3,5 million to Lionel for a consideration that was not measurable in money.

Result:

Keith cannot treat the transaction as a disposal for a consideration having a value of nil and claim the base cost of the aircraft as a capital loss. Keith and Lionel must treat the transaction as a disposal and acquisition at R3,5 million. Keith therefore realised a capital gain of R2,5 million (R3,5 million proceeds less R1 million base cost) in respect of the disposal, while Lionel acquired the aircraft for an expenditure under para 20(1)(a) of R3,5 million.

Example 3 – Disposal between connected persons not at arm's length*Facts:*

J Ltd holds 69% of the equity shares in Eye (Pty) Ltd.

Jay Ltd sold immovable property with a base cost of R1 million to Eye (Pty) Ltd for R2,2 million. Eye (Pty) Ltd planned to use the immovable property for purposes of erecting a factory building.

It transpired that the property was much sought after owing 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 was R2,9 million.

Result:

The price agreed to between Jay Ltd and Eye (Pty) Ltd is lower than the price that the property might have been expected to fetch had Jay Ltd and Eye (Pty) Ltd been independent persons dealing at arm's length. The market value (that is, R2,9 million) of the property is therefore substituted for the consideration agreed to between Jay Ltd and Eye (Pty) Ltd.

Example 4 – Disposal of depreciable asset between connected persons*Facts:*

Company A and Company B are connected persons in relation to each other. Company A sold a fully depreciated asset that it had acquired at a cost of R100 after valuation date to Company B for R100. The market value of the asset at the date of disposal was R120.

Result:

Under para 38(1)(a) Company A has proceeds of R120 (amount received) – R100 (recoupment) = R20 and a base cost of nil [R100 cost reduced by capital allowances of R100 under para 20(3)(a)] = R0, giving a capital gain of R20.

Note: This example reflects the law on or after 24 January 2005. Before that date para 38 deemed the asset to be disposed of for ‘proceeds’ equal to market value. The term ‘proceeds’ refers to the end result after applying para 35(3)(a). In the example this treatment has the effect of deeming Company A to have proceeds of R120, which leads to double taxation.

9.4.10 Waiver of debt

It is considered that para 38 does not apply to the waiver of debt other than through cession, whether motivated by sound commercial reasons or by gratuitousness. The reason is that while such a waiver involves a disposal by the creditor, it does not involve a corresponding acquisition by the debtor. In that regard, para 38(1) contains two items, (a) (which applies to the disposer) and (b) (which applies to the acquirer). These items are separated by the word ‘and’ meaning that for para 38 to apply there needs to be a disposer and an acquirer.⁵³¹ When the waiver involves connected persons, para 56(1) will require the creditor to disregard the capital loss unless the debtor suffers one of the consequences in para 56(2), such as a base cost reduction [para 12A(3)] or capital gain [para 12A(4)].

However, if debt is cancelled through cession, the creditor will have a disposal and the debtor will have a momentary acquisition (the debt acquired will be extinguished through merger) and in that event para 38 will apply.

9.5 Capital losses determined in respect of disposals to certain connected persons

Paragraph 39

9.5.1 The clogged loss rule

Under this rule a person's capital loss determined in respect of the disposal of an asset to a connected person is treated as a ‘clogged’ loss. In other words, the capital loss is ring-fenced and may be set off only against capital gains arising from disposals to the same connected person. It has been held that para 39 is an anti-avoidance provision which must be given a wider interpretation so as to suppress the mischief at which the provision is aimed and to advance the remedy. But this does not mean that the meaning of the provision being interpreted must be stretched beyond what its language permits.⁵³²

⁵³¹ It was for this reason that para 20(1)(h)(v) and (vi) were inserted to deal with the acquisition of assets from non-residents. In those situations the non-resident did not have a disposal by reason of para 2(1)(b) but the resident had an acquisition and needed to be given a step-up in base cost.

⁵³² ITC 1859 (2012) 74 SATC 213 (J) in [16].

9.5.2 Persons subject to ring-fencing of capital losses and timing of determination of relationship between parties [para 39(1)]

A person must disregard any capital loss determined in respect of the disposal of an asset to the persons set out in the table below. Capital losses of this nature are ‘clogged’ (ring-fenced) (see commentary on para 39(2) below). The table also sets out the time when the relationship between the parties must be determined. Although the parties mentioned in para 39(1)(b) may also be connected persons, the maxim *generalia specialibus non derogant*⁵³³ prevails and the more specific provisions of para 39(1)(b) must be given preference over those of para 39(1)(a). One of the reasons for determining the relationship immediately after the disposal is that in some instances the relationship is established only after the transaction. This situation typically occurs, for example, in an asset-for-shares swap under which one person disposes of an asset to a company in exchange for shares in that company.

Table 1 – Persons who must disregard capital losses

Paragraph 39(1)	Type of acquirer	When relationship with acquirer must be determined	Effective date
(a)	Connected person in relation to disposer	Immediately before disposal	1 October 2001
(b)(i)	A company that is a member of the same group of companies as the disposer	Immediately after disposal	Commencement of years of assessment ending on or after 1 January 2004
(b)(ii)	A trust with a company beneficiary that is a member of the same group of companies as the disposer	Immediately after disposal.	

Disposal to a person

For para 39 to apply, the asset must be disposed of ‘to’ a person specified in the provision. In some situations, an asset may be disposed of to no one in particular, as for example with the scrapping or extinction of an asset or when an asset is deemed to be disposed of and the deeming provision does not specify an acquirer, as in paras 12(1) and 77(1). In ITC 1859⁵³⁴ a company (A) purchased redeemable preference shares in another company (B) within the same group of companies from various third party banks. Shortly afterwards B redeemed the shares which resulted in A incurring a capital loss on redemption. The court held that the capital loss was not ring-fenced under para 39(1) because the shares had not been disposed of by A to B. Relying on the meaning of the word ‘to’ in the Concise Oxford Dictionary of ‘in the direction of; so as to reach’ the court stated the following:⁵³⁵

‘On adopting a literal interpretation of paragraph 39(1) the disposal of the asset must thus be “in the direction of”, or “so as to reach” the connected person. This implies a disposal of a kind in which the asset (or the rights represented therein, in the case of shares) must be transferred to the connected person.’

The court concluded that a redemption of redeemable preference shares resulted in the extinction and not in a transfer of the rights embodied in the shares to the company redeeming them or to any other person.

This issue is now addressed in para 39(5) which deems redeemable shares to be disposed of to the issuing company on redemption (see 9.5.7).

⁵³³ General provisions do not take from or reduce specific or special ones.

⁵³⁴ (2012) 74 SATC 213 (J).

⁵³⁵ ITC 1859 above in [19].

Caution needs to be exercised when seeking to apply the outcome of ITC 1859 to other situations such as the buy-back by a company of its shares or the waiver of a debt. With a share buy-back, para 11(2)(b) provides that there is no disposal by a company in respect of 'the issue, cancellation or extinction of a share in the company'. The purpose of this rule is to prevent an artificial capital loss from arising in the company after it has bought back its own shares for an amount of expenditure. The shares so acquired would have a base cost but there would be no proceeds when they are disposed of by merger or confusio. The point in relation to para 39 is that in such a situation the holder of shares does dispose of the shares to the company buying them back otherwise there would have been no need for para 11(2)(b).

Under s 35(5) of the Companies Act 71 of 2008 shares of a company that have been issued and subsequently acquired by that company have the same status as shares that have been authorised but not issued. Under s 35(4) of the same Act an authorised share of a company has no rights associated with it until it has been issued. It follows that when a company acquires its own shares any rights in those shares are immediately extinguished by confusio. Section 85(8) of the previous Companies Act 61 of 1973 was differently worded in that it stated that '[s]hares issued by a company and acquired under this section shall be cancelled as issued shares and restored to the status of authorized shares forthwith'. Paragraph 11(2)(b) caters for both the cancellation and the extinction of shares bought back by a company. It follows that when a company buys back its own shares from a connected person any capital loss incurred by that connected person will be clogged under para 39.

A capital loss of a resident corporate shareholder as a result of a share buy-back will be limited under para 19(1)(a) to the extent that the shareholder derives any 'exempt dividends' as defined in para 19(3)(b), that is, dividends exempt from normal tax and dividends tax. It is thus likely that any capital loss potentially subject to ring-fencing under para 39 will arise from an inadequate return of capital rather than from the dividend element of a share buy-back.

In *Union Free State Mining and Finance Corpn Ltd v Union Free State Gold and Diamond Corpn Ltd* Munnik AJ stated the following:⁵³⁶

'I do not think that a creditor can by the mere exercise of his will terminate the obligation without the concurrence of the debtor because as both Wessels [para 2344A] and Pothier [s 578] point out a release, waiver or abandonment is tantamount to making a donation to the debtor of the obligation from which he is to be released and until that donation has been accepted it has not been perfected. There may conceivably be circumstances in which a debtor does not wish to be released from his obligation. It may for a variety of reasons not suit him to be released. To allow the release, waiver or abandonment and the consequent making of a donation dependent solely on the will or action of the creditor would be tantamount to creating a contract at the will of one party which is a concept foreign to our jurisprudence.'

It is nevertheless a moot point whether in all circumstances the release by a creditor of a debtor from the payment of a debt results in a disposal of the claim from the creditor to the debtor. In some instances, it will be clear that such a disposal has occurred, for example, when the creditor cedes the claim to the debtor. The clogged loss rule in para 39 does not apply when a creditor disposes of a debt owed by a connected person at a capital loss and para 56(2) applies. The latter provision permits the capital loss to be claimed by the creditor despite para 39.

Any capital loss arising on disposal of a subsidiary's shares as a result of its liquidation or deregistration is not ring-fenced under para 39, since the shares are not disposed of to a connected person. Paragraph 77(1) simply deems the shares to be disposed of and does not

⁵³⁶ 1960 (4) SA 547 (W) at 549.

state to whom they are disposed of. The capital loss will, however, have to be disregarded when s 47(5) applies.

Under the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003 (the Amnesty Act) a person qualifying for amnesty could elect to be treated as the owner of a foreign discretionary trust's assets (see **8.39.2**). For CGT purposes the person remains the deemed owner until the asset is disposed of by the discretionary trust.⁵³⁷ The question arises whether the electing party is regarded as having disposed of the asset to the same person as the discretionary trust for the purposes of para 39. While s 4(3)(b) of the Amnesty Act simply deems the electing party to have disposed of the asset without saying to whom it is disposed of, reg 4(b)⁵³⁸ deems the electing party to

'deal with that foreign asset in the same manner as is dealt with by that discretionary trust'.

It is submitted that the effect of this regulation is, amongst other things, to deem the electing party to have disposed of the asset to the same person to whom it was disposed of by the discretionary trust, thus making para 39 potentially applicable.

On capital losses arising on the disposal of debts owed by connected persons, see **9.5.6** below.

The position before commencement of years of assessment ending on or after 1 January 2004

Paragraph 39(1)(b) was introduced by the Revenue Laws Amendment Act 45 of 2003 with effect from the commencement of years of assessment ending on or after 1 January 2004. Before that date para 39(1) dealt only with disposals to connected persons and the relationship between the parties had to be determined before any disposal. With the insertion of para 39(1)(b) the test to determine whether the parties were connected was moved to after the event for companies forming part of a group of companies and a trust with a beneficiary forming part of such a group.

Example 1 – Timing of determination of connected person status

Facts:

Holdco owns all the shares in Targetco that it had acquired in year 1 at a cost of R100 000. In year 5 Holdco disposed of its shares in Targetco to Acquiringco in exchange for a 70% interest in Acquiringco. Before the transaction Holdco and Acquiringco were unrelated companies. The market value of the Acquiringco shares was R80 000. Determine whether Holdco's capital loss of R20 000 is clogged under para 39.

Result:

The asset-for-share provisions in s 42 do not apply to the disposal by Holdco because the shares were disposed of at a capital loss (s 42 applies only to gain or break-even shares).

Before the disposal, Holdco and Acquiringco are unrelated parties. Immediately after the transaction, Holdco has a 70% interest in Acquiringco, which makes Holdco and Acquiringco members of the same group of companies. In these circumstances para 39(1)(b)(i) applies and the capital loss is clogged.

⁵³⁷ Section 4(3)(b) of the Amnesty Act.

⁵³⁸ Regulation 4(b) of GN R 1368, GG 25511 of 29 September 2003.

Example 2 – Disposal to trust with beneficiary that is a member of the same group of companies as disposer

Facts:

Holdco sold an asset with a base cost of R100 000 to the ABC Trust for R80 000. The trustees of the ABC Trust have the discretion to appoint any member of the Holdco group as a beneficiary. At the time the ABC Trust acquired the asset, the only nominated beneficiary was Oxfam. Immediately after the transaction, the trustees appointed Subco, a company in which Holdco has a 70% interest, as a beneficiary and awarded the asset to it.

Result:

Holdco's capital loss of R20 000 is clogged under para 39(1)(b)(ii) because

- after the transaction Subco was a beneficiary of the ABC Trust, and
- Holdco owns 70% of the shares in Subco, which makes Holdco and Subco members of the same group of companies.

9.5.3 Ring-fencing of capital losses [para 39(2)]

Any capital loss arising from a transaction between the persons mentioned in para 39(1) is not brought into account in determining those persons' aggregate capital gain or aggregate capital loss for the year of assessment in which that disposal takes place. The loss is in effect ring-fenced and can 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 in addition have to still qualify as a connected person at the time of those disposals.

9.5.4 Restricted meaning of 'connected person' [para 39(3)]

The definition of 'connected person' will not extend, for purposes of para 39(1), to

- any relative of a natural person other than a parent, child, stepchild, brother, sister, grandchild or grandparent of that person, or
- disposals of assets between the five funds of an insurer contemplated in s 29A.

The definition of 'relative' in s 1(1) includes a person's spouse and a spouse is therefore not a connected person for the purposes of para 39. However, nothing turns on this fact since capital gains and losses on transactions between spouses are disregarded under s 9HB.⁵³⁹

South African long-term insurers are required for income tax purposes to create five funds to conduct their business, namely, the

- individual policyholder fund;
- company policyholder fund;
- untaxed policyholder fund;
- corporate fund; and
- risk policy fund.

⁵³⁹ Before 17 January 2019 such capital gains and losses were disregarded under paragraph 67.

Section 29A(10) provides that the taxable income derived by an insurer in respect of its four tax paying funds must be determined separately in accordance with the provisions of the Act as if each such fund had been a separate taxpayer. It then provides that each of the five funds is deemed to be a separate company which is a connected person in relation to every other such fund for the purposes of s29A(6), (7) and (8) and ss 20, 24I, 24J, 24K, 24L, 26A and 29B and the Eighth Schedule. Disposals of assets between the funds are therefore disposals in respect of which capital gains or losses must be determined. Despite s 29A(10) deeming the five funds to be connected persons in relation to each other for the purposes of the Eighth Schedule, para 39(3)(b) provides that for the purposes of para 39(1) the five funds of an insurer are not to be treated as connected persons. Consequently, any capital losses arising on a disposal between the five funds of an insurer will not be clogged.

For disposals before 1 February 2006, capital losses [except those arising under s 29A(6) or (7)] remain clogged.⁵⁴⁰ As a result of a further amendment, it is now clear that a pre-1 February 2006 clogged loss arising from a transaction with one fund of an insurer can be set off against a subsequent capital gain arising from a transaction with the same fund.⁵⁴¹

9.5.5 Disposals to beneficiaries of share incentive trusts [para 39(4)]

[Applicable to disposals on or after 1 February 2006]⁵⁴²

Any capital losses arising in an employee share incentive trust are not clogged if

- they relate to any right, marketable security or equity instrument contemplated in s 8A or 8C,
- the disposal is by virtue of the beneficiary's employment with an employer, directorship of a company or services rendered or to be rendered by that beneficiary as an employee to an employer, or
- as a result of the exercise, cession, release, conversion or exchange by that beneficiary of the right, marketable security or equity instrument, and
- that trust is an associated institution as contemplated in para 1 of the Seventh Schedule in relation to that employer or company.

Under the definition of 'connected person' in s 1(1) a beneficiary of a trust is a connected person in relation to the trust. It follows that in the absence of para 39(4) a share incentive trust would be unable to set off a capital loss arising upon the disposal of a share to one employee against a capital gain arising on the disposal of a share to another employee. Since the trust and the employee normally act at arm's length, it is appropriate that the losses in question not be clogged.

⁵⁴⁰ Paragraph 39(3)(b) was widened to include all inter-fund disposals by s 73(1)(a) of the Revenue Laws Amendment Act 31 of 2005, effective 1 February 2006. Previously para 33(3)(b) excluded only disposals required as a result of a change of policyholders or to balance the assets and liabilities of the funds under s 29A(6) and (7) on the basis that such transfers were involuntary. The exclusion now includes disposals under s 29A(6), (7) and (8).

⁵⁴¹ Under s 63 of the Taxation Laws Amendment Act 8 of 2007 the reference in the opening words of para 39(3) to 'this paragraph' were changed to refer to para 39(1). The amendment was backdated, and deemed to have come into operation on 1 February 2006 and applies in respect of any disposal on or after that date. The amendment ensures that the funds remain connected for purposes of para 39(2) at the time of the subsequent capital gain, which is a pre-requisite for set-off.

⁵⁴² Paragraph 39(4) inserted by s 73(1)(b) of the Revenue Laws Amendment Act 31 of 2005, and applicable to any disposal on or after 1 February 2006.

9.5.6 Losses on disposal of certain debts not clogged [para 56(2)]

Paragraph 39 does not apply to a capital loss arising on the disposal of a debt owed to a creditor who is a connected person in relation to the debtor to the extent that the amount of that debt so disposed of represents

- an amount which is applied to reduce the expenditure in respect of an asset of the debtor under s 19(3) or para 12A(3) (deemed to have come into operation on 1 January 2018 and applies to years of assessment commencing on or after that date);
- an amount which must be taken into account by the debtor as a capital gain under para 12A(4) (deemed to have come into operation on 1 January 2018 and applies to years of assessment commencing on or after that date);
- an amount which the creditor proves must be or was included in the gross income of any acquirer of that debt;
- an amount that must be or was included in the gross income or income of the debtor or taken into account in the determination of the balance of assessed loss of the debtor under s 20(1)(a); or
- a capital gain which the creditor proves must be or was included in the determination of the aggregate capital gain or aggregate capital loss of any acquirer of the debt.⁵⁴³

For years of assessment commencing before 1 January 2013 para 39 did not apply to the extent that the amount of the debt so disposed of represented a capital gain which was included in the determination of the aggregate capital gain or aggregate capital loss of the connected debtor by virtue of para 12(5).

Example – Ring-fencing of losses between connected persons

Facts:

During year 1 Aitch Ltd sold undeveloped immovable property having a base cost of R1 million to Gee (Pty) Ltd, a 69%-owned subsidiary, at its market value of R500 000. During year 2 Aitch Ltd sold a further piece of undeveloped immovable property to Gee (Pty) Ltd with a base cost of R500 000 and a market value of R400 000. This sale was effected at a price of R600 000. During year 3 Aitch Ltd sold a shopping complex with a base cost of R1,5 million to Gee (Pty) Ltd at a market-related price of R1,8 million. During year 4 Aitch Ltd sold all the shares it held in Gee (Pty) Ltd to a foreign developer not linked to Aitch Ltd. Gee (Pty) Ltd subsequently made an offer to Aitch Ltd to buy the remaining immovable property held by Aitch Ltd. Aitch Ltd accepted the offer and sold the property that had been acquired by it at a base cost of R300 000 to Gee (Pty) Ltd at its market value of R800 000.

⁵⁴³ This provision came into operation as from the commencement of years of assessment ending on or after 1 January 2005.

<i>Result:</i>					
The position can be summarised as follows:					
Year	Asset	Market value at date of sale R	Aitch's base cost R	Aitch's gain / (loss) R	Comment
1	Undeveloped land	500 000	1 000 000	(500 000)	Loss ring-fenced under para 39 because H Ltd and G (Pty) Ltd are connected persons in relation to each other under para (d)(i) of the definition of 'connected person' in s 1(1).
2	Undeveloped land	400 000 (sold for 600 000)	500 000	(100 000)	Loss ring-fenced – market value substituted for actual selling price under para 38.
3	Shopping complex	1 800 000	1 500 000	300 000	Gain may be set off against accumulated clogged losses brought forward of R600 000 under para 39(2).
4	Immovable property	800 000	300 000	500 000	Gain may not be set off against remaining clogged loss of R300 000. Gee is no longer a connected person in relation to Aitch.

9.5.7 Redeemable shares [para 39(5)]

Under para 39(5) when a company redeems its shares, the holder of those shares is deemed to dispose of them to the company. This provision addresses the issue that arose in ITC 1859 in which the tax court held that when shares are redeemed, they are not disposed of 'to' the issuing company. See 9.5.2 for a discussion of ITC 1859.

9.6 Short-term disposals and acquisitions of identical financial instruments

Paragraph 42

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

Under para 42(1) a person that sells financial instruments at a capital loss (for example, listed shares) and replaces those financial instruments with ones of the same kind and of the same or equivalent quality within the 45-day period before or after the sale date, must be treated as having disposed of the financial instruments for an amount equal to their base cost. This rule does not apply to a disposal contemplated in s 29B. Under s 29B long-term insurers were deemed to dispose of all the assets in their policyholder funds at market value on 29 February 2012. This once-off mark-to-market event was introduced to deal with the increased inclusion rate which took effect on 1 March 2012 and has been excluded for the purposes of para 42 because it was outside the control of policyholders.

The person disposing of the financial instruments need not be the person reacquiring them. This rule extends beyond the seller and includes connected persons. For the purposes of this paragraph, however, 'relative' is narrowed in scope. The definition of 'connected person' will not extend, for purposes of this rule, to

- any relative of a natural person other than a parent, child, stepchild, brother, sister, grandchild or grandparent of that person; or
- disposals of assets between the five funds of an insurer contemplated in s 29A.⁵⁴⁴

The definition of 'relative' in s 1(1) includes a spouse. However, spouses are excluded for the purposes of para 42, since a transferor spouse must disregard any capital gain or loss under s 9HB(1).

The expression 'financial instrument of the same kind and of the same or equivalent quality' refers to substantially identical shares in the same company (see 9.7 for more on this expression).

The rule applies to a 45-day period *before* or *after* the sale date, to prevent 'buying the financial instruments back' before they have even been sold. These periods are extended (that is, do not include days) for periods in which the risk on the shares is hedged with offsetting positions (for example, when the person has an option to sell).

A seller to whom the paragraph applies is treated as having received proceeds equal to the base cost of the financial instrument disposed of (that is, there is no gain or loss for CGT purposes). The purchaser (if the same or a connected person), on the other hand, is required to add the capital loss realised by the seller to the actual cost incurred in 'repurchasing' the financial instruments. Effectively, the loss is 'held over' until such time as there is no restriction imposed upon the sale under this rule. The deemed cost of the asset in the acquirer's hands is treated as expenditure actually incurred for the purposes of para 20(1)(a).

The purchaser used to be deemed to acquire the financial instrument on the date on which the person who disposed of it acquired it. However, this deeming provision, which was inserted by the Revenue Laws Amendment Act 35 of 2007⁵⁴⁵ was deleted by the Taxation Laws Amendment Act 3 of 2008 to prevent the acquirer taking advantage of the three-year rule in s 9C under which the proceeds on disposal are deemed to be of a capital nature once the shares have been held for three years.⁵⁴⁶

Exclusion of identical assets allocated to policyholder funds [para 42(4)]

Under para 32(3B) a long-term insurer is obliged to use the weighted average method for determining the base cost of identical assets allocated to its policyholder funds under s 29A except for s 24J instruments and their derivatives, trading stock and reinsurance policies. The weighted average method is optional for Category III financial service providers as defined in s 29B. Paragraph 42(4) provides that para 42 does not apply to identical assets allocated by an insurer to its policyholder funds for which the weighted average base cost method is used.

⁵⁴⁴ Paragraph 42(3)(b) previously referred only to disposals under s 29A(6) or (7). It was amended by s 74(1) of the Revenue Laws Amendment Act 31 of 2005 and now covers all inter-fund disposals – including those contemplated in s 29A(8). This treatment was introduced to prevent the roll-over of unrealised capital losses from lower-taxed or non-taxed funds to higher-taxed funds. The amendment came into operation on 1 February 2006 and applies to any disposal on or after that date.

⁵⁴⁵ Inserted by s 74 of that Act and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2008.

⁵⁴⁶ Deleted by s 55 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

Precedence of the clogged loss rule

It is submitted that when both para 39 (the clogged loss rule) and para 42 apply to the same transaction, para 39 should take precedence.

Example 1 – Short-term sale and repurchase of loss-making shares*Facts:*

Mark bought 500 shares of Effe Ltd listed on a recognised exchange for R10 000 and sold them on 20 February 2020 for R3 000. On 1 April 2020 he bought 500 shares of Effe Ltd for R3 200.

Result:

Since the shares were repurchased within 45 days of loss-sale date, para 42 applies. Mark cannot claim the capital loss of R7 000 [R3 000 (proceeds) – R10 000 (base cost)]. Instead, he must adjust the base cost of the repurchased shares. The base cost of the repurchased shares is R10 200 under para 42(1)(a) and (b) (R3 200 actual cost plus R7 000 held-over loss).

Mark would also be affected by para 42 if he had purchased his 'new' shares on 24 January 2020 and then made the loss sale on 20 February 2020. But if Mark had waited and repurchased the 500 shares 46 days after the sale, para 42 would not apply and the R7 000 capital loss would be allowable. The base cost of the 500 shares repurchased would equal the cost actually incurred.

What if fewer shares are repurchased than were originally sold at a capital loss? Is the entire capital loss deferred? The answer is no. Only the portion of the loss attributable to the 'washed' sales is disallowed. If the person bought back only a portion of the shares sold, only a portion of the loss would be disallowed. The concept of 'grouping' the same financial instruments would not be applied. For example, 500 listed shares equate to 500 individual financial instruments and are not considered to be a single financial instrument.

Example 2 – Short-term sale and partial repurchase of shares*Facts:*

The facts are the same as Example 1 except that Mark bought back only 300 of the 500 shares (60%).

Result:

Mark can claim 40% of the loss on the sale, or R2 800. The remaining R4 200 of the loss disallowed under para 42 is added to the base cost of Mark's 300 'new' shares. Therefore, the base cost of his 'new' shares is R6 120 (300 'new' shares at a cost of R1 920 plus the held-over loss of R4 200).

Example 3 – Wash sales and the various identification methods*Facts:*

Craig holds the following shares in Lug Ltd, a company listed on a recognised exchange:

Date	Parcel	Number	R
1 October 2015	(A)	500	5 000
15 October 2018	(B)	500	4 500
20 February 2019	(C)	<u>500</u>	<u>3 250</u>
Subtotal		<u>1 500</u>	<u>12 750</u>

On 1 April 2019 he sold 500 Lug Ltd shares for R3 000. Determine whether para 42 applies to Craig if he adopts the following asset identification methods:

- (a) Weighted average
- (b) FIFO
- (c) Specific identification

Assume that

- when specific identification was adopted, parcel C was disposed of,
- no connected person in relation to Craig acquired Lug Ltd shares within 45 days of either side of 1 April 2019,
- Craig purchased no other shares after 1 April 2019, and
- the disposal is on capital account regardless of the identification method adopted.

Result:

Step 1: Determine whether a capital loss has resulted from the disposal

Using the different identification methods, the results are as follows:

Weighted average: The weighted-average base cost of the shares disposed of is $R12\,750 / 1\,500 = R8,50$ a share. Therefore, the base cost of the shares disposed of is $500 \times R8,50 = R4\,250$. The capital loss is $R3\,000$ (proceeds) – $R4\,250$ (base cost) = $-R1\,250$.

FIFO:

Under this method parcel A is deemed to be disposed of resulting in a capital loss of $R3\,000 - R5\,000 = R2\,000$.

Specific identification: The disposal of parcel C gives rise to a capital loss of $R3\,000 - R3\,250 = -R250$.

Step 2: Determine whether financial instruments of the same kind and of the same or equivalent quality were purchased within 45 days of either side of the loss-making disposal

This is indeed so, in that the shares purchased on 20 February 2019 were purchased within 45 days of the disposal on 1 April 2019.

Step 3: Disregard the capital loss and add it to the base cost of the shares acquired during the 45-day period

Weighted average:

The capital loss of R1 250 must be disregarded and added to the base cost pool as follows:

Date	Parcel	Number	R
1 October 2015	(A)	500	5 000
15 October 2018	(B)	500	4 500
20 February 2019	(C)	<u>500</u>	<u>3 250</u>
Subtotal		1 500	12 750
1 April 2019		(500)	(4 250)
Capital loss added back under para 42		<u>-</u>	<u>1 250</u>
		<u>1 000</u>	<u>9 750</u>

FIFO:

The capital loss of R2 000 must be disregarded and added to the base cost of parcel C which increases from R3 250 to R5 250.

Specific identification:

The shares acquired during the 45-day period must be 'of the same kind and of the same or equivalent quality'. This requirement does not include the same shares disposed of. Also, since parcel C has been disposed of, there are no shares acquired within the 45-day period to which the capital loss can be added.

In the circumstances the capital loss of R250 is allowable in full and para 42 does not apply.

9.7 Hold-over of capital gain on forced sale of listed shares

Paragraph 42A

Paragraph 42A was repealed with effect from the date of promulgation of the Taxation Laws Amendment Act 31 of 2013, namely, 12 December 2013. The commentary below therefore applies to disposals before that date.

Paragraph 42A applied in respect of any disposal on or after 1 March 2007⁵⁴⁷ but before 12 December 2013. It enabled a person to defer a capital gain upon a forced sale of listed shares as a result of a court order under section 311 of the Companies Act 61 of 1973. Such a forced disposal could have occurred, for example, because the company required the shares in order to facilitate a Black Economic Empowerment deal.

With the introduction of the Companies Act 71 of 2008, s 311 was repealed from 1 May 2011. The equivalent provision dealing with compulsory purchase of shares under the Companies Act 71 of 2008 is s 114. Under s 12(1) of the Interpretation Act 33 of 1957

'[w]here a law repeals and re-enacts with or without modifications, any provision of a former law, references in any other law to the provision so repealed shall, unless the contrary intention appears, be construed as references to the provision so re-enacted'.

It is accordingly accepted that the reference to s 311 in para 42A should be taken as referring to s 114 for compulsory purchases of shares undertaken under the Companies Act 71 of 2008.

⁵⁴⁷ Paragraph 42A was inserted by s 75 of the Revenue Laws Amendment Act 35 of 2007.

To the extent that s 114 requires only a special resolution and not a court order it will be accepted that para 42A will nevertheless still apply.

The deferral relief applied only if the shares were replaced with shares of the same kind and of the same or equivalent quality within 90 days of the forced sale.

The expression 'share of the same kind and of the same or equivalent quality' refers to substantially identical shares in the same company.

Thus, a shareholder who held a class A ordinary share in ABC Ltd (a listed company) that was forcibly acquired under s 311 of the Companies Act 61 of 1973, who wished to take advantage of para 42A, must have replaced that share with a class A ordinary share in ABC Ltd. If the particular class of share was no longer in issue, the share would have had to be replaced with one bearing substantially identical rights.

The purpose of para 42A was to enable persons who were forced to sell their listed shares under a s 311 scheme to replace those shares with substantially identical shares in order to restore their level of investment in the company concerned. The intention was not to grant relief to persons who replaced their shares with shares in other companies.

The expression in question has been used to refer to identical assets in other legislative provisions such as para 42 and in the Securities Transfer Tax Act 25 of 2007 in relation to securities-lending arrangements.

The word 'kind' would include the nature of the share (for example, ordinary v preference) as well as the company in which the share is held. 'Quality', being an inherent or distinguishing characteristic, would include the underlying rights in the share.

While the original share must have been listed, there was no requirement that the replacement share be listed. Delisting before replacement will affect the marketability of the replacement share but should not affect the 'kind' or 'quality' of the share in the sense of changing the underlying rights in the share.

The relief is provided as follows:

- The person is treated as having disposed of the old shares at an amount equal to their base cost (that is, there will be no capital gain on the forced sale).
- The expenditure in respect of the replacement shares must be reduced by the amount of the capital gain that arose on the forced sale of the old shares (this is the base cost of the replacement shares).
- If the capital gain exceeds the expenditure in respect of the replacement shares, the excess is treated as a capital gain on disposal of the old shares and the replacement shares are treated as having a base cost of nil.
- The person is treated as having acquired the replacement shares on the same date as the old shares (this rule is relevant for the purposes of the s 9C three-year 'safe haven' rule).

Example 1 – Forced sale of listed shares before 12 December 2013 followed by reacquisition of shares of the same kind*Facts:*

Kate owns 2 000 ordinary shares in XYZ Ltd, a company listed on the JSE. Under a court order issued under section 311 of the Companies Act, 1973 Kate was forced to sell 25% (that is, 500) of those shares to XYZ Ltd in return for a cash payment of R110 000. The shares sold have a base cost of R90 000.

Within 40 days of the buy-back, Kate repurchased 500 of XYZ Ltd's ordinary shares for R135 000 on the open market.

Result:

Were it not for para 42A, Kate would have had a capital gain of R110 000 – R90 000 = R20 000 in respect of the 500 ordinary shares. However, under para 42A Kate is treated as having disposed of the 500 shares at their base cost of R90 000 and hence no capital gain arises on the disposal. This is because

- the sale occurred as a result of a section 311 court order,
- the shares are listed,
- the sale would have given rise to a capital gain, and
- the repurchase occurred within 90 days.

The base cost of the newly repurchased shares is only R115 000 (R135 000 cost less the R20 000 deferred gain on the buy-back).

Example 2 – Gain on old 'forced sale' shares exceeds expenditure on new shares [pre-12 December 2013]*Facts:*

The facts are the same as Example 1, except that Kate acquired the 500 ordinary shares in XYZ Ltd for R15 000.

Result:

The capital gain on disposal of the old shares (R20 000) exceeds the expenditure on the new shares (R15 000) by R5 000. As a result

- the base cost of Kate's new shares is reduced to nil, and
- the excess of R5 000 is treated as a capital gain.

9.8 Dividends treated as proceeds on disposal of certain shares

Paragraph 43A

Paragraph 43A was substituted by the Taxation Laws Amendment Act 17 of 2017, with the substituted version coming into operation on 19 July 2017 and applicable in respect of any disposal on or after that date other than a disposal in terms of an agreement all the terms of which were finally agreed to before that date by all the parties to that agreement. The commentary below deals with the substituted version. For the previous version, see issue 6 of this guide. The Taxation Laws Amendment Act 23 of 2018 introduced para 43A(3) and the

definition of 'deferral transaction' to address schemes involving a disposal of shares following a transaction under the corporate restructuring rules in ss 41 to 47 (excluding s 46). These changes apply to disposals on or after 1 January 2019.

The Taxation Laws Amendment Act 34 of 2019 addressed dilution schemes under which shares are issued to a prospective purchaser instead of the existing holder of shares disposing of its interest to the purchaser. These amendments are deemed to come into operation on 20 February 2019.

Paragraph 43A is an anti-avoidance measure which increases the proceeds on disposal or deemed disposal of shares held by a company in another company when the disposal or deemed disposal is preceded or accompanied by the distribution of an exempt dividend by the company being sold.

9.8.1 Background

Economically there are two ways in which a corporate shareholder could realise value from a share. First, it could sell the share to a third party. For a share held as a capital asset, this will attract CGT at the rate of 22,4% on any capital gain (28% × 80%). Alternatively, if the shareholder company has a controlling interest, it could arrange for the company to make a distribution of CTC or a dividend. The distribution of CTC has adverse CGT consequences in that it results in the reduction in the base cost of the shares under para 76B. On the other hand, absent any anti-avoidance measures, the distribution of a dividend to a corporate shareholder has no adverse CGT or income tax consequences because

- dividends are exempt from normal tax under s 10(1)(k)(i);
- cash dividends paid from one resident company to another are exempt from dividends tax under s 64F(1)(a);
- dividends *in specie* paid from one resident company to another are exempt from dividends tax under s 64FA(1)(a) or (b);
- foreign dividends are fully exempt from normal tax under the participation exemption in s 10B(2)(a). The participation exemption will apply if the corporate shareholder holds, together with any other companies forming part of the same group of companies, at least 10% of the equity shares and voting rights in the company declaring the foreign dividend; and
- foreign dividends declared between two foreign companies situated in the same foreign country are fully exempt from normal tax under s 10B(2)(b).

These exemptions create an incentive for a company to convert sale proceeds to a dividend. In this way CGT is avoided on shares held as capital assets and income tax is avoided on shares held as trading stock.

In order to convert sale proceeds to exempt dividends, the company whose shares are to be sold distributes surplus cash or assets to the existing holders of shares by way of dividend. These pre-sale dividends reduce the market value of the company's shares and hence the proceeds to be derived on sale.

9.8.2 Definitions [para 43A(1)]

The following definitions apply for the purposes of para 43A:

9.8.2.1 Definition – ‘deferral transaction’

‘**“[D]eferral transaction”** means a transaction in respect of which the provisions of PART III of Chapter II were applied;’

Part III of Chapter II deals with the corporate restructuring rules in ss 41 to 47. Paragraph 43A does not apply to the disposal of shares under a “deferral transaction” for disposals on or after 1 January 2019.

9.8.2.2 Definition – ‘exempt dividend’

‘**“[E]xempt dividend”** means any dividend or foreign dividend to the extent that the dividend or foreign dividend is—

- (a) not subject to tax under Part VIII of Chapter II; and
- (b) exempt from normal tax in terms of section 10(1)(k)(i) or section 10B(2)(a) or (b);’

Part VIII of Chapter II deals with dividends tax. Section 10(1)(k)(i) provides an exemption from normal tax for local dividends other than those declared or paid by a headquarter company⁵⁴⁸ and those listed in the proviso to s 10(1)(k)(i). Section 10B(2)(a) relates to the participation exemption and section 10B(2)(b) relates to the country-to-country exemption. In essence, therefore, an exempt dividend is one that is neither subject to dividends tax nor normal tax.

9.8.2.3 Definition – ‘extraordinary dividend’

‘**“[E]xtraordinary dividend”**, in relation to—

- (a) a preference share, means so much of the amount of any dividend received or accrued in respect of that share as exceeds the amount that would have accrued in respect of that share had it been determined with reference to the consideration for which that share was issued by applying an interest rate of 15 per cent per annum for the period in respect of which that dividend was received or accrued;
- (b) any other share, means so much of the amount of any dividend received or accrued—
 - (i) within a period of 18 months prior to the disposal of that share; or
 - (ii) in respect, by reason or in consequence of that disposal,
 as exceeds 15 per cent of the higher of the market value of that share as at the beginning of the period of 18 months and as at the date of disposal of that share:

Provided that a dividend *in specie* that was distributed in terms of a deferral transaction must not be taken into account to the extent to which that distribution was made in terms of an unbundling transaction as defined in section 46(1)(a) or a liquidation distribution as defined in section 47(1)(a);’

Paragraph (a) refers to ‘the amount of any dividend received or accrued in respect of that share’. All extraordinary dividends from the date of acquisition of a preference share must be taken into account, since para (a) does not limit the amount to a particular period. A preference

⁵⁴⁸ Dividends paid by a headquarter company are considered for exemption under s 10B.

share dividend is extraordinary to the extent that it exceeds 15% of the consideration for which the shares were issued adjusted for the period to which the dividend relates.

For example, the extraordinary dividend on shares issued for R100 which pay a dividend of R10 every six months, is the difference between R10 and R7,50 ($R100 \times 15\% \times 6 / 12$) = R2,50.

If the shares were held for five years before disposal, the total extraordinary dividend would be $R2,50 \times 10$ (two dividends a year for five years) = R25.

Example 1 – Extraordinary dividend in relation to preference shares

Facts:

Company A's year of assessment ends on 31 March.

Company A acquired 100 000 redeemable preference shares on 1 April year 1 at R1 a share. Dividends were paid annually at the rate of 8% above the prime rate of interest on the preference shares. The preference shares were redeemable on 31 March year 6. The prime rate remained unchanged during the five-year period at 10%.

Result:

Company A received a dividend of R18 000 ($R100\,000 \times 18\%$) during each of the five years of assessment ending on 31 March year 2 to 31 March year 6.

The extraordinary dividend is calculated as follows:

	R
Dividends received ($R18\,000 \times 5$ years)	90 000
Less: Dividends calculated by applying an interest rate of 15% a year (Consideration of $R100\,000 \times 15\% \times 5$ years)	<u>(75 000)</u>
Extraordinary dividend	<u>15 000</u>

For a share other than a preference share, para (b)(i) of the definition of 'extraordinary dividend' applies to the sum of all dividends received or accrued during the 18 months preceding the disposal. Preference share dividends are addressed in para (a) of the definition.

Paragraph (b)(ii) is designed to capture dividends that are not declared before the disposal of the share but are distributed in consequence of the disposal, such as a dividend forming part of a share buy-back.

Example 2 – Extraordinary dividend in relation to a share other than a preference share

Facts:

Company A's year of assessment ends on 31 March.

Company A held 50% of the equity shares in Company B as capital assets. Company A disposed of these shares on 1 January 2020 for R3 million. At the beginning of the 18-month period before the disposal, the market value of the shares was R5 million.

Six months before disposal of the shares, Company A received a dividend of R2 million in respect of the shares.

Result:

The extraordinary dividend received by Company A is calculated as follows:

	R
Dividend received within 18 months before disposal of shares	2 000 000
Less: 15% x R5 million [15% of the higher of market value of R5 million (beginning of the 18-month period) or R3 million (date of disposal)]	<u>(750 000)</u>
Extraordinary dividend	<u>1 250 000</u>

Exclusion from definition of 'extraordinary dividend' of distributions in specie under s 46 and s 47

The proviso to the definition of 'extraordinary dividend' excludes dividends *in specie* distributed in terms of an unbundling transaction under s 46(1)(a) and a liquidation distribution under s 47(1)(a).

The following reason is provided for this exclusion in the *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2019*:⁵⁴⁹

'In specie distributions made in terms of unbundling transactions and liquidation transactions involving resident companies...will be disregarded when determining whether an extraordinary dividend accrued to or was received by a shareholder company. This is because these types of transactions are extraordinary dividends that are used by taxpayers to transfer assets to shareholder companies in respect of which tax on their unrealised gains will be collected in future.'

Under an unbundling transaction the value of the shares in the unbundling company would usually be reduced by the value of the unbundled company shares. However, under s 46 a portion of the base cost of the unbundling company shares must be allocated to the unbundled company shares, thus limiting the opportunity for avoiding CGT on a disposal of the unbundling company shares.

Shares distributed by a liquidating company to its holding company are subject to roll-over treatment under s 47(2). When a liquidating company makes a liquidation distribution to its holding company, the value of its shares will decrease but there is no opportunity for CGT avoidance because any capital gain or loss on disposal of the liquidating company shares must be disregarded under s 47(5).

9.8.2.4 Definition – 'preference share'

“[P]reference share” means a preference share as defined in section 8EA(1);'

Section 8EA defines a 'preference share' as follows:

“[P]reference share” means any share—

- (a) other than an equity share; or
- (b) that is an equity share, if an amount of any dividend or foreign dividend in respect of that share is based on or determined with reference to a specified rate of interest or the time value of money;'

⁵⁴⁹ In para 2.1.

The term 'equity share' is defined in s 1(1) as follows:

‘“**[E]quity share**” means any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution;’

A distribution by a company or a foreign company generally takes the form of a distribution of profits (dividends or foreign dividends) or capital (return of capital or foreign return of capital). As long as the right to participate in either of these types of distribution is unrestricted, the share will be an equity share. The share will not be an equity share if both rights are restricted.⁵⁵⁰ Under this definition some preference shares may be equity shares, for example, a participating preference share. But an equity share that pays dividends based on or determined with reference to a specified rate of interest or the time value of money will comprise a preference share under para (b) of the definition of 'preference share' in s 8EA(1), even if the right to capital is unrestricted.

The reference to a dividend or foreign dividend determined with reference to the time value of money could include, for example, a dividend expressed as an amount payable per month for the period that the share is held.

9.8.2.5 Definition – 'qualifying interest'

‘“**[Q]ualifying interest**” means an interest held by a company in another company, whether alone or together with any connected persons in relation to that company, that constitutes—

(a) if that other company is not a listed company, at least—

(i) 50 per cent of the equity shares or voting rights in that other company; or

(ii) 20 per cent of the equity shares or voting rights in that other company if no other person (whether alone or together with any connected person in relation to that person) holds the majority of the equity shares or voting rights in that other company; or

(b) if that other company is a listed company, at least 10 per cent of the equity shares or voting rights in that other company.’

The term “listed company” is defined in s 1(1) and means a company whose shares or depository receipts in respect of its shares are listed on any of the following exchanges:

- An exchange as defined in s 1 of the Financial Markets Act 19 of 2012 and licensed under section 9 of that Act. The JSE Ltd (JSE), ZARX (Pty) Ltd (ZAR X), 4 Africa Exchange (Pty) Ltd (4AX), A2X Markets (Pty) Ltd (A2X) and Equity Express Securities Exchange (Pty) Ltd (EESE) are the only exchanges currently licensed under s 9 of the Financial Markets Act.

⁵⁵⁰ See Interpretation Note 43 (Issue 7) dated 8 February 2019 'Circumstances in which Certain Amounts Received or Accrued from the Disposal of Shares are Deemed to be of a Capital Nature' in para 4.4 for commentary on the meaning of 'equity share'.

- A stock exchange in a country other than the Republic which has been recognised by the Minister of Finance as contemplated in para (c) of the definition of ‘recognised exchange’ in para 1. The list of recognised exchanges in countries outside the Republic was published in the *Government Gazette*⁵⁵¹ and is also available on the SARS website.

The term ‘connected person’ is defined in s 1(1).⁵⁵²

Example 1 – Qualifying interest in a company that is not a listed company

Facts:

Holdco owns 51% of the equity shares in both Company A and Company B. Company A holds 49% of the equity shares in Company C. Company B holds 2% of the equity shares in Company C.

Result:

Company A holds, together with Company B, 49% + 2% = 51% of the equity shares in Company C. Company A and Company B are connected persons in relation to each other by virtue of para (d)(i) and para (e) of the definition of ‘connected person’ in s 1(1). Therefore, Company A and Company B have a qualifying interest in Company C.

Example 2 – Qualifying interest in a company that is not a listed company

Facts:

Company A holds 20% of the equity shares in Company B. The remaining 80% of Company B’s equity shares are held equally by Tom, Dick, Harry and Jane who are not connected persons in relation to one another. Company B is not a listed company.

Result:

Company A holds a qualifying interest in Company B under para (a)(ii) of the definition of ‘qualifying interest’ in para 43A(1), since it holds at least 20% of Company B’s equity shares and no other person (whether alone or together with any connected person in relation to that person) holds the majority of the equity shares or voting rights in Company B. The four natural persons do not hold a qualifying interest in Company B, since only a company can hold a qualifying interest in another company under the definition of ‘qualifying interest’ in para 43A(1).

Example 3 – Qualifying interest in a listed company

Facts:

Jan holds 20% of the equity shares in Company A. Company A and Jan each hold 5% of the equity shares in Listed Company B.

Result:

Jan and Company A are connected persons in relation to each other under paras (d)(iv) and (e) of the definition of ‘connected person’ in s 1(1).

⁵⁵¹ GN R 997 in GG 22723 of 2 October 2001 and GN 1088 in GG 30484 of 16 November 2007 which added the Channel Islands Stock Exchange.

⁵⁵² See Interpretation Note 67 (Issue 4) dated 28 January 2020 ‘Connected Persons’.

Company A holds a qualifying interest in Listed Company B under para (b) of the definition of 'qualifying interest' in para 43A(1), since it holds, together with Jan at least 10% (5% + 5%) of Listed Company B's equity shares.

Jan does not hold a qualifying interest in Listed Company B, since only a company can hold a qualifying interest in another company under the definition of 'qualifying interest' in para 43A(1).

9.8.3 Extraordinary dividend taken into account as proceeds on disposal of certain shares [para 43A(2)]

Paragraph 43A applies, subject to para 43A(3), when

- a company holds shares in another company;
- it disposes of any of those shares under a transaction that is not a deferral transaction;
- that company held a qualifying interest in that other company at any time during the period of 18 months before that disposal;
- immediately before that disposal, those shares were held as a capital asset as defined in s 41; and
- an exempt dividend was received by or accrued to that company in respect of the shares disposed of which comprises an extraordinary dividend.

The qualifying interest requirement applies 'at any time' during the 18 months preceding the disposal. The holding requirement is therefore not continuous and would apply even if a company were to momentarily hold the qualifying interest. In determining the qualifying interest, the interests of connected persons in relation to the company must be included.

The term 'capital asset' as defined in s 41 means an asset as defined in para 1, which does not constitute 'trading stock' as defined in s 1(1). Shares held as trading stock must be dealt with under s 22B.

The definition of 'extraordinary dividend' contains separate rules for preference shares (that is, shares that are not equity shares or equity shares whose dividends or foreign dividends are linked to a specified rate of interest or the time value of money) [para (a)], and other shares [para (b)].

The distinction between para (a) and (b) extraordinary dividends is that there is no limit on the preference share dividends that must be brought to account, while dividends falling under para (b) are limited to those received or accrued

- within a period of 18 months before the disposal of the shares; or
- in respect, by reason or in consequence of the disposal.

The extraordinary dividend to be brought to account for a preference share is the amount by which the dividend exceeds the 15% threshold. The 15% threshold is determined by multiplying the consideration for which the shares were issued by an interest rate of 15% a year for the period for which the dividend was received or accrued.

For shares other than preference shares, the 15% is based on the higher of the market value of the shares as at the beginning of the period of 18 months and as at the date of disposal of the shares.

Under the above circumstances, the amount of any exempt dividend received by or accrued to the company in respect of the shares disposed of must, to the extent that the exempt dividend constitutes an extraordinary dividend, be taken into account

- as part of the proceeds from the disposal of those shares; or
- if those shares are treated as having been disposed of under para 43A(4), as a capital gain in respect of those shares (see **9.8.5**).

The above amounts must be taken into account in the year of assessment in which

- those shares are disposed of;
- those shares are treated as having been disposed of; or
- if that dividend is received or accrues after that year of assessment, the year of assessment in which that dividend is received or accrues.

When a company disposes of shares that are treated as having been disposed of previously by it under para 43A(4), the amount of any extraordinary dividend in respect of those shares must be included in the proceeds from that disposal only to the extent that it has not previously been taken into account in respect of those shares under para 43A(2). The purpose of this proviso is to prevent double counting when a deemed disposal is followed by an actual disposal. See Example 2 in **9.8.5**.

Example 1 – Exempt dividends taken into account as proceeds on disposal of preference shares

Facts:

Company A owns 51% of the equity shares and 100 000 redeemable preference shares in Company B, an unlisted company. Company A's year of assessment ends on the last day of February. Both the equity and preference shares were acquired on 1 March of year 1. The preference shares pay dividends once annually at the rate of 7% above the prime rate of interest and are redeemable at the end of 60 months. The prime rate remained unchanged during the period 1 March year 1 to 28 February year 6 at 10%. The preference shares were redeemed at their issue price of R1 a share on 28 February year 6.

Result:

Company A holds a qualifying interest as defined in para 43A(1) in Company B, since it holds 51% of the equity shares in Company B, which exceeds the required threshold of 50%. The redemption of the preference shares is not a deferral transaction and thus potentially falls within para 43A(2).

Since acquiring the preference shares, Company A has received five preference share dividends of R17 000 each ($R100\,000 \times 17\%$). Each preference share dividend is exempt from dividends tax under s 64F(1)(a) and normal tax under s 10(1)(k)(i) and accordingly comprises an 'exempt dividend' as defined in para 43A(1). Since the rate at which each preference share dividend was paid exceeded 15%, the excess comprises an 'extraordinary dividend' as defined in para 43A(1) ($R100\,000 \times 2\% \times 5 = R10\,000$). Under para 43A(2) the proceeds on disposal of the preference shares must therefore be increased by R10 000 to R110 000, resulting in a capital gain of R10 000 (proceeds R110 000 less base cost R100 000).

Example 2 – Exempt dividend taken into account as proceeds on disposal of equity shares*Facts:*

Company A has held all the equity shares in Company B on capital account for many years and wishes to dispose of them to Company C. Company A and Company C do not form part of the same group of companies as defined in s 41. At the beginning of the period of 18 months before the disposal, the shares were valued at R5 million. During the month preceding the disposal Company B declared a dividend to Company A of R2 million. The shares were then sold to Company C at market value of R3 million. All the companies are residents.

Result:

The disposal of the shares is not a deferral transaction and thus potentially falls within para 43A(2).

The dividend declared by Company B is an 'exempt dividend' as defined in para 43A(1) for Company A because it is exempt from both normal tax under s 10(1)(k)(i) and dividends tax under s 64F(1)(a). It is also an 'extraordinary dividend' as defined in para 43A(1) because it exceeds 15% of the higher of the market values of R5 million and R3 million at the beginning and end of the 18-month period preceding the disposal ($R5 \text{ million} \times 15\% = R750 \text{ 000}$).

Accordingly, to the extent that the dividend exceeds R750 000, that is R2 million – R750 000 = R1 250 000), the excess must be added to the proceeds on disposal of the shares. The proceeds will therefore be R3 million + R1 250 000 = R4 250 000.

Example 3 – Extraordinary dividend taken into account as proceeds on disposal of equity shares*Facts:*

Company A's year of assessment ends on 31 March.

Paul held 20% of the equity shares in resident Company A. Company A and Paul held 45% and 5% respectively of the equity shares and voting rights in non-resident Company B as capital assets. Company A disposed of its holding of these shares on 31 January 2020 to a resident for R4 million. At the beginning of the 18-month period before the disposal, the market value of the shares was R8 million.

One month before disposal of the shares, Company A received a foreign dividend of R3 million in respect of the shares. Company A and Company B are not listed companies.

Result:

Paragraph 43A(2) applies because its requirements have been met:

- The shares were not disposed of under a deferral transaction.
- Company A held a qualifying interest in Company B under para (a)(i) of the definition of 'qualifying interest' in para 43A(1), since it held, together with Paul, at least 50% (45% + 5%) of the equity shares in Company B. Paul and Company A are connected persons in relation to each other under paras (d)(iv) and (e) of the definition of 'connected person' in s 1(1) because Paul holds at least 20% of the equity shares or voting rights in Company A.

- The foreign dividend of R3 million received by Company A is exempt from normal tax under s 10B(2)(a), since Company A held at least 10% of the equity shares and voting rights in Company B.
- The foreign dividend of R3 million is not subject to dividends tax under s 64E(1), since it is paid by a foreign company in respect of a share which does not constitute a listed share and therefore does not constitute a 'dividend' as defined in s 64D.
- Part of the exempt dividend received by Company A is an extraordinary dividend.

The extraordinary dividend is calculated as follows:

	R
Foreign dividend received within 18 months before disposal of shares	3 000 000
Less: 15% × R8 million [15% of the higher of market value of R8 million (beginning of the 18-month period) or R4 million (date of disposal)]	<u>(1 200 000)</u>
Extraordinary dividend	<u>1 800 000</u>

In the 2020 year of assessment the extraordinary dividend of R1,8 million must be taken into account as part of the proceeds on disposal of the shares.

The total amount to be taken into account as proceeds in determining a capital gain or loss during the 2020 year of assessment by Company A from the disposal of the shares in Company B is R4 000 000 + R1 800 000 = R5 800 000.

Note:

Company A is not entitled to the participation exemption in para 64B, since it disposed of the shares in Company B to a resident.

Example 4 – Extraordinary dividend taken into account as proceeds on disposal of equity shares on dissolution of company

Facts:

Company A's year of assessment ends on 31 March.

Company A held 50% of the equity shares in Company B as capital assets which it acquired in 2007 at a cost of R600 000. During the 2020 year of assessment the board of directors of Company B resolved to wind up the company and took the necessary steps to give effect to the resolution. The market value of Company A's shares in Company B on the date of dissolution (30 April 2020) was RNil. At the beginning of the 18-month period before the date of dissolution (1 November 2018), the market value of the shares was R1 million.

On 1 April 2020 Company A was entitled to and received a dividend of R400 000 and a return of capital of R600 000 in consequence of the winding-up of the company.

Company A and Company B are residents and are not listed companies.

Result:

Paragraph 43A(2) applies, since the following requirements are met:

- The shares were not disposed of under a deferral transaction.

- Company A held a qualifying interest in Company B under para (a)(i) of the definition of 'qualifying interest' in para 43A(1), since it held at least 50% of the equity shares in Company B.
- The dividend of R400 000 received by Company A is exempt from normal tax under s 10(1)(k)(i) and exempt from dividends tax under s 64F(1)(a).
- Part of the exempt dividend received by Company A is an extraordinary dividend.

The extraordinary dividend is calculated as follows:

	R
Dividend received during the 18 months preceding the deemed disposal of the shares (Note)	400 000
Less: 15% x R1 million [15% of the higher of market value of R1 million (beginning of the 18-month period) or RNil on 30 April 2020 (date of deemed disposal)]	<u>(150 000)</u>
Extraordinary dividend	<u>250 000</u>

The extraordinary dividend of R250 000 must be taken into account as part of proceeds on the deemed disposal of the shares for CGT purposes, since the shares were held as capital assets. Since the dividend accrued on 1 April 2020, the extraordinary dividend of R250 000 must be taken into account as part of proceeds in Company A's 2021 year of assessment.

Company A will therefore determine a capital gain as follows:

		R
Proceeds under paragraph 43A		250 000
Less: Base cost		
Cost of acquisition of shares	600 000	
Less: Return of capital under paragraph 76B(2)	<u>(600 000)</u>	<u>(0)</u>
Capital gain		<u>250 000</u>

Note:

Under para 77(1)(a) Company A is deemed to have disposed of the shares on date of dissolution of the company, namely on 30 April 2020. At that time the company had already disposed of all its assets by way of distribution and hence there were no further proceeds in addition to the deemed proceeds under para 43A.

Example 5 – Extraordinary dividend taken into account as proceeds on disposal of equity shares by means of share buy-back

Facts:

Company A's year of assessment ends on 31 March.

Company A held 50% of the equity shares in Company B as capital assets. The board of directors of Company B resolved to buy back Company A's shares on 31 March 2020 for R9 million. The board of directors of Company B did not elect that any part of the consideration for the buy-back would be paid out of the company's contributed tax capital.

The market value of Company A's shares on 31 March 2020 as at the date of disposal was R9 million, being the consideration paid by Company B to acquire its shares. At the beginning of the 18-month period before the share buy-back, the market value of the shares was R10 million.

Company A and Company B are residents and are not listed companies.

Result:

Paragraph 43A(2) applies, since the following requirements are met:

- The shares were not disposed of under a deferral transaction.
- Company A held a qualifying interest in Company B under para (a)(i) of the definition of 'qualifying interest' in para 43A(1), since it held at least 50% of the equity shares in Company B.
- The amount of R9 million which accrued in respect of the share buy-back is a 'dividend' as defined in s 1(1) and s 64D. The dividend is exempt from normal tax under s 10(1)(k)(i) and exempt from dividends tax under s 64F(1)(a).
- Part of the exempt dividend received by Company A is an extraordinary dividend.

The extraordinary dividend is calculated as follows:

	R
Dividend received in consequence of disposal of shares	9 000 000
Less: 15% × R10 million [15% of the higher of market value of R10 million (beginning of the 18-month period) or R9 million (date of disposal)]	<u>(1 500 000)</u>
Extraordinary dividend	<u>7 500 000</u>

The extraordinary dividend of R7,5 million must be taken into account as part of proceeds on the deemed disposal of the shares in the 2020 year of assessment, since the shares were held as capital assets. The actual amount received by or accrued to Company A in respect of the share buy-back was R9 million, being the actual amount paid by Company B. This amount must, however, be reduced to RNil under para 35(3)(a) by the dividend of R9 million included in gross income under para (k) of the definition of 'gross income' in s 1(1).

The proceeds will therefore comprise the actual proceeds of RNil plus the deemed proceeds under para 43A(2) representing the extraordinary dividend of R7,5 million = R7,5 million.

9.8.4 Disposal of shares within 18 months after their acquisition under a deferral transaction, other than an unbundling transaction [para 43A(3)]

Paragraph 43A(3) applies when

- a company holds shares in another company;
- it disposes of any of those shares under a transaction that is not a deferral transaction; and
- that disposal occurs within a period of 18 months after having acquired those shares under a deferral transaction, other than an unbundling transaction.

Paragraph 43A(3) then deals with two situations in item (a) and (b), which are examined below.

The term 'deferral transaction' is defined in para 43A(1) and means a transaction undertaken under the corporate restructuring rules in ss 41 to 47. These rules cover an asset-for-share transaction (s 42), a substitutive share-for-share transaction (s 43), an amalgamation transaction (s 44), an intra-group transaction (s 45), an unbundling transaction (s 46) and a liquidation transaction (s 47).

To fall within para 43A(3), the shares must

- have been acquired under a deferral transaction other than an unbundling transaction (s 46); and
- not be disposed of under a deferral transaction (including s 46).

The following is stated in the *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018* on the reason for introducing para 43A(3):

‘[I]t is proposed that anti-avoidance rules dealing with dividend stripping should be triggered when the corporate re-organisation rules are abused by taxpayers that use the corporate re-organisation rules with the intention of subsequently disposing of their shares to unrelated purchasers outside of the realm of the re-organisation rules.’

Calculation of an 18-month period

The calculation of an 18-month period is of importance in determining whether para 43A(3) applies. In *Ex Parte Minister of Social Development & others Van der Westhuizen J* stated the following on the meaning of “month”:⁵⁵³

‘This Court has as yet not considered the computation of time or time periods. The general common law rule is that, in the calculation of time the civilian method is applicable, unless a period of days is prescribed by law or contracting parties intended another method to be used.

‘According to the civil computation method, a period of time expressed in months expires at the end of the day preceding the corresponding calendar day in the subsequent month. It is settled law that the commencement of a period of time in curial calculation is governed by the ordinary civilian method where any unit of time other than days is used.

‘It follows, therefore, that 18 months from the date of judgment on 6 September 2004 ended at midnight on 5 March 2006.’

Paragraph 43A(3) refers to a period of 18 months prior to the disposal of shares. It is therefore submitted that the last day of the 18-month period would be the day before the date of disposal. For example, if the disposal occurred on 6 January 2020, the 18-month period would run from 6 July 2018 to 5 January 2020.

Transferee company disposing of reduced-value shares to third party [para 43A(3)(a)]

Paragraph 43A(3)(a) applies under the following circumstances:

- A company must dispose of shares otherwise than under a deferral transaction. In other words, the shares must not be disposed of under s 42, 43, 44, 45, 46 or 47.
- Those shares must have been acquired by the company under a deferral transaction other than an unbundling transaction during the 18-month period preceding the disposal. In other words, the shares must have been acquired under s 42, 43, 44, 45 or 47.
- During the 18-month period preceding the disposal, an exempt dividend must have been received by or accrued to the person who disposed of the shares to the company under a deferral transaction (other than an unbundling transaction).
- The person and the company that acquired the shares under the deferral transaction must have been connected persons in relation to each other at any time during the 18-month period.

⁵⁵³ 2006 (4) SA 309 (CC) at 316.

For purposes of para 43A the exempt dividend is treated as a dividend that accrued to or was received by the company that disposed of the shares otherwise than under a deferral transaction in respect of those shares within the period during which that company held those shares. It will then be necessary to determine whether the dividend comprises an extraordinary dividend, and to the extent that it does, it must be added to the proceeds on disposal of the shares under para 43A(2).

This rule prevents connected persons from extracting exempt dividends from a company, transferring the reduced value shares tax free to another company under the corporate restructuring rules, and then using the latter company to dispose of them to a third party in order to avoid or reduce the CGT that might otherwise have become payable had the initial holder of the shares disposed of them directly to the third party. Typically, the initial holder of the shares that disposed of them under a deferral transaction will be a company but it could be any other person that qualifies for a dividends tax or normal tax exemption on the receipt or accrual of a dividend or foreign dividend. A typical example of para 43A(3)(a) would arise under an asset-for-share transaction under s 42 when Company A transfers shares in Company C to Company B in return for shares in Company B after first extracting an exempt dividend from Company C. Company B then sells the reduced value C shares to a third party thus realising a smaller capital gain. Company B must increase the proceeds on disposal of the shares by the extraordinary dividend.

Example 1 – Exempt dividend received by or accrued to a connected person, deemed to be a dividend received or accrued for purposes of para 43A – Para 43A(3)(a)

Facts:

Newco acquired 50% of the equity shares in Company C from Holdco under an asset-for-share transaction under s 42 as capital assets. Twelve months later, Newco disposed of the company C shares for R5 million to a third party.

At the beginning of the 18-month period before the disposal, the market value of these Company C shares was R6 million. Seventeen months before disposal of the shares, Holdco received a dividend of R1 million in respect of the shares in Company C which were disposed of to Newco. This dividend was exempt from normal tax and dividends tax.

Holdco, Newco and Company C are residents and are not listed companies. Holdco and Newco form part of the same group of companies.

Result:

Paragraph 43A(3)(a) applies, since the following requirements are met:

- The shares in Company C were not disposed of by Newco under a deferral transaction.
- The shares in Company C were disposed of by Newco within a period of 18 months after being acquired under a deferral transaction.
- Holdco received an exempt dividend of R1 million in respect of the shares that it held in Company C, which were disposed of to Newco, within 18 months before the disposal by Newco of those shares.
- Holdco was a connected person in relation to Newco under para (d)(i) of the definition of 'connected person' in s 1(1) within the period of 18 months prior to the disposal of the Company C shares by Newco.

Paragraph 43A(2) applies, since the following requirements are met:

- The shares in Company C were not disposed of by Newco under a deferral transaction.
- Newco held a qualifying interest in Company C under para (a)(i) of the definition of 'qualifying interest' in para 43A(1), since it held at least 50% of the equity shares or voting rights in Company C.
- The exempt dividend of R1 million received by Holdco is deemed to be a dividend received by or accrued to Newco for purposes of para 43A in respect of the shares held in Company C during the period that it held those shares.
- The dividend of R1 million deemed to have been received by Newco is exempt from normal tax under s 10(1)(k)(i) and from dividends tax under section 64F(1)(a).
- Part of the exempt dividend deemed to have been received by or accrued to Newco is an extraordinary dividend.

The extraordinary dividend is calculated as follows:

	R
Dividend deemed to have been received or accrued within 18 months before disposal by Newco of the shares in Company C	1 000 000
Less: 15% × R6 million [15% of the higher of market value of R6 million (beginning of the 18-month period) or R5 million (date of disposal)]	<u>(900 000)</u>
Extraordinary dividend	<u>100 000</u>

The deemed extraordinary dividend of R100 000 must be taken into account as part of proceeds on disposal of the shares in Company C by Newco in the year of assessment in which the shares were disposed of. The amount of R5 million received or accrued in respect of the disposal of the shares will, together with the deemed proceeds of R100 000 under para 43A(2), constitute proceeds for purposes of calculating the capital gain or capital loss on disposal of the shares.

Transferor of old shares disposing of reduced-value new shares acquired under deferral transaction to third party [para 43A(3)(b)]

The requirements of para 43A(3)(b) are as follows:

- A company must dispose of 'new' shares otherwise than under a deferral transaction.
- The 'new' shares must have been acquired by the company under a deferral transaction (other than an unbundling transaction) during the 18-month period preceding the disposal.
- The 'new' shares must have been acquired in return for or by virtue of the disposal of 'old' shares under a deferral transaction.
- An exempt dividend (other than in the form of new shares) must have been received by or accrued to the company in respect of the old shares within the 18-month period preceding the disposal of the new shares.

Under these circumstances, the dividend must for purposes of para 43A be treated as an amount that accrued to or was received by the company as an exempt dividend in respect of the new shares.

This provision is best illustrated by an asset-for-share transaction under s 42. A company strips a dividend from another company, then transfers those reduced-value 'old' shares to a new company in exchange for similarly reduced-value new shares in the new company. The new shares are then disposed of to a third party. The rule increases the actual proceeds on disposal of the new shares by the amount of the dividend on the old shares to the extent it comprises an extraordinary dividend. The scheme targeted by this rule seeks to break the link to the extraordinary dividend that was stripped out of the old shares because what is being sold to the third party is not the old shares but new shares in a different company.

Example 2 – Exempt dividend received by or accrued to a company from old shares, deemed to be a dividend received or accrued in respect of new shares [para 43A(3)(b)]

Facts:

Holdco owns all the shares in Company C. On 1 January year 1 Company C distributed a dividend of R1 million to Holdco. This dividend was exempt from normal tax and dividends tax. On 15 January year 1 Holdco formed Newco.

On 1 February year 1 Holdco disposed of all the shares in Company C to Newco in return for all the equity shares in Newco under an asset-for-share transaction in s 42. On 1 July year 2 Holdco disposed of the shares in Newco for R6 million to a third party.

Holdco and Newco are residents and are not listed companies.

Result:

Paragraph 43A(3)(b) applies, since the following requirements are met:

- The shares in Newco were not disposed of by Holdco under a deferral transaction.
- The shares in Newco were disposed of by Holdco within a period of 18 months after acquiring those shares under a deferral transaction (acquired 1 February year 1 and disposed of 1 July year 2).
- Holdco received an exempt dividend of R1 million in respect of the C shares during the 18-month period preceding the date of disposal of the Newco shares.

Paragraph 43A(2) applies, since the following requirements are met:

- The shares in Newco were not disposed of by Holdco under a deferral transaction.
- Holdco held a qualifying interest in Newco under para (a)(i) of the definition of 'qualifying interest' in para 43A(1), since it held at least 50% of the equity shares or voting rights in Newco.
- The exempt dividend of R1 million received by Holdco in respect of the Company C shares is deemed to be a dividend received by or accrued to Holdco for purposes of para 43A in respect of the Newco shares during the period that it held those shares.
- The dividend of R1 million deemed to have been received by Holdco is exempt from normal tax under s 10(1)(k)(i) and from dividends tax under section 64F(1)(a).
- Part of the exempt dividend deemed to have been received by or accrued to Holdco is an extraordinary dividend.

The extraordinary dividend is calculated as follows:

R

Dividend deemed to have been received or accrued within 18 months before disposal of the Newco shares by Holdco	1 000 000
Less: 15% × R6 million [15% of the higher of market value of RNil (beginning of the 18-month period) or R6 million (date of disposal)]	<u>(900 000)</u>
Extraordinary dividend	<u>100 000</u>
The proceeds on disposal of the Newco shares are determined as follows:	
Amount received or accrued on disposal of Newco shares (para 35)	6 000 000
Extraordinary dividend [para 43A(2)]	<u>100 000</u>
Proceeds to be taken into account in determining capital gain or loss	<u>6 100 000</u>

9.8.5 Dilution of effective interest in target company by issuing shares [para 43A(4)]

Paragraph 43A(4) was deemed to have come into operation on 20 February 2019. It applies to equity shares held by a company in a target company if the effective interest held by that company in the equity shares of that target company is reduced on or after that date. It deems a disposal of shares to occur for purposes of para 43A(2) when a company's interest in a target company is diluted through the issue of shares by the target company to another person. Such a deemed disposal is necessary because the decrease in value of a share is not a disposal except when a value-shifting arrangement occurs. For the consequences of the deemed disposal under para 43A(4), see the commentary on para 43A(2) in **9.8.3**.⁵⁵⁴

It applies when

- a company holds equity shares in another company (the target company);
- the target company issues new shares to a person other than that company; and
- the effective interest of that company in the equity shares of the target company is reduced by reason of the new shares issued by the target company.

Under the above circumstances the company must, for purposes of para 43A, be treated as having disposed, immediately after the new shares were issued, of a percentage of those equity shares. The percentage of shares disposed of is equal to the percentage by which the effective interest of that company in the equity shares of the target company has been reduced by reason of the new shares issued by the target company.

Any new shares that are convertible to equity shares must for purposes of para 43A(4) be treated as equity shares.

Example 1 – Deemed disposal as a result of decrease in effective interest

Facts:

ABC (Pty) Ltd (ABC) holds all the equity shares (100 shares) in Target (Pty) Ltd (Target). On 31 December 2019 Target's balance sheet appeared as follows:

⁵⁵⁴ As amended by the Taxation Laws Amendment Act 34 of 2019. Consequential amendments to para 43A(2) to accommodate the introduction of para 43A(4) were deemed to come into operation on the same date.

	R
Share capital (100 shares)	100 000
Retained income	<u>900 000</u>
Market value of shares (R10 000 a share)	<u>1 000 000</u>

On 1 January 2020 Target distributed all its reserves of R900 000 to ABC as an exempt dividend. At the end of the same day Target issued 25 shares to BEE (Pty) Ltd (BEE) for a consideration of R25 000. After these transactions Target's balance sheet appeared as follows:

	R
Share capital (125 shares)	125 000
Retained income	<u>-</u>
Market value of shares (R1 000 a share)	<u>125 000</u>

On 1 July 2018 the market value of the shares in Target was R930 000. ABC's year of assessment ends on the last day of February.

Result:

ABC's effective interest in the equity shares of Target has decreased from 100% (100 shares) to 80% ($100 / 125 \times 100$). This reduction triggers a deemed disposal for purposes of para 43A.

Target has declared an extraordinary dividend to ABC because

- the dividend of R900 000 was declared in the 18 months before the new shares were issued by Target; and
- a portion of the dividend of R900 000 is an extraordinary dividend because it exceeds 15% of the higher of the market value of the shares at the beginning of the 18-month period ($R930\ 000 \times 15\% = R139\ 500$) or at the date of deemed disposal ($R100\ 000 \times 15\% = R15\ 000$).

The extraordinary dividend is therefore as follows:

	R
Exempt dividend	900 000
Less: $R930\ 000 \times 15\%$	<u>(139 500)</u>
Extraordinary dividend	<u>760 500</u>

ABC's effective interest in Target has decreased by 20% (from 100% to 80%). Therefore, ABC is treated for purposes of para 43A(2) as having disposed of 20% of its shares in Target. The portion of the extraordinary dividend attributable to the deemed disposal is $20\% \times R760\ 500 = R152\ 100$ and this amount must be accounted for as a capital gain under para 43A(2) by ABC in its 2020 year of assessment.

Example 2 – Deemed disposal as a result of decrease in effective interest followed by actual disposal [proviso to para 43A(2)]

Facts:

The facts are the same as in Example 1 but the saga continues. On 3 January 2020 ABC disposed of its entire interest in Target for R100 000. The balance sheet of Target remained unchanged after the share issue on 1 January 2020. The market value of the Target shares on 3 July 2018 was R930 000.

Result:

The disposal of the shares is not a deferral transaction and thus potentially falls within para 43A(2).

The dividend declared by Target on 1 January 2020 is an 'exempt dividend' as defined in para 43A(1) for ABC because it is exempt from both normal tax under s 10(1)(k)(i) and dividends tax under s 64F(1)(a). It is also an 'extraordinary dividend' as defined in para 43A(1) because it exceeds 15% of the higher of the market values of R930 000 and R100 000 at the beginning and end of the 18 months preceding the disposal on 3 January 2020 (R930 000 × 15% = R139 500).

Accordingly, to the extent that the dividend exceeds R139 500, that is R930 000 – R139 500 = R790 500), the excess must be added to the proceeds on disposal of the shares. However, the extraordinary dividend must be reduced by any extraordinary dividend previously taken into account under para 43A(2), in this instance being the amount resulting from the dilution of ABC's interest in Target of R152 100.

The proceeds on disposal of the Target shares are therefore determined as follows:

	R
Amount received or accrued	100 000
Extraordinary dividend	790 000
Less: Extraordinary dividend previously taken into account	<u>(152 100)</u>
Proceeds on disposal	<u>737 900</u>

9.9 Base cost of asset of controlled foreign company operating in a country which has abandoned a hyperinflationary currency

Paragraph 43B

The abandonment by a country of its currency will usually occur after a period of hyperinflation. During such a period there will invariably be a lack of reliable exchange rate information for the purpose of determining the tax cost of assets because the official rate rarely reflects the true value of assets. The speed of the currency decline also makes it difficult to fix the exchange rate at a specified time.

Once a foreign currency is abandoned after a period of sharp decline in favour of a new, more stable currency, accounting rules often allow for the restatement of assets at market value. Paragraph 43B follows this approach because the continued use of historic costs is impractical.

Paragraph 43B applies when the functional currency of a CFC

- was the currency of a country which abandoned its currency, and had an official rate of inflation of 100% or more for the foreign tax year preceding that abandonment, and
- the CFC adopted a new functional currency as a consequence of that abandonment.

In the above circumstances the CFC must, for the purposes of determining the base cost of the asset, be deemed to have acquired the asset in the new currency

- on the first day of the foreign tax year of the CFC in which the new currency was adopted by the CFC, and

- for an amount equal to the market value of the asset on the date on which the new currency was adopted by the CFC.

Paragraph 43B is deemed to have come into operation on 1 January 2009 and applies in respect of foreign tax years of controlled foreign companies ending during years of assessment commencing on or after that date.

The Zimbabwe dollar is both an historical and current example of a hyperinflation currency. The use of the Zimbabwe dollar as an official currency was effectively abandoned on 12 April 2009 as a result of the Reserve Bank of Zimbabwe legalising the use of the rand and the US dollar as standard currencies for exchange. On 24 June 2019 the Reserve Bank of Zimbabwe abolished the multiple currency system and replaced it with a new Zimbabwe dollar. The IMF reported in September 2019 that Zimbabwe's inflation for the year ended 31 August 2019 was the highest in the world at 300%. The International Practices Task Force (IPTF) watch list at May 2019 lists the following countries as having cumulative inflation exceeding 100%: Angola, Argentina, Democratic Republic of Congo, South Sudan, Sudan and Venezuela. Countries with projected three-year cumulative inflation rates exceeding 100%: Islamic Republic of Iran, Yemen, and Zimbabwe.⁵⁵⁵

Example – Base cost of asset of CFC operating in a country which has abandoned a hyperinflationary currency

Facts:

SA Holdco owns all the shares of Z Co, a company which operates in Country Z. SA Holdco's year of assessment ends on 31 December, while Z Co's tax year ends on 30 June. For its 2008 and earlier tax years, Z Co adopted the Z dollar as its functional currency. Country Z abandoned the Z dollar on 12 April 2009 and adopted a number of currencies, including the US dollar as its official currency. Z Co adopted the US dollar as its functional currency.

On 30 September 2004 Z Co acquired a machine for US\$1 million, which it translated into its functional currency as Z\$5 284 900 000. The market value of the machine on 12 April 2009 was US\$800 000.

Result:

For the purposes of para 20, Z Co is deemed to have acquired the machine for US\$800 000 on 1 July 2008.

⁵⁵⁵ <<https://www.iasplus.com/en-ca/news/part-i-ifs/july-2019/hyperinflationary-economies-updated-iprf-watch-list-available>> [Accessed 2 November 2020].

Chapter 10 – Unquantified and unaccrued amounts

10.1 Overview

The treatment of unaccrued or unquantified amounts of proceeds and expenditure involves interplay between various sections of the Act and the Eighth Schedule. The provisions that are involved are set out in the table below.

Table 1 – Provisions relating to unaccrued or unquantified amounts

Provision	Description
Section 20B	Limitation of losses from disposal of depreciable assets arising from the allowance under s 11(o)
Section 23F(2) and (2A)	Limitation of losses from disposal of trading stock
Section 24M	Incurral and accrual of amounts in respect of assets acquired or disposed of for unquantified amounts
Section 24N	Incurral and accrual of amounts in respect of disposal or acquisition of equity shares
Paragraphs 3(b) and 4(b)	Capital gain or loss arising in year subsequent to the year of disposal
Paragraph 25(2)	Redetermination of capital gains and losses in respect of pre-valuation date assets
Paragraph 39A	Disposal of assets for unaccrued amounts of proceeds

The objectives of these provisions are, amongst others, to

- provide clarity on the treatment of unquantified amounts receivable or payable,
- prevent revenue and capital losses from being claimed up front, and
- provide rules for the redetermination of capital gains and losses for pre-valuation date assets.

10.2 Incurral and accrual of amounts in respect of assets acquired or disposed of for unquantified amount

Section 24M

Table 1 – Summary of s 24M

Section 24M	Description	Effect
(1)	Disposal of asset for unquantifiable consideration	Deems unquantified amounts not to accrue until they are quantified.
(2)	Acquisition of asset for unquantifiable consideration	Deems unquantified amounts not to be incurred until they are quantified.
(3)	Recovery or recoupment of amounts allowed as deductions	Recovery or recoupment under s 8(4) occurs as amounts are quantified.
(4)	Determination of deductions in respect of depreciable assets	Allowances that would have been granted in earlier years on amounts that become quantified in later years are allowed in full in the year of quantification.

10.2.1 Introduction

Assets are occasionally acquired or disposed of for a consideration that is not quantifiable at the date of acquisition. A typical example would be an asset acquired for a consideration based on future profits. The common law position with amounts receivable of such a nature is that while there may arguably be an accrual, there will be no 'amount'. Feetham JA stated in *CIR v Butcher Bros (Pty) Ltd*⁵⁵⁶ that in the context of the definition of 'gross income', the word 'amount' meant a consideration having an 'ascertainable money value' as opposed to mere 'conjectural value'.

South African courts have also considered the deductibility of unquantifiable expenditure. In *COT v 'A' Company*⁵⁵⁷ the court allowed a merchant banker to claim a loss on a loan to a debtor who had been liquidated, despite the amount of the final liquidation dividend not having been quantified. Citing this case with approval, the court in *Edgars Stores Limited v CIR*⁵⁵⁸ stated that it was necessary to draw a distinction between expenditure that was conditional, and expenditure in respect of which the obligation is unconditional but which can be quantified only in a subsequent year. Thus, the court approved the principle that it is permissible for the quantum of the deduction to be fixed on the basis of a fair and reasonable estimate. The degree of certainty as to whether the expenditure will be incurred is, however, a factor, for as was said in ITC 1601,⁵⁵⁹ there must be

'a clear measure of certainty as to whether the expenditure in contention is quantified or quantifiable'.

Section 24M defers the recognition of the accrual or incurral until the amount has been quantified. It does not deal with amounts that are quantifiable but have not accrued or been incurred because the agreement is subject to a suspensive condition. In the latter case the normal common law principles apply and the accrual or incurral is deferred until the condition is fulfilled. Capital losses arising from amounts that have not accrued (whether by reason of s 24M or some other reason) are ring-fenced under para 39A until all unquantified amounts have been quantified. Revenue losses arising under s 11(o) on disposal of qualifying depreciable assets are similarly ring-fenced under s 20B until all unquantified amounts that are receivable are quantified. Losses on the disposal of trading stock are ring-fenced under s 23F.

Section 24M does not determine the capital or revenue nature of the amounts that become quantifiable. It simply determines when amounts accrue or are incurred. If a person sells a business for a lump sum plus a share of the future profits, the lump sum will usually be of a capital nature and the share of the future profits of an income nature (see **2.4.1.20**).⁵⁶⁰ There is also a possibility that the future payments could be an annuity, in which instance they will be included in gross income by para (a) of the definition of 'gross income'.⁵⁶¹ For these reasons it is likely that most unquantifiable transactions involving future receipts will be on revenue account.

The words 'cannot be quantified' are not defined in s 24M. Of course, virtually anything can be quantified by attaching a number to it through estimation. Such a wide interpretation would defeat the object of s 24M. It is submitted that s 24M is directed at preventing the estimation of amounts when the quantum of the amount is dependent on future events. This interpretation is consistent with the meaning of the word 'amount' in the *Butcher Bros* case above, and the

⁵⁵⁶ *CIR v Butcher Bros (Pty) Ltd* 1945 AD 301, 13 SATC 21 at 34.

⁵⁵⁷ *COT v 'A' Company* 1979 (2) SA 409 (RAD), 41 SATC 59.

⁵⁵⁸ 1988 (3) SA 876 (A), 50 SATC 81 at 90.

⁵⁵⁹ (1995) 58 SATC 172 (C) at 179.

⁵⁶⁰ *Deary v Deputy Commissioner of Inland Revenue* 1920 CPD 541, 32 SATC 92 and *William John Jones v The Commissioners of Inland Revenue* [1920] 1 KB 711, 7 TC 310.

⁵⁶¹ See *Silke* in § 4.3.

way in which the word 'quantified' was used in the *Edgars Stores* case and ITC 1601 above. Section 24M therefore essentially entrenches the common law position.

10.2.2 Disposal of asset for unquantifiable consideration [s 24M(1)]

Section 24M(1) applies when a person disposes of an asset for a consideration all or part of which cannot be quantified in that year of assessment. If this happens the amount is deemed

- not to accrue to the person in that year, and
- to accrue in the year in which the amount becomes quantified.

The rule applies for the purposes of the Income Tax Act, which includes the Eighth Schedule. It therefore covers both capital assets and trading stock.

When the amount becomes quantifiable in the subsequent year, it will be treated as a capital gain under para 3(b)(i). With a pre-valuation date asset, the capital gain or loss must be redetermined under para 25(2).

10.2.3 Acquisition of asset for unquantifiable consideration [s 24M(2)]

Section 24M(2) applies when a person acquires an asset for a consideration all or part of which cannot be quantified in that year of assessment. If this happens, the amount is deemed

- not to have been incurred by the person in that year, and
- to have been incurred in respect of the acquisition of the asset in the year in which the amount becomes quantified.

The rule applies for the purposes of the Income Tax Act, which includes the Eighth Schedule. It therefore covers both capital assets and trading stock.

When the amount becomes quantifiable in the subsequent year, it will simply be added to the base cost of the asset in that subsequent year. If the asset is disposed of before the amount is incurred, the CGT consequences will be as follows:

- Post-valuation date asset – the amount incurred will be treated as a capital loss under para 4(b)(ii).
- Pre-valuation date asset – the capital gain or loss must be redetermined under para 25(2). The previous capital gain or loss will be reversed and the new capital gain or loss taken into account.

Example – Straight-forward gain on unquantified amounts

Facts:

In December 2011 Andrew acquired shares at a base cost of R250 000. In March 2015, he sold the shares to Bryan for a purchase consideration payable in instalments over five years with the first instalment due on 28 February 2016. The instalments are based on a formula linked to the average all share index of the JSE in each instalment year. The amounts ultimately received are R300 000, R200 000, R150 000, R110 000 and R240 000. Assume that the payments are of a capital nature and do not comprise an annuity.

Result:

Section 24M applies because unquantified payments are involved. The initial 2016 year will trigger a small R50 000 capital gain for Andrew. Subsequent years will trigger additional capital gains.

	2016 R	2017 R	2018 R	2019 R	2020 R	Total R
Proceeds	300 000	200 000	150 000	110 000	240 000	1 000 000
Less: Base cost	<u>(250 000)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(250 000)</u>
Capital gain	<u>50 000</u>	<u>200 000</u>	<u>150 000</u>	<u>110 000</u>	<u>240 000</u>	<u>750 000</u>

The base cost of the shares acquired by Bryan is accumulated over the five years as and when the amounts become quantified as illustrated below.

	2016 R	2017 R	2018 R	2019 R	2020 R	Total R
Amount payable	300 000	200 000	150 000	110 000	240 000	1 000 000
Base cost	300 000	500 000	650 000	760 000	1 000 000	

10.2.4 Recovery or recoupment of amounts allowed as deductions [s 24M(3)]

This subsection applies when

- a person has disposed of a depreciable asset, and
- all or a part of the consideration in respect of the disposal will be quantified only in a future year of assessment.

In these circumstances the recovery or recoupment of any capital allowances claimed in respect of such an asset under s 8(4) must be determined with reference to amounts that are deemed to accrue under s 24M. In other words, recoupments will take place as and when the selling consideration is quantified. From a CGT perspective this treatment is relevant for the purposes of determining the proceeds to be taken into account as a capital gain under para 3(b)(ii). Under para 35(3)(a) any amount recovered or recouped under s 8(4) will reduce the proceeds.

10.2.5 Determination of deductions in respect of depreciable assets [s 24M(4)]

This subsection applies when

- a person has acquired a depreciable asset in a previous year, and
- all or a part of the consideration in respect of the acquisition will be quantified only in a future year of assessment.

In these circumstances when amounts of expenditure become quantified, the person is given a 'catch up' allowance in respect of the additional expenditure incurred. This allowance is equal to the sum of all allowances that the person would have been entitled to had the expenditure been incurred in the initial year. Should sufficient time have elapsed since the asset was brought into use, the person could qualify for a full deduction in respect of the additional expenditure. This situation could occur, for example, when the cost of an asset is allowed as a deduction over four years under s 12C. The immediate write-off is relevant from a CGT perspective in determining the amount to be allowed as a capital loss under para 4(b)(ii), since the relevant expenditure must be reduced by the amount of any capital allowances under para 20(3)(a).

Example – Determination of capital allowances when purchase price of asset unquantified*Facts:*

In 2016 Lulu acquired a manufacturing machine from Kyle on the following terms:

- R190 000 in 2016
- 10% of the turnover generated by the machine over the next four years (2017 to 2020). These amounts eventually were R40 000 (2017), R250 000 (2018), R280 000 (2019) and R240 000 (2020).

Result:

The cost of the manufacturing machine acquired by Lulu that qualifies for capital allowances is accumulated over the five years as follows:

	2016	2017	2018	2019	2020	Total
	R	R	R	R	R	R
Cost incurred	190 000	40 000	250 000	280 000	240 000	1 000 000
Depreciation	40%	20%	20%	20%		
Cumulative %	40%	60%	80%	100%	100%	
On R190 000	76 000	38 000	38 000	38 000	-	190 000
On R40 000		24 000	8 000	8 000	-	40 000
On R250 000			200 000	50 000	-	250 000
On R280 000				280 000	-	280 000
On R240 000					240 000	240 000
Total depreciation	<u>76 000</u>	<u>62 000</u>	<u>246 000</u>	<u>376 000</u>	<u>240 000</u>	<u>1 000 000</u>

10.3 Incurral and accrual of amounts in respect of disposal or acquisition of equity shares (s 24N)

Section 24N

10.3.1 Application

This provision applies when

- a person during a year of assessment sells equity shares to another person, and
- a part of the purchase price is quantified or quantifiable but is due and payable by reference to future profits.

Under general principles the proceeds from such a sale would accrue to the seller in the year of sale and the purchase price would form part of the base cost of the purchaser in the same year. This provision is aimed at alleviating the cash flow difficulties that may be experienced by the seller under such an arrangement. It does this by deferring the accrual and incurral of the purchase price in the seller's and buyer's hands respectively to the extent and until the amounts become due and payable.

10.3.2 Conditions

Five conditions must be satisfied for the deferral to apply. These are as follows:

Significant deferred payment and link to future profits [s 24N(2)(a)]

More than 25% of the sales proceeds must be due and payable after the first year of assessment of the seller. The amount payable must also be based on the future profits of the company in which the shares are held. This requirement ensures that the deferred profit participation element is meaningful.

Sale of a meaningful company stake [s 24N(2)(b)]

One or more sellers must dispose of more than 25% of the total value of the equity shares in the same company during that year, and those sales must fall within s 24N. This rule assists the sale of a meaningful stake in a company. It is not intended to promote deferral for portfolio shares.

No connected persons [s 24N(2)(c)]

The sale must not occur between a seller and purchaser who are connected to each other after the disposal (for example, when buyer and seller are relatives or members of the same group of companies).

Resolutive condition [s 24N(2)(d)]

The sale must be subject to a performance requirement by the purchaser, namely, that the purchaser is obliged to return the equity shares to the seller if the purchaser fails to pay an amount when due. This resolutive condition means that the contingency 'profit participation' element is a core part of the transaction (as opposed to a standard deferred instalment agreement).

No cash equivalents [s 24N(2)(e)]

The amount payable to the seller cannot be payable under a financial instrument which is payable on demand or readily tradable in the open market. In other words, the claim cannot be a cash equivalent, thereby undermining the lack of cash-flow premise for relief.

10.3.3 Consequences for seller

In mechanical terms, the seller determines capital gains/losses during the initial year of disposal in the normal way, except that amounts due and payable in later years are ignored [s 24N(1)(a)(i)]. This calculation may trigger an initial capital gain or loss. Initial capital gains generate tax just like any other capital gain. However, initial capital losses are ring-fenced during that year [para 39A(1)]. The seller must then account for further consideration in later years as that consideration becomes due and payable [s 24N(1)(b)(i)]. This further consideration generates full capital gain during each year of instalment without any base cost deduction [para 3(b)(i)]. However, the seller reduces this gain to the extent of any remaining disregarded losses stemming from the initial year of transfer [para 39A(2)]. If any disregarded losses still exist after all instalments become due and payable, these remaining capital losses can be fully accounted for at that time [para 39A(3)].

10.3.4 Consequences for purchaser

If a purchaser acquires equity shares for consideration that wholly or partly includes amounts within s 24N, that purchaser's expenditure incurred (base cost) is accumulated over time. More specifically, the purchaser is initially viewed as having incurred expenditure to the extent of the consideration provided on transfer [s 24N(1)(a)(ii)]. Further expenditure is added to the

asset acquired as further amounts become due and payable [s 24N(1)(b)(ii)]. If the transferee sells an equity share before all amounts are due and payable, the gain on the transfer is calculated without reference to these amounts. However, further amounts paid or incurred by the transferee on the transferred asset will generate capital losses as those amounts are quantified [para 4(b)(ii)].

10.4 Disposal of asset for unaccrued amounts of proceeds

Paragraph 39A

10.4.1 Introduction

Paragraph 39A came into operation on 24 January 2005 and applies in respect of any disposal during any year of assessment commencing on or after that date.⁵⁶²

It frequently happens that assets are sold on terms that result in all or part of the proceeds from the disposal accruing only in a future year of assessment. This can arise under s 24M when a portion of the proceeds cannot be quantified, in which case the accrual is deferred to the year of quantification. In the absence of a provision to regulate such arrangements, the effect in many cases will be to trigger up-front capital losses. In essence para 39A ring-fences any capital loss arising from such a disposal until all the proceeds have accrued to the seller.

10.4.2 Disregarding of capital loss [para 39A(1)]

Under para 39A(1) a person must disregard a capital loss arising on disposal of an asset during a year of assessment when all the proceeds from that disposal will not accrue to that person during that year.

The primary source for making the determination as to whether all the proceeds have accrued will be the agreement of sale. Would capital losses continue to be ring-fenced if, for example, the sale agreement provides that the proceeds are equal to 10% of the profits for the next five years, and after four years the company has made consistent losses and is unlikely to turn a profit in the fifth year? Under these circumstances any capital loss will nevertheless still be ring-fenced until the end of the fifth year, since there is still a possibility, no matter how remote, that a profit will be derived that will generate proceeds. However, if the purchaser were to be liquidated and finally wound up by the end of the fourth year, one could conclude with absolute certainty that no further proceeds will accrue, and the capital loss will be claimable in year four.

10.4.3 Set-off of ring-fenced capital loss against subsequent capital gains [para 39A(2)]

A person who has a ring-fenced capital loss arising from the disposal of an asset in an earlier year under para 39A(1) may use that capital loss against any capital gains arising in the current year from the disposal of that asset. For example, proceeds that were unquantifiable in the year of disposal may become quantifiable in the current year and will be deemed to accrue in that year under s 24M(1)(b). Under para 3(b)(i) such proceeds will be treated as a capital gain in that year.

The deduction of the suspended loss is conditional upon the loss not otherwise having been allowed as a deduction. This situation would occur, for example, with a pre-valuation date asset in respect of which the capital gain or loss is redetermined from scratch in the current year. In this case the portion of the base cost that was suspended in the year of disposal will be taken into account in the redetermination of the capital gain or loss in the current year.

⁵⁶² Inserted by s 64(1) of the Revenue Laws Amendment Act 32 of 2004.

Example 1 – Overall gain on unaccrued amounts after suspended loss*Facts:*

Angus acquired an office block in December 2001 at a base cost of R500 000. In March 2019 he sold the office block to Moira. Under the contract the purchase price was payable in annual instalments over the next five years, with the first payment due on 28 February 2019. Each instalment was payable only if the purchaser achieved a net rental return of at least 10% during the relevant instalment year. The contingent instalments are R300 000 (2020), R200 000 (2021), R150 000 (2022), R110 000 (2023) and R240 000 (2024). The required rate of return was eventually achieved in each year. Assume that the proceeds are on capital account and are not an annuity.

Result:

The instalments are conditional and therefore accrue at the end of each year of assessment. In the 2020 year of assessment Angus will have a R200 000 suspended loss under para 39A(1). Subsequent years will trigger capital gains that must first be used against the suspended loss [para 39A(2)].

	2020 R	2021 R	2022 R	2023 R	2024 R	Total R
Proceeds	300 000	200 000	150 000	110 000	240 000	1 000 000
Less: Base cost	(500 000)	-	-	-	-	(500 000)
(Loss) gain	(200 000)	200 000	150 000	110 000	240 000	500 000
Suspended loss	<u>200 000</u>	<u>(200 000)</u>	-	-	-	-
Capital gain	-	-	<u>150 000</u>	<u>110 000</u>	<u>240 000</u>	<u>500 000</u>

Under para 20 Moira's base cost will be accumulated over the five years as and when she becomes unconditionally liable to pay the instalments: 2020: R300 000; 2021: R300 000 + R200 000 = R500 000 and so on.

Example 2 – Overall gain on unquantified amounts with a zero instalment year*Facts:*

Vincent acquired an office block in December 2001 at a base cost of R500 000. In June 2019 he sold the office block to Jules for a purchase price payable in 5 instalments with the first payment due on 29 February 2020. The amount of each instalment was determinable in accordance with a formula linked to the JSE property index. The amounts ultimately received are R400 000 (2020), R200 000 (2021), R150 000 (2022), R0 (2023) and R250 000 (2024). Assume that these amounts are on capital account and not an annuity.

Result:

Under s 24M(1) the instalments will accrue in the year in which they are quantified. Vincent will have a suspended loss of R100 000 in the first year under para 39A(1). Subsequent years will trigger capital gains that will first be used against the suspended loss under para 39A(2) with the zero instalment year having no net effect.

	2020 R	2021 R	2022 R	2023 R	2024 R	Total R
Proceeds	400 000	200 000	150 000	0	250 000	1 000 000
Less: Base cost	(500 000)	-	-	-	-	(500 000)
Gain (loss)	(100 000)	200 000	150 000	110 000	240 000	500 000
Suspended loss	<u>100 000</u>	<u>(100 000)</u>	-	-	-	-
Capital gain	-	<u>100 000</u>	<u>150 000</u>	<u>110 000</u>	<u>240 000</u>	<u>500 000</u>

Under s 24M(2) read with para 20 the base cost of the office block acquired by Jules will be accumulated over the five years as and when the payments are quantified as follows: 2020: R400 000; 2021: R600 000; 2022: R750 000; 2023: R750 000 and 2024: R1 000 000.

Example 3 – Fixed plus unaccrued amounts

Facts:

Jody acquired a property in December 2001 at a base cost of R500 000. In September 2019 she sold the property to Lance. Under the contract, Lance must pay the following amounts over the next five years commencing on 29 February 2020:

- Fixed instalments of R20 000 a year, plus
- contingent instalments of R90 000, R200 000, R150 000, R1 000 and R24 000. These instalments are contingent on preset occupancy levels being achieved in each of the years in question. In each year the target occupancy levels were achieved.

Result:

The fixed instalments of $R20\,000 \times 5 = R100\,000$ are all included as proceeds in Jody's hands in the 2020 year of assessment together with the first payment of R90 000 (para 35 and common law meaning of 'accrue'). Jody will become entitled to the contingent instalments only when the occupancy levels have been achieved at the end of each year and it is at this point that they will accrue to her. She will have a R310 000 suspended loss in 2020 under para 39A(1). Subsequent years will trigger capital gains that will first be used against the suspended loss [para 39A(2)].

	2020	2021	2022	2023	2024	Total
	R	R	R	R	R	R
Proceeds	190 000	200 000	150 000	1 000	24 000	565 000
Less: Base cost	(500 000)	-	-	-	-	(500 000)
(Loss) gain	(310 000)	200 000	150 000	1 000	24 000	65 000
Suspended loss	310 000	(200 000)	(110 000)	-	-	-
Capital gain	-	-	40 000	1 000	24 000	65 000

Under para 20 Lance's base cost is accumulated over the five years as and when he becomes unconditionally liable to pay Jody. His base cost will be as follows: 2020: R190 000; 2021: R390 000; 2022: R540 000; 2023: R541 000 and 2024: R565 000.

Example 4 – Buyer's sale of property before all amounts are incurred

Facts:

The facts are the same as Example 3 except that Lance sells the property to Trudy after the 2022 instalment. Lance's sale of the property does not alter the payment relationship with Jody. Lance immediately receives R620 000 upon sale of the property to Trudy.

Result:

The sale of the property by Lance has no effect on the gain calculations made by Jody. Lance's base cost at the time of disposal of the property to Trudy is R540 000 (that is, R190 000 + R200 000 + R150 000). This base cost produces a capital gain of R80 000 (R620 000 proceeds less R540 000 base cost). Further amounts paid by Lance to Jody will generate capital losses during the years in which those amounts are paid [para 4(b)(ii)]. Hence, Lance will have a R1 000 capital loss in 2023 and a R24 000 capital loss in 2024.

10.4.4 Lifting of ring-fencing of capital loss [para 39A(3)]

If a person can prove that no further proceeds will accrue, the remaining portion of any unused capital loss may be taken into account in determining that person's aggregate capital gain or loss for that year. In other words, the ring-fencing of the capital loss comes to an end. The determination whether any further proceeds will accrue must be made taking into account the terms of the sale agreement and any subsequent events which would prevent further proceeds from accruing. When any possibility exists under the sale agreement that further proceeds could accrue, no matter how remote, the ring-fencing of the capital loss will not be lifted. See also **10.4.2**.

Example – Overall loss on unaccrued amounts

Facts:

Marcellus acquired property in December 2001 at a base cost of R500 000. In December 2019 he sold the property to Wolf in 5 instalments of R40 000, R20 000, R15 000, R1 000 and R24 000, with the first payment due on 29 February 2020. Each instalment was, however, contingent on a required level of profitability being achieved in the relevant instalment year. The required level of profitability was eventually achieved in each year.

Result:

Since the amounts receivable are contingent, they do not accrue until the condition has been satisfied (normal common law principles). The initial 2020 year will trigger a R460 000 suspended loss for Marcellus under para 39A(1). This suspended loss will be partly offset with successive gains under para 39A(2). However, the transaction will generate a net R400 000 capital loss in 2024 once all instalments have been received. Under para 39A(3) that capital loss may be set off against other capital gains in that year. In other words, the loss ceases to be suspended.

	2020	2021	2022	2023	2024	Total
	R	R	R	R	R	R
Proceeds	40 000	20 000	15 000	1 000	24 000	100 000
Less: Base cost (500 000)	<u>(500 000)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(500 000)</u>
(Loss) gain	(460 000)	20 000	15 000	1 000	24 000	(400 000)
Suspended loss	<u>460 000</u>	<u>(20 000)</u>	<u>(15 000)</u>	<u>(1 000)</u>	<u>(424 000)</u>	<u>-</u>
Capital loss	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(400 000)</u>	<u>(400 000)</u>

Under para 20 and the common law principles governing the incurrance of expenditure, Wolf will have a base cost accumulated over the five years as and when he becomes unconditionally liable to pay Marcellus. Hence, Wolf will have a base cost as follows: 2020: R40 000; 2021: R60 000; 2022: R75 000; 2023: R76 000 and 2024: R100 000.

10.5 Disposal of certain debt claims

Paragraph 35A

10.5.1 Application [para 35A(1)]

Three conditions must be met before para 35A can apply.

- First, a person must have disposed of an asset during any year of assessment, and a portion of the proceeds will accrue only in a subsequent year of assessment. The reason for the non-accrual could be because the proceeds are not quantifiable in the year of disposal, or because they are subject to some contingency.

- Secondly, the person must subsequently have disposed of any right to claim payment in respect of that disposal. For example, the debt arising from the disposal is disposed of to a third party such as a factoring house.
- Thirdly, the claim must include any amount that has not yet accrued to that person at the time of the disposal of the claim. This requirement refers to the claim itself, and not to the right to claim payment in respect of the claim. The provision does not apply to a claim that is disposed of after all amounts have accrued to the seller of the asset.

The purpose of the provision is to prevent the understatement of proceeds subject to CGT on the disposal of an asset. The understatement occurs because the unaccrued proceeds are diverted to the disposal of the debt, which has an enhanced base cost equal to the market value of the asset disposed of. Furthermore, in the absence of para 35A the capital loss suspension provisions of para 39A are rendered ineffective in relation to the asset, since once the unaccrued proceeds are ceded, no further proceeds can accrue and any suspended capital loss will be claimable under para 39A(3). This treatment is more clearly explained in the example in **10.5.3**.

10.5.2 Deemed allocation of consideration from disposal of claim to disposal of asset [para 35A(2)]

This provision requires that a portion of the consideration received by or accrued to a person from the disposal of the unaccrued portion of the claim be treated as an accrual of consideration in respect of the disposal of the asset. The allocation must be done on some reasonable basis taking into account the present value of the claim, the probability of recovery and the probability of the contingent or unquantified portion of the claim ultimately being received.

10.5.3 Disregarding of portion of capital gain or loss on disposal of right to claim payment [para 35A(3)]

The capital gain or loss relating to the disposal of the unaccrued portion of the claim must be disregarded. However, the remaining accrued portion of the capital gain or loss must be taken into account in determining the aggregate capital gain or loss.

The acquirer of the claim must, under s 24M or normal common law principles, take the unaccrued portion of the claim into account when it accrues, either in determining gross income (for example, a factoring house) or as proceeds on disposal of a capital asset.

Example – Disposal of debt claim relating to unaccrued proceeds on disposal of asset

Facts:

On 29 February 2020 Jeremy sold plant having a base cost of R500 000 to Anne for a consideration of R1,2 million. The amount was payable on 1 May 2020 subject to the plant meeting certain performance criteria.

On the same day (29 February 2020) Jeremy disposed of his right to claim payment of R1,2 million due on 1 May 2020 to Debt Factors (Pty) Ltd for a cash consideration of R1,18 million. The market value of the plant on 29 February 2020 was R1,2 million.

Result:

Paragraph 35A applies because

- a portion of the proceeds in respect of the plant did not accrue at the time of its disposal;

- the right to claim payment from the disposal of the plant has been disposed of; and
- the claim disposed of had not accrued at the time of disposal.

Under para 35A(2) R1,18 million is treated as proceeds on disposal of the plant. Therefore, the capital gain or loss on disposal of the plant will be as follows:

	R
Proceeds	1 180 000
Less: Base cost	<u>(500 000)</u>
Capital gain	<u>680 000</u>

The base cost of the debt is the market value of the asset given in exchange, namely, R1,2 million.

	R
Proceeds	1 180 000
Less: Base cost	<u>(1 200 000)</u>
Capital loss	<u>(20 000)</u>

This capital loss on disposal of the unaccrued portion of the claim must be disregarded under para 35A(3).

Debt Factors (Pty) Ltd will have an income gain as follows:

	R
Gross income (received from Anne)	1 200 000
Less: Cost (paid to Jeremy)	<u>(1 180 000)</u>
Taxable income	<u>20 000</u>

The macro gain should be R1 200 000 – R500 000 = R700 000. The actual macro gain is R680 000 (asset – Jeremy) – R0 (debt – Jeremy) + R20 000 (Debt Factors) = R700 000.

In the absence of para 35A Jeremy would have had a capital loss of R500 000 on disposal of the asset [not suspended – para 39A(3)], and a R20 000 capital loss on disposal of the debt.

10.6 Limitation of allowance under s 11(o) [s 20B]

Section 20B

Section 20B was introduced by the Revenue Laws Amendment Act 32 of 2004. It came into operation on 1 January 2005 and applies in respect of any disposal during any year of assessment commencing on or after that date.

Section 20B contains a similar ring-fencing provision to para 39A that applies to ordinary losses on disposal of depreciable assets under s 11(o). The allowance under s 11(o) applies to specified depreciable assets with a useful life not exceeding 10 years. If an asset is disposed of for a consideration the whole or a part of which will accrue only in a year subsequent to the year of disposal, the initial ordinary loss will be ring-fenced [s 20B(1)]. As amounts accrue in subsequent years, they must be set off against the ring-fenced loss [s 20B(2)]. Once the suspended loss has been exhausted, further accruals will give rise to recoupments limited to the amount of capital allowances claimed [s 24M(3)]. Any amounts received in excess of the allowances claimed will give rise to capital gains under para 3(b)(i). Once all amounts have accrued the balance of any suspended s 11(o) loss can be claimed as a deduction against ordinary income [s 20B(3)].

Example – Depreciable asset with a suspended ordinary allowance under s 11(o), recoupment and capital gain

Facts:

Kyle acquired a manufacturing machine on 1 March 2019 at a cost of R500 000. After depreciating the machine by R200 000 (40% under s 12C), he sold the machine to Lulu on 30 June 2019. Under the terms of the contract, Lulu must pay the following amounts which are each contingent on the number of products produced by the machine in the respective years. R190 000 (2020), R40 000 (2021), R250 000 (2022), R280 000 (2023) and R240 000 (2024).

Result:

Section 20B applies because a portion of the consideration receivable has not accrued in the year of disposal. The initial 2020 year will trigger a R110 000 suspended s 11(o) loss for Kyle [s 20B(1)]. This suspended loss will be offset by successive income [s 20B(2)]. Once all suspended losses have been used, further accruals will generate recoupment of the amount claimed under s 12C of R200 000 [s 24M(3)]. Further amounts will generate capital gains under para 3(b). The net cumulative amounts will be R200 000 of ordinary recoupment and R500 000 of capital gain.

	2020	2021	2022	2023	2024	Total
	R	R	R	R	R	R
Receipts	190 000	40 000	250 000	280 000	240 000	1 000 000
Less: Tax value	<u>(300 000)</u>	-	-	-	-	<u>(300 000)</u>
Loss/Recoup	(110 000)	40 000	250 000	280 000	240 000	700 000
Suspended loss	<u>110 000</u>	<u>(40 000)</u>	<u>(70 000)</u>	-	-	-
Recoupment	-	-	<u>180 000</u>	<u>20 000</u>	-	<u>200 000</u>
Capital gain	-	-	-	<u>260 000</u>	<u>240 000</u>	<u>500 000</u>

10.7 Incurral and accrual of amounts in respect of option contracts

Section 24L

Section 24L was introduced in 1999 to address the claiming of up-front deductions by entities such as banks which acquired options for the purposes of acquiring financial instruments to be held as trading stock. Since the options themselves did not constitute trading stock, the acquiring entity was entitled to an up-front deduction under s 11(a) and did not suffer an inclusion in closing trading stock under s 22(1).

Section 24L(2) spreads the deduction claimable by the option holder over the period of the option contract or until the option is exercised. For years of assessment commencing before 1 January 2019, a matching spread of the amount received or receivable was afforded to the grantor under s 24L(3). However, s 24L(3) now specifically excludes amounts of a capital nature for years of assessment commencing on or after 1 January 2019, and therefore the spread no longer applies for CGT purposes.

Section 24L(2), which spreads the deduction, applies 'for the purposes of the Act', which includes the Eighth Schedule.

For CGT purposes the spreading of the deduction is unlikely to have much impact, since the full amount incurred must be added to the base cost of the asset acquired in consequence of the exercise of the option [para 20(1)(ix)] and by the time that happens s 24L would have allowed the entire deduction.

The granting of an option is a disposal by the grantor under para 11(1)(f). Under para 33(3)(a) no part of the base cost of the underlying asset may be allocated to the granting of the option. As a result, the proceeds received or accrued upon the granting of an option will constitute a capital gain.

For years of assessment commencing before 1 January 2019, the effect of s 24L(3) was to spread the proceeds over the option period until the option was exercised. When the option period straddled a year of assessment, the result was that a capital gain was triggered in the year of assessment in which the option was granted and further capital gains were then brought to account in subsequent years of assessment under para 3(b). But as noted earlier, this treatment no longer applies and any proceeds are recognised at the time of disposal when the option is granted [para 13(1)(a)(vi)].

Example 1 – Spreading of amount received or receivable by the grantor of an option (years of assessment commencing before 1 January 2019)

Facts:

Cynthia owns a farm which she intends to dispose of.

On 1 February 2019 Cynthia granted Anne an option to buy her farm at a strike price of R10 million at any time during the next six months for a consideration of R60 000.

Result:

During the 2019 year of assessment Cynthia must bring a capital gain of R10 000 to account ($R60\,000 \times 1 / 6$) under s 24L(3).

In the 2020 year of assessment Cynthia must recognize the balance of the capital gain of R50 000 ($R60\,000 \times 5 / 6$) under s 24L(3) read with para 3(b).

Example 2 – Recognition of amount received or receivable by the grantor of an option (years of assessment commencing on or after 1 January 2019)

Facts:

Cynthia owns a farm which she intends to dispose of.

On 29 February 2020 Cynthia granted Anne an option to buy her farm at a strike price of R10 million at any time during the next six months for a consideration of R60 000.

Result:

Cynthia must recognise a capital gain of R60 000 during the 2020 year of assessment (proceeds of R60 000 – base cost of nil) because s 24L(3) no longer applies for years of assessment commencing on or after 1 January 2019. Cynthia's first year of assessment commencing on or after 1 January 2019 is the 2020 year of assessment (1 March 2019 to 29 February 2020). Section 24L(3) excludes the amount of any premium or like consideration received or receivable by a person under an option contract if that amount is of a capital nature for years of assessment commencing on or after 1 January 2019. The base cost of the option is nil under para 33(3)(a).

Chapter 11 – Primary residence exclusion

PART VII: PRIMARY RESIDENCE EXCLUSION

11.1 Definitions

Paragraph 44

Paragraph 44 contains a number of definitions that apply for the purposes of Part VII unless the context indicates otherwise.

11.1.1 Definition – ‘an interest’

<p>‘ “[A]n interest” means—</p> <p>(a) any real or statutory right; or</p> <p>(b) a share owned directly in a share block company as defined in the Share Blocks Control Act or a share or interest in a similar entity which is not a resident; or</p> <p>(c) a right of use or occupation,</p> <p>but excluding—</p> <p>(i) a right under a mortgage bond; or</p> <p>(ii) a right or interest of whatever nature in a trust or an asset of a trust, other than a right of a lessee who is not a connected person in relation to that trust.’</p>
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The definition of ‘an interest’ contains three items.

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

A lessee hiring a residence has an interest in that residence under the last item (a right of use or occupation) despite not owning the residence. The effect of such an interest is that when a qualifying person has an interest in a residence, that person’s primary residence can be determined if that person or a beneficiary of a special trust or a spouse of that person or beneficiary ordinarily resides in it as his or her main residence, and if that residence is used mainly for domestic purposes.

Excluded from the definition of ‘an interest’ are

- a right under a mortgage bond; and
- a right or interest of whatever nature in a trust or an asset of a trust, other than a right of a lessee who is not a connected person in relation to that trust

Upon registration of a mortgage bond in the deeds registry, the mortgagee (lender) acquires real rights in the mortgaged property comprising the right to restrain its alienation and the right to claim a preference in respect of its proceeds on insolvency of the mortgagor (debtor).⁵⁶³

⁵⁶³ *Lief NO v Dettman* 1964 (2) SA 252 (A) at 259.

Since these rights have nothing to do with the use of the property as a primary residence, they are excluded from the definition of ‘an interest’.

A beneficiary having a vested right in a property held by a trust will not qualify for the primary residence exclusion, even if he or she resides in the residence, since the vested right comprises an interest in a residence. Although the property may have been vested in the beneficiary, it remains an asset of the trust in which that beneficiary has an interest. The exclusion from relief would not extend to a residence administered by a *bewind* trust, since the beneficiary retains full ownership of the residence and it cannot be described as an asset ‘of’ a trust.

Bona fide lessees are removed from the ambit of the exclusion.

11.1.2 Definition – ‘primary residence’

‘ “[P]rimary residence” means a residence—

- (a) in which a natural person or a special trust holds an interest; and
- (b) which that person or a beneficiary of that special trust or a spouse of that person or beneficiary—
 - (i) ordinarily resides or resided in as his or her main residence; and
 - (ii) uses or used mainly for domestic purposes.’

The words ‘used’ and ‘resided’ mean that a residence will constitute a primary residence if it was so used or resided in on or after the valuation date. It is not a requirement that the residence be used or resided in as a primary residence at the time of disposal. The implications of a primary residence that has not been used or resided in throughout the period on or after the valuation date are addressed in paras 47 and 49.

Vacant land and partially completed residences

A person who buys land with the intention of erecting a primary residence on it and then for whatever reason fails to carry out that intention will not qualify for the primary residence exclusion, since the land will not meet the requirements of the definitions of ‘residence’ and ‘primary residence’.

Para 48(b) deems a person to have ordinarily resided in a residence for the purposes of para 47 during the period in which

‘that residence was being erected on land acquired for that purpose in order to be used as that person’s primary residence’.

However, para 48(b) does not deem the partially completed residence to be a residence or a primary residence. In the latter regard the opening words of para 47 refer to the disposal of an interest in a residence that is or was a primary residence. Once that requirement has been met, para 47 requires apportionment of the overall capital gain or loss with reference to the period in which the person was ordinarily resident. It is at this point that para 48(b) ensures that the period during which the residence was being erected does not taint the primary residence. It follows that until the residence is completed and becomes a primary residence para 48(b) will not apply.

11.1.2.1 General

Under para (a) of the definition of 'primary residence' a company, close corporation or trust (other than a special trust) owning a residence in which a shareholder, member or beneficiary ordinarily resides and uses for domestic purposes would not qualify for the primary residence exclusion of a capital gain or loss made upon disposal of such residence.

The persons referred to in para (b) of the definition of 'primary residence' include the spouse of either the natural person or the beneficiary of the special trust. The effect of including these persons is to allow a primary residence to retain its status as a primary residence when one spouse resides in it and the other spouse who owns it does not reside in it, for whatever reason. This concession is subject to the various other provisions relating to primary residences. The intention of this extension to the definition is to make provision for situations in which

- the spouse owning the primary residence is forced to seek employment away from where the home is located;
- that spouse does not own another property qualifying as a primary residence; and
- the other spouse continues to reside in the primary residence.

The definition of 'spouse' in s 1(1) was widened for constitutional reasons and now includes 'a same-sex or heterosexual union which is intended to be permanent'.

11.1.2.2 Polygamous marriages

What is the position when a husband is married to more than one wife under customary law and each wife lives in a different residence owned by the husband? Following the coming into force of the recognition of Customary Marriages Act 120 of 1998 on 15 November 2000, each of the wives is recognised as a spouse. The husband will have to choose which of the residences is to be regarded as his primary residence. A person may not claim the primary residence exclusion in respect of more than one residence at a time.

11.1.2.3 Mainly for domestic purposes

In order to qualify as a primary residence, the residence must be used '*mainly* for domestic purposes'. In *SBI v Lourens Erasmus (Eiendoms) Bpk*⁵⁶⁴ Botha JA held that the word 'mainly' prescribed a purely quantitative standard of more than 50%.

Example – Residence not qualifying as primary residence

Facts:

Dheveni owns a two-storey building. She runs a shop on the ground floor and lives upstairs. The area of the ground floor is 110 m², while the area of the top floor is 100 m².

Result:

Since Dheveni uses less than 50% of the residence for domestic purposes, the entire residence will not qualify as a primary residence.

⁵⁶⁴ 1966 (4) SA 444 (A), 28 SATC 233 at 245.

11.1.2.4 Non-residents

11.1.2.4.1 The meaning of ‘ordinarily resides’

Non-residents are potentially liable to CGT on the disposal of immovable property they hold in South Africa [para 2(1)(b)].

Under suitable circumstances a non-resident can have a primary residence in South Africa. A key requirement of the definition of ‘primary residence’ is that the residence must be one in which the person

‘*ordinarily resides* or resided in as his or her main residence’.

In determining whether a person ‘ordinarily resides’ in a residence, the usual common law principles used for determining whether a person is ordinarily resident can be applied. In *Cohen v CIR*⁵⁶⁵ Schreiner JA explained the meaning of ordinary residence as follows:

‘But his ordinary residence would be the country to which he would naturally and as a matter of course return from his wanderings, as contrasted with other lands it might be called his usual or principal residence and it would be described more aptly than other countries as his real home. If this suggested meaning were given to “ordinarily” it would not, I think, be logically permissible to hold that a person could be “ordinarily resident” in more than one country at the same time.’

However, when a non-resident has no other primary residence, these tests seem inappropriate.

11.1.2.4.2 No primary residence offshore

If a non-resident does not own a primary residence elsewhere and buys one for the purpose of residing in it during an extended visit to South Africa, the South African residence may comprise a primary residence. This outcome is so even though the person is not ordinarily resident in South Africa. The residence in South Africa would be the one where the person ‘ordinarily resides’ while in South Africa and would comprise his or her ‘main residence’ while in South Africa.

11.1.2.4.3 More than one primary residence

The South African home of a non-resident will not comprise a primary residence if the non-resident owns a primary residence in his or her home country. It would not be a residence in which the non-resident ‘ordinarily resides’ as his or her ‘main’ residence.⁵⁶⁶

A determination has to be made as to where a person ordinarily resides. Such a determination cannot be made over a short period of a year unless there is clear evidence that the person has decided to permanently move his or her place of ordinary residence. The temporary letting of the overseas residence will not render the South African residence a primary residence, since the person does not ordinarily reside in the South African residence as his or her main residence. The letting of a residence could be an indicator of a change of primary residence but it is by no means a decisive factor.

⁵⁶⁵ 1946 AD 174, 13 SATC 362 at 371.

⁵⁶⁶ See also ITC 1807 (2006) 68 SATC 154 (C). In that case an employee of a UK Company was assigned to a SA company for 32 months. The issue under appeal was whether the employee was away from his ‘usual place of residence’ for purposes of determining whether residential accommodation supplied to him during his stay in SA was exempt from tax under para 9(7) of the Seventh Schedule. The court held that a person’s ordinary place of residence is the place where he or she is ordinarily resident. The employee was accordingly held to be away from his usual place of residence, which was the UK.

11.1.3 Definition – ‘residence’

‘ “[R]esidence” means any structure, including a boat, caravan or mobile home, which is used as a place of residence by a natural person, together with any appurtenance belonging thereto and enjoyed therewith.’

The type of ‘structure’ envisaged is one of a more permanent nature containing sufficient facilities to make it habitable. An underground structure or a structure built into a cliff-face would possibly qualify as a residence while a tent would possibly not qualify as a residence.⁵⁶⁷ An ‘appurtenance’ would be considered as an appendage or something forming part of the residence such as a separate garage, various outbuildings, a swimming pool or a tennis court. There is a dual requirement for something to constitute an ‘appurtenance’. It must be enjoyed with the residence and must belong to the residence.

The further away that an appurtenance is from the main residence, the less likely it will be regarded as ‘belonging’ to the main residence. The leading United Kingdom case on proximity of buildings is *Lewis (Inspector of Taxes) v Lady Rook*.⁵⁶⁸ In that case the main house was an 8-bedroom mansion set in 10,5 acres of land, but the court concluded that a gardener’s cottage 175 metres from the house was clearly not within its curtilage. In cases in which there is an identifiable main house it was held that no building could form part of a dwelling house with the main house unless that building is appurtenant to, and within the curtilage of, the main house. A curtilage is a small court, yard, or piece of ground, attached to a dwelling house and forming one enclosure with it.

Example – Non-qualifying appurtenance*Facts:*

James owns two flats in Lofty Towers, one on the second floor and the other on the sixth floor. His two teenage daughters live in the second floor flat, and he uses the one room as a storeroom. The family has their meals in the sixth floor flat.

Result:

The second-floor flat is not an appurtenance in relation to the sixth-floor flat. Although it may be enjoyed with the sixth-floor flat, it does not, viewed objectively, belong to that flat. It is physically remote from the sixth-floor flat and is a separate residence.⁵⁶⁹

⁵⁶⁷ See ATO Tax Determination TD 92/158 dated 17 September 1992 which states that in most cases a tent will not be regarded as a substantial structure within the context of the equivalent Australian provision.

⁵⁶⁸ *Lewis (Inspector of Taxes) v Lady Rook* [1992] 1 WLR 662, [1992] STC 171.

⁵⁶⁹ The United Kingdom HM Revenue & Customs requires that the flats be contiguous. See the *Capital Gains Manual* in CG64305 available at <<http://www.hmrc.gov.uk/manuals/cgmanual/CG64305.htm>> [Accessed 2 November 2020]. When flats are located on different floors or are separated by other flats, the United Kingdom HM Revenue & Customs will grant private residence relief only in exceptional circumstances. Factors considered are the length of occupation and use.

11.2 General principle

Paragraph 45

11.2.1 The primary residence exclusion [para 45(1)]

Subject to para 45(2) and (3), a natural person or a special trust must in determining an aggregate capital gain or loss on disposal of a primary residence disregard

- so much of the capital gain or loss to the extent that it does not exceed R2 million⁵⁷⁰ (2007 to 2012 years of assessment: R1,5 million; 2006 and earlier years of assessment: R1 million),⁵⁷¹ or
- subject to para 45(4), a capital gain if the proceeds on disposal do not exceed R2 million).⁵⁷²

These exclusions are overridden by para 45(2), (3) and (4).

The R2 million proceeds rule described in the second bullet point above was designed to relieve taxpayers of having to keep a record of the base cost of residences with a market value of R2 million or less.

Under para 45(1A) the Minister may announce in the national annual budget contemplated in s 27(1) of the Public Finance Management Act, that, with effect from a date or dates mentioned in that announcement, the amount of the primary residence exclusion under para 45(1)(a) or (b) will be altered to the extent mentioned in the announcement.

If the Minister makes such an announcement, that alteration comes into effect on the date or dates determined by the Minister in that announcement and continues to apply for a period of 12 months from that date or those dates subject to Parliament passing legislation giving effect to that announcement within that period of 12 months.

Under para 45(2) the amounts of R2 million have to be apportioned when more than one person has an interest in the same primary residence. Paragraph 45(3) allows a person only one primary residence at a time. Paragraph 45(4) precludes the use of the R2 million proceeds threshold when a primary residence has not been ordinarily resided in on or after the valuation date or when it has been tainted by trade usage.

For the 2010 to 2012 years of assessment when the R1,5 million exclusion applied, a taxpayer did not have a right of election between para 45(1)(a) and (b). In other words, a taxpayer who disposed of an 'untainted'⁵⁷³ primary residence for R2 million or less was required to disregard the full amount of any capital gain even if it exceeded R1,5 million. However, capital losses

⁵⁷⁰ The primary residence exclusion was increased from R1,5 million to R2 million by s 10 of the Rates and Monetary Amounts and Amendment of Revenue Laws Act 13 of 2012 and deemed to have come into operation on 1 March 2012 and applies to years of assessment commencing on or after that date.

⁵⁷¹ The primary residence exclusion was increased from R1 million to R1,5 million by s 33 of the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

⁵⁷² The R2 million threshold was introduced by s 73 of the Taxation Laws Amendment Act 17 of 2009 and deemed to have come into operation on 1 March 2009 and applies in respect of years of assessment commencing on or after that date. It was amended retrospectively to the same date by s 103(1) of the Taxation Laws Amendment Act 7 of 2010 to apply only to capital gains.

⁵⁷³ See para 45(4).

were not affected by para 45(1)(b). Thus, a taxpayer whose proceeds were R2 million or less could claim a capital loss to the extent that it exceeded R1,5 million.

There is no limit on the number of times a person can qualify for the exclusion of R2 million, even during the same year of assessment. It applies each time a primary residence is disposed of and there is no lifetime limit. Thus, a person could qualify for more than one primary residence exclusion in a year of assessment if multiple primary residences were disposed of in that year. However, a person who regularly disposes of and acquires primary residences as part of a scheme of profit-making could be subject to a full inclusion in income in the same way as a share-dealer and in such event the exclusion of R2 million will not avail the person. Under these circumstances, the person would hold the primary residences as trading stock. The cost price of a residence held as trading stock would be deductible under s 11(a) and if the residence were still on hand at the end of the year of assessment, its value (cost price or written-down value) would be included in gross income by way of closing stock under s 22(1). The closing stock value would form the opening stock deduction in the next year of assessment under s 22(2). Double taxation and double deductions for CGT purposes would be eliminated by para 35(3)(a) and para 20(3)(a) respectively.

Example 1 – Capital gain on disposal of primary residence

Facts:

On 1 October 2001 Obert purchased a residence to be used solely as his primary residence for a total cost of R1,25 million. During the 2020 year of assessment Obert sold this primary residence for R3,5 million in order to purchase another primary residence.

Result:

Assuming Obert pays income tax at the maximum marginal rate of 45% and that he has no other capital gains or losses in the 2020 year of assessment, his additional income tax liability as a result of the capital gain realised is determined as follows.

	R
Proceeds	3 500 000
Less: Base cost	<u>(1 250 000)</u>
Subtotal	2 250 000
Disregarded under para 45(1)(a)	<u>(2 000 000)</u>
Balance subject to CGT	250 000
Less: Annual exclusion	<u>(40 000)</u>
Aggregate capital gain	<u>210 000</u>
Taxable capital gain (R210 000 × 40%)	<u>84 000</u>
Tax payable (R84 000 × 45%)	<u>37 800</u>

Example 2 – Proceeds not exceeding R2 million and capital loss would have arisen

Facts:

Tineke bought her primary residence in 2004 for R3,5 million. She disposed of it during the 2020 year of assessment for R1,4 million.

Result:

Although the proceeds do not exceed R2 million, para 45(1)(b) does not apply to capital losses. Accordingly, Tineke's capital loss is determined as follows:

	R
Proceeds	1 400 000
Less: Base cost	<u>(3 500 000)</u>
Subtotal	(2 100 000)
Disregarded under para 45(1)(a)	<u>(2 000 000)</u>
Capital loss	<u>(100 000)</u>

11.2.2 Apportionment of the primary residence exclusion when more than one person has an interest in a primary residence [para 45(2)]

The primary residence exclusion of R2 million (2007 to 2012: R1,5 million; 2006 and earlier years of assessment: R1 million) and the R2 million proceeds threshold operate on a 'per primary residence' basis and not on a 'per person holding an interest in the primary residence' basis. This requirement means that when, for example, two individuals have an equal interest in the same primary residence, each of them will be entitled to a primary residence exclusion of a maximum of R1 million (2007 to 2012 years of assessment: R750 000; 2006 and earlier years of assessment: R500 000). In this example they would also disregard any capital gain or loss if the proceeds on disposal of each person's share were R1 million or less.

This situation would typically apply to spouses married in community of property.

When more than one person holds an interest in the same residence, the primary residence exclusion and the proceeds threshold are split only between those persons who occupy the residence as their *primary residence*. The interests of persons who do not reside in the residence as their primary residence are not taken into account.

Example 1 – Spouses married in community of property

Facts:

Neil and Marlane are married in community of property. On 1 October 2001 they purchased a primary residence for R1 million which formed part of their joint estate. During the 2020 year of assessment they sold it for R4 million.

Result:

Assuming that Neil and Marlane have no other capital gains or losses in the 2020 year of assessment, their taxable capital gains are determined as follows:

	Total R	Neil R	Marlane R
Capital gain apportioned under para 14	3 000 000	1 500 000	1 500 000
Less: Disregarded under para 45(2)	<u>(2 000 000)</u>	<u>(1 000 000)</u>	<u>(1 000 000)</u>
Balance subject to CGT	<u>1 000 000</u>	500 000	500 000
Less: Annual exclusion		<u>(40 000)</u>	<u>(40 000)</u>
Aggregate capital gain		<u>460 000</u>	<u>460 000</u>
Taxable capital gain (R460 000 × 40%)		<u>184 000</u>	<u>184 000</u>

Example 2 – Residence qualifying as primary residence for part of the period of ownership*Facts:*

Otto acquired a house in Durban before 1 October 2001 which He used as his primary residence for six years following that date. The base cost of the house was R1 300 000 on valuation date. On 1 October 2007 he moved to Pretoria where he bought a new primary residence. He decided to let the house in Durban for investment purposes. After 12 years of letting he sold the property for R7 600 000 on 1 October 2019.

Result:

Otto's capital gain is calculated as follows:

The capital gain is R6 300 000 (R7 600 000 – R1 300 000). The portion of the gain that relates to the period when the residence was a primary residence is 6 / 18, that is, R6 300 000 × 6 / 18 = R2 100 000.

	Primary residence R	Not a primary residence R	Total R
Gain	2 100 000	4 200 000	6 300 000
Less: PR exclusion	(2 000 000)	-	(2 000 000)
Capital gain	<u>100 000</u>	<u>4 200 000</u>	<u>4 300 000</u>

This example illustrates that it is necessary to first determine the portion of the capital gain or loss attributable to the primary residence before applying the exclusion of R2 million to that part.

Example 3 – More than one person having an interest in a residence which is not a primary residence of some of those persons*Facts:*

Beatrix and Beatriz are sisters. They each owned a 50% share in a house which Beatriz occupied as her primary residence. Beatrix did not live in the residence because she lived in another house. The sisters disposed of the residence and each realised a gain of R2 million for their respective shares.

Result:

Beatriz will be entitled to the full primary residence exclusion of R2 million, since she is the only person having an interest in the residence as a primary residence. Beatrix is not entitled to the primary residence exclusion, since she did not occupy the residence as her primary residence.

11.2.3 Only one residence at a time may be a primary residence of a person [para 45(3)]

Only one residence may be a primary residence of a person for any period during which that person held more than one residence. This requirement means that there could never be an overlapping period when one person owns two residences and uses both as primary residences, except when para 48 applies. The latter provision allows for a two-year overlap under specified circumstances.

Example – Ownership of more than one primary residence*Facts:*

After living in Cape Town for some years, Quartus purchased homes in Cape Town and Johannesburg for R500 000 each on 1 October 2001. He owned a business that operated in both Cape Town and Johannesburg and spent six months of each year in each home, although he remained a Capetonian at heart with most of his social acquaintances and family residing in Cape Town. On 29 February 2020 he retired and sold both homes in order to acquire a retirement cottage in a quiet coastal village. The Cape Town home realised R2,6 million and the Johannesburg home R1,8 million.

Result:

Since Quartus presented evidence that his personal and economic relations are closer to Cape Town than to Johannesburg, it is accepted that his Cape Town home is his primary residence.

Cape Town

	R
Proceeds	2 600 000
Less: Base cost	<u>(500 000)</u>
Gain	2 100 000
Less: Primary residence exclusion	<u>(2 000 000)</u>
Capital gain	<u>100 000</u>

Johannesburg

Proceeds	1 800 000
Less: Base cost	<u>(500 000)</u>
Capital gain	<u>1 300 000</u>

Quartus will therefore include capital gains totalling R1 400 000 (R100 000 + R1 300 000) in his aggregate capital gain or loss for the 2020 year of assessment.

11.2.4 Restriction on use of the R2 million proceeds threshold for exclusion [para 45(4)]

Under para 45(1)(b) a natural person or special trust must disregard the capital gain or loss on disposal of a primary residence if the proceeds on disposal are R2 million or less. However, this exclusion does not apply if the natural person or special trust

- was not ordinarily resident in the residence throughout the period commencing on or after the valuation date during which that person or special trust held that interest, or
- used the residence or a part of it for the purposes of carrying on a trade for any portion of the period commencing on or after the valuation date during which the person or special trust held the interest.

These disqualifying criteria are required to ensure that the portion of a capital gain or loss that does not relate to the use of a residence as a primary residence is brought to account as a capital gain or loss. A taxpayer who has such a tainted primary residence will similarly not qualify for the exclusion of R2 million on the 'tainted' portion of any capital gain or loss.

Example 1 – When the R2 million threshold does not apply (period not ordinarily resident)*Facts:*

Lizette acquired her primary residence in Durban in 1998. On 1 October 2002 she moved to Kriel where she purchased a new primary residence. She used the Durban residence as a holiday home until 30 September 2008. On 1 October 2008 she sold the Kriel home and moved back to the Durban residence which she reoccupied as her primary residence until 30 September 2019 when she sold it for R1,9 million. The base cost of the Durban residence was R100 000.

Result:

The proceeds threshold of R2 million under para 45(1)(b) for the exclusion of a capital gain on disposal of a primary residence does not apply because Lizette was not ordinarily resident in the Durban residence as her primary residence for a portion of the period on or after the valuation date (1 October 2002 to 30 September 2008 = 6 years). The overall gain is R1 800 000 [R1,9 million (proceeds) less R100 000 (base cost)]. Of this amount, 12/18 or R1 200 000 qualifies for the exclusion of R2 million. The balance of R600 000 (6 / 18 × R1,8 million) must be brought to account as a capital gain in determining Lizette's aggregate capital gain or loss.

Example 2 – When the threshold of R2 million does not apply (trade usage)*Facts:*

Antoinné acquired her primary residence in 1996. From 1 October 2001 until she sold it on 31 January 2020, she used 10% of the house as a home study and consulting room for her legal practice. The proceeds on disposal of the residence amounted to R2 million and its base cost was R500 000.

Result:

The proceeds threshold under para 45(1)(b) of R2 million for the exclusion of a capital gain on disposal of a primary residence does not apply because Antoinné used a portion of the house for the purposes of trade during the period on or after the valuation date. She will therefore have to determine a capital gain or loss. Of the overall gain of R1,5 million [R2 million (proceeds) less R500 000 (base cost)], R150 000 (10%) comprises a capital gain which must be accounted for in determining her aggregate capital gain or loss for the 2020 year of assessment. The balance of the overall gain of R1 350 000 (R1,5 million – R150 000) must be disregarded because it is less than the primary residence exclusion of R2 million.

11.3 Part-disposal of a primary residence

In some circumstances part of the primary residence may be disposed of. This situation could happen, for example, when

- a part of the main residence is disposed of (for example, by converting a single house into a pair of maisonettes),
- the bare *dominium* or usufruct in the residence is disposed of,
- a part of the primary residence is bequeathed to a surviving spouse, or
- a part of the rights attaching to the residence are lost as a result of the obstruction of the view from the residence.

Paragraph 45(1) does not deal explicitly with the part-disposal of a primary residence. This fact raises the question whether the primary residence exclusion is available under such circumstances. Under para 46(c) the exclusion is not available when land is disposed of separately from the 'residence'. It is provided that the land must be

'disposed of at the same time and to the same person as that residence'.

But this does not address the situation in which a part of the residence is disposed of.

Even in the core disposal rules in para 11, the part-disposal principle is not explicitly stated. Yet, it is clearly recognised in para 33 which sets out how the base cost of a part of an asset that has been disposed of is to be determined. It can therefore be accepted that the exclusion will be available when a part of the residence is disposed of.

The next question is how the exclusion must be apportioned under such a part-disposal.

The underlying principle is that a person's primary residence exclusion should not exceed R2 million for a single physical structure. Thus, if a person decides to embark on a piecemeal disposal of a residence, the person's exclusion should not exceed R2 million for the sum of the parts. Unlike the annual exclusion, the primary residence exclusion is unavailable annually and is tied to the physical structure. This view is supported by para 45(2), which requires that when more than one natural person or special trust jointly holds an interest in a primary residence at the same time (a natural consequence of a part-disposal), the exclusion of R2 million must be apportioned in relation to each interest so held.

Example 1 – Part-disposal of primary residence

Facts:

Wouter owns a large house with a base cost of R2 million and a current market value of R10 million. He sold a 40% interest in the residence to Lynette for R4 million. They occupied the house as their primary residence. Lynette and Wouter are not spouses.

Result:

Wouter's primary residence exclusion on the part disposed of is R800 000 (R4 000 000 / R10 000 000 × R2 000 000).

His capital gain is determined as follows:

	R
Proceeds	4 000 000
Less: Base cost (40%×R2 000 000)	<u>(800 000)</u>
Gain	3 200 000
Less: Primary residence exclusion (see above)	<u>(800 000)</u>
Capital gain	<u>2 400 000</u>

After the disposal, under para 45(2) the remaining primary residence exclusion of R1,2 million (R2 000 000 – R800 000) will be allocated between Wouter and Lynette in accordance with their respective interests as follows:

	R
Wouter – R1,2 million × 60%	720 000
Lynette – R1,2 million × 40%	<u>480 000</u>
	<u>1 200 000</u>

Example 2 – Further part-disposal of primary residence*Facts:*

The facts are the same as in Example 1 but the saga continues. Two years later Wouter sold his 60% interest to Lynette for R6 million.

Result:

Wouter's capital gain is determined as follows:

	R
Proceeds	6 000 000
Less: Base cost (R2 000 000 – R800 000)	<u>(1 200 000)</u>
Gain	4 800 000
Less: Primary residence exclusion (balance remaining)	<u>(720 000)</u>
Capital gain	<u>4 080 000</u>

Lynette's primary residence exclusion remains at R480 000.

Example 3 – Disposal of appurtenance*Facts:*

Ernie owns a two-hectare property on which his primary residence is situated. The grounds include a swimming pool and tennis court. After receiving an offer from a developer that he could not refuse, Ernie decided to subdivide his property and sell the portion of the land containing the swimming pool and tennis court.

Result:

The portion of the land disposed of will not qualify for the primary residence exclusion, since it has not been disposed of at the same time and to the same person as the structure used as a place of residence [para 46(c)]. The appurtenances (tennis court and swimming pool) have not been disposed of 'together with' the residence. The view is held that in order to constitute the disposal of a 'residence', the appurtenances must be disposed of at the same time as the main residential structure (see the definition of 'residence').

11.4 Awards of damages in respect of loss of a view

Following the *Paola*⁵⁷⁴ case, there have been a number of cases in which persons have instituted actions for damages as a result of their view being obstructed by the erection of structures by other persons. Awards of this nature are subject to CGT when the residence is not held as trading stock. When the offending structures are erected, the person who erected them creates a right in favour of the injured party. The right so acquired is disposed of when it is extinguished by way of discharge. The proceeds from that disposal will be the amount received or accrued. The proceeds in respect of a disputed claim will accrue only once it is settled. The base cost of the right disposed of would include, for example, legal fees in bringing the action to court, as well as a part of the base cost of the residence and the land on which it is situated. The portion of the base cost disposed of must be determined under para 33.

For the purposes of para 45(1) the primary residence exclusion must be apportioned to the damages receivable, and the remaining portion of the exclusion will be available when the primary residence is subsequently disposed of.

⁵⁷⁴ *Paola v Jeeva NO & others* 2004 (1) SA 396 (SCA).

Example – Award of damages for obstruction of view*Facts:*

Amanda owns a house with stunning sea views in Margate that she uses as her primary residence. Matthew owns the land between Amanda's house and the high water mark. He proceeded to erect a double-storey house in front of Amanda's house that completely obstructed her sea view. Matthew's actions had the effect of devaluing Amanda's house and she sued Matthew for damages. After a protracted legal battle, the court awarded Amanda R500 000 which Matthew duly paid. The base cost of Amanda's house was R420 000 and its market value immediately before receipt of the damages was R3 million. Amanda incurred legal fees of R10 000 that could not be recovered from Matthew. Two years later Amanda disposed of the house for R2,5 million.

Result:

Amanda's capital gain is determined as follows:

Award of damages

Base cost of part disposed of	R
House ($R500\ 000 / R3\ 000\ 000 \times R420\ 000$)	70 000
Legal fees	<u>10 000</u>
	<u>80 000</u>
Primary residence exclusion used ($R500\ 000 / R3\ 000\ 000 \times R2\ 000\ 000$)	<u>333 333</u>
Proceeds	500 000
Less: Base cost	<u>(80 000)</u>
Gain	420 000
Less: Primary residence exclusion	<u>(333 333)</u>
Capital gain	<u>86 667</u>

Disposal of house

The capital gain on disposal of Amanda's house is determined as follows:

Proceeds	2 500 000
Less: Base cost ($R420\ 000 - R70\ 000$)	<u>(350 000)</u>
Gain	2 150 000
Less: Primary residence exclusion ($R2\ 000\ 000 - R333\ 333$)	<u>(1 666 667)</u>
Capital gain	<u>483 333</u>

11.5 Size of residential property qualifying for exclusion

Paragraph 46

The term 'primary residence' does not include the land on which it is situated. This paragraph extends the primary residence exclusion to include such land, including unconsolidated adjacent land, subject to three important exceptions.

11.5.1 The size limitation [para 46(a)]

The primary residence exclusion applies only to so much of the land that does not exceed two hectares. For land that exceeds two hectares it will be necessary to determine the capital gain attributable to the two-hectare portion, and apply the exclusion of R2 million against that portion.

11.5.2 The use with the residence requirement [para 46(b)]

The land must be used mainly for domestic or private purposes together with the residence. Examples include land containing a swimming pool, tennis court or stables. Whether it is used 'together' with the residence is a question of fact.

11.5.3 The simultaneous disposal requirement [para 46(c)]

The land must be disposed of

- at the same time, and
- to the same person as the residence.

Example – Sale of portion of land without primary residence

Facts:

Wilna acquired a primary residence on 4 000 square metres of land before valuation date. On 1 October 2001 she determined the market value of the property as R3,6 million. In 2005 she erected a wall around the property at a cost of R300 000. On 29 February 2020 she decided to subdivide the property and disposed of 1 000 square metres of vacant land forming part of the property for R1,4 million. Wilna no longer had any record of the original acquisition cost of the primary residence. She estimated the market value of the entire property immediately before the sale at R6 million.

Result:

Since Wilna does not have a record of pre-valuation date expenditure, she will have to use the market value basis to determine the valuation date value of the property.

Under para 33(1) the base cost of the part disposed of is equal to $R1,4 \text{ million} / R6 \text{ million} \times R3,6 \text{ million} = R840 \text{ 000}$. The portion of the expenditure on the wall disposed of is equal to $R1,4 \text{ million} / R6 \text{ million} \times R300 \text{ 000} = R70 \text{ 000}$.

The base cost of the part disposed of is thus $R840 \text{ 000} + R70 \text{ 000} = R910 \text{ 000}$. Wilna will thus realise a capital gain of $R1,4 \text{ million (proceeds)} - R910 \text{ 000 (base cost)} = R490 \text{ 000}$.

The remaining market value on valuation date available for use when the primary residence is ultimately disposed of is $R3,6 \text{ million} - R840 \text{ 000} = R2 \text{ 760 000}$. The remaining expenditure on the wall which can also be taken into account when the primary residence is ultimately disposed of is $R300 \text{ 000} - R70 \text{ 000} = R230 \text{ 000}$.

11.5.4 Adjacent land

The word 'adjacent' as used in the words 'unconsolidated adjacent land' does not mean adjoining, and it is not necessary for two properties to be in contact with each other. On the contrary, the word must be given the meaning of close to or near.⁵⁷⁵ It has been held that a mine located four miles away from another was not adjacent thereto.⁵⁷⁶ Each case must be judged on its own merits to determine whether the required degree of proximity is present.

Example – Apportionment when land exceeds two hectares

Facts:

Rick acquired a smallholding, three hectares in size, shortly after 1 October 2001. The total cost of acquisition amounted to R2 450 000. At the time vacant land in the area was selling for R583 333 a hectare. He took occupation of the property immediately after it had been acquired and occupied it throughout the period of ownership until the property was sold. Over the period of ownership improvements amounting to R150 000 were effected to the property. These comprised the cost of perimeter fencing (R120 000) and the cost of a lock-up garage (R30 000). Repairs amounting to R18 000 were also carried out. The smallholding was sold for R6 million and estate agent's commission of 8% (R480 000) was paid. The price of vacant land in the area at the time of sale was R1 666 667 a hectare. The total property was used mainly for domestic purposes in association with the primary residence.

Result:

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

Proceeds – The market value of 3 hectares of land in the area was $R1\ 666\ 667 \times 3 = R5\ \text{million}$. It is therefore estimated that the residential building was sold for $R6\ \text{million} - R5\ \text{million} = R1\ \text{million}$.

Acquisition cost – The market value of 3 hectares of land in the area at the time of acquisition was $R583\ 333 \times 3 = R1\ 750\ 000$. It is therefore estimated that the residential building was acquired for $R2\ 450\ 000 - R1\ 750\ 000 = R700\ 000$.

Cost of improvements – The cost of the perimeter fencing has been allocated to the land and the lock-up garage has been allocated to the residential building. The garage is an 'appurtenance' that falls within the definition of 'residence' in para 45.

Estate agent's commission – On land = $R5\ 000\ 000 \times 8\% = R400\ 000$. On building = $R1\ 000\ 000 \times 8\% = R80\ 000$.

⁵⁷⁵ *City of Wellington v Borough of Lower Hutt*, [1904] AC 773.

⁵⁷⁶ *Kimberley Waterworks Co, Ltd v De Beers Consolidated Mines, Ltd* [1897] AC 515 at 518.

	Land R	Residential Building R	Total R
Proceeds	5 000 000	1 000 000	6 000 000
<i>Less:</i>			
Acquisition cost	(1 750 000)	(700 000)	(2 450 000)
Cost of improvements	(120 000)	(30 000)	(150 000)
Repairs (not part of base cost)	-	-	-
Estate agent's commission on sale	<u>(400 000)</u>	<u>(80 000)</u>	<u>(480 000)</u>
Capital gain	<u>2 730 000</u>	<u>190 000</u>	<u>2 920 000</u>

The above method of apportionment is presented for illustrative purposes and may not be appropriate in other situations. Any method of apportionment must be logical, fair and reasonable and take into account the facts and circumstances of the particular case.

The next step is to determine the portion of the capital gain on the land (R2 730 000) that is attributable to the primary residence. That portion, together with the capital gain on the residential building, will comprise the capital gain on the primary residence (before applying the primary residence exclusion).

	Primary Residence (2 ha) R	Remaining Land (1 ha) R	Total R
Land	1 820 000	910 000	2 730 000
Residential buildings	<u>190 000</u>	<u>-</u>	<u>190 000</u>
Capital gain	2 010 000	910 000	2 920 000
<i>Less: Primary residence exclusion</i>	<u>(2 000 000)</u>	<u>-</u>	<u>(2 000 000)</u>
Balance subject to CGT	<u>10 000</u>	<u>910 000</u>	<u>920 000</u>

The capital gain on the land has been allocated on an area basis as follows:

$R2\,730\,000 \times 2 / 3 = R1\,620\,000$ (primary residence portion)

$R2\,730\,000 \times 1 / 3 = R910\,000$ (1 ha remaining land portion).

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

11.6 Apportionment for periods when not ordinarily resident

Paragraph 47

Paragraph 47 applies when an individual or special trust

- disposes of an interest in a residence which is or was a primary residence, and
- that individual or a beneficiary of that special trust or a spouse of that individual or beneficiary, was not ordinarily resident in that residence throughout the period on or after the valuation date during which that individual or special trust held that interest.

Under these circumstances para 45(1)(a) (the exclusion of R2 million) applies only in respect of the portion of the capital gain or loss on disposal of the primary residence that is attributable to any period on or after the valuation date during which the person, beneficiary or spouse was so ordinarily resident.

The overall capital gain or loss must therefore be split into 'primary residence' and 'non-primary residence' portions, with only the primary residence portion of the overall capital gain or loss qualifying for the exclusion of R2 million under para 45(1)(a). The exclusion of R2 million is not apportioned.

The non-primary residence portion of the overall capital gain or loss must be fully accounted for and is not subject to exclusion under para 45, although the annual exclusion may be available to the extent that it has not been used against other capital gains and losses. The apportionment must be done on a time basis with reference to the period on or after the valuation date. The fact that the person may not have been resident in the residence before valuation date is not taken into account. It is impermissible to apportion the overall capital gain by using the market value of the property on the date of ceasing to be resident. Only time apportionment is permitted.

Paragraph 47 is subject to paras 48 and 50. The latter two provisions relax the apportionment rule by deeming the person to be ordinarily resident in a residence even though in reality this is not the case.

The meaning of the words 'ordinarily resident' has been considered in a number of court decisions in an income tax context. The principles laid down in these cases can also be used as guidelines as to its meaning in the context of the primary residence provisions.⁵⁷⁷

Example 1 – Apportionment of capital gain for period not ordinarily resident

Facts:

Seni bought a property for R1 million on 1 October 2012. She used the property as her primary residence until she emigrated from South Africa on 30 April 2014. She placed the property on the market in 2020 and finally sold it for R6 million on 31 January 2020.

⁵⁷⁷ See Interpretation Note 3 (Issue 2) dated 20 June 2018 'Resident: Definition in Relation to a Natural Person – Ordinarily Resident' and the cases there cited.

Result:

Upon emigrating Seni is no longer considered ordinarily resident in South Africa and hence, would not be considered ordinarily resident in her residence from the date of emigration. No deemed disposal of the property takes place by virtue of s 9H(4)(a) because the asset is immovable property situated in South Africa. The period of residence is determined as follows:

Tax year	Primary residence	Not a primary residence	Total
	Months	Months	Months
2013	5	-	5
2014	12	-	12
2015	2	10	12
2016	-	12	12
2017	-	12	12
2018	-	12	12
2019	-	12	12
2020	-	<u>11</u>	<u>11</u>
	<u>19</u>	<u>69</u>	<u>88</u>

	R
Proceeds	6 000 000
Less: Base cost	<u>(1 000 000)</u>
Gain	5 000 000
Less: Portion of gain relating to period of ordinary residence and qualifying for primary residence exclusion (19 / 88 × R5 000 000)	<u>(1 079 545)</u>
Capital gain	<u>3 920 455</u>

If Seni has no other capital gains or losses in the year of disposal, this amount will be reduced further by the annual exclusion of R40 000.

Example 2 – Ordinarily resident despite physical absence*Facts:*

Thomas's employer transferred him from East London to Durban. He had owned his home in East London for 20 years and decided 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 moved to Durban where they hired a residence as Thomas had only two years before he retired. They spent their holidays in East London and stayed in the home. Upon retirement Thomas and his wife returned to their home in East London. By that stage their son had completed his studies and intended to move out of the home.

Result:

Can Thomas 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 para 47, which would require apportionment if Thomas was not considered ordinarily resident in the East London home during his two-year absence.

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

Example 3 – Not ordinarily resident

Facts:

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

Result:

From the information at hand Victor would be considered not to be ordinarily resident in Plettenberg Bay. Victor resides in a home belonging to his wife where he is permanently located. He is employed in Johannesburg and has never returned to Plettenberg Bay other than for holidays. Victor would not be considered ordinarily resident in Plettenberg Bay and hence any capital gain made upon disposal of his residence in Plettenberg Bay would be subjected to CGT in full.⁵⁷⁸

11.7 Disposal and acquisition of primary residence

Paragraph 48

Paragraph 47 provides for apportionment when a person was not ordinarily resident in a primary residence throughout the period on or after the valuation date. Paragraph 48 prevents this apportionment by deeming a natural person or a beneficiary of a special trust to have been ordinarily resident in a residence when that person or beneficiary was absent from it for a continuous period not exceeding two years. This rule applies in four situations.

11.7.1 Residence vacated and offered for sale [para 48(a)]

This item deals with an overlapping period of ownership. It overrides the general rule in para 45(3) which provides that a person may not have more than one primary residence at the same time.

It applies when

- a residence was a person's primary residence,
- at that time it was offered for sale, and

⁵⁷⁸ See ITC 961 (1961) 24 SATC 648 (F).

- vacated

due to the acquisition or intended acquisition of a new primary residence.

This concession will not apply to any period during the two years in which the residence was let. This outcome follows from para 48(a) which requires the residence to be vacated, and from the fact that para 49 is not subject to para 48.

Example – Old residence offered for sale owing to acquisition/intended acquisition of new residence

Facts:

Xolani was transferred from Knysna to Cape Town and struggled to sell her home in Knysna. In the meantime, she acquired a home in Cape Town and was able to eventually sell her Knysna home 18 months later.

Result:

Under para 48(a) Xolani is treated as having been ordinarily resident in the Knysna home during the 18 months that it was on the market. No apportionment of any capital gain or loss on disposal of the Knysna home is therefore required.

11.7.2 Erection of new primary residence [para 48(b)]

This item caters for the situation in which land has been purchased with the intention of erecting a primary residence on it. Land on its own would not be a primary residence, since the definition of 'residence' means 'any structure'. A primary residence cannot exist without a 'structure'. Therefore, for the duration of the time taken to erect a structure, (that is, a home) that period would not qualify as the owner's ordinary residence without this overriding provision. It effectively allows a person a two-year period in which to complete the erection of a residence to be used as a primary residence without penalising that person.

11.7.3 Primary residence rendered accidentally uninhabitable [para 48(c)]

This item is similar to para 48(b) and caters for situations in which a primary residence is rendered accidentally uninhabitable, for example, is destroyed by fire, flood, earthquake, landslide, wind or other similar act. It would not, however, apply when a person deliberately destroys a residence, for example, by setting fire to it in order to fraudulently claim against insurance.

11.7.4 Death of person with an interest in a primary residence [para 48(d)]

This item applies to the two-year period after the death of the person who held an interest in the primary residence. During this period or until the residence is disposed of by the executor of the estate, whichever is the shorter, the deceased is treated as having been ordinarily resident in the residence. See **16.3.4**.

Example – Disposal of primary residence by executor

Facts:

Piet acquired a residence after the valuation date at a cost of R1 million. He lived in the residence as his primary residence for five years before letting it for five years. He died at the end of the 10-year holding period while living overseas in a residential hotel. The residence was valued at R3,5 million on his date of death. His executor sold the residence to a third party after three years for R6,5 million.

Result:**Piet**

Under s 9HA(1) Piet is deemed to have disposed of the residence for proceeds of R3,5 million, resulting in an overall gain of R2,5 million (R3,5 million proceeds – R1 million base cost). Under para 49 the portion of the capital gain qualifying for the exclusion of R2 million is $R2,5 \text{ million} \times 5 / 10 \text{ years} = R1\,250\,000$. The remaining portion of the capital gain of R1 250 000 will not qualify for the primary residence exclusion. Assuming that there are no other capital gains and losses Piet will thus have a taxable capital gain of $R1\,250\,000 - R300\,000$ (annual exclusion in year of death) = $R950\,000 \times 40\%$ inclusion rate = R380 000.

Piet's deceased estate

Under s 25(2) Piet's deceased estate is treated as having acquired the residence at a base cost of R3,5 million. The proceeds on disposal were R6,5 million leaving an overall gain of R3 million. Under para 40(3) the deceased estate must be treated in the same manner as if Piet had disposed of the residence. Since Piet had lived in the residence as his primary residence for five years, he would have been entitled to the primary residence exclusion had he continued to live. Under para 48(d) Piet is deemed to have ordinarily resided in the residence for two years after his date of death. Therefore, for the purposes of para 47, the portion of the capital gain to be disregarded under para 45 by Piet's deceased estate is $R3 \text{ million} \times 2 / 3 \text{ years} = R2 \text{ million}$. Since this amount is equal to the primary residence exclusion, it must be disregarded in full. The remaining portion of the capital gain of R1 million (R3 million – R2 million) constitutes a capital gain. Assuming that Piet's estate has no other capital gains and losses, it will have a taxable capital gain of $R1 \text{ million} - R40\,000$ annual exclusion = $R960\,000 \times 40\%$ inclusion rate = R384 000.

Note:

The fact that Piet did not ordinarily reside in the residence on his date of death is not a bar to him or his estate being entitled to the primary residence exclusion. The definition of 'primary residence' in para 44 refers to a person that 'ordinarily resides or resided in' and which the person 'uses or used mainly for domestic purposes'. In other words, the inclusion of the past tense in the definition means that the residence does not have to be ordinarily resided in or used for domestic purposes at the time of disposal. It suffices if the residence was so used for a portion of the period on or after the valuation date.

Both Piet and his deceased estate are entitled to the exclusion of R2 million because they are separate persons for income tax purposes and are not deemed under the Act to be one and the same person.

Had Piet's executor continued to let the residence for a portion of the two-year period on or after the date of death, Piet's deceased estate would not have been entitled to the exclusion of R2 million in respect of any part of the capital gain attributable to the period of letting by virtue of para 49.

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

In each of the situations in para 48(a) to (d), if the actual period exceeds two years, the concession will be limited to two years, and an apportionment will be necessary. As with para 47, the apportionment must be done on a time basis. It is impermissible to apportion the overall capital gain by using the market value of the property at the end of the two-year period.

11.8 Non-residential use

Paragraph 49

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

A primary residence becomes tainted during any period in which a part of it is used for the purpose of trade. It is irrelevant whether the person is or was entitled to any deduction for the expenditure relating to the part used for trade purposes.

A primary residence can be tainted through trade usage in a variety of ways. For example,

- the residence could be occupied as a primary residence for a period and let for a period;
- a portion of the residence could be used for trade purposes while the rest is used as a primary residence, such as the ground floor being used as a shop or one or more rooms being used as a home office or consulting rooms.

The overall capital gain or loss on disposal of the primary residence must be apportioned between its tainted and untainted elements. The exclusion of R2 million in para 45(1)(a) is available for set-off against the untainted portion of the capital gain or loss, while the tainted portion of the capital gain must be fully brought to account, subject to the availability of the annual exclusion. The exclusion of R2 million remains intact and is not apportioned. The manner in which the capital gain or loss is so apportioned will depend on the facts and circumstances of the particular situation. Sometimes a time-based apportionment will be appropriate, for example, when the entire residence is occupied as a primary residence for a period and then let for the remainder of the period). In other situations, a calculation based on floor area will be appropriate, for example, when a portion of the residence is used for trade purposes. In other situations, a combination of the time and area methods may have to be used, for example, when the residence was used exclusively as a primary residence for a period and then a portion of it was used for trade purposes.

Only the period on or after the valuation date is taken into account in the apportionment calculation. This point will be of relevance to a residence acquired before the valuation date.

Use of residence for trade purposes by other persons

Paragraph 49 provides for apportionment of a capital gain or loss on disposal of a primary residence into primary residence and non-primary residence portions when the person who disposes of the residence or the beneficiary of the special trust uses it for the purposes of trade. While para 49(b) makes reference only to 'that person' and 'a beneficiary of that special trust', the word 'spouse' is mentioned in the words following para 49(b) ('that person, beneficiary or spouse'). It is thus considered that any trade usage by the spouse of a person, or beneficiary of a special trust will result in apportionment of any capital gain or loss into primary residence and non-primary residence portions.

It does not, however, address the situation in which a person other than 'that person, beneficiary or spouse' uses the residence for trade purposes without the payment of rent, such as a child of the person. It follows that apportionment cannot be applied in such situations. Nevertheless, para (b)(ii) of the definition of 'primary residence' in para 44 requires that the residence be used by the person or beneficiary 'mainly for domestic purposes'. Thus, a person or special trust will not be entitled to the exclusion of R2 million if a child of the person or beneficiary of the special trust used 51% of the residence for trade purposes because it could

not then be said that the person, beneficiary or spouse had used the residence mainly for domestic purposes.

Example 1 – Letting of primary residence

Facts:

On 1 March 2007 Mary acquired a residence at a cost of R1 million which she used as her primary residence until 28 February 2014. On 1 March 2014 she moved out of the residence and let it to a tenant at a monthly rental. The letting of the residence continued until 1 March 2019 when Mary disposed of the residence for proceeds of R4 million.

Result:

The overall capital gain on disposal of the residence is R4 million – R1 million = R3 million. Mary held the residence for a total period of 12 years. She used the residence as a primary residence for 7 years and let it for 5 years. It follows that 7 / 12 of the capital gain of R3 million will qualify for the primary residence exclusion while the remaining 5 / 12 will not. Mary's capital gain will therefore be determined as follows:

	R
Tainted capital gain R3 million × 5 / 12	1 250 000
Capital gain attributable to primary residence R3 million × 7 / 12	<u>1 750 000</u>
Overall capital gain before exclusion	<u>3 000 000</u>
Capital gain attributable to primary residence before exclusion	1 750 000
Less: Primary residence exclusion R2 million limited to capital gain	<u>(1 750 000)</u>
Capital gain on primary residence portion	-
Capital gain on tainted portion	<u>1 250 000</u>
Total capital gain	<u>1 250 000</u>

Example 2 – Residence used partly for trade purposes

Facts:

Yolandi acquired a residence after valuation date for R350 000 and resided in it for ten years. During this time, she operated her media relations consulting business from the premises. Approximately 35% of the floor space was used for business purposes. Yolandi also claimed 35% of her current costs as a business expense against her business income for tax purposes. As an opportunity arose for her to expand her business 10 years after she had acquired the property, she purchased another residence in which to live and converted her old residence into business premises. Fifteen years after converting the property she sold it for R2 650 000. Improvements over the years and all other costs associated with the acquisition and disposal of the property amounted to R250 000.

Result:

	R
Proceeds upon disposal	2 650 000
Less: Base cost (R350 000 + R250 000)	<u>(600 000)</u>
Capital gain	2 050 000
Less: Part in respect of period not ordinarily resident (R2 050 000 × 15 / 25)	<u>(1 230 000)</u>
	820 000
Less: Part partially used for trade purposes (R820 000 × 35%)	<u>(287 000)</u>
Capital gain attributable to portion used as a primary residence	<u>533 000</u>

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

Example 3 – Apportionment of capital gain between domestic and business use*Facts:*

Alfredo owns a five-bedroomed house in Oranjezicht, Cape Town. In 1998 after the last of his children had left home, he decided to convert the residence into a guesthouse. He set aside 4 of the bedrooms for guests, while he and his wife kept the remaining bedroom for their personal use. The market value of the residence on 1 October 2001 was R5 million. On 29 February 2020 Alfredo disposed of the residence for R6,5 million. During the period on or after valuation date Alfredo managed to let out the 4 bedrooms 60% of the time. During the remaining 40% of the time the bedrooms were vacant, but available for letting. The floor area of the 4 bedrooms was 120 m², while the total area of the residence was 300 m².

The guests had the use of the lounge, dining-room, kitchen and swimming pool. Alfredo did not, however, claim any expenditure for normal tax purposes on these shared facilities as he regarded the guests' use as incidental. Alfredo adopted the market-value method for determining the valuation date value of the residence.

Result:

Overall capital gain:	R
Proceeds	6 500 000
Less: Base cost	<u>(5 000 000)</u>
Capital gain	<u>1 500 000</u>

Floor area used for business and private purposes:

	m ²
Business	120
Private	<u>180</u>
	<u>300</u>

Allocation of overall capital gain between business and private portions:

Business	$R1\,500\,000 \times 120 / 300 = R600\,000$
Private	$R1\,500\,000 \times 180 / 300 = R900\,000$

The capital gain attributable to the primary residence portion is reduced to nil by the exclusion of R2 million (R900 000 – R2 000 000). The business portion of the gain of R600 000 will be subject to CGT in full, less the annual exclusion provided it has not been used against other capital gains.

Although the 4 bedrooms were let only 60% of the time, they were nevertheless set aside exclusively for business use even when not occupied. They cannot therefore be regarded as having been used for domestic purposes. The position might have been different had Alfredo used those rooms for domestic purposes for 11 months of the year and let them for only one month while he went on his annual vacation. In that case it would have been acceptable to subject only 1/12 of the gain attributable to the 4 bedrooms to CGT.

In this example, the Commissioner has not attributed any part of the capital gain to the shared use areas such as the kitchen, lounge and dining room. What would have happened if Alfredo had claimed a portion of the rates, electricity and other expenses attributable to the shared use areas against the rent he derived? In that event the Commissioner would have regarded a similar portion of those areas as being used for business purposes. And if more than 50% of the entire residence was used for business purposes Alfredo would not have been entitled to the primary residence exclusion. In that event the residence would not have been used 'mainly' as a primary residence as defined. It suffices to say that it is difficult to lay down hard and fast rules for apportionment of the overall capital gain or loss in situations such as this. Each situation must be judged on its merits.

11.9 Rental periods

Paragraph 50

The purpose of this paragraph is to

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

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

- The primary residence may not be let for more than five years. If a primary residence were let for say, six years, the full six years will be regarded as non-residential use, and not just the period in excess of five years. It is an all-or-nothing concession and is not subject to apportionment.
- The qualifying person must actually reside in the primary residence for a continuous period of at least one year before and after the period that it is let. This condition ensures that the residence is a primary residence of the qualifying person before letting the property and that the qualifying person will return to and reside in the property after the rental period. When the valuation date is straddled, regard must be had to the period before 1 October 2001 to determine whether the person qualifies for the exclusion. For example, on 1 October 2001 a person may have been overseas and letting his or her residence. Provided that the person resided in the residence for more than a year before letting the residence, and the letting period before and after 1 October 2001 does not exceed five years, the person will have met the relevant requirements.
- No other residence must be treated as the primary residence of the qualifying person during the period that the primary residence is let and retains its status as a primary residence of the qualifying person. Since this paragraph treats the property let as a primary residence of the qualifying person letting the property, this condition prevents any overlap where another property owned by the qualifying person was actually used

as a primary residence while tenants occupied the let property. This paragraph therefore does not override the general principle contained in para 45(3).

- The qualifying person must be temporarily absent from South Africa or employed or engaged in carrying on business in South Africa at a location further than 250km from the residence. The first part of this condition caters for persons who remain ordinarily resident in South Africa, such as diplomats. The second part is an anti-avoidance provision. It enables a resident who lives in South Africa the opportunity to let a primary residence provided that he or she is employed or was engaged in carrying on business in the Republic at a location further than 250km from the primary residence being let. The 250km must be measured as the crow flies. In this regard s 5 of the Interpretation Act 33 of 1957 provides as follows:

'5. Measurement of distance.—In the measurement of any distance for the purpose of any law, that distance shall, unless the contrary intention appears, be measured in a straight line on a horizontal plane.'

Example – Spouses each owning residence and working within 250km

Facts:

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

Result:

Paragraph 50 is inapplicable because both spouses are employed within a 250 km radius from their respective residences. They will, however, be able to apportion any capital gains that might arise upon the disposal of their respective residences in relation to the period that each residence qualified as a primary residence.

11.10 Valuation of primary residences on farms

11.10.1 Introduction

Farm residences are usually not sold separately from farms. This fact makes it difficult to apportion the base cost and proceeds between the farm residence and the rest of the farm. Reliable historic information on the market value of farm residences which can be used as comparable transactions for valuation purposes is, therefore, not always available. In the interest of finding practical solutions the methodology set out below is suggested.

11.10.2 Valuation date value of an asset acquired before 1 October 2001 (valuation date)

Subject to the kink tests in paras 26 and 27, a person can determine the valuation date value of a farm residence by using the market-value, time-apportionment or '20% of proceeds' method.

Market value

Under para 29(1)(c) read with para 31(1)(f) farmers must choose one of the following methods to value their farms:

- The value contemplated in para (b) of the definition of 'fair market value' in s 1 of the Estate Duty Act which is the value determined by a Land Bank valuer; or
- Market value – the price which could have been obtained upon the sale of the immovable property between a willing buyer and willing seller dealing at arm's length in an open market.

There is a restriction on the use of Land Bank value. It may be used only on the death of the person or when the property is disposed of by donation or non-arm's length transaction when

- that value was adopted on valuation date as the valuation date value, or
- that person acquired the immovable property by donation, inheritance or a non-arm's length transaction at Land Bank value.

When a person disposes of a pre-valuation date farm property to a third party, the proceeds will be the amount received or accrued on the sale. If the market-value method is adopted for determining the valuation date value of the farm, either market value or Land Bank value may be used depending on which value was determined by 30 September 2004 and adopted. In most cases the Land Bank value is lower than the market value and this fact will affect the quantum of the capital gain or loss. See also **8.35.5**.

11.10.3 Methods of valuation

The methodology suggested below for the valuation of primary residences on farms does not preclude the taxpayer from using any other method for determining the market value as at 1 October 2001, or on other dates as required for CGT purposes, so long as that market valuation can be properly substantiated.

SARS will be prepared to accept the following methodology used in determining the market value of a farmer's primary residence:

11.10.4 Farms with a market value not exceeding R300 000

For farms the market value of which does not exceed R300 000 on valuation date or if acquired after valuation date, the cost of acquisition does not exceed R300 000, it will be accepted that

- the market value of the primary residence is equal to one-third of the market value of the farm on the valuation date, or
- if acquired after valuation date, the expenditure incurred in acquiring the primary residence is equal to one third of the expenditure incurred to acquire the farm, and
- if the farm is disposed of for proceeds not exceeding R300 000, one-third of the proceeds were received or accrued in respect of the disposal of the primary residence.

This treatment will apply only on condition that the owner occupied the primary residence and used it mainly for his or her domestic purposes.

11.10.5 Proceeds in excess of R300 000

When a primary residence was valued in the manner described above and the farm is disposed of for proceeds in excess of R300 000, it will be accepted that the base cost is the amount as calculated above, but another method of determining the amount of proceeds to be allocated to the primary residence must be used. Similarly, if a person wishes to allocate an amount other than the one-third of the market value or proceeds to the value of the primary residence, he or she will have to use another method of determining the market value of the primary residence.

11.10.6 Comparable sales

When two farms in the same area share similar factors such as the quality of soil, vegetation, topography, development, and water supply, the market value of the land per hectare, would be similar. If both farms were sold, and only one had a primary residence on it, the market value of the primary residence could be calculated by reducing the sale price of the farm on which the house is situated by the estimated cost of the land determined by using the price per hectare obtained for the other farm.

In most instances the value of a farm residence is less than the value of a comparable residence in the nearest town. If there are no transactions in the circumstances contemplated in the previous paragraph that can be used as comparisons in the valuation of a farm residence, a comparison with sales of residences in the nearest town could be used in the appropriate circumstances. An adjustment would have to be made to the value of the farm residence to recognise the difference in values of the residences as a result of their different locations.

11.10.7 Adjusted replacement cost

The market value of the primary residence of a farmer may be determined by using the adjusted replacement cost method.

The market value of the portion of the bare land, not exceeding two hectares, which is used for domestic or private purposes, must be determined.

The replacement cost of the improvements constituting the primary residence must be determined and reduced by an appropriate rate to make provision for the age, physical condition, functionality, marketability and location of the residence. This adjusted replacement cost must then be added to the market value of the part of the bare land determined above to establish the total market value of the primary residence.

Since the determination of the appropriate rate to reduce the replacement cost for the factors mentioned above can be contentious, this method should be used as a last resort only if no other method can be used.

11.10.8 Time-apportionment base cost

The time-apportionment method can be used to determine the valuation date value of a primary residence on a farm when the acquisition or erection costs of the residence can be determined. Such a determination and use of the time-apportionment method would be possible, for example, if

- a farmer erected a primary residence after acquisition of a farm and kept records of the cost of erection; or
- the farmer was able to determine the portion of the purchase price paid for the primary residence (for example, because it was specified in the sale agreement).

11.10.9 Conclusion

SARS has the right to call for information in connection with valuations and challenge whether the appropriate method was used as well as whether the actual value is correct. If the method used for valuation of the residence on 1 October 2001 differs from the method used when the farm is disposed of, reasons for the change in the method will have to be provided.

11.11 Transferring a residence out of a company

The tax consequences that flow from the transfer of a residence out of a company after the expiry of the relief measures described in **Appendix A** (which ended on 30 September 2002), **Appendix B** (which ran from 11 February 2009 to 30 September 2010) and **Appendix C** (which ran from 1 October 2010 to 31 December 2012) are as follows:

- The company will be subject to CGT on any capital gain arising from the disposal.
- Should the residence be distributed as a dividend *in specie*, dividends tax will be payable on the distribution by the company unless an exemption applies.
- Transfer duty will be payable by the shareholder on the acquisition, or if the company is a vendor, the company will have to charge VAT on the transaction.
- The shareholder will face CGT consequences upon disposal of the shares in the company.
- It is unlikely that the company will qualify for the lower corporate tax rates applicable to a small business corporation. In order to qualify as a small business corporation, s 12E(4)(a)(iii) requires that

‘not more than 20 per cent of the total of all receipts and accruals (other than those of a capital nature) and all the *capital gains* of the company, close corporation or co-operative consists collectively of investment income and income from the rendering of a personal service’.

(Emphasis added)

The definition of ‘investment income’ in s 12E(4)(c) includes

‘any proceeds derived from investment or trading in financial instruments (including futures, options and other derivatives), marketable securities or immovable property’.

A residential property holding company would typically carry out no trading activities. It is therefore likely that 100% of its receipts and accruals will consist of a capital gain on sale of the property, thus disqualifying it as a small business corporation.

Example – Transfer of a residence out of a company when para 51A does not apply*Facts:*

Ronnie owns all the shares in Ronprops (Pty) Ltd ('Ronprops'). The only asset of Ronprops is a house in Umhlanga in which Ronnie's parents live rent free. Ronnie purchased the shares in the company from Barry on 30 May 1992 at a price of R100 000. The market value of the property on 1 October 2001 was R2 million, and the current market value on 31 December 2019 was R3 million. The company has never incurred any expenditure or derived any income. The market value of Ronnie's shares on valuation date was R1 950 100. In order to eliminate the cost of keeping the company alive and to reduce the future tax consequences of holding the property in the company, Ronnie instructed his conveyancing attorney to transfer the property into his name and asked his accountant to liquidate the company as soon as the transfer had been made. The balance sheet of Ronprops appeared as follows on 31 December 2019, the day before the residence was distributed to Ronnie.

Balance sheet – 31 December 2019

	R
Share capital	100
Loan account	49 900
Non-distributable reserve	<u>2 950 000</u>
	<u>3 000 000</u>
House – at current market value (Original cost, 1 August 1983 = R50 000)	<u>3 000 000</u>

The company was finally dissolved on 29 February 2020.

*Result:**CGT in the company*

Under para 75(1)(a) the property is deemed to be disposed of by the company for an amount received or accrued equal to its market value (R3 million) on the date of distribution (1 January 2020). The base cost is the higher of

- R2 million using market value, or
- R1 525 000 using time apportionment (see below).

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R50\,000 + [(R3\,000\,000 - R50\,000) \times 19 / 38] \\
 &= R1\,525\,000.
 \end{aligned}$$

Therefore, market value will be used as the base cost.

	R
Proceeds	3 000 000
Less: Base cost	<u>(2 000 000)</u>
Capital gain	<u>1 000 000</u>
Taxable capital gain R1 000 000 × 80%	800 000
CGT R800 000 × 28%	224 000

Dividends tax

The company will be liable for dividends tax at 20% on the portion of the distribution *in specie* that comprises a dividend.

An amount of R3 million will be returned to Ronnie, made up as follows:

	R
CTC	100
Loan account R49 900 + 224 000 (CGT) + R454 333 (dividends tax)	728 233
Dividend	<u>2 271 667</u>
Returned to Ronnie	<u>3 000 000</u>

The amount of the dividend is a balancing figure, that is, the value of the property awarded to the shareholder less the portion not comprising a distribution (that is, the repayment of the loan account) less the CTC. The minimum amount distributable as a dividend can be calculated as follows:

	R
Profits before CGT and dividends tax	2 950 000
Less: CGT	<u>(224 000)</u>
Profit available for distribution before dividends tax	<u>2 726 000</u>

Accounted for as follows:

Dividend $R2\,726\,000 \times 100 / 120$	2 271 667
Dividends tax $R2\,271\,667$ (dividend) $\times 20\%$	<u>454 333</u>
	<u>2 726 000</u>

The CGT consequences for the holder of shares

On dissolution of the company Ronnie's shares are disposed of under para 77(1)(a).

Ronnie's choices under para 26(1) for determining the valuation date value of his shares are

- market value of R1 950 100,
- 20% of proceeds, being $R100 \times 20\% = R20$, or
- time-apportionment base cost:

$$Y = B + [(P - B) \times N / (N + T)]$$

$$= R100\,000 + [(R100 - R100\,000) \times 10 / 29]$$

$$= R65\,552$$

Paragraph 27 applies because the shares have been disposed of at an historical loss (cost R100 000; proceeds R100). Under para 27(3)(b) Ronnie must use the lower of market value and the time-apportionment base cost as the valuation date value because the market value on valuation date exceeds the cost of the shares.

	R
Proceeds (para 35)	100
Less: Base cost (time-apportionment base cost)	<u>(65 552)</u>
Capital loss	<u>(65 452)</u>

Paragraph 19 will not limit the capital loss because the dividend was subject to dividends tax in the company and is thus not an 'exempt dividend' under para 19(3). The capital loss is not clogged under para 39 because the shares are not disposed of to anyone in particular (see **9.5.2**).

The transfer duty consequences for the holder of shares

Ronnie will have to pay transfer duty on the market value of the residence of R3 million, determined as follows (rates last amended 1 March 2017):

R	%	R
900 000	0	0
<u>350 000</u>	3	10 500
500 000	6	30 000
500 000	8	40 000
<u>750 000</u>	11	<u>82 500</u>
<u>3 000 000</u>		<u>163 000</u>

The total tax cost to Ronnie is therefore R224 000 (CGT) + R454 333 (dividends tax) + R163 000 (transfer duty) = R841 333. Ronnie does, however, have the benefit of the capital loss of R65 452 which will be available for set-off against other capital gains arising in the year of assessment in which the shares are deemed to be disposed of. If there are no other capital gains available for set-off in that year, the capital loss will be reduced by the annual exclusion of R40 000 and the balance will be carried forward as an assessed capital loss to future years of assessment in which it will be available for set-off.

Note: Had Ronnie used the residence mainly for domestic purposes from 11 February 2009, he could have taken advantage of the window of opportunity ending on 31 December 2012 provided by para 51A to transfer the residence into his own name in that way avoiding transfer duty, CGT and dividends tax (see **Appendix C**).

Chapter 12 – Other exclusions

PART VIII: OTHER EXCLUSIONS

12.1 General principle

Paragraph 52

Paragraph 52 provides that when determining the aggregate capital gain or aggregate capital loss of a person, any capital gains and capital losses must be disregarded in the circumstances and to the extent set out in Part VIII.

12.2 Personal-use assets

Paragraph 53

A capital gain or loss determined on the disposal of a personal-use asset of a natural person or a special trust must be disregarded [para 53(1)].

A personal-use asset is defined in para 53(2) as

‘an asset of a natural person or a special trust that is used mainly for purposes other than the carrying on of a trade’.

Examples of personal-use assets include artwork, jewellery, household furniture and effects, a microlight aircraft or hang glider with a mass of 450kg or less, a boat that is 10 metres or less in length, veteran cars, private motor vehicles (including a vehicle used mainly for business purposes in respect of which a travel allowance is received), stamp or coin collections (but excluding gold or platinum coins whose value is mainly derived from the metal content). In order to qualify as a personal-use asset, the asset must be used ‘mainly’ for non-trade purposes. The word ‘mainly’ has been held to mean more than 50% (see **11.1.2.3**).

For the reasons set out in **7.1** personal-use assets do not include the following [para 53(3)]:

- A coin made mainly from gold or platinum of which the market value is mainly attributable to the material from which it is minted or cast.
- Immovable property.
- An aircraft, the empty mass of which exceeds 450kg.⁵⁷⁹
- A boat exceeding 10 metres in length.
- A financial instrument as defined in s 1(1). This definition includes, amongst others, assets such as shares, participatory interests in collective investment schemes, debt and cryptocurrency. It follows that Bitcoin and other cryptocurrencies can never constitute a personal-use asset.
- Any fiduciary, usufructuary or other like interest, the value of which decreases over time.
- Any contract under which a person, in return for payment of a premium, is entitled to policy benefits upon the happening of a certain event and includes a reinsurance policy in respect of such a contract, but excluding any short-term policy contemplated in the

⁵⁷⁹ The Domestic Air Services Regulations, 1991 issued by the Civil Aviation Authority define ‘microlight aeroplane’ as one ‘the empty mass of which does not exceed 450 kilograms’.

Short-term Insurance Act. Examples of such policies include an endowment policy or a life policy.

- Any short-term policy contemplated in the Short-term Insurance Act to the extent that it relates to any asset which is not a personal-use asset. For example, a policy of insurance against fire or theft in respect of commercial property or a 15-metre yacht. Apportionment will have to be applied to premiums paid in respect of assets used partly for trade and non-trade purposes.
- A right or interest of whatever nature to or in any of the assets mentioned above.

While capital gains arising from these assets will be subject to CGT, the losses made on disposal of some of them are disregarded under para 15.

Paragraph 53(4) provides that for the purposes of para 53(2), an asset of a natural person or a special trust to whom an allowance is or was paid or payable in respect of the use of that asset for business purposes, must be treated as being used mainly for purposes other than the carrying on of a trade. This provision therefore excludes motor vehicles in respect of which a travelling allowance under s 8 is payable as well as other assets such as cellular telephones.

12.3 Retirement benefits

Paragraph 54

Retirement benefits paid in lump sums are disregarded in determining any capital gain or capital loss. The exclusion covers

- a receipt in the form of a lump sum benefit as defined in the Second Schedule which is in essence an amount paid in consequence of membership of a domestic pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, and
- a lump sum benefit paid from any fund, arrangement or instrument situated outside the Republic which provides similar benefits under similar conditions to a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund approved under the Act.⁵⁸⁰

12.4 Long-term assurance

Paragraph 55

12.4.1 What is a 'policy'? [para 55(2)]

For the purposes of para 55(1), para 55(2) provides that 'policy' means

'a policy as defined in section 29A with an insurer'.

Section 29A(1) defines 'policy' as follows:

‘ “[P]olicy” means a long-term policy as defined in section 1 of the Long-term Insurance Act, other than a policy issued by a foreign reinsurer conducting insurance business through a branch in the Republic in terms of section 6 of the Insurance Act.’

⁵⁸⁰ Paragraph 54(b) was amended to include a reference to pension and provident preservation funds by s 56 of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

Importantly, a Policy of reinsurance issued by a branch of a foreign reinsurer will not qualify for exclusion of a capital gain or loss under para 55 because of the exclusion in the definition of ‘policy’ in s 29A. This fact should be borne in mind when reading the definitions that follow because they include such policies.

The term ‘long-term policy’ is defined in s 1 of the Long-term Insurance Act 52 of 1998 as follows:

‘ “[L]ong-term policy” means—

(a) in respect of a registered insurer, an assistance policy, a disability policy, fund policy, health policy, life policy or sinking fund policy, or a contract comprising a combination of any of those policies; and includes a contract whereby any such contract is varied;

(b) in respect of a licensed insurer, a life insurance policy as defined in section 1 of the Insurance Act;’

The Long-term Insurance Act contains definitions of assistance policy, disability policy, fund policy, health policy, life policy and sinking fund policy. In particular, a life policy is defined as follows:

‘ “[L]ife policy” means a contract in terms of which a person, in return for a premium, undertakes to—

(a) provide policy benefits upon, and exclusively as a result of, a life event; or

(b) pay an annuity for a period;

and includes a reinsurance policy in respect of such a contract.’

Such a policy would include, for example, a purchased annuity.

The Insurance Act 18 of 2017 defines ‘Life insurance policy’ as follows:

‘ “[L]ife insurance policy” means any arrangement under which a person, in return for provision being made for the rendering of a premium to that person, undertakes to meet insurance obligations—

(a) on the happening of a life event, health event, disability event or death event; or

(b) on or from a fixed determinable date or at the request of the policyholder,

but excludes—

(i) a deposit with an institution authorised under the Banks Act, 1990 (Act No. 94 of 1990), the Mutual Banks Act, 1993 (Act No. 124 of 1993), or the Co-operative Banks Act, 2007 (Act No. 40 of 2007); and

(ii) participatory interests in a collective investment scheme registered in terms of the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002),

and includes a renewal or variation of that arrangement.’

12.4.2 Disregarding of capital gains and losses by original beneficial owner [para 55(1)(a)(i)]

Paragraph 55(1)(a)(i) provides that any capital gain or loss on disposal of a long-term policy must be disregarded by its original beneficial owner or one of its original beneficial owners. The type of policy envisaged is one that gives rise to the receipt or accrual of an amount in the hands of the original beneficial owner or owners upon its disposal. The exclusion applies

to a long-term policy as defined in the Long-term Insurance Act 52 of 1998, issued by a South African insurer.

Example – Disposal of policy by original beneficial owner

Facts:

John and Jack are the original beneficial co-owners of an endowment policy. They donate the policy to Jill. Jill then cedes the policy back to Jack. Finally, Jack receives the policy proceeds on maturity from the insurer.

Result:

Disposal by John and Jack to Jill:

Since the policy was donated, an amount equal to the market value of the policy is deemed to have been received by or accrued to John and Jack under para 38. However, under para 55(1)(a)(i) they must disregard any capital gain or loss on disposal of the policy as they were original beneficial owners at the time of the donation.

Disposal by Jill to Jack:

Under para 38 Jill is deemed to have acquired the policy at market value on the date of acquisition. She must account for any capital gain or loss arising on the cession to Jack, since she was not an original beneficial owner.

Receipt of proceeds on maturity by Jack:

Under para 55(1)(a)(i) Jack must disregard any capital gain or loss arising on termination of the policy, since he was one of the original beneficial owners.

12.4.3 Exclusion of certain second-hand policy proceeds

A person must disregard any capital gain or loss determined in respect of a disposal that resulted in the receipt by or accrual to that person of an amount derived in the circumstances set out in para 55(1)(a) to (d).

12.4.3.1 The spouse, nominee, dependant or deceased estate exclusion [para 55(1)(a)(ii)]

An amount derived by the

- spouse,
- nominee,
- dependant as contemplated in the Pension Funds Act 24 of 1956, or
- deceased estate

of the original beneficial owner of a long-term policy with a South African insurer will not give rise to a capital gain or loss, provided that no amount has been or will be directly or indirectly paid in respect of any cession of the policy.

A dependant is defined in s 1 of the Pension Funds Act 24 of 1956 as follows:

‘ “[D]ependant”, in relation to a member, means—

- (a) a person in respect of whom the member is legally liable for maintenance;
- (b) a person in respect of whom the member is not legally liable for maintenance, if such person—
 - (i) was, in the opinion of the board, upon the death of the member in fact dependent on the member for maintenance;
 - (ii) is the spouse of the member;
 - (iii) is a child of the member, including a posthumous child, an adopted child and a child born out of wedlock;
- (c) a person in respect of whom the member would have become legally liable for maintenance, had the member not died.’

When an individual during his or her lifetime cedes a policy to another person (other than a spouse or dependant under the Pension Funds Act, 1956), that other person will not be regarded as the nominee of that individual. The word ‘nominee’ is used in para 55(1)(a)(ii) to refer to the situation in which the original beneficial owner nominates another person as the beneficiary upon the life insured’s death. If the original beneficial owner has ceded the policy to a person (other than a spouse or dependant under the Pension Funds Act, 1956), the other person is a cessionary, not a nominee.

If another person cedes a policy back to the original beneficial owner, the original beneficial owner will, on reacquisition of the policy, still be regarded as the original beneficial owner for the purposes of para 55(1)(a)(i). This treatment is so despite the initial owner not being the original beneficial owner for the entire duration of the policy. The second or a subsequent third party owner who cedes the policy will, however, not qualify for exclusion from CGT on any capital gain arising on that cession, assuming that none of the other exclusions in para 55 apply.

Example 1 – Cession of policy between spouses

Facts:

Paul and Steve are involved in a permanent same-sex union. Paul is the original beneficial owner of a policy, which he ceded to Steve. What are the CGT implications for Steve upon surrender of the policy if

- (a) Paul donated the policy to him, or
- (b) he paid Paul something for the policy?

Result:

Paul and Steve are spouses as defined in s 1(1) and the roll-over provisions of s 9HB apply. In other words, Steve takes over Paul’s expenditure and any valuation date market value for the purpose of determining the base cost of the policy.

Policy ceded for no consideration:

Any gain or loss arising in Steve’s hands will be excluded by para 55(1)(a)(ii).

Policy ceded for consideration:

Steve will be subject to CGT when he surrenders the policy. The exclusion in para 55(1)(a)(ii) does not apply if any amount was paid or is payable for the cession of the policy.

Example 2 – Cession of policy to nominee*Facts:*

Sam is the original beneficial owner, but not the life assured, of an endowment policy. He nominates Hazel as the beneficiary and then cedes the policy to her for R1. What are the implications for Hazel when she surrenders the policy?

Result:

Hazel is the nominated beneficiary (nominee), but despite being a nominee, any capital gain or loss arising in her hands on surrender of the policy will be subject to CGT because she paid R1 for the policy. The exclusion in para 55(1)(a)(ii) applies only when the nominee does not pay an amount for the policy.

12.4.3.2 The former spouse exclusion [para 55(1)(a)(iii)]

The former spouse of the original beneficial owner of a long-term policy with a South African insurer must disregard any capital gain or loss arising from the disposal of that policy when

- as a result of that disposal an amount has been received by or accrued to that former spouse; and
- that policy was ceded to that spouse in consequence of a divorce order; or

that policy was ceded to that spouse in consequence of an agreement of division of assets which has been made an order of court in the case of a union contemplated in para (b) (religious marriage) or (c) (permanent same-sex or heterosexual union) of the definition of “spouse” in s 1(1).

Example – Surrender of policy acquired from former spouse under a divorce order*Facts:*

Zeb and Agnes were married under customary law in 1956 and their marriage complied with the requirements set out in the Recognition of Customary Marriages Act 120 of 1998. Zeb was the original beneficial owner of an endowment policy. Zeb and Agnes divorced and the court ordered that Zeb’s policy be ceded to Agnes. Agnes surrendered the policy.

Result:

Under para 55(1)(a)(iii) no capital gain or loss will arise in Agnes’s hands when she surrenders the policy.

12.4.3.3 The employee / director exclusion [para 55(1)(b)]

A person must disregard any capital gain or loss determined in respect of a disposal that resulted in the receipt by or accrual to that person of an amount in respect of any policy, when that person

- is or was an employee or director whose life was insured under that policy, and
- any premiums paid by that person’s employer were deducted under s 11(w).

This provision applies when an employer cedes a policy taken out on the life of an employee or director to that employee or director and the employer has deducted the premiums under s 11(w). When the policy eventually pays out to the employee or director or the employee or director cedes the policy for consideration, the employee or director must disregard any capital gain or loss. Paragraph 55(1)(b) will not apply if the employer has not actually deducted any premiums under s 11(w).

In order to enjoy the exclusion, the employee or director does not have to be currently in the service of the employer (the provision includes a person who ‘was’ an employee or director).⁵⁸¹

Example – Cession of policy to director when premiums not deducted under s 11(w)

Facts:

ABC (Pty) Ltd (ABC) took out a key-man’ policy on the life of Bradley, one of its directors. The policy agreement does not contain a clause indicating that s 11(w) applies to the premiums payable by the company. Bradley resigned as director and wishes to take cession of the policy.

Result:

The policy will be regarded as a ‘second-hand’ policy and the proceeds will be subject to CGT in Bradley’s hands should he dispose of it. Paragraph 55(1)(b) provides for an exclusion only if the employer claimed a deduction under s 11(w). Since ABC did not claim a deduction, the requirements of para 55(1)(b) were not fulfilled. No capital gain or loss will arise in ABC should it receive any proceeds from Bradley in respect of the policy, Since ABC is the original beneficial owner of the policy [para 55(1)(a)(i)].

12.4.3.4 The partners and shareholders exclusion [para 55(1)(c)]

This provision concerns so-called buy-and-sell arrangements which occur when partners or shareholders take out insurance against the death, disability or illness⁵⁸² of their fellow partners and shareholders. The purpose is to provide them with funds to buy out their fellow partner or shareholder’s interest in the partnership or company should the fellow partner or shareholder die, become disabled or severely ill. When the business comes to an end, there is no purpose for the policies and they are often ceded to the person whose life was insured under the policy. This provision allows the life assured to acquire the policy from the original beneficial owner, and ensures that the policy is treated in the same way as if that life assured had been the original beneficial owner. For the exclusion to apply the person acquiring the policy must not have paid any of the premiums in respect of the policy while the other person was the beneficial owner.

The provision does not cover the cession of a portion of a policy to an incoming partner or shareholder. Should such a cession occur, the policy will be a second-hand policy in the hands of the cessionary and any capital gain or loss will have to be accounted for by that cessionary when it eventually pays out.⁵⁸³

⁵⁸¹ This issue was clarified by the amendment of the provision by the Revenue Laws Amendment Act 45 of 2003, effective 22 December 2003.

⁵⁸² With effect from 22 December 2003 this provision was amended by the Revenue Laws Amendment Act 45 of 2003. The word ‘illness’ was qualified to cover severe illness, and payouts arising from disability or severe illness were brought in (previously the item covered only receipts or accruals on death). The word ‘severe’ was deleted by s 73 of the Taxation Laws Amendment Act 17 of 2017 in line with a 2014 amendment to s 10(1)(gl). According to the *Explanatory Memorandum* on the underlying bill, the word ‘illness’ includes severe illness. The amendment came into operation on 18 December 2017.

⁵⁸³ See Harry Joffe ‘Capital Gains Tax and Business-assurance Policies’ (June 2009) *De Rebus* 37.

Example – The buy-and-sell exclusion*Facts:*

Abe and Bart were partners and drew up a properly structured buy-and-sell agreement, funded by long-term policies. Under the arrangement Abe was the owner (payer and beneficiary) of a policy on the life of Bart and Bart was the owner (payer and beneficiary) of a policy on the life of Abe. The partnership was dissolved and the parties wished to retain the policies on their own lives. Abe ceded his policy to Bart and Bart ceded his policy to Abe.

Result:

Any capital gain or loss in the hands of Abe and Bart on ultimate surrender of the policies will be excluded under para 55(1)(c).

12.4.3.5 The retirement fund policy exclusion [para 55(1)(d)]

A capital gain or loss must be disregarded when

- a policy was originally taken out on the life of a person,
- that policy is provided to that person or dependant by or in consequence of that person's membership of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, and⁵⁸⁴
- an amount is received or accrued in respect of the disposal of that policy.

In such cases the retirement fund would have been the original owner of the policy. The member may be given the option to take over the policy upon retirement and may then retain, surrender or cede the policy. However, when the member subsequently cedes such a policy to a dependant, the dependant will not qualify for the exclusion, since the policy would not have been provided to that dependant in consequence of the member's membership of the retirement fund.

Example 1 – Policy ceded to member of retirement fund*Facts:*

Dave was a member of a pension fund. He was the life assured on an individual policy held by the fund. On retirement the policy was ceded by the fund to Dave. Dave surrendered the policy.

Result:

Any capital gain or loss arising in Dave's hands on surrender of the policy will be excluded for CGT purposes.

Example 2 – Proceeds of policy paid to dependant of member of retirement fund*Facts:*

Shirley was a member of a provident fund. She was the life assured on a policy that was taken out by the fund. She had one legal dependant being her son Denys. She died and the policy proceeds were paid to Denys.

⁵⁸⁴ The reference to pension and provident preservation funds was inserted into para 55(1)(d) by s 57 of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

Result:

Denys must disregard any capital gain or loss arising on the amount received by him.

12.4.3.6 Risk policy with no value [para 55(1)(e)]

A person must disregard any capital gain or capital loss determined in respect of a disposal that resulted in the receipt by or accrual to that person of an amount in respect of a risk policy with no cash value or surrender value.

The purpose of this provision is to exclude both original owner and second-hand risk policies from CGT. As a general rule, para 55 does not apply to capital gains and losses on disposal of second-hand policies. However, an exception is made in para 55(1)(e) for risk policies because the nature of such policies is such that they do not have inherent tradable value.

12.4.3.7 Policies in respect of which the premiums were taxed as a fringe benefit or not deductible [para 55(1)(f)]

A person must disregard any capital gain or capital loss determined in respect of a disposal that resulted in the receipt by or accrual to that person of an amount if the amount received or accrued constitutes an amount contemplated in s 10(1)(gG) or (gH).

The amounts received or accrued directly or indirectly from certain employer-owned policies or policies acquired by cession from an employer are required to be included in the gross income of the employee or director under para (d)(ii) and (iii) of the definition of 'gross income'. This inclusion applies even if the amounts are paid to a nominee or dependant of the employee or director. It also applies to policies owned by a past employer.

Section 10(1)(gG) then exempts such amounts from normal tax under specified conditions, for example, in the case of a pure risk policy when the employee was subject to tax on the premiums as a fringe benefit on or after 1 March 2012 and did not deduct them under s 11(a) or with any other policy, when all the premiums since the policy was entered into have been included in the person's income as a fringe benefit.

Section 10(1)(gH) exempts from normal tax any amount received or accrued in respect of a policy of insurance when

- the policy relates to death, disablement or illness of an employee or director, or former employee or director, of the person that is the policyholder; and
- no amount of premiums payable in respect of that policy on or after 1 March 2012 is deductible from the income of that person for the purposes of determining the taxable income derived by the person from carrying on any trade.

This exemption would apply, for example, when the risk policy taken out by the employer does not contain a clause which makes s 11(w) applicable. As a result, the employer would not have been entitled to claim the premiums as a deduction against income.

The purpose of para 55(1)(f) is thus to mirror for CGT purposes the relief granted to an employee, director or employer under s 10(1)(gG) or (gH).

12.4.4 Second-hand policies subject to CGT

12.4.4.1 Non-qualifying second-hand policies

A 'second-hand policy' conventionally refers to a policy that has been ceded absolutely to an independent third party on the traded policy market. Capital gains and losses arising on the

disposal of such a policy will be subject to CGT in the 'second-hand' recipient's hands unless specifically excluded by para 55.

12.4.4.2 Why are second-hand policies subject to CGT?

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

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

12.4.4.3 Determination of capital gains and losses on second-hand policies

Determination of base cost

The base cost of a second-hand policy acquired before 1 October 2001 could be determined using any of the acceptable prescribed methods. Most likely these would involve either the time-apportionment base cost method or the market-value method.

In accordance with para 31(1)(b) the market value of a policy is the higher of

- surrender value, and
- fair market value determined by the insurer assuming that the policy runs to maturity.

The market-value method would also have to be used on donation, death and cessation or commencement of residence.

Disposal events

A disposal of a second-hand policy could occur in a variety of circumstances, some of which are listed below:

- Cession [para 11(1)(a)]
- Surrender [para 11(1)(b)]
- Withdrawal in whole or part) (paras 11(1)(b) and 33)
- Donation [para 11(1)(a)]
- Death (s 9HA)
- Commencement or cessation of residence (para 12(2)(a) and s 9H]

The maturity of a policy (or the attainment of an option date) is not in itself a disposal. Policies are open-ended and will continue past the maturity date unless there is an intervention by the policyholder to surrender the policy or to withdraw proceeds from the policy. The only significant change to certain policies on 'maturity' may be a guarantee provided on the investment portion of the policy.

12.4.4.4 Part-withdrawals from second-hand policies

Each time a policyholder makes a withdrawal from a second-hand policy a part-disposal will occur, and it will be necessary to determine a capital gain or loss in respect of the part disposed of. The base cost of the part disposed of is determined under para 33 in accordance with the following formula:

$$\text{Base cost of part disposed of} = \frac{\text{Amount withdrawn}}{\text{Market value of policy immediately before withdrawal}} \times \text{Base cost}$$

This calculation can become fairly complex and a market value will have to be obtained immediately before each withdrawal. For an example of a part-disposal when the time-apportionment method has been adopted, see Example 2 in **8.37.2**.

Example – Part-disposal of second-hand policy

Facts:

In 1996 Brenda took out a 5-year endowment policy as the original beneficial owner. Keith purchased the policy from Brenda in 2000 for R100 000. The market value of the policy on 1 October 2001 was R90 000. Keith made the following withdrawals:

Date	Amount	Market value immediately before withdrawal
	R	R
1 July 2017	5 000	100 000
1 July 2018	6 000	108 000
1 July 2019	120 000	120 000

Keith adopted the market-value method for determining the valuation date value of the policy.

Result:

Keith's capital gain or loss is determined as follows:

2018 year of assessment

Proceeds	R 5 000
Less: Base cost	(4 500)
R5 000 / R100 000 × R90 000	
Capital gain	<u>500</u>

Base cost after part-disposal: R90 000 – R4 500 = R85 500.

2019 year of assessment

Proceeds	R 6 000
Less: Base cost	(4 750)
R6 000 / R108 000 × R85 500	
Capital gain	<u>1 250</u>

Base cost after part-disposal: R85 500 – R4 750 = R80 750.

2020 year of assessment (final withdrawal)

Proceeds	120 000
Less: Base cost (R120 000 / R120 000 × R80 750)	(80 750)
Capital gain	<u>39 250</u>

12.4.4.5 Foreign policies subject to CGT

No exclusion is granted for the disposal of long-term policies with foreign long-term insurers that are not licensed under the Insurance Act 18 of 2017. The rationale behind this approach is that since the build-up in these policies is not subject to income tax in South Africa, it is only fair that they be subject to CGT on disposal by applying the normal principles for determining a capital gain or loss on disposal of an asset.

The exclusion of foreign policies stems from the definition of 'policy' as defined in para 55(2). Under that subparagraph 'policy' means for the purposes of para 55(1)

'a policy as defined in section 29A with an insurer'.

This definition has two components: a policy and an insurer.

Policy

A policy as defined in s 29A(1) does not include a policy issued by a foreign reinsurer conducting insurance business through a branch in South Africa under s 6 of the Insurance Act (see **12.4.1**).

Insurer

Under para 1 an 'insurer' means

'an insurer as defined in section 29A(1)'.

Under s 29A(1) an 'insurer' means

'any long-term insurer as defined in section 1 of the Long-term Insurance Act, other than a foreign reinsurer conducting insurance business through a branch in the Republic in terms of section 6 of the Insurance Act'.

Under s 1 of the Long-term Insurance Act 52 of 1998 a 'long-term insurer' means

'a registered insurer or a licensed insurer'.

The Insurance Act 18 of 2017 came into operation on 1 July 2018. Insurers that were registered under the Long-term Insurance act are required to be licensed under the Insurance Act, 2017 and there is a two-year transitional period for this to be achieved. Section 23 of the Insurance Act provides for the licensing of the branch of a foreign reinsurer or subsidiary of a foreign insurer. However, as noted above, a branch of a foreign reinsurer is not an insurer as defined in s 29A(1) and any policies issued by it would therefore fall outside para 55. But a policy issued by a licensed South African subsidiary of a foreign insurer would qualify.

In summary, capital gains and losses arising on policies issued by

- a branch of a foreign reinsurer (whether licensed or not); and
- a foreign insurer not licensed under the Insurance Act,

will not qualify for exclusion of a capital gain or loss under para 55.

12.5 Disposal by creditor of debt owed by connected person

Paragraph 56 (Debt defeasance)

Paragraph 56 prevents persons from receiving the benefit of losses on debt when the debt involved most likely represents a disguised donation or capital contribution, neither of which would otherwise create a capital loss. Under the specifics of this rule, a creditor cannot receive a loss on any disposal of a debt owed by a connected person, even if the disposal of that debt is to an unconnected person.

Circumstances under which para 56(1) does not apply [para 56(2)]

Despite para 39 and para 56(1) a creditor will be allowed a capital loss on disposal of a debt owed by a connected person when the circumstances set out below prevail. Section 7C(2) will, however, disallow a capital loss even if para 56(2) applies – see **12.5A**.

Table 1 – Circumstances in which para 56(1) does not apply

Paragraph 56(2)	Circumstances in which a creditor will be entitled to a capital loss on disposal of a debt
(a)(i)	To the extent that the debt disposed of represents an amount which is applied to reduce the expenditure in respect of an asset of the debtor under s 19(3) or para 12A(3). ⁵⁸⁵
(a)(ii)	To the extent that the debt disposed of represents an amount which must be taken into account by the debtor as a capital gain under para 12A(4). ⁵⁸⁶
(b)	An amount which the creditor proves must be or was included in the gross income of any acquirer of that debt.
(c)	An amount that must be or was included in the gross income or income of the debtor or taken into account in the determination of the balance of assessed loss of the debtor under s 20(1)(a).
(d)	A capital gain which the creditor proves must be or was included in the determination of the aggregate capital gain or loss of any acquirer of the debt. ⁵⁸⁷

A creditor who disposes of a debt at a discount to a third party must prove that the amount of the loss will be treated as gross income or a capital gain in the hands of the acquirer of the debt. It is submitted that this calls for a hypothetical enquiry as to whether the acquirer would have been subjected to tax on the amount of the unrealised income or capital gain at the date of acquisition had that acquirer immediately disposed of the debt at that point at its face value. For example, if the acquirer were a tax-exempt body or non-resident, the requirement would not be met. Creditors who attempt to circumvent this rule should bear in mind the provisions dealing with impermissible tax avoidance arrangements in Part IIA (ss 80A to 80L).

⁵⁸⁵ Substituted by s 63(1) of the Taxation Laws Amendment Act 34 of 2019 and deemed to have come into operation on 1 January 2018 and applicable to years of assessment commencing on or after that date.

⁵⁸⁶ Substituted by s 63(1) of the Taxation Laws Amendment Act 34 of 2019 and deemed to have come into operation on 1 January 2018 and applicable to years of assessment commencing on or after that date.

⁵⁸⁷ This provision came into operation as from the commencement of years of assessment ending on or after 1 January 2005.

Ring-fencing under para 39 inapplicable

Paragraph 56(2) applies 'despite paragraph 39'. This qualification means that any loss that the creditor becomes entitled to claim is not subject to the ring-fencing provisions of para 39 and may, therefore, be set off against other capital gains derived from transactions with unconnected persons.

Example 1 – Cancellation of debt owed by connected person when debtor not taxable on corresponding capital gain [para 56(1)]*Facts:*

In 2019 Catinka lent R50 000 to her son, Ben, who is resident in Bermuda in order to settle his university fees. In 2020 Catinka cancelled the loan after Ben failed to make any payments on the loan.

Result:

Under para 56(1) Catinka must disregard the loss on the debt cancellation because Ben is a connected person in relation to her. The exceptions in para 56(2) do not apply to Catinka because Ben is a non-resident falling outside South Africa's taxing jurisdiction.

Example 2 – Capital loss allowable when debtor required to reduce base cost under para 12A [para 56(2)(a)(i)]*Facts:*

Company A and Company B are connected persons in relation to each other but are not part of the same group of companies. Company B's year of assessment ends on 30 June.

On 1 July 2015 Company A lent Company B R2 million which Company B used to acquire land from Company C with a base cost of R2 million.

On 1 July 2019 Company A waived R500 000 of the debt owed by Company B because of Company B's inability to settle the debt in full. Company B continued to hold the land at the time of the partial debt cancellation.

Result:

Since Company B will have to reduce the base cost of its land by R500 000 under para 12A(3), Company A will be entitled to claim the capital loss of R500 000 under para 56(2)(a)(i). This capital loss will not be clogged because para 56(2) applies despite paragraph 39.

Example 3 – Debt cancelled in year of assessment subsequent to that in which asset disposed of [para 56(2)(a)(ii)]*Facts:*

Charles lent his sister Jade R1 million during the 2009 year of assessment which she used to acquire a holiday home for the same amount in the same year of assessment. In the 2019 year of assessment Jade disposed of the holiday home for R2,1 million. She still owed Charles 1 million. In the 2020 year of assessment Charles waived the loan in full.

Result:

Charles and Jade are connected persons in relation to each other because they are relatives within the second degree of consanguinity.

In the 2019 year of assessment Jade made a capital gain of R1,1 million (R2,1 million proceeds – R1 million base cost). In the 2020 year of assessment Jade must redetermine this capital gain by taking into account the debt cancellation. Jade's base cost must therefore be reduced to nil under para 12A(3), resulting in a redetermined capital gain of R2,1 million. The difference between this redetermined capital gain and the capital gain previously recognised is R1 million (R2,1 million – R1,1 million), which Jade must account for as a capital gain in the 2020 year of assessment under para 12A(4).

Under para 56(2)(a)(ii) Charles will be entitled to claim the capital loss of R1 million on waiver of the loan because Jade had a corresponding capital gain under para 12A(4). This capital loss will not be clogged because para 56(2) applies despite paragraph 39.

Example 4 – Cession of debt at less than face value to moneylender [para 56(2)(b)]

Facts:

Alan, Bert and Carl are brothers. Alan owes Bert R100 payable in five years' time. Carl carries on a debt factoring business. Bert disposed of the debt owed to him by Alan to Carl for R70, being the market value of the debt at the time. After a number of years Alan repaid Carl the full amount of R100.

Result:

The consequences for each of the parties are as follows:

Alan

Alan is left unscathed by the transaction. He previously owed R100 to Bert, and after the debt was ceded owed the same amount to Carl. From his perspective, one creditor has simply been substituted for another. No portion of the debt was discharged for less than its face value, so para 12A does not apply.

Bert

Bert had a base cost in respect of the loan of R100 and received proceeds of R70. The disposal took place at market value, so para 38 does not apply. He will therefore have a capital loss of R30. He is entitled to this loss because the amount will be included in Carl's gross income in the future as a moneylender. The amount does not have to be included in Carl's gross income in the same year of assessment – para 56(2)(b) states that the amount 'must be' included in gross income. As a result, Bert must determine whether Carl will have to include the amount in his gross income in the future. Bert's loss is not clogged because para 56(2) applies despite para 39.

Carl

Carl acquired the loan for R70 and received R100 giving a profit of R30. Since he is a moneylender, the profit will be spread over the period of the loan under s 24J and will be included in his gross income.

Example 5 – Loan waived and amount included in debtor’s income [para 56(2)(c)]*Facts:*

Stopper (Pty) Ltd and Topper (Pty) Ltd are wholly owned subsidiaries. Stopper operates a land-dealing business, while Topper manufactures furniture. Topper had for many years held a piece of land on which it intended to erect a warehouse for the purpose of storing its products. However, owing to falling sales the directors decided to dispose of the land to Stopper at market value of R1 million on loan account. A year later Stopper managed to sell the property to an unconnected party for R1,5 million after the property market had taken off. The R0,5 million profit was included in Stopper’s taxable income. Topper then decided to waive its right to claim the debt of R1 million owed by Stopper, which resulted in the same amount being included in Stopper’s income under s 19(5) read with s 8(4)(a).

Result:

Topper will be able to claim the capital loss of R1 million, which will not be clogged (para 56(2)(c) allows the loss ‘despite para 39’).

Example 6 – Cession of debt at less than face value to person who will be subject to tax on capital gain [para 56(2)(d)]*Facts:*

Abe and Bart are brothers. Bart owes Abe R100 000. Abe needs the cash and sells the claim to his sister Claudette, a resident, for R80 000.

Result:

Since Claudette is subject to tax in South Africa, it is reasonable to assume that when Bart repays the loan, she will realise a capital gain of R20 000. Under para 56(2)(d) Abe will be entitled to a capital loss of R20 000.

12.5A Capital losses arising from loans, advances or credit to which s 7C applies

Section 7C(2)

12.5A.1 Estate duty avoidance and s 7C

A full analysis of s 7C is outside the scope of this guide.

Section 7C is aimed at the avoidance of estate duty when a loan is provided to a trust or company in which a trust has the required interest. This type of estate duty avoidance can take two forms:

- First, the loan, advance or credit is provided interest free or at a low rate of interest and is used to finance growth assets in the trust, or in a company in which a trust has the required interest. In this way the donor’s estate remains pegged at the amount of the loan, while the growth in the assets occurs in the trust or in the company in which the trust has the required interest. These arrangements are addressed in s 7C(3) by deeming the difference between the official rate of interest and the actual rate of interest to be a donation during each year of assessment, with resultant donations tax consequences. In this way, the donations tax payable acts as a proxy for the estate duty savings. This situation is not addressed in this commentary.
- Secondly, the loan, advance or credit is disposed of, typically through waiver, which results in a capital loss. Section 7C(2) addresses this situation by requiring the capital

loss to be disregarded. This aspect of estate duty avoidance is addressed in this commentary.

12.5A.2 Definitions

For ease of reference, a number of terms are defined below for the purpose of this commentary. These are not definitions used in s 7C but are used for the sake of brevity and clarity.

'loan' means a loan, advance or credit provided directly or indirectly by a lender to a borrower;

'lender' means

- a natural person who directly or indirectly provides a loan to a borrower; or
- at the instance of a natural person, a company that is a connected person in relation to that natural person under para (d)(iv) of the definition of 'connected person' that directly or indirectly provides a loan to a borrower (see **12.5A.4.1**).

'borrower' means

- a trust with the required connected person link; or
- company in which a trust referred to above has the required interest,

to which a loan has been directly or indirectly provided by a lender (see **12.5A.4.3**).

12.5A.3 Disallowance of capital losses on s 7C loans [s 7C(2)]

Section 7C(2) provides, amongst other things,⁵⁸⁸ that a capital loss may not be claimed on any amount owing in respect of a loan referred to in s 7C(1) (see **12.5A.4**) when that loss arises from

- the disposal, including by way of a reduction or waiver; or
- the pfailure, wholly or partly, of a claim for payment.

The disposal of a debt through cession falls within the ambit of s 7C(2), as does the waiver of a debt in whole or in part.

A failure of a claim for payment would include the extinction of a claim by prescription or the sequestration or liquidation of the debtor.

Section 7C(2) makes no reference to s 7C(3) which deals with the rate of interest. It is therefore irrelevant whether the loan bears interest at a rate at least equal to the official rate. Thus, persons who use the annual donations tax exemption of R100 000 in s 56(2)(b) to waive part of their loans will be unable to claim a capital loss on such portion even if the loan bears interest at least equal to the official rate. The purpose of the section is estate duty avoidance and the waiver of a loan would have the effect of diminishing the donor's estate.

12.5A.4 Requirements to be a lender or a borrower [s 7C(1)]

In order for a capital loss on a loan to be disallowed under s 7C(2), the loan must fall within s 7C(1).

⁵⁸⁸ Also not claimable under s 7C(2) is any deduction, loss or allowance.

Section 7C(1) sets out the requirements to be a lender or a borrower. In addition, s 7C(1) provides that the loan may be directly or indirectly provided by the lender to the borrower.

12.5A.4.1 Lender

The person providing the loan may be either a natural person or a company. If the lender is a company, the loan must have been made at the instance of a natural person who is a connected person in relation to the company under para (d)(iv) of the definition of 'connected person' in s 1(1). Under para (d)(iv) a natural person is a connected person in relation to a company if that person individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20% of

- the equity shares in the company; or
- the voting rights in the company.

Example 1 – Lender comprising a company [s 7C(2)]

Facts:

Gert holds 18% of the equity shares in Gert (Pty) Ltd. The remaining shares are held by Gert's two sons in equal shares of 41%. Gert is the managing director of Gert (Pty) Ltd and 'calls the shots'. Gert initiated a resolution under which Gert Ltd made a loan of R10 million interest free to his family trust. Gert, his wife and two sons are beneficiaries of the trust.

Result:

Gert (Pty) Ltd meets the requirements to be a lender for purposes of s 7C(1) because the loan to the trust has been made by the company at the instance of Gert who is a connected person in relation to the company under para (d)(iv) of the definition of 'connected person'. Under para (d)(iv) Gert is a connected person in relation to the company because he holds, together with connected persons in relation to himself, at least 20% of the equity shares in the company. In this regard, Gert holds 18% and his two sons (connected to him as relatives) each own 41%, which makes a combined holding of 100%.

12.5A.4.2 Direct or indirect lending

The funds must be lent directly or indirectly by the lender to the borrower. Direct lending would occur when the lender makes a loan to the borrower. Indirect lending would occur when the funds are diverted through an intermediary. For example, the lender could make a loan to a third party, such as a bank, on condition that the funds are on-lent to the borrower.

12.5A.4.3 Borrower

A borrower may be a trust or a company which meets the specified requirements described below.

Borrower is a trust [s 7C(1)(i)]

A borrower that is a trust must be a connected person in relation to

- the lender (natural person or company); or

- any person that is a connected person in relation to the lender.

A borrower that is a trust will be a connected person in relation to a lender if the lender is a beneficiary of the trust or a connected person in relation to a beneficiary of the trust.⁵⁸⁹

Example 2 – Connected person relationship between a trust that is a borrower and a natural person who is a lender

Facts:

John lent R10 million interest free to a trust of which he and his relatives were beneficiaries.

Result:

The trust qualifies to be a borrower because it is a connected person in relation to John on two alternative grounds. First, it is a connected person in relation to John because he is a beneficiary of the trust. Secondly, it is a connected person in relation to John because John is a relative of other beneficiaries of the trust, and hence a connected person in relation to those beneficiaries.

A relative of John would include his spouse and anybody related to him or his spouse within the third degree of consanguinity, or any spouse of anyone so related.⁵⁹⁰

The degree of relationship between two natural persons is determined by counting the number of steps up to a common ancestor and then, if necessary, the number of steps down to the person concerned. For example, a cousin is related in the fourth degree (person [up to] parent (1) [up to] grandparent (2) [down to] uncle or aunt (3) [down to] cousin (4)).

Example 3 – Connected person relationship between a trust that is a borrower and a company that is a lender

Facts:

Company X lent R10 million to a trust. Patrick, a beneficiary of the trust, held at least 20% of the equity shares in Company X.

Result:

The trust is a connected person in relation to Company X⁵⁹¹ because Company X is a connected person in relation to Patrick⁵⁹² and Patrick is a beneficiary of the trust.⁵⁹³

As a general observation, there are many different scenarios in which a natural person or company could be a connected person in relation to a trust and in each instance the definition of ‘connected person’ must be carefully studied.⁵⁹⁴

⁵⁸⁹ Paragraph (b) and (e) of the definition of ‘connected person’ in s 1(1).

⁵⁹⁰ The term ‘relative’ is defined in s 1(1).

⁵⁹¹ A connected person in relation to a beneficiary of a trust is a connected person in relation to the trust under para (b)(ii) of the definition of ‘connected person’ in s 1(1).

⁵⁹² Paragraph (d)(iv) and (e) of the definition of ‘connected person’ in s 1(1).

⁵⁹³ A beneficiary of a trust is a connected person in relation to the trust under para (b)(i) of the definition of ‘connected person’ in s 1(1).

⁵⁹⁴ See Interpretation Note 67 (Issue 4) dated 28 January 2020 “*Connected Persons*”.

Borrower is a company [s 7C(1)(ii)]

A company will be a borrower if at least 20% of

- the equity shares in that company are held, directly or indirectly; or
- the voting rights in that company can be exercised,

by a trust referred to above, whether alone or together with

- any person who is a beneficiary of that trust;
- the spouse of a beneficiary of that trust; or
- any person related to that beneficiary or that spouse within the second degree of consanguinity.

Persons related to a person within the second degree of consanguinity include

- a father or mother (first degree);
- a child (first degree);
- a grandparent (second degree); and
- a brother or sister (second degree).

An uncle or aunt, great-grandparent or nephew or niece are related within the third degree of consanguinity and are excluded. So too is a cousin (fourth degree).

Example 4 – Borrower comprising a company held by a trust*Facts:*

The Peter Family trust holds 10% of the shares in Peter (Pty) Ltd. The beneficiaries of the trust are Peter, his two children, father and grandfather. The remaining 90% of the shares are held by Anne [Peter's spouse (5%)], Tom [Peter's grandchild (5%)], Joe [his uncle (20%)] and Frank [his cousin (60%)].

Result:

Although the trust holds only 10% of the equity shares of Peter (Pty) Ltd, the holdings of Peter's spouse (5%) and grandchild (5%) must be added to the trust's holding in determining whether the 20% threshold has been met. While his spouse and grandchild are not beneficiaries of the trust, Peter is a beneficiary and his spouse qualifies to be counted as does Tom because Tom is related to him within the second degree of consanguinity. Consequently, the trust holds 20% of the equity shares together with Peter's spouse and grandchild and this makes the company a borrower for purposes of s 7C(1).

12.5A.5 Loans acquired by cession [s 7C(1A)]

A loan to a borrower acquired by cession can potentially fall within s 7C.

12.5A.6 Exemptions

There are a number of situations in which s 7C(2) does not apply.⁵⁹⁵ Briefly these are when

- the trust or company is a PBO approved by the Commissioner under s 30(3) or a small business funding entity approved by the Commissioner under s 30C;
- subject to various requirements, the loan is provided in exchange for a vested right to the receipts and accruals and assets of the trust;
- the loan is to a special trust for a person with a disability (type-A trust);⁵⁹⁶
- the trust or company (borrower) used the loan wholly or partly for purposes of funding the acquisition of an asset and
 - the natural person who provided the loan or at whose instance a company provided the loan⁵⁹⁷ or the spouse of that natural person used that asset as a primary residence as contemplated in para (b) of the definition of 'primary residence' in para 44 (see note below) throughout the period during that year of assessment during which that trust or company held that asset; and
 - the amount owed relates to the part of that loan that funded the acquisition of that asset;
- the loan constitutes an affected transaction as defined in s 31(1) that is subject to the provisions of that section;
- the loan was provided to that trust or company under an arrangement that would have qualified as a sharia compliant financing arrangement as contemplated in s 24JA, had that trust or company been a bank as defined in that section;
- the loan is subject to s 64E(4). In the present context, s 64E(4) would, for example, potentially apply when a company makes a loan to a resident trust and fails to charge at least the official rate of interest. This action triggers a dividend *in specie* for dividends tax purposes equal to the difference between the interest calculated at the official rate and the amount actually charged; and
- the trust was created solely for purposes of giving effect to an employee share incentive scheme meeting specified requirements.

Note: In relation to the exclusion of what would have constituted a primary residence but for the residence being held by a trust, or company in which a trust has an interest, para (b) of the definition of 'primary residence' means a residence which that person or a beneficiary of that special trust or a spouse of that person or beneficiary

- ordinarily resides or resided in as his or her main residence; and
- uses or used mainly for domestic purposes.

⁵⁹⁵ Section 7C(5)(a) to (h).

⁵⁹⁶ Paragraph (a) of the definition of 'special trust' in s 1(1).

⁵⁹⁷ The wording of s 7C(5)(d) is unclear on whether a natural person at whose instance a company provided the loan qualifies as a user of the 'primary residence', since it refers only to the person in s 7C(1)(a) ('a natural person'). However, since s 7C(1)(b) refers to 'that person', meaning a natural person referred to in s 7C(1)(a), it is accepted that a natural person at whose instance a company provided the loan will also qualify as a user for purposes of s 7C(5)(d).

12.6 Disposal of small business assets on retirement

Paragraph 57

The purpose of this paragraph is to provide relief to small business persons who have invested their resources in their businesses.

12.6.1 Definitions [para 57(1)]

Paragraph 57(1) contains two definitions that apply for the purposes of para 57.

<p>‘ “[A]ctive business asset” means—</p> <p>(a) an asset which constitutes immovable property, to the extent that it is used for business purposes; or</p> <p>(b) an asset (other than immovable property) used or held wholly and exclusively for business purposes,</p> <p>but excludes—</p> <p>(i) a financial instrument; and</p> <p>(ii) an asset held in the course of carrying on a business mainly to derive any income in the form of an annuity, rental income, a foreign exchange gain or royalty or any income of a similar nature;’</p>

The concession applies ‘to the extent’ that immovable property is used for business purposes. This requirement means that the exclusion will not apply to the part of the immovable property used for non-business purposes, and an apportionment will be required. It follows that the presence of a farmhouse on a farm will not debar the farmer from claiming the exclusion in respect of the rest of the farm. A person who operates a shop on the ground floor of a double-storey building and lives on the first floor will be entitled to the exclusion in respect of the gain attributable to the area used for the shop.

Non-qualifying assets

The intention is to exclude assets generating passive income and to rather target active business assets.

A ‘financial instrument’ is defined in s 1(1) and includes, amongst others, loans, advances, debt, debentures, shares, bank deposits, participatory investments in collective investment schemes, futures, options, forward exchange contracts, index linked investments and cryptocurrencies.

The exclusion of assets producing rental income applies to both movable and immovable property. For example, it would apply equally to a block of flats occupied by tenants or a fleet of vehicles forming part of a car-hire business.

Individuals carrying on business through companies or close corporations need to pay particular attention to the way in which the business is structured and whether it is the shares in a company or the assets of the company that are being disposed of. It frequently happens that a person owns two companies, X and Y. X owns the immovable property out of which the business is operated, while Y carries out the business operations and pays rent to X. In this situation the shares in X will be disqualified from the relief because X derives its income from rent. Yet, if the immovable property were located in the same company in which the business operations were carried on, the shares in that company would potentially qualify for the exclusion. A shareholder will not qualify for the relief if the company disposes of its active

business assets to a third party because the company will likely be left with a financial instrument such as a bank account or debit loan account, neither of which are active business assets, thus disqualifying its shares from the exclusion.

‘ “[S]mall business” means a business of which the market value of all its assets, as at the date of the disposal of the asset or interest contemplated in subparagraph (2), does not exceed R10 million.’⁵⁹⁸

In determining whether a business qualifies, the market value of all the assets, regardless of their nature, must be taken into account. The liabilities of the business must be ignored for this purpose. With a business operated by a partnership or company, the threshold of R10 million relates to the assets of the partnership or company as a whole, and not to the fractional interest of each partner or shareholder in the underlying assets of the business. Thus, a partnership consisting of two equal partners which has assets of R15 million will not qualify as a ‘small business’, despite the fractional interest of each partner in the assets of the partnership being less than R10 million.

12.6.2 Requirements for exclusion [para 57(2)]

Under para 57(2) only a natural person may disregard a capital gain under the relief provided and only in respect of the disposal of an ‘active business asset’, if that asset or interest in a partnership or a company

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

The term ‘superannuation’ refers to retirement, particularly from a pension fund.

In respect of a disposal, three instances are envisaged.

- First, the disposal of an active business asset of a small business owned by a natural person as a sole proprietor. What is envisaged is an economic unit loosely termed a ‘business’ as opposed to individual assets. A sole proprietor’s ‘business’ might mean a ‘taxi business’ or a ‘printing business’ or an ‘accounting business’ or a ‘farming business’ as distinct from all the assets of the sole proprietor, for instance, a primary residence, household furniture, or an investment in a portfolio of a collective investment scheme.
- Secondly, the disposal of an interest in each of the active business assets of a business, qualifying as a small business, owned by a partnership, upon that natural person’s withdrawal from that partnership to the extent of his or her interest in that partnership.
- Thirdly, the disposal of an entire direct interest in a company consisting of at least 10% of the equity of the company, to the extent that the interest relates to active business assets of the company which must qualify as a small business.

⁵⁹⁸ The threshold was increased from R5 million to R10 million by s 11(1)(a) of the Rates and Monetary Amounts and Amendment of Revenue Laws Act 13 of 2012, deemed to come into operation on 1 March 2012 and applies to years of assessment commencing on or after that date.

In relation to shares in a company, the use of the word 'entire' means that all the shares held must be disposed of during a year of assessment. For example, if a person held 10% of the shares and sold 5% in the first year of assessment and the remaining 5% in the second year of assessment, the transaction would not qualify because at the end of year 1 the person would not have disposed of the entire interest. There would be no way of knowing whether the entire interest will in fact be disposed of in year 2 and the assessment cannot be held open until the end of year 2. Tax is an annual event and there needs to be finality in the raising of assessments. There is also a presumption against retrospectivity in a statute unless the contrary can be shown to have been clearly intended.

The interest in the company carrying on the small business must be directly held by the individual in order to qualify for the exclusion. For example, if an individual disposes of shares in a holding company that holds shares in a subsidiary that carries on a small business, the individual will not qualify for the exclusion. Besides the interest in the subsidiary being indirect, the shares in the subsidiary are financial instruments, which are excluded from the definition of 'active business asset'.

The date of acquisition of shares acquired as a result of an asset-for-share transaction under s 42 must be determined in accordance with s 42(2)(a)(ii) when determining whether the shares have been held for at least five years. Under the latter provision the shares are deemed to be acquired on the date on which the transferred asset was acquired by the transferor and not on the date of the asset-for-share transaction.

In addition, the exclusion applies 'to the extent' which means that the company's assets must be separated between active business assets and non-qualifying assets such as financial instruments. The exclusion will not apply to the portion of the capital gain attributable to non-qualifying assets.

Example – Interest in a company carrying on a small business

Facts:

Ben, aged 65, owns 50% of ABC (Pty) Ltd and is also its managing director. On 29 February 2020, with the object of retiring from the business, he concluded an agreement for the sale of his 50% interest to Edward for R2 million. Ben had acquired his shares in 2005 at a cost of R200 000. The balance sheet of ABC (Pty) Ltd as at 29 February 2020 appeared as follows:

	R
Goodwill	2 000 000
Factory building	6 000 000
Plant and machinery	1 000 000
Trading stock	500 000
Trade debtors and employee advances	300 000
Bank account	<u>200 000</u>
	10 000 000
Less: Creditors	<u>(6 000 000)</u>
Net asset value	<u>4 000 000</u>
Ben's share (50%)	2 000 000

Ben does not own any other businesses and has not made use of the exclusion under para 57 in earlier years. He does, however, own a single property from which he derives rental income. The property is valued at R2 million.

Result:

Ben has a capital gain on disposal of his 50% interest of R2 000 000 – R200 000 = R1 800 000 before applying the exclusion under para 57.

The trade debtors and employee advances (R300 000) and bank balance (R200 000) are financial instruments and therefore do not constitute active business assets. The remaining assets (R9 500 000) qualify as active business assets. Therefore, the portion of the capital gain not qualifying for exclusion under para 57 is $R500\,000 / R10\,000\,000 \times R1\,800\,000 = R90\,000$. Note that it is the gain that is apportioned, not the exclusion, which remains intact. The balance of the capital gain ($R1\,800\,000 - R90\,000 = R1\,710\,000$) will qualify and will be disregarded in full. The capital gain of R90 000 will have to be accounted for by Ben although it may be reduced by the annual exclusion to the extent that it has not been used against other capital gains. Ben can make use of the remaining exclusion of R90 000 ($R1\,800\,000 - R1\,710\,000$) if he disposes of any other active business assets of another small business within 24 months of the disposal of his shares.

The letting of a single property on the scale envisaged in this example is not considered to constitute a business for the purposes of para 57(6) and will therefore not disqualify Ben from claiming the exclusion [see commentary below on para 57(6)].

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

12.6.3 Amount to be disregarded [para 57(3)]

Under para 57(3) the sum of the amounts to be disregarded under para 57(2) during a person's lifetime may not exceed R1,8 million⁵⁹⁹ (2012: R900 000;⁶⁰⁰ 2007 to 2011: R750 000;⁶⁰¹ 2006 and earlier years of assessment: R500 000). The disregarded amount is therefore cumulative and is not in respect of each business or asset disposed of.

The amount of R1,8 million is per person. Thus, a couple married in community of property would each be potentially entitled to the R1,8 million exclusion, provided they individually comply with all the relevant requirements. For example, if a couple married in community of property jointly hold 10% of the shares in a company carrying on a small business, they would not qualify for the relief because they each hold less than 10% of the company's shares. Also, a spouse that was not substantially involved in the operations of the small business will not be entitled to the exclusion by reason of para 57(2).

The disregarded amount applies only to capital gains and not to capital losses.

12.6.4 Time limit for disposal of assets [para 57(4)]

Under para 57(4) all capital gains qualifying under para 57(2) must be realised within 24 months of the first qualifying disposal. This rule applies to all active business assets of all small businesses held by the person and not only to active business assets of a particular small business. Under s 1 of the Interpretation Act 33 of 1957 'month' means a calendar month. Thus, if the initial sale occurred on 14 April of year 1 then the last sale must occur no later

⁵⁹⁹ The exclusion was increased from R900 000 to R1,8 million by s 11(1)(b) of the Rates and Monetary Amounts and Amendment of Revenue Laws Act 13 of 2012, deemed to come into operation on 1 March 2012 and applies to years of assessment commencing on or after that date.

⁶⁰⁰ The exclusion was increased from R750 000 to R900 000 by s 115 of the Taxation Laws Amendment Act 24 of 2011, deemed to come into operation on 1 March 2011 and applies to years of assessment commencing on or after that date.

⁶⁰¹ The exclusion was increased from R500 000 to R750 000 by s 34 of the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

than 13 April of year 3. In this regard, Van der Westhuizen J stated the following in *Ex parte Minister of Social Development & others*:⁶⁰²

'This Court has as yet not considered the computation of time or time periods. The general common-law rule is that, in the calculation of time the civilian method is applicable, unless a period of days is prescribed by law or contracting parties intended another method to be used.

'According to the civil computation method, a period of time expressed in months expires at the end of the day preceding the corresponding calendar day in the subsequent month. It is settled law that the commencement of a period of time in curial calculation is governed by the ordinary civilian method where any unit of time other than days is used.

'It follows, therefore, that 18 months from the date of judgment on 6 September 2004 ended at midnight on 5 March 2006.'

Example – Time limit for realisation of active business assets

Facts:

Hildegard owns three qualifying small businesses. The sum of the capital gains on disposal of the active business assets of each of these businesses was R700 000, R500 000 and R800 000 respectively. She sold the first business on 15 June of year 1, the second business on 31 July of year 2 and the third business on 14 June of year 3. Consider the implications under para 57(4) assuming all other requirements of para 57 have been met. Also consider what the outcome would have been if she sold the third business on 15 June of year 3.

Result:

Sale of all businesses no later than 14 June of year 3

All capital gains have been realised within 24 months of the first disposal on 15 June of year 1 in accordance with para 57(4). The sum of the capital gains amounts to R2 million, which exceeds the exclusion of R1,8 million by R200 000. Thus, in the first year of assessment Hildegard must disregard the total capital gain of R700 000 (first small business). In the second year of assessment she must disregard R500 000 (second small business). In the third year of assessment she may disregard only R600 000 of the R800 000 capital gain on disposal of the third small business, since that is all that remains of the R1,8 million cumulative lifetime limit (R1 800 000 – R700 000 – R500 000 = R600 000).

Sale of third business on 15 June of year 3

If Hildegard sold the third business on 15 June of year 3, she would be one day too late and no portion of the capital gain of R800 000 would qualify for exclusion under para 57(2).

12.6.5 Multiple businesses [para 57(5) and (6)]

Under para 57(5) a natural person operating more than one small business may include all qualifying disposals for every such small business in determining the capital gain to be disregarded.

Paragraph 57(6) provides that para 57 does not apply when a person owns more than one business either by way of a sole proprietorship, a partnership interest or a direct interest in the

⁶⁰² 2006 (4) SA 309 (CC) at 316.

equity of a company consisting of at least 10%, and the total market value of all assets in respect of all those businesses exceeds R10 million.⁶⁰³

It will be observed that this rule uses the word ‘business’ and not small business. It also refers to ‘assets’ and not ‘active business assets’. Thus, in determining whether the R10 million threshold has been exceeded, the interests in all businesses and not just small businesses must be included. Likewise, all assets used in a business must be included, even if they produce passive income. For example, an individual who owns a manufacturing business with assets of R6 million and a 10% interest in a company that owns a block of flats worth R7 million from which it derives rental income will not qualify for the exclusion of any capital gain on disposal of the manufacturing business, since the sum of the business assets will be R13 million. This outcome arises even though the asset of the company is not an active business asset and therefore disqualifies the equity interest from qualifying for the relief.

The term ‘business’ is not defined in the Act. By contrast, ‘trade’ is defined in s 1(1) and includes ‘business’ and is a much wider concept. There have been several cases in which the letting of a single property has been held not to constitute the carrying on of a business but it is a question of fact and degree.⁶⁰⁴ The taxpayer’s intention and the degree of activity would no doubt be relevant factors in deciding borderline cases.

Example – Disposal of small business assets

Facts:

On attaining the age of 55 on 1 January 2018, Elias wished to retire. He operated a fleet of five taxis in the Gauteng Province as a sole proprietor and had done so for the past eight years. He was substantially involved in the operations of the taxi business although he personally did not do any driving.

Elias owed nothing on these vehicles. He found a buyer for the taxi business who took it over ‘lock, stock and barrel’ for R1,5 million on 28 February 2018. Of this amount, R1 million related to self-generated goodwill having a nil base cost and the remaining R500 000 related to the price paid for the taxis. The cost, total capital allowances claimed for tax purposes to date of sale and consideration received for each taxi were as follows:

	Cost	Capital Allowances	Consideration received
	R	R	R
Taxi 1	150 000	150 000	20 000
Taxi 2	175 000	175 000	30 000
Taxi 3	200 000	200 000	40 000
Taxi 4	225 000	135 000	160 000
Taxi 5	250 000	50 000	250 000
	1 000 000		500 000

⁶⁰³ The threshold of R10 million was increased from R5 million by s 139 of the Taxation Laws Amendment Act 31 of 2013 with effect from years of assessment commencing on or after 1 March 2012.

⁶⁰⁴ See Income Tax Practice Manual [online] (My LexisNexis: Archive) in [A:B22] ‘Business, Carrying on’. See also ITC 615 (1946) 14 SATC 399 (U); ITC 883 (1959) 23 SATC 328 (T); ITC 1529 (1991) 54 SATC 252 (T).

Elias was 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 operated a successful brewery. The market value of the brewing plant and equipment was R2 475 000. A liability of R500 000 in respect of this equipment was still outstanding. The only other asset owned by the close corporation was a 100% shareholding in a company. The company's only asset was the brewery building let to the close corporation for a market-related rental. The market value of these shares was R2 025 000. Elias and Fani each held a 50% interest in the close corporation. On 31 May 2019 Fani purchased Elias's interest in the close corporation upon Elias's retirement for R2 million, 15 months after the disposal of Elias's taxi business. The member's interest originally cost each party R100 000.

Result:

Taxi Business

	Cost received R	Capital Allowances R	Base cost R	Consideration R	Recoupment R	Capital gain R
Taxi 1	150 000	(150 000)	-	20 000	20 000	-
Taxi 2	175 000	(175 000)	-	30 000	30 000	-
Taxi 3	200 000	(200 000)	-	40 000	40 000	-
Taxi 4	225 000	(135 000)	90 000	160 000	70 000	-
Taxi 5	<u>250 000</u>	(50 000)	200 000	<u>250 000</u>	50 000	-
	<u>1 000 000</u>			<u>500 000</u>		-
						R
Capital gain on sale of taxis						-
Capital gain on sale of goodwill					<u>1 000 000</u>	
Total					1 000 000	
Less: Exclusion (R1,8 million limited to R1 million)					<u>(1 000 000)</u>	
Capital gain					<u>-</u>	

Note: Had Taxis 4 and 5 been sold above cost, the resulting capital gain realised on their disposal would not have qualified to be disregarded under para 57(2), since they would not have been held for a continuous period of at least five years.

Brewery

Under para 57(2)(c) Elias may disregard only so much of the capital gain on disposal of his member's interest as relates to active business assets of a small business carried on by the close corporation. It is therefore necessary to determine the portion of the assets of the close corporation that qualify as 'active business assets'. The shares held by the close corporation are not an active business asset since they comprise financial instruments. The liabilities of the close corporation are ignored, since para 57(2)(c) refers to 'assets' and not 'net assets'.

Determination of capital gain on disposal of member's interest

	%	R
Active business assets	55	2 475 000
Non-active business assets	<u>45</u>	<u>2 025 000</u>
Total assets	<u>100</u>	<u>4 500 000</u>

	Active 55 R	Non-active 45% R	Total 100% R
Proceeds	1 100 000	900 000	2 000 000
Less: Base cost	<u>(55 000)</u>	<u>(45 000)</u>	<u>(100 000)</u>
Capital gain	1 045 000	855 000	1 900 000
Less: Remaining exclusion	<u>(800 000)</u>	<u>-</u>	<u>(800 000)</u>
Capital gain	<u>245 000</u>	<u>855 000</u>	<u>1 100 000</u>

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 R1,8 million of the capital gains realised provided that the disposals occur within a period of two years, which they do. The first disposal occurred on 28 February 2018 and the final disposal was on 31 May 2019, 15 months apart.

In the 2018 year of assessment Elias must disregard the full capital gain of R1 million on disposal of the taxi business because it is less than the exclusion of R1,8 million.

In the 2020 year of assessment he must disregard R800 000 of the portion of the capital gain on disposal of his member's interest attributable to active business assets (R1 045 000). The amount of the exclusion available in the 2020 year of assessment is equal to R1,8 million less the capital gain of R1 million excluded in the 2018 year of assessment.

12.6.6 Changes in thresholds by Minister [para 57(7)]

The Minister may announce in the national annual budget contemplated in s 27(1) of the Public Finance Management Act, that, with effect from a date or dates mentioned in that announcement, the market value of all assets referred to in the definition of 'small business' in para 57(1) [R10 million], the sum of the amounts referred to in para 57(3) [R1,8 million] or the total market value of all assets referred to in para 57(6) [R10 million] will be altered to the extent mentioned in the announcement.

If the Minister makes an announcement of an alteration contemplated above, that alteration comes into effect on the date or dates determined by the Minister in that announcement and continues to apply for a period of 12 months from that date or those dates subject to Parliament passing legislation giving effect to that announcement within that period of 12 months.

12.6A Disposal of micro business assets

Paragraph 57A

A registered micro business as defined in the Sixth Schedule must disregard any capital gain or loss in respect of a disposal by that business of any asset used mainly for business purposes.⁶⁰⁵

The word 'mainly' means 'more than 50%'. Thus, a person who uses land and buildings partly as a residence and partly for business purposes must disregard any capital gain or loss on disposal of the land and buildings if more than 50% of them are used for business purposes.

⁶⁰⁵ Under s 80(2) of the Revenue Laws Amendment Act 60 of 2008 para 57A came into operation on 1 March 2009 and applies in respect of years of assessment commencing on or after that date.

Since a financial instrument held on capital account is not 'used' for business purposes (it is 'held'), capital gains and losses on shares and other financial instruments must be brought to account for CGT purposes and will not qualify for the exclusion under para 57A.

Accounting for receipts and accruals of a capital nature under the Sixth Schedule

The presumptive turnover tax imposed on a 'registered micro business' under the Sixth Schedule acts as a substitute for any CGT that may arise on the disposal of micro business assets. Under para 6 of the Sixth Schedule the taxable turnover of a registered micro business includes 50% of all receipts of a capital nature from the disposal of

- immovable property mainly used for business purposes, other than trading stock; and
- any other asset used mainly for business purposes, other than any financial instrument.

Thus, if a manufacturer disposed of a factory building, 50% of the consideration derived on its disposal would be included in taxable turnover. But a person who holds land as trading stock would include 100% of the consideration from the sale of such trading stock in taxable turnover.

The 50% inclusion rule does not apply to financial instruments used for business purposes, for example, the sale of shares by a share-dealer. Note that shares held as trading stock can produce a receipt or accrual of a capital nature if they comprise equity shares under s 9C.

The definition of 'investment income' in para 1 of the Sixth Schedule includes proceeds from the disposal of financial instruments.

Under para 3(b)(ii) of the Sixth Schedule if more than 20% of a company's receipts comprise investment income and income from the rendering of a professional service, it will not comprise a micro business.

Under para 3(e) of the Sixth Schedule a person will not qualify as a micro business if the total of all amounts received by that person from the disposal of

- immovable property used mainly for business purposes; and
- any other asset of a capital nature used mainly for business purposes, other than any financial instrument,

exceeds R1,5 million over a period of three years comprising the current year of assessment and the immediately preceding two years of assessment, or such shorter period during which that person was a registered micro business.

12.7 Exercise of options

Paragraph 58

Paragraph 58 provides that the capital gain or loss of a person determined in respect of the termination of an option as a result of the exercise by that person of that option be disregarded. This disregarding is necessary because any amount paid for an option to acquire or dispose of an asset, other than a personal-use asset, will be allowed as part of the base cost of the asset under para 20(1)(c)(ix) (option acquired on or after valuation date) or 20(1)(f) (option acquired before valuation date but exercised after that date).

Some common option terms

Strike price – the price at which the buyer of an option can buy (in the case of a call) or sell (in the case of a put) the underlying asset.

Call option – an agreement that gives a person the right, but not the obligation, to buy an asset at a specified price (strike price) within a specified time period.

Put option – an agreement that gives a person the right, but not the obligation, to sell an asset at a specified price (strike price) within a specified time period.

'In the money' – A call option is 'in the money' if the price of the underlying asset is higher than the exercise (strike) price. A put option is 'in the money' if the price of the underlying asset is below the exercise price.

'In the water' – A call option is 'in the water' if the price of the underlying asset is lower than the exercise (strike) price. A put option is 'in the water' if the price of the underlying asset is above the exercise price.

Example 1 – Exercise of option to buy an asset*Facts:*

Gert purchased an option to acquire a farm for farming purposes. Gert paid R100 000 for the option to acquire the farm at a price of R1 million. At the date of exercise of the option the market value of the farm was R1 250 000.

Result:

When the option is exercised, the base cost in respect of the farm will be as follows:

	R
Cost of acquisition [para 20(1)(a)]	1 000 000
Cost of option [para 20(1)(c)(ix)]	<u>100 000</u>
Base cost	<u>1 100 000</u>

The option, which is an asset and which had a cost of R100 000, has terminated as a result of the exercise of the option. Were it not for para 58 read with para 20(1)(c)(ix), Gert would have had proceeds on disposal of the option equal to the difference between the market value of the farm on the date of exercise (R1 250 000) and the strike price (R1 000 000) = R250 000. This outcome would have resulted in a capital gain of R250 000 – R100 000 = R150 000. Instead, this capital gain is disregarded and will be brought to account only when the farm is disposed of, assuming that it maintains its market value.

The grantor

The person who granted Gert the option will have a disposal under para 11(1)(f), proceeds of R100 000 under para 35 and a zero base cost under para 33(3)(a). The granting of an option is not treated as a part-disposal of the underlying asset. As a result, no portion of the base cost of the asset for which the option is granted may be allocated to the granting of the option. However, any incidental expenditure directly related to the disposal of the option, such as legal fees to draw up the option, would constitute an admissible base cost deduction in the determination of the capital gain on the disposal of the option. In this instance, however, no incidental expenditure was incurred and the grantor will therefore have a capital gain of R100 000.

Example 2 – Exercise of option to sell an asset*Facts:*

Mark acquired a piece of land that cost him R80 000 after the valuation date. John granted Mark a put option at a cost of R1 000 which enabled Mark to sell the land to John at a strike price of R100 000 during the next two years. Within the two-year period Mark exercised the option and disposed of the land to John for R100 000.

Result:

When the option was exercised, it was extinguished and this would normally have given rise to a capital loss of R1 000. However, under para 58 the loss must be disregarded. Instead, the cost of the option is added to the base cost of the land under para 20(1)(c)(ix).

Mark's capital gain is determined as follows:

	R
Proceeds	100 000
<i>Less:</i>	
Cost of land – para 20(1)(a)	(80 000)
Cost of option – para 20(1)(c)(ix)	<u>(1 000)</u>
Capital gain	<u>19 000</u>

12.8 Compensation for personal injury, illness or defamation

Paragraph 59

Under para 59 a natural person or a special trust must disregard a capital gain or a capital loss in respect of a disposal of a claim resulting in that person or trust receiving compensation for personal injury, illness or defamation of that person or beneficiary. A similar approach is taken in the United Kingdom⁶⁰⁶ and Australia.⁶⁰⁷ The reason for this exclusion is that any compensation received would normally be intended to restore the person who has suffered harm to the position he or she was in before the injury, illness or defamation.

Example – Amounts received in respect of unfair dismissal and defamation*Facts:*

After his employer had made his life unbearable, Lester was forced to resign. He subsequently sought employment elsewhere but each time he approached prospective employers they would phone his previous employer who would 'bad mouth' him. He decided to take the matter to the CCMA which held that he had been constructively dismissed and he was awarded an amount of R50 000 in respect of unfair dismissal. Not being satisfied with the sum he had received, Lester threatened to launch a further action for defamation. The employer agreed to settle and paid him a further R20 000 in full and final settlement, while also agreeing to desist from commenting on him to prospective employers.

Result:

The amount of R50 000 received in respect of unfair dismissal is taxable in Lester's hands under para (d) of the definition of 'gross income'. The R20 000, being of a capital nature and unrelated to his employment, falls outside para (d)⁶⁰⁸ and is excluded from CGT under para 59.

⁶⁰⁶ Section 51(2) of the Taxation of Chargeable Gains Act, 1992.

⁶⁰⁷ Section 118–37 of the Income Tax Assessment Act, 1997.

⁶⁰⁸ See ITC 1289 (1979) 41 SATC 149 (T).

This exclusion does not, however, extend to all forms of damages and compensation. A right to claim damages or compensation is an asset for CGT purposes, being a personal right. The receipt of those damages is a disposal of that right which may give rise to a capital gain. The base cost of the right may consist, for example, of the legal fees incurred in bringing the action to court.

12.9 Gambling, games and competitions (para 60)

Paragraph 60

Paragraph 60 provides as a general rule that capital gains and losses arising from gambling, games and competitions will not be subject to CGT. However, *capital gains* of this nature will be subject to CGT if they

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

This paragraph encompasses all manner of activities such as horse racing, the National Lottery,⁶⁰⁹ casino winnings and the like. It is immaterial whether the winnings are in the form of a prize or cash.

In order for there to be proceeds as defined in para 35, a prize must have a money value. In *C: SARS v Brummeria Renaissance (Pty) Ltd & others*⁶¹⁰ it was held that it did not follow that if a receipt or accrual cannot be turned into money, it has no money value. The ability to turn a prize into money is merely one of the tests for determining whether an accrual has a money value. The court confirmed that the test was objective, not subjective. It follows that even if a prize is non-transferable it can still have a money value.

Local gambling activities contribute to the *fiscus* indirectly in the form of betting taxes and value-added tax. A portion of the proceeds from the National Lottery 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.

Following the SCA decision in *FirstRand Bank Limited v National Lotteries Board*⁶¹¹ that the bank's 'Million-a-month' competition comprised an illegal lottery, it is clear that winnings from the competition are subject to CGT.

Example – Gambling winnings

Facts:

Errol is a keen gambler and won the following amounts:

	R
Pick 6 winnings from the Greyville racecourse tote	50 000
Roulette winnings from Sun City casino	10 000
United Kingdom Lotto winnings	55 000
Illegal 'bucket shop' racehorse winnings (Durban)	5 000

⁶⁰⁹ Conducted under the Lotteries Act 57 of 1997.

⁶¹⁰ 2007 (6) SA 601 (SCA), 69 SATC 205.

⁶¹¹ 2008 (4) SA 548 (SCA) .

Result:

Errol's Pick 6 and roulette winnings are excluded from CGT, being from legal gambling in South Africa. However, his United Kingdom Lotto winnings and illegal racehorse winnings are subject to CGT. As regards his Lotto winnings, he can claim the cost of his Lotto ticket as part of base cost.

12.10 Portfolios of collective investment schemes other than portfolios of collective investment schemes in property (para 61)

Paragraph 61

The Collective Investment Schemes Control Act 45 of 2002 came into operation on 3 March 2003 and replaced the Unit Trusts Control Act 54 of 1981, and the Participation Bonds Act 55 of 1981. It provides a comprehensive modern legislative framework to regulate and supervise the collective investment industry, which includes equity unit trusts, property unit trusts and participation mortgage bond schemes. The Act is based on internationally accepted principles and best practices.

Paragraph 61 deals with the CGT consequences for a holder of a participatory interest in a portfolio of a collective investment scheme other than a collective investment scheme in property. It also addresses the CGT consequences for the portfolio. The term 'portfolio of a collective investment scheme' is defined in s 1(1) and includes the following portfolios as well as a portfolio of a collective investment scheme in property:

- a portfolio of a collective investment scheme in participation bonds;
- a portfolio of a collective investment scheme in securities; and
- a portfolio of a declared collective investment scheme.

Each of these portfolios is individually defined in s 1(1) as follows:

‘ “[P]ortfolio of a collective investment scheme in participation bonds” means any portfolio comprised in any collective investment scheme in participation bonds contemplated in Part VI of the Collective Investment Schemes Control Act managed or carried on by any company registered as a manager under and for the purposes of that Part;’

‘ “[P]ortfolio of a collective investment scheme in securities” means any portfolio comprised in any collective investment scheme in securities contemplated in Part IV of the Collective Investment Schemes Control Act managed or carried on by any company registered as a manager under section 42 of that Act for the purposes of that Part;’

‘ “[P]ortfolio of a declared collective investment scheme” means any portfolio comprised in any declared collective investment scheme contemplated in Part VII of the Collective Investment Schemes Control Act managed or carried on by any company registered as a manager under section 64 of that Act for the purposes of that Part;’

The term 'portfolio of a hedge fund collective investment scheme' is also defined in s 1(1) and means any portfolio held by any hedge fund business that qualifies as a declared collective investment scheme under s 63 of the Collective Investment Schemes Control Act.

Before its amendment by the Taxation Laws Amendment Act 17 of 2009, para 61 referred to a collective investment scheme 'contemplated in paragraph (e)(i) of the definition of "company" in section 1'. This reference referred to a CISS, which was deemed to be a company, even though in reality it was a trust. Paragraph (e)(i) was deleted by s 7(1)(a) of the

Taxation Laws Amendment Act 17 of 2009⁶¹² with the result that a CISS or so-called ‘equity unit trust’ is no longer a company for the purposes of the Act, and reverts to its true status, namely, a form of vesting trust. Under a typical CISS trust deed the investors are not entitled to any asset of the portfolio and are also not entitled to vote in relation to any of its assets. For details of how a CIS would have been taxed in the absence of para 61 see **14.11.5.3**.

Paragraph 61 requires the holder to determine any capital gain or loss when the participatory interest is disposed of.

Under para 61 a holder of a participatory interest in a CISS must

- determine a capital gain or loss in respect of the participatory interest when it is disposed of [para 61(1)]; and
- use the proceeds on disposal of that participatory interest and its base cost to make that determination [para 61(2)].

Under para 61(3) any capital gain or loss on a disposal by a portfolio of a collective investment scheme, other than a portfolio of a collective investment scheme in property, must be disregarded.

Section 25BA regulates the conduit-pipe principle for ordinary income. It provides that income distributed by the portfolio within a year of receipt or accrual must be accounted for by the beneficiary, while amounts not so distributed are taxed in the portfolio. The one-year distribution rule does not, however, apply to interest received by or accrued to the portfolio and is taxed in the hands of the holder upon distribution.⁶¹³ Section 25BA does not apply to an amount of a capital nature.

Foreign collective investment schemes

Paragraph (e)(ii) of the definition of ‘company’ in s 1(1) includes in that definition a

‘portfolio comprised in any investment scheme carried on outside the Republic that is comparable to a portfolio of a collective investment scheme in participation bonds or a portfolio of a collective investment scheme in securities in pursuance of any arrangement in terms of which members of the public (as defined in section 1 of the Collective Investment Schemes Control Act) are invited or permitted to contribute to and hold participatory interests in that portfolio through shares, units or any other form of participatory interest’.

An investor in such a portfolio would thus be regarded as holding a share in a company and must apply the normal rules applicable to shares.

The treatment of investments in portfolios that are not similar to a collective investment scheme in securities or participation bonds will depend on the type of investment vehicle in which the investments are housed.

⁶¹² The deletion came into operation as from the commencement of years of assessment commencing on or after 1 January 2010.

⁶¹³ Under s 73 of the Taxation Laws Amendment Act 31 of 2013 applicable to years of assessment commencing on or after 1 January 2014.

12.11 Donations and bequests to public benefit organisations and exempt persons (para 62)

Paragraph 62

Any capital gain or capital loss determined in respect of the donation or bequest of an asset to one of the persons set out in the table below must be disregarded. Before 22 December 2003 this exclusion applied only to donations or bequests to public benefit organisations.

Table 1 – Exclusion of capital gains and losses in respect of disposals to certain bodies

Paragraph 62	Type of body
(a)	Government of the Republic in the national, provincial or local sphere.
(b)	A public benefit organisation contemplated in para (a) of the definition of 'public benefit organisation' in s 30(1) that has been approved by the Commissioner under s 30(3). ⁶¹⁴
(c)	<p>A person contemplated in s 10(1)(cA) or (d)(iv):</p> <p>(cA):</p> <p>Any institution, board or body (other than a company as defined in the Companies Act, any co-operative, close corporation, trust or water services provider) established by or under any law and which, in the furtherance of its sole or principal object</p> <ul style="list-style-type: none"> • conducts scientific, technical or industrial research; • provides necessary or useful commodities, amenities or services to the State (including any provincial administration) or members of the general public; or • carries on activities (including the rendering of financial assistance by way of loans or otherwise) designed to promote commerce, industry or agriculture or any branch thereof. <p>Any association, corporation or company contemplated in para (a) of the definition of 'company' in s 1(1), all the shares of which are held by any such institution, board or body, if the operations of such association, corporation or company are ancillary or complementary to the object of such institution, board or body.</p> <p>The institution, board, body or company must meet a number of requirements including approval by the Commissioner.</p> <p>(d)(iv):</p> <p>A company, society or other association of persons established to promote the common interests of persons (being members of such company, society or association of persons) carrying on any particular kind of business, profession or occupation approved by the Commissioner under s 30B.</p>

⁶¹⁴ This provision was amended by s 52(a) of the Revenue Laws Amendment Act 20 of 2006 to remove the reference to a PBO that was exempt from tax under s 10(1)(cN). The amendment was required because of the introduction of partial taxation for PBOs with effect from years of assessment commencing on or after 1 April 2006.

Paragraph 62	Type of body
(d)	A person referred to in <ul style="list-style-type: none"> • s 10(1)(cE) – Any political party registered under s 15 of the Electoral Commission Act 51 of 1996, • s 10(1)(e): <ul style="list-style-type: none"> ➤ A body corporate established under the Sectional Titles Act 95 of 1986, ➤ A share block company established under the Share Blocks Control Act 59 of 1980, ➤ Any other association of persons (including a non-profit company) formed for managing the collective interests of its members, including expenditure applicable to the common immovable property of such members and the collection of levies for which such members are liable.
(e) ⁶¹⁵	A recreational club which is a company, society or other organisation as contemplated in the definition of 'recreational club' in s 30A(1) that has been approved by the Commissioner under s 30A.

Vesting of an asset by a trust

Any capital gain arising on the vesting of an asset by a trust in the Government, a provincial administration, organisation, person or club contemplated in para 62(a) to (e) cannot be attributed to such a body under para 80(1), since such bodies are specifically excluded from its ambit. As a consequence, such capital gains remain in the trust. For purposes of para 62, the act of vesting an asset by a trust in such a body is likely to be a 'donation' if the trustee is acting in accordance with the benevolent intention of the founder as embodied in the trust deed. It follows that under these circumstances any capital gain or loss arising in the trust upon the vesting of an asset must be disregarded under para 62.

Example – Donation to public benefit organisation

Facts:

Sea (Pty) Ltd donated vacant immovable property with a market value of R1 million to a South African university. The company had purchased the property after the valuation date for R200 000 and paid R20 000 to transfer the property into its name.

Result:

The donation is a 'disposal' under para 11(1)(a). Under para 38 the company is treated as if it disposed of the property for proceeds equal to the market value of R1 million. The capital gain is $R1\ 000\ 000 - (R200\ 000 + R20\ 000) = R780\ 000$. This gain is disregarded under para 62.

⁶¹⁵ Inserted by s 52(c) of the Revenue Laws Amendment Act 20 of 2006. This provision ensures that capital gains and losses arising from donations of assets to recreational clubs will continue to be excluded. Clubs were previously exempt under s 10(1)(d)(iv)(aa) and donations to such bodies qualified for exclusion under para 62(c). Clubs now qualify for partial exemption under s 10(1)(cO) and for this reason are now addressed under para 62(e).

12.12 Exempt persons (para 63)

Paragraph 63

Paragraph 63 requires that a person must disregard any capital gain or loss in respect of the disposal of an asset

- when any amount constituting gross income of whatever nature,
- would be exempt from tax under s 10,
- were it to be received by or accrue to the person.

Section 10 contains a number of exemptions from income tax. The exemptions provide

- complete exemption from tax in respect of the receipts or accruals of specified persons [for example, certain professional bodies approved by the Commissioner under s 30B – s 10(1)(d)(iv)(bb)],
- partial exemption from tax in respect of certain types of receipts or accruals of specified persons (for example, the levy income of a body corporate or share block company [s 10(1)(e)], the receipts and accruals of a PBO (s 10(1)(cN) and a recreational club [s 10(1)(cO)],
- exemption (complete or limited) for specified types of income (for example, the interest exemption).

The exclusion under para 63 is aimed at the first category, namely, persons enjoying complete exemption from tax. In order to determine whether a person falls within para 63, it is necessary to enquire hypothetically whether the person would be exempt regardless of the type of gross income that the person may receive in the future. This enquiry goes further than a mere projection based on the assets or activities of the body at the end of the relevant year of assessment. In evaluating whether a person's future gross income from any source would be exempt from tax under s 10, it is necessary to make the assumption that it will continue to comply with the requirements governing its current exempt status. For example, the fact that a professional body may lose its exempt status if it does something contrary to regulations prescribed by the Minister would not be taken into account.

The receipts and accruals of a mining closure rehabilitation company or trust contemplated in s 37A are exempt from normal tax provided the company or trust meets the requirements of s 10(1)(cP). Such a company or trust must therefore disregard its capital gains and losses under para 63.

The untaxed policyholder fund of a long-term insurer is exempt from tax under s 29A(9). The owners of policies in this fund include pension, provident, retirement annuity and benefit funds as well as persons whose gross income of whatever nature would be exempt from tax under s 10 [s 29A(4)(a)]. Since the untaxed policyholder fund is not exempt under s 10, it does not derive its exemption under para 63, but rather from having a zero-inclusion rate under para 10(b)(ii).

Section 10(1)(d)(i) provides that there shall be exempt from normal tax the receipts and accruals of any

- pension fund;
- pension preservation fund;
- provident fund;

- provident preservation fund;
- retirement annuity fund; or
- a beneficiary fund defined in s 1 of the Pension Funds Act 24 of 1956.

Consequently, these funds must disregard all their capital gains and losses under para 63.

A person enjoying partial exemption from tax, such as a body corporate or share block company under s 10(1)(e), does not qualify under this paragraph. PBOs and recreational clubs are also excluded from para 63 since the introduction of the system of partial taxation for these bodies. PBOs are addressed under para 63A, and recreational clubs under para 65B.

Example – Non-qualifying person deriving exempt income

Facts:

Holdco Ltd's assets consist exclusively of shares in other group companies and it derives all its income in the form of exempt dividends. During the year of assessment it disposed of the shares in one of its subsidiaries, Subco (Pty) Ltd and realised a capital gain of R1 million.

Result:

The capital gain will not be excluded by para 63 despite all Holdco's receipts and accruals during the year of assessment being exempt from tax under s 10(1)(k). Had Holdco derived some other income such as interest or management fees in the future, that income would be taxable. It cannot therefore be said that Holdco's receipts and accruals 'would have' been exempt from tax under s 10.

12.13 Public benefit organisations

Paragraph 63A

12.13.1 The system of partial taxation

A system of partial taxation for PBOs that undertake trading activities was introduced by the Revenue Laws Amendment Act 31 of 2005 through an amendment to s 10(1)(dN).⁶¹⁶ PBOs previously disregarded all their capital gains and losses under para 63, which applies to persons who are completely exempt from tax no matter what type of activity they undertake. Once PBOs became potentially taxable, they could no longer seek refuge under para 63, and it was necessary to introduce a new provision to cater for the CGT consequences of PBOs. This provision came in the form of para 63A, which applies to years of assessment commencing on or after 1 April 2006.⁶¹⁷ The position is therefore that

- before their first year of assessment commencing on or after 1 April 2006 PBOs fell under para 63, and
- after that date they fall under para 63A.

Much of the material in these notes is also addressed in Interpretation Note 44.⁶¹⁸

⁶¹⁶ Section 10(1)(cN) was amended by s 16(1)(a) of the Revenue Laws Amendment Act 31 of 2005. The amendment came into operation on 1 April 2006 and applies in respect of any year of assessment commencing on or after that date.

⁶¹⁷ The effective date of para 63A was introduced by s 64(2) of the Taxation Laws Amendment Act 8 of 2007.

⁶¹⁸ Interpretation Note 44 (Issue 3) dated 21 February 2020 'Public Benefit Organisations: Capital Gains Tax'.

12.13.2 Valuation date of PBOs

Under para (a) of the definition of ‘valuation date’ in para 1, the valuation date of a person who ceases to be an exempt person under para 63 is the date on which that person ceases to be an exempt person. Since all PBOs fall outside para 63 with effect from the introduction of partial taxation of PBOs, the valuation date of PBOs in existence on 1 April 2006 will be the first day of their first year of assessment commencing on or after 1 April 2006. For example, a PBO with a March year end will have 1 April 2006 as its valuation date, since this is the commencement of the 2007 year of assessment.

The valuation date value of a pre-valuation date asset forms part of the base cost of that asset and ensures that any pre-valuation date growth or decline in value is disregarded for CGT purposes.

The following methods of determining the base cost of an asset on valuation date are available:

- Market value of the asset on that date (paras 26, 27, 29 and 31)
- 20% of proceeds after first deducting allowable para 20 expenditure incurred on or after the valuation date (para 26)
- The time-apportionment base cost of the asset (para 30)
- The weighted-average method under para 32(3A)

The weighted-average method is available only for the four categories of identical assets listed in para 32(3A) (listed shares, participatory interests in collective investment schemes, gold and platinum coins whose prices are published in a newspaper, and listed s 24J instruments). This limitation on the permitted use of the method is unlikely to be of much relevance to a PBO because of the exclusion of capital gains and losses on such assets under para 63A(a) discussed below.

Under para 29(4), a PBO may not adopt or determine the market value of an asset unless it has valued the asset within two years from the valuation date. There is, however, no time limit for the valuation of financial instruments listed on a recognised exchange and participatory interests in South African collective investment schemes (see **8.33.8.2**). The early submission requirements for valuation forms relating to the high-value assets listed in para 29(5) do not apply to PBOs [para 29(8)].

The table below summarises the valuation dates for PBOs in existence on 1 April 2006 and the final date by which they were required to complete their valuations.

Table 1 – Summary of valuation dates for PBOs in existence on 1 April 2006

Year of assessment ending on the last day of	Valuation date	Final day for completion of valuation
March	1 April 2006	31 March 2008
April	1 May 2006	30 April 2008
May	1 June 2006	31 May 2008
June	1 July 2006	30 June 2008
July	1 August 2006	31 July 2008
August	1 September 2006	31 August 2008
September	1 October 2006	30 September 2008
October	1 November 2006	31 October 2008
November	1 December 2006	30 November 2008
December	1 January 2007	31 December 2008
January	1 February 2007	31 January 2009

Year of assessment ending on the last day of	Valuation date	Final day for completion of valuation
February	1 March 2007	28 February 2009

If time-apportionment is adopted for an asset acquired by a PBO for no consideration before the valuation date, 'B' in the time-apportionment formulae must be determined in accordance with the principles set out in **8.5A**.

12.13.3 Disregarding of capital gains and losses (para 63A)

Under para 63A a PBO approved by the Commissioner under s 30(3) must disregard any capital gain or loss in respect of the disposal of three categories of asset.

Category 1 – Non-trade assets [para 63A(a)]

This category applies to assets not used by the PBO on or after valuation date in carrying on any business undertaking or trading activity. It covers assets that are not 'used' but are 'held', such as investments in the nature of shares, or participatory interests in collective investment schemes. It also includes assets used exclusively for non-trade purposes, such as an asset used exclusively in carrying on a public benefit activity (PBA). Only the usage of the asset on or after the valuation date is taken into account, with any trade usage before that date being ignored.

Example 1 – Asset used exclusively on or after valuation date in carrying on public benefit activities [para 63A(a)]

Facts:

A PBO's year of assessment ends on 30 April. It provides health care services to poor and needy persons. It acquired immovable property on 30 June 2003 from which it provided health care services. During the period 30 June 2003 to 30 April 2006 30% of the property was let to third parties while the remaining usage was in respect of PBAs. Since the valuation date (1 May 2006) the property was used exclusively in carrying on PBAs. The property was sold on 30 September 2019 resulting in a capital gain of R100 000.

Result:

Under para 63A(a) the capital gain of R100 000 must be disregarded, since the property was used exclusively on or after the valuation date (1 May 2006) to carry on PBAs. Any trade usage before valuation date is disregarded.

Example 2 – Assets held (not used) by PBO [para 63A(a)]

Facts:

An approved PBO conducts the sole activity of caring for homeless children. It has invested surplus funds in a collective investment scheme. The PBO disposed of its participatory interest in the collective investment scheme at a capital gain of R25 000 to fund the purchase of additional accommodation.

Result:

The capital gain must be disregarded under para 63A(a), since the participatory interests were 'held' by the PBO and not 'used' in carrying on a business undertaking or trading activity.

Category 2 – Minimal trading assets [para 63A(b)(i)]

This category applies when substantially the whole of the use of the asset by the PBO on and after valuation date was directed at a purpose other than carrying on a business undertaking or trading activity. An example of such an asset is one that is used, say, 10% of the time for trading purposes and 90% of the time for PBO activities. The words ‘substantially the whole of the use’ are accepted by SARS to mean 90% or more. However, to overcome certain practical difficulties, SARS will accept a percentage of not less than 85%.⁶¹⁹ Such assets do not fall into the first category because they are used, albeit to a limited extent, in carrying on a business undertaking or trading activity.

The percentage of the asset used for trade or business purposes must be determined using a method appropriate to the circumstances. For example, a proportion based on time, floor area or a combination of the two may be appropriate.

Example 3 – Determination of ‘substantially the whole of the use’ on a time basis [para 63A(b)]*Facts:*

The financial year of a religious institution ends on 30 April. The institution has been approved as a PBO under section 30. It acquired a manse in 1995 for occupation by its resident minister. The minister’s term of office ended on 30 June 2006 and the manse was let to a third party from 1 July 2006 to 31 December 2007.

The newly appointed minister took occupation on 1 January 2008 and continued to occupy the manse until it was sold on 30 April 2019.

Result:

The PBO’s valuation date is 1 May 2006, being the first day of its first year of assessment commencing on or after 1 April 2006. The asset was held for 156 months from valuation date to the date of sale (1 May 2006 to 30 April 2019). During this period the manse was used to carry on PBAs for 138 months (2 + 136) and let for 18 months. This represents a usage of 88,4% ($138 / 156 \times 100$) for carrying on PBAs from the valuation date. The PBO has therefore used substantially the whole of the manse from the valuation date in carrying on its PBAs.

The PBO must accordingly disregard any capital gain or capital loss on the disposal of the manse.

Paragraph 63A(b)(i) applies and the PBO must accordingly disregard any capital gain or capital loss on the disposal of the manse.

⁶¹⁹ See Interpretation Note 24 (Issue 4) dated 12 February 2018 ‘Income Tax: Public Benefit Organisations: Trading Rules – Partial Taxation of Trading Receipts’.

Example 4 – Determination of ‘substantially the whole of the use’ on a floor area basis [para 63A(b)]*Facts:*

A PBO provides counselling services to prisoners and conducts its PBAs from its own premises. The PBO uses only a portion of the house for counseling services and lets the remaining rooms to third parties at a market-related rental. The whole area of the property is 210 m². The area of the property which is let is 30 m² and the balance of 180 m² is used for PBAs. The financial year-end of the PBO is 28 February. The property was sold on 30 June 2019 realising a capital gain. Valuation of the property took place on 1 March 2007.

Result:

As from the first day of its first year of assessment commencing on or after 1 April 2006 (that is, from 1 March 2007), the PBO is subject to para 63A. In this case floor area provides an appropriate basis for determining whether the property was substantially used to conduct PBAs on or after the valuation date. The area used for carrying on PBAs in relation to the whole property is 85,7% ($180 / 210 \times 100$). The capital gain on sale of the property must be disregarded, since substantially the whole of the property was used in carrying on PBAs (more than 85%).

Example 5 – Determination of ‘substantially the whole of the use’ on an hourly usage basis [para 63A(b)]*Facts:*

An educational institution approved under s 30 has acquired a separate property for the purposes of developing sports grounds. Hockey fields and tennis courts were subsequently constructed on the property. During school holidays and over periods when the facilities were not used by the PBO, they were let to outside sports clubs, coaches and other third parties at market-related rates on which the PBO was partially taxed with effect from the commencement of its financial year ending 31 December 2007. The PBO was obliged to dispose of the property on 8 March 2019 as a result of a commercial development on the adjoining properties and a capital gain was made on the transaction. Hourly usage of the property by third parties was 12%, with PBA usage being 88%.

Result:

The PBO has used substantially the whole of the property from the valuation date in carrying on its PBAs. The capital gain on disposal of the property must accordingly be disregarded under para 63A(b)(i).

Category 3 – Permissible trading assets [para 63A(b)(ii)]

This category applies when substantially the whole of the use of the asset by the PBO on or after valuation date was directed at carrying on a business undertaking or trading activity contemplated in s 10(1)(cN)(ii)(aa), (bb) or (cc). The permissible activities covered by these provisions are set out in the table below.

Table 1 – Permissible business undertakings or trading activities

Section 10(1)(cN)(ii)	Type of business undertaking or trading activity
(aa)	One that <ul style="list-style-type: none"> • is integral and directly related to the sole or principal object of that PBO as contemplated in para (b) of the definition of ‘public benefit organisation’ in s 30, • is carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost, and • does not result in unfair competition in relation to taxable entities.
(bb)	An undertaking or activity of an occasional nature that is undertaken substantially with assistance on a voluntary basis without compensation.
(cc)	An undertaking or activity approved by the Minister by notice in the <i>Gazette</i> . The Minister must be satisfied about various factors before granting approval, such as the scope and benevolent nature of the activity, the direct connection and interrelationship of the undertaking or activity with the sole or principal object of the PBO, its profitability and any economic distortion that may result from the exemption.

See comments under category 2 on SARS’s interpretation of the phrase ‘substantially the whole of the use’.

Example 6 – Asset used to carry on a permissible trading activity [para 63A(b)(ii)]

Facts:

An approved PBO conducts PBAs of providing facilities for the care of persons with a disability. As a therapeutic and remedial activity, the PBO acquired land on which the residents were taught to grow vegetables. The produce was primarily used for own consumption and any surplus was sold to a local home industry. All the labour was undertaken by the residents. The PBO disposed of the land on which the vegetable gardening took place resulting in a capital gain.

Result:

The vegetable gardening activity falls within the permissible trading rules of s 10(1)(cN)(ii)(aa), since it forms part of the PBA of caring for and providing training for the residents. The capital gain on sale of the land is disregarded for CGT purposes.

Example 7 – Asset used to carry on a permissible trading activity [para 63A(b)(ii)]

Facts:

A PBO conducts PBAs of caring for poor and needy persons 60 years and older. The PBO holds an annual fete as a fundraising event for which it has acquired a marquee. The fundraising event is undertaken with the assistance of volunteers and the items sold are all donated.

Result:

This event qualifies as an occasional trading activity which falls within s 10(1)(cN)(ii)(bb). Any capital gain or loss on sale of the marquee must be disregarded.

Example 8 – PBOs: Determination of valuation date values*Facts:*

A PBO with a financial year ending on 31 March owns immovable property on which it carries on its PBAs. The property was acquired on 1 June 1992 at a cost of R40 000.

With effect from 1 June 2006 the PBO let 20% of its property to a commercial business at an arm's length rental.

No expenditure was incurred on improvements to the property from date of acquisition.

On 31 December 2019 the PBO disposed of the property for proceeds of R110 000. The estate agent's commission amounted to R7 000.

The PBO determined that the market value of the property on 1 April 2006 was R80 000.

Determine the capital gain or loss on disposal of the property assuming that the valuation was performed on

- 31 March 2008, or
- 31 August 2008.

Result:

The valuation date of the PBO is 1 April 2006, namely, the first day of its first year of assessment commencing on or after 1 April 2006. If the PBO wishes to adopt the market-value method for determining the valuation date value of the property, the valuation should have been determined by 31 March 2008, namely, within two years of the valuation date. It follows that

- when the valuation was done on 31 August 2008, the market value was not determined within time and the PBO must resort to the time-apportionment or '20% of proceeds' method to determine the base cost of the property as at 1 April 2006, and
- when the valuation was performed on 31 March 2008, the market value was determined in time and the PBO may adopt the market value of the property on 1 April 2006 as the valuation date value of the property. The PBO is also entitled to use the time-apportionment or '20% of proceeds' method if it so chooses.

Time-apportionment base cost

Valuation date = 1 April 2006 (note 1)

N = Number of years before valuation date (1 June 1992 to 31 March 2006), determined as follows:

1 June 1992 to 31 May 2005 = 13 years

1 June 2005 to 31 March 2006 = 10 months (treated as a full year)

$N = 13 + 1 = 14$

T = Number of years after valuation date (1 April 2006 to 31 December 2019)

1 April 2006 to 31 March 2019 = 13 years

1 April 2019 to 31 December 2019 = 2 months (treated as a full year)

$T = 13 + 1 = 14$

P = Amount received or accrued reduced by selling expenses (note 2)

= R110 000 – R7 000 = R103 000

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R40\,000 + [(R103\,000 - R40\,000) \times 14 / (14 + 14)] \\
 &= R40\,000 + (R63\,000 \times 14 / 28) \\
 &= R40\,000 + R31\,500 \\
 &= R71\,500
 \end{aligned}$$

$$\begin{aligned}
 \text{Base cost} &= \text{time-apportionment base cost} + \text{post-valuation date expenditure} \\
 &= R71\,500 + R7\,000 \\
 &= R78\,500
 \end{aligned}$$

$$\begin{aligned}
 \text{Capital gain} &= \text{Proceeds} - \text{base cost} \\
 &= R110\,000 - R78\,500 \\
 &= R31\,500
 \end{aligned}$$

Note:

1. The TAB calculator for PBOs and recreational clubs on the SARS website can be used to determine the time-apportionment base cost for a PBO, since it can handle variable valuation dates.
2. This example assumes that no improvements were made on or after the valuation date. Had such improvements been made, the proceeds formula in para 30(2) would have had to be applied to determine 'P'.

'20% of proceeds' method

Valuation date value = 20% × (proceeds less post-valuation date expenditure)

$$\text{VDV} = 20\% \times (R110\,000 - R7\,000)$$

$$\text{VDV} = 20\% \times R103\,000$$

$$\text{VDV} = R20\,600$$

$$\begin{aligned}
 \text{Base cost} &= \text{VDV} + \text{post-valuation date expenditure} \\
 &= R20\,600 + R7\,000 \\
 &= R27\,600
 \end{aligned}$$

$$\begin{aligned}
 \text{Capital gain} &= \text{Proceeds} - \text{base cost} \\
 &= R110\,000 - R27\,600 \\
 &= R82\,400
 \end{aligned}$$

Market-value method (valuation done on or before 31 March 2008)

$$\begin{aligned}
 \text{Base cost} &= \text{Market value on 1 April 2006} + \text{post-valuation date costs} \\
 &= R80\,000 + R7\,000 \\
 &= R87\,000
 \end{aligned}$$

$$\begin{aligned}
 \text{Capital gain} &= \text{Proceeds} - \text{base cost} \\
 &= R110\,000 - R87\,000 \\
 &= R23\,000
 \end{aligned}$$

12.14 Assets used to produce exempt income (para 64)

Paragraph 64

A person must disregard any capital gain or loss in respect of the disposal of an asset which is used by that person solely to produce amounts which are exempt from normal tax under s 10 or s 12K⁶²⁰ (receipts and accruals from the disposal of a 'certified emission reduction'). Excluded from this concession are

- assets of PBOs [s 10(1)(cN)];
- assets of recreational clubs [s 10(1)(cO)];
- assets used to produce interest that is exempt under the so-called basic interest exemption [s 10(1)(j)]; and
- shares, or participatory interests in collective investment schemes, that are used to produce exempt dividend income [s 10(1)(k)].

Assets of PBOs are dealt with under para 63A. Recreational clubs are granted roll-over relief under para 65B.

12.15 Awards under the Restitution of Land Rights Act [para 64A(a)]

Paragraph 64A(a)

Persons who were dispossessed of their land as a result of racially discriminatory laws or practices may seek compensation under

- the Restitution of Land Rights Act 22 of 1994; or
- the measures as contemplated in Chapter 6 of the National Development Plan: Vision 2030 of 11 November 2011 released by the National Planning Commission, Presidency of the Republic of South Africa.

The compensation under the Restitution of Land Rights Act 22 of 1994 may be in the form of a restitution of a right to land, an award or compensation.

The compensation under the measures as contemplated in Chapter 6 of the National Development Plan: Vision 2030 may take the form of land or a right to land.

A person who has submitted a claim for land restitution effectively disposes of his or her claim for the amount of the award or compensation received.

Any capital gain or loss on disposal of this nature must be disregarded.

This provision does not apply to a person whose land is expropriated under the Restitution of Land Rights Act. Although para 64A(a) refers to 'compensation', this is not compensation paid to the person whose land is expropriated. The type of compensation envisaged in para 64A(a) is that which is of the same nature as a 'restitution of a right to land' and 'an award', that is, it is compensation paid to a land claimant. A person whose land is expropriated may, however, be entitled to roll-over relief under para 65 if the land is replaced (see **13.1**).

⁶²⁰ The reference to s 12K was inserted by s 76(1) of the Taxation Laws Amendment Act 17 of 2009 and is deemed to have come into operation on 11 February 2009 and applies in respect of disposals on or after that date.

By contrast, a person who donates land or a right to land under the measures as contemplated in Chapter 6 of the National Development Plan must disregard any capital gain or loss on that disposal under para 64D.

The base cost of land acquired by a claimant must be determined by applying the barter or exchange principle described in **8.5**, that is, the expenditure incurred under para 20 in acquiring such land would be equal to the market value of the right to claim the land which has been given up in exchange for the land.

12.16 Government scrapping payments [para 64A(b)]

Paragraph 64A(b)

Paragraph 64A(b) was deleted by s 121(1)(b) of the Taxation Laws Amendment Act 22 of 2012 with effect from years of assessment commencing on or after 1 January 2013. Its deletion was consequential on the introduction of a new system for dealing with government grants which included the introduction of s 12P and the Eleventh Schedule. The commentary below therefore relates to the period before the deletion of para 64A(b).

A person must disregard any capital gain or loss in respect of a disposal that resulted in that person receiving a government scrapping payment, if the Minister has by Notice in the *Gazette* identified the programme or scheme for purposes of para 64A.⁶²¹

A grant received by or accrued to a person under the tax recapitalisation programme announced by the Minister of Finance in the 2006 medium term budget policy statement is exempt from tax with effect from 31 October 2006 for the purposes of para 64A.⁶²² Under the programme the Government pays taxi operators R50 000 for each minibus taxi handed over for destruction.

12.16A Land donated under land reform measures

Paragraph 64D

A person must disregard any capital gain or loss in respect of the disposal by way of a donation of land or right to land by virtue of the measures as contemplated in Chapter 6 of the National Development Plan: Vision 2030 of 11 November 2011 released by the National Planning Commission, Presidency of the Republic of South Africa.

This exclusion grants relief to persons who donate land under the above land reform measures. Were it not for this exclusion, the person donating land or a right to land would be deemed to have proceeds equal to the market value of the land or right to land under para 38, which could give rise to a capital gain which would act as a disincentive to those wishing to take part in the land reform initiative.

⁶²¹ Paragraph 64A(b) was inserted by s 55 of the Revenue Laws Amendment Act 20 of 2006, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

⁶²² GN 365 GG 34233 of 29 April 2011.

12.16B Disposal by trust under share incentive scheme

Paragraph 64E

Under some share-incentive arrangements employees acquire units in the form of a right to an amount equal to the value of shares held by a share-incentive trust. Under such a 'phantom scheme' the employees are not entitled to the shares held by the trust but instead are allocated units which increase or decrease in value in line with the share price. For pre-existing shareholders this arrangement ensures that their interests are not diluted, while simultaneously enabling the employees to participate in the fortunes of the company. Typically, the employees would be entitled to any growth in value of the company's shares after meeting various requirements, such as having been in the service of the employer for a number of years. There is, however, potential for economic double taxation under such an arrangement, since the trust would be subject to CGT on any capital gain on disposal of the shares, while employees will have to include an amount equal to such gain in their income under s 8C. Paragraph 64E seeks to eliminate this double taxation by allowing the trust to disregard any capital gain to the extent that an equivalent amount is included in the income of the employees under s 8C.

Paragraph 64E applies when

- a trust determines a capital gain in respect of the disposal of an asset (usually comprising shares in an employer company); and
- a beneficiary of the trust has a vested right to an amount derived from that capital gain (this amount is represented by the 'phantom' shares or units).

Under these circumstances, the trust must disregard so much of that capital gain as is equal to that amount if that amount must be included in the income of that trust beneficiary under s 8C

- as an amount received or accrued in respect of a restricted equity instrument; or
- taken into account in determining the gain or loss in the hands of that trust beneficiary in respect of the vesting of a restricted equity instrument.

Paragraph 64E is deemed to have come into operation on 1 March 2017 and applies in respect of amounts received or accrued on or after that date.

Example – Disregarding of capital gain by share incentive trust under para 64E*Facts:*

Qualifying employees of Company X are beneficiaries of the X Employee Share Incentive Trust. The trust holds shares in Company X. Under the so-called 'phantom scheme' employees are given units by the trust entitling them to an amount equal to the growth in value of the Company X shares. However, their entitlement to any increase in value is subject to them being in service for a period of five years.

Gerrie is one of the employees participating in the share-incentive arrangement. On 1 March 2015 the trust acquired 100 000 shares from Company X at a cost of R100 000 at which point Gerrie was allocated 100 000 units by the trust which gave him a contingent interest in the value of the shares. On 29 February 2020 the shares had risen in value to R180 000, at which point the trust sold the shares for that amount, realising a capital gain of R80 000 which was vested in Gerrie. He included the amount in his income under s 8C.

Result:

The trust must disregard the capital gain of R80 000, since an equivalent amount has been included in Gerrie's income under s 8C.

12.17 Recreational clubs (para 65B)

Paragraph 65B

12.17.1 Background

Section 10(1)(d)(iv)(aa) used to provide a complete exemption from income tax for the receipts and accruals of any

'company, society or other association of persons established to—
 (aa) provide social and recreational amenities or facilities for the members of such company, society or other association; or
 (bb) [not applicable],
 approved by the Commissioner subject to such conditions as the Minister may prescribe by regulation'.

As a consequence, for CGT purposes, approved recreational clubs enjoyed complete exclusion from CGT under para 63.

This treatment changed with the introduction of a system of partial taxation for recreational clubs. Section 10(1)(d)(iv)(aa) was deleted by s 10(1)(k) of the Revenue Laws Amendment Act 20 of 2006 and a new s 10(1)(cO)⁶²³ was introduced to deal with clubs.

The deletion of s 10(1)(d)(iv)(aa) came into operation on 1 April 2007 and applies to a club as from its first year of assessment commencing on or after that date, that is, it is aligned with the commencement date of s 10(1)(cO).⁶²⁴

Extension of the old dispensation

Clubs enjoying approval under s 10(1)(d)(iv)(aa) were required to reapply for approval under s 30A by no later than 31 March 2009. It since emerged that many clubs missed the deadline for lodging their applications for approval under s 30A because they were unaware of the change in legislation.

Representations were made to give clubs that had missed the 31 March 2009 deadline more time to reapply for exemption. Consequently, the deletion of s 10(1)(d)(iv)(aa) was deferred by s 95(1) of the Taxation Laws Amendment Act 17 of 2009 for the clubs described below.

⁶²³ Section 10(1)(cO) was inserted in the principal Act by s 10(1)(j) of the Revenue Laws Amendment Act 20 of 2006. Under s 10(3) of Act 20 of 2006, s 10(1)(cO) came into operation on 1 April 2007 and applies to a club as from its first year of assessment commencing on or after that date.

⁶²⁴ See s 97(1) of the Taxation Laws Amendment Act 8 of 2007, which amended s 10(3) of the Revenue Laws Amendment Act 20 of 2006. Under the amendment, s 10(1)(k) of Act 20 of 2006 came into operation on 1 April 2007 and applies in respect of any year of assessment commencing on or after that date.

The amendment, which adds s 10(4) to the Revenue Laws Amendment Act 20 of 2006, reads as follows:

‘(4) Paragraph (k) of subsection (1) shall come into operation on 1 April 2007 and applies in respect of any year of assessment commencing on or after that date: Provided that the receipts and accruals of a company, society or other association of persons which was approved by the Commissioner under section 10(1)(d)(iv) of the Income Tax Act, 1962, will continue to be exempt from tax until the earlier of—

(a) the last year of assessment ending on or before 30 September 2010;

or

(b) the year of assessment preceding the year of assessment during which section 10(1)(cO) applies to the receipts and accruals of that company, society or other association of persons.’

This rule means that a club that had approval under s 10(1)(d)(iv)(aa) and which had not applied for approval under s 30A, will continue to enjoy complete exemption from income tax under s 10(1)(d)(iv)(aa) up to and including its last year of assessment ending on or before 30 September 2010. If a club enjoying exemption under s 10(1)(d)(iv)(aa) applied before 31 March 2009 for approval under s 30A for a year of assessment ending before 30 September 2010, that club must comply with s 10(1)(cO) from the effective date of that provision (that is, from the first day of the club’s first year of assessment commencing on or after 1 April 2007). In other words, those clubs will not be given an extension of their original complete exempt status under s 10(1)(d)(iv)(aa).

The new dispensation

Under the new regime recreational clubs are subject to a system of partial taxation, the cornerstones of which are ss 10(1)(cO) and 30A and para 65B. In order to enjoy partial exemption under s 10(1)(cO), clubs must apply to the Commissioner for approval under s 30A.

Clubs are now potentially taxable on investment income and trading income not integral and directly related to the provision of social and recreational amenities or facilities for club members that exceeds the greater of

- 5% of total membership fees and subscriptions due and payable, and
- R120 000⁶²⁵ [s 10(1)(cO)(iv)].

As a result of the loss of their complete exempt status, clubs are no longer able to automatically disregard capital gains and losses on the disposal of any of their assets. Apart from falling outside para 63, they will also not qualify for exclusion under para 64, since that provision now specifically excludes any asset used to produce exempt receipts and accruals contemplated in s 10(1)(cO).

Roll-over relief is, however, granted in respect of the disposal of recreational club property under para 65B. But unlike PBOs, no exclusion applies to the disposal of investments such as shares and participatory interests in collective investment schemes.

⁶²⁵ The current amount of R120 000 in s 10(1)(cO)(iv)(bb) was introduced by s 28(1)(c) of the Taxation Laws Amendment Act 24 of 2011 and applies to amounts received or accrued during years of assessment commencing on or after 1 March 2011. The previous amount of R100 000 was introduced by s 16(1)(b) of the Revenue Laws Amendment Act 60 of 2008 and applies to years of assessment commencing on or after 1 March 2009. The initial threshold was R50 000.

A club approved under s 30A that loses its approval status and fails to transfer its assets and liabilities to another approved club or South African PBO must include an amount equal to the market value of its remaining assets less its *bona fide* liabilities in its taxable income in the year of assessment in which approval was withdrawn or the dissolution took place [s 30A(8)]. There is no relationship between this inclusion in taxable income and the Eighth Schedule, since it does not give rise to a deemed disposal or acquisition of the errant club's assets. There is clearly a strong incentive for clubs to remain within the ambit of s 30A.

The valuation date of a club for CGT purposes is the date on which it becomes partially taxable under s 10(1)(cO) (that is, when it falls outside para 63). See in this regard para (a) of the definition of 'valuation date' in para 1. Thus, a club that has been approved under s 30A before 31 March 2009 and which was in existence on 1 April 2007 that has a 31 March year-end will have a valuation date of 1 April 2007. The valuation dates for clubs in existence on 1 April 2007 which were approved under s 30A on or before 31 March 2009 are summarised in the table below.

Table 1 – Valuation dates for recreational clubs in existence on 1 April 2007 (other than clubs to which Table 2 applies)

Year of assessment ending on the last day of	Valuation date	Final day for completion of valuation
March	1 April 2007	31 March 2009
April	1 May 2007	30 April 2009
May	1 June 2007	31 May 2009
June	1 July 2007	30 June 2009
July	1 August 2007	31 July 2009
August	1 September 2007	31 August 2009
September	1 October 2007	30 September 2009
October	1 November 2007	31 October 2009
November	1 December 2007	30 November 2009
December	1 January 2008	31 December 2009
January	1 February 2008	31 January 2010
February	1 March 2008	28 February 2010

Table 2 – Valuation date for recreational clubs exempted under s 10(1)(d)(iv)(aa) which had not applied for approval under s 30A by 31 March 2009

Year of assessment ending on the last day of	Valuation date	Final day for completion of valuation
March	1 April 2010	31 March 2012
April	1 May 2010	30 April 2012
May	1 June 2010	31 May 2012
June	1 July 2010	30 June 2012
July	1 August 2010	31 July 2012
August	1 September 2010	31 August 2012
September	1 October 2010	30 September 2012
October	1 November 2009	31 October 2011
November	1 December 2009	30 November 2011
December	1 January 2010	31 December 2011
January	1 February 2010	31 January 2012
February	1 March 2010	28 February 2012

Under para 29(4)(b)(i) clubs have to value their assets within two years of their valuation date if they wish to adopt the market-value method. However, para 29(4)(b)(ii) provides that the two-year valuation limit does not apply to

- financial instruments listed on a recognised exchange, and
- participatory interests in South African collective investment schemes in securities or property.

The market value of these financial instruments must be determined in accordance with para 31(1)(a) and (c)(i) respectively (see **8.33.8.2**).

Proof of the valuation must be retained for five years from the date of submission of the return of income reflecting the disposal (see **8.33.10.1** and **22.3**). The early submission requirements relating to the high-value assets referred to in para 29(5) do not apply to clubs [para 29(8)].

Clubs that do not comply with the two-year valuation period will have to use time-apportionment (para 30) or the '20% of proceeds' method (para 26).

A TAB Calculator for PBOs and recreational clubs which can handle variable valuation dates is available on the SARS website under Types of tax / Capital gains tax / Calculators to determine the time-apportionment base cost of an asset of a PBO or club.

A club established on or after 1 April 2007 does not have a valuation date, since it acquires its assets at cost or deemed cost equal to market value if acquired by donation (para 38) or bequest [s 25(3)(b)].

See also *Tax Guide for Recreational Clubs* (Issue 3) dated 29 February 2016 available on the SARS website under Legal Counsel/ Legal Counsel Publications / Find a Guide.

12.17.2 Application of para 65B

Paragraph 65B applies to recreational clubs approved by the Commissioner under s 30A. Such a club can elect to apply para 65B to the disposal of an asset the whole of which was used mainly for purposes of providing social and recreational facilities and amenities for members of the club. The reference to ‘the whole of which’ was clearly intended to preclude from roll-over relief an asset a part of which is used exclusively for non-recreational use, such as the long-term letting of a floor of a clubhouse. In *SBI v Lourens Erasmus (Eiendoms) Bpk*⁶²⁶ Botha JA held that the word ‘mainly’ prescribed a purely quantitative standard of more than 50%. Thus, if a club lets out its building less than 50% of the time while using it for recreational purposes during the rest of the time, it will qualify under para 65B.

Examples – The whole of which is mainly used

Example 1

A club lets its building less than 50% of the time while using it for the remaining period to carry on social and recreational activities in terms of its sole or principal object.

Result:

The building will qualify for roll-over relief for CGT purposes.

Example 2

A social club owns a building with an area of 300 m². The club uses only one room (21 m²) once a week for its social activities and lets the remainder of the building as office accommodation.

Result:

If the club sells the building, it will not be entitled to elect the roll-over relief because the whole of the building was not mainly used to provide social facilities for its members.

The following requirements must be met before the election can be made:

- Proceeds must accrue to the club in respect of the disposal, and must exceed or be equal to the base cost of the asset (that is, a capital gain or break-even situation).
- An amount at least equal to the receipts and accruals from the disposal has been or will be expended to acquire one or more replacement assets all of which will be used mainly for such purposes. In other words, para 65B will not apply when less than the amount derived from the disposal is spent on replacement assets. While the new assets need not necessarily fulfil the same function as the old asset, they must be used

⁶²⁶ 1966 (4) SA 444 (A), 28 SATC 233 at 245.

mainly for purposes of providing social and recreational facilities and amenities for club members.

- The contracts for the acquisition of the replacement asset or assets must all have been or will be concluded within 12 months after the date of the disposal of the asset. The replacement asset or assets must all be brought into use within three years of the disposal of the asset. The Commissioner may, however, extend the period within which the contract must be concluded or asset brought into use. However, the period may not be extended by more than six months, and then only if all reasonable steps were taken to conclude the contracts or bring the assets into use.
- The asset must not be deemed to have been disposed of and to have been reacquired by the club. This situation could occur for example, when a club asset is converted to trading stock, in which case para 12(2)(c) will trigger a disposal and reacquisition.

12.17.3 Disregarding of capital gain [para 65B(2)]

A club that makes the election must disregard any capital gain when determining its aggregate capital gain or loss, subject to para 65B(3), (4) and (5).

12.17.4 Apportionment of capital gain across multiple replacement assets [para 65B(3)]

The capital gain derived from the disposal of the old asset must be apportioned to the replacement assets in accordance with the following formula:

$$\frac{\text{Receipts expended on replacement asset}}{\text{Receipts expended on acquiring all replacement assets}} \times \text{Capital gain}$$

12.17.5 Recognition of capital gain [para 65B(4)]

A club disposing of a replacement asset must treat any capital gain apportioned to that replacement asset under para 65B(3) as a capital gain in respect of that replacement asset. This treatment does not apply when the capital gain has been brought to account elsewhere under para 65B, for example, because the contract for the replacement asset was signed too late or the asset was not brought into use within the prescribed time.

12.17.6 Failure to conclude contract or bring assets into use [para 65B(5)]

This provision deals with the consequences when

- a club fails to conclude a contract, or
- fails to bring any replacement asset into use
- within the period prescribed in para 65B(1)(c)(ii) and (iii).

In such event the club must

- treat the capital gain contemplated in para 65B(2) as a capital gain on the date on which the relevant period ends,
- determine interest at the prescribed rate on that capital gain from the date of that disposal to the above date, and
- treat that interest as a capital gain on the above date when determining the club's aggregate capital gain or loss.

Example 1 – Roll-over relief: one replacement asset*Facts:*

The Rovers Recreational Club, which has a year-end of 30 June, has been approved by the Commissioner under s 30A. The club acquired its clubhouse in 1980 by donation and determined its market value on 1 July 2007 (its valuation date) at an amount of R9 million. On 31 December 2009 the club extended its restaurant at a cost of R1 million.

On 20 April 2019 the club sold its clubhouse for R12 million and elected to apply para 65B to the disposal. The whole of the clubhouse was used mainly for social and recreational purposes.

On 10 November 2019 the club entered into an agreement to acquire a new clubhouse at a cost of R15 million. The club took occupation of its new premises on 1 January 2020.

Determine the CGT consequences of the disposal and replacement of the clubhouse assuming the market-value method is used to determine the base cost of the old clubhouse.

Result:

The club qualifies to use para 65B for the following reasons:

- The proceeds from the disposal of the clubhouse exceed its base cost [R12 million less (R9 million plus R1 million)].
- An amount at least equal to the proceeds from disposal of the clubhouse has been expended (the proceeds from the disposal of the clubhouse are R12 million and the cost of the new clubhouse is R15 million).
- The contract for the replacement of the clubhouse was entered into within 12 months after its disposal (the date of disposal of the clubhouse was 20 April 2019 and the agreement for the acquisition of the new clubhouse was signed on 10 November 2019).
- The new clubhouse was brought into use within three years of the disposal of the clubhouse (the clubhouse was sold on 20 April 2019 and the new clubhouse was occupied on 1 January 2020).

The capital gain on the disposal of the clubhouse is determined as follows:

	R
Proceeds	12 000 000
Less: Base cost (R9 000 000 + R1 000 000)	(10 000 000)
Capital gain	<u>2 000 000</u>

Under para 65B(2) the aggregate capital gain of R2 million is disregarded and deemed to be a capital gain in respect of the new clubhouse when it is eventually disposed of.

Example 2 – Acquisition of more than one replacement asset*Facts:*

The Lily Whites Cricket Club, an approved recreational club under s 30A, has a year-end of 30 June. It acquired land and buildings for R1 million in March 2004 which were used to provide social and recreational facilities for its members. Improvements of R15 000 were effected to the change rooms on 1 August 2007. The land and buildings were sold to a developer on 30 April 2019 for R3 515 000. The market value of the property on valuation date, which is 1 July 2007, was R2 million. The club elected to apply para 65B to the disposal of its land and buildings.

On 31 May 2019 the club concluded an agreement with Woodglen Primary School for the acquisition of its playing field and cricket ground at a cost of R2 million. On 30 June 2019 the club concluded another agreement to purchase an adjacent property with a building suitable for a new clubhouse at a cost of R3 million. In both instances the assets (replacement assets) were acquired for purposes of providing social and recreational amenities or facilities to the club's members. The club moved into the new clubhouse and began using the playing field on 30 November 2019.

Determine the CGT consequences of the disposal of the club's land and buildings.

Result:

Capital gain on disposal of the club's land and buildings

	R	R
Proceeds		3 515 000
Less: Base cost		
Market value – 1 July 2007	(2 000 000)	
Improvements – 1 August 2007	<u>(15 000)</u>	<u>(2 015 000)</u>
Capital gain to be disregarded		<u>1 500 000</u>

Roll-over relief – para 65B

The disposal of the club's land and buildings qualifies for roll-over relief under para 65B for the following reasons:

- The proceeds from the disposal of its land and buildings exceed its base cost (the sale realised a capital gain of R1 500 000).
- An amount at least equal to the proceeds from disposal of its land and buildings has been expended (the proceeds from the sale of its land and buildings were R3 515 000 and the cost of the replacement assets was R5 million).
- The contracts for the acquisition of the replacement assets were entered into within 12 months of the disposal of the club's land and buildings (the land and buildings were sold on 30 April 2019 and the agreements for the acquisition of the replacement assets were signed on 31 May 2019 and 30 June 2019 respectively).
- The new clubhouse and playing field were brought into use within three years of the disposal of the club's land and buildings (land and buildings were sold on 30 April 2019 and the new clubhouse and playing field were brought into use on 30 November 2019).

Capital gain apportioned to cricket ground (replacement asset)

$$\frac{\text{Receipts expended on replacement asset}}{\text{Receipts expended on acquiring all replacement assets}} \times \text{Capital gain}$$

$$= R2\,000\,000 / R5\,000\,000 \times R1\,500\,000$$

$$= R600\,000 \text{ to be taken into account when the replacement asset is disposed of.}$$

Capital gain attributable to adjacent property with a building suitable for a new clubhouse (replacement asset)

$$\frac{\text{Receipts expended on replacement asset}}{\text{Receipts expended on acquiring all replacement assets}} \times \text{Capital gain}$$

$$= R3\,000\,000 / R5\,000\,000 \times R1\,500\,000$$

$$= R900\,000 \text{ to be taken into account when the replacement asset is disposed of.}$$

12.18 Small business funding entities (para 63B)

Paragraph 63B

Paragraph 63B came into operation on 1 March 2015.

The term ‘small business funding entity’ is defined in s 1(1) as follows:

‘ “[S]mall business funding entity” means any entity, approved by the Commissioner in terms of section 30C;’

The receipts and accruals of a small business funding entity are exempt from normal tax under s 10(1)(cQ) to the extent that they comply with the provisions of that section.

The small business funding entity must have as its sole or principal object the provision of funding for small, medium and micro-sized enterprises. The latter entities are defined in s 1(1) as follows:

‘ “[S]mall, medium or micro-sized enterprise” means any—

(a) person that qualifies as a micro business as defined in paragraph 1 of the Sixth Schedule; or

(b) any person that is a small business corporation as defined in section 12E(4);’

A small business funding entity approved by the Commissioner under s 30C must disregard any capital gain or capital loss determined on the disposal of an asset if

- it did not use that asset in carrying on any business undertaking or trading activity; or
- substantially the whole of the use of that asset by it was directed at
 - a purpose other than carrying on a business undertaking or trading activity; or
 - carrying on a business undertaking or trading activity contemplated in s 10(1)(cQ)(ii)(aa), (bb) or (cc).

Category 1 – Non-trade assets [para 63B(a)]

This category applies to an asset not used in carrying on any business undertaking or trading activity. It covers assets that are not ‘used’ but are ‘held’, such as investments in shares or participatory interests in collective investment schemes.

Example 1 – Assets held (not used) by small business funding entity [para 63B(1)(a)]*Facts:*

An approved small business funding entity conducts the sole activity of providing funding to micro businesses. It has invested surplus funds in a collective investment scheme. The small entity disposed of its participatory interest in the collective investment scheme at a capital gain of R250 000 to fund advances to a micro business.

Result:

The capital gain must be disregarded under para 63B(1)(a), since the participatory interests were ‘held’ by the entity and not ‘used’ in carrying on a business undertaking or trading activity.

Category 2 – Minimal trading assets [para 63B(1)(b)(i)]

This category applies when substantially the whole of the use of the asset by the entity was directed at a purpose other than carrying on a business undertaking or trading activity. An example of such an asset is one that is used, say, 10% of the time for trading purposes and 90% of the time for funding small, medium and micro-sized enterprises. The words 'substantially the whole of the use' are accepted by SARS to mean 90% or more. However, to overcome certain practical difficulties, SARS will accept a percentage of not less than 85%. Such assets do not fall into the first category because they are used, albeit to a limited extent, in carrying on a business undertaking or trading activity.

The percentage of the asset used for trade or business purposes must be determined using a method appropriate to the circumstances. For example, a proportion based on time, floor area or a combination of the two may be appropriate.

Category 3 – Permissible trading assets [para 63B(1)(b)(ii)]

This category applies when substantially the whole of the use of the asset by the small business funding entity was directed at carrying on a business undertaking or trading activity contemplated in s 10(1) (cQ) (ii) (aa), (bb) or (cc). The permissible activities covered by these provisions are set out in the table below.

Table 1 – Permissible business undertakings or trading activities

Section 10(1)(cQ)(ii)	Type of business undertaking or trading activity
(aa)	An undertaking or activity that <ul style="list-style-type: none"> • is integral and directly related to the sole or principal object of that small business funding entity; • is carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost; and • does not result in unfair competition in relation to taxable entities.
(bb)	An undertaking or activity that is of an occasional nature and undertaken substantially with assistance on a voluntary basis without compensation.
(cc)	An undertaking or activity that is approved by the Minister by notice in the <i>Gazette</i> , having regard to <ul style="list-style-type: none"> • the scope and benevolent nature of the undertaking or activity; • the direct connection and interrelationship of the undertaking or activity with the sole or principal object of the small business funding entity; • the profitability of the undertaking or activity; and • the level of economic distortion that may be caused by the tax exempt status of the small business funding entity carrying out the undertaking or activity.

A small, medium or micro-sized enterprise is exempt from normal tax on any amount received by or accrued to it from a small business funding entity under s 10(1)(zK). The receipt or accrual of such an amount which is used to acquire, create or improve an asset will result in the base cost of the asset being reduced under s 23O.

12.19 Disposal of equity shares in foreign companies (para 64B)

Paragraph 64B

12.19.1 Effective date

Paragraph 64B came into operation on 1 June 2004 and applies in respect of the disposal of any equity share in any foreign company on or after that date. Since then the provision has been amended numerous times to accommodate, amongst other things, decreases in the percentage holding required to qualify for the exclusion, to insert and later remove highly complex anti-avoidance measures and to keep up with the changes in the way in which returns of capital are dealt with. Before 1 January 2013 the provision excluded shares held in a foreign financial instrument holding company but that exclusion no longer applies.

12.19.2 Background

In the 2003 Budget Review, the Minister of Finance announced his intention to allow the tax-free repatriation of foreign dividends to South Africa. This dividend exemption, known as the 'participation exemption', was subsequently introduced into s 10(1)(k)(ii)(*dd*) and later moved to s 10B(2)(a). One of the requirements for the exemption is that the South African holder of shares receiving the dividend must hold at least 10%⁶²⁷ of the equity shares and voting rights in the foreign company. Before 8 November 2005 the percentage was 25% and before 1 April 2012 it was 20%.⁶²⁸

The participation exemption is frequently found in continental European systems, such as France, Netherlands, Belgium and Denmark. This exemption often exists alongside the tax-free sale of foreign shares involving the same percentage stake because profits from the sale of shares merely represent retained dividends. Paragraph 64B gives effect to this tax-free disposal. It is probably best described as a 'participation exclusion', since it applies to both capital gains and losses. In broad terms South African holders of shares are allowed to make a tax-free sale of foreign shares in a foreign company in which they hold an interest of at least 10% as long as that sale is made to non-residents. The latter requirement encourages the repatriation of foreign funds to South Africa.

12.19.3 Exclusion of capital gains and losses on disposal of foreign company shares [para 64B(1)]

Paragraph 64B(1) provides that, subject to para 64B(4), a person other than a headquarter company must disregard any capital gain or capital loss determined in respect of the disposal of any equity share in any foreign company [other than an interest contemplated in para 2(2)], if

- that person (whether alone or together with any other person forming part of the same group of companies as that person) immediately before that disposal
 - held an interest of at least 10% of the equity shares and voting rights in that foreign company;⁶²⁹ and

⁶²⁷ The percentage was decreased from 20% to 10% by s 116(1)(b) of the Taxation Laws Amendment Act 24 of 2011 and applies to disposals made on or after 1 April 2012.

⁶²⁸ The previous holding of 'more than 25%' was changed to 'at least 20%' by s 79(1)(a) of the Revenue Laws Amendment Act 31 of 2005. The amendment came into operation on 8 November 2005.

⁶²⁹ The reference to voting rights was inserted by s 58(1)(b) of the Taxation Laws Amendment Act 3 of 2008, and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

- held that interest for a period of at least 18 months prior to that disposal, subject to the relaxation of this rule when a company disposing of the interest is part of a group of companies (discussed below); and
- that interest is disposed of to any person that is not a resident (other than a CFC or any person that is a connected person in relation to the person disposing of that interest) for an amount that is equal to or exceeds the market value of the interest.

The term 'foreign company' is defined in s 1(1) and means a company that is not a resident.

Exclusions from para 64B(1)

Headquarter companies are excluded from para 64B(1) but are addressed in para 64B(2).

The equity shares must be disposed of to a non-resident but will not qualify for the exclusion if they are disposed of to a CFC or a connected person in relation to the disposer.

The selling price of the equity shares must equal or exceed their market value in order to qualify for the exclusion.

Also excluded from para 64B(1) is any interest contemplated in para 2(2), that is, shares in a company when 80% or more of the market value of the equity shares is directly or indirectly attributable to immovable property in South Africa and the person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20% of the equity shares in that company.

Paragraph 64B(1) has been made subject to para 64B(4) which deals with foreign returns of capital. It follows that para 64B(4) takes precedence. More specifically, para 64B(4) is not subject to the 18-month holding rule in para 64B(1).

The 'at least 10%' holding requirement [para 64B(1)(a)(i)]

In determining whether a person holds at least 10% of a foreign company's equity shares and voting rights, no regard must be had to indirect holdings. Paragraph 64B(1)(a)(i) refers to the equity shares being 'held' by the person and this means a direct holding. Had it been intended to include indirect holdings the words 'directly or indirectly' would have been used.

Only the direct interest of a person other than a company (for example, an individual or a trust), is taken into account in determining whether the 10% threshold has been met. No account is taken of the interests of connected persons in relation to that person. But with a company, the interest is determined by adding together the interest of the company and the interest of any other company forming part of the same group of companies as that company. This treatment amounts to a simple summation of the direct interests of all the companies in the group of companies in the foreign company. As long as the companies in the group together hold at least 10% of the foreign company's equity shares and voting rights immediately before a disposal, any disposal of such shares by any one of the group companies, no matter how small, will meet the minimum holding requirement.

Example 1 – Determination of percentage interest for a group company (1)

Facts:

Holdco Ltd, a South African company, holds all the equity shares and voting rights in Abacus (Pty) Ltd, which in turn holds 4% of the equity shares and voting rights in Brutus Inc, an oil refining company registered in Bermuda. Holdco holds 6% of the equity shares and voting rights in Brutus directly. Determine whether Holdco and Abacus meet the minimum equity share and voting rights requirements to qualify for the participation exemption in para 64B.

Result:

Since Holdco and Abacus are members of the same group of companies, their combined interest in Brutus must be determined to see whether it is at least 10%. In this instance their combined interests amount to $4\% + 6\% = 10\%$, so both companies meet the minimum interest requirement for exclusion under para 64B.

Example 2 – Determination of percentage interest for a group company (2)*Facts:*

A, B and D are members of the same group of companies.

C is a foreign company.

A holds 80% of the equity shares and voting rights in B.

B holds 2% of the equity shares and voting rights in C.

B holds 100% of the equity shares and voting rights in D.

D holds 4% of the equity shares and voting rights in C.

A holds 3% of the equity shares and voting rights in C directly.

D sells its 4% interest in C to a non-resident. Is D subject to the exclusion under para 64B?

Result:

Combined group holding in C = 3% (A) + 2% (B) + 4% (D) = 9% .

Since the group together does not hold at least 10% of C, D does not qualify for the exclusion under para 64B. No regard must be had to B's indirect interest in C via D in determining the group's interest.

When must the 'at least 10%' interest be determined?

The percentage holding is determined immediately before the disposal. As a result, a person can dispose of a small percentage interest and still qualify for the exclusion of any capital gain or loss, as long as before that disposal the person held an interest of at least 10%.

Example 3 – Disposal of interest in foreign company when different holding requirements applied*Facts:*

On 1 March 2003 Ashini acquired 75 equity shares comprising a 75% interest in Jackson Inc, a foreign manufacturing company at a cost of R75 000. She then disposed of her shares to non-residents for proceeds as follows:

	Number Of shares	Proceeds R
1 October 2004	5	20 000
1 October 2005	40	200 000
31 March 2012	21	80 000
31 March 2019	9	R40 000

Determine which of Ashini's capital gains are excluded under para 64B.

Result:

Ashini made the following capital gains:

			R
1 October 2004	R20 000 – R5 000 (5 / 75 × R75 000)	=	15 000
1 October 2005	R200 000 – R40 000 (40 / 75 × R75 000)	=	160 000
31 March 2012	R80 000 – R21 000 (21 / 75 × R75 000)	=	59 000
31 March 2019	R40 000 – R9 000 (9 / 75 × R75 000)	=	31 000

The capital gain of R15 000 will be excluded under para 64B because the shares were disposed of after 18 months and Ashini held a 75% interest in the company before the disposal which exceeded the required > 25% threshold which applied before 8 November 2005.

The capital gain of R160 000 will be excluded because immediately before the disposal Ashini had held her shares for more than 18 months and held an interest of 70% which exceeded the required > 25% threshold.

The capital gain of R59 000 will be excluded because Ashini held 30% of the shares immediately before the disposal, which is more than the 'at least 20%' requirement for exclusion that applied on or after 8 November 2005.

The capital gain of R 31 000 must be taken into account for CGT purposes because Ashini held an interest of only 9% immediately before the disposal which is less than the 'at least 10%' interest required for disposals on or after 1 April 2012.

The 18-month holding requirement [para 64B(1)(a)(ii)]

The exclusion applies to a person that has held an interest of at least 10% of the equity shares and voting rights in the foreign company for at least 18 months. Once the 18-month period has been reached, and while it is maintained in respect of a *de minimis* holding of at least 10%, the exclusion applies to the disposal of any equity shares in the company, even if they have been held for less than 18 months.

If a person disposes of the equity shares in tranches, the exclusion will apply only while the person holds at least 10% of the equity shares and voting rights in the company. As soon as the person falls below the 10% threshold, any further capital gains and losses may not be disregarded, despite those shares having been held at an earlier time when the threshold was exceeded.

Example 1 – The 18-month rule**Facts:**

Three years ago, Celia acquired 75% of the equity shares and voting rights in a foreign trading company. Six months ago, she acquired the remaining 25% shareholding. As a result of a sharp downturn in the company's prospects, she disposed of her entire holding to a non-resident. The 75% holding realised a capital gain of R100 000 while the 25% holding realised a capital loss of R40 000. All the shares were acquired as a long-term investment.

Result:

Both the capital gain and capital loss must be disregarded because Celia held at least 10% of the equity shares and voting rights in the company for at least 18 months before she disposed of her entire holding.

Example 2 – Disposal of shares in tranches*Facts:*

Ernest held 18% of the equity shares and voting rights in Foreign Trading Co for five years. However, because the company's prospects had deteriorated, he sold his shares. In order not to flood the market, he disposed of the shares to non-residents in two tranches of 9% each, with a gap of three months between each sale. The first 9% holding realised a capital gain of R1 million, while the second 9% holding realised a capital gain of R1,2 million.

Result:

Ernest must disregard the capital gain of R1 million, since he held at least 10% of the shares immediately before the disposal of his first 9% holding. However, he must account for the capital gain of R1,2 million, since immediately before he sold the second 9% holding, he held only 9% of the company's equity shares. Had Ernest sold the shares in tranches of 8% and 10% respectively, he would have disregarded any capital gain or loss on disposal of both tranches.

Acquisition of shares from group company

A special rule applies if the person is a group company that acquired the shares from another group company. In such event, the combined periods that the two group companies held the shares must exceed 18 months. This group concession does not extend beyond the immediately preceding holding. For example, if Group Co 1 acquires a foreign company from Group Co 2, which had bought it from Group Co 3, only the holding periods of Group Co 1 and Group Co 2 can be taken into account when Group Co 1 disposes of its interest in the foreign company.

Example 3 – 18-month rule when foreign company shares acquired from another group company*Facts:*

SA Holdco owns 100% of CFC 1 and CFC 2. On 1 March 2018 CFC 1 acquired a 26% interest in Foreign Co. On 28 February 2019 CFC 1 sold its interest in Foreign Co to CFC 2. On 1 October 2019 CFC 2 disposed of Foreign Co to a non-resident third party for a market-related consideration. Does CFC 2 meet the 18-month holding period requirement under para 64B(1)?

Result:

CFC 1 had held Foreign Co for 12 months, while CFC 2 held it for 7 months. Therefore, the combined holding period is 19 months, which exceeds 18 months. As a result, CFC 2 meets the 18-month holding requirement in para 64B(1).

The non-resident purchaser requirement [para 64B(1)(b)]

The resident must dispose of the equity shares in the foreign company to a non-resident other than a CFC or a connected person in relation to the disposer for an amount that is equal to or exceeds the market value of the shares.

A capital gain arising under a deemed disposal triggered on the cessation of residence under s 9H will not qualify for exclusion under para 64B, since s 9H(2) and (3) deem the person to dispose of the shares to a resident.

A CFC is a foreign company because it is a non-resident [see definition of “foreign company” in s 1(1)]. For the purposes of determining the net income of a CFC under s 9D a CFC is deemed to be a resident when applying the definition of “gross income”, para 2(1)(a) and various other provisions including certain attribution rules. Thus, a person who disposes of equity shares in a CFC will potentially qualify for the exclusion under para 64B because the shares in question would be held in a foreign company. Likewise, a CFC that disposes of equity shares in another CFC to a non-resident will also potentially qualify for the participation exclusion when determining its net income. However, in both these situations the seller is not permitted to dispose of the equity shares in a CFC to another CFC. A CFC is excluded as a transferee in view of the expanded offshore corporate restructuring rules in ss 41 to 47. Hence, an unbundling transaction does not fall within the participation exclusion but can fall under s 46.

It is also not permitted for a person to dispose of the shares to a non-resident connected person in relation to the disposer.⁶³⁰ For more information on the definition of ‘connected person’ in s 1(1) see Interpretation Note 67 (Issue 4) dated 28 January 2020 ‘Connected Persons’.

The actual consideration given in exchange for the equity shares in the CFC must be equal to or exceed the market value of the shares. This full value (cash or cash-equivalent) consideration requirement ensures that the exclusion under para 64B will not be used as a migration or divestiture technique.

Example 1 – Qualifying sale of shares in CFC

Facts:

South African Holding Company holds all the shares of CFC 1, which in turn holds all the shares of CFC 2. CFC 1 has a value of R50 million. CFC 1 sells all the shares to Foreign Company which has no direct or indirect South African shareholders. Foreign Company provides R20 million in cash and issues a R30 million note in exchange.

Result:

The sale of CFC 2 by CFC 1 qualifies for exclusion under para 64B. The sale is to a foreign company that is not a CFC and the consideration received equals the value transferred.

Example 2 – Non-qualifying disposal of foreign company shares by CFC

Facts:

South African Holding Company holds all the shares of CFC 1, which in turn holds all the shares of CFC 2, and CFC 2 holds all the shares of CFC 3. CFC 2 unbundles all the shares of CFC 3 to CFC 1.

Result:

The unbundling does not qualify for the exclusion under para 64B because it is to a CFC. However, this unbundling qualifies for roll-over relief under the offshore reorganisation rules in s 46.

⁶³⁰ Under s 117 of the Taxation Laws Amendment Act 25 of 2015 this requirement came into operation on 5 June 2015 and applies to disposals on or after that date.

12.19.4 Disposal of equity shares by headquarter company [para 64B(2)]

The term ‘headquarter company’ is defined in s 1(1) as follows:

‘ “[H]eadquarter company”, in respect of any year of assessment means a company contemplated in section 91(1) in respect of which an election has been made in terms of that section;’

A headquarter company must disregard any capital gain or loss determined in respect of the disposal of any equity share in any foreign company if that headquarter company (whether alone or together with any other person forming part of the same group of companies as that headquarter company) immediately before that disposal held at least 10% of the equity shares and voting rights in that foreign company. This rule is subject to para 64B(4) and excludes an interest referred to in para 2(2), that is, shares in a company when 80% or more of the market value of the equity shares is directly or indirectly attributable to immovable property in South Africa and the headquarter company (whether alone or together with any connected person in relation to that headquarter company), directly or indirectly, holds at least 20% of the equity shares in that company.

In determining the ‘at least 10%’ holding requirement in the foreign company it is necessary to aggregate only the direct holdings of the headquarter company and any direct holdings of any other company forming part of the same group of companies as the headquarter company.

No minimum holding period applies to a headquarter company.

The blanket exemption for headquarter companies stems from the fact that the headquarter company has a number of other deviations from the general rules. First, this entity may not participate in the reorganisation roll-over rules. Secondly, all transfers and conversions to a headquarter company will trigger immediate tax. The net effect is to allow for the headquarter company to operate somewhat freely from the South African net because the funds are derived offshore and redeployed offshore and because entry into the system requires an exit charge.

12.19.5 Capital gain on disposal of CFC to connected person [para 64B(3)]

Paragraph 64B(3) applies to the disposal of any equity share in any foreign company on or before 31 December 2012.

The exclusion of capital gains and losses under para 64B operates in conjunction with the participation exemption for foreign dividends in s 10B(2)(a). The exclusion of capital gains is intended to facilitate internal restructurings of offshore foreign subsidiaries. The exclusion also allowed for the sale of certain foreign shareholdings to foreign persons with the expectation that the loss of foreign shareholdings would be replaced with valuable consideration. However, it became apparent that some multinationals were seeking to use the exclusion so as to divest themselves of their foreign subsidiaries with foreign subsidiary ownership transferring abroad with little or no consideration remaining within South Africa’s jurisdiction. These transactions also contained schemes that attempted to avoid any STC so as to achieve a wholly tax-free divestiture. Paragraph 64B(3) was designed to remedy these concerns.

Under para 64B(3) any capital gain disregarded as a result of the exclusion under para 64B(1) or (4) is treated as a net capital gain under para 8(b) in specified circumstances. The treatment of an amount as a net capital gain has the effect that no capital losses for the year of assessment or any assessed capital loss brought forward from the preceding year of assessment may be set off against the amount. Before para 64B(3) can be applied, four requirements must be met.

First requirement [para 64B(3)(a)]

Before the disposal the foreign company being disposed of must be a CFC in relation to

- the person claiming the exclusion under para 64B, or
- any other company in the same group of companies as that person.

Second requirement [para 64B(3)(b)]

The equity share in the CFC must have been disposed of by a person to a connected person in relation to that person either before or after that disposal.

Third requirement [para 64B(3)(c)]

The third requirement will be met if any one of three scenarios prevails.

First scenario [para 64B(3)(c)(i)]

Under the first scenario the person must have disposed of the equity shares

- for no consideration, or
- for a consideration which does not reflect an arm's length price.

This scenario does not apply when the company has distributed the CFC's shares in the circumstances contemplated in the second scenario.

Second scenario [para 64B(3)(c)(ii)]

The second scenario applies when the equity shares in the CFC were disposed of by a person by way of a distribution. However, this scenario does not apply when

- that distribution was made to a company that forms part of the same group of companies as that person; or
- the full amount of that distribution was included in the income of a holder of shares in that foreign company or would, but for s 10B(2)(a) or (b), have been so included.

Section 10B(2)(a) exempts a foreign dividend if the person deriving the foreign dividend (whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10% of the total equity shares and voting rights in the company declaring the foreign dividend (the participation exemption for foreign dividends). Section 10B(2)(b) exempts a foreign dividend paid or declared to a company by a foreign company resident in the same country as that company.

Third scenario [para 64B(3)(c)(iii)]

The third scenario deals with a secondary or third disposal of any consideration received or accrued from the sale of the equity shares in the CFC. For example, if the equity shares in the CFC were sold to a non-resident for R100 on credit and the resulting debt asset is disposed of in the circumstances contemplated in the provision, the provision will apply. The provision goes one step further and also applies when the initial consideration is exchanged for another amount and that second amount is then disposed of in the manner contemplated in the provision. This situation could happen when the CFC's shares are sold in exchange for a debenture and that debenture is then exchanged for other shares which are then disposed of under the provision.

The above disposal must form part of a transaction, operation or scheme involving the disposal of the CFC equity shares.

The disposal of the consideration must meet one of the following requirements:

First scenario [para 64B(3)(c)(iii)(aa)]

The provision will apply when the consideration or substituted consideration is disposed of

- for no consideration, or
- for a consideration which does not reflect an arm's length price.

This scenario does not apply when the company distributes the consideration in the circumstances contemplated in the second scenario below.

The second scenario [para 64B(3)(c)(iii)(bb)]

The provision applies when the consideration or substituted consideration is disposed of by a distribution by a company. This scenario does not apply when the full amount of that distribution was included in the income of a holder of shares in that company or would but for s 10B(2)(a) or (b) have been so included.

The fourth requirement [para 64B(3)(d)]

The CFC ceased in terms of any transaction, operation or scheme of which the disposal of the equity share forms part, to be a CFC in relation to

- the person disposing of its shares, or
- other company in the same group of companies as that person.

In relation to the fourth requirement described above, regard must be had solely to any rights contemplated in para (a) of the definition of 'participation rights' in s 9D. Paragraph (a) of the definition of 'participation rights' in s 9D(1) refers to

'the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature, in that company'.

12.19.6 Disregarding of capital gain arising from foreign return of capital [para 64B(4)]

A person meeting the qualifying requirements must disregard any capital gain determined in respect of any foreign return of capital received by or accrued to that person from a 'foreign company' as defined in s 9D. This disregarding applies when that person (whether alone or together with any other person forming part of the same group of companies as that person) holds at least 10% of the total equity shares and voting rights in that company. Such a capital gain could arise under para 76B if a foreign return of capital exceeds the expenditure contemplated in para 20 in respect of the share.

It could also apply to a share buy-back under which all or part of the consideration is in the form of a foreign return of capital. While a share buy-back is a normal disposal under para 11(1)(a) from the shareholder's perspective, the foreign return of capital would comprise all or part of the proceeds on that disposal and any resulting capital gain would consequently potentially be excluded under para 64B(4).

The rule does not apply to any interest contemplated in para 2(2) (shares in a land-rich company).

Paragraph 64B(4) is intended to provide similar relief to that conferred on foreign dividends under s 10B(2)(a), and it carries the same purpose, namely, to encourage the repatriation of funds to South Africa.

12.19.7 Exclusion of equity shares in a portfolio of a collective investment scheme [para 64B(5)]

Paragraph 64B does not apply in respect of any capital gain or loss determined in respect of

- the disposal of any equity share in any portfolio of a collective investment scheme contemplated in para (e)(ii) of the definition of ‘company’ in s 1(1); and
- any distribution contemplated in para 64B(4) by any such portfolio.

12.20 Disposal of restricted equity instruments

Paragraph 64C

A person must disregard any capital gain or capital loss determined in respect of the disposal of any restricted equity instrument as contemplated in

- s 8C(4)(a) (exchange of one restricted equity instrument for another);
- S 8C(5)(a) (disposal of restricted equity instrument for a non-arm’s length price or to a connected person – the acquirer is treated in the same manner as the employee or director who originally acquired the restricted equity instrument and will bear the s 8C consequences when the restriction is lifted); or
- S 8C(5)(c) (disposal of restricted equity instrument to employer or associated institution or other person by arrangement with the employer for an amount which is less than the market value of the restricted equity instrument).

Under s 8C an income gain or loss is determined on a restricted equity instrument when the restriction is lifted [s 8C(1) read with s 8C(3)]. Thus, for example, an employee or director can exchange one restricted equity instrument for another without triggering s 8C. Nevertheless, such an exchange is a disposal under para 11 and it was therefore necessary to mirror the tax-neutral treatment in s 8C for CGT purposes while the equity instrument remains restricted.

Paragraph 64C applies to years of assessment commencing on or after 1 March 2016.

Examples – Disposal of restricted equity instruments not giving rise to a capital gain or loss

Facts (1):

Gary owned 100 shares in ABC Ltd which comprised restricted equity instruments under s 8C. As a result of an asset-for-share transaction, Gary had to dispose of his ABC shares in exchange for restricted shares in XYZ Ltd.

Result:

The exchange of shares does not trigger an inclusion in Gary’s income under s 8C because the shares in XYZ Ltd are also restricted. Under para 64C Gary must disregard any capital gain or loss determined on disposal of an equity instrument contemplated in s 8C(4)(a), which deals with the exchange of one restricted equity instrument for another. He must therefore disregard any capital gain or loss on exchange of the shares in ABC Ltd for shares in XYZ Ltd.

Facts (2):

Bradley owned 100 shares in ABC Ltd which comprised restricted equity instruments under s 8C. While the shares were restricted, he disposed of them to his family trust of which he and his family were beneficiaries.

Result (2):

Bradley's disposal of his shares in ABC Ltd to his family trust does not trigger an income gain or loss under s 8C because the shares were restricted at the time of their disposal. In addition, Bradley must account for any income gain or loss under s 8C(5)(a) made by his family trust when the restrictions are lifted. Under para 64C Bradley must disregard any capital gain or loss determined on disposal of an equity instrument contemplated in s 8C(5)(a), which deals, amongst other things, with the disposal of a restricted equity instrument to a connected person. Bradley and his family trust are connected persons in relation to each other by virtue of him being a beneficiary of the trust.⁶³¹ Bradley must therefore disregard any capital gain or loss on disposal of the shares to his family trust.

Facts (3):

Renni owned 100 shares in ABC Ltd which comprised restricted equity instruments under s 8C. She had paid R100 a share. Upon resigning from her employer, the shares had a market value of R150 a share. Under the terms of the share arrangement, Renni was obliged to dispose of the shares to her employer at a price of R120 a share under a predetermined formula.

Result (3):

Under s 8C(2)(a)(i)(aa) Renni is deemed to dispose of the shares for their actual proceeds of R120.

Section 8C(5)(c) deals, amongst other things, with the disposal of a restricted equity instrument to an employer at below market value. It provides that s 8C(5)(a) must not apply, which means that the employee would not have to account for any income gain or loss deemed to be determined by the employer when the restriction is lifted.

Under para 64C Renni must disregard any capital gain or loss on disposal of the shares, since it would already have been accounted for under s 8C.

12.21 International shipping companies

Section 12Q

Section 12Q was inserted into the Act by S 41(1) of the Taxation Laws Amendment Act 31 of 2013 with effect from 1 April 2014 and applies in respect of years of assessment commencing on or after that date.

Under s 12Q(2)(b) an international shipping company must, in determining its aggregate capital gain or loss for a year of assessment, disregard any capital gain or loss determined in respect of a South African ship engaged in international shipping. The terms 'international shipping', 'international shipping company' and 'South African ship' are defined in s 12Q(1) as follows:

‘ “[**I**]nternational shipping” means the conveyance for or compensation of passengers or goods by means of the operation of a South African ship mainly engaged in international traffic;’

⁶³¹ Paragraph (b)(i) of the definition of 'connected person' in s 1(1).

‘ “[~~I~~]**International shipping company**” means a company that is a resident that operates one or more South African ships that are utilised in international shipping;’

‘ **South African ship**” means a ship—

- (a) which is registered in the Republic in accordance with Part 1 of Chapter 4 of the Ship Registration Act, 1998 (Act No. 58 of 1998); or
- (b) another ship or ships used temporarily in lieu of the ship contemplated in paragraph (a) by virtue of that ship being subject to repair or maintenance.’

Chapter 13 – Roll-overs

PART IX: ROLL-OVERS

13.1 Involuntary disposal (para 65)

Paragraph 65

13.1.1 Summary of provisions

Table 1 – Summary of para 65

Paragraph 65	Description
(1)	Conditions under which an election to defer a capital gain may be made
(2)	Disregarding of capital gain in year of disposal
(3)	Allocation of capital gain over multiple replacement assets
(4)	Depreciable assets – spreading of capital gain in proportion to capital allowances on replacement asset
(5)	Recognition of any remaining untaxed portion of a capital gain in year of disposal of replacement asset
(6)	Failure to conclude contract or bring replacement asset into use
(7)	Replacement assets comprising personal-use assets

13.1.2 Introduction

Paragraph 65 enables a person to elect to defer a capital gain when an asset has been disposed of by way of operation of law, theft or destruction. No specific form is prescribed for the making of the election. An electing party must simply complete the return of income on the basis that the election has been made, and, if there is a SARS enquiry, will have to show that the requirements of para 65 have been complied with.

The words ‘operation of law’ were substituted for the word ‘expropriation’ by the Revenue Laws Amendment Act 45 of 2003. *Black’s Law Dictionary*⁶³² describes these words as follows:

‘[O]peration of law. The means by which a right or a liability is created for a party regardless of the party’s actual intent <because the court didn’t rule on the motion for rehearing within 30 days, it was overruled by operation of law>.’

The words are wider than ‘expropriation’ and would cover, for example, a property disposed of pursuant to the gazetting of a land claim under the Restitution of Land Rights Act 22 of 1994. In other words, it is not required of a taxpayer to contest such a claim through the courts in order to secure the roll-over relief conferred by para 65. The relief would not, however, apply to a person who disposes of an asset under the mere threat of the lodging of a claim under any law.

With depreciable assets, s 8(4)(e) provides matching deferral relief for any recoupment of capital allowances. The election must be made in the tax return reflecting the disposal of the old asset.

Paragraph 65 also applies when an asset is partly disposed of, for example, when a building is destroyed by fire. It is implicit throughout the Eighth Schedule that a part-disposal is a disposal and that a part of an asset is also an asset. This principle can be inferred from para 33 which contains rules for determining how much of the base cost of an asset to allocate to the part disposed of.

⁶³² Bryan A Garner and Henry Campbell Black (1860–1927), 8 ed (2004) Thomson/West, St Paul, MN.

When an asset is partly destroyed, it will be necessary to determine whether the replacement of the destroyed portion is a repair or an improvement. Under para 20(2)(b) the cost of repairs is excluded from base cost. In ITC 617⁶³³ the court distinguished a repair from the renewal of an asset as follows:

'Repair is restoration by renewal or replacement of subsidiary parts of the whole. Renewal as distinguished from repair is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject matter under discussion.'

Example – Part-disposal through destruction

Facts:

Carin's vacation home was destroyed by fire. The base cost of the land was R100 000 while the base cost of the building was R900 000. The insurance company paid Carin R2 million to replace the building while the actual replacement cost was R2,5 million.

Result:

The destruction of the holiday home has resulted in a part-disposal, giving rise to a capital gain of R1,1 million (R2 million proceeds less R900 000 allocable base cost). The base cost of the reconstructed holiday home including the land is R100 000 + R2,5 million = R2,6 million. The capital gain of R1,1 million must be disregarded under para 65 and accounted for when the holiday home is disposed of.

13.1.3 Conditions under which an election to defer a capital gain may be made [para 65(1)]

A person can elect to apply para 65 to the disposal of an asset (other than a financial instrument) under the following conditions:

- The asset must be disposed of by way of operation of law (for example, expropriation), theft or destruction. Thus, a farmer who simply sells a farm and replaces it with another farm would not qualify for the relief.
- Proceeds must accrue to the person by way of compensation (for example, an insurance payout).
- The proceeds must be equal to or exceed the base cost of the asset (that is, a capital gain or break-even situation). When a capital loss arises, this provision does not apply, since most persons would want to claim the capital loss in the year of assessment in which it arises. This provision also applies when the proceeds are equal to the base cost of an asset. This treatment is necessary because despite not having a capital gain, a person may have a recoupment under s 8(4), and one of the pre-requisites for the equivalent relief provided by s 8(4)(e) is an election under para 65 or 66.
- If less than all the proceeds are expended in acquiring a replacement asset, para 65 will not apply. It is possible, however, to acquire a replacement asset costing more than the proceeds realised upon the disposal of the old asset.
- The relief applies when an amount at least equal to the receipts and accruals from the asset disposed of 'has been' or 'will be' expended to acquire one or more asset referred to in the provision as 'replacement asset or assets'. The description of the new assets as replacement assets is intended to be more than just a label. The replacement asset must fulfil the same function as the old asset. For example, if a person receives compensation for the expropriation of a farm and invests the proceeds on loan account in a company, para 65 will not apply. A new farm must be acquired. The new asset

⁶³³ (1946) 14 SATC 474 (U) at 476.

must also be 'brought into use' – a clear indication that the provision is directed at tangible replacement assets. The use of the words 'has been' indicates that it is possible to acquire a replacement asset before disposing of the old asset. When the replacement asset is acquired in advance of the involuntary disposal of the old asset, there should be a causal link that confirms that the new asset is indeed a 'replacement'.

- All the replacement assets must be from a South African source contemplated in s 9(2)(j) or (k).

Section 9(2)(j) covers immovable property held by the person or any interest or right of whatever nature of the person to or in immovable property contemplated in para 2, which is situated in South Africa. It would thus be possible to replace a farm situated in or outside South Africa with another farm situated in South Africa. Conversely it would not be possible to replace such a farm with one outside South Africa. While para 2 includes equity shares in a company holding immovable property in South Africa, it would not be possible to replace immovable property with equity shares in a land-rich company, since para 65 does not apply to a financial instrument. Thus, such shares could not comprise a 'replacement asset' (see the previous bullet point on what constitutes a replacement asset).

Section 9(2)(k) contemplates movable assets. For a resident, such an asset must not be attributable to a permanent establishment outside South Africa and the proceeds from its disposal must not be subject to any taxes on income payable to any sphere of government of any country other than South Africa. For a non-resident, the asset must be attributable to a permanent establishment situated in South Africa.

The requirement to replace an asset with one from a South African source is designed, for example, to prevent a resident from replacing an asset with one attributable to a foreign permanent establishment, with the result that South Africa may lose its taxing rights over the asset under the relevant tax treaty. Alternatively, even if the asset does not form part of a foreign permanent establishment, it must not be subject to tax in a foreign country. Were it to be so subject to tax, South Africa would likely have to give credit for the foreign taxes under s 6quat, thus eroding the South African tax base. The requirement also prevents a non-resident who would be subject to CGT on South African immovable property or assets effectively connected with a permanent establishment in South Africa under para 2(1)(b) from replacing such assets with non-taxable assets from a non-South African source.

- The relief applies when the contract for the replacement asset has been or will be concluded within 12 months of the disposal of the asset. The words 'has been' cover the situation in which the replacement is acquired before the disposal of the old asset.
- All the replacement assets must be brought into use within three years of the disposal of the asset. A replacement asset may be acquired (contract concluded) and brought into use before the disposal of the asset being replaced.
- The Commissioner may, on application by the taxpayer, extend the 12-month and three-year periods by no more than six months if all reasonable steps were taken to conclude those contracts or bring those assets into use.
- The asset must not be deemed to have been disposed of and to have been reacquired by the person. For example, the relief will not apply in a 'degrouching' situation in which a deemed disposal and immediate reacquisition is triggered.

13.1.4 Disregarding of capital gain [para 65(2)]

A person making the above election must disregard the capital gain in the year of disposal, subject to

- para 65(4), which spreads the capital gain in proportion to capital allowances on any depreciable replacement assets;
- para 65(5), which triggers the capital gain (or in the case of a depreciable asset, any untaxed remaining portion of it) when the replacement asset is disposed of; and
- para 65(6), which triggers the capital gain if a contract for the replacement asset is not concluded or the replacement asset is not brought into use within the prescribed periods.

Example – Hold-over of gain resulting from involuntary disposal

Facts:

Heidi's holiday house, which has a base cost of R550 000, burnt down completely on 15 February 2019. The house was insured for its replacement cost of R600 000 and the insurance company settled her claim for this sum on 18 October 2019. On 21 November 2019 Heidi contracted with a building contractor to rebuild her house and the project was completed on 7 March 2020. She spent the December 2020 holidays at her holiday house.

Result:

The destruction of Heidi's holiday house is a disposal under para 11. However, the time of the disposal is regulated by para 13, which in this instance provides that 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 2019. Under para 35 the proceeds of the disposal comprise the insurance payment that she received in consequence of the disposal of the house by destruction.

The result is that Heidi is treated as having disposed of her holiday house in the year of assessment ending on 29 February 2020 at a capital gain of R50 000. She is able to satisfy the Commissioner that she has concluded a contract to replace the destroyed holiday house within one year of its disposal and that she will bring its replacement into use within three years of its disposal. Heidi is therefore entitled to disregard the capital gain of R50 000 in the year of disposal. The gain will be held over and brought to account when the replacement home is disposed of.

13.1.5 Allocation of capital gain over multiple replacement assets (para 65[3])

Paragraph 65(3) applies when the amount received or accrued from the disposal of the old asset is used to acquire more than one replacement asset. The disregarded capital gain must be spread across the replacement assets in accordance with the following formula:

Capital gain attributable to a replacement asset =

$$\text{Disregarded capital gain} \times \frac{\text{Receipts and accruals expended on replacement asset}}{\text{Receipts and accruals expended on all replacement assets}}$$

This formula must be used for the purpose of para 65(4) and (5), which deal with depreciable assets.

Example – Allocation of capital gain across multiple replacement assets*Facts:*

Neptune Ltd acquired a machine after the valuation date at a cost of R100 000. During the year of assessment under review a flood irreparably damaged the machine. The insurer paid out R120 000, being the replacement cost. Neptune Ltd decided to replace the old machine with two smaller machines X and Y. The X machine cost R90 000 and the Y machine R30 000.

Result:

The capital gain of R20 000 on disposal of the old machine will be allocated to the replacement machines as follows:

Machine X: $R90\,000 / R120\,000 \times R20\,000 = R15\,000$

Machine Y: $R30\,000 / R120\,000 \times R20\,000 = R5\,000$

These capital gains will be brought to account in future years of assessment in accordance with the respective capital allowances claimable in respect of each of the machines.

13.1.6 Depreciable assets – spreading of capital gain in proportion to capital allowances on replacement asset [para 65(4)]

If a person acquires a depreciable replacement asset, the capital gain on disposal of the old asset must be recognised as the deductions or allowances on the replacement asset are claimed. The portion of the capital gain allocated to the replacement asset that must be recognised in a year of assessment is determined in accordance with the following formula:

$$\text{Disregarded capital gain attributed to replacement asset} \times \frac{\text{Allowance or deduction claimed in year of assessment}}{\text{All qualifying allowances or deductions for all years of assessment based on cost or value of replacement asset at date of acquisition}}$$

Any allowances on improvements to a depreciable replacement asset must be taken into account in the numerator of this formula. As a result, the recognition of the capital gain will be accelerated.

Example – Replacement of depreciable asset with single replacement asset*Facts:*

Arson Ltd, which has a February financial year-end, purchased a machine on 28 February 2019 at a cost of R100 000. On 31 December 2019 the machine was destroyed by fire. The company received R120 000 from its insurer as compensation on 29 February 2020. Arson Ltd purchased a more advanced replacement machine on 30 June 2020 at a cost of R150 000. Determine the capital gain to be brought to account in the 2021 to 2024 years of assessment.

Result:

Under para 13(1)(c) the old machine was disposed of when the full compensation was received on 29 February 2020. The capital gain on disposal of the old machine during the 2020 year of assessment amounts to R20 000 (amount by which the consideration received exceeds the original cost). Under para 65 this capital gain must be disregarded and spread over future years of assessment in proportion to the capital allowances to be claimed on the replacement asset.

The capital allowances on the new machine will be as follows:

2021 R150 000 × 40% = R60 000

2022 R150 000 × 20% = R30 000

2023 R150 000 × 20% = R30 000

2024 R150 000 × 20% = R30 000

The capital gain of R20 000 must be recognised as follows:

2021 R20 000 × R60 000 / R150 000 (40%) = R8 000

2022 R20 000 × R30 000 / R150 000 (20%) = R4 000

2023 R20 000 × R30 000 / R150 000 (20%) = R4 000

2024 R20 000 × R30 000 / R150 000 (20%) = R4 000

13.1.7 Recognition of any remaining untaxed portion of a capital gain in year of disposal of replacement asset [para 65(5)]

Any portion of a previously disregarded capital gain allocated to a replacement asset that has not been brought to account must be treated as a capital gain in the year of assessment in which the replacement asset is disposed of. Such a capital gain on a depreciable asset would occur when the replacement asset has not been fully depreciated at the time of its disposal.

Continuing relief for consecutive disposals and replacements

It is possible to make an election under para 65 when the asset being disposed of is itself a replacement asset. Any capital gain arising from the disposal of an old asset is treated as a capital gain in respect of the replacement asset when the replacement asset is disposed of. This treatment has the effect of providing an ongoing chain of relief in respect of depreciable replacement assets.

On the impact of para 65 on the corporate restructuring rules in ss 42, 44, 45 and 47, see s 41(9).

13.1.8 Failure to conclude contract or bring replacement asset into use [para 65(6)]

This provision provides for the recognition of any disregarded capital gain when the person

- fails to conclude a contract within 12 months or
- fails to bring any replacement asset into use within three years.

In this event, the disregarded capital gain is brought to account in the year of assessment in which the 12-month or three-year period ends.

A further capital gain as compensation for the loss of interest to the fiscus

There is a sting in the tail awaiting a person who claimed deferral relief but failed to bring a replacement asset into use. A further capital gain must be brought to account in order to compensate the *fiscus* for the loss of interest it has suffered as a result of the unwarranted deferral benefit enjoyed by the person. This treatment also obviates the need to revise the assessment relating to the year in which the old asset was disposed of. The capital gain is equal to the disregarded capital gain multiplied by the 'prescribed rate' of interest. The interest calculation will run from the date of disposal of the old asset until the expiry of the relevant 12-month or three-year period. The relevant prescribed rates that ruled during this period must be used.

The term 'prescribed rate' is defined in s 1(1) as follows:

‘ “[P]rescribed rate”, in relation to any interest payable in terms of this Act, means for the purposes of—

- (a) interest payable to any taxpayer under the provisions of section 89*quat*(4), a rate determined at four percentage points below the rate contemplated in paragraph (b); or
- (b) any other provision of this Act, such rate as the Minister may from time to time fix by notice in the *Gazette* in terms of section 80(1)(b) of the Public Finance Management Act, 1999 (Act No. 1 of 1999): Provided that where the Minister fixes a new rate in terms of that Act, that new rate applies for purposes of this Act from the first day of the second month following the date on which that new rate came into operation;’

The table below sets out the prescribed rates for the purpose of para (b) of the above definition since CGT was introduced.

Table 2 – Annual prescribed rates

Applicable Period		Rate %
From	To	
1 September 1999	29 February 2000	14,5
1 March 2000	30 September 2002	13
1 October 2002	31 March 2003	15,5
1 April 2003	30 June 2003	16,5
1 July 2003	31 August 2003	15
1 September 2003	30 September 2003	14
1 October 2003	30 November 2003	13
1 December 2003	31 October 2004	11,5
1 November 2004	31 October 2006	10,5
1 November 2006	28 February 2007	11,0
1 March 2007	31 October 2007	12,0
1 November 2007	29 February 2008	13,0
1 March 2008	31 August 2008	14,0
1 September 2008	30 April 2009	15,0
1 May 2009	30 June 2009	13,5
1 July 2009	31 July 2009	12,5
1 August 2009	31 August 2009	11,5
1 September 2009	30 June 2010	10,5
1 July 2010	28 February 2011	9,5
1 March 2011	30 April 2014	8,5
1 May 2014	31 October 2014	9,0
1 November 2014	31 October 2015	9,25
1 November 2015	29 February 2016	9,50
1 March 2016	30 April 2016	9,75
1 May 2016	30 June 2016	10,25
1 July 2016	31 October 2016	10,5
1 November 2017	30 June 2018	10,25
1 July 2018	28 February 2019	10,0
1 March 2019	31 October 2019	10,25
1 November 2019	30 April 2020	10,0
1 May 2020	30 June 2020	9,75
1 July 2020	31 August 2020	7,75
1 September 2020	Until change*	7,25

*Last updated: 12 August 2020.

An updated list of prescribed rates is also available on the SARS website under Legal Counsel / Legal Counsel Publications / Tables of interest Rates.

13.1.9 Replacement assets comprising personal-use assets [para 65(7)]

If a replacement asset or assets constitute personal-use assets, para 65 does not apply. The purpose of this provision is to prevent a person from benefiting from the deferral of the gain on disposal of a trade asset when that person replaces it with a personal-use asset. Since there would be no benefit to the economy from such a switch, there would be no point in the *fiscus* granting the person a deferral benefit. The term 'personal-use asset' is defined in para 53(2), and excludes immovable property. If a person replaces a single asset with multiple assets, the relief will be denied in full should any one of those replacement assets be a personal-use asset.

Example – Personal-use replacement asset*Facts:*

Skip owned a fishing business in Scottburgh. His 6-metre ski boat, which had cost him R200 000 in 2016, sank on 31 January 2020 after it was struck by a freak wave. The insurance company paid him out R300 000 (the replacement cost) on 29 February 2020. As a result of the declining fish stocks in the area, he decided to cease catching fish commercially and to retire. Using the insurance proceeds and his savings, he purchased a 9-metre launch with a cabin for R400 000. Skip and his friends used the launch as a pleasure craft.

Result:

Skip will be subject to CGT on the capital gain of R100 000 and will not be entitled to the deferral benefits offered by para 65.

13.2 Reinvestment in replacement assets (para 66)

Paragraph 66

The Revenue Laws Amendment Act 45 of 2003 extensively amended para 66 with effect from 22 December 2003. For the commentary on the position before these amendments, see issue 5 of this guide.

Table 1 – Summary of para 66

Paragraph 66	Description
(1)	Conditions under which an election to defer a capital gain may be made
(2)	Disregarding of capital gain in year of disposal
(3)	Allocation of capital gain over multiple replacement assets
(4)	Spreading of capital gain in proportion to capital allowances on replacement asset
(5)	Recognition of any remaining untaxed portion of a capital gain in year of disposal of replacement asset
(6)	Recognition of any remaining untaxed portion of a capital gain in year in which asset no longer used for purposes of trade.
(7)	Failure to conclude contract or bring replacement asset into use

Introduction

Paragraph 66 enables a person to elect to defer a capital gain arising on the disposal of qualifying depreciable assets when the proceeds are reinvested in qualifying depreciable assets. Section 8(4)(e) provides matching deferral relief for any recoupment of capital allowances on such assets. The election must be made in the tax return reflecting the disposal of the old asset.

Conditions under which an election to defer a capital gain may be made [para 66(1)]

A person can elect to apply para 66 to the disposal of an asset (other than a financial instrument) under the following conditions:

- The asset must have qualified for a capital deduction or allowance under s 11(e), 11D(2),⁶³⁴ 12B, 12C 12DA, 12E, 14, 14*bis* or 37B.⁶³⁵
- The proceeds must be equal to or exceed the base cost of the asset (that is, a capital gain or break-even situation). Capital losses are unlikely to arise, since in most situations the person would claim a revenue loss in the form of an allowance under s 11(o). Even if a capital loss did arise, this provision does not apply, as most persons would want to claim the capital loss in the year of assessment in which it arises. This provision also applies when the proceeds are equal to the base cost of an asset. This treatment is necessary because despite not having a capital gain, a person may have a recoupment under s 8(4), and one of the pre-requisites for the equivalent relief provided by s 8(4)(e) is an election under para 65 or 66. If less than all the proceeds are expended in acquiring a replacement asset, para 66 will not apply. It is possible, however, to acquire a replacement asset costing more than the proceeds realised upon the disposal of the old asset.
- The relief applies when an amount at least equal to the receipts and accruals from the asset disposed of 'has been' or 'will be' expended to acquire one or more replacement assets all of which will qualify for a deduction or allowance under s 11(e), 11D(2), 12B, 12C 12DA, 12E or 37B. The use of the words 'has been' indicate that it is possible to acquire a replacement asset before disposing of the old asset, although if this is done too far in advance it will be questionable whether the asset so acquired is a 'replacement'. The reference to 'an amount *at least equal* to the receipts and accruals from that disposal' means that it is not a requirement that the actual consideration derived on the disposal be used to acquire the replacement asset but rather an amount equal to such consideration. For example, the amount received on disposal may be used to discharge a pre-existing debt, while the replacement may be acquired using new debt or pre-existing funds. There is no requirement that the replacement asset must fulfil the same function as the old asset. The only requirement is that the replacement asset must qualify for an allowance under the specified sections of the Act. For example, a person could dispose of a machine qualifying for a deduction under s 12C, and use the proceeds to acquire a motor vehicle qualifying under s 11(e). It is also not a requirement that the replacement asset be used in the same type of business. For example, a taxpayer may dispose of business X as a going concern and acquire qualifying replacement assets as part of business Y.
- All the replacement assets must be from a South African source contemplated in s 9(2)(j) or (k).

Section 9(2)(j) covers immovable property held by the person or any interest or right of whatever nature of the person to or in immovable property contemplated in para 2,

⁶³⁴ The reference to s 11D(2) was inserted in para 66(1)(a), (c) and (4) by s 67 of the Taxation Laws Amendment Act 8 of 2007, deemed to have come into operation on 2 November 2006 and applies in respect of any disposal on or after that date.

⁶³⁵ The reference to ss 12DA and 37B was inserted in para 66(1)(a), (c) and (4) by s 79 of the Revenue Laws Amendment Act 35 of 2007, deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2008.

which is situated in South Africa. An environmental waste disposal asset contemplated in s 37B is an example of a depreciable asset that would comprise immovable property.

Section 9(2)(k) contemplates movable assets. For a resident, such an asset must not be attributable to a permanent establishment outside South Africa and the proceeds from its disposal must not be subject to any taxes on income payable to any sphere of government of any country other than South Africa. These two requirements should be read disjunctively; in other words, a replacement asset will not qualify if it meets either of the requirements. For a non-resident, the asset must be attributable to a permanent establishment situated in South Africa.

When a resident replaces the asset with one located in a permanent establishment outside South Africa, any capital gain on that asset may be placed outside the South African tax net and for this reason para 66 will not apply. This situation could happen, for example, when an offshore company that is a resident (a CFC) has a foreign branch that carries on a 'foreign business establishment'. The capital gains of such a branch would not be subject to CGT by virtue of s 9D(9)(b). Movable assets of a non-resident can be subject to CGT only if they form part of a permanent establishment in South Africa (para 2). If the non-resident replaces such an asset with one that is not part of a permanent establishment in South Africa, the replacement asset will not fall within the South African tax net. For this reason, the replacement asset must also form part of a permanent establishment in South Africa if the non-resident wishes to enjoy the deferral benefits of para 66 when disposing of the old asset.

- The relief applies when the contract for the replacement asset has been or will be concluded within 12 months of the disposal of the asset. The words 'has been' cover the situation in which the replacement is acquired before the disposal of the old asset.
- All the replacement assets must be brought into use within three years of the disposal of the asset. A replacement asset may be acquired (contract concluded) and brought into use before the disposal of the asset being replaced.
- The Commissioner may, on application by the taxpayer, extend the 12-month and three-year periods by no more than six months if all reasonable steps were taken to conclude those contracts or bring those assets into use.
- The asset must not be deemed to have been disposed of and to have been reacquired by the person. For example, the relief will not apply in a 'degrouching' situation in which a deemed disposal and immediate reacquisition is triggered.

Disregarding of capital gain [para 66(2)]

A person who makes the election referred to above must disregard the capital gain in the year of disposal, subject to

- para 66(4), which spreads the capital gain in proportion to capital allowances on any depreciable replacement assets;
- para 66(5), which triggers any untaxed remaining portion of a capital gain when the replacement asset is disposed of;
- para 66(6), which triggers any untaxed remaining portion of a capital gain when the person ceases to use the asset in the course of that person's trade; and
- para 66(7), which triggers the capital gain if a contract for the replacement asset is not concluded or the replacement asset is not brought into use within the prescribed periods.

Allocation of capital gain over multiple replacement assets [para 66(3)]

This paragraph applies when the amount received or accrued from the disposal of the old asset is used to acquire more than one replacement asset. The disregarded capital gain must be spread across the replacement assets in accordance with the following formula:

Capital gain attributable to a replacement asset =

$$\text{Disregarded capital gain} \times \frac{\text{Receipts and accruals expended on}}{\text{Receipts and accruals expended on all replacement assets}}$$

This formula must be used when determining a capital gain under para 66(4) [spread of gain in proportion to allowances], (5) [gain arising on disposal of replacement asset] and (6) [gain on cessation of trade use].

Spreading of capital gain in proportion to capital allowances on replacement asset [para 66(4)]

A person acquiring a qualifying replacement asset must account for the capital gain on disposal of the old asset as the allowances on the replacement asset are claimed. The portion of the capital gain allocated to the replacement asset that must be recognised in a year of assessment is determined in accordance with the following formula:

$$\text{Disregarded capital gain attributed to replacement asset} \times \frac{\text{Allowance or deduction claimed in year of assessment}}{\text{All qualifying allowances or deductions for all years of assessment based on cost or value of replacement asset at date of acquisition}}$$

Any allowances on improvements to a qualifying replacement asset must be taken into account in the numerator of this formula. As a result, the recognition of the capital gain will be accelerated.

Recognition of any remaining untaxed portion of a capital gain in year of disposal [para 66(5)]

This provision deals with the situation in which a qualifying replacement asset has been disposed of and not all the capital gain has been recognised at the date of disposal. In other words, the asset has not been fully depreciated at that time. When this happens, any remaining untaxed portion of the capital gain must be recognised in the year of disposal.

Continuing relief for consecutive disposals and replacements

It is possible to make an election under para 66 when the asset being disposed of is itself a replacement asset. Any capital gain arising from the disposal of an old asset is treated as a capital gain in respect of the replacement asset when the replacement asset is disposed of. This treatment has the effect of providing an ongoing chain of relief in respect of qualifying replacement assets.

Cessation of trade [para 66(6)]

Any untaxed portion of a capital gain must be recognised in the year of assessment in which a person ceases to use the asset in that person's trade

Failure to conclude contract or bring replacement asset into use [para 66(7)]

This provision provides for the recognition of any disregarded capital gain when the person

- fails to conclude a contract within 12 months or
- fails to bring any replacement asset into use within three years.

In this event, the disregarded capital gain is brought to account in the year of assessment in which the 12-month or three-year period ends.

A further capital gain as compensation for the loss of interest to the fiscus

There is a sting in the tail awaiting a person who claimed deferral relief but failed to bring a replacement asset into use. A further capital gain must be brought to account in order to compensate the *fiscus* for the loss of interest it has suffered as a result of the unwarranted deferral benefit enjoyed by the person. This treatment also obviates the need to revise the assessment relating to the year in which the old asset was disposed of. The capital gain is equal to the disregarded capital gain multiplied by the ‘prescribed rate’ of interest. The interest calculation will run from the date of disposal of the old asset until the expiry of the relevant 12-month or three-year period. The relevant prescribed rates that ruled during this period must be used. For a detailed discussion of the meaning of ‘prescribed rate’ see the commentary on para 65(6).

13.3 Transfer of asset between spouses (s 9HB)

Section 9HB

Before 17 January 2019 the rules relating to the transfer of an asset between spouses were in para 67. On or after that date they are now in s 9HB. For commentary on para 67, see Issue 7 of this guide.

13.3.1 Scope and application

Section 9HB provides for a deferral (‘roll-over’) of a capital gain or loss when an asset is transferred between spouses during their lifetimes. The roll-over is mandatory and spouses do not have the option to elect out of it.

The roll-over rules applicable to a deceased person and his or her surviving spouse are in s 9HA(1)(a) and (2) (deceased person) and s 25(4) (surviving spouse) and apply to persons dying on or after 1 March 2016 – see **16.2.10** (deceased person) and **16.4.4** (surviving spouse). Before that date they were in paras 40(1)(a) and 67(2).

A consequence of moving the roll-over rules into the main body of the Act is to make them applicable to trading stock, livestock and produce. However, s 9HB does not deal with allowance assets as is the case with s 25(4) on death. As a result, s 8(4)(k) will continue to trigger a potential recoupment of allowances in the hands of the transferor spouse, since that provision covers assets disposed of by donation and between connected persons. It deems the disposing party to have disposed of the asset for an amount equal to market value on the date of donation or disposal. The transferee spouse will also not take over any accumulated allowances from the transferor spouse.

There are other differences in the roll-over methodology used in s 9HA(2) on death and the rules applicable during the lifetimes of the spouses under s 9HB. For example, while s 9HB(5) also bars a roll-over to a non-resident spouse, it does permit a roll-over to a non-resident spouse for the assets listed in para 2(1)(b) and (2) (immovable property, shares in a land-rich

company and assets of a permanent establishment in South Africa). By contrast, s 9HA(2) permits no roll-over whatsoever to a non-resident spouse, regardless of the type of asset. Another difference relates to the roll-over for trading stock, livestock or produce. Under s 9HA(2) only expenditure incurred in the year of death is taken into account in determining the deemed consideration received or accrued by the transferor. By contrast, under s 9HB(3) the deemed consideration to be included in gross income comprises all expenditure allowed as a deduction, including amounts incurred in prior years of assessment. This treatment could result in the transferor becoming liable for income tax in the year of transfer as a result of the recoupment of amounts previously written off (see **13.3.4**).

13.3.1 Events treated as transfers between spouses [s 9HB(2)]

Under s 9HB(2) the following deeming rules apply to persons who are no longer spouses:

- A person whose spouse dies must be treated as having disposed of an asset to that spouse immediately before the date of death of that spouse, if ownership of that asset is acquired by the deceased estate of that spouse in settlement of a claim arising under s 3 of the Matrimonial Property Act 88 of 1984. The Matrimonial Property Act 88 of 1984 makes the accrual system automatically applicable to a marriage out of community of property unless its application is specifically excluded in the antenuptial contract.⁶³⁶ Under the accrual system a claim will arise on death in the hands of one spouse against the other for the difference in growth of the estates of the spouses.⁶³⁷ For example, if the growth in value of spouse A's estate during the marriage is R100, and the growth in value of spouse B's estate is R50, spouse B will have a claim of R25 against spouse A on dissolution of the marriage.

The accrual system does not result in a splitting of capital gains and losses between spouses. A capital gain or loss on disposal of an asset by a person married out of community of property must be accounted for by the spouse who owns the asset. A claim under the accrual system arises only on death or divorce of a spouse⁶³⁸ or under an order of court.⁶³⁹ It does not affect the tax treatment of the spouses during the subsistence of the marriage or even on its termination. It is a claim for a sum of money, not a pre-existing entitlement to specific assets or income of the other spouse. The accrual claim is thus contingent on death or divorce and its quantum also depends on the value of the estates of the spouses at the time of those events. It might happen, for example, that gains accumulated earlier in a marriage are later lost or expended. It does not therefore have any impact on the incidence of an accrual of an amount of gross income or proceeds on disposal of an asset.

When assets of the surviving spouse are given to the deceased estate in settlement of an accrual claim arising on death under s 3 of the Matrimonial Property Act, the transfer of such assets will be subject to roll-over treatment under s 9HB. An equivalent roll-over rule applies to the deceased person under s 9HA(2) read with s 25(4).

- A person must be treated as having disposed of an asset to his or her spouse, if that asset is transferred to that spouse in consequence of

➤ a divorce order; or

⁶³⁶ Section 2 of the Matrimonial Property Act 88 of 1984.

⁶³⁷ Section 3 of the Matrimonial Property Act 88 of 1984.

⁶³⁸ Section 3 of the Matrimonial Property Act 88 of 1984.

⁶³⁹ Under s 8 of the Matrimonial Property Act 88 of 1984 the court can order the division of the accrual of the estate of a spouse if that spouse's conduct is seriously prejudicial to the other spouse's ultimate accrual claim on dissolution of the marriage [s 8(1)]. The court can also exclude the accrual system completely [s 8(2)].

- in the case of a religious marriage or permanent same sex or heterosexual union, an agreement of division of assets which has been made an order of court.

The term ‘spouse’ is defined in s 1(1) as follows:

‘ “[S]pouse”, in relation to any person, means a person who is the partner of such person—

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

and “married”, “husband” or “wife” shall be construed accordingly: Provided that a marriage or union contemplated in paragraph (b) or (c) shall, in the absence of proof to the contrary, be deemed to be a marriage or union out of community of property;’

In divorce settlements it sometimes happens that the courts will take the assets of a discretionary family trust into account in arriving at a settlement.⁶⁴⁰ The taking into account of the trust assets in this way does not mean that the court has pierced the trust or declared it invalid; merely that the trust’s assets have been taken into consideration in arriving at the amount payable out of the personal estate of one of the parties to the divorce. In these circumstances roll-over relief will apply because the assets are being transferred from one former spouse to the other, and not from the trust.

When persons marry in community of property, they each dispose of half their assets to each other except for assets excluded by antenuptial contract before the marriage. The time of this disposal occurs immediately after they become spouses with the result that the roll-over provisions of s 9HB will apply. In *Ex parte Andersson*⁶⁴¹ Watermeyer J stated:

‘The legal position as I understand it is that save for certain exceptional cases, which are not presently relevant, community of property comes into being as soon as a marriage is solemnised unless prior to the marriage the spouses have concluded an agreement which excludes community of property.’

Example – Assets of a discretionary trust taken into consideration in arriving at a divorce settlement

Facts:

A and B are in the process of becoming divorced. A’s estate is worth R50 and B’s estate is worth R100. A is a beneficiary of a discretionary family trust. The value of the trust’s net assets at the date of divorce is R100. The court determines that A has *de facto* control over the trust and hence that it is just and equitable that the trust be taken into account in arriving at a settlement. The court directs that A must pay B R25.

⁶⁴⁰ *Badenhorst v Badenhorst* 2006 (2) SA 255 (SCA) and *Jordaan v Jordaan* 2001 (3) SA 288 (C). See also (January 2010) 82 *TSH* at 9.

⁶⁴¹ 1964 (2) SA 75 (C) at 77.

Result:

The amount of R25 comes out of A's assets, and not those of the trust. Thus, after the settlement the parties' assets are as follows:

	R
A's assets (R50 – R25)	25
Discretionary family trust's assets	<u>100</u>
	<u>125</u>
B's assets (R100 + R25)	<u>125</u>

The transfer of assets to the value of R25 from A to B qualifies for roll-over relief under s 9HB(2)(b).

By contrast, roll-over relief will not apply to assets of a discretionary trust that are distributed to a party to the divorce in his or her capacity as a beneficiary, since the trust is a separate legal person for tax purposes and not a 'spouse' as required by s 9HB(2)(b). In these circumstances the trustees would have exercised a discretion in awarding an amount to one of the divorced parties who is a beneficiary.

13.3.2 The transferor (disposing) spouse [s 9HB(1)(a)]

Section 9HB(1)(a) provides that the disposing spouse must disregard any capital gain or loss when disposing of an asset to his or her spouse.

13.3.3 The transferee (acquiring) spouse [s 9HB(1)(b)]

Section 9HB(1)(b) ensures that the spouse to whom an asset is disposed of takes over all aspects of the history of the asset from that person's spouse. The transferee spouse is deemed to have

- acquired the asset on the same date that the asset was acquired by the transferor;
- incurred an amount of expenditure equal to the expenditure contemplated in para 20 that was incurred by that transferor in respect of that asset;
- incurred that expenditure on the same date and in the same currency that it was incurred by the transferor;
- used that asset in the same manner that it was used by the transferor; and
- received an amount equal to any amount received by or accrued to that transferor in respect of that asset that would have constituted proceeds on disposal of that asset had that transferor disposed of it to a person other than the transferee.

The dates and amounts of expenditure need to be taken over by the acquiring spouse for the purposes of determining the time-apportionment base cost of pre-valuation date assets. The currency of expenditure is taken over by the transferee for the purposes of determining a capital gain or loss under para 43 when the transferee disposes of the asset. For example, if the transferor spouse acquired the asset in USD and the transferee spouse disposed of the asset in USD, the capital gain or loss would be determined under para 43(1) because the expenditure and proceeds are in the same foreign currency. Had the currency of expenditure not rolled over to the transferee, the transferee would have been required to determine the capital gain or loss under para 43(1A) because the expenditure and proceeds would have been in different currencies.

The usage of the asset needs to be taken over to ensure, for example, that any business usage of an otherwise exempt asset is taxed.

Any amount received by or accrued to the transferor that would have constituted proceeds on disposal of the asset is also carried across to the transferee spouse. One example of such an amount is when the transferor spouse has disposed of the asset under a suspensive sale agreement, has received some proceeds, and then transfers the rights under the contract to the transferee spouse in whose hands the condition will be fulfilled.

Under para 29(4)(a)(iii) the transferee spouse is deemed to have adopted or determined any market value on valuation date that was adopted or determined by the transferor spouse.

Under s 9HB(1)(b)(ii) an asset is treated as having been acquired for an amount equal to the expenditure incurred by the disposing spouse. It follows that any amounts paid by the acquiring spouse to the disposing spouse for an asset must be disregarded.

Transfers of assets between spouses for the purpose of tax avoidance may result in the capital gain or loss arising in the hands of the transferee spouse being attributed to the transferor spouse under para 68.

Example – Business use of asset before transfer to spouse

Facts:

John used 10% of his primary residence as an office on or after valuation date before transferring the residence to his wife.

Result:

When his wife ultimately disposes of the primary residence, 10% of the capital gain in respect of the period before she acquired it will be taxable in her hands.

13.3.4 Disposal of trading stock, livestock or produce [s 9HB(3)]

A person who disposes of an asset consisting of trading stock, livestock or produce contemplated in the First Schedule to his or her spouse, must be treated as having disposed of that asset for an amount received or accrued that is equal to the amount that was allowed as a deduction in respect of that asset for purposes of determining that person's taxable income, before the inclusion of any taxable capital gain.

Unlike s 9HA(2), the formulation of this roll-over rule is not necessarily without adverse consequences for the transferor spouse, as amounts allowed in earlier years of assessment such as a diminution in the value of trading stock determined under s 22(1)(a) may be recouped at the time of disposal to the transferee spouse (see Example 2 below).

Example 1 – Disposal of trading stock by transferor spouse

Facts:

Hennie acquired trading stock at a cost of R100 000 on 1 March 2019 and claimed it as a deduction under s 11(a). In July 2019 he disposed of the trading stock to his wife for a consideration of R80 000.

Result:

Under s 9HB(3) Hennie is deemed to have disposed of the trading stock for an amount received or accrued equal to R100 000, being equal to the amount that was allowed as a deduction in respect of the trading stock. The amount he actually received from his wife must be disregarded. For CGT purposes the proceeds will be nil under para 35(3)(a) while the base cost will also be nil under para 20(3)(a).

Example 2 – Disposal of trading stock by transferor spouse*Facts:*

Hennie acquired trading stock at a cost of R100 000 on 1 March 2019 and claimed it as a deduction under s 11(a). He continued to hold the trading stock on 29 February 2020 but by that stage its market value had dropped to R90 000. Taking into account the diminution in value under s 22(1)(a), Hennie included R90 000 in closing stock. In July 2020 he disposed of the trading stock to his wife for a consideration of R80 000.

Result:

Under s 9HB(3) Hennie is deemed to have disposed of the trading stock for an amount received or accrued equal to R100 000, being equal to the amounts that were allowed as a deduction in respect of the trading stock. The actual amount received from his wife of R80 000 must be disregarded. These allowable amounts comprised R10 000 in respect of the write-down of trading stock under s 11(x) read with s 22(1)(a) and R90 000 under s 22(2) (opening stock). Hennie will therefore have a net inclusion in taxable income of R10 000 in the 2021 year of assessment, which in effect amounts to a recoupment of the amount written down in the 2020 year of assessment.

For CGT purposes the proceeds will be nil under para 35(3)(a) while the base cost will also be nil under para 20(3)(a).

13.3.5 Trading stock, livestock or produce acquired by transferee spouse [s 9HB(4)]

When a person acquires an asset consisting of trading stock, livestock or produce contemplated in the First Schedule from his or her spouse, that person and his or her spouse must, for purposes of determining any taxable income derived by that person, be deemed to be one and the same person with respect to the date of acquisition of that asset by that person and the amount and date of incurral by that spouse of any cost or expenditure incurred in respect of that asset as contemplated in s 11(a) or 22(1) or (2).

The assumption of the date of acquisition of trading stock in the form of shares by the transferee spouse may be relevant for the purposes of determining the three-year period under s 9C when the transferee spouse disposes of the shares.

13.3.6 Non-resident spouses and anti-avoidance

Section 9HB(5) is an anti-avoidance measure that prevents a tax-free roll-over to a non-resident spouse except for the assets listed in s 9J (interests of non-residents in immovable property held as trading stock) and para 2(1)(b), namely,

- immovable property situated in South Africa held by that person or any interest or right of whatever nature of that person to or in immovable property situated in South Africa

including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources; or

- any asset effectively connected with a permanent establishment of that person in South Africa.

Since the latter assets fall within South Africa's taxing jurisdiction for non-residents, and are additionally subject to the withholding tax in s 35A, they qualify for the roll-over relief under s 9HB(1). By contrast, on death no roll-over is provided for such assets under s 9HA(2) with the result that they will be deemed to be disposed of under s 9HA(1) at market value and any capital gain or loss must be taken into account by the deceased spouse.

Example – Transfer of assets to non-resident spouse

Facts:

Bruce and Sheila plan to immigrate to Australia. Sheila has no CGT assets and is the first to emigrate so as to set up their new home in Perth. After she has left, Bruce transfers the following assets to Sheila:

	Base cost R	Market Value R
Holiday home at Plettenberg Bay	1 000 000	2 000 000
Listed shares	2 500 000	5 000 000

Result:

Bruce will be subject to CGT on the capital gain of R2,5 million (R5 million – R2,5 million) on the transfer of the shares under para 38, while Sheila will be liable for CGT only when she disposes of the Plettenberg Bay property.

13.4 Interests in collective investment schemes in property

Years of assessment commencing before 1 April 2013

In reality a portfolio of a collective investment scheme in property operates as a trust and is governed by the Financial Sector Conduct Authority and must comply with the Collective Investment Schemes Control Act.

For years of assessment commencing before 1 April 2013 the portfolio was dealt with as a trust for tax purposes. Under para 67A the holder of the participatory interest determined a capital gain or loss on disposal of the interest and any flow-through of capital gains and losses arising in the trust to the holder was blocked. Paragraphs 67A and 67AB contained similar rules to those in paras 76 and 76A for dealing with capital distributions.

These portfolios were listed on the JSE.

Years of assessment commencing on or after 1 April 2013 but before years of assessment commencing on or after 1 January 2015

For years of assessment commencing on or after 1 April 2013 para (e)(iii) of the definition of 'company' in s 1(1) was amended to include a portfolio of a collective investment scheme in property.

Since specific provisions dealing with the CGT consequences of portfolios of collective investment schemes in property no longer exist, the normal rules applicable to companies and

their shareholders would, in theory, apply to a portfolio that does not qualify as a REIT for years of assessment commencing on or after 1 April 2013 but before years of assessment commencing before 1 January 2015. Such a portfolio would be taxed as a company and its distributions of dividends would be subject to dividends tax. The treatment of such portfolios in this manner is, however, theoretical because the six remaining listed portfolios have listed on the REIT board of the JSE and their CGT treatment will be determined under s 25BB.

Years of assessment commencing on or after 1 January 2015

Paragraph (e)(iii) was amended by the Taxation Laws Amendment Act 31 of 2013 to add the words ‘that qualifies as a REIT’. This amendment came into effect for years of assessment commencing on or after 1 January 2015. The provision was further amended by the Taxation Laws Amendment Act 43 of 2014 with effect from 1 January 2015 and again by the Taxation Laws Amendment Act 23 of 2018 with effect from 17 January 2019 and now reads as follows:

‘(iii) portfolio of a collective investment scheme in property that qualifies as a REIT as defined in the listing requirements of an exchange approved in consultation with the Minister and published by the Prudential Authority, as defined in section 1 of the Financial Markets Act, in terms of section 11 of that Act;’

Section 11 of the Financial Markets Act deals with listing of securities and requires an exchange to make listing requirements, and sets out the matters that should be dealt with in those listing requirements.

In theory, a portfolio of a collective investment scheme in property that does not qualify as a REIT is a type of vesting trust and must follow the normal rules applicable to trusts in determining the CGT consequences of its actions. The treatment of such portfolios in this manner is theoretical because the six remaining listed portfolios have listed on the REIT board of the JSE and their CGT treatment is determined under s 25BB.

13.5 REITs

Section 25BB

Before the introduction of the REIT board on the JSE, listed entities offering property investments in South Africa generally consisted of either

- a portfolio of a collective investment scheme in property (colloquially known as a PUT (property unit trust); or
- a property loan stock company (PLS).

Portfolio of a collective investment scheme in property

The portfolio of a collective investment scheme in property operated as a trust both in reality and for tax purposes. However, for years of assessment commencing on or after 1 April 2013 these portfolios were deemed to be companies for tax purposes [para (e)(iii) of the definition of ‘company’ in s 1(1)] although in reality they continued to operate as trusts.

The units of a portfolio fall within the definition of ‘share’ in s 1(1) which reads as follows:

‘“[S]hare” means, in relation to any company, any unit into which the proprietary interest in that company is divided;’

A portfolio of a collective investment scheme in property is able to convert to a company under s 44 by using the amalgamation procedure described in that section. The definition of a 'shareholder' in s 41(1) includes a holder of a participatory interest in such a portfolio. Under s 44 such a holder would qualify for roll-over relief, that is, the details of the participatory interest would be carried over to the shares in the resultant company. The proviso to s 44(4A) stipulates that when the amalgamated company is a portfolio of a collective investment scheme in property, the price at which the participatory interests in that collective investment scheme were issued shall be added to the CTC of the class of shares issued by the resultant company.

A portfolio may wish to convert to a company under s 44 to take advantage of the corporate rules in ss 41 to 47 and the less restrictive operating environment governed by the listings requirements of an approved exchange as opposed to oversight by the FSCA and compliance with the Collective Investment Schemes Control Act.

Property loan stock company

The property loan stock company operated as a company both in reality and for tax purposes. Such a company issued linked units comprising a share and a debenture. Most of the company's profits were distributed to linked unit holders in the form of interest on the debentures. With the introduction of ss 8F and 8FA such companies (assuming they did not qualify for REIT status) would have faced the prospect of having their interest payments disallowed with the result that there was a strong incentive for them to exchange their linked units for equity shares. Section 43 facilitates this process by granting roll-over relief to the linked unit holders.

The REIT dispensation

The term 'REIT' stands for 'real estate investment trust' but this acronym is somewhat misleading because in reality most REITs are companies although a REIT can also be a trust when it takes the form of a portfolio of a collective investment scheme in property.

Section 25BB was introduced in order to provide consistent tax treatment for the listed property sector (that is, to treat PUTs and PLSs in the same way) and to bring it in line with international best practice thus making the REIT attractive to international investors.

A REIT trust or a REIT company both trade on the REIT board of the JSE which sets out listings requirements for REITs (s 13 of the JSE Listings Requirements). Other exchanges are now also able to apply to the Minister for approval in order to list shares in REITs. The approval must be published by the appropriate authority, as contemplated in s 1 of the Financial Markets Act, under s 11 of that Act.

In determining its taxable income, a REIT or a controlled company must deduct any 'qualifying distribution' as defined in s 25BB(1). Such a qualifying distribution includes an outgoing dividend and any interest paid on a linked unit but excludes a dividend arising from a buy-back of a share under para (b) of the definition of 'dividend' in s 1(1). The deduction for qualifying distributions is limited to taxable income before taking into account any qualifying distribution, assessed loss brought forward from the previous year of assessment or taxable capital gain.

A resident holder of a share in a REIT must include the amount of any dividends received or accrued in income since such dividends are not exempt from normal tax.⁶⁴² A dividend received by or accrued to a non-resident is exempt from normal tax but will attract dividends tax on or after 1 January 2014 [s 64F(2)]. Interest on linked units is treated as a dividend [s 25BB(6)] which means that it will attract normal tax without the benefit of the interest exemption in s 10(1)(i) for a resident and dividends tax for a non-resident.

⁶⁴² Paragraph (aa) of the proviso to s 10(1)(k)(i).

One advantage of this treatment is that interest on monies borrowed to finance the acquisition of shares or units in a REIT will now be in the production of income, thus meeting at least one of the requirements of s 11(a). By contrast, interest would generally not be deductible by virtue of s 23(f) if the dividends were exempt from normal tax.

A REIT is defined in s 1(1) as follows:

- ‘ **“REIT”** means a company—
- (a) that is a resident; and
 - (b) the shares of which are listed—
 - (i) on an exchange (as defined in section 1 of the Financial Markets Act and licensed under section 9 of that Act); and
 - (ii) as shares in a REIT as defined in the listing requirements of an exchange approved in consultation with the Minister and published by the appropriate authority, as contemplated in section 1 of the Financial Markets Act, in terms of section 11 of that Act;’

Section 13(1)(x) of the JSE Listings Requirements defines a REIT as follows:

‘ **“REIT”** means Real Estate Investment Trust and is defined as an applicant issuer which receives a REIT status in terms of the Listings Requirements.’

REIT status listing criteria for property entities other than collective investment schemes in property are dealt with in paras 13.46 to 13.54, 13.59 and 13.60 and those for collective investment schemes in property in paras 13.55 to 13.59 and 13.61 of the JSE Listings Requirements.

Section 25BB(1) contains definitions of ‘controlled company’, ‘property company’, ‘qualifying distribution’ and ‘rental income’. Two of these definitions which are relevant for CGT purposes are reproduced below.

‘ **“[C]ontrolled company”** means a company that is a subsidiary, as defined in IFRS, of a REIT;’

A ‘subsidiary’, as defined in IFRS 10, means an entity that is controlled by another entity. The meaning of ‘control’ is discussed in paras 5 to 18 of IFRS 10. Paragraph 5 of IFRS 10 states that an investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee. Paragraph 6 of IFRS 10 stipulates that an investor controls an investee when it is exposed or has rights to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

A company will, therefore, be a “controlled company” if it is controlled by a REIT.

- ‘ **“[P]roperty company”** means a company—
- (a) in which 20 per cent or more of the equity shares or linked units are held by a REIT or a controlled company (whether alone or together with any other company forming part of the same group of companies as that REIT or that controlled company); and
 - (b) of which at the end of the previous year of assessment 80 per cent or more of the value of the assets, reflected in the annual financial statements prepared in accordance with the Companies Act or IFRS for the previous year of assessment, is directly or indirectly attributable to immovable property;’

Disregarding of certain capital gains and losses by the REIT [s 25BB(5)]

A REIT or a controlled company must disregard any capital gain or loss in respect of the disposal of

- immovable property of that REIT or controlled company at the time of that disposal;
- a share or a linked unit in a company that is a REIT at the time of that disposal; or
- a share or a linked unit in a company that is a property company at the time of that disposal.

The REIT or controlled company will have to account for capital gains and losses on any assets not falling into any of the above categories.

Shareholder-level consequences

Holders of shares in a REIT (whether comprising equity shares or a participatory interest in a portfolio) must account for any capital gain or loss on disposal of their shares. A return of CTC will trigger a return of capital which must be accounted for under para 76B.

For more information, see Interpretation Note 97 dated 8 December 2017 'Taxation of REITs and Controlled Companies'.

13.6 Disposal of immovable property by share block company (para 67B)

Paragraph 67B

A share block company is a company contemplated in the Companies Act 71 of 2008 that operates a share block scheme as defined in the Share Blocks Control Act 59 of 1980. Under such a scheme the shares confer a right to or an interest in the use of immovable property.⁶⁴³ The articles of the company must incorporate this right of use.⁶⁴⁴ Details of the shareholder's exclusive right of use of certain areas of the property and the right to use the common property are contained in a use agreement which may also make provision for management rules.

Typically, a share block company would comprise a block of flats with the shareholders holding a right of use over their assigned flats, garages and servant's quarters with a right to use the common property such as a swimming pool, wash lines and grounds.

For various reasons including the difficulty in obtaining loan finance through a pledge of the shares, shareholders in a share block company may wish to take transfer of their units either through conversion to sectional title or by having the company transfer full title to them.

Conversion to sectional title

A share block company that wishes to open a sectional title register so that it can allow share block holders the right to take transfer of the property for which they hold the right of use, must follow the procedures prescribed in s 8(3) read with Schedule 1 to the Share Blocks Control Act 59 of 1980. Under item 8 of this Schedule the share block holder who wishes to take transfer of the property must surrender his or her share certificate and right of use of the property in return for transfer of the property.

⁶⁴³ Section 10(b) of the Share Blocks Control Act 59 of 1980.

⁶⁴⁴ Section 7(2) of the Share Blocks Control Act 59 of 1980.

Transfer of full title

Before a company can transfer its immovable property directly to its shareholders it will be necessary to pass a special resolution in general meeting under s 8(1)(c) of the Share Blocks Control Act. After the resolution has been passed the company may alienate or cede the underlying immovable property to its shareholders like any ordinary company, for example, either by distribution or sale of the property. In these instances, the exclusive use areas will often be subdivided before distribution or sale.

This procedure could be used to liquidate the company and transfer ownership directly to the shareholders. However, common-use areas may not always be easily distributed amongst the shareholders. In these instances, the exclusive use areas are transferred to the shareholders with the common-use areas remaining with the company, meaning that the company does not liquidate.

An issue that frequently arises is whether a share block company can distribute the 'bare *dominium*' (residual value) in its immovable property to its shareholders without the shareholders first cancelling their right of use and occupation. There are several reasons why such a transaction is not possible. First, while reference is often made loosely to a bare *dominium* being held by a share block company and a usufruct being held by its shareholders, the right of use held by the shareholder is not a usufruct and the 'bare *dominium*' is nothing more than the residual value of the property because the share block company already owns the full title to the property. A usufruct over immovable property is a real right while the right of use held by the shareholder in a share block company is a personal right against the company⁶⁴⁵ and it is not possible to merge a personal right and a real right in the deeds registry. Secondly, s 8(3)(c) of the Share Blocks Control Act prohibits the transfer of a unit to a member otherwise than through Schedule 1, which deals with conversion to sectional title. Item 8(2)(b) of Schedule 1 provides that the shareholder must waive any right of use. Thirdly, while a right of use remains stapled to a share under s 10(b), the company is presumed to be a share block company (s 4). Thus, it is submitted that in order to transfer a unit to a member under freehold title the right of use must be cancelled in order to convert the share block company to a normal company. Such action would render the Share Blocks Control Act, and in particular the requirements of s 8(3)(c) inapplicable.

Disposal

Although when seen from the point of view of the share block holder these procedures for transferring title are merely a change in the form of ownership of the immovable property, a conversion to sectional title or a transfer of full title is a disposal. In either case it will be necessary to cancel the right of use in order to restore full title to the company. Such a cancellation will result in a disposal by the shareholder to the company which could give rise to a capital gain or loss. Another disposal will occur when the company disposes of the property to the shareholders. Paragraph 67B is aimed at conferring roll-over treatment under these circumstances in order to avoid triggering a capital gain or loss in the company or in the shareholders' hands.

Paragraph 67B was deemed to come into operation on 1 October 2001 but initially applied only to a conversion from share block to sectional title.⁶⁴⁶ Its ambit was extended to disposals

⁶⁴⁵ JC Sonnekus *Sectional Titles* vol 2 Share Blocks And Time-sharing/Historical development of share block schemes [online] (My LexisNexis May 2017) in 1 2. The author notes that the share block holder does not own the flat and does not have a real right which can be mortgaged. He also notes that the Registrar of Deeds cannot identify the shareholders' names, since they are not part of the registration system.

⁶⁴⁶ Paragraph 67B was inserted by s 110(1) of the Revenue Laws Amendment Act 45 of 2003 and deemed to come into operation on 1 October 2001.

on or after 1 January 2013 to encompass a transfer of full title in the immovable property from the share block company.⁶⁴⁷

Definitions [para 67B(1)]

Paragraph 67B(1) contains definitions of ‘share’ and ‘share block company’. The term ‘share’ is defined as follows:

‘ “[S]hare” means a share as defined in section 1 of the Share Blocks Control Act;’

The Share Blocks Control Act defines ‘share’ as follows:

‘ “share”—

(a) means a share as defined in section 1 (1) of the Companies Act in relation to a company, and includes a debenture of a company and a right to or an interest in any such share or debenture;

(b) includes any other interest in a company;

(c) does not include a right to or an interest in the assets of a company derived from a lease in respect of such assets;’

Importantly, the definition of ‘share’ includes a debenture and any other interest in the company. It is submitted that the effect of this definition is to bring a shareholder’s loan account within the roll-over treatment provided by para 67B.

Application [para 67B(2)]

Paragraph 67B applies when

- a person holds a right of use of a part of the immovable property of a share block company which is conferred by reason of the ownership of a share by that person in that share block company; and
- that person acquires ownership of that part of immovable property from that share block company as part of any transaction under which a disposal of that part of immovable property is made by that share block company.

Paragraph 67B will apply even if all the shares in the share block company are owned by a single person.

Paragraph 67B does not apply to any portion of the common property that remains in the company and is not disposed of to the shareholders.

Disregarding of capital gains and losses [para 67B(3)]

The person acquiring the immovable property as a result of a transaction referred to in para 67B(2) must disregard any capital gain or loss determined in respect of any disposal of the share under para 67B(3)(b)(i). Since the right of use forms part of the bundle of rights attaching to the share,⁶⁴⁸ any capital gain or loss on its disposal by cancellation will also be disregarded.

⁶⁴⁷ Paragraph 67B was substituted by s 129(1) of the Taxation Laws Amendment Act 22 of 2012 with effect from 1 January 2013 and applicable in respect of disposals made on or after that date.

⁶⁴⁸ Section 10(b) of the Share Blocks Control Act 59 of 1980.

Likewise, the share block company disposing of the immovable property must disregard any capital gain or loss determined on that disposal under para 67B(3)(a).

Roll-over rules for person acquiring the immovable property [para 67B(3)(b) and (c)]

The capital gain or loss made by the person acquiring the immovable property is deferred until the person actually disposes of it. This outcome is achieved by carrying across the details set out in the table below in respect of the shares and improvements to the immovable property.

Table 1 – Carry-over of details from shares, loan account and improvements to the immovable property

Paragraph 67B(3)	Details of the shares, loan account and improvements	Treated as details in respect of the immovable property acquired from the share block company
(b)(ii)(aa)	Expenditure incurred under para 20 of acquiring shares and loan account	Cost of acquisition.
(b)(ii)(bb)	Date of incurral of expenditure in acquiring the shares and loan account	Date of incurral of expenditure in acquiring the immovable property
(b)(ii)(cc)	Cost under para 20 of improvements made by shareholder to immovable property	Cost of improvements.
(b)(ii)(dd)	Date of incurral of expenditure in effecting improvements to the part of the immovable property of the share block company in respect of which the person had a right of use as a result of the ownership of the share	Date of incurral of expenditure in effecting improvements to the immovable property
(b)(ii)(ee)	Date of acquisition of share and loan account	Date of acquisition.
(b)(ii)(ff)	Use of the immovable property in respect of which the person had a right of use as a result of the ownership of the share.	Use of immovable property.
(c)	Market value adopted or determined under para 29(4) in respect of share	Market value adopted or determined under para 29(4) in respect of immovable property.

The carry-over of the relevant costs and dates of acquisition and incurral from the shares and loan account to the immovable property enables the shareholder to use the time-apportionment base cost method in establishing the valuation date value of immovable property when the shares were acquired before the valuation date. The carry-over of the use of the immovable property while the person was a shareholder in the share block company enables the period of ordinary residence to be recognised for the purpose of the primary residence exclusion in para 45.

13.7 Mineral rights conversions and renewals (para 67C)

Paragraph 67C [Effective 1 May 2004]

Paragraph 67C deals with mineral, mining, prospecting, exploration and production rights held before the introduction of the Mineral and Petroleum Resources Development Act 28 of 2002 and mining rights issued under that Act. It provides that there is no disposal under para 11 when existing rights are converted wholly or partially to new rights. The table below summarises the types of rights and relief granted. Since the old and new rights are deemed to be one and the same asset, any valuation under para 29(4), dates of incurral and acquisition and costs will simply be carried across to the new rights. This treatment is important for the purpose of determining the valuation date value of pre-valuation date mineral rights.

Table 1 – Roll-over relief in respect of mineral right conversions and renewals

Paragraph 67C	Type of old right	Type of disposal to be disregarded	Roll-over relief
(a)	<ul style="list-style-type: none"> • Old order right, or • OP26 right as defined in Schedule II of the Mineral and Petroleum Resources Development Act 28 of 2002.	When an old order right or OP26 right wholly or partially <ul style="list-style-type: none"> • continues in force, or • is converted into a new right under the same Schedule. 	The continued, converted or renewed right or permit is treated as one and the same asset as the right before continuation, conversion or renewal for purposes of the Income Tax Act.
(b)	Any <ul style="list-style-type: none"> • prospecting right, • mining right, • exploration right, • production right, • mining permit, • retention permit, or • reconnaissance permit as defined in s 1 of the Mineral and Petroleum Resources Development Act 28 of 2002.	When an existing right is wholly or partially renewed under that Act,	

Effective date

Paragraph 67C came into operation on the date that the Mineral and Petroleum Resources Development Act 28 of 2002 came into operation, namely, 1 May 2004.

13.8 Communications licence conversions

Paragraph 67D

Paragraph 67D⁶⁴⁹ deals with the conversion of existing licences referred to in Chapter 15 of the Electronic Communications Act 36 of 2005 to new licences under s 93 of that Act. The *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009* provides the following background to the insertion of para 67D:

'Telecommunications licences are regulated by the Independent Communications Authority of South Africa (ICASA). Under the current system, the old telecommunications licences were technologically specific. This fact meant that the services which mobile telecommunications service providers offered were mutually exclusive from the services provided by non-mobile telecommunications service providers. In an effort to promote a more open and competitive environment, ICASA has sought to eliminate the system of exclusive rights granted to certain telecommunications companies for the provision of fixed communications or mobile cellular

⁶⁴⁹ Paragraph 67D was inserted by s 77 of the Taxation Laws Amendment Act 17 of 2009 and is deemed to have come into operation on 1 January 2009 and applies in respect of licences converted on or after that date.

communications. In effect, all licences will be comprehensive – covering both fixed and mobile telecommunication operations.

‘This conversion from existing narrow licences to new comprehensive licences has occurred pursuant to the direction of ICASA under the broad mandate of section 93 of the Electronic Communications Act 36 of 2005 (ECA). The conversions occurred pursuant to *Government Gazette* 31803 of 16 January 2009 . . .

‘The industry-wide conversion under Section 93 of the ECA will not be treated as a disposal for capital gains tax purposes. The conversion is outside the control of the relevant parties and re-arranges telecommunication rights for the industry as a whole. The conversion should instead be viewed as a rollover event (with the tax attributes of the existing licences generally rolled over into the new licences) so that all gains and losses are deferred until the converted licences are subject to a subsequent disposal.

‘More specifically, roll-over treatment will be achieved by creating a dual set of rules (one for capital gains purposes and the other for depreciation purposes under normal tax). Both sets of rules will cover a simple conversion of an existing licence to a new licence as well as the conversion of multiple existing licences to a new licence and the conversion of a single licence into multiple licences. No provisions are necessary for telecommunications licences as trading stock.’

(Spelling corrected.)

Paragraph 67D(1) provides for a no gain / no loss disposal of existing licences. The licensee is deemed to dispose of an existing licence for an amount equal to its base cost on the date of conversion.

Under para 67D(2) a new licence is deemed to be acquired at a cost recognised for the purposes of para 20 equal to the expenditure on the existing licence or licences which gave rise to that new licence. On a one-for-one conversion the expenditure on the existing licence is carried across to the new licence. On a consolidation of multiple existing licences into a single new licence, the aggregate cost of the existing licences is carried across to the new licence. On a split of an existing licence into multiple new licences, the cost of the existing licence must be allocated across the new licences in proportion to the relative market values of the new licences.

The licensee is deemed to have incurred the cost allocated to the new licence on the day immediately after the conversion.

Since the existing licence is deemed to be disposed of on the date of conversion, the new licence is deemed to be acquired on the same date under para 13(2). A new licence will therefore always be a post-valuation date asset and the market value, time-apportionment or ‘20% of proceeds’ method used for determining a valuation date value for pre-valuation date assets cannot be used to determine the base cost of a new licence. The reason for this formulation was adopted in order to keep the determination of base cost of a new licence as simple as possible.

Example – Conversion of existing licences to a single new licence

Facts:

Telecommunications Company owns two existing telecommunications licences – pre-existing Licence A and pre-existing Licence B. Pre-existing Licence A was acquired for R40 million on 1 April 1998 and has a useful life of 15 years. Pre-existing Licence B was acquired for R80 million on 1 January 2008 and has a useful life of 20 years.

In 2008 the company claimed a depreciation allowance of R4 million for pre-existing Licence B under s 11(gD), which was introduced in 2008. On 16 January 2009 both licences were converted into a new Combined Licence under s 93 of the Electronic Communications Act. The new licence has a 20-year useful life.

Result:

The s 93 conversion does not result in a capital gain or a recoupment.

The combined Licence has an expenditure under para 20 and a depreciable cost of R116 million [R40 million plus R80 million less the R4 million previously deducted under s 11(gD)].

The depreciation of the R116 million is based on a 20-year useful life starting from the day immediately after conversion (17 January 2009).

13.9 Tax-free investments

Section 12T

Section 12T was introduced with effect from 1 March 2015. It enables a natural person to invest an amount in cash not exceeding R33 000 (2018 to 2020 years of assessment; R30 000: 2016 and 2017) during any year of assessment in a ‘tax free investment’ as defined in s 12T up to a maximum of R500 000 during the person’s lifetime. The term ‘tax free investment’ is defined in s 12T(1) as follows:

‘ “[T]ax free investment” means any financial instrument or policy as defined in section 29A—

- (a) administered by a person or entity designated by notice by the Minister in the *Gazette*;⁶⁵⁰
- (b) owned by—
 - (i) a natural person; or
 - (ii) the deceased estate or insolvent estate of a natural person that is deemed to be one and the same person as that natural person in respect of the contributions made by that person; and
- (c) that complies with the requirements of the Regulations contemplated in subsection (8).⁶⁵¹

For the purposes of contributions, the insolvent or deceased estate of a natural person is deemed to be one and the same person as the natural person. This treatment means, for example, that in the year of death the combined contributions of the deceased person and that person’s deceased estate may not exceed R33 000 (2018 to 2020), nor may the cumulative capital contributions of the deceased person and the estate exceed R500 000. To the extent that the deceased person has not used the R33 000 exemption in the year of death, and assuming that the R500 000 cumulative threshold has not been exceeded, the executor may invest the funds of the deceased estate in a tax-free investment. The executor would also be entitled to invest R33 000 (2018 to 2020) a year in the years of assessment following the estate’s first year of assessment.

⁶⁵⁰ For the persons or entities who can administer tax-free investments see GN 171 GG 38508 of 25 February 2015.

⁶⁵¹ See GN R 172 GG 38509 of 25 February 2015.

Example – Contributions to tax-free investment by deceased estate*Facts:*

On 1 March 2016 Ricky invested R20 000 in a tax-free investment, being a designated savings account with XYZ Bank. On 30 June 2016 she passed away.

Result:

The executor of Ricky's deceased estate will be entitled to invest R10 000 of the estate funds in a tax-free investment during the 2017 year of assessment (R30 000 less the amount invested by Ricky of R20 000). In the 2018 and subsequent years of assessment the executor will be entitled to invest R33 000 a year of the funds of the deceased estate in tax-free investments until Ricky's estate is wound up, provided that the cumulative threshold of R500 000 comprising both Ricky's capital contributions and those of the deceased estate is not exceeded.

Under s 12T(2) any amount received by or accrued to a natural person, deceased estate or insolvent estate of that person in respect of a tax-free investment is exempt from normal tax. Examples of the sort of income that would be exempt from tax would include interest income on designated savings accounts or taxable dividends, such as a dividend from a REIT. Dividends are exempt from dividends tax under s 64F(1)(o).

Section 12T(3) provides that a person must disregard any capital gain or loss on disposal of a tax free investment. Such a disposal would include a transfer from one tax free investment to another. The realisation of tax-free investments by the executor of a deceased estate or the trustee of an insolvent estate must also be disregarded.

The types of investment that qualify as tax-free investments are prescribed by regulation [s 12T(8)] and include savings accounts, collective investment schemes, exchange traded funds and policies with long-term insurers. Under the regulations a person is entitled to transfer from one tax free investment to another but no such transfer may occur before 1 March 2016 (reg 9). Any such transfer is not taken into account in determining whether the R33 000 and R500 000 limits have been exceeded [s 12T(6)].

A person who exceeds the R33 000 annual limit or R500 000 lifetime limit will be subject to normal tax at the rate of 40% on the excess capital invested [s 12T(7)]. However, the income and capital gains generated by such excess will be tax free.

Example – Tax-free investment*Facts:*

On 1 March 2019 Lizette invested R33 000 in a tax-free investment in the form of an exchange traded fund (ETF). On 1 July 2019 she invested a further R33 000 in a tax-free investment with the ABC Collective Investment Scheme. On 29 February 2020 Lizette disposed of both investments realizing a capital gain of R5 000 on the ETF and R8 000 on the collective investment scheme.

Result:

Since Lizette exceeded the R33 000 threshold by R33 000 during the 2020 year of assessment when making the collective investment scheme investment, she will be subject to normal tax on the excess: $40\% \times R33\,000 = R13\,200$. However, Lizette may disregard the capital gains on the two investments under s 12T(3).

Chapter 14 – Trusts and trust beneficiaries

PART XII: TRUSTS, TRUST BENEFICIARIES AND INSOLVENT ESTATES

14.1 Summary

The CGT consequences of trusts can be rather confusing for the uninitiated because of the number of permutations. In an effort to clear up this confusion the position is summarised below.

The trustee can

- vest an unconditional right to the asset,
- sell the asset,
- distribute the asset, or
- distribute the gain
- in the current year, or
- in a future year.

The beneficiary can

- sell his or her vested or contingent right in the trust,
- acquire a vested or contingent right in the trust, or
- acquire the asset from the trust.

Non-resident beneficiaries are treated differently to resident beneficiaries.

Under the rules discussed in this chapter a capital gain will either be taxed in the trust or in the hands of the beneficiary. However, these basic rules can be overridden by special attribution rules contained in paras 68 to 72, which provide for the whole or part of a trust capital gain to be taxed in the hands of the trust donor. These special rules are discussed in the next chapter,

Finally, there are special rules dealing with resident beneficiaries of non-resident trusts (para 80(3)) and the death of a beneficiary of a special trust (para 82).

A beneficiary of a trust is a connected person in relation to a trust.⁶⁵² It follows that non-arm's length transactions between the trust and its beneficiaries must be at market value (para 38). And from the trust's perspective capital losses arising from transactions with beneficiaries will be clogged (ring-fenced) (para 39), except for any right, marketable security or equity instrument contemplated in s 8A or 8C disposed of to employees under specified circumstances [para 39(4)].

⁶⁵² Paragraph (b)(i) of the definition of 'connected person' in s 1(1).

The CGT consequences of trusts are summarised in the table below.

Table 1 – CGT consequences of trusts (excluding attribution of capital gains to donors under para 68 to 72)

Event	Paragraph	CGT Consequence
RESIDENT TRUSTS		
Vesting, distribution and sale of asset – resident beneficiary		
Trustee vests an unconditional interest in an asset in a resident beneficiary	80(1) 38(1)(b)	Capital gain disregarded in trust and taxed in beneficiary's hands at time of vesting. Base cost of vested interest in beneficiary's hands = market value of interest at date of vesting. (Subject to attribution to donor under paras 68, 69 and 71.)
Trustee distributes asset to resident beneficiary who has a vested interest in that asset	11(2)(e) 11(1)(a) 35 13(1)(a)(ix) 38(1)(b) 20 35 13(1)(a)(iiA), 38(1)(b) 20	<p><i>2008 and prior years of assessment</i> Trust not taxed – not a disposal Capital gain or loss triggered in beneficiary's hands owing to exchange of right to delivery of trust asset for the actual asset. Proceeds of right disposed of = market value of asset at date of distribution Base cost of right disposed of = market value at time of vesting Base cost of asset acquired = market value at time of exchange</p> <p><i>2009 and subsequent years of assessment</i> No capital gain or loss arises in the trust, since it is deemed to distribute the asset at the time of vesting. No capital gain or loss arises in the hands of a beneficiary, since the exchange of rights is deemed to occur on date of vesting (proceeds will equal base cost). Base cost of asset acquired = market value at time of exchange.</p>
Resident beneficiary sells asset after acquisition	Normal rules	Further gain or loss triggered on disposal
Vesting, distribution and sale of asset – non-resident beneficiary		
Trustee of resident trust vests asset in non-resident beneficiary	Normal rules 11(1)(d)	If para 72 does not apply, the capital gain will be taxed in the trust (para 72 = attribution back to donor).
Trustee distributes an asset to a non-resident beneficiary who has a vested interest in the asset	11(2)(e)/ 2(1)(b)	<p><i>2008 and prior years of assessment</i> Trust not taxed – disposal by trust has already occurred through vesting under para 11(1)(d). If the vested right is an 'interest' contemplated in para 2(1)(b), the beneficiary will be taxed on the exchange of the vested right for the real right in the asset. Gain or loss</p>

Event	Paragraph	CGT Consequence
	2(1)(b) 13(1)(a)(iiA)	determined in same way as resident beneficiary Otherwise, non-resident not taxed <i>2009 and subsequent years of assessment</i> No capital gain or loss arises in the trust since it is deemed to distribute the asset at the time of vesting. Vested interest in para 2(1)(b) asset – same provisions apply as for a resident beneficiary (no capital gain or loss). Vested interest in other assets – no capital gain or loss arises since such assets fall outside the Eighth Schedule.
Non-resident beneficiary sells asset after acquiring it from trust	Normal rules, 2(1)(b)	If para 2(1)(b) asset – further gain taxed. Otherwise, non-resident not taxed
Retention of gain or loss in trust		
Trustee sells asset and does not distribute gain	Normal rules	Gain taxed in trust at following rates: <ul style="list-style-type: none"> • Normal trust – at 36% (80% × 45%). • Special trust – at 18% or less (40% × marginal rate which is a max of 45% for the 2020 year of assessment) Only special trusts created solely for persons with a disability as defined in section 6B(1) which incapacitates them from earning sufficient income for their maintenance, or from managing their own financial affairs qualify for exclusions applicable to individuals (for example, annual exclusion, primary residence exclusion). [Subject to attribution to donor under para 70]
Trustee sells an unvested asset at a loss	Normal rules	Loss retained in trust – cannot be distributed
Distribution of gain		
Trustee sells asset and distributes gain to resident beneficiary not having a prior vested interest in the asset in the same year	80(2)	Capital gain ignored in trust and taxed in beneficiary's hands in that year. [Subject to attribution to donor under paras 68, 69 and 71 or disregarding of capital gain in trust under para 64E]
Trustee sells asset and distributes gain to non-resident beneficiary not having a prior vested interest in the asset in the same year	Normal rules	Gain taxed in trust [Subject to attribution to resident donor under para 72]

Event	Paragraph	CGT Consequence
Trustee sells asset and distributes gain in a future year to resident beneficiary not having a prior vested interest in the asset.	Normal rules	<p>The capital gain is taxed in the trust in the year in which the asset is disposed of. When the earlier year gain is distributed in a subsequent year, no further gain or loss should arise in the trust or the beneficiary's hands, since</p> <ul style="list-style-type: none"> • the Eighth Schedule does not make provision for the attribution of earlier year capital gains from resident trusts, • the withdrawal of an amount from a rand-denominated bank account will not result in a further gain or loss because the para 38 proceeds should equal the base cost of the bank account, and • the receipt of the trust capital will not result in a gain in the beneficiary's hands because <ul style="list-style-type: none"> ➤ the beneficiary's right to claim the distribution will have a base cost equal to market value under para 38, and ➤ upon receipt of the distribution that right is disposed of for proceeds equal to that market value.
Sale of vested and contingent rights by beneficiaries		
Resident beneficiary sells contingent right	81	Beneficiary taxed on proceeds with zero base cost. The base cost is deemed to be nil even if the beneficiary paid something for the contingent right.
Resident beneficiary sells vested right	Normal rules	Beneficiary is taxed on proceeds less base cost. Base cost could be acquisition cost or market value at date of vesting.
Non-resident sells vested right	Normal rules	Non-resident beneficiary will be taxed on proceeds less base cost if para 2(1)(b) asset. Otherwise not taxed.

Event	Paragraph	CGT Consequence
NON-RESIDENT TRUSTS		
Current year capital gain, including an amount that would have been a capital gain had the trust been a resident, arising from vesting of asset	80(1)	Capital gain taxed in beneficiary's hands in year of vesting of asset
Vesting of current year capital gain, including an amount that would have been a capital gain had the trust been a resident	80(2)	Capital gain taxed in beneficiary's hands in year in which it vests
Amount vested represents an earlier year capital gain, including an amount that would have been a capital gain had the trust been a resident	80(3)	Capital gain taxed in beneficiary's hands in year of vesting

14.2 Historical background

The trust was unknown to Roman or Roman-Dutch law. Trusts were introduced into England shortly after the Norman Conquest. The English Court of Chancery developed the trust from the Germanic *Salman* or *Treuhand* institution. The trust of English law forms an integral part of all common law legal systems, including American law. In South Africa the trust was introduced during the 19th century by usage without the intervention of the legislature. The English conception of an equitable ownership distinct from, but co-existing with, the legal ownership is foreign to South African law. South African courts have evolved and are still in the process of evolving the law of trusts by adapting the trust idea to the principles of South African law.⁶⁵³

In the 1915 Appellate Division case of *Estate Kemp & others v McDonald's Trustee*, Solomon JA said the following:⁶⁵⁴

'[T]he constitution of trusts and the appointment of trustees are matters of common occurrence in South Africa at the present day. Thus it is a recognised practice to convey property to trustees under antenuptial contracts; trustees are appointed by deed of gift or by will to hold and administer property for charitable or ecclesiastical or other purposes; the property of limited companies and other corporate bodies is vested in trustees and the term is used in a variety of other cases, as e.g. in connection with assigned or insolvent estates. The underlying conception in these and other cases is that while the legal *dominium* of property is vested in the trustees, they have no beneficial interest in it but are bound to hold and apply it for the benefit of some person or persons or for the accomplishment of some special purpose. The idea is now so firmly rooted in our practice, that it would be quite impossible to eradicate it or to seek to abolish the use of the expression trustee, nor indeed is there anything in our law which is inconsistent with the conception.'

See also *Estate Munro v CIR*.⁶⁵⁵

⁶⁵³ *Braun v Blann & Botha NNO & another* 1984 (2) SA 850 (A) at 859.

⁶⁵⁴ 1915 AD 491 at 507.

⁶⁵⁵ 1925 TPD 693, 1 SATC 163.

14.3 Trusts under the Income Tax Act

A 'trust' as defined in s 1(1) means

'any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person'.

The Act contains two definitions of 'special trust', one in s 1(1) and the other more restrictive definition, in para 1. See **14.13**.

Paragraph (c) of the definition of 'person' in s 1(1) includes 'any trust'. This definition was inserted following the decision in *CIR v Friedman & others NNO*⁶⁵⁶ which held that a trust is not a person. The trust is therefore a taxable entity for CGT purposes in its own right.

14.4 Trusts under South African common law

Under South African law there are three types of trust:

- Founder transfers ownership of assets to a trustee for benefit of beneficiaries ('ownership trust').
- Founder transfers ownership of assets to beneficiaries but control rests with the trustees (*bewind* trust).
- Trustee administers affairs of another for example, a mental patient, in the capacity of a curator.

The Trust Property Control Act 57 of 1988, which also defines a trust, draws no distinction between the ownership trust and the *bewind* trust, and recognises both types of trust.

This chapter is primarily concerned with the first type of trust.

14.5 Types of trusts

Trusts can be described in various ways, for example, in relation to

- their method of formation (*inter vivos* and testamentary trusts);
- the rights they confer on beneficiaries (vesting and discretionary trusts); or
- their purpose (trading trusts, asset-protection trusts, special trusts, charitable trusts).

These descriptions are not mutually exclusive. For example, an *inter vivos* trust can be both a trading trust and a discretionary trust.

14.5.1 The *bewind* trust

In a *bewind* trust the founder makes a gift or bequest to the beneficiary and vests the administration of the assets in the administrator or trustee. This structure is known as a *bewind* in Dutch law and a *bewindhebber* in Roman-Dutch law. In a *bewind* trust the ownership of the assets of the trust vests in the beneficiary, but the administration of the trust vests in the trustee or *bewindhebber*.⁶⁵⁷

⁶⁵⁶ 1993 (1) SA 353 (A), 55 SATC 39.

⁶⁵⁷ *Bafokeng Tribe v Impala Platinum Ltd & others* 1999 (3) SA 517 (BH) and *C: SARS v Dyefin Textiles (Pty) Ltd* 2002 (4) SA 606 (N), 65 SATC 126 at 131.

For CGT purposes the *bewind* trust can be ignored for the purpose of this chapter, since the beneficiaries have full beneficial ownership of the trust assets, and will have to account for any CGT consequences in their personal capacities upon disposal of such assets.

14.5.2 Inter vivos and testamentary trusts

Inter vivos trusts – trusts created during the lifetime of an individual; and

Testamentary trusts – trusts created upon the death of an individual under the last will and testament.

14.5.3 Vesting and discretionary trusts

Vesting trust – Under a vesting trust the assets and income of the trust are vested in the beneficiaries. The beneficiaries have vested rights to the income and or capital.

Discretionary trust – Under a discretionary trust the trustees have the discretion as to whether and how much of the income or capital to distribute to the beneficiaries. In these circumstances the beneficiaries merely have contingent rights to the trust income or capital.

While the above descriptions are in common usage, they can be somewhat misleading, in that many trusts are not purely discretionary or vesting, but rather hybrid entities. For instance, a discretionary trust may become a vesting trust once the trustees have exercised their discretion and vested the assets and income in the beneficiaries.

Vesting and discretionary trusts are addressed in more detail below. Paragraphs 80 to 82 of Part XII of the Eighth Schedule address the CGT consequences of discretionary trusts and their beneficiaries. More specifically, paras 80 and 81 deal with the CGT consequences at the moment of vesting.

The CGT consequences for beneficiaries who have already acquired their vested rights are dealt with under the core rules and the attribution rules in paras 68 to 73 in Part X. Once a trust's assets or gains have been vested in a beneficiary, the vesting trust virtually ceases to have CGT consequences in its own right, these having been passed on to the beneficiaries or the donors at the time of vesting.

14.5.4 Special trusts

Under the definition of 'special trust' in s 1(1), special trusts fall into two categories, namely,

- those for persons with a disability as defined in s 6B(1) which incapacitates them from earning sufficient income for their maintenance, or from managing their own financial affairs [para (a)]; and
- testamentary trusts for minors [para (b)]. The para (a) type of special trust is generally treated as a natural person for CGT purposes, and therefore receives far more favourable treatment. Special trusts are dealt with in detail under **14.13**.

14.5.5 Charitable trusts

A charitable trust can qualify for exemption from income tax under s 10(1)(cN), and hence CGT under para 63A if it is approved by the Commissioner as a public benefit organisation (PBO) under s 30. In order to qualify for exemption a trust of this nature also has to carry on an approved public benefit activity as set out in Part I of the Ninth Schedule. Any capital gain or loss arising from the donation or bequest of an asset to an approved PBO must be disregarded under para 62.

14.5.6 Offshore trusts

With many residents having invested funds offshore, it is useful to mention some common trust terms found in offshore jurisdictions. Offshore trusts tend to be formed in tax-haven countries that impose no or low rates of tax on trusts and embrace the English common law of trusts.

Blind trust (also known as a limping trust or black hole trust) – This is a highly secretive vehicle typically formed for the purpose of concealing assets from revenue or exchange control authorities. It is impossible to identify the settlor, the purpose of the trust or true beneficiaries from the trust deed. A dummy settlor establishes the trust by donating a nominal sum to a trustee. The trust deed contains the name of a discretionary beneficiary (for example, the Red Cross) but that beneficiary is usually not informed of its status as beneficiary. The trustees have the discretion to add or change the beneficiaries. The true beneficiaries are named in a ‘letter of wishes’ provided to the trustee. Once the trust is established assets can be added to the trust and additional beneficiaries added. A United Kingdom criminal case should serve as a warning to persons making use of such trusts to conceal assets.⁶⁵⁸

Bare trust (or simple trust) – Under a bare trust (found in the United Kingdom especially) the beneficiaries have immediate and absolute entitlement to the income and capital of the trust, and have the right to take actual possession of trust property. A bare trustee has no active duties to perform, and is essentially a nominee.⁶⁵⁹

The Protector – A protector is someone appointed by the settlor to supervise the trustees and to ensure that they administer the trust in accordance with the letter of wishes.

Letter of wishes – A document in which the settlor indicates his or her wishes for the administration of the trust assets, both during his or her lifetime and afterwards. It is merely a guide and while not binding on the trustees, they will in practice give effect to it. It can be amended at any time.

14.5.7 Invalid trusts

It should not lightly be assumed that all trusts are valid. If a trust is found to be invalid, the trust would be a nullity and it will be necessary to assess the capital gains or losses in the hands of the true owner of the assets concerned. Three features of invalid trusts are considered here.

Trust without identifiable beneficiaries

In order to be valid, a trust must be for the benefit of one or more named persons or class of ascertainable persons. But for certain minor exceptions, South Africa does not recognise ‘purpose’ (impersonal) trusts. The beneficiaries must, with reasonable certainty, be capable of objective determination since a trust without an object is a nullity.

A typical example of an invalid trust is one containing a clause such as the following:

‘ “[B]eneficiary” means that person or those persons who may from time to time be selected by the Trustees in their entire and absolute discretion to be a beneficiary or beneficiaries under this Trust.’

⁶⁵⁸ See P Webb ‘Cold Stone Jug’ (November/December 2003) *Accountancy SA* 29.

⁶⁵⁹ See <<http://www.hmrc.gov.uk/manuals/cgmanual/CG34320.htm>> [Accessed 2 November 2020].

In *Khabola NO v Ralitabo NO*⁶⁶⁰ a trust was found to be invalid because it had no named beneficiaries and was in fact held to be a partnership. The court referred to the definition of ‘trust’ in the Trust Property Control Act 57 of 1988 which reads as follows:

‘ “[T]rust” means the arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed—

- (a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or
- (b) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument,

but does not include the case where the property of another is to be administered by any person as executor, tutor or curator in terms of the provisions of the Administration of Estates Act, 1965 (Act no. 66 of 1965);’

Sole trustee and sole beneficiary

A trust will be invalid if upon formation it has only one trustee who is the sole beneficiary. In *Land & Agricultural Development Bank of SA v Parker & others* Cameron J held as follows:⁶⁶¹

‘The core idea of the trust is the separation of ownership (or control) from enjoyment. Though a trustee can also be a beneficiary, the central notion is that the person entrusted with control exercises it on behalf of and in the interests of another. This is why a sole trustee cannot also be the sole beneficiary: such a situation would embody an identity of interests that is inimical to the trust idea, and no trust would come into existence.’

Founder cannot be sole trustee on formation

It is submitted that the founder cannot be the sole trustee of a trust upon its formation for at least two reasons. First, the founder must be divested of ownership of the assets to form part of the trust property. A trust is formed by contract and a person cannot contract with himself or herself. Secondly, the Trust Property Control Act defines a trust as follows:

‘ “[T]rust” means the arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed—

- (a) to *another person*, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument;’

(Emphasis added.)

⁶⁶⁰ (5512/2010) [2011] ZAFSHC 62 (24 March 2011).

⁶⁶¹ 2005 (2) SA 77 (SCA).

Honoré expresses a similar sentiment as follows:⁶⁶²

'It is not possible for a trust to be created of assets of which the founder is to remain sole owner, though there is nothing to prevent the founder remaining a co-owner of the trust property, eg as co-trustee.'

Du Toit also supports this view by stating the following:⁶⁶³

'A trust founder can be a co-trustee of a trust created by him. A founder cannot, however, create an ownership trust by simply transferring property to himself as sole trustee, by reason of the fact that such an arrangement lacks the requisite relinquishment of control over property by the founder.'

Sham trusts v alter ego trusts

In *Van Zyl NO & another v Kaye NO & others*⁶⁶⁴ the case concerned, amongst others, a Cape Town property held by a family trust which had been controlled by one Kaye, an insolvent. The trustees wanted to bring the trust's property into Kaye's insolvent estate. Binns-Ward J noted the distinction between a sham trust and an 'alter ego' trust.

He stated the following on a sham trust:

'If the Trust were a sham, the original trustees would be seen as having acquired the Cape Town property as agents of Kaye, and it would thus have been acquired for him as their principal.'⁶⁶⁵

'Indeed, the applicants' approach renders it necessary to highlight that establishing that a trust is a sham and "going behind the trust form" entail fundamentally different undertakings. When a trust is a sham, it does not exist and there is nothing to "go behind". In my view, the applicants have confused and conflated the concepts in their founding papers. As I shall endeavour to explain, "going behind" the trust is not an available remedy on the alleged facts.'⁶⁶⁶

'The maladministration of an asset validly vested in a properly founded trust does not afford a legally cognisable basis to contend that the trust does not exist, or that the asset no longer vests in the duly appointed trustees.'⁶⁶⁷

'Holding that a trust is a sham is essentially a finding of fact. Inherent in any determination that a trust is a sham must be a finding that the requirements for the establishment of a trust were not met, or that the appearance of having met them was in reality a dissimulation.'⁶⁶⁸

On an alter ego trust, Binns-Ward J noted that the concept would find application

'in a context in which the trustees treat the property of the trust as if it were their personal property and use the trust essentially as their alter ego – an all too frequent phenomenon in certain family and business trusts in which the trustees are both the effective controllers as well as the beneficiaries. The remedy might entail the making of a declaration that a trust asset shall be made available to satisfy the personal liability of a trustee, but it does not detract from the character of the asset as one of the trust and not that of the trustee; the existence of the trust remains acknowledged.'⁶⁶⁹

'Going behind the trust form (or 'piercing its veneer', as the concept is sometimes described) essentially represents the provision by a court of an equitable remedy to a third party affected by an unconscionable abuse of the trust form. It is a remedy that will be afforded in suitable or appropriate cases. The notion of the provision of such a remedy has been postulated as a desirable

⁶⁶² E Cameron *et al Honoré's South African Law of Trusts* 5 ed (2002) Juta & Co Ltd at page 6.

⁶⁶³ F du Toit *South African Trust Law Principles and Practice* 2 ed (2007) LexisNexis at page 5 in 1 3 1.

⁶⁶⁴ 2014 (4) SA 452 (WCC).

⁶⁶⁵ Paragraph [15].

⁶⁶⁶ Paragraph [16].

⁶⁶⁷ Paragraph [18].

⁶⁶⁸ Paragraph [19].

⁶⁶⁹ Paragraph [21].

development in our law; see *Parker*.⁶⁷⁰ I suspect that, rather like the position with ‘piercing of the corporate veil’ in the case of companies, closely defining the applicable principles in the cases in which it is afforded or withheld may prove elusive. That is why I consider it appropriate to describe it as an equitable remedy in the ordinary, rather than technical, sense of the term; one that lends itself to a flexible approach to fairly and justly address the consequences of an unconscionable abuse of the trust form in given circumstances. It is a remedy that will generally be given when the trust form is used in a dishonest or unconscionable manner to evade a liability, or avoid an obligation.’⁶⁷¹

‘I am not aware of any matter in which a South African court has yet “pierced the veneer” of a trust or gone behind it, although the court came close to doing so in *Van der Merwe*’^{672, 673}

In the result the court found that the property was owned by the trust and that the trust was not a sham.

14.6 The trustee

The term ‘trustee’ is defined in s 1(1) as follows:

‘ “[T]rustee”, in addition to every person appointed or constituted as such by act of parties, by will, by order or declaration of court or by operation of law, includes an executor or administrator, tutor or curator, and any person having the administration or control of any property subject to a trust, usufruct, fideicommissum or other limited interest or acting in any fiduciary capacity or having, either in a private or in an official capacity, the possession, direction, control or management of any property of any person under legal disability.’

The trustee is the representative taxpayer of a trust.⁶⁷⁴

Although legal ownership of the trust assets vests in the trustee, a trustee does not enjoy beneficial ownership of the trust assets.⁶⁷⁵ In this regard Joubert JA said the following in *Braun v Blann & Botha NNO & another*.⁶⁷⁶

‘The trustee is the owner of the trust property for purposes of administration of the trust but *qua* trustee he has no beneficial interest therein.’

In *Crookes NO & another v Watson & others* Steyn JA stated the following:⁶⁷⁷

‘It is merely pro forma, and by way of more or less technical legal abstraction that he is recognised as the holder of the *dominium*, denuded of all benefit to himself.’

And in *CIR v MacNeillie's Estate* Steyn CJ stated that⁶⁷⁸

‘it is trite law that the assets and liabilities in a trust vest in the trustee’.

A trustee has a fiduciary duty to administer the trust assets for the benefit of the beneficiaries.⁶⁷⁹

⁶⁷⁰ *Land & Agricultural Development Bank of SA v Parker & others* 2005 (2) SA 77 (SCA).

⁶⁷¹ Paragraph [22].

⁶⁷² *Van der Merwe NO v Hydraberg Hydraulics CC & others* 2010 (5) SA 555 (WCC).

⁶⁷³ Paragraph [23].

⁶⁷⁴ Under para (c) of the definition of ‘representative taxpayer’ in s 1(1).

⁶⁷⁵ *Estate Kemp & others v McDonald's Trustee* 1915 AD 491.

⁶⁷⁶ 1984 (2) SA 850 (A) at 859.

⁶⁷⁷ 1956 (1) SA 277 (A) at 305.

⁶⁷⁸ 1961 (3) SA 833 (A), 24 SATC 282 at 840G – H.

⁶⁷⁹ Section 9(1) of the Trust Property Control Act 57 of 1988; *Sackville West v Nourse & another* 1925 AD 516; *Administrators, Estate Richards v Nichol & another* 1999 (1) SA 551 (SCA).

14.7 Rights of beneficiaries

In order to appreciate the CGT consequences of trusts, and more particularly, beneficiaries, it is essential to have an understanding of the legal rights enjoyed by beneficiaries. These rights may be divided into two categories:

- Vested and contingent rights
- Personal and real rights

14.7.1 Vested rights

A 'vested right' can have a different meaning depending on the context in which the words are used. This fact was highlighted in the case of *Jewish Colonial Trust Ltd v Estate Nathan*⁶⁸⁰ in which Watermeyer JA stated the following:

'Unfortunately the word "vest" bears different meanings according to its context. When it is said that a right is vested in a person, what is usually meant is that such person is the owner of that right – that he has all rights of ownership in such right including the right of enjoyment. If the word "vested" were used always in that sense, then to say that a man owned a vested right would mean no more than a man owned a right. But the word is also used in another sense, to draw a distinction between what is certain and what is conditional; a vested right as distinguished from a contingent or conditional right. When the word "vested" is used in this sense Austin (Jurisprudence, vol 2, lect 53), points out that in reality a right of one class is not being distinguished from a right of another class but that a right is being distinguished from a chance or a possibility of a right, but it is convenient to use the well-known expressions vested right and conditional or contingent right.'

In referring to the *Jewish Colonial Trust* case, Milne J stated the following in ITC 1328:⁶⁸¹

'It is clear also from this case that a vested right may nevertheless be vested even though in some instances enjoyment of the right may be postponed. See also *Estate Dempers v SIR*, 1977 (3) SA 410 (AD) at 425G–H (39 SATC 95).⁶⁸² Here it is quite clear that each of the beneficiaries acquires an immediate right to the income although enjoyment of it is postponed until the exercise of discretion by the trustee in favour of that beneficiary or the death of the beneficiary. It is not a necessary consequence of vesting that the beneficiary has a legal right to claim payment. See *Jewish Colonial Trust* case (above) at 177 to the foot of p 181.'

The principles set out above and in a number of other cases are summarised in the table below.

Table 2 – Characteristics of a vested right

Case Law	Characteristic
<i>Jewish Colonial Trust Ltd v Estate Nathan</i> ⁶⁸³ .	A vested right is certain as opposed to a contingent right which is conditional.
<i>In re Allen Trust</i> ; ⁶⁸⁴ <i>Estate Dempers v SIR</i> ⁶⁸⁵ and ITC 1328. ⁶⁸⁶	Enjoyment of a vested right may be postponed.
ITC 76 ⁶⁸⁷ and <i>CIR v Polonsky</i> . ⁶⁸⁸	A vested right is an accrued right.

⁶⁸⁰ 1940 AD 163 at 175–6.

⁶⁸¹ (1980) 43 SATC 56 (N) at 60.

⁶⁸² At SATC 112.

⁶⁸³ 1940 AD 163 at 175–6.

⁶⁸⁴ 1941 NPD 156.

⁶⁸⁵ 1977 (3) SA 410 (A), 39 SATC 95 at 112.

⁶⁸⁶ (1980) 43 SATC 56 (N) at 59–60.

⁶⁸⁷ (1927) 3 SATC 68 (U).

⁶⁸⁸ 1942 TPD 249, 12 SATC 11.

Case Law	Characteristic
ITC 1328 above.	It is not a necessary consequence of vesting that the beneficiary has a legal right to claim payment.
<i>CIR & others v Sive's Estate</i> . ⁶⁸⁹	Property may be vested in a trustee purely for the purpose of administration.
<i>Greenberg & others v Estate Greenberg</i> . ⁶⁹⁰	A legatee does not acquire <i>dominium</i> in the property of an estate immediately upon the death of the testator. All the legatee acquires is a vested right to claim from the executors at some future date delivery of the legacy, that is, after confirmation of the liquidation and distribution account.
ITC 816 ⁶⁹¹	Until the liquidation and distribution account is confirmed, no <i>dominium</i> in any asset or any right in the estate vests in an heir or legatee.
<i>Hiddingh v CIR</i> , ⁶⁹² <i>Hansen's Estate v CIR</i> , ⁶⁹³ ITC 1656. ⁶⁹⁴	The right of an income beneficiary of a trust is a personal right of action against a trustee to receive the whole or part of the income produced by the trust assets and does not constitute a real right in respect of such assets.
<i>Estate Kemp & others v McDonald's Trustee</i> , ⁶⁹⁵ <i>Braun v Blann & Botha NNO & another</i> . ⁶⁹⁶	While legal ownership of trust property is vested in the trustees, they do not have beneficial ownership of such property.
<i>McAlpine v McAlpine NO & another</i> ⁶⁹⁷	The time when a person acquires an unconditional right (the time of vesting) is <i>dies cedit</i> , as opposed to the right of enjoyment (<i>dies venit</i>). Conditional or contingent rights are subject to a suspensive condition as distinct from a resolutive condition. In the realm of contract a suspensive condition suspends the full operation of the obligation and renders it dependent on the occurrence of an uncertain future event; whereas in the case of a resolutive condition the normal consequences flow from the contract, but on the happening of an uncertain future event these consequences are annulled (see 5 LAWSA, first re-issue, paragraphs 191 and 192 and the authorities there cited).

Vesting is not the same as ownership. Legal ownership can be given to a trustee while the income or capital in the trust property can be vested in a beneficiary. A vested right is a personal right.⁶⁹⁸

⁶⁸⁹ 1955 (1) SA 249 (A) at 269.

⁶⁹⁰ 1955 (3) SA 361 (A).

⁶⁹¹ (1955) 20 SATC 496 (T).

⁶⁹² 1940 AD, 11 SATC 54 at 211.

⁶⁹³ 1956 (1) SA 398 (A), 20 SATC 254.

⁶⁹⁴ (1998) 61 SATC 195 (C) at 200.

⁶⁹⁵ 1915 AD 491.

⁶⁹⁶ 1984 (2) SA 850 (A) at 860A.

⁶⁹⁷ 1997 (1) SA 736 (A).

⁶⁹⁸ *SIR v Rosen* 1971 (1) SA 172 (A), 32 SATC 249 at 189; *CIR v Lazarus' Estate & another* 1958 (1) SA 311 (A), 21 SATC 379 at 320; *Estate Kemp & others v McDonald's Trustee* 1915 AD 491 at 503, 506, 510; *Levin v Gutkin, Fisher & Schneier* 1997 (3) SA 267 (W) at 284D .

Once an asset has been vested in a beneficiary, actions by the trustee are actions on behalf of the beneficiary. This result flows from para 11(1)(d) read with para 13(1)(a)(iiA). The position can be compared to an agent acting on behalf of a principal, although a trustee is not an agent.⁶⁹⁹ A beneficiary who has a vested right of this nature has an interest in the underlying assets. In *Hansen's Estate v CIR*⁷⁰⁰ Hoexter JA confirmed that such a right was an interest for the purposes of the Estate Duty Act when he stated that

'[t]he net income of the trust fund is derived from all the assets of the fund, and the holder of the right to receive the net income therefore has a financial interest in each and all of those assets. That financial interest is protected by law to this extent that the holder is entitled to prevent, by legal action, any maladministration of any asset by the trustee. In my opinion a financial interest in any property which is of such a nature that the holder has *locus standi* to prevent the maladministration of that property is an interest within the meaning of section 10(b).'

In Roman law the time of vesting is referred to as *dies cedit*, while the time of enjoyment is referred to as *dies venit*.⁷⁰¹ In *Samaradiwakara & another v de Saram & others*, Lord de Villiers, in delivering the judgment of the Privy Council, explained the distinction as follows:⁷⁰²

'The phrase used in Roman-Dutch law to indicate that a thing has begun to be owing, the right to which is therefore transmissible, is *dies cessit*, as distinguished from *dies venit*, when a time for enjoyment has arrived, and a thing can be claimed: see Voet (36.2.1.).'

14.7.2 Contingent rights

A contingent right is merely a *spes* – an expectation that might never be realised (see *Jewish Colonial Trust* case above and ITC 76.⁷⁰³

For example, a beneficiary will have a contingent right when a trustee has a discretion as to

- whether to pay capital or income, or
- how much to pay or distribute,

to a beneficiary.

A beneficiary who has a contingent right merely has a right against the trustees to administer the trust in accordance with the trust deed.

14.7.3 Personal rights

Personal rights have as their object performance by another, and the duty to perform may arise from a contract. Personal rights may give rise to real rights, for instance, a personal obligation to grant someone a servitude matures into a real right on registration.⁷⁰⁴

A personal right (*jus in personam* or *jus ad rem*) is a right in or against a person or a thing. A beneficiary's vested or contingent right in a trust asset is a personal right. Both vested and contingent beneficiaries share the following personal right in common: They both have the right to expect the trustee to administer the trust assets in accordance with the trust deed.

A beneficiary who has a *jus in personam* can in due course acquire an additional personal right, being a right to claim payment, delivery or transfer of an asset.⁷⁰⁵ This right is referred to as a *jus in personam ad rem acquirendam*.

⁶⁹⁹ *Hoosen & others NNO v Deedat & others* 1999 (4) SA 425 (SCA) at 431G–H .

⁷⁰⁰ 1956 (1) SA 398 (A), 20 SATC 246 at 255.

⁷⁰¹ Per Heher J in *Jowell v Bramwell-Jones & others* 1998 (1) SA 836 (W) at 872G–H .

⁷⁰² 1911 AD 465 at 469.

⁷⁰³ (1927) 3 SATC 68 (U) at 70.

⁷⁰⁴ *National Stadium SA (Pty) Ltd v Firstrand Bank Ltd* [2011] 3 All SA 29 (SCA) at 39.

⁷⁰⁵ *De Leef Family Trust NNO v CIR* 1993 (3) SA 345 (A), 55 SATC 207 at 216.

14.7.4 Real rights

Real rights have as their object a thing (Latin: *res*; Afrikaans: *saak*). Real rights give rise to competencies: ownership of land entitles the owner to use the land or to give others rights in respect thereof. Others may say that ownership consists of a bundle of rights, including the right to use the land, but it does not really matter who is right on this point.⁷⁰⁶

A real right (*jus in rem* or *jus in re*) is a right that is enforceable against all persons. It is the badge of ownership. Such a right must be distinguished from a *jus ad rem*, which is merely a personal right to oblige a person to give or to refrain from doing something. For example, assume that a beneficiary becomes entitled to possession of a particular asset on a certain date. At that time the beneficiary will have a *jus ad rem* against the trustee to effect transfer. Once transfer has been effected the beneficiary will own either another personal right or a real right, depending on the nature of the asset. For example, if the asset comprised shares, the beneficiary would hold a bundle of personal rights against the company; if the asset was a debt claim, the beneficiary would hold a personal right against the debtor; and if the asset was an object such as a motor vehicle or immovable property, the beneficiary would own a real right in the asset.

14.7.5 Exchange of rights

The position before the commencement of years of assessment ending on or after 1 January 2009

The definition of ‘asset’ in para 1 is framed in wide terms and embraces both personal and real rights. A beneficiary of a trust who has a vested (personal) right in an asset will eventually exchange that personal right for the asset itself, which could comprise a personal right or a real right, depending on the type of asset. An exchange of this nature will trigger a disposal in that beneficiary’s hands under para 11(1)(a).

Some commentators have argued that there is no separate acquisition of the actual asset upon its distribution by the trustee and hence no exchange of rights by virtue of para 11(2)(e) read with para 13(2). Paragraph 11(2)(e) states that there is no disposal

‘by a trustee in respect of the distribution of an asset of the trust to a beneficiary to the extent that that beneficiary has a vested interest in that asset’.

And para 13(2) states that

‘[a] person to whom an asset is disposed of is treated as having acquired that asset at the time of disposal of that asset as contemplated in subparagraph (1)’.

Since there is no time of disposal by the trustee, it is argued that there can be no time of acquisition by the beneficiary.

However, this analysis is flawed because para 13(2) does not regulate the time of acquisition of all assets. Merely because the disposing party does not have a disposal does not mean that the acquirer does not have an acquisition. For example, under para 11(2)(b) the issue by a company of its own shares is deemed not to be a disposal, yet, it can hardly be suggested that a shareholder who receives those shares does not acquire them.⁷⁰⁷

⁷⁰⁶ *National Stadium SA (Pty) Ltd v Firstrand Bank Ltd* [2011] 3 All SA 29 (SCA) at 39.

⁷⁰⁷ See Gerard Swart ‘Interpreting Some Core Concepts Governing the Taxation of Capital Gains’ (2005) 17 SA Merc LJ 1 at 14.

Example 1 – Exchange of personal right for underlying asset (old rules)*Facts:*

The John Smith Will Trust was created under the last will and testament of John's grandfather who passed away on 1 July 2002. The will provided that John was to inherit the family farm when he turned 25. Should John have died before turning 25, the farm would, under the will, have gone to his estate. The market value of the farm at the date of the grandfather's death was R1 million. At that time John was 20 years old. Upon reaching the age of 25 the trustee transferred the farm into John's name. The market value of the farm at the date of transfer was R1,2 million. After farming for 10 years John decided to sell the farm, and realised proceeds of R1,8 million.

Result:

When his grandfather died, John acquired a personal right (*jus in personam ad rem acquirendam*) against the trustee of the John Smith Will Trust to claim delivery of the farm when he turned 25.

Base cost of the personal right to claim delivery

The base cost of the personal right is determined under para 38 because

- John is a connected person in relation to the trust, being a beneficiary,⁷⁰⁸ and
- the trust disposed of the farm to John for a consideration that is not an arm's length consideration (John paid nothing for the farm).

Under para 38(1)(b) John is treated as having acquired the farm at market value of R1 million.

Exchange of personal right for real right

When John took transfer of the farm, his personal right to claim delivery was extinguished in exchange for a real right (*jus in rem*), being the farm itself. The exchange is a disposal under para 11(1)(a). The proceeds are equal to the market value of the asset acquired (R1 200 000), since this constitutes an 'amount' for the purposes of para 35. See the commentary on the exchange of an asset as a disposal event in **6.1.1.5**. John therefore has a capital gain of R200 000 [R1 200 000 (proceeds) – R1 000 000 (base cost)].

Base cost of the real right acquired (the farm)

The base cost of the *jus in rem* (the farm) is its market value of R1,2 million. See 'Assets acquired by barter or exchange' in **8.5**.

Upon disposal of the farm John's capital gain is R600 000 [R1 800 000 (proceeds) – R1 200 000 (base cost)].

⁷⁰⁸ Paragraph (b)(ii) of the definition of 'connected person' in s 1(1).

The position as from the commencement of years of assessment ending on or after 1 January 2009

Three amendments have been effected by the Revenue Laws Amendment Act 60 of 2008 to prevent the triggering of a capital gain or loss in the hands of a beneficiary having a vested interest in an asset when the trustee distributes that asset to the beneficiary. These amendments involve the deletion of paras 11(2)(e) and 13(1)(d) and the insertion of para 13(1)(a)(iiA) which reads as follows:

‘13. Time of disposal.—(1) The time of disposal of an asset by means of—

(a) a change of ownership effected or to be effected from one person to another because of an event, act, forbearance or by operation of law is, in the case of—

(i) & (ii) [not applicable]

(iiA) the distribution of an asset of a trust by a trustee to a beneficiary to the extent that the beneficiary has a vested interest in the asset, the date on which the interest vests.’

The effect of the above provision is to take the time of disposal of the asset by the trust back to the time of vesting of the asset. Correspondingly, under para 13(2) the time of acquisition of the asset by the beneficiary is taken back to the time when the beneficiary acquired a vested interest in the asset. When the trustee distributes the asset, there will still be a disposal by the beneficiary in the form of an exchange of the vested interest in the asset for the asset itself, but it will not give rise to a capital gain or loss because the proceeds (being the market value of the asset itself received or accrued) will equal the base cost of the vested interest in the asset (being equal to market value established under para 38 when acquired from the trust). Going forward, the base cost of the asset is equal to the amount by which the beneficiary is impoverished through giving up the vested interest in the asset, being the same market value.

Example 2 – Exchange of personal right for underlying asset(2009 and subsequent years of assessment)

Facts:

The facts are the same as in the previous example, except that the transaction takes place during the 2009 or a subsequent year of assessment.

Result:

As in the above example, John acquired the farm at a base cost of R1 million under para 38(1)(b).

Exchange of personal right for underlying asset

When John takes transfer of the farm, there is a disposal under para 11(1)(a) as a result of the exchange of rights. This exchange is backdated to the time of vesting under para 13(1)(a)(iiA). The effect is that the proceeds from the disposal, being the real right in the farm, must be determined at the time of vesting which results in neither a capital gain nor a capital loss.

	R
Proceeds (market value of farm received – para 35)	1 000 000
Less: Base cost of vested right [para 38(1)(b)]	(1 000 000)
Capital gain or loss	-

Base cost of farm

The base cost of the farm is established under para 20(1)(a) through an exchange transaction, and is equal to the amount by which John was impoverished in giving up the vested right in the farm at the time of vesting, namely, R1 million.

Sale of farm

When John sells the farm, there will be a disposal under para 11(1)(a) giving rise to a capital gain as follows:

	R
Proceeds from sale of farm (para 35)	1 800 000
Less: Base cost of farm [para 20(1)(a)]	<u>(1 000 000)</u>
Capital gain	<u>800 000</u>

14.8 Impact of the core rules

The disposal of an asset to or by a trust, for example by vesting it in a beneficiary of the trust, is as a rule subject to the core principles governing disposals, base cost and proceeds as well as to the general anti-avoidance and loss limitation rules. The disposal of an asset to a beneficiary is, for example, subject to the connected person rule in para 38. In particular, regard must be had to paras (a) to (bA) of the definition of ‘connected person’ in s 1(1), which read as follows:

‘ “[C]on~~ne~~cted person” means—

- (a) in relation to a natural person—
 - (i) any relative; and
 - (ii) any trust (other than a portfolio of a collective investment scheme) of which such natural person or such relative is a beneficiary;
- (b) in relation to a trust (other than a portfolio of a collective investment scheme)—
 - (i) any beneficiary of such trust; and
 - (ii) any connected person in relation to such beneficiary;
- (bA) in relation to a connected person in relation to a trust (other than a portfolio of a collective investment scheme), any other person who is a connected person in relation to such trust;’

Examples – Connected persons in relation to trusts and their beneficiaries

1. John is a beneficiary of the John Smith Trust.

From John’s perspective, the John Smith Trust is a connected person in relation to him [para (a)(ii)].

From the John Smith Trust’s perspective, John is a connected person in relation to it [para (b)(i)].

2. Ruth is not a beneficiary of the John Smith Trust but she is John’s sister.

From Ruth’s perspective, the John Smith Trust is a connected person in relation to her [para (a)(ii)]

From the John Smith Trust’s perspective, Ruth is a connected person in relation to it [para (b)(ii)]

3. Jane is unrelated to John but is also a beneficiary of the John Smith Trust.

Under para (bA) Jane is a connected person in relation to John, and John is a connected person in relation to Jane.

For more on the definition of ‘connected person’ see Interpretation Note 67 (Issue 4) dated 28 January 2020 ‘Connected Persons’.

A disposal to a trust might be subject to the ‘clogged loss’ rule in para 39 (see 9.5 for more details).

Example – Clogged losses in relation to trusts and their beneficiaries

Facts:

Abe bought an asset in year 1 at a cost of R200 000. He is a beneficiary of the Abe Trading Trust. In year 6 he sold it to the trust at its current market value of R150 000, realising a capital loss of R50 000.

Result:

Under para 39 he will not be able to use the capital loss of R50 000 against his other capital gains, but will be able to use it only against current or future capital gains arising from transactions with the Abe Trading Trust.

14.9 The CGT consequences of vesting trusts

14.9.1 What is a vesting trust?

A vesting trust can be described as one in which all the assets have been vested in the beneficiaries.

14.9.2 The position upon vesting

The vesting of a trust asset in a beneficiary triggers a disposal by the trust [para 11(1)(d)]. What happens to capital gains and losses arising in the trust as a result of the vesting of an asset or a capital gain in a beneficiary? The general rule is that gains will flow through to the beneficiary and be taxed in that beneficiary’s hands [para 80(1) or (2)]. In certain situations, however, capital gains cannot be attributed to a beneficiary, and will either be taxed in the trust or be attributed to a donor under para 68, 69 or 72. No flow through of capital gains is permitted when the beneficiary is

- a non-resident;
- a spouse and the asset was acquired by the trust from the person’s spouse as part of a scheme to avoid tax (para 68); and
- a minor child and the trust asset was acquired by the trust by reason of a donation, settlement or other disposition by the child’s parent (para 69).

Had a flow through of capital gains been allowed in these circumstances, a loss of income to the *fiscus* would have resulted. Tax recovery from non-residents would have proved problematic, and with tax-motivated donations between spouses and parent-minor child dispositions, income splitting would have resulted.

The attribution rules in paras 68 to 72 are addressed in **Chapter 15**.

14.9.3 Capital losses

A capital loss arising on vesting of a trust asset in a beneficiary under para 11(1)(d) remains in the trust, since no provision is made for the attribution of capital losses, whether to a beneficiary or a donor.

A capital loss arising from the vesting of an asset in a beneficiary may be set off only against capital gains arising from transactions with that same beneficiary (para 39).

14.9.4 The position after vesting

Once the right to claim a trust asset has been vested in a beneficiary (whether resident or non-resident), there will be no further CGT consequences for the trust, and the beneficiaries must account for any further capital gain or loss on disposal of their vested rights. The trustee holds the vested assets on behalf of the beneficiary, and actions by the trustee in respect of those assets are actions on behalf of that beneficiary (see comments above on vested rights).

In line with the above principle, an asset vested in a non-resident beneficiary of a resident trust will not trigger any consequences for the trust or the non-resident unless the asset is one contemplated in para 2(1)(b) such as immovable property in South Africa. In the latter event the non-resident beneficiary would have to account for any capital gain or loss.

Example – Vested assets disposed of by resident trust on behalf of non-resident beneficiary

Facts:

On 31 December of year 1 the trustees of the ABC Family Trust (a resident) vested the following assets in Rene, a resident of Australia:

Flat in Clifton (market value R10 million, base cost R4 million)

JSE-listed shares in XYZ Ltd (market value R2 million, base cost R1,5 million).

On 30 June of year 5 Rene requested the trustees to dispose of the assets and to transfer the proceeds to the trust's bank account in which she retained a vested right. The flat realised R15 million and the shares realised R2,2 million.

The assets of the trust were acquired by donation from Rene's grandfather who died some years ago.

What are the implications for Rene and the trust?

Result:

On 31 December of year 1 the trust realised the following capital gains under para 11(1)(d):

Flat R6 million (R10 million proceeds – R4 million base cost)

Shares in XYZ Ltd R500 000 (R2 million proceeds – R1,5 million base cost)

The trust will therefore have an aggregate capital gain of R6,5 million (R6 million + R500 000). These capital gains cannot be attributed to Rene under para 80(1), since she is a non-resident.

Under para 38 the flat will have a base cost of R10 million in Rene's hands.

On 30 June of year 5 Rene will realise a capital gain on disposal of the flat of R5 million (R15 million proceeds – R10 million base cost). The buyer of the flat will be obliged to withhold tax of $7,5\% \times R15 \text{ million} = R1\,125\,000$ under s 35A(1)(a) and pay that amount to SARS as an advance payment of Rene's normal tax liability unless she applies for a tax directive under s 35A(2).

The sale of the shares will not give rise to a capital gain in Rene's hands, since they do not fall under para 2(1)(b).

There is no attribution to Rene's grandfather under para 72 in year 1, since he was deceased at the time the trust realised the assets.

14.9.5 Transfer of vested asset to beneficiary

Before the commencement of years of assessment ending on or after 1 January 2009 the transfer of a vested asset to a beneficiary resulted in an exchange of rights, requiring the determination of a capital gain or loss by the beneficiary. On or after this date, as a result of the introduction of para 13(1)(a)(iiA), the transfer of an asset to a vested beneficiary results in neither a capital gain nor a capital loss – see **14.7.5**.

14.9.6 Admission of additional vested beneficiary

Some trust deeds permit a new beneficiary to invest cash in an existing vesting or *bewind* trust in which the market value of the assets differs from their base cost. These trust structures are typically set up as private equity funds. Under such an arrangement, and assuming that the investors have a vested right in the underlying trust assets (as opposed to the trust capital)

- the new beneficiary will acquire a vested right in the pre-existing assets at market value; and
- the pre-existing beneficiaries will dispose of a fractional interest in those assets in exchange for a vested right in the cash invested by the new beneficiary.

This disposal will trigger a capital gain or loss in the pre-existing beneficiaries' hands. The CGT treatment in these cases is similar to the admission of a new partner in a partnership.

On the question of having a vested right to the trust capital as opposed to the trust assets, see **14.11.5.3**.

14.10 The CGT consequences of discretionary trusts

The assets of a discretionary trust are treated as those of the trust until an unconditional right to those assets is vested in a beneficiary. Such vesting will be treated as a disposal by the trust at market value (paras 11(1)(d) and 38). Under para 80 the capital gain determined in respect of that disposal will be taxed in the hands of the *resident* beneficiary in whom that right vests unless that gain is attributed to another person under para 68, 69 or 71.

14.11 Attribution of capital gain to resident beneficiary (para 80)

Paragraph 80

14.11.1 Some general observations on para 80(1) and (2)

A trust is a 'person' for tax purposes and a taxpayer in its own right. Any capital gain or loss arising in a trust must therefore be determined and accounted for by that trust unless there is

a specific rule which directs that the capital gain or loss must be accounted for by another person. Such a rule describes a process known as ‘attribution’.

Two sets of attribution rules exist, namely,

- those that attribute a capital gain to a donor (paras 68 to 72), and
- those that attribute a capital gain to a resident beneficiary (para 80).

These rules attribute only capital gains; capital losses are never attributed, and thus will always remain in the trust.

A capital gain will usually arise in a trust when it disposes of an asset. Two of the most common forms of disposal by a trust are

- the sale of an asset by the trust to a third party [para 11(1)(a)], and
- the vesting of an interest in an asset of a trust in a beneficiary [para 11(1)(d)].

The proceeds that accrue to a trust upon the vesting of an asset in a beneficiary and the base cost of the vested right for the beneficiary will usually be determined under para 38 at market value.

Paragraph 38 would usually apply between the trust and its beneficiaries when

- a right in the asset is vested in the beneficiary for no consideration and the distribution was motivated by the gratuitous intent of the settlor (a donation); or
- The trust disposed of the asset to the beneficiary for a consideration that does not comprise an arm’s length price.

A vesting for no consideration comprises a donation because the trustees are merely giving effect to the benevolent intent of the settlor. Some commentators have sought to distinguish between a distribution and a donation but this distinction is unjustified when the distribution is motivated by the gratuitous intent of the settlor. It is for this reason that s 56(1)(l) exempts from donations tax property ‘disposed of under and in pursuance of any trust’. Had a distribution from a trust not comprised a donation, there would have been no need for such an exemption. There is a common law presumption that a statute does not contain purposeless provisions.⁷⁰⁹ In *Welch’s Estate v C: SARS* the court in comparing the definition of ‘donation’ in s 55 with the common law meaning of the term stated the following:⁷¹⁰

‘In my opinion the legislature has not eliminated from the statutory definition the element which the common law regards as essential to a donation, namely, that the disposition be motivated by pure liberality or disinterested benevolence and not by self-interest or the expectation of a *quid pro quo* of some kind from whatever source it may come.’

In *Abraham Krok Trust v C: SARS* the court stated the following:⁷¹¹

‘A donation that is made by a trustee to the beneficiary of a trust would ordinarily attract donations tax. But such a donation is exempted from the tax by s 56(1)(l),⁵ which exempts “property which is disposed of under a donation if such property is disposed of under and in pursuance of any trust”. In *Welch’s Estate*⁷¹² Marais J observed that “the obvious purpose of [the exemption] is to avoid donations tax being levied twice upon what was in essence one donation by the donor”.

In the same vein he said later:⁷

⁷⁰⁹ *C: SARS v Danwet 202 (Pty) Ltd* [2018] JOL 40192 (SCA), 81 SATC 91 at 94.

⁷¹⁰ 2005 (4) SA 173 (SCA), 66 SATC 303 at 314.

⁷¹¹ [2011] 2 All SA 591 (SCA), 73 SATC 105 at 110.

⁷¹² *Welch’s Estate v C: SARS* 2005 (4) SA 173 (SCA), 66 SATC 303.

“Section 56(1)(f) seems to be intended to protect the donor and the trustee from the levying yet again of donations tax upon the ultimate disposal by the trustee of the *corpus* to the beneficiary who gives nothing in return for it. Its apparent purpose is simply to avoid taxing twice what is in reality one donation traceable to the initial act of the donor in settling assets upon the trust.”⁷

⁵ Incorrectly referred to as s 56(1)(e) in *Welch’s Estate*.

⁶ At para [25].

⁷ At para [70].

A capital gain may also have to be accounted for by a trust as a result of attribution, for instance, when a resident trust is a beneficiary of another trust. On the vesting of a capital gain through multiple discretionary trusts, see **14.11.5.1** [para 80(1)] and **14.11.6.3** [para 80(2)].

Paragraph 80(1) deals with the attribution of a capital gain from a trust to a resident beneficiary at the time of vesting of an asset. Any capital gain arising in the trust on vesting of an asset in a non-resident will either be taxed in the trust or be attributed to a resident donor under para 72. The beneficiary, whether resident or non-resident, acquires the asset at the time of vesting at a base cost equal to its market value. After the asset has been vested in a resident or non-resident beneficiary the trust is out of the picture for CGT purposes, since it has disposed of its asset under para 11(1)(d) and has nothing more to dispose of. After acquiring the vested interest in the asset, the beneficiary must account for any further capital gain or loss that arises when the asset is disposed of to a third party.⁷¹³ The trustee’s role after vesting becomes that of a pure administrator whose actions are performed on behalf of the beneficiary – see **14.7.1**.

A capital gain arising in a trust cannot be attributed to another person unless the attribution rules in paras 68 to 72 or 80 provide for it. This point is particularly important when dealing with non-resident beneficiaries (see **14.11.4**).

Paragraph 80(1) and (2) deal with attribution to resident beneficiaries, and are subject to the special attribution rules in paras 68, 69 and 71.⁷¹⁴ In other words, paras 68, 69 and 71 take precedence over para 80(1) and (2). It follows that the flow-through of a capital gain to a resident beneficiary under para 80(1) or (2) may be blocked when paras 68, 69 and 71 apply. The relevant capital gain will instead be taxed in the hands of the person specified in these special attribution rules, which are described in the table below.

Table 3 – Attribution rules that override para 80(1) and 80(2)

Paragraph	Attribution rule
68	Capital gain attributed to spouse (donation motivated by tax avoidance)
69	Capital gain attributed to parent of minor child
71	Capital gain subject to revocable vesting

Paragraph 80(1) and (2) are not subject to para 70 because para 70 applies when a capital gain arising in a trust is not vested in a resident beneficiary, and para 80 deals specifically with the vesting of an asset or capital gain in a resident beneficiary. Paragraph 80(1) and (2) are

⁷¹³ See Binding Private Ruling BPR 056 dated 23 October 2009.

⁷¹⁴ The reference to para 72 in para 80(2) was deleted by the Taxation Laws Amendment Act 17 of 2017 with effect from 1 March 2017 and applies to amounts received or accrued on or after that date. The reference to para 72 in para 80(1) was deleted by s 87 of the Taxation Laws Amendment Act 23 of 2018 and came into operation on 1 March 2019 and applies to disposals on or after that date.

not subject to para 72 because para 80 does not permit a capital gain (or any amount that would have constituted a capital gain) to be vested in a non-resident beneficiary.

Non-applicability of s 25B to capital gains and losses

Section 25B deals with income and has no relevance to capital gains and losses. This fact can be seen from the heading (Income of trusts and beneficiaries)⁷¹⁵ and from the history of the provision.⁷¹⁶ Section 25B applies to both resident and non-resident trusts. Before it was amended by the Revenue Laws Amendment Act 32 of 2004, the opening words of s 25B(1) referred to 'any income' but this was changed to 'any amount' as a result of uncertainty whether the word 'income' was being used in its defined sense of gross income less exempt income, or in the more general sense of the word. If it meant the former, many types of income derived by non-resident trusts would have been excluded because the definition of 'gross income' includes in the gross income of a non-resident only amounts from a South African source. Even if it were contended that the word 'amount' could include an amount of a capital nature, under the maxim *generalia specialibus non derogant* the Eighth Schedule must take precedence over s 25B, since it is the more specific provision.

Further evidence that s 25B applies only to income can be seen from the fact that it is 'subject to the provisions of section 7'. Section 7 deals largely with the attribution of income to a donor. Had it been intended that s 25B also apply to capital gains, s 25B would have been made subject to the special attribution rules in paras 68, 69 and 71.

A capital gain cannot be attributed under s 25B(1) because it does not constitute an amount received or accrued. It is comprised of proceeds less base cost. Could it be argued that proceeds fall to be dealt with under s 25B(1) while base cost is addressed in s 25B(3)? For the reasons already explained, the amount contemplated in s 25B(1) does not include amounts of a capital nature. Secondly, s 25B(3) refers to a 'deduction or allowance'. These words are typically used to refer to amounts deducted from income, and when the legislature refers to the base cost of an asset in the main body of the Act, it tends to do so explicitly as in s 9HA(2) and s 12P. In addition, s 25B(4) limits the deductions or allowances attributed to a beneficiary under s 25B(3) to the income of the beneficiary. It would make no sense to limit the base cost of an asset to the income of a beneficiary.

The Eighth Schedule contains self-contained provisions for dealing with trusts and their beneficiaries. There is therefore no conflict between s 25B and the Eighth Schedule, and the specific provisions of the Eighth Schedule must prevail.

For the sake of clarity, it is proposed in the Taxation Laws Amendment Bill, 2020 to exclude from s 25B(1) 'an amount of a capital nature which is not included in gross income'.

14.11.2 Application of para 80(1) and (2) to non-resident trusts

Paragraph 80(1) and (2) refer to a capital gain that would have been determined by a non-resident trust had it been a resident. The purpose of this wording is to extend the range of assets potentially subject to attribution, since a non-resident would otherwise determine a

⁷¹⁵ See *Huang v Bester NO 2012 (5) SA 551 (GSJ)* at 557 where the court stated 'In South Africa the approach has been that headings may be referred to for the purpose of determining the sense of any "doubtful" expression in a section of a statute'. See in this regard *Chotabhai v Union Government (Minister of Justice) and Registrar of Asiatics 1911 AD 13* at 24.

⁷¹⁶ In *KwaZulu-Natal Bookmakers' Society v Phumelela Gaming and Leisure Ltd 2019 JDR 1752 (SCA)* the court stated the following: 'The legislative history of a statute may be used as an aid in its interpretation. As stated in *Joosub Ltd v Ismail 1953 (2) SA 461 (A)* at 466 D, "The history of the sub-section may throw light on the proper construction of the words."'

capital gain only in respect of the disposal of the limited range of assets described in para 2(1)(b), namely

- immovable property situated in South Africa held by that person or any interest or right of whatever nature of that person to or in such property including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources;
- any asset effectively connected with a permanent establishment of that person in South Africa; and
- the other interests contemplated in para 2(2) such as shares in a company holding immovable property in South Africa, subject to specified requirements.

14.11.3 Types of disposal giving rise to attribution to a beneficiary

Capital gains arising from disposals set out in the table below are subject to attribution to a beneficiary.

Table 4 – Disposals giving rise to capital gains in a trust

Paragraph 80	Type of disposal by resident trust
(1)	Vesting of an interest in an asset in a resident beneficiary [para 11(1)(d)]
(2)	Other disposals, for example, the sale of an asset by a trust to a third party (para 11 or 12).

14.11.4 Events not subject to attribution under para 80(1) and (2)

The attribution rules in para 80(1) and (2) do not apply to the events set out in the table below:

Table 5 – Events not subject to attribution

Event	Treatment under the core rules	Reason
Asset or capital gain vested in a non-resident beneficiary	A capital gain arising on the vesting of <ul style="list-style-type: none"> • an asset, or • a current year capital gain, in a non-resident beneficiary is taxed in the trust, unless attributed to a resident donor under para 72. 	In all of these scenarios no provision is made for the relevant capital gain or loss to be attributed to the beneficiary.
Capital loss arising in a trust, whether arising upon the vesting of an asset in a beneficiary or as a result of the disposal of an asset to a third party,	Capital loss remains in the trust.	

Event	Treatment under the core rules	Reason
A capital gain that arose in an earlier year that is vested in a subsequent year.	A capital gain arising in the trust in an earlier year that was not vested in a beneficiary in that earlier year is taxed in the trust in that earlier year unless attributed to a donor under para 70. When the equivalent amount is subsequently vested, it merely represents the vesting of after-tax capital and is not a capital gain capable of attribution.	
A capital gain arises in a trust but there is no corresponding capital profit available for vesting (see 14.11.6.4)		
Asset vested in the Government, a provincial administration, organisation, person or club contemplated in para 62(a) to (e)	The trust must disregard any capital gain or loss under para 62.	Paragraph 80(1) precludes such attribution. ⁷¹⁷
Asset acquired by a person as an equity instrument as contemplated in s 8C(1) [see para 80(1) and 64E]	The trust will have to account for any capital gain or loss at the time when the restrictions are lifted [para 13(1)(a)(iiB)].	Paragraph 80(1) precludes such attribution.
A capital gain vested in a person contemplated in para 62(a) to (e)	The trust will be subject to CGT on the capital gain unless it is attributed to a donor under paras 68 to 72.	Paragraph 80(2) precludes such attribution. ⁷¹⁸ The exclusion in para 62 does not apply because the capital gain does not arise from the disposal of an asset to the exempt / partially exempt entity.

The conduit-pipe principle and non-resident beneficiaries

The default position is that a trust must account for any capital gain or loss that arises when it disposes of an asset. As discussed in **14.11.1**, para 80 provides an exception to the default position by attributing a capital gain from the trust in which it arises to a resident beneficiary. No mention is made in para 80(1) and (2) of a non-resident beneficiary, and so no attribution to such a person is possible.

⁷¹⁷ Paragraph 80(1) was amended to preclude attribution to the entities contemplated in para 62(a) to (e) by s 86(a) of the Revenue Laws Amendment Act 60 of 2008. The amendment is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

⁷¹⁸ Paragraph 80(2) was amended to preclude attribution to the entities contemplated in para 62(a) to (e) by s 86(b) of the Revenue Laws Amendment Act 60 of 2008. The amendment was deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009.

It has been argued⁷¹⁹ that the conduit-pipe principle established in *Armstrong v CIR*⁷²⁰ and confirmed in *SIR v Rosen*⁷²¹ should apply as a matter of general application, even though para 80(1) and (2) permit attribution only to resident beneficiaries. In other words, it is contended that the capital gains arising on vesting are not taxable in the trust, but flow directly through to the non-resident beneficiaries under the common law. At issue is whether the legislature intended to modify the common law. In *Nedbank Ltd & others v National Credit Regulator & another* Malan JA stated the following:⁷²²

‘The rule of interpretation is that a statutory provision should not be interpreted so as to alter the common law more than is necessary unless the intention to do so is clearly reflected in the enactment, whether expressly or by necessary implication:

“[I]t is a sound rule to construe a statute in conformity with the common law, save where and insofar as the statute itself evidences a plain intention on the part of the Legislature to alter the common law. In the latter case the presumption is that the Legislature did not intend to modify the common law to any extent greater than is provided in express terms or is a necessary inference from the provisions of the enactment.”⁸⁰

‘Steyn⁸¹ cautioned:

“n Doelbewuste afwyking moet nie verwing word om in die vorms van die gemene reg te kan inpas nie.”’

⁸⁰ *Mills v Starwell Finance (Pty) Ltd* 1981 (3) SA 84 (N) at 87B – D and further *S v Leeuw* 1980 (3) SA 815 (A) at 823F – G; *Casserley v Stubbs* 1916 TPD 310 at 312; *Joss v Board of Executors* 1979 (1) SA 780 (C) at 782A – C; *Gouws v Theologo & others* 1980 (2) SA 304 (W) at 306C – D; *Shell South Africa (Edms) Bpk v Gross h/a Motor Maintenance* 1980 (4) SA 151 (T) at 152H – 153A; *Johannesburg Municipality v Cohen's Trustees* 1909 TS 811 at 818.

⁸¹ L C Steyn *Die Uitleg van Wette* (5 ed) (1981) at 99.

The above quote from Steyn can be translated as follows:

‘An intentional deviation must not be distorted in order to fit into the forms of the common law.’

In the matter under discussion the key question is whether the legislature plainly intended to deviate from the common law by necessary implication because the legislature did not exclude the common law in express terms.

In *The Queen v The Inhabitants of Watford*, Lord Denman CJ stated the following:⁷²³

‘It is important to keep in view the state of the law, with which we must assume that the Legislature was acquainted, when that statute passed.’

⁷¹⁹ David Clegg ‘Non-Resident Beneficiaries of a Trust and the Conduit Principle’ (January 2008) 57 *The Taxpayer* 7, Trevor Emslie ‘CGT: Resident, Non-Resident and PBO Trust Beneficiaries’ (May 2010) 59 *The Taxpayer* 84 and follow-up article by the same author in (September/October 2010) 59 *The Taxpayer* 162, and Lynette Olivier and Michael Honiball *The Taxation of Trusts in South Africa* (1 November 2009) Siber Ink, South Africa at 139. For views which agree with those expressed in this guide see C Divaris (2009) 79 *TSH* and (2010) 87 *TSH*; M L Stein *Capital Gains Tax – Stein* [online] (My LexisNexis: April 2019) in 10.1, *Silke on South African Income Tax* [online] (My LexisNexis: October 2019) in § 24.127 and R C Williams *Capital Gains Tax – A Practitioner’s Manual* 2 ed (2005) Juta Law Publishers at 80.

⁷²⁰ 1938 AD 343, 10 SATC 1.

⁷²¹ 1971 (1) SA 172 (A), 32 SATC 249.

⁷²² 2011 (3) SA 581 (SCA) at 601.

⁷²³ (1846) 9 QB 626 at 635.

In *Fluor Corporation and Affiliates v The United States* Bryson, Circuit Judge, echoed the above principle in stating that⁷²⁴

'[f]amiliar principles of statutory construction teach that Congress is presumed to be aware of judicial interpretations of the law, and that when Congress enacts a new statute incorporating provisions similar to those in prior law, it is assumed to have acted with awareness of judicial interpretations of the prior law. See *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 382 n. 66, 102 S.Ct. 1825, 1841 n. 66, 72 L.Ed.2d 182 (1982); *Lorillard v. Pons*, 434 U.S. 575, 589, 98 S.Ct. 866, 875, 55 L.Ed.2d 40 (1978); *Kelly v. United States*, 826 F.2d 1049, 1052 (Fed.Cir.1987).'

This principle has also been recognised by the courts in South Africa. In *Fundstrust (Pty) Ltd (In Liquidation) v Van Deventer* Hefer JA stated the following:⁷²⁵

'The principle that Parliament is presumed to be acquainted with the existing law and with the interpretation of earlier legislation by the Courts can only be applied if the words in question had acquired a settled and well-recognised judicial interpretation before the relevant legislation was passed (*Ex parte Minister of Justice: In re R v Bolon* 1941 AD 345 at 360).'

It can therefore be assumed that the legislature was aware of the conduit-pipe principle at the time it enacted para 80. Indeed, if one has regard to the historical developments relating to the taxation of trusts and their beneficiaries in South Africa, it is plain that this was the case.

The general rule of interpretation is that a statute must be construed as a whole.⁷²⁶ It is, therefore, also necessary to look beyond para 80 to determine why that provision was worded in the way that it was at the time of its enactment.

In *Trustees of the Phillip Frame Will Trust v CIR*⁷²⁷ it was held that a trust was not a 'person' for tax purposes and that making a trustee a 'representative taxpayer' did not make a trust a taxable entity. As a result of this case, the definition of 'person' was amended in 1991 (backdated to 1 March 1986)⁷²⁸ to include 'any trust'. At the same time, s 25B was inserted⁷²⁹ to ensure that the conduit-pipe principle could continue to be applied to income vested in the same year of assessment in which it was derived. Without s 25B(1) the conduit-pipe principle would have been blocked because the effect of deeming a trust to be a 'person' was to cause a trust to be a taxpayer in its own right.

In *Rosen's* case Trollip JA stated the following:⁷³⁰

'Consequently *Armstrong's* case in my view authoritatively established the conduit principle for general application in our system of taxation *in appropriate circumstances*.

...

'The principle rests upon sound and robust common sense; for, by treating the intervening trustee as a mere administrative conduit-pipe, it has regard to the substance rather than the form of the distribution and receipt of the dividends.'

(Emphasis added.)

⁷²⁴ 126 F.3d 1397; 80 A.F.T.R.2d 97-6022, 97-2 USTC P 50,615 in 47.

⁷²⁵ 1997 (1) SA 710 (A) at 732.

⁷²⁶ Per Centlivres JA in *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A), 15 SATC 381 at 389.

⁷²⁷ 1991 (2) SA 340 (W), 53 SATC 166. The decision of the court *a quo* was upheld in *CIR v Friedman & others* NNO 1993 (1) SA 353 (A), 55 SATC 39.

⁷²⁸ Amended by s 2(1)(b) of the Income Tax Act 129 of 1991 and deemed to have come into operation as from the commencement of years of assessment which commenced or commence on or after 1 March 1986.

⁷²⁹ Inserted by s 27(1) of the Income Tax Act 129 of 1991 and deemed to have come into operation as from the commencement of years of assessment which commenced or commence on or after 1 March 1986.

⁷³⁰ At SATC 267.

In arriving at its conclusion, the court was primarily concerned with the problem of economic double taxation between a company and its shareholders. Mrs Rosen had received a distribution of income derived from dividends earned on shares held by a trust, and one of the issues facing the court was whether she was entitled to the 'dividend allowance', whose purpose was to alleviate economic double taxation. At that time dividends were taxable in the hands of individuals and to prevent effectively taxing a company's profits twice (that is, in the company and in the shareholder's hands) a dividend allowance was granted to the shareholder under the then s 19(3). The court held that the income retained its character as dividends in Mrs Rosen's hands, and she was therefore entitled to the dividend allowance.

There is a vast difference between the legislative provisions that prevailed at the time of the *Armstrong* and *Rosen* cases and the provisions that are currently enacted. A trustee of a discretionary trust is no longer merely an 'administrative conduit pipe' for tax purposes. The trust has been clothed with its own separate legal *persona* and is a taxable entity in its own right. The trust is the beneficial owner of its assets until they are disposed of through vesting [para 11(1)(d)] or otherwise (for example, by sale). There is also no question of double taxation in the way in which para 80 operates. The intention of the legislature in not providing for attribution to non-resident beneficiaries was to prevent loss to the *fiscus*, since non-residents are subject to CGT only on the limited range of assets listed in para 2(1)(b), namely, immovable property in South Africa, interests and rights in such immovable property, assets effectively connected with a permanent establishment in South Africa and other deemed interests in immovable property such as shares in a land-rich company meeting specified requirements. The capital gains are derived by the trust and are clearly within South Africa's taxing jurisdiction. South Africa has a right to keep such capital gains within its jurisdiction by permitting attribution only to resident beneficiaries. There is accordingly no question of discrimination against non-resident beneficiaries. The legal maxim *expressio unius est exclusio alterius*⁷³¹ supports the view that by specifically mentioning only a resident beneficiary in para 80(1) and (2) the legislature intended to exclude non-resident beneficiaries.

The conduit-pipe principle cannot, therefore, be applied to override the legislative intent. Paragraph 80 remains the sole mechanism for attributing a capital gain arising in a trust to a beneficiary.

If a capital gain has not been attributed out of a trust to a specific person, the core rules must be applied and the trust must bear the CGT consequences. In other words, attribution is something that cannot be read in; it can be applied only when it is provided for.

For example, a capital gain that is not vested in a beneficiary of a trust in the year in which it arises will be taxed in the trust at the effective rate applicable to trusts unless the gain was derived by reason of a donation, settlement or other disposition and is subject to conditional vesting. In such event, it might be taxable under para 70 in the hands of the resident who made that donation, settlement or other disposition.

It has also been contended that the legislature recognised the conduit-pipe principle in relation to non-resident beneficiaries in para 72.

Paragraph 72 applies when

- a resident has made a donation, settlement or other disposition to any person (other than a non-resident entity similar to a PBO contemplated in s 30);

⁷³¹ The expression of one thing implies the exclusion of the other. This maxim of interpretation was applied by De Villiers JA in *SA Estates and Finance Corporation Ltd v CIR* 1927 AD 230, 2 SATC 193 at 195. Although it was noted that the maxim 'was one which had at all times to be applied with great caution', the court found that its use was legitimate in the case under review.

- a capital gain (including any amount that would have constituted a capital gain had that person been a resident) attributable to that donation, settlement or other disposition has arisen during a year of assessment; and
- an amount consisting of or derived, directly or indirectly, from
 - that capital gain; or
 - the amount that would have constituted a capital gain,has during that year vested in or is treated as having vested in any non-resident (other than a CFC, in relation to that resident).

In these circumstances the person in whom the capital gain vests must disregard it and the donor must take it into account. The term ‘capital gain’ is given a wider meaning by disregarding the fact that the person in whom it vests is a non-resident.

The argument is that para 72 states that the capital gain must be disregarded in determining the aggregate capital gain or loss of the person in whom it vests, being, so it is contended, the non-resident beneficiary who was entitled to the capital gain under the conduit-pipe principle. However, para 72 does not mention a trust or beneficiaries. It was framed in wide terms and covers a variety of situations involving, amongst others, non-resident individuals, resident trusts with non-resident beneficiaries and non-resident trusts with non-resident beneficiaries. For example, if a non-resident trust sold immovable property in South Africa, any resulting capital gain would vest in that trust and would have to be disregarded by it and taken into account by the resident donor. Even if the trustee of a non-resident trust vested such a capital gain in a non-resident beneficiary in the same year of assessment, the capital gain would still vest in the trust for CGT purposes because para 80(2) does not apply to a non-resident beneficiary. The same result would apply if a resident trust disposed of an asset and vested the resulting capital gain in a non-resident beneficiary. Again, the capital gain would vest in the resident trust for CGT purposes and it would have to disregard the capital gain. In the latter regard para 72 refers to the *person* in whom the capital gain vests. There will be circumstances in which the person in whom a capital gain vests has no need to disregard the capital gain. In such a case the reference to a person disregarding a capital gain will simply not apply.

Finally, unlike a dividend, a capital gain is an artificial tax concept comprising proceeds less base cost. It is unclear how a conduit-pipe principle can apply to expenditure making up the base cost of an asset, since the beneficiary cannot be held liable for the expenditure incurred by a trustee in respect of an asset. The *Armstrong* and *Rosen* cases were simply concerned with dividend income retaining its character so that the beneficiary could obtain a dividend allowance. Besides being decided before a trust became a ‘person’, these cases did not deal with the attribution of expenditure.

Vesting of capital gain arising in an earlier year of assessment

The vesting in a beneficiary of a capital gain that arose in an earlier year of assessment is not subject to attribution under para 80(2), since that provision deals only with a current-year vesting.

However, the vesting of a capital gain of this nature will invariably involve the vesting of an asset, which could conceivably give rise to an attributable capital gain in the trust. More often than not, though, the vesting of an earlier-year capital gain should not give rise to a capital gain in the trust. For example, a distribution by way of a bank transfer is a part-disposal of an asset of the trust, namely, its bank account, but a transfer of this nature will not normally give rise to a capital gain or loss.

14.11.5 Vesting of asset [para 80(1)]

The vesting of an interest in an asset of a trust in a beneficiary triggers a disposal by the trust under para 11(1)(d). When a capital gain is determined in a trust on vesting of an asset in a resident beneficiary, the gain must be disregarded by the trust and taken into account by the resident beneficiary. The determination of a capital gain by a non-resident trust includes a capital gain that would have been determined had the trust been a resident. This wording expands the range of assets subject to attribution under para 80(1) from those described in para 2(1)(b) to those described in para 2(1)(a), namely, 'any asset of a resident'. In the absence of this expansion, a non-resident trust would determine a capital gain only in respect of a limited range of assets such as immovable property in South Africa, assets of a permanent establishment in South Africa, and shares in land-rich companies meeting specified criteria.

No attribution to non-resident beneficiaries

If a trustee vests an asset in a non-resident beneficiary, any resulting capital gain will remain in the trust, unless attributed to a resident donor under paras 68 to 72. Paragraph 80(1) provides no mechanism for attributing a capital gain to a non-resident beneficiary (see **14.11.4**). However, once vesting of the asset has taken place, any further gain or loss arising on disposal of the vested asset must be accounted for by the beneficiary, whether resident or non-resident. Non-resident beneficiaries will not derive capital gains and losses after vesting unless the asset is one listed in para 2(1)(b).

No attribution of capital losses

There is also no mechanism for capital losses arising on vesting of an interest in an asset of a trust to be attributed to either resident or non-resident beneficiaries. Such losses must always be accounted for by the trust.

Attribution of a capital gain to a spouse married in community of property

Any capital gain arising on vesting of an interest in an asset of a trust in a resident beneficiary who is married in community of property is taxable in the hands of that beneficiary, and is not split between the beneficiary and his or her spouse. Note that para 14 apportions a capital gain between spouses married in community of property only when that gain arises on disposal of an asset by one of the spouses. It does not deal with an attributed capital gain arising on disposal of an asset by a trust.

Attribution to specified exempt bodies

Attribution to the various exempt and partially exempt entities contemplated in para 62(a) to (e) (for example, an approved PBO or recreational club) is specifically precluded by para 80(1). However, any capital gain or loss arising on the vesting of an asset in such entities must be disregarded by the trust under para 62. This measure was introduced to prevent the exempt or partially exempt entity from being subject to CGT on an attributed capital gain.

Acquisition of s 8C equity instrument

Paragraph 80(1) does not apply to a person who acquires an asset from a trust as an equity instrument as contemplated in s 8C(1). The trust must account for the capital gain or loss under para 11 when the equity instrument vests as contemplated in s 8C, that is, when the restrictions on the equity instrument are lifted [para 13(1)(a)(iiB)]. In other words, the trust must determine the capital gain or loss under the core rules [for example, as a sale under para 11(1)(a) or upon a common law vesting under para 11(1)(d)] and then, at a later time, bring that capital gain or loss to account when the restrictions on the equity instrument are lifted.

14.11.5.1 Vesting of an asset through multiple discretionary trusts

Assume that discretionary Trust A's beneficiary is discretionary Trust B and Trust B's beneficiary is X, Trust A vests an asset in Trust B which results in a capital gain of R100 being attributed to Trust B under para 80(1). The question arises whether that capital gain can in turn be attributed by Trust B to X in the same year of assessment. Based on the wording of para 80(1), the view is held that Trust B must account for the capital gain, and the vesting of the same asset by Trust B in X will not result in the capital gain of R100 being attributed to X.

The words 'the trust' in para 80(1)(a) refer to the same trust in the opening words of the subparagraph, namely, the trust that determined a capital gain in respect of the vesting of an asset. No capital gain will arise in Trust B when it vests the asset in X because under para 38 Trust B acquires the asset for a base cost equal to market value at the time of vesting and its proceeds upon immediately vesting the asset in X are equal to that same market value. Trust B has not determined a capital gain in respect of the vesting of an asset and para 80(1) can therefore have no application.

14.11.5.2 Vesting of asset in vesting trust

A discretionary trust may have a vesting trust as one of its beneficiaries. The vesting of an interest in an asset in such a vesting trust by the trustees of the discretionary trust triggers a disposal of the asset in the discretionary trust under para 11(1)(d). The proceeds on the disposal must be accounted for at market value under para 38 because the discretionary trust's beneficiaries are connected persons in relation to it. Any capital gain arising on this disposal must be disregarded by the discretionary trust under para 80(1)(a) to the extent that it is vested in resident beneficiaries who must account for the capital gain attributed to them under para 80(1)(b).

It needs to be determined whether the attributed capital gain must be accounted for under para 80(1)(b) by the vesting trust or by its beneficiaries. Paragraph 80(1)(b) provides that the capital gain

'must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary to whom that asset was so disposed of'.

It must thus be determined to whom the assets of the discretionary trust were disposed of.

A beneficiary as defined in s 1(1)

'means a person who has a vested or contingent interest in all or a portion of the receipts or accruals or the assets of that trust.'

In order to have a vested interest in an asset of a trust a beneficiary must be the beneficial owner of the asset. If the assets of the vesting trust vest automatically in its beneficiaries under its trust deed, it is the beneficiaries of the trust who have a beneficial interest in the trust's assets and not the trust. With such an automatic vesting the trustee of the vesting trust is not required to vest the assets in the trust beneficiaries and there is no secondary disposal. The trust is in a similar position to a nominee or quasi-agent, having control over the asset but not beneficial ownership of it. Thus, when the discretionary trust vests the asset in the vesting trust it is in fact disposing of it to the vesting trust's beneficiaries and the vesting trust is a pure administrative conduit pipe. In such circumstances the beneficiaries having a vested interest in the assets of the vesting trust must account for the capital gain attributed to them under para 80(1)(b).

The position would *a fortiori* be the same with a *bewind* trust since the beneficiaries of such a trust are the owners of the assets administered by it.

As discussed in **14.11.5.3**, not all vesting trusts confer a right to the trust's assets on their beneficiaries. The trust deed of the vesting trust must therefore be carefully scrutinized to determine whether the beneficiaries have vested interests in the trust's assets.

Example – Discretionary trust vesting asset in vesting trust

Facts:

One of the beneficiaries of Discretionary Trust A is Vesting Trust B. The beneficiaries of Trust B are C and D who are both resident individuals. The trustees of Trust A vest an asset having a base cost of R20 and a market value of R100 in Trust B.

The trust deed of Trust B provides that its beneficiaries have equal vested interests in all its assets including present and future assets acquired by it.

Result:

Under para 80(1) Trust A must disregard the capital gain of R80 and C and D must each account for a capital gain of R40 (R80 × 50%).

Since C and D each acquired equal beneficial ownership in the asset of Trust A when it was vested in Trust B, it is they and not Trust B who must account for the capital gain. Trust B merely holds the asset on behalf of C and D as a pure administrator.

14.11.5.3 Vesting of capital v vesting of an asset

Paragraph 11(1)(d) provides that the vesting of an interest in an asset of a trust in a beneficiary is a disposal. Any capital gain arising on such a vesting is attributed to a resident beneficiary under para 80(1).

However, many so-called vesting trusts do not operate on the basis of conferring entitlement to individual trust assets on a beneficiary. Rather they vest the income or capital of the trust in the beneficiary. The word 'capital' may or may not be defined in the trust deed but usually it means the assets less the liabilities of the trust. This type of trust vehicle is commonly found in the form of investment-type trusts in which beneficiaries invest funds in the trust, such as a collective investment scheme in securities. For example, the model trust deed of a collective investment scheme in securities states that subject to a clause dealing with the repurchase of a participatory interest of an investor, 'an investor shall not be entitled to any asset of the portfolio'.⁷³²

In these circumstances it does not follow that a beneficiary who has a right to the trust capital has a vested right in the trust assets. All the beneficiary has is a right to claim the residue in the trust at a future date. This point is even more apparent when the trust has the power to incur liabilities for which the beneficiary cannot be held liable. If it were argued that the beneficiary has a right to the trust assets while the trust was free to incur liabilities it would mean that the trust would be insolvent because the trust would have no beneficial interest in the assets it holds yet would be saddled with liabilities. The fact that a trust has no liabilities at a particular time does not necessarily mean that a beneficiary has a vested right to the trust assets because the trustees may be empowered to encumber the trust's assets in future.

The terms of the trust deed must also be carefully scrutinized to determine the ultimate destination of the trust assets. For example, the trust deed may stipulate that in the event of the death or liquidation of the beneficiary the trust assets must be transferred to the beneficiary's children or to another organization having similar objects. In such event the beneficiary merely has a contingent right to the trust assets.

⁷³² Clause 34.6 of the CISCA model deed for a CIS in securities.

The effect of such a trust deed is that para 11(1)(d) will not trigger a disposal in the trust when the beneficiary acquires a vested right to the trust capital. Capital gains and losses of the trust will also not automatically flow through to the beneficiaries of the trust when the trustees dispose of trust assets to third parties.⁷³³ Another effect is that the beneficiary will have a base cost for any vested interest in the trust capital for which the beneficiary has incurred expenditure under para 20 while the trust will simultaneously have a base cost for its assets for which it has incurred expenditure. The position is thus not dissimilar to a company and its shareholders. It also does not follow that a beneficiary of a single beneficiary trust will have a vested right in the trust's assets for the reasons already explained.

The vesting of a capital gain of such a trust must be dealt with under para 80(2) which addresses the situation in which a beneficiary has a vested right in a capital gain but not in the asset the disposal of which gave rise to that capital gain. Under para 80(2) the trust must disregard the capital gain if the beneficiary is a resident and the resident beneficiary must correspondingly account for it. Vesting could occur in a number of ways, for example, through a distribution of cash or an asset to a beneficiary or by crediting the beneficiary's loan account. It will, however, be necessary to carefully scrutinize the trust deed to determine exactly what the beneficiary is entitled to.

A beneficiary's vested right in the capital of the trust will be disposed of when the beneficiary disposes of it to another beneficiary or when the trust is terminated.

Example 1 – Termination of trust in which beneficiary has a right to the capital

Facts:

X and Y each invested R50 in a vesting trust. Under the trust deed they are each entitled to 50% of the income and capital of the trust but have no entitlement to the trust assets. The trust used the R100 received from X and Y to purchase an asset for R100. Several years later the asset had grown in value to R500 and it was decided that the asset should be disposed of and the trust terminated. The trustee duly sold the asset for R500 and awarded R250 to X and Y respectively after which the existence of the trust was terminated.

Result:

A capital gain of R400 (R500 – R100) arose in the trust on the disposal of the asset. Under para 80(2) this capital gain is disregarded by the trust and must be accounted for in equal shares by X (R200) and Y (R200). Each beneficiary receives R250 comprising the capital gain of R200 and a return of trust capital of R50 on termination of the trust. The beneficiaries made neither a capital gain nor a capital loss on the disposal of their interests in the trust, since the proceeds of R50 are equal to the base cost of the interest of R50.

Example 2 – Termination of trust in which beneficiary has a right to the capital

Facts:

X and Y each invested R50 in a vesting trust. Under the trust deed they are each entitled to 50% of the income and capital of the trust but have no entitlement to the trust assets. The trust deed makes provision for the substitution of beneficiaries. The trust used the R100 received from X and Y to purchase an asset for R100. When the asset had grown in value to R300, X sold X's share to Z for R150. When the asset reached a value of R500, it was decided that the asset should be awarded in equal shares to Y and Z and the trust terminated.

⁷³³ This is why, for example, a portfolio of a collective investment scheme in securities must disregard any capital gain or loss on disposal of its assets under para 61(3).

Result:

X has a capital gain of R100 (R150 – R50) in respect of the disposal of X's interest in the trust to Z. The base cost of Z's interest is R150. When the asset is awarded to Y and Z, a capital gain of R400 (R500 – R100) arises in the trust and is attributed to Y and Z in equal shares of R200 under para 80(2).

Y and Z each receive an asset worth R250, representing the capital gain attributed to them under para 80(1) of R200 and a return of capital of R50. Y makes neither a capital gain nor a capital loss on the disposal of Y's interest on termination of the trust (R50 – R50). Z makes a capital loss of R100 on disposal of Z's interest in the trust (R150 – R50). This capital loss may be set off against the attributed capital gain of R200, leaving Z with an aggregate capital gain of R100. The capital loss of R100 is not clogged under para 39 because both the capital gain and the capital loss arise from transactions with the trust.

The base cost of Y and Z's share in the asset is R250 under para 38.

14.11.6 Vesting of capital gain in same year of assessment [para 80(2)]

14.11.6.1 Application

Paragraph 80(2) applies when a capital gain is determined in respect of the disposal of an asset by a trust in a year of assessment during which a resident beneficiary [other than a person contemplated in para 62(a) to (e)]

- has a vested right, or
- acquires a vested right (including a right created by the exercise of a discretion),
- to an amount derived from that capital gain but not to the asset, the disposal of which gave rise to that capital gain.

The determination of a capital gain by a non-resident trust includes a capital gain that would have been determined had the trust been a resident. This wording expands the range of assets subject to attribution under para 80(2) from those described in para 2(1)(b) to those described in para 2(1)(a), namely, 'any asset of a resident'. In the absence of this expansion, a non-resident trust would determine a capital gain only in respect of a limited range of assets such as immovable property in South Africa and assets of a permanent establishment in South Africa.

Paragraph 80(2) could apply to

- a discretionary trust when the trustee realises a capital gain on disposal of an asset to a third party and during the same year of assessment vests that capital gain in a resident beneficiary, or
- a vesting trust when the beneficiary has a prior vested right in the capital gain but not in the asset (this is similar to an income beneficiary).

When these requirements are met, an amount that is equal to so much of the amount to which that beneficiary of that trust is entitled in terms of that right as consists of or is derived, directly or indirectly, from that capital gain must

- be disregarded for the purpose of calculating the aggregate capital gain or loss of the trust, and

- be taken into account as a capital gain for the purpose of calculating the aggregate capital gain or loss of that beneficiary.

The scope of para 80(2) is constrained by the requirement in item (b) that the relevant amount must be taken into account by ‘that beneficiary’. The words ‘that beneficiary’ refer to the beneficiary mentioned in the opening words, namely, a beneficiary of the trust that disposed of the asset.

Thus, a beneficiary that derives an amount ‘directly or indirectly’ must be a beneficiary as defined in s 1(1) of the trust that disposed of the asset.

Section 1(1) defines ‘beneficiary’ in relation to a trust to mean

‘a person who has a vested or contingent interest in all or a portion of the receipts or accruals or the assets of that trust’.

A person can be a beneficiary as defined in s 1(1) without necessarily being named as a beneficiary in the trust deed of the trust disposing of the asset. This situation can arise when a vesting trust (Trust 2) is interposed between the trust disposing of the asset (Trust 1) and the beneficiaries of the vesting trust (Trust 2). Under such an arrangement the beneficiaries of the vesting trust (Trust 2) may have a vested right in the capital gain determined by the trust disposing of the asset (Trust 1) by virtue of their rights in the vesting trust (Trust 2).

Given that a trust pays CGT at the effective rate of 36% while individuals pay CGT at an effective rate ranging from 0 to 18%, identifying the beneficiary in a chain of trusts that must account for the capital gain under para 80(2)(b) is critical.

Various permutations involving different types of trust can arise (see **14.11.6.3**).

When a vesting trust is involved in the chain, it must be determined whether its beneficiaries have vested rights in its assets or capital gains. If they do, it means that the vesting trust is a pure administrator acting on behalf of the beneficiaries who will have vested rights in the trust’s assets or capital gains determined by or attributed to it. Under these circumstances, the existence of the vesting trust in the chain can effectively be ignored. However, not all vesting trusts confer vested rights in respect of their assets or capital gains. The beneficiaries of such a trust may have a right to the trust capital as opposed to having a claim against an individual trust asset. The trust deed must therefore be examined to determine the exact nature of the beneficiaries’ rights.

When the chain comprises two resident discretionary trusts, any capital gain determined by the first trust will have to be accounted for by the second trust and it will not be possible for the second trust to on-distribute the capital gain to its beneficiaries.

It is understood that the words ‘directly or indirectly’ were inserted to address a chain of multiple non-resident trusts. However, given the fact that any resident beneficiary must be a beneficiary of the non-resident trust disposing of the asset, these words are likely to be of limited effectiveness. It is for this reason that the Taxation Laws Amendment bill, 2020 proposes to deal separately with non-resident trusts deriving amounts which would have constituted capital gains had they been residents (proposed para 80(2A)). The purpose of the proposed para 80(2A) is to allow a capital gain to flow through multiple non-resident trusts until it reaches a resident beneficiary.

However, even if para 80(2) is inapplicable, para 72 may deem any capital gain arising in the chain to a resident donor.

Any capital loss arising on disposal of an asset by a trust is not subject to attribution and will remain in the trust.

The special ‘attribution to donor’ rules in paras 68, 69 and 71 take precedence over para 80(2).⁷³⁴ For example, a capital gain that was vested by the trustee in a minor child and which arose from a donation by the parent of that child must not be attributed to the child under para 80(2), nor may it remain in the trust, but must be attributed to the parent under para 69.

Paragraph 64E also takes precedence over para 80(2) and enables a trust to disregard a capital gain when an equivalent amount is taken into account by a beneficiary under s 8C (see **12.16B**).

A capital gain cannot be attributed to a person who is not a resident, since para 80(2) allows for attribution to resident beneficiaries only (see **14.11.4**).

Attribution is also not possible to the exempt and partially exempt entities referred to in para 62(a) to (e), such as an approved PBO or recreational club. Such a capital gain must be accounted for by the trust, or a resident donor under paras 68 to 71, and may not be disregarded under para 62 because it does not arise from the disposal of an asset to such an entity, a pre-requisite for the application of para 62.

A trust may have income and capital beneficiaries. The question as to which one of these classes of beneficiary is entitled to be vested with a capital gain will depend on the terms of the trust deed. The trust deed may, for example, leave the decision as to what is capital or income to the discretion of the trustees but they will need to exercise care in making this determination lest they should prejudice either class of beneficiary. The trust deed may also provide that the capital of the trust includes any capital gains, in which event capital gains will not be capable of being vested in income beneficiaries. If the trust deed is silent, recourse will have to be had to the common law meaning of income and capital such as the tree and fruit analogy (see **2.4.1.4**). In *RA Hill v Permanent Trustee Co of New South Wales, Ltd*⁷³⁵ the Privy Council held that a dividend declared in anticipation of liquidation was income. As a result, the dividend went to the income beneficiary of the trust shareholder and not to the remainderman (equivalent of a bare *dominium* holder). The case is, however, of academic interest for CGT purposes since dividends are excluded from proceeds under para 35(3)(a).

Capital gains cannot be vested under para 80(2) by nomination or election – there must be an actual vesting conferring unconditional entitlement to trust property on the beneficiary. This vesting could take various forms, such as a distribution of cash or an asset *in specie* or by crediting the beneficiary’s loan account.

14.11.6.2 Vesting of capital gain in multiple beneficiaries

Should a capital gain arise in a discretionary trust, the trustee may

- vest it in multiple beneficiaries, or
- vest a part of it in a single beneficiary or in multiple beneficiaries and retain a portion in the trust. This situation may happen, for example, when the trustee wishes to use a

⁷³⁴ A reference to para 72 was deleted by the Taxation Laws Amendment Act 17 of 2017. This amendment came into operation on 1 March 2017 and applies to amounts received or accrued on or after that date. The reference to para 72 was originally erroneously inserted when it was inadvertently included with the references to the other ‘attribution to donor’ rules in paras 68 to 71. It was unnecessary to refer to para 72 in para 80(2) because para 80(2) does not make provision for a capital gain to be attributed to a non-resident beneficiary.

⁷³⁵ [1930] All ER 87, 1930 AC 720.

portion of the capital gain against an unclogged capital loss that has arisen in the trust (that is, assuming para 39 does not apply).⁷³⁶

Example 1 – Vesting of capital gain in multiple beneficiaries

Facts:

The ABC Family Trust has three contingent beneficiaries, Nico, Ed and Deon, all of whom are South African residents over the age of 18. During year 1 the trustee disposed of immovable property which gave rise to a capital gain of R30 000. The trustee immediately vested that gain in the three beneficiaries in equal proportions.

Result:

The capital gain of R30 000 is disregarded in the ABC Trust and each resident beneficiary is deemed to have a capital gain of R10 000 under para 80(2)(b).

Example 2 – Vesting of portion of capital gain in multiple beneficiaries when trust has capital loss

Facts:

The XYZ Family Trust has three contingent beneficiaries, Hilde, Tammy and Varuna, all of whom are South African residents over the age of 18. The trust's assets were funded by donation by Tracy, now deceased. During year 1 the trustee disposed of immovable property which gave rise to a capital gain of R45 000. The trust has a capital loss of R15 000 arising from the sale of some shares to a third party. The trustee vested R30 000 in the three beneficiaries in equal shares, and retained the balance of the capital gain of R15 000 in the trust.

Result:

Under para 80(2) the XYZ Family Trust must disregard R30 000 of the capital gain of R45 000 and each beneficiary must account for a capital gain of R10 000. The remaining portion of the capital gain (R15 000) is set off against the unclogged capital loss of R15 000, resulting in neither a capital gain nor a capital loss in the trust.

There is no attribution to Tracy under para 70, since she is deceased.

14.11.6.3 Capital gain flowing through multiple discretionary trusts

Can a capital gain flow through multiple resident discretionary trusts when it is vested by each consecutive trustee in the same year of assessment?

The words 'the trust' in para 80(2)(a) refer to the same trust mentioned in the opening words of the subparagraph, namely, the trust that has determined a capital gain in respect of the disposal of an asset.⁷³⁷ A beneficiary that happens to be a trust does not determine a capital

⁷³⁶ Paragraph 80(2) was amended by s 58 of the Revenue Laws Amendment Act 20 of 2006 to include the italicised words 'the whole or the portion of the capital gain so vested'. The purpose of the amendment was to put it beyond doubt that a portion of a capital gain could be vested in single or multiple beneficiaries. The amendment is deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2007.

⁷³⁷ The words 'arises in a trust' which appeared in the opening words of para 80(2) were substituted with 'determined in respect of the disposal of an asset by a trust' by s 86(b) of the Revenue Laws Amendment Act 60 of 2008 and deemed to have come into operation as from the commencement of years of assessment ending on or after 1 January 2009. The purpose of the amendment was to

gain in respect of the disposal of an asset – it must simply account for the capital gain attributed to it under para 80(2)(b). Such an attributed capital gain cannot be further attributed.

Thus, a capital gain of a discretionary trust can be attributed only once and cannot flow through multiple resident discretionary trusts in the same year of assessment. Any subsequent on-distribution of an amount equal to the attributed capital gain simply represents a disposal which does not give rise to a capital gain or loss, usually just a part-disposal of the on-distributing trust's bank account.

On the vesting of an asset through multiple discretionary trusts under para 80(1), see **14.11.5.1**.

Example – Consecutive vesting of capital gain by multiple trusts

Facts:

Trust B is a beneficiary of Trust A and Walter is a beneficiary of Trust B. Trust A and Trust B are discretionary trusts.

Trust A disposed of an asset in year 1 resulting in a capital gain which the trustee vested in Trust B in the same year of assessment. The trustee of Trust B then vested an amount equal to the capital gain in Walter in year 1. All parties are residents.

Result:

Under para 80(2) the capital gain must be disregarded by Trust A and accounted for by Trust B. The attributed gain in Trust B is not one that arises from the disposal of an asset by Trust B. It cannot therefore be on-attributed to Walter. The words 'that beneficiary' in para 80(2)(b) refer to the beneficiary of the trust that disposed of the asset (Trust A). Walter is not a beneficiary of Trust A.

14.11.6.3A Multiple vesting trusts and the flow-through principle

Unlike multiple discretionary trusts, the flow-through principle can apply to multiple vesting trusts. This result follows from para 11(1)(d), which results in the disposal of an asset of a trust to a beneficiary when that asset is vested in that beneficiary.

Example 1 – Multiple vesting trusts and the treatment of a capital gain or loss

Facts:

Trust B has a vested interest in all the assets of Trust A. Muneer has a vested interest in all the assets of Trust B. In year 1 Trust A disposes of an asset to a third party.

Result:

Trust A and Trust B are unaffected by the transaction for CGT purposes because they have already disposed of the asset to their respective beneficiaries on vesting under para 11(1)(d).

In year 1 Muneer must account for any capital gain or loss on disposal of the asset by Trust A. The actions of the trustee of Trust A are actions on behalf of Muneer.

The above applies whether Muneer is a resident or a non-resident.

bring the wording in line with that used in para 80(1). As for the position before this amendment, the view is held that attribution of a capital gain through multiple discretionary trusts was not possible.

A similar result will ensue when a discretionary trust has a vesting trust as one of its beneficiaries. If the discretionary trust sells an asset to a third party and vests the resulting capital gain in the vesting trust, it is the resident beneficiaries of the vesting trust who must account for the capital gain, since the vesting trust stands in the position of a pure administrator having no beneficial interest in the capital gain. However, the trust deed must be carefully scrutinized in order to determine whether the beneficiaries indeed have a vested interest in the capital gain. See also 14.11.5.2 and 14.11.5.3 which deal with similar issues under para 80(1) in relation to the vesting of assets in vesting trusts and their beneficiaries.

Example 2 – Vesting of capital gain in vesting trust

Facts:

One of the beneficiaries of discretionary Trust A is vesting Trust B. The beneficiaries of Trust B are resident individuals C and D who have equal vested rights in Trust B. The trust deed of Trust B provides that its beneficiaries have equal vested interests in all its assets including present and future assets acquired by it.

During the year of assessment, Trust A disposed of an asset to a third party at a capital gain of R100. The trustees of Trust A vested the capital gain in Trust B during the same year of assessment.

Result:

Under para 80(2) Trust A must disregard the capital gain of R100 and C and D must each account for a capital gain of R50. Trust B does not have a beneficial interest in the capital gain and stands in the position of a pure administrator acting on behalf of C and D.

Example 3 – Vesting trust with discretionary trust as beneficiary but beneficiary does not have a vested right in asset

Facts:

Discretionary trust Y is a beneficiary of Vesting Trust X. Discretionary Trust Y has two beneficiaries, individuals A and B. The trust deed of Vesting Trust X provides that its beneficiaries are entitled only to the capital of the trust on termination and that beneficiaries have vested rights in any capital gains of the trust. The deed also specifically states that no beneficiary has any claim on the assets of the trust before termination. During the year of assessment, Vesting Trust X vested a capital gain of R100 000 in Discretionary Trust Y which in turn vested R50 000 in A and R50 000 in B.

Result:

Discretionary Trust Y has a vested right in the capital gain that arose in Vesting Trust X. Under para 80(2) Vesting Trust X must disregard that capital gain and Discretionary Trust Y must take it into account. However, since Discretionary Trust Y did not have a vested right in the asset that gave rise to the capital gain, it has not disposed of the asset held by Vesting Trust X. The capital gain will accordingly be taxed in Discretionary Trust Y and cannot be on-attributed to A and B.

14.11.6.4 Vesting of capital profits v capital gains

Under para 80(2) a trustee can vest a capital gain in a beneficiary. In determining what a trustee can vest, one must have regard to the trust deed, which is likely to refer to the accounting concept of profits of a capital nature. It could therefore be argued that it is impossible for a trustee to vest a capital gain, since it is an artificial tax concept that may bear

little resemblance to the actual economic or accounting capital profit. But the legislation has to be given meaning, and the legislature no doubt intended that the vesting of a capital gain should as far as possible follow the real-life vesting of accounting capital profits.

In the context of pre-valuation date assets, it is evident that in some situations a capital gain will arise while for accounting purposes there may be a lesser capital profit, a loss or a break-even situation. In these situations, vesting of the capital gain in a beneficiary will be possible only to the extent that a capital profit is available for vesting. The principle that a trustee cannot vest deemed income was established in *Hulett v CIR*.⁷³⁸

Example 1 – Capital gain but accounting capital loss

Facts:

The trustees of the ABC Family Trust have elected to use the weighted-average method to determine the base cost of listed shares. The following details relate to the disposal by the trustees of listed shares in XYZ Ltd:

	R
Original cost	100
Market value on valuation date	50
Proceeds	70

Result:

The capital gain of R20 (R70 – R50) cannot be vested in a beneficiary, since there is an overall accounting capital loss of R30 (R70 – R100).

The reverse situation could also occur, namely, an accounting capital profit but a CGT capital loss. Since capital losses cannot be vested, the capital loss could not be attributed to a beneficiary even if the accounting capital profit were to be vested in that beneficiary.

If a capital profit exceeds a capital gain, it will be possible, based on the wording of para 80(2), for the trustee to attribute the entire capital gain to a beneficiary by distributing an equal amount of capital profit. In other words, it is not necessary for the entire capital profit to be distributed before it can be said that the capital gain has been attributed. However, should the trustee fail to specify what is being distributed, the allocation of the capital gain between the trust and the beneficiary will have to be done on a pro rata basis. This result follows from the fact that a capital profit is fungible.

Example 2 – Attribution of capital gain when capital profit exceeds capital gain

Facts:

The ABC Family Trust is a discretionary trust. During a year of assessment, the trust disposed of a pre-valuation date asset, details of which were as follows:

	R
Original cost	100 000
Market value on 1 October 2001	160 000
Proceeds	210 000

The accounting records reflected a capital profit of R110 000 (R210 000 – R100 000).

⁷³⁸ 1944 NPD 263, 13 SATC 58.

The trustees adopted the market-value method for determining the valuation date value of the asset. This adoption resulted in a capital gain of R210 000 – R160 000 = R50 000. Before the end of the year of assessment, the trustees passed a resolution vesting the capital gain of R50 000 in a beneficiary of the trust. The pre-CGT capital profit of R160 000 – R100 000 = R60 000 was retained in the trust.

Result:

Under para 80(2) the beneficiary will be subject to CGT on a capital gain of R50 000.

Example 3 – Attribution when capital profit exceeds capital gain and source of distribution is unspecified

Facts:

The facts are the same as in Example 2 except that the trustee failed to specify the source of the distribution.

Result:

The capital gain of R50 000 will be apportioned as follows:

	R
To trust $R50\,000 \times R60\,000 / R110\,000$ (taxed in trust)	27 273
To beneficiary $R50\,000 \times R50\,000 / R110\,000$ [para 80(2)]	<u>22 727</u>
	<u>50 000</u>

14.11.6A Disregarded capital gains and para 80

When a trust realises a capital gain that is potentially subject to exclusion under para 45 or Part XIII (paras 53 to 64E), the issue arises whether it is the trust that must disregard the capital gain or its beneficiaries. Examples include a capital gain on disposal of a primary residence held by a special trust (para 45), and a capital gain arising from the realisation of a long-term policy (para 55).

The exclusion provisions in the Eighth Schedule generally confer the exclusion on the person that owns the asset. For example, para 45 refers to ‘the disposal of the primary residence of that person or that special trust’ and para 55(1)(a) requires the person to be the original beneficial owner or one of the beneficial owners of the policy. It follows that if such a capital gain were to be attributed to a beneficiary, it is unlikely that the beneficiary would qualify to disregard the capital gain.

Paragraph 45 requires the person to disregard the applicable portion of the capital gain or loss when determining an aggregate capital gain or loss.

Similarly, in relation to the other exclusions set out in Part XIII, para 52 states that Capital gains and capital losses must be disregarded in the circumstances and to the extent set out in that Part when determining the aggregate capital gain or loss of a person.

A person’s aggregate capital gain for a year of assessment under para 6 is the amount by which the sum of that person’s capital gains for that year and any other capital gains which are required to be taken into account in the determination of that person’s aggregate capital gain or loss for that year, exceeds the sum of

- that person’s capital losses for that year; and

- in the case of a natural person or a special trust, that person's or special trust's annual exclusion for that year.

The wording of the definition of aggregate capital loss in para 7 is similar and need not be repeated here.

Under para 80(1) a trust that vests an asset in a resident beneficiary must disregard any resulting capital gain for purposes of calculating its aggregate capital gain or loss and the beneficiary must take it into account. Similarly, under para 80(2) a trust that disposes of an asset to a third party and vests any resulting capital gain in a resident beneficiary must disregard the capital gain for purposes of calculating its aggregate capital gain or loss and the beneficiary must take it into account.

The question is whether the resulting capital gain that must be disregarded by the trust and taken into account by the beneficiary under para 80 is the capital gain before or after the exclusion under para 45 or paras 53 to 64E.

SARS takes the view that the capital gain contemplated in para 80 is one determined after applying para 45 or paras 53 to 64E. It is considered that the trust goes through a two-step process when determining its aggregate capital gain or loss. Under the first step, it must disregard those capital gains that qualify for exclusion under para 45 or paras 53 to 64E and include what remains in the sum of its capital gains and losses. In the second step involving para 80, it must disregard any capital gain surviving exclusion under the first step and the beneficiary must take it into account.

The vesting of a disregarded capital gain falls outside para 80 and must be treated by the beneficiary in the same way as a distribution of after-tax capital.

Example 1 – Treatment of disregarded capital gain by trust and beneficiary

Facts:

The ABC Special Trust was created for the benefit of Jonathan, a person with a disability. The trust meets the requirements of para (a) of the definition of 'special trust' in s 1(1). Both Jonathan and the trust are residents and the trust was not funded by a donation, settlement or other disposition. During the 2020 year of assessment, the trust disposed of its primary residence and realised a capital gain of R3 million which it vested in Jonathan.

Result:

The trust must disregard R2 million of the capital gain under para 45. The remaining portion of the capital gain of R1 million must be disregarded by the trust under para 80(2) and be taken into account by Jonathan in determining his aggregate capital gain or loss. Jonathan will not be subject to CGT on the disregarded portion of the capital gain of R2 million, which falls outside para 80(2) and represents a distribution of trust capital.

Example 2 – Treatment of disregarded capital gain by trust and its beneficiaries

Facts:

The Ian Family Trust, a resident discretionary trust, was created by Ian for the benefit of his three children. The trust had taken out a long-term policy on Ian's life and had paid all the premiums since inception. It was the original beneficial owner of the policy and sole beneficiary under the policy. During the 2020 year of assessment, Ian passed away and the trust received

the insurance proceeds of R6 million which the trustees immediately resolved to vest in equal shares in the three children during the 2020 year of assessment.

Result:

The trust must disregard any capital gain or loss arising from the amount received or accrued of R6 million under para 55(1)(a). The beneficiaries will each receive a distribution of trust capital of R2 million which will not constitute a capital gain in their hands.

14.11.7 Tax-saving effect of attributing capital gains to beneficiaries

For the 2020 year of assessment the taxable capital gain of a trust other than a special trust is taxed at an effective rate of 36% (45% flat rate × 80% inclusion rate) compared to the effective rate of between 0% and 18% applicable to an individual or 22,4% applicable to a company. If dividends tax at 20% is taken into account, the after-CGT cost of extracting a capital gain from a company is 37,92% (22,4% + 15,52%)⁷³⁹ The attribution of a capital gain to a donor or beneficiary who is a natural person or a person other than a trust will therefore result in a lower effective tax rate in respect of that gain.

14.11.8 Capital gain attributed to resident beneficiary of non-resident trust [para 80(3)]

Paragraph 80(3) applies when during any year of assessment

- any resident acquires a vested right to any amount representing capital of any non-resident trust;
- that resident had a contingent right to that capital in any previous year of assessment;
- that capital consists of or is derived, directly or indirectly, from an amount determined as a capital gain of that trust or which would have been determined as a capital gain of that trust had that trust been a resident; and
- that capital gain or the amount that would have been determined as a capital gain has not been subject to tax in South Africa under the Act.

Under the above circumstances that amount must be taken into account as a capital gain when determining the aggregate capital gain or aggregate capital loss of that resident in respect of the year of assessment in which that resident acquired that vested right.

This provision mirrors s 25B(2A).

Paragraph 80(3) does not address the attribution of a capital gain which arises in and is vested in the same year of assessment (that is, it deals only with prior year capital gains which have been capitalised). That task is left to para 80(1) and (2).

The term 'capital' must comprise or be derived directly or indirectly from capital gains which were not vested in beneficiaries in previous years of assessment. A capital gain could be derived indirectly by the non-resident trust, for example, if non-resident trust 1 disposed of an asset to a third party and distributed the resulting capital gain to non-resident trust 2 which in turn on-distributed the amount to a resident beneficiary.

⁷³⁹ $R100 - R22,40 = R77,60 \times 20\% = R15,52.$

The rule targets any

- capital gains on the assets contemplated in para 2(1)(b) but only when such gains were not subject to tax in South Africa at the time they arose (for example, because of the application of a tax treaty); and
- any amount that would have constituted a capital gain had the trust been a resident (that is, capital gains on assets referred to in para 2(1)(a).

An example of a capital gain on an asset referred to in para 2(1)(b) which could be subject to attribution under para 80(3) is shares in a company holding only immovable property in South Africa. For example, under South Africa's tax treaty with the United Kingdom the rule in article 13 that deems shares in a property-rich company to be immovable property does not apply to listed shares. The United Kingdom thus enjoys an exclusive taxing right on the disposal of such shares even though they could potentially fall within para 2(2). It would therefore not be possible to tax the trust in such a jurisdiction when the capital gain arises on disposal of the listed shares. Nevertheless, such a capital gain will be taxable in the hands of a resident beneficiary when vested in a subsequent year of assessment because the capital gain would not have previously been subject to tax in South Africa.

Another example of a capital gain that would have been subject to tax in South Africa arises when the capital gain was attributed to a resident donor under para 72 at the time it arose. When an amount derived from that capital gain is subsequently vested in a resident beneficiary by the non-resident trust, it will not again be subject to tax in the hands of the resident beneficiary.

The translation of a capital gain or loss in foreign currency must be dealt with under para 43 as it read at the time when the trust disposed of the asset. The rules for translating a capital gain or loss on disposal of a share acquired or disposed of in a foreign currency changed substantially for individuals and non-trading trusts disposing of assets on or after 1 March 2013.⁷⁴⁰ Disposals of shares before that date were generally dealt with under paragraph 43(4) although unlisted shares could have been dealt with under paragraph 43(1) or (2) (now deleted) in some exceptional circumstances. Paragraph 43(4) drew no distinction between individuals, trusts and companies, and applied the translation methodology currently in para 43(1A). Paragraph 43(4) was deleted with effect from 1 March 2013 in respect of disposals on or after that date.

A capital gain that arose from the disposal of an asset by a non-resident trust before the valuation date is not a capital gain as defined in para 1. When an amount derived from such a gain is subsequently distributed to a resident beneficiary on or after the valuation date, it will not be subject to CGT in the hands of a resident beneficiary under para 80(3).

A contingent beneficiary who was a non-resident and becomes a resident will be taxable on the full amount of any capital gain which arose in the non-resident trust and was vested in that resident beneficiary in a subsequent year of assessment. In other words, the capital gain is not reduced to take account of any period during which the beneficiary was a non-resident. The converse is also true, that is, a beneficiary in whom a capital gain is vested after that beneficiary ceases to be a resident will not be taxable even though some of the growth in the trust's asset may have occurred while that beneficiary was a resident.

⁷⁴⁰ The change, originally introduced by section 117 of the Taxation Laws Amendment Act 22 of 2012, applied to disposals on or after 1 January 2013. However, this effective date was later changed to 1 March 2013 by section 208 of the Taxation Laws Amendment Act 31 of 2013 which amended section 117(2) of Act 22 of 2012.

Example 1 – Capital gain vested in resident beneficiary by non-resident trust in year of assessment subsequent to that in which asset is disposed of*Facts:*

The Hilde Family Trust was established in one of the Channel Islands for the benefit of Hilde and her children by her late grandfather who passed away in 2006. During the 2019 year of assessment the trust disposed of shares listed on the London Stock Exchange to a third party for proceeds of £100 000. The trust had acquired these shares in 2005 at a cost of £20 000. The trustees vested the capital gain of £80 000 in Hilde during the 2020 year of assessment. The average exchange rate for the 2019 year of assessment was £1 = R17,8338, which was more favourable for Hilde for determining the capital gain than the spot rate at the time of disposal. The Hilde Family Trust did not carry on a trade.

Result:

The Hilde Family Trust determined a capital gain of £80 000 (£100 000 proceeds – £20 000 base cost) in the 2019 year of assessment. Since this capital gain was not vested during the 2019 year of assessment, it became part of the trust capital. When an amount derived from that capital gain was vested in Hilde in the 2020 year of assessment, it was deemed to be a capital gain in her hands in that year under para 80(3).

Under para 43(1) the capital gain of £80 000 must be translated to rand at the spot rate at the time of disposal or at the average exchange rate in the year of assessment in which the asset was disposed of. The capital gain is thus £80 000 × 17,8338 = R1 426 704 which Hilde must include as a capital gain in her 2020 return of income.

Example 2 – Capital gain derived indirectly by resident beneficiary from non-resident trust*Facts:*

The Ben Family Trust was formed in the Channel Islands by Ben for his family. Ben passed away in 2008. One of the beneficiaries of the trust was a discretionary trust (the Diane Family Trust) also formed and managed in the Channel Islands for Ben's granddaughter Diane, a resident, and her family. During the 2018 year of assessment the Ben Family Trust disposed of shares in a company listed on the London Stock Exchange. These shares had been acquired by the trust in 2006 at a cost of £20 000 and were disposed of for proceeds of £100 000. During the 2019 year of assessment the Ben Family Trust vested an amount equal to the capital gain of £80 000 in the Diane Family Trust. During the 2020 year of assessment, the trustees of the Diane Family Trust resolved to vest an amount equal to the amount received from the Ben Family Trust in Diane. The average exchange rate during the 2018 year of assessment was £1 = R17,1664 which was more favourable for Diane than the spot rate on the date of disposal. The Ben Family Trust did not carry on a trade.

Result:

The Ben Family Trust derived a capital gain of £80 000 (£100 000 – £20 000) in the 2018 year of assessment. Since this capital gain was not vested in the same year of assessment, it became part of the Ben Family Trust's capital. In the 2019 year of assessment the Ben Family Trust vested an amount equal to the capital gain of £80 000 in the Diane Family Trust which then became part of the Diane Family Trust's capital. In the 2020 year of assessment an amount equal to the capital gain of £80 000 was derived indirectly by Diane when the Diane Family Trust vested the £80 000 in her. Under para 80(3) Diane is deemed to derive a capital gain of £80 000 during the 2020 year of assessment.

Under para 43(1) the capital gain of £80 000 must be translated to rand at the spot rate at the time of disposal or at the average exchange rate in the year of assessment in which the asset was disposed of. The capital gain is thus £80 000 × R17,1664 = R1 373 312 which Diane must include as a capital gain in her 2020 return of income.

14.11.9 Exclusion of participation exemption [para 80(4)]

For purposes of para 80(1) to (3), para 80(4) turns off the participation exemption in para 64B(1) and (4) when a non-resident trust holds a qualifying interest in a foreign company. Were it not for this rule, the non-resident trust would derive a disregarded capital gain when it disposed of the equity shares in the foreign company to a non-resident [para 64B(1)] or when it received a foreign return of capital [para 64B(4)].⁷⁴¹ Consequently but for para 80(4), when the disregarded capital gain was attributed to a resident beneficiary under para 80, it would not have been possible to subject the amount to CGT in the hands of the beneficiary.

The exclusion of the application of para 64B must meet two preconditions: A minimum shareholding/voting rights requirement and the amount not already having been subject to tax under another attribution rule.

Minimum holding requirement [para 80(4)(a)]

The non-resident trust must hold directly or indirectly more than 50% of the total participation rights, as defined in s 9D(1), or exercise more than 50% of the voting rights, in the foreign company, whether alone or together with any one or more persons that are connected persons in relation to that trust.

Elimination of double taxation [para 80(4)(b)]

A capital gain must not be disregarded under para 64B(1) or (4) to the extent to which that amount is not derived from an amount that must be included in the income of or attributed to

- the resident to whom an amount is attributed under para 80(1), (2) or (3); or
- a resident who is a connected person in relation to the resident referred to in the above bullet point.

The reference to an amount included in income covers the situation in which the CFC rules in s 9D apply to shares held through a trust. Paragraph (b) of the definition of 'controlled foreign company' in s 9D(1) includes as a CFC

⁷⁴¹ A capital gain could arise under para 76B(3) if the foreign return of capital exceeded the expenditure in respect of the share.

'any foreign company where the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident'.

Paragraph (b) was inserted in the definition to address the situation in which a parent company avoids the CFC attribution rules by interposing a discretionary foreign trust or foundation between the parent company and its subsidiary, while still retaining control over the subsidiary. By deeming such a controlled subsidiary to be a CFC, its net income will be attributed to its parent under s 9D(2) and included in the parent's income.

IFRS 10 'Consolidated Financial Statements' requires an entity (subsidiary) to be consolidated when the parent company exercises 'control' over the entity. The standard defines the principle of 'control' and establishes control as the basis for consolidation in the consolidated financial statements. Consolidated financial statements are financial statements that present the assets, liabilities, equity, income, expenses and cash flows of a parent and its subsidiaries as those of a single economic entity.

Under IFRS 10 an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.⁷⁴² Power may, for example, be exercised through voting rights in respect of equity shares.⁷⁴³

Example – Parent company required to consolidate foreign company held by non-resident trust and trust disposing of shares in foreign company

Facts:

On 1 March 2018 SA Parent Company invested R100 000 in Foreign Discretionary Trust. The trust used the funds to acquire all the shares in Foreign Company C. Through various complex contractual arrangements SA Parent Company was able to control the voting rights in Foreign Company C. All the entities in this example have years of assessment ending on the last day of February.

In July 2019 the trust disposed of its interest in Foreign Company C to a non-resident for R500 000, resulting in a capital gain of R400 000 which it vested in SA Parent Company. During the period 1 March 2018 to 31 July 2019 SA Parent Company included net income of R350 000 in its income under s 9D(2).

Result:

Foreign Company C is a CFC in relation to SA Parent Company by virtue of para (b) of the definition of 'controlled foreign company' in s 9D(1) because it is required to consolidate the results of Foreign Company C in its consolidated financial statements under IFRS 10.

Since the trust disposed of the shares to a non-resident, it would have qualified for the participation exemption in para 64B in respect of the capital gain of R400 000 but for para 80(4) which turns off the exemption.

Under para 80(4)(b) the exemption must not be turned off to the extent that SA Parent Company derived the amount of R400 000 from an amount that was included in its income. Net income of R350 000 was included in SA Parent Company's income under s 9D(2) during the period that the shares were held by the trust. This net income would have boosted the

⁷⁴² Paragraph 6.

⁷⁴³ Paragraph 11.

value of the equity shares held by the trust and hence it can fairly be inferred that it is included in the capital gain of R400 000. The capital gain must therefore be reduced by that amount. SA Parent Company must therefore account for an attributed capital gain of R50 000 (R400 000 – R350 000) under para 80(2).

14.11.10 Other sundry examples

Example 1 – Disposal by first beneficiary of vested right and subsequent disposal by trustee of asset on behalf of second beneficiary

Facts:

Vernon invested R100 000 in a vesting trust. The trustee bought shares with the R100 000. The shares declined in value to R20 000 and Vernon sold his interest in the trust to Willem for R20 000, taking an R80 000 loss. The shares then rebounded in value to R100 000, at which point the trustee sold them for neither a capital gain nor a capital loss. The trustee then distributed R100 000 to Willem, saying it was a return of capital.

Result:

Vernon's interest in the trust was acquired for a base cost of R100 000 and consists of a claim against the trustee in respect of the assets of the trust vested in Vernon. Any action by the trustee in respect of those assets will be an action on behalf of Vernon. Any sale of those shares will therefore be effected on behalf of Vernon while the proceeds from such sale will accrue to or be received by the trustee on behalf of Vernon. Vernon's interest in the trust, namely, the claim to the trust asset is, however, a separate asset that can be the subject of a separate disposal if Vernon is entitled to transfer that claim to another person. Vernon will therefore show a capital loss of R80 000 in respect of the disposal of the interest in the trust to Willem, while Willem will acquire the interest at a base cost of R20 000.

The subsequent sale of the shares by the trustee is a disposal on behalf of the person having a vested right to those shares, namely, Willem. The trust will therefore not determine a capital gain or a capital loss in respect of the disposal of those shares as they are disposed of on behalf of a specific beneficiary and not for the benefit of the trust. The proceeds from that disposal accrue to or in favour of Willem. The disposal of those shares by the trustee results in the extinction of Willem's claim to those shares [thus constituting a disposal of that claim under para 11(1)] and the concurrent substitution of a new claim, namely, the claim for the proceeds that accrue to or in favour of Willem. The disposal of Willem's claim to the shares (acquired by Willem at a base cost of R20 000) in return for the new claim to the proceeds of R100 000 therefore results in a capital gain of R80 000 in Willem's hands.

Willem acquires a new asset (the claim to the proceeds on the sale of the shares) in return for the disposal of Willem's previous claim to the shares. The cost of acquisition of the new claim is therefore equal to the value of the previous claim at the time of its disposal in return for the new claim, that is, R100 000. The base cost to Willem of the new claim is therefore R100 000. The subsequent distribution of R100 000 to Willem will therefore amount to the extinction or disposal, under para 11, of Willem's remaining interest in the trust for an amount equal to its base cost, thus resulting in neither a capital gain nor a capital loss.

Example 2 – Disposal by first beneficiary of vested right and subsequent distribution by trustee of asset to second beneficiary*Facts:*

Xavier invested R100 000 in a vesting trust. Under the trust deed the trust beneficiaries have vested rights in the trust assets. The deed also makes provision for beneficiary substitution. The trustee bought shares with the R100 000. The shares declined in value to R20 000 and Xavier sold his interest to Yanga for R20 000, taking an R80 000 loss. The shares then rebounded in value to R100 000, at which point the trustee distributed them to Yanga.

Result:

The trust is unaffected by the transaction since the actions of the trustee are merely actions on behalf of the beneficiaries who have vested interests in its assets.

The distribution of the shares to Yanga results in a disposal of her vested right in the shares in exchange for full ownership in the shares. The time of disposal is taken back to the time of vesting under para 13(1)(a)(iiA). Since the shares had a market value of R20 000 at the time of vesting, Yanga will make neither a capital gain nor a capital loss on the exchange of rights and will simply acquire the shares at a base cost of R20 000, being equal to the market value of the vested right given up. See 8.5 for the application of barter or exchange principles in establishing the base cost of an asset.

Example 3 – Part-disposal of vested right resulting from payment by trustee and subsequent disposal of remaining vested right*Facts:*

Zahir invested R100 000 in a vesting trust. The trustee bought shares with the R100 000. The shares rose in value to R200 000 at which point the trustee borrowed R150 000 from a bank. The shares were used as security for the loan. The trustee distributed the proceeds of the loan to Zahir as a non-refundable payment in respect of her interest in the trust. Zahir subsequently sold the interest in the trust to Ashok for R50 000.

Result:

The distribution of R150 000 to Zahir represents a payment in satisfaction of part of Zahir's claim against the trustee for the vested asset. It therefore results in the extinction of part of Zahir's interest in the trust. The R150 000 in effect represents the proceeds from the part-disposal of Zahir's interest in the trust. Zahir's capital gain in respect of this part-disposal is determined as follows:

Portion of the base cost of entire interest (R100 000) attributable to the part disposed of as determined under para 33:

$$\begin{aligned}
 &= \frac{\text{Market value of part disposed of}}{\text{Market value of entire asset}} \times \text{Base cost of entire asset} \\
 &= \frac{\text{R150 000}}{\text{R200 000}} \times \text{R100 000} \\
 &= \text{R75 000}
 \end{aligned}$$

Proceeds from part-disposal of interest	R 150 000
Less: Base cost of part disposed of	(75 000)
Capital gain	<u>75 000</u>

Zahir's capital gain in respect of the disposal of the remaining interest in the trust is as follows:

	R
Proceeds from the disposal of the remaining interest	50 000
Less: Base cost of remaining interest (R100 000 – R75 000)	<u>(25 000)</u>
Capital gain	<u>25 000</u>

Example 4 – Beneficiary with vested right to trust asset receiving loan from trust financed by third party; trustee then surrendering asset to third party in settlement of loan

Facts:

Bob invested R100 000 in a vesting trust. The trustee bought shares with the R100 000. The shares rose in value to R200 000 at which point the trustee borrowed R150 000 from a bank by using the shares as security. The trustee advanced 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 surrendered the shares to the bank in full and final payment of the loan of R150 000 as well as in settlement of an amount of R30 000 payable as interest on the loan.

Result:

The transfer of the shares as security for the loan obtained by the trustee does not amount to the disposal, on behalf of Bob, of those shares to the bank [see para 11(2)(a)]. There is also no disposal of an asset as a result of the loan advanced to Bob. No portion of the interest payable to the bank will qualify as part of the base cost of the shares, since 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. Under para 35(1)(a) the proceeds from that disposal will be equal to the amount of the debt extinguished on behalf of Bob, namely, R180 000. This amount will accrue to or in favour of Bob and will therefore be taken into account as the proceeds from the extinction of Bob's interest in the trust. Bob's capital gain is therefore R180 000 – R100 000 = R80 000. No capital gain will be determined separately in the trust in respect of the disposal of the shares to the bank, since this was done on behalf of Bob.

Example 5 – Beneficiary having vested right to trust asset; trustee using asset as security to borrow funds to purchase further asset on behalf of beneficiary; subsequent disposal of further asset and repayment of loan

Facts:

Catherine invested R100 000 in a vesting trust. The trustee bought listed shares with the R100 000. The shares rose in value to R200 000 at which point the trustee borrowed R150 000 by using the shares as security. The trustee used the proceeds of the loan to buy further shares on behalf of Catherine. The trustee subsequently sold the new shares for R230 000 and used the proceeds to

- repay the loan of R150 000;
- pay interest of R30 000 on the loan; and
- distribute the remaining R50 000 to Catherine.

Result:

Catherine has a vested right to the new shares bought on her behalf. The base cost of this right is R150 000, that is, the liability incurred on her behalf in respect of the loan used to finance the acquisition of the shares and which is to be repaid from the proceeds of shares to which she has a vested right. The interest expense that is to be paid or eventually recovered from those proceeds also qualifies as an expense in her hands. A third of that interest of R30 000, namely, R10 000, qualifies under para 20(1)(g) for inclusion in the base cost of her right to the new shares. The total base cost directly attributable under para 33(2) to Catherine's right to the new shares therefore amounts to R160 000. The subsequent disposal on her behalf of the new shares results in an accrual of an amount of R230 000 to or in her favour. This amount represents proceeds from the disposal of her claim to those shares and results in a capital gain of R70 000 in her hands. The amount paid to Catherine of R50 000 has no CGT consequence, since it merely represents a return of her after-tax capital that was managed by the trustee on her behalf.

Example 6 – Discretionary trust – assets sold to trust via interest-free loan – trust and seller connected persons – transactions deemed to take place at market value – losses clogged – assets subject to revocable vesting – attribution of income and capital gain under s 7(3) and para 73 – gain vested in non-resident beneficiary taxed in trust or attributed to resident donor under para 72

Facts:

Deborah set up a trust in South Africa. The trustees of the trust are Deborah, Eileen (an accountant in Guernsey) and Fish (a lawyer in Johannesburg).

Deborah sold the following assets to the trust at market value:

	Market value	Base cost	Capital gain (loss)
	R	R	R
Shares in Papa Ltd	800 000	200 000	600 000
Shares in Oscar Ltd	200 000	250 000	(50 000)
Undeveloped immovable property	500 000	100 000	400 000
Rent-producing shopping complex	500 000	200 000	300 000
Deborah's residence	<u>100 000</u>	20 000	80 000
	<u>2 100 000</u>		

Result:

Had the disposals not been at market value, they would have been treated as having been made at market value under para 38. The trust qualifies as a connected person in relation to Deborah, since the trust beneficiaries include her spouse and children. The disposals by Deborah to the trust are therefore governed by the connected persons rules governing the amount of the proceeds of such disposals (para 38) and the clogging of capital losses determined in respect of such disposals (para 39).

Under para 39 the capital loss of R50 000 can be deducted only from the capital gains determined in respect of the other disposals to the trust in the same or a subsequent year of assessment and not from gains from disposals to persons other than the trust. In this instance the capital loss is not clogged, since it is exceeded by the capital gains arising from other disposals to the trust by Deborah. The capital gain of R80 000 in respect of the residence qualifies for the primary residence exclusion in Deborah's hands, since she ordinarily resided in the residence.

The sales took place on credit and Deborah's loan of R2 100 000 to the trust bears no interest and is payable on demand. The beneficiaries of the trust are Deborah's children Gail and Harold (a minor), Deborah's spouse Ian and a list of charitable and educational institutions. The trustees have an unfettered discretion on the vesting, in a beneficiary, of any trust income or of any trust assets or of any gain from the disposal of any trust assets.

The following events occurred in the first year of the trust's existence:

- Gail emigrated.
- The trust earned rental income of R40 000 and dividend income of R12 500.
- The trustees exercised their discretionary powers at the end of that year by vesting the income of R52 500 in Harold.

	Market value R	Base cost R	Capital gain R
Deborah's residence is vested in Ian	140 000	100 000	40 000
Undeveloped property is sold to a third party but the proceeds are not vested in any beneficiary	700 000	500 000	200 000
Shares are vested in Gail	610 000	500 000	<u>110 000</u>
			<u>350 000</u>

The failure to charge any interest on the loan of R2,1 million is a donation, settlement or other disposition. The value of this benefit is equal to the interest expense saved by the trust as a result of this loan. Assuming that the trust would have been able to obtain a loan from a bank or other institution at an interest rate of 12,5% a year, the trust saves an amount, during the first year, equal to the amount of interest that would have been payable at this rate, namely, R262 500. The trust would not have been able to distribute the full amount of any trust income and the full market value of any trust asset to the trust beneficiaries had it been obliged to pay R262 500 in interest.

The rental income of R40 000 and the dividends of R12 500 would have had to be applied to pay the interest charge and can therefore be treated as having arisen by reason of the donation made by Deborah. The income that was vested in Deborah's minor child can therefore be taxed in her hands under s 7(3).

Under para 73 the amount of the income so deemed to be that of Deborah must be deducted from the total amount of interest saved by the trust as a result of the interest-free loan extended by Deborah. The remaining amount, namely, R210 000, represents the maximum amount of the capital gain that may be attributed to Deborah. It represents the portion of the gains that would have had to be applied by the trust to pay interest at a market-related rate.

The trust cannot claim the primary residence exclusion on the capital gain from the disposal of the residence to Ian, since the trust is not a natural person or a special trust as required by the definition of 'primary residence' in para 44. The gain of R40 000 must be taken into account in Ian's hands under para 80(1) unless Deborah made the donation, settlement or other disposition mainly for purposes of tax avoidance (para 68). If this were the case, the gain would have to be taken into account in Deborah's hands.

The vesting in a beneficiary of a trust asset or of the capital gain determined in respect of the disposal of a trust asset is, under the trust deed, clearly subject to a contingent event, namely, the exercise of the discretionary powers of the trustees. The capital gain of R200 000 in respect of the undeveloped property that was not vested in any beneficiary of the trust in the year of assessment in which it arose will therefore be subject to para 70 with the result that it will be taken into account in Deborah's hands.

Finally, the gain of R110 000 on the shares vested in Gail will not be attributed to her under para 80, since she is not a resident. R10 000 of the gain will be deemed back to Deborah under para 72, while the remaining R100 000 will be taxed in the trust under the core rules. The R10 000 is the remaining amount of the interest that is available to be deemed to the donor (R262 500 (total interest) – R52 500 [s 7(3)] – R200 000 (para 70) = R10 000).

The above example may be summarised as follows:

	R
Rent	40 000
Interest	<u>12 500</u>
Total income	52 500
Less: Distributed to Harold (minor)	<u>(52 500)</u>
	-
Deemed back to Deborah – s 7(3)	52 500

Interest-free loan

R2 100 000 × 12,5% = R262 500

Therefore, interest available for deeming of capital gains back to Deborah (para 73):

= R262 500 – R52 500 = R210 000

	Capital Gain R	Deborah R	Ian R	Trust R
Residence vested in Ian	40 000	-	40 000	-
Undeveloped property not vested	200 000	200 000	-	-
Shares vested in Gail (non-resident)	<u>110 000</u>	<u>10 000</u>	<u>-</u>	<u>100 000</u>
Total gains realised	<u>350 000</u>	<u>210 000</u>	<u>40 000</u>	<u>100 000</u>

14.12 Base cost of interest in a discretionary trust (para 81)

Paragraph 81

A beneficiary's contingent interest in a discretionary trust is treated as having a base cost of nil. This provision overrides para 38(1)(b) which provides that an asset acquired from a connected person must have a base cost equal to market value. The full proceeds from the disposal of the contingent interest will therefore be treated as a capital gain.

The above provision does not affect the 'connected person rule' under para 38(1)(b) as regards the vesting of a right to an asset in a beneficiary of a trust. Once vesting takes place the beneficiary will acquire the asset at a base cost equal to its market value at the date of vesting. In other words, there are two assets:

- the vested right to or in the asset – dealt with under para 38(1)(b), and
- the discretionary interest in the trust – dealt with under para 81.

Any expenditure incurred by a beneficiary under para 20 in acquiring a contingent interest in a discretionary trust must be disregarded. This outcome follows from the clear wording of para 81, which deems the base cost, whatever it may be in reality under para 20, to be nil.

Example – Sale of discretionary interest in a trust*Facts:*

Johanna, Kim, Les and Marius are the beneficiaries of a discretionary trust. The only asset of the trust is a holiday home that has a base cost of R360 000. The trustees of the trust vested one-fourth of the house in Marius. The market value of that portion at the time it was vested in Marius was R300 000. The vesting gave rise to a capital gain of R300 000 – (R360 000) × $\frac{1}{4}$ = R210 000 in the trust which was attributed to Marius under para 80(1). The base cost of Marius's vested interest in the house is R300 000 under para 38.

No rights to the house have been vested in any of the other beneficiaries. Johanna and Marius sold their interests in the trust for R150 000 and R350 000 respectively.

Result:

The base cost of Johanna's interest in the trust is nil. Johanna's capital gain on disposal of her interest will therefore be R150 000 while that of Marius will be R50 000 [R350 000 (proceeds) – R300 000 (base cost)]

14.13 Special trusts

Section 1(1) and para 1 – Definition of 'special trust', paras 5(1), 10(a) and 82

Besides this commentary, reference can also be had to the *Guide to the Taxation of Special Trusts (Issue 3)* dated 8 September 2020.

The term 'special trust' is defined in both the Eighth Schedule under para 1 and in s 1(1).

The s 1(1) definition contains two categories of special trust.

14.13.1 Trusts for beneficiaries with a disability [para (a)]

The first category of special trust is one created solely for the benefit of one or more persons who is or are persons with a disability as defined in s 6B and that disability incapacitates such person or persons from earning sufficient income for their maintenance, or from managing their own financial affairs.

The trust is deemed not to be a special trust for years of assessment ending on or after the date on which all such persons are deceased. For example, if the last of the beneficiaries died on 30 June 2019, the trust will not be a special trust for the 2020 year of assessment. If the trust is created for the benefit of more than one person, all those persons must be relatives in relation to each other.

This type of special trust is treated in the same manner as an individual for the purposes of the Eighth Schedule. Under para 1 a special trust means

'a trust contemplated in paragraph (a) of the definition of "special trust" in section 1'.⁷⁴⁴

Paragraph (a) of the definition of 'special trust' in s 1(1) requires that the trust be created 'solely' for the benefit of one or more persons with a disability who meet the qualifying criteria.

⁷⁴⁴ Inserted by the Revenue Laws Amendment Act 74 of 2002 and came into operation from the commencement of years of assessment ending on or after 1 January 2003.

While a special trust as defined in s 1(1) can be a discretionary trust, a vesting trust or a *bewind* trust, the status of a trust as a special trust for CGT purposes is of relevance only if its capital gains or losses fall to be taxed in the trust. Thus, when a beneficiary of a vesting trust has a vested right to the assets or capital gains derived by the trust, those capital gains fall to be taxed in the beneficiary's hands and the provisions of the Act relating to special trusts are not of any application to such capital gains. A *bewind* trust will similarly not benefit from being a special trust, since its capital gains will be taxable in the hands of its beneficiary.

The trust deed of a trust created for a single beneficiary must be examined to determine whether the beneficiary has a vested right to the assets of the special trust. Should the beneficiary have such a vested right, the special trust is essentially ignored for CGT purposes and any capital gains and losses must be determined in the beneficiary's hands with any actions of the trustees merely being actions on behalf of, and for the benefit of, the beneficiary.

Some trust deeds provide that the beneficiary shall have a vested right to the 'trust capital' as opposed to the trust assets. It then becomes necessary to consider the meaning of 'trust capital' with reference to any definition in the trust deed and to determine whether it can be equated with a vested right in the trust assets. It may, for example, merely mean that the beneficiary has a vested right to the residue in the trust at the time of its termination or a vested right to income of a capital nature, but not a vested right (ownership) in the trust assets.

An indicator that the beneficiary does not have a vested right to the assets of the trust would be if the trustees are empowered to borrow money in the name of the trust without the beneficiary being liable for such debts, since the trust will of necessity have to be the owner of the assets in order to meet its liabilities.

The trust deed may also indicate that the beneficiary does not have a vested right to the trust assets upon termination of the trust. If the trust deed provides that the residue must be distributed to the beneficiary's deceased estate, it may indicate that the beneficiary has a vested right to the trust assets. By contrast, if the trust deed provides for the trust assets to be distributed to another person, such as the beneficiary's children or spouse, this would indicate that the beneficiary does not have a vested right to the trust assets.

Having a vested right to the assets of a trust does not mean that the beneficiary must be able to enjoy the trust assets immediately, enjoyment can be postponed despite the beneficiary having unconditional entitlement to the assets.

In all instances it will be necessary to study the terms of the trust deed to determine the extent to which the special trust (as opposed to its beneficiary) is liable for CGT.

It follows that a special trust in which the beneficiary has a vested right to the trust's assets would defeat the purpose of conferring the benefits of the annual exclusion, primary residence exclusion and sliding scale tax rate on the trust because once all the assets of the trust have become vested in the beneficiaries the trust would be out of the picture for CGT purposes, having disposed of all its assets to the beneficiaries under para 11(1)(d). It is submitted that the legislature envisaged that the special trust would be a discretionary trust and that other persons could benefit from the trust assets after the death of the last beneficiary with a disability. See, for example, para 82 which recognises that the trust will continue in existence after the death of the last beneficiary with a disability. However, in order to qualify as a special trust, the trustees must not have any discretion to vest the income or assets of the trust in another person not having a disability while any qualifying beneficiary with a disability is still alive.

The following provisions of the Eighth Schedule which apply to a natural person or the deceased estate of a natural person apply equally to a para (a) special trust:

Table 1 – Provisions affecting special trusts

Paragraph	Provision
5(1)	Annual exclusion
10	Inclusion rate
45(1)	Primary residence exclusion
53(1)	Personal-use assets
59	Compensation for personal injury, illness or defamation
82	Death of beneficiary of special trust

14.13.2 Testamentary trusts for relatives who include minors [para (b)]

The second category covers trusts created under the will of a deceased person solely for the benefit of beneficiaries who are relatives of that deceased person. In order to qualify as a special trust, the beneficiaries must satisfy the following requirements:

- They must all be relatives of the deceased person;
- They must be living on the date of death of the deceased (including a conceived but unborn child); and
- The youngest beneficiary must be under the age of 18 on the last day of the year of assessment of the trust.

It follows that as soon as there are no more beneficiaries under the age of 18 on the last day of the year of assessment, the special trust loses its status as a special trust. For example, if the youngest beneficiary turns 18 on 30 June 2019, the trust will not be a special trust for the 2020 year of assessment.

Under para 10(a) this type of special trust also qualifies for the same 40% inclusion rate as an individual. However, for the purposes of the rest of the Eighth Schedule, this type of special trust is treated as a normal trust.

Its treatment as a normal trust means that it will not enjoy the annual exclusion (2020: R40 000), the primary residence exclusion (2020: R2 million), the exclusion for personal-use assets or the exclusion for amounts received as compensation for personal injury, illness or defamation. Paragraph 82, which enables a trust to remain a special trust for up to two years after the death of a beneficiary, is also inapplicable.

Special trusts pay income tax on the same sliding scale as individuals. By contrast, normal trusts are subject to income tax at a flat rate of 45% (2020). Trusts (whether special or otherwise) are not entitled to the primary, secondary or tertiary rebates granted to individuals under s 6.

14.13.3 Death of beneficiary of special trust (para 82)

Paragraph 82

A trust created solely for the benefit of persons with a disability⁷⁴⁵ loses its status as a special trust for years of assessment ending on or after the death of the last of its beneficiaries with a disability. The rate of tax to be applied to the taxable capital gain of the special trust after the

⁷⁴⁵ A special trust contemplated in para (a) of the definition of a 'special trust' in s 1(1).

death of the beneficiaries with a disability will be the flat rate of 45% (2020) for trusts. Paragraph 82 is aimed at preserving, for purposes of the Eighth Schedule, the status of a trust as special trust in spite of the death of the beneficiary. The trust will continue to be treated as a special trust for purposes of the Eighth Schedule until the earlier of

- the disposal of all assets held by the trust; or
- two years after the beneficiary's death.

During the above period the trust will have an effective CGT rate of $45\% \times 40\% = 18\%$ (2018 to 2020); 2017: 32,8% ($80\% \times 41\%$). After the period ends, the trust will pay CGT at the rate of $80\% \times 45\% = 36\%$ (2018 to 2020; 2017: 32,8% ($80\% \times 41\%$)) and will no longer enjoy the various exclusions such as the annual exclusion and primary residence exclusion.

Chapter 15 – Attribution of capital gains

PART X: ATTRIBUTION OF CAPITAL GAINS

15.1 Summary

This chapter explains the special attribution rules that override the core attribution rules discussed in the previous chapter. Under these special rules a capital gain is deemed back to the donor but the amount that can be deemed back may be restricted depending on the circumstances. If the asset has been financed by a low or interest-free loan from the donor, the amount that can be attributed is limited to

- the interest saving enjoyed by the trust,
- less any income deemed back to the donor under s 7.

There is no limit on the extent of the attribution of a capital gain for an asset funded by a donation. Just as all the income generated by the asset will be deemed back to the donor under s 7, so too will the entire capital gain be deemed back to the donor under these rules. Attribution cannot occur after a donor ceases to exist, for example, because of death.

Part X deals with the attribution of a capital gain as defined in para 1. It follows that capital losses can never be attributed to a donor under Part X, nor can they be set off against attributable capital gains before attribution, even if they arise in the same year of assessment from the same donation, settlement or other disposition. Capital losses will therefore always remain in the trust.

Table 1 – Summary of attribution rules: capital gain deemed back to donor (para 68 to 72)

Event	Paragraph	CGT Consequence
Gain vested in spouse for tax avoidance purposes	68	Taxed in hands of donor spouse. If not avoidance scheme, gain will flow through to spouse beneficiary under para 80
Gain vested in a minor by parent	69	Gain deemed back to donor – no flow through permitted, except to the extent that the gain is not attributable to a donation, settlement or other disposition.
Gain not vested in beneficiary because subject to condition (for example, exercise of trustee's discretion)	70	Taxed in hands of donor. Once a capital gain has been vested, this rule does not apply and the gain will flow through to a resident beneficiary unless another rule applies such as para 68 or 69
Vesting of gain can be revoked by donor	71	Taxed in hands of donor
Asset or gain vested in non-resident beneficiary	72	Taxed in hands of donor

15.2 The meaning of donation, settlement or other disposition

The words 'donation settlement or other disposition' are used throughout the attribution rules in paras 68 to 72. These words have received extensive judicial consideration in relation to s 7, the leading case being *Ovenstone v SIR*⁷⁴⁶ in which the appellant had lent his four

⁷⁴⁶ 1980 (2) SA 721 (A), 42 SATC 55.

children, two of whom were minors, money in order to enable them to acquire shares in a company without security and bearing interest at the same rate that the bank charged him. Having regard to the appellant's business standing, wealth, and relationship with his bank, that rate might well have been a special, low rate. The shares concerned had generated taxable dividend income, and the Secretary had included the dividends derived by the two minors in the appellant's income under section 7(3) on the basis that the failure to charge an arm's length rate of interest constituted a donation, settlement or other disposition. Dismissing the appeal, Trollip JA stated the following:⁷⁴⁷

'To sum up: the critical phrase in s 7(3) – "any donation, settlement or other disposition" – excludes any disposal of property that is a wholly commercial or business one, ie made for due consideration; it covers any disposal of property made wholly gratuitously out of liberality or generosity; it also covers any disposal of property made under a settlement or other disposition for some consideration but in which there is an appreciable element of gratuitousness and liberality or generosity.'

The judge noted that when the transaction was partly gratuitous and partly for consideration, an apportionment between the two elements was permissible. Thus, for example, if an interest rate of 6% were charged but an arm's length rate was 10%, the gratuitous element of 4% (10% – 6%) would comprise a 'donation, settlement or other disposition' and result in attribution of income to that extent.

A summary of the main principles that South African courts have developed in interpreting these words are summarised below:

- A donation involves a gratuitous disposal of an asset out of liberality or generosity. The donee is enriched and the donor correspondingly impoverished. If the donee gives any consideration it is not a donation (see *The Master v Thompson's Estate*⁷⁴⁸ and *Estate Welch v C: SARS*⁷⁴⁹ and the commentary on the latter case in **8.7**), (*Ovenstone* case above).
- As long as the capital remains unpaid, the failure to charge interest on a loan is a continuing donation of the interest (*CIR v Berold*⁷⁵⁰).
- The phrase 'any donation, settlement or other disposition' excludes any disposal of property made for due consideration, but covers any disposal of property
 - made wholly gratuitously out of liberality or generosity; or
 - made under a settlement or other disposition for some consideration but in which there is an appreciable element of gratuitousness and liberality or generosity. (*Ovenstone's* case above)
- The expression 'donation, settlement or other disposition' must be read *eiusdem generis*⁷⁵¹ as 'donation, settlement or other similar disposition' (*Ovenstone's* case above). In other words, the word 'disposition' must be given a restrictive meaning.

⁷⁴⁷ At SATC 76.

⁷⁴⁸ 1961 (2) SA 20 (FC), 24 SATC 157 at 24F–26C, 48F–49C .

⁷⁴⁹ 2005 (4) SA 173 (SCA), 66 SATC 303.

⁷⁵⁰ 1962 (3) SA 748 (A) at 753F, 24 SATC 729 at 735–6.

⁷⁵¹ Under this rule of interpretation, when specific words are followed by general words, the general words must be restrictively interpreted to have the same sense or to refer to the same class as the specific words.

- In *CIR v Woulidge*⁷⁵² assets were sold at market value on an interest-free loan. The loan itself was held not to be a donation because due consideration had been received in respect of the sale. This fact was evident from
 - the terms of the deed of sale,
 - the market-related purchase price, and
 - the subsequent repayment of the loan.
- If the disposition contains both appreciable elements of gratuitousness and of proper consideration, an apportionment may be made between the two elements. This apportionment is for the purpose of determining the deemed income received by or accrued to the donor. The taxpayer bears the burden of proof to show that such an apportionment is possible and how a court should give effect to it (*Ovenstone's case* above at 740D–F). See also *Joss v SIR*.⁷⁵³
- In determining the rate of interest that should be charged on a loan, regard must be had to what the trust would have paid had it borrowed the funds on normal commercial terms. The rate that the donor would have paid is irrelevant (*Ovenstone's case* above).
- The *in duplum* rule which restricts the amount of interest that can be charged on a loan to the outstanding capital balance, does not apply in determining the amount of interest to be attributed to a donor under the attribution rules. It can be applied only in the real world of commerce and economic activity where it serves considerations of public policy in the protection of borrowers against exploitation by lenders (*Woulidge's case* above). This principle has now been codified in s 7D, which also provides that interest must be calculated as simple interest on a daily basis.

In deciding whether a capital gain is attributable to a donation, settlement or other disposition, the principle established in *CIR v Widan*⁷⁵⁴ must be applied. In other words, there must be some close causal relation between the capital gain and the donation. In determining this connection, regard must be had to the real efficient cause of the capital gain being generated. This determination should be a fairly simple exercise with an asset financed directly by an interest-free or low-interest loan.

15.3 Attribution of capital gain to spouse (para 68)

Paragraph 68

The treatment of a person's capital gains that are derived directly or indirectly from that person's spouse mirrors that afforded to ordinary income under s 7(2). That part of a person's capital gain as can be attributed under this rule 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 taken into account in the hands of that spouse when the latter made, entered into or carried out that transaction mainly for purposes of the avoidance of any tax, duty or levy administered by the Commissioner. The Acts administered by the Commissioner involving tax, duties or levies are set out in Schedule 1 of the South African Revenue Service Act 34 of 1997. At the time of writing (February 2020) the Commissioner administered 24 different Acts and sections

⁷⁵² 2002 (1) SA 68 (SCA), 63 SATC 483.

⁷⁵³ 1980 (1) SA 674 (T), 41 SATC 206.

⁷⁵⁴ 1955 (1) SA 226 (A), 19 SATC 341.

of Acts, and any regulation, proclamation, government notice or rule issued under the listed legislation or any agreement entered into under this legislation or the Constitution. Some of the more well-known Acts administered include the following:⁷⁵⁵

- Customs and Excise Act 91 of 1964
- Diamond Export Levy Act 15 of 2007
- Diamond Export Levy (Administration) Act 14 of 2007
- Employment Tax Incentive Act 26 of 2013
- Estate Duty Act 45 of 1955
- Income Tax Act 58 of 1962
- Merchant Shipping (International Oil Pollution Compensation Fund) Administration Act 35 of 2013
- Mineral and Petroleum Resources Royalty Act 28 of 2008
- Mineral and Petroleum Resources Royalty (Administration) Act 29 of 2008
- Sections 4 and 28 of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003
- Securities Transfer Tax Act 25 of 2007
- Securities Transfer Tax Administration Act 26 of 2007
- Skills Development Levies Act 9 of 1999
- Tax Administration Act 28 of 2011
- Transfer Duty Act 40 of 1949
- Value-Added Tax Act 89 of 1991
- Unemployment Insurance Contributions Act 4 of 2002
- Voluntary Disclosure Programme and Taxation Laws Second Amendment Act 8 of 2010

This rule also applies when a person's capital gain is derived from a trade carried on by that person in association or in partnership with that person's spouse or when it is derived from that spouse or from a partnership or company at a time when that spouse was a member of that partnership or the sole, main or one of the principal holders of shares in that company. The rule then applies to 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 taking into account amongst other things, the nature of the relevant trade, the extent of that person's participation in it and the services rendered by that person.

A donation by a person to that person's spouse will as a rule not result in a capital gain in that person's hands, since the base cost of that asset will be transferred to that spouse under s 9HB. However, if the donation was made mainly for purposes of avoiding a tax, duty or levy administered by the Commissioner, the subsequent disposal of the asset by the spouse to whom it was donated might result in the inclusion of any resultant capital gain in the hands of

⁷⁵⁵ See Schedule 1 of the South African Revenue Service Act 34 of 1997 for a list of legislation administered by the Commissioner.

the spouse who made the donation. Such donation, settlement or other disposition made by a person to a trust of which that person's spouse is a beneficiary, might also result in the application of this rule when a trust asset or the capital gain from the disposal of such asset is subsequently vested in that spouse.

Example – Attribution of capital gain to spouse

Facts:

Barker and his wife Cherel operate a successful car rental business in partnership at O R Tambo International Airport. Since Barker takes a leading role in the business while his wife's involvement is minimal, they share profits in the ratio of 90:10. They had originally bought the car-hire franchise for R100 000 in 2002, with Barker contributing R90 000 and his wife R10 000. During the 2020 year of assessment with business booming, Barker decided it was time to retire. In order to avoid CGT, he transferred his share in the business to Cherel. Under s 9HB Barker was treated as making neither a capital gain nor loss on the transfer, while Cherel was deemed to have acquired it for an expenditure of R90 000. During the same year of assessment, she sold the business to a third party for R430 000 and she and Barker moved to Hermanus. She included the taxable capital gain of R116 000 in her 2020 tax return ($R430\,000$ (proceeds) – $R100\,000$ (base cost) = $R330\,000$ – $R40\,000$ (annual exclusion) = $R290\,000 \times 40\%$ (inclusion rate)). Because she was over 65, she fell below the tax threshold and paid no tax. Assume that Barker did not qualify for the small business asset exclusion in para 57. Note: For the sake of simplicity it is assumed that the business comprised a single asset but in practice capital gains must be determined for each individual asset making up a business, since a 'business' is not an asset.

Result:

Harry, a tax auditor with SARS noticed the transaction, and after establishing the facts, and being satisfied that this was a scheme the sole purpose of which was to avoid CGT, subjected 90% of the capital gain of R330 000 to tax in Barker's hands under para 68.

See Example 6 in **Chapter 14** for another example of the application of this rule.

15.4 Attribution of capital gain to parent of minor child (para 69)

Paragraph 69

This rule mirrors the rule embodied in s 7(3) and (4) under which income received by, accruing to or in favour of or expended for the benefit of a minor is in certain circumstances deemed to be that of a parent of that minor. Any amount of a minor child's capital gain or of a capital gain that has vested in or is treated as having vested in that child during the year in which it arose and that is attributable to a donation, settlement or other disposition made by a parent of that child is treated as the capital gain of that parent. This rule also applies when the gain is attributable to a donation, settlement or other disposition made by another person in return for some donation, settlement or other disposition or some other consideration made or given by a parent of that child in favour, directly or indirectly, of that person or his or her family.

If an asset was acquired by a trust with an interest-free or low-interest loan before the valuation date, the amount of the benefit derived before that date must not be taken into account in determining how much of the capital gain to attribute to the 'donor'. The benefit in this instance is the non-charging of interest at an arm's length rate. Since the Eighth Schedule was introduced with effect from 1 October 2001, and given that base cost is determined at that date, it can be only the non-charging of interest on or after that date that contributes to the capital gain.

Example – Parent – minor child disposition*Facts:*

On 1 October 2016 Lorna lent R100 000 interest-free to the Lorna Family Trust. Had the trust borrowed the funds on overdraft it would have paid interest at the annual rate of 15%. The discretionary beneficiaries of the trust are Lorna, and her two minor children, Conrad and Bronwyn. The trustee used the funds to purchase some listed shares in Mbona Ltd, a company listed on the JSE. On 29 February 2020 the trustee sold the shares at a capital gain of R205 000 and vested it in Conrad (16) and Bronwyn (14) in equal shares. No dividends were derived during the period that the shares were held by the trust.

Result:

There has been a donation, settlement or other disposition in that no interest has been charged on the loan. The following interest would have been payable on the loan on or after the valuation date had the funds been borrowed from the bank:

Year ended	R
28 February	
2017 (R15 000 × 5 / 12)	6 250
2018	15 000
2019	15 000
2020	15 000
	51 250

Under para 69, R51 250 of the capital gain of R205 000 will be taxed in the hands of Lorna, while the balance (R153 750) will be taxed in the hands of Conrad (R76 875) and Bronwyn (R76 875).

15.5 Attribution of capital gain subject to conditional vesting (para 70)

Paragraph 70

In specified circumstances, capital gains arising as a result of a conditional donation or similar transaction can be attributed to the donor under para 70.

The circumstances arise when

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

A common form of conditional vesting occurs when the vesting of a trust asset or capital gain in a beneficiary is subject to the trustees' discretion.

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

Paragraph 70 is similar to s 7(5).

When an asset acquired by the trust is funded by a low or interest-free loan, the amount of the capital gain to be attributed to the donor (the lender) under para 70 is limited to the benefit derived by the trust. This benefit is the difference between the interest that the trust actually paid and the interest that the trust would have paid had it borrowed the funds from a third party on an arm's length basis. But when the acquisition of the asset is funded by a donation, there is no limit on the amount of the capital gain that can be attributed to the donor.

Example – Attribution of capital gain subject to conditional vesting

Facts:

Frank (35) and Furter (37) are resident beneficiaries of the Frankfurter Family Trust, a resident discretionary trust formed by their grandfather. Under the trust deed, the trustee has an unfettered discretion whether to vest any of the income or capital of the trust in the beneficiaries. On 1 March 2017 their father, Trevor, lent R100 000 to the trust which the trustee used to purchase listed shares on a South African exchange. Had the trust borrowed the funds from the bank, it would have paid interest at the annual rate of 15%. On 29 February 2020 the trustee sold the shares at a capital gain of R60 000. Of this amount he vested R10 000 in Frank, while the remaining R50 000 was retained in the trust. All dividends earned on the shares were vested in Frank and Furter.

Result:

The trust saved interest of $R100\ 000 \times 15\% \times 3 = R45\ 000$ over the three years that the shares were held. Under para 70, R45 000 of the capital gain left in the trust must be taxed in the hands of Trevor, while R5 000 will be taxed in the trust. Had the trustee vested the entire gain of R60 000 in Frank and Furter, it would have been taxed in their hands and there would have been no attribution to Trevor. Had Trevor donated the amount of R100 000 to the trust, the entire amount of R50 000 would have been attributed to him.

Paragraph 70 requires a capital gain to be attributed to the donor, not an aggregate capital gain. Thus, if a trust had a capital gain subject to attribution under para 70 on disposal of asset 1 of R100 and a capital loss on disposal of asset 2 of R100, the capital gain of R100 would be attributed to the donor while the capital loss of R100 would remain in the trust.

15.6 Attribution of capital gain subject to revocable vesting (para 71)

Paragraph 71

Under para 71 a capital gain arising as a result of a revocable vesting can in certain circumstances be attributed to the donor.

The circumstances are those in which

- a donation, settlement or other disposition confers a right upon a beneficiary who is a resident to receive a capital gain attributable to that donation, settlement or other disposition,
- that right may be revoked or conferred upon another by the person who conferred it; and
- that capital gain has in terms of that right vested in that beneficiary during a year of assessment throughout which the person who conferred that right has been a resident and has retained the power to revoke that right.

In these circumstances the capital gain will be taken into account in determining the aggregate capital gain or loss of the person who retained the power of revocation and disregarded in the determination of the aggregate capital gain or loss of the beneficiary.

Paragraph 71 is similar to s 7(6).

Example – Revocable vesting

Facts:

Scrooge Jr, aged 25, is the sole beneficiary of the Scrooge Family Trust. Under the trust deed the trustee has the discretion to vest the assets or income of the trust in Scrooge Jr. In addition, the trustee also has the power to revoke the vesting of the income or assets in Scrooge Jr should the trustee be satisfied that Scrooge Jr has acted irresponsibly in managing his financial affairs.

During year 1 the trustee vested a piece of land in Scrooge Jr giving rise to a capital gain of R100 000 in the trust. In year 2, after Scrooge Jr had wasted R20 000 of his funds in an unsuccessful gambling spree at a casino, the trustee revoked the vested right that he had conferred on Scrooge Jr.

Result:

Under para 71 the capital gain of R100 000 will be taxed in the Scrooge Family Trust in year 1.

Note: It is irrelevant that the vesting was revoked in the subsequent year of assessment. Attribution occurs because the trustee has the power to revoke the vested right. Whether that power is exercised is irrelevant.

15.7 Attribution of capital gain vesting in a person who is not a resident (para 72)

Paragraph 72

Circumstances in which attribution to donor applies [para 72(1)]

The attribution rules in para 72 apply when

- a donation, settlement or other disposition (see **15.2**) is made by a resident to any person⁷⁵⁶ (other than an entity that is not resident and which is similar to a public benefit organisation contemplated in s 30);⁷⁵⁷ and
- a capital gain (including any amount that would have constituted a capital gain had that person been a resident)⁷⁵⁸ attributable to that donation, settlement or other disposition has arisen during a year of assessment; and
- an amount consisting of or derived, directly or indirectly, from
 - that capital gain; or
 - the amount that would have constituted a capital gain,

⁷⁵⁶ This person could be a resident (for example, a resident trust) or a non-resident.

⁷⁵⁷ Amended with effect from 22 December 2003 by s 112 of Act 45 of 2003. Previously the provision referred to a foreign entity as defined in s 9D of a similar nature.

⁷⁵⁸ The words in brackets were inserted by the Revenue Laws Amendment Act 31 of 2005, came into operation on 1 February 2006, and apply in respect of any capital gain determined in respect of any disposal on or after that date.

has during that year vested in or is treated as having vested in any person who is not a resident (other than a controlled foreign company, in relation to that resident).

Inapplicability of para 64B when determining capital gain on disposal of foreign shares [para 72(2)]

Under para 72(2)⁷⁵⁹ In determining, for purposes of para 72(1), whether an amount would have constituted a capital gain had a person been a resident, the provisions of para 64B(1) and (4) must be disregarded in respect of an amount derived by that person, directly or indirectly, from the disposal of an equity share in a foreign company if

- more than 50 per cent of the total participation rights, as defined in s 9D(1), or of the voting rights in that company are directly or indirectly held or are exercisable, as the case may be, by that person whether alone or together with any one or more persons that are connected persons in relation to that person; and
- the resident who made the donation, settlement or other disposition or any person that is a connected person in relation to that resident is a connected person in relation to the person who is not a resident; and
- to the extent to which that amount is not included in the income of or attributed as a capital gain to
 - the resident who made that donation, settlement or other disposition; or
 - a resident who is a connected person in relation to the resident referred to in the immediately preceding bullet point.

Paragraph 64B(1), known as the participation exemption, in essence requires a person to disregard a capital gain or loss on disposal of equity shares in a foreign company when

- the equity shares have been held for at least 18 months prior to disposal;
- the person holds an interest of at least 10% of the equity shares and voting rights; and
- the equity shares are disposed of to a non-resident.

Paragraph 64B(4) requires a person to disregard a capital gain determined in respect of the receipt or accrual of a foreign return of capital if the person holds at least 10% of the foreign company's equity shares and voting rights. Such a capital gain could arise under para 76B(3) if the foreign return of capital exceeded the base cost of the shares. Note that shares in a land-rich company contemplated in para 2(2) holding South African immovable property are excluded from the participation exemption.

⁷⁵⁹ Paragraph 72(2) came into operation on 1 March 2019 and applies in respect of amounts vesting on or after that date.

Example 1 – inapplicability of participation exemption when determining amount to be attributed to resident donor [para 72(2)]*Facts:*

Des established the Des Family Trust on one of the Channel Islands for the benefit of himself, his wife and children. The trust was funded with an interest-free loan account. The trustees used the funds to acquire 51% of the equity shares in ABC Ltd, a foreign company which carried on business outside South Africa at a cost of R1 million. Five years later the trustees disposed of all the shares to a non-resident for R3 million. They did not vest the capital profit of R2 million in any beneficiary of the trust.

Result:

Had it been a resident, the Des Family Trust would have realised a capital gain of R2 million (R3 million proceeds – R1 million base cost). A donation, settlement or other disposition has arisen as a result of Des making the interest-free loan to his family trust. This continuing donation will potentially result in attribution to Des of the whole or a part of the capital gain of R3 million under para 72(3). The fact that the capital gain would have been disregarded under para 64B had the trust been a resident must be ignored under para 72(2) because

- the trust held more than 50% of the participation rights or voting rights in the company;
- Des is a connected person in relation to the trust because he is a beneficiary of the trust [para (a) of the definition of ‘connected person’ in s 1(1)]; and
- the trust has not vested the capital gain in Des, his wife or children and hence no capital gain has been attributed to any of them under para 80(2).

Attribution to donor [para 72(3)]

In the circumstances described in para 72(1), the capital gain or amount that would have constituted a capital gain had the person been a resident must be disregarded in the hands of the person in whom it vests and be taken into account when determining the aggregate capital gain or loss of the person who made the donation, settlement or other disposition.

The word ‘vest’ means ‘become unconditionally entitled to’. Although it is usually used in describing the action of a trustee in conferring entitlement to a capital gain or asset on a beneficiary, the word is used in a wider sense in para 72. This usage can be seen from the absence of a reference to a trust or a beneficiary in para 72. Thus, for example, a capital gain (including any amount which would have constituted a capital gain) will vest

- in a non-resident trust if the trustee sells an asset to a third party and retains the capital gain; or
- in a non-resident individual who sells the asset giving rise to that capital gain.

The words ‘treated as having vested’ would apply, for example, to a resident or non-resident trust if the trustee vests a capital gain in a non-resident beneficiary. In this situation para 80(2) does not permit the attribution of a capital gain to a non-resident beneficiary, and the capital gain will for CGT purposes be treated as having vested in the trust.

The words

‘any amount that would have constituted a capital gain had that person been a resident’

were inserted in para 72(b) from 1 February 2006 to widen the meaning of a capital gain in the context of a non-resident for the purposes of para 72. Under para 2(1)(b) the Eighth Schedule applies only to two categories of assets of a non-resident, namely, South African immovable property including specified rights and interests in such property and assets effectively connected with a permanent establishment in South Africa. Were it not for the above words, it could be argued that non-residents cannot derive capital gains from the sale of other assets such as listed shares, and hence that such gains cannot be attributed back to the resident donor. Section 7(8), the ordinary income equivalent of para 72, was similarly amended in 2004.

Example 2 – Attribution of capital gain vesting in non-resident

Facts:

On 1 March 2017 Millhouse sold an asset to the Millhouse Family Trust at market value of R100 000. The trust was a discretionary trust. The purchase price was credited to his loan account, and no interest was charged on the loan. Had the trust borrowed the funds from the bank to purchase the asset, it would have paid interest at the annual rate of 15%. The beneficiaries of the trust are Millhouse and his son Richard who resides in Brisbane, Australia. On 29 February 2020 the trustee vested the asset in Richard at a time when its market value was R150 000.

Result:

The interest saved by the trust amounted to R45 000 ($R100\,000 \times 15\% \times 3$). Under para 11(1)(d) the vesting of an asset in Richard is a disposal. Since Richard is a connected person in relation to the trust, the transaction must be accounted for at market value under para 38. Therefore, the vesting of the asset gives rise to a capital gain of R50 000 ($R150\,000 - R100\,000$). Of this amount, R45 000 will be taxed in the hands of Millhouse under para 72, and the remaining R5 000 will be taxed in the trust. Paragraph 80 makes no provision for a flow-through of a capital gain to a non-resident beneficiary.

Paragraph 72 does not apply to a person who made a donation, settlement or similar disposition to a trust before becoming a resident. The donor must be a resident at the time of making the donation, settlement or similar disposition and it is irrelevant if that donor subsequently becomes a resident. In the United Kingdom case of *Inland Revenue Commissioners v Willoughby & related appeal*⁷⁶⁰ the House of Lords held that an individual, who had transferred assets abroad before becoming ordinarily resident in the United Kingdom, could not be brought within the relevant anti-avoidance provision because it required the avoider to be ordinarily resident at the time of the transfer.

15.8 Attribution of income and capital gain (para 73)

Paragraph 73

An amount of income and a capital gain derived from or attributable to a donation, settlement or other disposition made by a person might be subject to the attribution rules in s 7 and paras 68 to 72, respectively. In the absence of para 73 this simultaneous attribution of income and a capital gain might have resulted in the taxation of both amounts in the hands of the person who made the donation, settlement or other disposition. Paragraph 73 limits the total

⁷⁶⁰ [1997] 4 All ER 65.

amount of the income and capital gain that can be taxed in the hands of that person to the amount of the benefit derived from that donation, settlement or other disposition by the person to whom it was made. The quantified benefit to the latter person from, for example, an interest-free or low-interest loan will therefore determine the extent to which any resulting income and capital gain can be attributed to the person who provided that benefit. In applying s 7 the word 'income' is not used in its defined sense of gross income less exempt income. This outcome was the finding of the court in *CIR v Simpson*,⁷⁶¹ a case that dealt with the meaning of the word 'income' as used in the equivalent of s 7(2). After examining the history of the provision, the court held that the word 'income' should be given its ordinary meaning of profits or gains (that is, after allowable deductions).

Based on the principle that 'income' means 'profits or gains' it is submitted that exempt income such as a local dividend, is subject to attribution under s 7. This interpretation will reduce the amount of the benefit that can be used to attribute any capital gain. In addition, it is considered that s 7 must be applied before para 73.

Example 1 – Attribution of exempt income and capital gain

Facts:

At the beginning of year 1 Dirk lent R100 000 interest-free to his discretionary family trust. Had the trust borrowed the funds from a bank it would have paid interest at the rate of 10% a year. The trust used the funds to purchase South African-listed shares. During the year dividends of R3 000 were received. On the last day of the year of assessment the shares were sold for R110 000. Assume that the disposal is on capital account and that the Trust did not distribute the income of the trust or the capital gain to any beneficiary.

Result:

The benefit derived by the trust from the loan is $R100\,000 \times 10\% = R10\,000$. First, R3 000 of the benefit is deemed back to Dirk under s 7(5), since it represents the 'profit' of the trust (cf *Simpson's* case). Secondly, the remaining benefit of $R10\,000 - R3\,000 = R7\,000$ is used to attribute R7 000 of the capital gain to Dirk. The remaining portion of the capital gain (R3 000) is taxed in the trust.

If an asset was acquired by a trust with an interest-free or low-interest loan before the valuation date, the amount of the benefit derived before that date must not be taken into account in determining how much of the capital gain to attribute to the 'donor'. The benefit in this instance is the non-charging of interest at an arm's length rate. Since the Eighth Schedule was introduced with effect from 1 October 2001, and given that base cost is determined at that date, it can be only the non-charging of interest on or after that date that contributes to the capital gain.

There is also a general presumption against the retrospective application of a statute (see 1.2.7). It follows that the incidence of the tax should not be determined by events that took place before the valuation date.

⁷⁶¹ 1949 (4) SA 678 (A), 16 SATC 268.

Example 2 – Attribution of income and capital gain*Facts:*

On 1 July 1997 Wayne sold a residential building to the Wayne Family Trust for R1 million. The purchase price was funded by an interest-free loan from Wayne. Had the trust funded the acquisition by obtaining a bond from a bank, it would have paid interest at the rate of 15% a year.

The property was let from the date of acquisition until the date of disposal and the following rental income was derived:

1998: R95 000, 1999: R100 000, 2000: R105 000, 2001: R110 000, 2002: R110 000, 2003: R120 000.

The market value of the property on valuation date was R1,2 million, and this was adopted by the trust as the valuation date value. On 28 February 2003 the trust sold the property for R1,5 million and reinvested the funds in another project. The trust did not distribute any portion of its income or capital gain to the beneficiaries of the trust.

Result:

The net rental income derived by the trust, the amount deemed back to Wayne under s 7(5) and the balance that could not be deemed back because the income was insufficient is summarised below.

The maximum amount that can be attributed to Wayne each year is as follows:

1998 year of assessment (1 July 1997 to 28 February 1998): $R1\,000\,000 \times 15\% \times 8 / 12 = R100\,000$

Subsequent years of assessment: $R1\,000\,000 \times 15\% = R150\,000$

Year ended 28 February	Net rental income	Amount attributed to Wayne under s 7(5)	Balance of benefit [15% x R1 million x period less amount attributed under s 7(5)]
	R	R	R
1998	95 000	95 000	5 000
1999	100 000	100 000	50 000
2000	105 000	105 000	45 000
2001	110 000	110 000	40 000
2002	110 000	110 000	40 000
2003	120 000	120 000	<u>30 000</u>
			<u>210 000</u>

The capital gain derived by the trust is as follows:

Proceeds	R 1 500 000
Less: Base cost	(1 200 000)
Capital gain	<u>300 000</u>

The portion of this gain to be attributed to Wayne under para 73 is determined as follows:

2002 $R40\,000 \times 5 / 12$	R 16 667
2003	<u>30 000</u>
	<u>46 667</u>

The remaining portion of the capital gain of R300 000 – R46 667 = R253 333 will be taxed in the trust. The continuing donation of interest before 1 October 2001 has not been taken into account in determining the quantum of the capital gain to be attributed to the donor. It is considered that since the capital gain relates to the post-1 October 2001 period, only the donation of interest during that period should be taken into account.

See Example 6 in **Chapter 14** for another example of the application of this rule.

15.9 Amnesty – attribution after deemed disposal by electing party

Section 4(3)(b) of the Exchange Control Amnesty and Amendment of Taxation Laws Act, 2003; Regulations issued under s 30 of the aforementioned Act⁷⁶²

Section 18 of the Rates and Monetary Amounts and Amendment of Revenue Laws Act 13 of 2016

15.9.1 Background

Under s 4 of the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003 (Amnesty Act), a resident was entitled to elect to be the deemed owner of the assets of a non-resident discretionary trust. The electing party is deemed to have acquired the assets at market value on 1 March 2002 and to have disposed of them at market value when the trust disposes of them to any other person.

Similar rules were again introduced in the form of additional voluntary disclosure relief under s 18 of the Rates and Monetary Amounts and Amendment of Revenue Laws Act 13 of 2016 (SVDP legislation). The electing party is deemed to have held the asset from the date that the discretionary trust acquired it and to have disposed of it when

- the asset is disposed of by the trust;
- the electing party would be treated as having disposed of the asset under the Income Tax Act [for example, when the electing party ceases to be a resident (s 9H) or dies (s 9HA)]; or
- in the case of a deceased estate, company or other juristic person, the day before that person ceases to exist by operation of law.

15.9.2 Suspension of attribution rules

Section 4(3)(b) of the Amnesty Act provides that

‘the provisions of sections 7(5), 7(8) and 25B of the Income Tax Act, 1962, and paragraphs 70, 72 and 80 of the Eighth Schedule to that Act, shall not apply in respect of any income, expenditure or capital gain relating to that foreign asset, *while* it is so deemed to be held by that person’.

(Emphasis added.)

⁷⁶² GN R 1368 GG 25511 of 29 September 2003.

Regulation 7 provides as follows:

‘7. For the purposes of section 4(3)(b) of the Act—

(a) sections 7(5), 7(8) and 25B of the Income Tax Act, 1962, and paragraphs 70, 72 and 80 of the Eighth Schedule to the Income Tax Act, 1962, do not apply in respect of—

(i) any income received or accrued or expenditure incurred by a trust relating to a foreign asset; or

(ii) any capital gain determined by a trust in respect of the disposal of a foreign asset,

during the period that the foreign asset is deemed to be held by the donor in terms of section 4(1) of the Act; and

(b) any income received or accrued or expenditure incurred by a trust before 1 March 2002 in respect of a foreign asset is deemed to have been received or accrued or incurred, as the case may be, during the period that the foreign asset is so deemed to be held by that person.’

Similarly, section 18(4) of the SVDP legislation provides as follows:

‘(4) Sections 7(5), 7(8) and 25B of the Income Tax Act and paragraphs 70, 72 and 80 of the Eighth Schedule to that Act, must not apply in respect of any income, expenditure or capital gain relating to that asset, during the time an asset is deemed to be held by the person as contemplated in subsection (1).’

15.9.3 Attribution during the period of deemed ownership

The use of the word ‘while’ in s 4(3)(b) of the Amnesty Act and the words ‘during the time’ in s 18(4) of the SVDP legislation make it clear that attribution under the specified provisions is suspended during the period of deemed ownership. In the case of the 2003 amnesty, this view is reinforced by Regulation 7(a), which more or less repeats in a slightly expanded form what is stated in the Amnesty Act. It was necessary to suspend the attribution rules during this period in order to prevent the same amount from being taxed twice.

15.9.4 Attribution before the period of deemed ownership

Section 4(3)(b) of the Amnesty Act suspended attribution only during the period of deemed ownership. It said nothing about the period before such deemed ownership, which meant that potential amnesty applicants would not have been shielded from attribution in respect of this period. In order to prevent the taxation of such amounts, Regulation 7(b) was introduced. It deems income received or accrued and expenditure incurred by the trust before 1 March 2002 to have been received or accrued or incurred as the case may be, during the period of deemed ownership. This deeming is only for the purposes of s 4(3)(b) of the Amnesty Act – in other words, for the purposes of suspending the attribution rules.

15.9.5 Resumption of attribution upon cessation of deemed ownership

The use of the word ‘while’ in s 4(3)(b) of the Amnesty Act and the words ‘during the time’ in s 18(4) of the SVDP legislation suggest that attribution under the specified provisions is suspended only while the electing party is the deemed owner. Once deemed ownership ends, there is by implication a return to reality, and attribution resumes in the normal way. There is a counter argument that the deemed sale at market value precludes any further attribution. It is submitted, however, that such an interpretation conflicts with the use of the word ‘while’ in s 4(3)(b) and the words ‘during the time’ in s 18(4)). It also has the effect of extending the

amnesty to the post-amnesty period, which could never have been the intention of the legislature. The purpose of the deemed disposal at market value was to determine a capital gain or loss in the deemed owner's hands, and to prevent the imposition of donations tax on the deemed owner.

SARS is aware that some financial institutions are aggressively punting a scheme which they claim prevents attribution under s 7(8) and para 72 after cessation of deemed ownership. The scheme involves the transfer of the assets of the trust to a second trust (referred to as a 'pour-over' trust). The promoters of the scheme contend that this will break the link between the original donation and the disposal of the assets by the pour-over trust, and hence render s 7(8) and para 72 ineffective. SARS does not accept this contention, since the capital gain in the pour-over trust is attributable to, and the proximate cause of, the original donation.⁷⁶³ Taxpayers entering into such schemes face the prospect of the imposition of penalties and s 89*quat* interest should they fail to declare income and capital gains arising in the pour-over trust.

Example – Attribution of capital gain after cessation of deemed ownership under the amnesty legislation

Facts:

In 1998 Michael took R1 million offshore in contravention of the exchange control regulations and donated it to the Michael Family Trust, a non-resident discretionary trust established in Jersey. He did not declare the amount for donations tax purposes. The trustee purchased shares in Propco Ltd, a company registered in the Cayman Islands. Propco's sole asset consisted of a penthouse in Umhlanga Rocks. The market value of the shares on 1 March 2002 was R1,5 million. In October 2003 Michael applied for amnesty and made the required election under s 4 of the Amnesty Act in respect of the Propco shares. On 1 March 2005 when the shares were valued at R2,1 million the trustee vested the shares in the Michael 2 Trust, another Jersey-based trust. On 30 June 2019 the Michael 2 Trust sold the shares to a third party for R3 million.

Result:

On 1 March 2002 Michael became the deemed owner of the Propco shares with a base cost of R1,5 million. On 1 March 2005 he was deemed to have disposed of them for R2,1 million resulting in a capital gain in his hands of R600 000. In the 2020 year of assessment the capital gain arising in the Michael 2 Trust of R900 000 (R3 million – R2,1 million) will be attributed to Michael under para 72. This result occurs because the shares were acquired out of proceeds that can be traced back to the donation Michael made to the Michael Trust. The attribution rules resume once Michael ceases to be the deemed owner.

15.10 Right of recovery

Section 90

Under the proviso to s 90, any person may recover so much of the tax paid by him or her as is due to the inclusion in his or her taxable income of any capital gain under para 68, 69, 70, 71 or 72 from the person entitled, whether personally or in a representative capacity, to the proceeds on the disposal of the asset, which gave rise to the capital gain. This provision is aimed at preventing a cash-flow problem for the donor who has a deemed capital gain but lacks the funds to pay the attributable tax. The right to claim the tax back from the donee is at the discretion of the donor.

⁷⁶³ See *CIR v Widan* 1955 (1) SA 226 (A), 19 SATC 341.

Chapter 16 – Deceased estates

16.1 Introduction

A number of significant amendments affecting deceased persons and their deceased estates came into operation on 1 March 2016 and apply to persons dying on or after that date. For the position before 1 March 2016, see issue 5 of this guide.

The changes affecting CGT involved moving some of the rules in paras 40, 41 and 67 to the main body of the Act in the form of a new s 9HA and a redrafted s 25. Section 9HA deals with the deceased person, while s 25 deals with the deceased estate and heirs or legatees, including a surviving spouse. Some of the more noteworthy effects of these changes are the following:

- Before 1 March 2016 there was no deemed recoupment of capital allowances on the date of death. An allowance asset was deemed to be disposed of at market value under para 40(1) on the date of death but this disposal applied only for purposes of the Eighth Schedule. Consequently, the difference between the deemed proceeds and the base cost (tax value) of an asset was accounted for as a capital gain or loss. On or after 1 March 2016 an allowance asset is deemed to be disposed of on the date of death under s 9HA(1) for the purposes of the Act as a whole, thus potentially bringing any previously claimed allowances within the ambit of s 8(4)(a) and s 11(o). Thus, the deemed disposal of an allowance asset under s 9HA(1) may trigger an income inclusion under s 8(4)(a) or revenue loss under s 11(o). A capital gain could also arise in addition to any recoupment if the market value of the allowance asset on the date of death exceeds its cost.
- Before 1 March 2016 the amount by which the market value of trading stock held and not disposed of on the date of death exceeded its closing stock value was dealt with as a capital gain because the trading stock was regarded as held by the deceased on the date of death for the purposes of s 22(1) while for CGT purposes it was regarded as disposed of. Now s 9HA deems trading stock to be disposed of on the date of death at market value, which results in the deemed consideration being included in the deceased person's gross income and hence excluded from proceeds under para 35(3)(a).
- Similarly, before 1 March 2016 farmers included the standard value of livestock on date of death in closing stock, with the difference between market value and standard value giving rise to a capital gain. On or after 1 March 2016 the livestock is no longer held and not disposed of as a result of the deemed disposal under s 9HA(1) and a farmer must include the market value of livestock in gross income on the date of death. The market value of produce will similarly be included in gross income on the date of death and will no longer be accounted for as closing stock.
- The roll-over treatment previously afforded on death under para 67(3) continues under s 9HA(1)(a) and (2) for the deceased person and under s 25(4) for the surviving spouse, but has now been extended to allowance assets, trading stock, livestock and produce.
- Section 25 used to permit income derived by the estate to flow through to ascertainable heirs or legatees, while capital gains and losses realised by the executor had to be accounted for by the estate. Thus, under the previous system relatively few estates had to be brought on register for income tax purposes. It was only those estates that derived a taxable capital gain or those exceptional estates in which there were no ascertainable heirs or legatees which could have been potentially liable for income tax.

On or after 1 March 2016 the position regarding capital gains remains unchanged. If the estate realises a taxable capital gain, it will be liable for any resulting CGT in its own right. The substantial change has come about with the treatment of income derived by the estate. Income is no longer permitted to flow through to an ascertainable heir or legatee and the estate must account for all its income until the liquidation and distribution account becomes final, after which the heirs must account for the income, even if it is derived in the name of the estate (for example, interest on an estate bank account). The fact that income earned during the 21-day period is not reflected in the liquidation and distribution account is irrelevant for the purposes of determining the estate's tax liability. Executors must ensure that they have withheld an amount equal to the estate's tax liability before distributing funds to the heirs, lest they be held personally liable for the estate's tax liability under s 155 of the Tax Administration Act. The fact that interest income continues to be generated on the estate bank account is no bar to the finalization of the estate's tax liability because any interest earned on the account after the date on which the liquidation and distribution account becomes final will accrue to the heirs under s 7(1). The estate qualifies for the interest exemption of R23 800 under s 10(1)(j)(ii)⁷⁶⁴ which may prevent registration if the estate has interest of less than that figure, but given that an estate does not qualify for the primary, secondary or tertiary rebates, even R1 of taxable income will render it liable to income tax. For example, if its interest income exceeds R23 800 or it has other taxable income such as rental income, taxable dividends from a REIT or a taxable capital gain, it will need to register as a separate taxpayer. This treatment is likely to result in many more estates having to register as separate taxpayers. The deceased estate is given its own tax number and its returns of income can be submitted via e-filing.

- The deceased estate of a person who died before 1 March 2016 which is liable for tax in its own right (for example, because there was no ascertainable heir) is still brought on register as a type-A special trust, even if registered on or after 1 March 2016. In other words, it is not registered in the same way as the estate of a person dying on or after 1 March 2016.

This chapter considers the position of the following persons:

- The deceased person [s 9HA(1) and (2), para 62]
- The deceased estate [s 25(1), (2), (3)(a), (5) and (6) and para 40(3)]
- The heirs or legatees, including the surviving spouse [s 9HA(3), s 25(3)(b), (4) and (6)]

Upon death a natural person's year of assessment comes to an end and a new entity comes into existence, namely, the deceased estate. In reality a deceased estate is not a person but simply a collection of rights and obligations of the deceased person administered by an executor.

In *Estate Smith v CIR*⁷⁶⁵ the court held that an executor was not a representative taxpayer in respect of income derived by the estate. Undeterred by this setback, the Commissioner then sought to appoint the executor as agent for the tax due by Smith's estate. On appeal, in *CIR*

⁷⁶⁴ Interest received by the deceased estate is brought to account under s 25(1)(a) and since a deceased estate does not have an age, it qualifies for the exemption in s 10(1)(j)(ii). Since the interest does not fall under s 25(1)(b), there is no need to have regard to the age that the deceased would have been had he or she still been alive. Section 25(1)(b) is designed to include amounts in the estate's income that would otherwise not have comprised income in the estate, such as a contingent bonus payment.

⁷⁶⁵ 1960 (3) SA 375 (A), 23 SATC 399.

*v Emary NO*⁷⁶⁶ the court held that a deceased estate was merely an aggregate of assets and liabilities and not a person. It was therefore not possible to appoint the executor as agent of a non-existent person.

The Act was subsequently amended to rectify the shortcomings highlighted in the *Smith and Emary* cases. More particularly, paragraph (b) of the definition of 'person' in s 1(1) includes 'the estate of a deceased person'. The definition of 'representative taxpayer' in s 1(1) provides that a representative taxpayer must be a natural person who resides in South Africa, and in relation to a deceased estate is the executor or administrator of such deceased estate 'in respect of the income received by or accrued to any deceased person during his lifetime and the income received by or accrued to the estate of any deceased person'. For the purposes of the definition of 'representative taxpayer', income includes any amount received or accrued or deemed to have been received or accrued in consequence of the disposal of any asset envisaged in the Eighth Schedule. The term 'executor' is defined in s 1(1) to mean

'any person to whom letters of administration have been granted by a Master or an Assistant Master of the High Court appointed under the Administration of Estates Act, 1965 (Act No. 66 of 1965), in respect of the estate of a deceased person under any law relating to the administration of estates, and includes a person acting or authorized to act under letters of administration granted outside the Republic but signed and sealed by such a Master or Assistant Master for use within the Republic and, in any case where the estate is not required to be administered under the supervision of such a Master or Assistant Master, the person administering the estate'.

Under para (a) of the proviso to s 66(13)(a) in the year of assessment in which a person dies, a return must be made for the period commencing on the first day of that year of assessment and ending on the date of death. Under s 6(4) the primary, secondary and tertiary rebates must be apportioned for a period of assessment of less than 12 months.

The first return for the deceased estate commences on the day after the date of death and ends on the last day of February or, if earlier, on the date on which the liquidation and distribution account becomes final. For subsequent years of assessment, the executor of a deceased estate must continue to submit returns of income for each year of assessment until the liquidation and distribution account becomes final. The deceased estate of a natural person is excluded as a provisional taxpayer.⁷⁶⁷

16.2 The deceased person

16.2.1 Deemed disposal by deceased person [s 9HA(1)]

A deceased person is treated as having disposed of his or her assets at the date of death for an amount received or accrued equal to the market value as defined in para 1 of those assets on that date, other than the following assets:

- Assets disposed of for the benefit of his or her resident surviving spouse as contemplated in s 9HA(2). These assets are subject to roll-over treatment under s 25(4). This relief is similar to that granted to a deceased spouse for estate duty purposes under s 4(q) of the Estate Duty Act 45 of 1955. The surviving spouse, provided he or she is a resident, inherits the base cost and all aspects of the history of the asset (date of acquisition and usage) from the deceased spouse under s 25(4) and will have to account for any capital gains or losses when the asset is ultimately

⁷⁶⁶ 1961 (2) SA 621 (A), 24 SATC 129.

⁷⁶⁷ Paragraph (ff) of the definition of 'provisional taxpayer' in the Fourth schedule.

disposed of. The provision is not an exclusion from CGT but merely a deferral measure that has the effect of shifting the incidence of the tax from the deceased to the surviving spouse. The roll-over relief applies automatically and neither the deceased person nor the surviving spouse can elect out of it. A deceased person whose surviving spouse is a non-resident will not qualify for the exclusion and must account for the deemed proceeds at market value. No exception is made in this regard, even if the assets concerned fall under para 2(1)(b).⁷⁶⁸

- A long-term insurance policy of the deceased, if any capital gain or capital loss that would have been determined in respect of a disposal that resulted in proceeds of that policy being received by or accruing to the deceased would have been disregarded under para 55. Capital gains or losses on long-term policies held by individuals are determined within the individual policyholder fund of a long-term insurer and are not taxed again at policyholder level.
- An interest of the deceased in
 - a pension, pension preservation, provident, provident preservation or retirement annuity fund in South Africa; or
 - a fund, arrangement or instrument situated outside South Africa which provides benefits similar to a pension, pension preservation, provident, provident preservation or retirement annuity fund,

if any capital gain or capital loss that would have been determined in respect of a disposal of that interest that resulted in a lump sum benefit being received by or accruing to the deceased would have been disregarded under para 54. Lump sums from these various retirement funds are subject to income tax according to a separate set of annual cumulative tables and thus do not also attract CGT.

The definition of 'market value' in para 1 refers in turn to para 31. The market values as specified in para 31 must be used in determining the amount deemed to be received or accrued – see **8.35**.

16.2.2 Bequests to specified exempt or partially exempt bodies.

Under para 62 any capital gain or loss determined in respect of an asset bequeathed to the Government of South Africa in the national, provincial or local sphere, a PBO contemplated in para (a) of the definition of a 'public benefit organisation' in s 30(1) approved by the Commissioner under s 30(3), a recreational club approved by the Commissioner under s 30A, or specified other entities exempt under s 10 must be disregarded. See **12.11**.

Any capital gain or loss arising on the disposal of an asset by an executor in order to give effect to a cash bequest to a PBO will not be excluded in the hands of the deceased person under para 62. In addition, the estate may have to account for a capital gain or loss if the amount realised by the executor differs from the market value of the asset on the date of death. In order to qualify for the exclusion under para 62, the deceased must bequeath a specific asset to the PBO. See **12.11**.

⁷⁶⁸ By contrast, the disposal of an asset contemplated in s 9J or para 2(1)(b) between spouses while they are alive qualifies for roll-over relief under s 9HB(5), which makes an exception for such assets.

16.2.3 Record-keeping and valuation issues

An executor will have to select a valuation method for any pre-valuation date assets held by the deceased at the date of death. Should the deceased have failed to determine the market value of an asset (other than financial instruments whose prices were published in the *Gazette*) on 1 October 2001 during the three years ending 30 September 2004, the executor will have to resort to either the time-apportionment method (if a record of pre-valuation date expenditure exists) or the '20% of proceeds' method. Taxpayers should keep records of costs and valuations performed in order to enable their executors to properly determine capital gains and losses. In finalising the deceased's tax returns up to date of death, the executor will be bound by whatever asset identification method was adopted under para 32 by the deceased (specific identification, FIFO or weighted average) for South African-listed shares, participatory interests in portfolios of collective investment schemes, and gold or platinum coins.

If the deceased failed to keep a record of post-valuation date value expenditure, it may be possible for the executor and SARS to agree on an estimated assessment under s 95(3) of the Tax Administration Act 28 of 2011.

16.2.4 Trading stock, livestock and produce and allowance assets

For persons dying on or after 1 March 2016, the market value of trading stock, livestock and produce must be included in the gross income of the deceased person on the date of death under s 9HA(1) except if such assets have been bequeathed to a surviving spouse. Consequently, such amounts will be excluded from proceeds under para 35(3)(a).

Livestock or produce acquired on or after the valuation date (1 October 2001) will have a base cost of nil under para 20(3)(a) to the extent that the cost of its acquisition was allowable as a deduction under s 11(a). While the deduction granted to a farmer for livestock may be limited under para 8 of the First Schedule, para 8(3) provides that para 8 does not apply to livestock no longer held and not disposed of. Since the deceased farmer is deemed to have disposed of all livestock on date of death under s 9HA(1), para 8 cannot apply to such livestock, meaning that the deduction for livestock, if previously limited, will be allowed in full on the date of death. On the question of game livestock, see Interpretation Note 69 (Issue 2) dated 23 November 2017 'Game Farming'. Regarding produce, see Interpretation Note 79 (Issue 2) dated 23 November 2017 'Produce held by Nursery Operators'.

Post-valuation date trading stock allowed as a deduction under s 11(a) or s 22(2) (opening stock) will also have a base cost of nil under para 20(3)(a).

The deemed disposal of an allowance asset on the date of death under s 9HA(1) may potentially trigger a recoupment of previous capital allowances under s 8(4)(a) or at the election of the executor, a loss on disposal under s 11(o). A capital gain will usually arise if the amount received or accrued exceeds the cost of the allowance asset.

Example 1 – Recoupment of capital allowances plus capital gain on death under s 9HA(1)

Facts:

Rene acquired an aircraft in 2018 at a cost of R10 million on which she had claimed capital allowances of R6 million at the time of her death on 31 January 2020. The market value of the aircraft on her date of death was R12 million.

Result:

	R
Cost of aircraft	10 000 000
Less: Capital allowances	<u>(6 000 000)</u>
Tax value	4 000 000
Amount deemed received or accrued on deemed disposal	<u>12 000 000</u>
Difference	<u>8 000 000</u>

The difference comprises a recoupment under s 8(4)(a) of R6 million plus a capital gain of R2 million. The capital gain is determined as follows:

		R
Amount deemed to be received or accrued on deemed disposal		12 000 000
Less: Recoupment under s 8(4)(a) [para 35(3)(a)]		<u>(6 000 000)</u>
Proceeds		6 000 000
Less: Base cost		
Cost of aircraft	10 000 000	
Less: Capital allowances [para 20(3)(a)]	<u>(6 000 000)</u>	<u>(4 000 000)</u>
Capital gain		<u>2 000 000</u>

Example 2 – Livestock on hand at date of death of taxpayer*Facts:*

At the time of his death on 31 January 2020 Farmer Brown held a bull acquired in 2017 at a cost of R50 000. It was subsequently accounted for in closing and opening stock at standard value of R50. The market value of the bull on 31 January 2020 was R70 000.

He also held six cows, five of which were purchased in 2017 at a total cost of R50 000, with the remaining cow being bought in November 2019 at a cost of R12 000. The standard value of the cows was R40 each and their market value on date of death was R15 000 each.

Determine the effect of s 9HA(1) on Farmer Brown's taxable income for the 2020 year of assessment. Farmer Brown had sufficient income from farming operations to make para 8 of the First Schedule inapplicable.

Result:

Deemed amount received or accrued on date of death:

	R
1 Bull @ market value	70 000
6 cows market value of R15 000 × 6	<u>90 000</u>
	160 000
Less:	
Opening stock	
1 bull	(50)
5 cows 5 × R40	(200)
Cost of cow acquired in November 2019	<u>(12 000)</u>
Net increase in taxable income	<u>147 750</u>

There are no CGT consequences for Farmer Brown because the amounts were fully taken into account on revenue account:

Proceeds:

	R
Deemed amount received or accrued on date of death R70 000 + R90 000	160 000
Less: Amount included in gross income [para 35(3)(a)]	<u>(160 000)</u>
Proceeds	<u>-</u>

Base cost:

Cost of acquisition of bull in 2017	50 000
Cost of acquisition of 5 cows in 2017	50 000
Cost of acquisition of 1 cow in November 2019	<u>12 000</u>
Total cost	112 000
Less: Amount allowed under s 11(a) [para 20(3)(a)]	<u>(112 000)</u>
Base cost	<u>-</u>

Example 3 – Determination of taxable capital gain of natural person in year of death*Facts:*

Richard Spectre died on 31 August 2019 leaving the following assets:

	Base Cost	Market value on date of death
	R	R
Primary residence	1 000 000	3 100 000
Holiday home	250 000	350 000
Household furniture and effects	500 000	800 000
Yacht (11 metres in length)	300 000	200 000
Endowment policy	100 000	150 000
Second-hand endowment policy	200 000	300 000
Listed shares	600 000	900 000

In his will he stipulated that

- the holiday home was to be left to his surviving spouse,
- the endowment policy was to be left to his son,
- the second-hand endowment policy was to be left to Retina South Africa, a registered public benefit organisation, and
- the remaining assets were to be sold and the proceeds split equally between his wife and son.

Result:

The taxable capital gain or loss of Richard Spectre is determined as follows:

Asset	Base Cost	Market value	Capital gain/(loss)	Exclusions/roll-overs	Total	Provision conferring non-disposal, exclusion or roll-over
	R	R	R	R	R	
Primary residence	1 000 000	3 100 000	2 100 000	(2 000 000)	100 000	45(1)
Holiday home	250 000	350 000	N/A – no Disposal			s 9HA(1)(a) read with s 9HA(2)
Household furniture and effects	500 000	800 000	300 000	(300 000)	-	para 53(1)
Yacht	300 000	200 000	(100 000)	100 000	-	para 15
Endowment policy	100 000	150 000	50 000	(50 000)	-	s 9HA(1)(b) read with para 55(1)(a)(i)
Second-hand endowment policy	200 000	300 000	100 000	(100 000)	-	para 62
Listed shares	600 000	900 000	300 000	-	<u>300 000</u>	
					<u>400 000</u>	
					R	
Sum of capital gains and losses					400 000	
Less: Annual exclusion					(300 000)	
Aggregate capital gain					<u>100 000</u>	
Taxable capital gain (40% × R100 000)					<u>40 000</u>	

16.2.5 Pre-valuation date livestock

The base cost of pre-valuation date livestock is calculated in the normal way, using the time-apportionment, market value or '20% of proceeds' method. Although livestock could in certain circumstances conceivably qualify as identical assets, the weighted-average method may not be used for these assets, since it is reserved for listed shares, participatory interests in collective investment schemes, gold and platinum coins and listed s 24J instruments [para 32(3A)]. Livestock qualifying as identical assets must therefore be identified using the specific identification or first-in-first-out method.

Under s 26(2) a person who enters into a sheep lease is deemed to continue farming operations and must account for the livestock in question under the First Schedule. Paragraph

3(3) of the First Schedule deems any livestock which is the subject of a sheep lease to be held and not disposed of by the grantor of the sheep lease. The effect of this provision is to disregard the fact that in reality many of the original livestock may no longer be alive at the time when the sheep lease terminates (for example, when the grantor dies). If the sheep lease was entered into before the valuation date and expires on the death of the grantor after the valuation date, the livestock on hand at the date of the grantor's death will be regarded as pre-valuation date assets and the valuation date values may be determined using the market value on valuation date, time-apportionment base cost or '20% of proceeds' method.

16.2.6 Plantations and growing crops

Under common law, growing timber and crops accede to the land (*superficies solo cedit* – whatever is attached to the land forms part of it).

Plantations: Paragraph 14(1) of the First Schedule provides that any amount received by or accrued to a farmer in respect of the disposal of any plantation shall, whether such plantation is disposed of separately or with the land on which it is growing, be deemed not to be a receipt or accrual of a capital nature and shall form part of such farmer's gross income. However, to fall within para 14(1) the taxpayer must be a farmer. In *C: SARS v Kluh Investments (Pty) Ltd*⁷⁶⁹ the respondent company had allowed another company to conduct plantation farming for that company's own account and that company's only obligation was to return the plantation intact when the agreement came to an end. Shortly afterwards the respondent sold the plantation to this company and at issue was whether the portion of the consideration relating to the plantation had to be included in the respondent's gross income under paragraph 14(1). The court held that paragraph 14 did not apply to the respondent because it was not carrying on farming operations. It did not have

- the right to the yield of the plantation;
- the use of the land and the plantation; or
- derive any income from it.

Except when an asset is bequeathed to a surviving spouse, s 9HA(1) deems the asset to be disposed of for an amount equal to its market value. It will therefore be necessary to split that market value into its capital and revenue components in order to give effect to para 14(1) of the First Schedule.

Paragraph 14(2) of the First Schedule sets out how the allocation is to be made. It provides that When any plantation is disposed of by a farmer with the land on which it is growing, the amount to be included in the farmer's gross income under para 14(1) shall

- if the amount representing the consideration payable in respect of the disposal of the plantation is agreed to between the parties to the transaction, be the amount so agreed to; or
- failing such agreement, be such portion of the consideration payable in respect of the disposal of the land and the plantation as represents the consideration payable for the plantation. In such event, the executor must apportion the market value of the land and the plantation based on the relative market values of the respective assets on the date of death.

⁷⁶⁹ 2016 (4) SA 580 (SCA), 78 SATC 177.

The portion representing the plantation must be included in the deceased's gross income while the portion relating to the land will represent a receipt or accrual of a capital nature, assuming the farm was held on capital account, and thus form part of proceeds under para 35.

Growing crops: When a farm property is disposed of on a going-concern basis, there is no requirement to include the value of any growing crops in gross income, except when the sale agreement specifies an amount in respect of those crops.⁷⁷⁰ The result is that the value of the crops is simply treated as part and parcel of the value of the land and is an amount of a capital nature.⁷⁷¹ The same treatment applies on death, and the value of the standing crops will simply be included in the market value of the farmland and will form part of the proceeds on disposal of the farmland on date of death under s 9HA(1).

16.2.7 Usufructs created on death

Usufructs created on the death of a person must be valued under para 31(1)(d). This valuation involves determining the present value of the annual right of use at 12% a year over the expected life of the person receiving the benefit, or when the right of enjoyment is a lesser period, over that lesser period. Under para 31(2), if the asset subject to the usufructuary interest cannot reasonably be expected to produce an annual yield of 12% on the value of the asset, the Commissioner must decide, on application by the taxpayer, such sum as reasonably represents the annual yield. The yield so determined is treated as being the annual value of the right of enjoyment of the asset for purposes of para 31(1)(d).

Typically, listed shares tend to produce a dividend yield of only 2 to 3%. See *C: SARS v Klosser's Estate*,⁷⁷² an estate duty case in which the court upheld the Commissioner's use of an annual yield of 2,5% for listed shares. The court held that the Commissioner was required to make predictions as to the future yield and that these could be based only on facts which included the yield at the time of death and in the past. The Commissioner had invited the taxpayer to provide statistics of the yield over the past three years but the taxpayer had not responded to the request. The court also rejected the taxpayer's argument that the assets could be subject to change in future because no evidence to this effect had been adduced. In the result the court upheld the Commissioner's use of an annual yield of 2,5% for the listed share portfolio.

Paragraph 31(2) prescribes the method for determining the market value of a usufruct.

A part-disposal will be triggered in the hands of the deceased person when a usufruct is bequeathed to a surviving spouse. The usufruct portion of the part-disposal will qualify for roll-over treatment under s 9HA(2) (see **16.2.10**).

See **24.1.1** for a more detailed explanation and a number of examples dealing with usufructs.

Paragraph 31(1)(d) deals with the market value of a usufruct granted to a person. It does not deal with the market value of a ceasing usufruct, since the usufructuary does not grant the usufruct to anyone, and in any event, its value would be nil for CGT purposes.

⁷⁷⁰ See 'Farming – Growing Crops, Sale of' *Income Tax Practice Manual* [online] (My LexisNexis: June 2015) at [A:F15].

⁷⁷¹ *Baikie v CIR* 1931 AD 496, 5 SATC 193.

⁷⁷² 2000 (4) SA 993 (C), 63 SATC 93.

16.2.8 Annual exclusion in year of death

Under para 5(2) the annual exclusion of a deceased person in the year of death is R300 000 (2013 to 2020); R200 000 (2012); R120 000 (2008 to 2011), R60 000 (2007) and R50 000 (2006 and earlier years of assessment). The annual exclusion is designed to grant a measure of relief for the 'bunching effect' that occurs as a result of the simultaneous deemed disposal of all the assets of the deceased. It is not subject to apportionment even when the period of assessment is less than a year. For more on the annual exclusion see **5.3**.

16.2.9 Small business asset relief

Under para 57 a deceased person may qualify for relief from CGT on capital gains adding up to R1,8 million (2013 to 2020); R900 000 (2012); R750 000 (2007 to 2011); R500 000 (2006 and earlier years of assessment) in respect of the disposal of small business assets. Death is listed as a qualifying disposal event in para 57(2). This amount is a once-in-a-lifetime concession, and will be unavailable on a person's death if the concession had already been fully used during the person's lifetime. In order to qualify for the exclusion, all qualifying assets must be realised within a period of 24 months commencing with the first disposal. This requirement will be met if all qualifying assets are disposed of on the date of death under s 9HA, or if the first qualifying disposal occurred within the 24 months preceding the date of death. The market value of all the assets of the small business may not exceed R10 million.

The small business asset relief must be determined on an asset-by-asset basis. Under para 57(2) the asset must have been held for a continuous period of at least five years before disposal. It will therefore be necessary for the executor to determine when each asset held on the date of death was acquired by the deceased. If any small business asset was acquired within the five years preceding the date of death, it must be excluded from consideration for the exclusion. See **12.6 – Disposal of small business assets on retirement**.

16.2.10 Assets transferred to a surviving spouse [s 9HA(2)]

Under s 9HA(2) a deceased person whose surviving spouse is a resident is treated as having disposed of an asset for the benefit of that surviving spouse if that asset is acquired by that surviving spouse by

- testamentary succession or *ab intestato*;
- as a result of a redistribution agreement between the heirs and legatees of that person in the course of liquidation or distribution of the deceased estate of that person; or
- in settlement of a claim arising under s 3 of the Matrimonial Property Act 88 of 1984.

In each of these situations the assets of the deceased transferred to the resident surviving spouse are subject to roll-over treatment under s 9HA(2)(b) read with s 25(4). Importantly, the roll-over does not apply if the surviving spouse is a non-resident. Non-resident spouses are excluded because the *fiscus* would be prejudiced if capital gains could be rolled over from a taxable person to a non-taxable person, and non-residents are potentially subject to CGT only on the limited range of assets listed in para 2(1)(b). Unlike s 9HB(5), which applies while the spouses are alive, s 9HA does not make an exception for the assets listed in para 2(1)(b) or s 9J (immovable property, including shares in a land-rich company meeting specified requirements held as trading stock). It follows that the roll-over relief will not apply even if the deceased person bequeathed immovable property in South Africa or assets of a permanent

establishment in South Africa to a non-resident spouse. This was a deliberate policy decision and not an oversight.

It is a requirement under s 9HA(2)(a) for the roll-over to apply that the surviving spouse must 'acquire' the relevant assets. Such an acquisition would occur if the surviving spouse acquired ownership or beneficial ownership in the assets.

If the deceased's last will and testament provides that the deceased's assets are to be disposed of to a testamentary *bewind* trust for the benefit of a surviving spouse, the roll-over treatment under s 9HA(2) and s 25(4) will apply, since under such a trust the surviving spouse would be the owner of the relevant assets. The same treatment would apply to assets bequeathed to a vesting trust for the benefit of the surviving spouse provided that the surviving spouse has beneficial ownership in the assets concerned. Caution needs to be exercised when determining whether a trust asset has in fact vested in a beneficiary. In some situations, the beneficiary may have a right to trust capital as opposed to a right in an individual asset and a right to trust capital may not necessarily equate to a vested interest in a trust asset. Rather, such a right may merely represent a right to the residue of the trust at a future date (see **14.11.5.3**).

Assets bequeathed to a surviving spouse under the deceased's last will and testament which are disposed of by the executor to a third party before the liquidation and distribution account has become final do not qualify for roll-over treatment under s 9HA(2) because they are not acquired by the surviving spouse.⁷⁷³

The words '*ab intestato*' mean 'from a person dying intestate' which results in the deceased's assets devolving upon the heirs according to the law of intestate succession.⁷⁷⁴

Section 2C of the Wills Act 7 OF 1953 provides that a benefit to which a descendant (other than a minor child or mentally ill descendant) of the deceased was entitled under a will, will vest in the surviving spouse if the surviving spouse is entitled to a benefit under the will and the descendant renounces his or her right to the benefit. This provision is replicated in s 1(6) of the Intestate Succession Act 81 of 1987. Section 1(4)(b) of the latter Act provides that in applying s 1 the term 'intestate estate' includes any part of an estate which does not devolve by virtue of a will. It follows that an asset obtained by the surviving spouse in this manner is treated as having been acquired *ab intestato* and will therefore qualify for roll-over relief under s 9HA(2) read with s 25(4).

Under testamentary succession, assets are bequeathed under a valid last will and testament. Roll-over relief does not apply to the transfer of an asset from the deceased estate to a surviving spouse in satisfaction of a maintenance claim by the surviving spouse under s 2 of the Maintenance of Surviving Spouses Act 27 of 1990, since such a claim does not arise by testamentary succession.

Under a redistribution agreement the heirs can agree to redistribute the assets of the estate amongst themselves. Heirs receiving assets worth more than what they originally inherited may, under the agreement, have to pay in the difference to the estate. The liquidation and distribution account will reflect the effect of the redistribution agreement and it will therefore be possible to finalise the CGT consequences for the deceased person and the surviving spouse only once the account has lain open for inspection for the prescribed period without objection having been lodged against it.⁷⁷⁵ See **16.4.8** for more on redistribution agreements.

⁷⁷³ Both s 9HA(2)(a) and s 25(4)(a) require the surviving spouse to acquire the asset in order to qualify for roll-over treatment.

⁷⁷⁴ Intestate Succession Act 81 of 1987.

⁷⁷⁵ Section 35(12) of the Administration of Estates Act 66 of 1965.

The Matrimonial Property Act 88 of 1984 makes the accrual system automatically applicable to a marriage out of community of property unless its application is specifically excluded in the antenuptial contract.⁷⁷⁶ Under the accrual system a claim will arise on death in the hands of one spouse against the other for the difference in growth of the estates of the spouses,⁷⁷⁷ For example, if the growth in value of spouse A's estate during the marriage is R100, and the growth in value of spouse B's estate is R50, spouse B will have a claim of R25 against spouse A on dissolution of the marriage.

The accrual system does not result in a splitting of capital gains and losses between spouses. A capital gain or loss on disposal of an asset by a person married out of community of property must be accounted for by the spouse who owns the asset. A claim under the accrual system arises only on death or divorce of a spouse⁷⁷⁸ or under an order of court.⁷⁷⁹ It does not affect the tax treatment of the spouses during the subsistence of the marriage or even on its termination. It is a claim for a sum of money, not a pre-existing entitlement to specific assets or income of the other spouse. The accrual claim is thus contingent on death or divorce and its quantum also depends on the value of the estates of the spouses at the time of those events. It might happen, for example, that gains accumulated earlier in a marriage are later lost or expended. It does not therefore have any impact on the incidence of an accrual of an amount of gross income or proceeds on disposal of an asset.

When assets of the deceased person are given to the surviving spouse in settlement of an accrual claim arising on death under s 3 of the Matrimonial Property Act, the transfer of such assets will be subject to roll-over treatment under s 9HA(2) read with s 25(4).

In each of the above situations, under s 9HA(2)(b) the deceased spouse is treated as having disposed of the asset for an amount received or accrued equal to, in the case of

- trading stock, or livestock or produce contemplated in the First Schedule, the amount that was allowed as a deduction in respect of that asset for purposes of determining that person's taxable income, before the inclusion of any taxable capital gain, for the year of assessment ending on the date of that person's death; or
- any other asset, the base cost of that asset, as contemplated in the Eighth Schedule, as at the date of that person's death.

The purpose of this rule is to place the deceased person in a tax-neutral position, avoiding a net income gain or loss on the disposal of trading stock, livestock or produce, a recoupment under s 8(4)(a) on the disposal of allowance assets or any capital gain or capital loss on the disposal of assets other than trading stock, livestock or produce. With trading stock, livestock and produce, the consideration is equal to the amount allowed as a deduction in the year of death. Amounts claimed in earlier years are ignored. For example, if a farmer acquired a bull for R100 000 in year 1 and claimed a deduction of R100 000 under s 11(a) in that year, and died in year 3 still holding the bull, the deduction at the beginning of year 3 would be equal to the standard value of the bull of R50 included in opening stock, and this amount would

⁷⁷⁶ Section 2 of the Matrimonial Property Act 88 of 1984.

⁷⁷⁷ Section 3 of the Matrimonial Property Act 88 of 1984.

⁷⁷⁸ Section 3 of the Matrimonial Property Act 88 of 1984.

⁷⁷⁹ Under s 8 of the Matrimonial Property Act 88 of 1984 the court can order the division of the accrual of the estate of a spouse if that spouse's conduct is seriously prejudicial to the other spouse's ultimate accrual claim on dissolution of the marriage [s 8(1)]. The court can also exclude the accrual system completely [s 8(2)].

comprise the deemed consideration for the deceased person. Under the one-and-the-same-person principle in s 25(4), the surviving spouse would be deemed to have acquired the bull for R50, since the amount of R100 000 had already been claimed by the late spouse and the same amount cannot be claimed by both persons. However, there would be no CGT consequences for the surviving spouse, since the opening stock would be eliminated from base cost under para 20(3)(a).

Example – Disposal of assets to surviving spouse by deceased person

Facts:

Irvine died leaving his holiday home to the value of R750 000 acquired at a cost of R80 000 to his wife Janice. The remainder of his assets, none of which qualified for any exclusions, were acquired by him at a cost of R500 000 and were valued at R1,2 million at the time of his death.

All assets were acquired after the valuation date.

Result:

Under s 9HA(1) Irvine is treated as having disposed of the assets not left to Janice for proceeds of R1,2 million as at the date of his death resulting in a capital gain of R700 000 (R1 200 000 proceeds – R500 000 base cost).

Under s 9HA(2)(b)(ii) Irvine is treated as having disposed of the holiday home bequeathed to Janice for proceeds of R80 000, resulting in neither a capital gain nor a capital loss. Under s 25(4) Janice is deemed to have acquired the holiday home at a cost of R80 000 and must use that figure in determining the base cost of the holiday home when she ultimately disposes of it.

Assets inherited from a spouse before valuation date

The predecessor to s 9HA(2), namely, para 67(2), did not apply when a surviving spouse inherited an asset from his or her spouse before valuation date. In such a situation there was no roll-over of expenditure or dates of acquisition and incurral from the deceased spouse to the surviving spouse under the previous roll-over provisions of para 67. There are several reasons for this result. First, under para 67(2)(a) the deceased was deemed to have *disposed of* his or her assets to his or her spouse for the purposes of para 67(1). Under para 2, the Eighth Schedule applies only to disposals on or after the valuation date, and this included a deemed disposal under para 67(2)(a). Secondly, para 97 applied to disposals between spouses during the transitional period, which implies that para 67(2)(a) did not apply retrospectively. Finally, there is a general presumption against the retrospective interpretation of a statute (see **1.2.7**). Since para 67(2)(a) does not apply, the cost and date of acquisition must be ascertained from the facts. It is submitted that the time of acquisition in most cases is the date on which the survivor became unconditionally entitled to the asset. In most instances this would be the date on which the liquidation and distribution account became final under s 35(12) of the Administration of Estates Act. The cost of acquisition must be determined in accordance with common law principles taking into account the extinction of the personal right to claim delivery – see **8.5A**. Usually 'B' in the time-apportionment formula will be equal to the market value of the asset at the time of its acquisition by the transferee spouse. 'N', being the number of years before the valuation date will be determined from the actual date of acquisition described above, and not from the date on which the deceased person acquired the asset.

16.2.11 Buy-and-sell agreements

Partners in a business or shareholders in private companies frequently enter into buy-and-sell agreements. Under such an arrangement the partners or shareholders take out life policies ON each other's lives. Should a partner or shareholder die, the owner of the policy will receive the policy proceeds CGT free under para 55(1)(c) provided none of the premiums were paid by the deceased person (see **12.4.3.4**). Those proceeds can then be used by the policyholder to purchase the deceased person's interest in the partnership or company. Any such shares must be valued at the date of death and will give rise to a capital gain or loss for the deceased person under s 9HA(1). Shares in a private company must be valued under para 31(3) at the price which could have been obtained upon their sale between a willing buyer and a willing seller dealing at arm's length in an open market without taking into account any restriction on their transferability or any provision stipulating how they are to be valued. Thus, any selling price stipulated in the buy-and-sell agreement must be disregarded and an arm's length market value determined at the date of death. Such market value would also have to be used for estate duty purposes.⁷⁸⁰ The deceased estate will acquire the shares at the same market value under s 25(2)(a) and dispose of them to the living partner or shareholder at the price stipulated in the buy-and-sell agreement. Such disposal will not qualify for roll-over treatment for the deceased person even if the proceeds are awarded to a surviving spouse, since the surviving spouse would not have 'acquired' the shares as envisaged in s 9HA(2)(a).⁷⁸¹

16.3 The deceased estate

16.3.1 Acquisition of assets by deceased estate from deceased person [s 25(2)]

Except for an asset bequeathed to a surviving spouse, the deceased estate is treated as having acquired an asset from the deceased person for an amount of expenditure incurred equal to the market value contemplated in para 31 of the asset as at the date of death of the deceased person.

An asset bequeathed to a surviving spouse is treated as having been acquired by the deceased estate for an amount of expenditure incurred equal to

- trading stock, or livestock or produce contemplated in the First Schedule, the amount that was allowed as a deduction in respect of that asset for purposes of determining that person's taxable income, before the inclusion of any taxable capital gain, for the year of assessment ending on the date of that person's death; or
- any other asset, the base cost of that asset, as contemplated in the Eighth Schedule, as at the date of that person's death.

The deemed acquisition rule in s 25(2) must be read with the deemed disposal rule in s 25(3)(a), which together provide for a tax-neutral transfer of assets from the deceased estate to heirs or legatees, including a surviving spouse.

⁷⁸⁰ Section 5(1)(f)bis of the Estate Duty Act 45 of 1955.

⁷⁸¹ Until the liquidation and distribution account becomes final, no *dominium* in any asset of the deceased estate vests in the surviving spouse.

16.3.2 Assets disposed of to third parties during the winding-up period

Section 25(1) provides that the following amounts must be treated as income of the deceased estate of the deceased person

- any income received by or accrued to or in favour of any person in his or her capacity as the executor of the estate of a deceased person.
- Any amount received or accrued as contemplated in the above bullet point which would have been income in the hands of that deceased person had that amount been received by or accrued to or in favour of that deceased person during his or her lifetime.

The second bullet point will be relevant when determining the capital or revenue nature of amounts received by or accrued to the deceased estate from the disposal of assets. For example, if the estate disposes of livestock or produce and the deceased carried on farming operations, the amounts realized by the estate on disposal of the livestock or produce will be included in its gross income irrespective of whether it can be argued that the estate is not carrying on farming operations.

The deceased estate is a separate person for tax purposes⁷⁸² and is required to account for all income and capital gains and losses during the winding-up period. The executor must account for all income and capital gains and losses up until the liquidation and distribution account becomes final. For commentary on determining the date on which the account becomes final, see **16.4.2** under the heading 'Time of acquisition'.

Example – Determination of taxable capital gain of deceased estate

Facts:

Richard Spectre died on 31 August 2018. Under his will the following assets were not bequeathed to specific heirs and his executor, Argie Bargie, proceeded to dispose of them over two years of assessment.

2019 year of assessment

Household furniture and effects with a base cost of R800 000 were sold for R850 000.

Listed shares with a base cost of R900 000 were sold for R980 000.

2020 year of assessment

Richard's primary residence with a base cost of R3,1 million was sold for R3,3 million.

The yacht was acquired by the estate from Richard at a base cost of R200 000 and sold for R250 000. In order to realise a better price for the yacht, Argie Bargie had the navigation equipment upgraded at a cost of R5 000.

⁷⁸² See para (b) of the definition of 'person' in s 1(1). The executor is the 'representative taxpayer' as defined in s 1(1) under para (e) of that definition in relation to the deceased person and his or her estate.

Result:

The taxable capital gain of Richard's estate will be determined as follows:

2019 year of assessment

	Proceeds R	Base cost R	Capital gain R
Household furniture and effects	850 000	800 000	50 000
Listed shares	980 000	900 000	80 000

The household furniture and effects are personal-use assets and any capital gain or loss on their disposal would have had to be disregarded in Richard's hands under para 53. Accordingly, the capital gain in his estate will also be disregarded under para 40(3).

The estate will be liable for CGT on the listed shares, calculated as follows:

Capital gain	R 80 000
Less: Annual exclusion	(40 000)
Aggregate capital gain	40 000
Inclusion rate	<u>40%</u>
Taxable capital gain	<u>16 000</u>

2020 year of assessment

	Proceeds R	Base cost R	Capital gain R
Primary residence	3 300 000	3 100 000	200 000
Yacht	250 000	205 000	45 000

The capital gain on the disposal of the primary residence must be disregarded, since it is covered by the primary residence exclusion of R2 million.

The base cost of the yacht is its market value on Richard's death (R200 000) plus the R5 000 spent on upgrading it. The taxable capital gain on disposal of the yacht is calculated as follows:

Capital gain	R 45 000
Less: Annual exclusion	(40 000)
Aggregate capital gain	5 000
Inclusion rate	<u>40%</u>
Taxable capital gain	<u>2 000</u>

16.3.3 Assets disposed of to heirs or legatees [s 25(3)(a)]

Under s 25(3)(a) the deceased estate is treated as having disposed of an asset to an heir or legatee for an amount received or accrued equal to the amount of expenditure incurred by the deceased estate in respect of that asset. The purpose of this rule is to ensure that the deceased estate does not suffer an income gain or loss on the disposal of trading stock, livestock or produce and that it does not incur a capital loss or derive a capital gain on assets other than trading stock, livestock or produce. This rule also applies to assets transferred to a surviving spouse, since such surviving spouse would also be an heir or legatee.

16.3.4 Deceased estate treated as natural person and residence [s 25(5) and para 40(3)]

Treatment of deceased estate as natural person [s 25(5)(a) and para 40(3)]

A deceased estate must be treated as if it were a natural person, other than for purposes of

- the primary, secondary and tertiary rebates (s 6) ;
- the medical scheme fees tax credit (s 6A); and
- the additional medical expenses tax credit (s 6B).

Thus, a deceased estate will be taxed on the same sliding scale as a natural person and will enjoy the interest exemption under s 10(1)(i)(ii) of R23 800. While the deceased estate is treated as a natural person, it is not deemed to be the same natural person as the deceased person. Thus, any assessed loss (s 20) or assessed capital loss (para 9) existing at the time of death will be forfeited and not carried over to the deceased estate. The deceased estate and the deceased person are not deemed to be one and the same person, unlike the position with an insolvent estate and the person before sequestration under s 25C.

Paragraph 40(3) contains a similar but more specific rule. It provides that for the purposes of the Eighth Schedule, the disposal of an asset by the deceased estate of a natural person shall be treated in the same manner as if that asset had been disposed of by that natural person. This deeming provision means that the deceased estate will be entitled to the various exclusions and inclusion rate applicable to natural persons.

The estate will, in particular, be entitled to an annual exclusion (2017 to 2020: R40 000; 2016: R30 000) in the year in which it comes into existence, that is, in its first year of assessment commencing on the day after the date of death and ending on the last day of February (or date of finalisation of the estate if earlier). The annual exclusion is not apportioned in the first or last year of assessment of the estate, even though the period of assessment may be less than a year.

Under para 48(d) a primary residence held by a deceased estate is treated as being ordinarily resided in by the deceased person for a maximum period of two years after the date of death. Should the executor take longer than two years to dispose of the residence, the period exceeding two years will not qualify as a primary residence, and the gain or loss must be apportioned on a time basis. The exclusion of R2 million in para 45 may be set off only against the portion of the gain applicable to the first two years following the date of death – see **11.7.4**.

The deceased estate is not entitled to any unused portion of the small business asset exclusion of R1,8 million in para 57 for a number of reasons. In this regard, while the deceased estate is treated as having disposed of an asset in the same manner as the deceased person, it is not treated as having acquired it on the same date as the deceased person. The deceased estate's date of acquisition is the date of death, and given that most estates are wound up within five years, it is unlikely that it would be able to comply with the five-year holding period. In addition, para 57(3) requires that the exclusion 'may not exceed R1,8 million during that natural person's lifetime'. The reference to 'lifetime' clearly envisaged that the exclusion would come to an end on the date of the person's death. Once the natural person dies, it is no longer possible for that person to be involved in the business operations, an estate does not have an

age and it does not suffer from ill health, retire on pension or die and is thus unable to comply with the other requirements in para 57(2).

The deceased estate is entitled to disregard any capital gain or loss under para 53 for the disposal of any personal-use assets, that is, assets used mainly for purposes other than carrying on a trade. Typical examples include furniture, household appliances, private motor vehicles and stamp collections. However, para 53(3) excludes specified assets from qualifying as personal-use assets. These excluded assets include among others, gold and platinum coins whose value is mainly attributable to their metal content, immovable property and large boats and aircraft, financial instruments, usufructs and fiduciary interests. The term 'financial instrument' in s 1(1) includes cryptocurrency such as Bitcoin.

Residence of deceased estate [s 25(5)(b)]

In *Nathan's Estate v CIR*⁷⁸³ it was held that a deceased estate is resident where the estate is administered. However, the *Nathan's Estate* case dealt with provincial legislation many decades ago and today the question of residence is statutorily provided for in the definition of 'resident' in s 1(1). Under para (b) of that definition a deceased estate would be resident in South Africa if it were established or formed in South Africa or if it had its place of effective management in South Africa. Given that an estate has only a deemed existence as a 'person', it is questionable whether it can be said to be established or formed. The default position is therefore the place of effective management, or in estate parlance, the place where it is administered.

However, s 25(5)(b) overrides the definition of 'resident' in s 1(1) by deeming a deceased estate to be a resident if the deceased person was a resident. The effect of this provision is to bring the worldwide assets of a deceased resident under para 2(1)(a) within the tax net for the deceased estate, regardless of where that estate is administered. It also means, for example, that a foreign company may be a CFC in relation to a resident deceased estate while it holds the shares in the foreign company.

Section 25(5)(b) does not, however, deal with the situation in which the deceased person was a non-resident. On the taxation of the deceased estate of a non-resident, see **16.3.4**.

16.3.4 Deceased estate of a non-resident

When a non-resident dies leaving South African assets, it will be necessary for the Master to appoint an executor to wind up the South African portion of the estate.

Under para 2(1)(b) a non-resident is liable to CGT only on the disposal of

- immovable property situated in South Africa held by that person or any interest or right of whatever nature of that person to or in immovable property situated in South Africa including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources; and
- any asset effectively connected with a permanent establishment of that person in South Africa.

⁷⁸³ 1948 (3) SA 866 (N), 15 SATC 328 at 342.

Under para 2(2) the term ‘interest in immovable property’ includes other interests such as shares in a company holding immovable property in South Africa if the shareholder owns at least 20% of the shares and 80% or more of the value of the shares is directly or indirectly attributable to immovable property in South Africa (excluding trading stock).

A non-resident who dies holding the above assets will accordingly be deemed to dispose of them under s 9HA(1) and his or her deceased estate will be deemed to acquire them under s 25(2).

Thus, for example, the deceased estate of a non-resident would potentially be liable for CGT on post-death growth in value on the disposal of a holiday home in South Africa, whether held under freehold, sectional title or by means of an interest in a share block company. If the holiday home were held in a company (assuming it to be the company’s only asset) and the deceased estate holds at least 20% of the shares, the sale of the shares by the executor will also potentially attract CGT on any growth in the value of the shares after date of death.

By contrast, the deceased estate of a non-resident will not be liable for CGT on the disposal of an asset falling outside para 2(1)(b) for at least two reasons. First, such an asset would not have been deemed to have been disposed of by the deceased person under s 9HA(1) and hence could not be acquired by the deceased estate under s 25(2)(a). Secondly, the disposal would be governed by para 40(3).

Under para 40(3) the deceased estate of a natural person must be treated in the same manner as if that asset had been disposed of by that natural person. In other words, the deceased estate of a non-resident must be treated in the same manner as if that deceased estate were also a non-resident.

The provisions of any tax treaty applicable to the deceased person should also be considered to determine whether South Africa’s taxing rights have been excluded in relation to para 2(1)(b) assets. For example, the tax treaty with the United Kingdom grants the country of residence an exclusive taxing right in respect of listed shares, even if held in a land-rich company.

16.3.5 Pre-valuation date estates

Reading para 2 with para 40(1) it is evident that para 40(1) dealt only with disposals occurring on or after the valuation date.

The notion that valuations can be carried out retrospectively for an unlimited period also conflicts with the whole scheme of the Eighth Schedule. See in this regard the commentary in **9.4** on para 38, which also applies prospectively. When a person has died before the valuation date and the estate is not finalised by that date, the executor will be regarded as having acquired the assets for an expenditure of nil. In these circumstances the executor should have considered determining a market value as at 1 October 2001 in respect of the assets acquired before 30 September 2004.⁷⁸⁴ The need for the executor to determine a valuation would have been unnecessary for South African-listed shares, South African unit trusts, South African-listed warrants and agricultural and financial futures. The prices of these assets were published in the Government Gazette and are therefore established. An executor who has

⁷⁸⁴ Paragraph 29(4)(a) contains the cut-off date for performing valuations.

failed to value assets whose prices were not published in the Gazette must resort to the time-apportionment or '20% of proceeds' method.

16.4 Heirs or legatees

16.4.1 Meaning of heir or legatee

A legatee is a person who receives a legacy under a valid will. By contrast, an heir is entitled to the residue of the estate once the legacies and debts have been paid. *LAWSA* explains a legacy as follows:⁷⁸⁵

'A legacy is a disposition by which the testator gives the legatee a specific thing or collection of things or an amount of money. The distinguishing feature between an heir and a legatee is "the specificity of benefit" given to the legatee.'

(Footnotes suppressed.)

16.4.2 Acquisition of assets by heirs or legatees [s 25(3)(b)]

Under s 25(3)(b) an heir or legatee is treated as having acquired an asset for an amount of expenditure incurred equal to the expenditure incurred by the deceased estate in respect of the asset.

Such expenditure can be divided into two categories, namely,

- expenditure deemed to be incurred by the deceased estate under s 25(2) in acquiring an asset from the deceased person; and
- expenditure actually incurred or deemed to be incurred by the deceased estate under some other provision (not addressed in s 25 but under the core rules).

Assets acquired from the deceased person [s 25(2)]

For an heir or legatee other than a surviving spouse to which s 25(4) applies, the expenditure incurred by the deceased estate in respect of an asset acquired from the deceased person is the amount referred to in s 25(2)(a), which in turn refers to the amount in s 9HA(1). That amount is equal to the market value of the asset contemplated in para 31 on date of death.

In determining the base cost of assets acquired by a surviving spouse, a distinction needs to be drawn between

- assets formerly owned by the deceased person; and
- assets acquired by the deceased estate which were not owned by the deceased person.

For an asset acquired from the deceased person, a resident surviving spouse is not governed by the general acquisition rule in s 25(3)(b) but is rather subject to roll-over treatment under the more specific provisions of s 25(4). Were s 25(3)(b) to be followed, the incorrect result would be obtained. For example, assume that the deceased acquired an asset before valuation date for R100. The deceased is deemed under s 9HA(2)(b) to dispose of the asset at its 'base cost' at the date of death. Such a hypothetical 'base cost' may well be

⁷⁸⁵ MJ de Waal *et al* Volume 31 second edition volume [online] (My LexisNexis: 28 February 2011) in para 331.

indeterminable because in order to determine the valuation date value for a pre-valuation date asset using the time-apportionment or '20% of proceeds' method, it is necessary to know the amount of the proceeds. Even assuming it was possible to use market value, it would mean that the estate was deemed to acquire the asset for expenditure equal to that market value, and that expenditure would then become the surviving spouse's expenditure, which would conflict with the expenditure roll-over rule in s 25(4).

For an asset acquired by the deceased estate other than from the deceased person, a surviving spouse must, like any other heir or legatee, follow s 25(3)(b) and take over the expenditure of the deceased estate in respect of the asset. This issue is discussed in more detail below.

Expenditure incurred by executor after date of death

It may happen that an executor will acquire further assets during the winding-up period which were not owned by the deceased person at the date of death. Such assets could take the form of purchased assets, assets acquired by distribution *in specie* or as a capitalisation share. The executor may also incur further expenditure on assets acquired from the deceased person, such as improvement expenditure under para 20(1)(e) or one-third of the interest on monies borrowed to purchase listed shares or collective investments under para 20(1)(g). Such expenditure incurred on assets awarded to heirs or legatees (including a surviving spouse) will be taken over by those heirs or legatees under s 25(3)(b).

The base cost of shares acquired by the estate as a distribution in specie from an existing share portfolio must be determined in accordance with the applicable base cost rule. For instance, shares received as a distribution in specie have a base cost equal to market value under para 75(1)(b). However, if such shares are acquired as a result of an unbundling transaction under s 46, it will be necessary for the executor to allocate some of the base cost of the unbundling company shares held on date of death to the unbundled company shares, and in that event para 75(1)(b) will be inapplicable. Capitalisation shares received by the deceased estate will have a base cost of nil under s 40C. In such instances, it is imperative to establish the exact nature of the underlying transaction so that the applicable base cost rules can be applied. Although applying the appropriate base cost rule will not impact on the estate when the assets are awarded to heirs or legatees because of the no gain or loss treatment afforded to the deceased estate under s 25(3)(a), it will be of importance to the heirs or legatees in establishing the base cost of their inherited assets under s 25(3)(b).

Time of acquisition

The exact date on which an heir or legatee acquires an asset from the deceased estate can be of importance, for example, under s 9C(2) for the purpose of determining whether a share has been held by an heir or legatee for at least three years and is thus on capital account. Section 25(3)(b) does not contain a time of acquisition rule and reliance must therefore be placed on common-law principles for determining the time of acquisition of an inherited asset. The position of a surviving spouse acquiring an asset from the deceased is, however, different, since s 25(4)(b)(i) carries over the date of acquisition of an asset from the deceased to a surviving spouse.

It is submitted that the deceased estate disposes of an asset to an heir or legatee (other than the surviving spouse) on the date on which the heir or legatee becomes unconditionally entitled to the asset. An heir or legatee becomes so unconditionally entitled when the liquidation and distribution account becomes final. An heir will not necessarily be entitled to all assets reflected in the account. For example, an heir will not be entitled to an asset that must be used to settle a creditor's claim. In the latter event the asset remains the property of the deceased estate until it is disposed of in order to settle the creditor's claim.

The liquidation and distribution account is required to lie open for a period not less than 21 days for inspection by any person interested in the estate.⁷⁸⁶ This period must be stipulated by the executor in the *Government Gazette* and in one or more newspapers circulating in the district in which the deceased was ordinarily resident.⁷⁸⁷

The estate becomes distributable after the period stipulated in the notice assuming no objection has been lodged against the account, and it is at this point that the account becomes final.⁷⁸⁸ Until the liquidation and distribution account is confirmed, no *dominium* in any asset vests in an heir or legatee.⁷⁸⁹

Should objection be lodged against the account, the date on which an heir becomes entitled to an estate asset will depend on the facts. For example, if the objection is sustained and the revised liquidation and distribution account lies open for inspection for a further 21 days, the account will become final after that period assuming no further objection has been lodged against the revised account. If the Master dismisses the objection and the aggrieved party applies to court to have the Master's decision set aside, the account will become final only when the court process is completed.

On the reckoning of the 21-day period, s 4 of the Interpretation Act 33 of 1957 provides as follows:

'4. Reckoning of number of days.—When any particular number of days is prescribed for the doing of any act, or for any other purpose, the same shall be reckoned exclusively of the first and inclusively of the last day, unless the last day happens to fall on a Sunday or on any public holiday, in which case the time shall be reckoned exclusively of the first day and exclusively also of every such Sunday or public holiday.'

Thus, if the account was advertised in the Gazette on Wednesday 3 January 2018, the period of 21 days will end at midnight on Wednesday 24 January 2018. The heir or legatee will thus acquire the asset on 25 January 2018, even if it is actually distributed after that date.

Stipulation in will that assets must be realised

Should the will state that the assets of the deceased are to be sold and the proceeds distributed amongst a number of heirs, and one of those heirs agrees to take over a specific asset in part or full settlement of his or her share, s 25(3) will still apply. The estate will dispose of the asset at neither a gain nor a loss, and the heir will acquire the asset at an amount equal to the expenditure incurred or deemed to be incurred by the deceased estate. Should a

⁷⁸⁶ Section 35(4) of the Administration of Estates Act 66 of 1965.

⁷⁸⁷ Section 35(5)(a) of the Administration of Estates Act 66 of 1965.

⁷⁸⁸ Section 35(12) of the Administration of Estates Act 66 of 1965.

⁷⁸⁹ ITC 816 (1955) 20 SATC 496 (T) at 498; *Greenberg & others v Estate Greenberg* 1955 (3) SA 361 (A) at 366; *CIR v Estate CP Crewe & another* 1943 AD 656, 12 SATC 344 at 377.

surviving spouse elect to take such an asset instead of a cash award, the asset will be subject to roll-over treatment under s 25(4), assuming it was owned by the deceased.

Bequest price

An heir acquiring an asset from a deceased estate in return for agreeing to take over a liability of the estate, or on condition of accepting a future obligation, must disregard that liability or obligation for purposes of determining the base cost of the asset. The need to disregard such a liability follows from s 25(3)(b), which deems the expenditure in respect of the acquisition of the asset to be the expenditure incurred by the deceased estate.

Example 1 – Inheritance of asset subject to acceptance of liability

Facts:

Mary's late father's estate comprised a house with a market value on date of death of R500 000. The house was bonded to the extent of R450 000. Mary informed the executor that she was willing to take over the bond. With the bank's consent, the house was awarded to Mary by the executor.

Result:

Under s 25(3)(b) the base cost of the house in Mary's hands is deemed to be R500 000. The fact that she will have to repay the bond of R450 000 is not taken into account.

Example 2 – Acceptance of asset subject to future obligation

Facts:

Under the last will and testament of his late father, Jimmy inherited the family farm subject to the condition that he pays an annuity of R60 000 a year to his mother for the remainder of her life. The farm had a market value on date of death of R2 million disregarding the annuity obligation.

Result:

Under s 25(3)(b) the base cost of the farm in Jimmy's hands is deemed to be R2 million. Jimmy will not be entitled to add the cost of the annuity to the base cost of the farm. While the R60 000 a year cost to Jimmy is a cost to him of acquiring the farm, s 25(3)(b) takes precedence and is the sole and exclusive mechanism for determining the para 20 acquisition cost of the farm, and any actual acquisition costs incurred by Jimmy must be disregarded. Paragraph 21 will also prevent any double deduction. Jimmy's mother will be taxed on the annuity under para (a) of the definition of 'gross income'.

Disposal of personal right in return for real right

The disposal by an heir or legatee of a personal right to claim delivery of an asset in exchange for a real right in the asset when the executor distributes the asset to the heir or legatee should not give rise to a capital gain or loss – see **6.1.3.13**.

16.4.3 Asset transferred directly to heir or legatee [s 9HA(3)]

Section 9HA(3)⁷⁹⁰ deals with the situation in which an asset is transferred directly from the deceased person to an heir or legatee instead of being routed through the deceased estate. Such a transfer can happen, for example, with certain second-hand or foreign endowment policies.

It provides that the heir or legatee must be treated as having acquired the asset for an amount of expenditure equal to the market value of the asset as defined in para 1 as at the date of death of the deceased person. The definition of 'market value' in para 1 in turn refers to the methods for determining market value in para 31.

16.4.4 Assets acquired by surviving spouse [s 25(4)]

Section 25(4) applies to an asset acquired by a surviving spouse of a deceased person as contemplated in s 9HA(2) for purposes of determining the amount of any

- allowance or deduction to which that spouse may be entitled or that is to be recovered or recouped by or included in the income of that spouse in respect of that asset; or
- the amount of any capital gain or capital loss in respect of a disposal of that asset by that spouse.

Such a surviving spouse is treated as one and the same person as the deceased person and deceased estate with respect to

- the date of acquisition of that asset by that deceased person;
- any valuation of that asset effected by that deceased person as contemplated in para 29(4);
- the amount of any expenditure and the date on which and the currency in which that expenditure was incurred in respect of that asset
 - by that deceased person as contemplated in s 9HA(2)(b); and
 - by that deceased estate, other than the expenditure contemplated in s 9HA(2)(b);
- the manner in which that asset had been used by the deceased person and the deceased estate; and
- any allowance or deduction allowable in respect of that asset to the deceased person and the deceased estate.

The purpose of s 25(4) is to enable the surviving spouse to step into the shoes of the deceased person as regards the history of the asset. The roll-over of the dates of acquisition will be of relevance should the surviving spouse wish to use the time-apportionment method for determining the valuation date value of the inherited assets. It will also be of relevance when determining whether a share has been held for at least three years under s 9C.

⁷⁹⁰ The equivalent rule used to be in para 40(1A) and applies to persons dying before 1 March 2016.

Under s 9HA(2)(a) it is a requirement for roll-over relief that the surviving spouse must acquire the asset. If the executor disposes of the asset and awards the cash to the surviving spouse, the roll-over will not apply and the deceased will be treated as having disposed of the asset at market value under para 9HA(1) while the deceased estate will be treated as having acquired it at the same market value.

Under s 25(4) the surviving spouse is treated as having used the asset in the same manner as the deceased person. This treatment means, for example, that assets such as a residence that was used by the deceased as a primary residence will be deemed to have been used by the surviving spouse as a primary residence for the same period that it fulfilled that function in the hands of the deceased person. Similarly, assets that were used as personal-use assets will retain their character as personal-use assets for the period during which they were used as such by the deceased person. It also means that an asset tainted by trade usage will remain so tainted for the relevant period when taken over by the surviving spouse. For example, if the deceased used 10% of the primary residence as a home office, the surviving spouse will be deemed to have used 10% of the residence as a home office for the same period that the deceased used it, and on disposal the part of the overall gain or loss attributable to the trade usage will not qualify for the primary residence exclusion by virtue of para 49.

It may happen that the deceased person and his or her surviving spouse each had their own primary residence. The question arises how the surviving spouse must treat the inheritance of such a primary residence when it is ultimately disposed of by him or her, given that para 45(3) requires that a person may not have more than one primary residence at any one time. It is considered that the surviving spouse will have to choose which residence he or she wishes to treat as his or her primary residence for the overlapping period. If he or she chooses to make the inherited residence a primary residence, then his or her own residence cannot be a primary residence for the same period.

16.4.5 Pre-valuation date inheritances

The now repealed para 40(2) applied only to acquisitions by heirs on or after the valuation date because under para 2 the Eighth Schedule applies only to disposals on or after the valuation date, and this includes a deemed disposal under para 40(1).

Nevertheless, an asset acquired by inheritance before the valuation date will have an expenditure for the purposes of para 20 equal to its market value on the date on which it was unconditionally acquired – see **8.5A**. The presence of expenditure in respect of pre-valuation date inherited assets is relevant for the purposes of determining 'B' in the time-apportionment base cost formula. Other options for determining the valuation date value of inherited assets include the market-value and '20% of proceeds' methods.

An heir acquiring an asset from a pre-valuation date estate on or after the valuation date acquires it at the base cost of the estate. Under these circumstances the executor is regarded as having acquired the assets for an expenditure of nil, and unless that executor determined a market value before 30 September 2004 (for assets whose prices were not published in the Gazette), the heir may be faced with the prospect of taking over a nil base cost or, if the executor has incurred some post-valuation date expenditure, a low base cost from the estate.

A person who inherited an asset before valuation date from his or her spouse is similarly not entitled to a roll-over of expenditure or dates of acquisition and incurral under the now repealed para 67(2). Such a person should determine any cost by applying the principles in **8.5A**.

16.4.6 Assets acquired by inheritance from non-resident estates

The base cost of an asset acquired by an heir from a person who at the time of his or her death was not a resident must be determined under s 25(3)(b) if that asset is one contemplated in para 2(1)(b) (immovable property in South Africa including specified rights and interests in such property or assets effectively connected with a permanent establishment in South Africa), or

- para 20(1)(h)(v) in any other case.

Under para 20(1)(h)(v)⁷⁹¹ the base cost is equal to

- the market value of the asset immediately before the death of the person, and
- any expenditure contemplated in para 20 incurred by the executor in respect of the asset in the process of liquidation or distribution of the deceased estate.

16.4.7 Massed estates

Massing occurs when spouses draw up a joint will providing for the massing of their estates. It is sometimes prompted by the prohibition on the subdivision of agricultural land under the Subdivision of Agricultural Land Act 70 of 1970. Massing is governed by s 37 of the Administration of Estates Act 66 of 1965. Typically, the surviving spouse will receive the usufruct over the deceased's assets in return for giving up the bare *dominium* in his or her own assets. The bare *dominium* given up by the survivor is dealt with by the executor as if it were an asset of the deceased. Upon adiation, the surviving spouse's share of the bare *dominium* is disposed of to the deceased estate.

The CGT consequences for the deceased spouse are governed by s 25(3)(b) and (4). A capital gain or loss must be determined on the disposal of the bare *dominium* by the deceased person to the deceased estate under s 9HA(1), and the deceased will qualify for roll-over relief under s 9HA(2) in respect of the usufruct granted to the deceased's surviving spouse.

The base cost of the bare *dominium* disposed of by the deceased person to his or her estate must be determined under the part-disposal rules in para 33. The proportion of the expenditure and any market value on valuation date to be allocated to the usufruct is determined in accordance with the ratio that the market value of the usufruct on date of death bears to the market value of the total asset on the same date. The portion of the total expenditure and any market value on valuation date attributable to the bare *dominium* is the balance (that is, the total expenditure and any market value less the portion attributed to the usufruct).

⁷⁹¹ Under s 107(2) of the Revenue Laws Amendment Act 20 of 2006, para 20(1)(h)(v) came into operation as from the commencement of years of assessment ending on or after 1 January 2007.

Massing can result in a donation for donations tax purposes if the value of the usufruct received is less than the value of the bare *dominium* given up by the surviving spouse. However, this does not mean that para 38 will apply to the disposal by the surviving spouse to the deceased estate. First, a donation for the purposes of para 38 is something wholly gratuitous and the survivor usually receives the usufruct in return. Secondly, even if the proceeds do not represent an arm's length price, the surviving spouse and the deceased estate are not connected persons in relation to each other in respect of an asset disposed of by the surviving spouse to the estate. A surviving spouse will not be able to add any donations tax paid under para 20(1)(c)(vii) to the base cost of the assets disposed of unless a common law donation has been made (that is, no quid pro quo is received) and the market value of the asset exceeds the allowable para 20 expenditure excluding the donations tax (para 22). See 8.7.

There is some uncertainty how the proceeds received by the surviving spouse in respect of the usufruct are to be determined. Likewise, there is uncertainty how the base cost of the bare *dominium* acquired from that surviving spouse must be determined by the deceased estate. It is submitted that the matter must be dealt with under the core disposal rules on the basis of a barter transaction. To the extent that the value of the usufruct received by the surviving spouse exceeds the value of the bare *dominium* given up, the excess will be regarded as pure inheritance not forming part of the barter transaction.

Example – Massed estates

Facts:

John and Jane were married in community of property in 1987 and entered into a joint will that provided for the massing of their estates. Under the will, Jane is to receive a usufruct over her remaining life in respect of the family farm while the bare *dominium* in the farm is to be left to the John Family Trust. The farm was acquired by the couples' joint estate at a cost of R1 million in 2010. John passed away on 30 January 2020, and Jane then adiated (accepted the terms of the joint will). At the time of her husband's death Jane would have been 65 at her next birthday. The market value of the farm on date of death was R5 million. Ignore the primary residence exclusion. What are the CGT implications for John and Jane?

Result:

John

Expectation of Jane's life according to Table A = 15,18 years

Present value of R1 a year for life: 6,841 61

Value of usufruct left to Jane:

$R2\ 500\ 000 \times 12\% \times 6,841\ 61 = R2\ 052\ 483.$

Value of bare *dominium* left to John Family Trust = $R2\ 500\ 000 - R2\ 052\ 483 = R447\ 517.$

Base cost of bare *dominium* = $R500\ 000 \times R447\ 517 / R2\ 500\ 000 = R89\ 503$

Capital gain = $R447\ 517 - R89\ 503$

= R358 014

Under s 9HA(1)(a) there is no disposal of the usufruct by John, since it is subject to roll-over treatment under s 9HA(2).

Jane

Jane has disposed of her share of the bare *dominium* in the farm which had a market value on the date of John's death of R447 517. She has received a usufruct with a market value of R2 052 483. Of this R447 517 represents proceeds under a barter transaction in respect of the bare *dominium* she has given up, while the balance (R1 604 966) represents pure inheritance.

Jane retains the usufruct portion of her share of the farm. She therefore has a capital gain, determined as follows:

	R
Proceeds	447 517
Less: Base cost	<u>(89 503)</u>
Capital gain	<u>358 014</u>

The base cost of Jane's usufruct is made up as follows:

Acquired from John's estate R500 000 – R89 503	410 497
Own portion retained	<u>410 497</u>
	<u>820 994</u>

When Jane passes away, there will be a disposal of the usufruct under para 11(1)(b) without any proceeds (see **24.1.1**).

The John Family Trust

The John Family Trust acquires the bare *dominium* in the property from John's deceased estate at a base cost equal to the base cost in the estate [s 25(3)(b)]. The base cost of the bare *dominium* in the estate is made up as follows:

	R
Acquired from John	447 517
Acquired from Jane	<u>447 517</u>
	<u>895 034</u>

The base cost of the amount acquired from Jane is equal to the cost to the estate of awarding John's usufruct to Jane. In other words, it is similar to the result that would be obtained under a barter transaction under which the cost to each party is the market value by which that party's assets have been diminished.

Reconciliation

Assuming that the farm was disposed of to a third party immediately before John's death:

	R
Proceeds	5 000 000
Less: Base cost	<u>(1 000 000)</u>
Capital gain	<u>4 000 000</u>

Sum of capital gains assuming farm sold at market value on day after date of death		
	R	R
John – bare <i>dominium</i>		358 014
Jane – bare <i>dominium</i>		358 014
Jane – assuming usufruct sold		
Proceeds R2 052 483 x 2	4 104 966	
Less: Base cost	<u>(820 994)</u>	
Capital gain	3 283 972	
<i>John Family Trust</i>		
Proceeds R447 517 x 2	895 034	
Less: Base cost	<u>(895 034)</u>	
No gain or loss	_____ -	_____ -
Total		<u>4 000 000</u>

16.4.8 Redistribution agreements

Heirs of full capacity may freely renounce, waive or dispose of their rights under a will.⁷⁹² They can agree to reshuffle the assets that were bequeathed to them under the will by entering into a redistribution agreement. Such a contractual arrangement can overcome the problem of co-ownership that might otherwise arise and enables heirs to agree among themselves on the assets they would like to inherit. Each heir that is a party to such an agreement must contribute something and receive something in exchange for the arrangement to constitute a redistribution agreement. The liquidation and distribution account will reflect the effect of the redistribution agreement.

In *Klerck NO v Registrar of Deeds*⁷⁹³ the deceased had been married in community of property and bequeathed his half of the joint estate to his stepson. One of the assets in the estate comprised immovable property encumbered by a mortgage bond. The stepson agreed to take over the property and the debts of the estate and paid the surviving spouse an amount to equalize their positions. As a result of the bond and other debts in the estate, the executor would have had to dispose of the immovable property in order to discharge the debts with the result that it would not have devolved upon the surviving spouse or heir. Since the immovable property would not have gone to the stepson or surviving spouse, there was no immovable property available for distribution to the surviving spouse which could then form part of a redistribution agreement. Clayden J stated that⁷⁹⁴

'in every redistribution there must be involved sale, exchange, or donation between one heir and another, or between the heir and the surviving spouse. But the mere fact that a sale between two heirs or between an heir and the surviving spouse is entered into does not necessarily mean that a redistribution is brought about by that sale'.

Dowling J continued as follows:⁷⁹⁵

'There is contemplated some sort of reshuffle of assets in the estate, which would in any case have passed to the heirs, in a way which departs in some respect from the actual disposition of the will or the normal course of devolution *ab intestato*.'

⁷⁹² *Bydowell v Chapman, NO & others* 1953 (3) SA 514 (A) at 523.

⁷⁹³ 1950 (1) SA 626 (A) .

⁷⁹⁴ At 629. See also *Hoeksma & another v Hoeksma* 1990 (2) SA 893 (A).

⁷⁹⁵ At 631.

In *Bydawell v Chapman, NO & others*⁷⁹⁶ the court held that a family agreement cannot alter the terms of a will or the devolution of an estate. Beneficiaries may contract⁷⁹⁷ to render to each other the fruits of the devolution, if and when they mature or accrue, but cannot alter the devolution by contract.

A family agreement or arrangement must be distinguished from a redistribution agreement. The former attempts to change the administration of an estate or the devolution under a will⁷⁹⁸ while the latter deals with the assets which devolve upon each heir. The former is invalid while the latter is not, provided the necessary formalities are complied with.

Section 14(1)(a) of the Deeds Registries Act 47 of 1937 provides that

‘transfers of land and cessions of real rights therein shall follow the sequence of the successive transactions in pursuance of which they are made, and if made in pursuance of testamentary disposition or intestate succession they shall follow the sequence in which the right to ownership or other real right in the land accrued to the persons successively becoming vested with such right’.

Section 14(1)(b) of the same Act then confirms that

‘it shall not be lawful to depart from any such sequence in recording in any deeds registry any change in the ownership in such land or of such real right’.

The proviso to s 14(1)(b) then makes an exception to this rule by stating that

‘(iii) if in the administration of the estate of a deceased person (including a fiduciary) any redistribution of the whole or any portion of the assets in such estate takes place among the heirs and legatees (including ascertained fideicommissary heirs and legatees) of the deceased, or between such heirs and legatees and the surviving spouse, the executor or trustee of such estate may transfer the land or cede the real rights therein direct to the persons entitled thereto in terms of such redistribution’.

Section 14(2) provides as follows:

‘(2) In any transfer or cession in terms of any proviso to subsection (1)(b), there shall be paid the transfer duty which would have been payable had the property concerned been transferred or ceded to each person successively becoming entitled thereto.’

Despite s 14(2), the Transfer Duty Act provides an exemption in s 9(1)(e)(i) for an heir or legatee in respect of

‘property of the deceased acquired by *ab intestato* or testamentary succession or as a result of a re-distribution of the assets of a deceased estate in the process of liquidation’.

⁷⁹⁶ 1953 (3) SA 514 (A). See also (June 2013) 123 *TSH5* for extracts from other cases dealing with family agreements.

⁷⁹⁷ Through the process of *Schichten en deelen* under Roman-Dutch law.

⁷⁹⁸ *Starkey & others v McElligott & others* 1984 (4) SA 120 (D) at 130. See also *Greenberg & others v Estate Greenberg* 1955 (3) SA 361 (A) at 377.

While this exemption is unrelated to CGT, it is helpful in understanding that a real right in the inherited property first flows to the legatee to whom the testator bequeathed the property, and that real right is then disposed of by contractual arrangement under the terms of the redistribution agreement.

Redistribution agreement not involving a surviving spouse

In determining whether a redistribution agreement gives rise to a disposal, the position of an agreement that does not involve a surviving spouse will first be considered. Under these circumstances there are two disposals, namely,

- from the deceased estate to the heirs under s 25(3) in accordance with the will or the law of intestate succession; and
- from one heir to another in accordance with the terms of the redistribution agreement between the heirs.

Under s 25(3)(b) an heir acquires an asset from the deceased estate for an amount of expenditure incurred equal to the expenditure incurred by the deceased estate in respect of the asset. Generally, such expenditure would be equal to the market value of the asset on the date of death but could also include post-death qualifying base cost expenditure incurred on the asset by the executor. Any redistribution of the assets of the deceased estate can occur only once the liquidation and distribution account has become final, for it is only at that point that the assets of the estate accrue to the heirs. In the latter regard in ITC 816 Faure Williamson J stated the following:⁷⁹⁹

'In the case of a deceased's estate the principle is quite clear that an heir or legatee has in fact no right to claim the payment of any amount at all until the confirmation of the liquidation and distribution account, except where special provision is made in a will to the contrary. Furthermore it is quite clear that until the liquidation and distribution account is confirmed no *dominium* in any asset or any right in the estate vests in an heir or legatee.'

The finalisation of the liquidation and distribution account represents a suspensive condition under a redistribution agreement and hence the time of disposal of assets by the parties to such an agreement is determined under para 13(1)(a)(i) as the date on which the condition is satisfied. The implication for an heir who enters into a redistribution agreement is that a capital gain or loss could arise if the market value of the asset being swapped has changed from the date of death. Paragraph 38 will apply to substitute market value for any consideration that does not represent an arm's length price between connected persons. This point is of importance because heirs are often relatives⁸⁰⁰ in relation to one another and hence connected persons.

Heirs receiving assets worth more than what they originally inherited may, under the agreement, have to pay in the difference to the estate.

⁷⁹⁹ (1955) 20 SATC 496 (T) at 498. See also *Greenberg & others v Estate Greenberg* 1955 (3) SA 361 (A) at 377 and *CIR v Estate CP Crewe & another* 1943 AD 656, 12 SATC 344 at 377.

⁸⁰⁰ See definition of 'relative' in s 1(1) which treats as relatives persons related within the third degree of consanguinity. This definition must be read with para (a)(i) of the definition of 'connected person' in s 1(1).

Donations tax may become payable if the parties do not receive full consideration for the assets being disposed of. A portion of such donations tax may qualify to be added to the base cost of the asset being disposed of or acquired (see **8.7** for donations tax paid by donor and **8.8** for donations tax paid by donee).

Example 1 – Redistribution agreement not involving a surviving spouse

Facts:

During year 1 Bob died and bequeathed his estate to his two sons Jack and Darryl in equal shares. On the date of death, the estate comprised 100 shares in XYZ Ltd worth R1 million (base cost: R200 000) and a bank balance of R1,1 million. The estate expenses amounted to R100 000 leaving cash of R1 million available for distribution.

During year 2 Jack and Darryl entered into a redistribution agreement. At the time the shares had grown in value to R1,2 million. Darryl agreed to exchange his 50 shares worth R600 000 in return for a cash payment of R600 000. Jack paid R100 000 of his own funds into the estate to facilitate the transaction. During year 3 the liquidation and distribution account became final. It reflected that Jack was to receive 100 shares while Darryl was to receive R1,1 million.

Result:

Bob

Bob is deemed to have disposed of the 100 shares for proceeds determined under s 9HA(1) of R1 million resulting in a capital gain of R800 000 (proceeds of R1 million less base cost of R200 000). The disposal of Bob's bank account at face value results in neither a capital gain nor a capital loss.

Darryl

When the liquidation and distribution account becomes final, Darryl will dispose of his 50 shares acquired by inheritance with a base cost of R500 000 determined under s 25(3)(b) in return for cash proceeds of R600 000. Darryl will thus realise a capital gain of R100 000 (proceeds of R600 000 less base cost of R500 000).

Jack

When the liquidation and distribution account becomes final, Jack will acquire the 100 shares at a base cost of R1,1 million comprising

- R500 000 for 50 shares acquired from the deceased estate determined under s 25(3)(b); and
- R600 000 for 50 shares acquired from Darryl being the expenditure actually incurred under para 20(1)(a). In other words, this amount was paid out of R500 000 in cash acquired from the deceased estate by inheritance and R100 000 paid out of Jack's own resources.

Bob's deceased estate

Under s 25(2)(a) Bob's deceased estate is deemed to acquire the 100 shares at a base cost of R1 million. In accordance with Bob's will these shares are disposed of to Jack and Darryl in equal shares for proceeds equal to the base cost of the estate under s 25(3)(a) resulting in neither a capital gain nor a capital loss. The fact that 50 of the shares were simultaneously disposed of by Darryl to Jack under a contractual arrangement which the executor gave effect to does not affect the deceased estate.

The estate acquired its bank account from Bob for a base cost of R1,1 million under s 25(2)(a). The executor settled the estate expenses of R100 000 thus reducing the base cost of the estate's bank account to R1 million. Under the will the estate must award R500 000 to Jack and Darryl. Under s 25(3)(a) this disposal is made for proceeds equal to the base cost to the estate resulting in neither a capital gain nor a capital loss (proceeds of R500 000 × 2 = R1 million less base cost of R1 million).

Under the redistribution agreement the estate received a further R100 000 from Jack which was deposited into its bank account. The base cost of this deposit, being the expenditure actually incurred for the purposes of para 20, is R100 000 because the estate is correspondingly obligated to pay the amount to Darryl. Under para 35(1)(a) the proceeds on disposal of this amount are equal to the amount of the debt discharged of R100 000 when Darryl is paid, also resulting in neither a capital gain nor a capital loss.

Redistribution agreement involving a surviving spouse

The only place in the Act in which reference is made to a redistribution agreement is s 9HA(2)(a)(ii). Under that provision, a deceased person must, if his or her surviving spouse is a resident, be treated as having disposed of an asset for the benefit of that surviving spouse if that asset is acquired by that surviving spouse as a result of a redistribution agreement between the heirs and legatees of that person in the course of liquidation or distribution of the deceased estate of that person.

The effect of s 9HA(2)(a)(ii) read with s 25(4) is to apply roll-over treatment to the deceased person and his or her surviving spouse. In other words, the surviving spouse steps into the shoes of the deceased person and takes over the details of the asset from the deceased person such as cost and date of acquisition for the purposes of determining the base cost of the asset. As a practical matter it will be possible to finalise the tax position of the deceased person and the surviving spouse only once the redistribution agreement has been signed because it is only at that point that it can be established with reasonable certainty which assets will be acquired by the surviving spouse. In practice the redistribution agreement tends to be signed shortly before the liquidation and distribution account is advertised.

The Eighth Schedule does not state how an heir who transacts with a surviving spouse under a redistribution agreement must be treated. For example, assume asset X devolves upon heir A and asset Y devolves upon surviving spouse and they decide to exchange assets under a redistribution agreement. The surviving spouse is deemed under s 25(3)(b) to acquire asset X from the deceased estate and not from heir A. If full effect is given to this fiction, heir A could not have acquired the asset from the deceased estate and must be treated as not having disposed of it to the surviving spouse. The only logical conclusion therefore is that heir A must disregard the disposal of asset X to the surviving spouse and must be regarded as having

acquired asset Y directly from the deceased estate. If heir A has to pay the surviving spouse any additional consideration for asset Y, such consideration must be disregarded for the purposes of determining the base cost of asset Y. Similarly, if surviving spouse pays heir A for asset X, that transaction must be disregarded for the purposes of determining the base cost of asset X, since the sole method for determining the base cost of asset X is through the roll-over rules in s 25(4).

Example 2 – Redistribution agreement involving a surviving spouse

Facts:

Under his last will and testament, Jack bequeathed his farm valued at R3 million to his wife Jill and his share portfolio valued at R2,5 million to his son Walter. The base cost of the farm in Jack's hands was R500 000, and that of the share portfolio, R700 000. Both the farm and the shares were acquired by Jack after valuation date. There is no primary residence on the farm. Jill and Walter entered into a redistribution agreement under which

- Walter took over the farm and paid R500 000 into the estate for the benefit of Jill; and
- Jill took over the share portfolio.

What are the CGT implications for Jack, Jill and Walter?

Result:

Jack

Jack determined a capital gain on disposal of his farm as follows:

	R
Proceeds from deemed disposal under s 9HA(1)	3 000 000
Less: Base cost	<u>(500 000)</u>
Capital gain	<u>2 500 000</u>

No capital gain or loss arose on disposal of the shares, since there was a roll-over to Jill under s 9HA(2).

Jill

Jill acquired the share portfolio at Jack's base cost of R700 000 under s 25(4).

Walter

Walter acquired the farm at a base cost of R3 million under s 25(3)(b). The R500 000 paid by Walter to the estate is disregarded, since s 25(3)(b) is the sole determinant of Walter's acquisition cost for the purposes of para 20(1)(a).

When spouses are married in community of property, the surviving spouse's half share in the joint estate is administered by the executor. As a result, it is possible for such a surviving spouse to enter into a redistribution agreement with the heirs even if that surviving spouse is not an heir.⁸⁰¹ A surviving spouse who disposes of his or her half share in the assets to heirs in exchange for movables such as cash or the other half of those assets will trigger a disposal with attendant CGT consequences for that surviving spouse.

⁸⁰¹ *Klerck NO v Registrar of Deeds* 1950 (1) SA 626 (A) at 629.

Example 3 – Redistribution agreement involving marriage in community of property and a surviving spouse who is not an heir

Facts:

Dennis and Barbara were married in community of property. Dennis passed away on 28 February of year 1. The assets of the joint estate at the time of Dennis's death comprised immovable property (not a primary residence) worth R2 million, furniture and personal effects worth R500 000 and a savings account containing R1,9 million. After paying the estate expenses of R400 000 the savings account contained R1,5 million. The base cost of the immovable property was 800 000.

Dennis bequeathed his half of the joint estate to his son Clive. Barbara and Clive entered into a redistribution agreement under which Barbara agreed to dispose of her half in the immovable property worth R1 million in return for the remaining half share in the furniture and personal effects worth R250 000 plus a cash payment of R750 000. The market value of the assets in the joint estate remained unchanged until the liquidation and distribution account became final at the end of year 2.

Result:

Dennis

Under s 9HA(1) Dennis is deemed to dispose of his half of the assets in the joint estate for proceeds equal to their market value. He will thus have a capital gain on disposal of his half of the immovable property determined as follows:

	R
Proceeds R2 million × 1 / 2 (para 14)	1 000 000
Less: Base cost R800 000 × 1 / 2 (para 14)	<u>(400 000)</u>
Capital gain	<u>600 000</u>

Any capital gain or loss on disposal of the furniture and effects is disregarded under para 53, since these comprise personal-use assets. The disposal of the savings account does not give rise to a capital gain or loss, since the proceeds deemed to be derived under s 9HA(1) are equal to the base cost of the account.

Barbara

The disposal by Barbara of her half share in the immovable property to Clive under the redistribution agreement gives rise to a capital gain in her hands determined as follows:

	R
Proceeds R2 million × 1 / 2 (para 14)	1 000 000
Less: Base cost R800 000 × 1 / 2 (para 14)	<u>(400 000)</u>
Capital gain	<u>600 000</u>

The proceeds of R1 million comprise furniture and effects of R250 000 plus cash of R750 000 received from Clive.

The base cost of the furniture and effects is increased by R250 000 while the base cost of the amount deposited by Barbara in her bank account is increased by R750 000. In both instances these amounts represent the expenditure actually incurred for the purposes of para 20 by Barbara in giving up her half in the immovable property worth R1 million.

Clive

Clive acquired the following assets under the will at the base cost specified, determined under s 25(3)(b):

	R
Half share in immovable property	1 000 000
Half share in furniture and effects	250 000
Half share in savings account (R1,9 million – R400 000) / 2	750 000

Clive disposed of the furniture and fittings and savings account in exchange for the remaining half share in the immovable property. No capital gain or loss arose on the disposal of the furniture and fittings and savings account, since the proceeds of R1 million, equal to the value of the immovable property received, were equal to the base cost of these two assets. The immovable property had a base cost of R2 million, comprising R1 million determined under s 25(3)(b) (the portion acquired from the deceased estate) and R1 million, being the expenditure actually incurred by Clive under para 20 in giving up the half share in the furniture and effects and savings account that he inherited under the will.

Dennis's deceased estate

Dennis's deceased estate acquired the immovable property, furniture and effects and savings account at market value on the date of death under s 25(2)(a). Under the will the executor disposed of these assets to Clive after first settling the estate expenses for proceeds equal to their base cost. Consequently, no capital gain or loss arose in the deceased estate.

16.4.9 Tax payable by heir of a deceased estate [s 25(6)]

A natural person is treated under s 9HA(1) as disposing of all of his or her assets, with some exceptions, on the date of 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 instances in which a significant capital gains tax charge arises owing to the growth in the value of the assets although the deceased estate is heavily indebted and would not be liable for estate duty.

Such a scenario may have an impact on the liquidity of the deceased estate, resulting in the assets having to be sold to meet the CGT liability. Section 25(6) provides an opportunity for the heir to acquire an asset from the estate provided that the heir accepts a part of the CGT liability. This option would, for example, allow a family farm to be retained by the descendants of the deceased.

When

- the CGT relating to the taxable capital gain⁸⁰² of the deceased person exceeds 50% of the 'net value' of the deceased estate, as determined for the purposes of s 4 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,

⁸⁰² As defined in para 10, which is determined in respect of all the assets deemed to be disposed of by the deceased under s 9HA(1) and not just in respect of the asset being taken over by the heir.

an heir or legatee who would have been entitled to the asset may accept both the asset and the liability on condition that the portion of the CGT exceeding 50% of the net asset value described above is paid by him or her. This liability must 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.⁸⁰³ Under s 23(d) the interest payable to SARS is not deductible. 50% of the net value of the estate must be used to settle the remaining CGT liability. Situations may arise in which the estate has insufficient cash resources to settle the portion of the CGT liability not taken over by the heir. In these circumstances the heir could inject the necessary funds into the estate in order to enable the executor to settle the estate's portion of the CGT liability. This option would, of course, depend upon the heir's ability to raise the necessary funds.

The net value of an estate is determined under s 4 of the Estate Duty Act 45 of 1955 before deducting the allowance under s 4A (R3,5 million for the deceased person, or if applicable, R7 million reduced by the portion of such allowance not used by previously deceased spouses of the deceased person). The amount remaining after deducting the allowance is referred to as the 'dutiable amount', and is irrelevant for the purposes of s 25(6).

Example – Tax liability of estate taken over by heir

Facts:

After Luke had passed away the net value of his estate before any CGT liability was as follows:

Assets

	R
Share portfolio (base cost: R400 000)	3 000 000
Private motor vehicle	120 000
Cash at bank	50 000

Liabilities

Bank loan secured over share portfolio	(2 500 000)
Sundry creditors	<u>(350 000)</u>
Net value of estate before CGT liability	<u>320 000</u>

The sole heir of Luke's estate, Luke Jr, informed the executor that he would like to take over the share portfolio of his late father's estate. In order to facilitate the transfer, he was, if possible, also prepared to take over any remaining liabilities of the estate, and meet the costs of winding-up. Luke Jr's father was paying tax at the maximum marginal rate at the time of his death on 31 January 2020. Luke indicated that as he was a bit cash strapped, he would like to take maximum advantage of s 25(6).

⁸⁰³ The definition of 'prescribed rate' is in s 1(1). See **13.1.8** for a table of prescribed rates of interest.

Result:

The CGT payable by the estate and the portion of it that can be taken over by Luke Jr is determined as follows:

Step 1 – Determine CGT liability attributable to asset to be taken over

	R
Deemed proceeds on disposal of share portfolio	3 000 000
Less: Base cost	<u>(400 000)</u>
Capital gain	2 600 000
Less: Annual exclusion	<u>(300 000)</u>
Aggregate capital gain	<u>2 300 000</u>
Taxable capital gain 40% × R2 300 000	<u>920 000</u>
Tax on taxable capital gain at 45%	<u>414 000</u>

Step 2 – Determine 50% of net value of estate before CGT liability

Net value of estate before CGT liability	<u>320 000</u>
50% × R320 000	<u>160 000</u>

Step 3 – Allocate CGT liability between estate and heir

Total CGT liability – as above	414 000
Less: Portion to be paid by estate – 50% of net value of estate	<u>(160 000)</u>
Portion to be taken over by Luke Jr	<u>254 000</u>

The executor then sold the motor vehicle for R120 000 and paid SARS R160 000. Luke Jr arranged with his local SARS office to settle his portion of the CGT liability of R254 000 in monthly instalments over three years commencing from the time the Master authorised the distribution of the assets of the estate. He was obliged to pay interest at the prescribed rate on the amount outstanding.

16.4.10 Life rights

A person who acquires a life right in a retirement village is entitled to occupy a dwelling for his or her lifetime, and if married, the right will typically continue until the last surviving spouse is deceased.

The form taken by these life rights varies a great deal. Some schemes used to be structured on the basis that the retiree would grant an interest-free loan to the developer which would be repaid on the retiree's death, but it is understood that this arrangement became less common following the *Brummeria* case.⁸⁰⁴ More common these days is the arrangement under which the retiree purchases the life right for cash. Upon the death of the retiree, the developer sells a new life right to another retiree and the deceased is paid a percentage of the proceeds or the capital profit after first deducting any necessary costs of repairs. When the agreement, for example, provides that the proceeds after repair costs will be shared on a 50/50 basis, a capital loss may well result. Some of the CGT issues arising from life rights ownership are considered here.

⁸⁰⁴ C: *SARS v Brummeria Renaissance (Pty) Ltd & others* 2007 (6) SA 601 (SCA), 69 SATC 205.

Asset

A life right in a retirement village is a right of occupation, and comprises a statutory real right established under the Housing Development Schemes for Retired Persons Act 65 of 1988. The term ‘right of occupation’ is defined in s 1 of that Act as follows:

‘**“right of occupation”** means the right of a purchaser of a housing interest—

- (a) which is subject to the payment of a fixed or determinable sum of money by way of a loan or otherwise, payable in one amount or in instalments, in addition to or in lieu of a levy, and whether or not such a sum of money is in whole or in part refundable to the purchaser or any other person or to the estate of the purchaser or of such other person; and
- (b) which confers the power to occupy a portion in a housing development scheme for the duration of the lifetime of the purchaser or, subject to section 7, any other person mentioned in the contract in terms of which the housing interest is acquired, but without conferring the power to claim transfer of the ownership of the portion to which the housing interest relates;’

Section 4A of that Act sets out the nature of a life right and provides as follows:

‘4A. Right of occupation shall confer same right as registered lease.—The holder of a right of occupation shall for the purposes of any law have the same rights as those conferred on a lessee in terms of a lease as contemplated in section 1(2) of the Formalities in respect of Leases of Land Act, 1969 (Act No. 18 of 1969), registered against the title deed of the leased land, and such rights shall rank in priority over any other right whether or not such other right has been registered or endorsed against the title deed and irrespective of the time when such other right was registered or endorsed.’

The holder of a life right therefore has the same rights as a lessee under a registered long lease and such a right is an asset comprising immovable property for CGT purposes (see **4.1.2.3**).⁸⁰⁵

Disposal and proceeds

Upon the death of a life right holder, the life right is deemed to be disposed of under s 9HA(1) for proceeds equal to its market value as defined in para 31 at the date of the holder’s death. When the life right is permitted to continue for a surviving spouse, the base cost of the deceased will be taken over by the surviving spouse under s 9HA(2) read with s 25(4).

On the death of the last surviving life-right holder, the proceeds to be brought to account under s 9HA(1) will be equal to the amount provided for in the agreement, since that amount comprises the market value of the right at the date of death. It is considered that a life right is not a fiduciary, usufructuary or other similar interest to be valued under para 31(1)(d). Rather, it is ‘any other asset’ contemplated in para 31(1)(g), and the price predetermined in the purchase agreement represents 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. This result follows because the life right holder would normally have negotiated the price to be paid by the developer upon expiry of the right on an arm’s length basis.

⁸⁰⁵ See para (b) of the definition of ‘immovable property’ in s 102(1) of the Deeds Registries Act 47 of 1937.

Primary residence

A life right is 'an interest' as defined in para 44, since it comprises a real right as well as a right of occupation. It is also a 'residence', comprising a structure used by a natural person as a place of residence. It would also comprise a 'primary residence', since it is ordinarily resided in as the person's main residence and is used mainly for domestic purposes. The primary residence exclusion in para 45 will therefore usually apply, and this means that the first R2 million of capital gain or loss must be disregarded.

Should a capital loss exceed R2 million, the issue arises whether para 15(c) would operate to disallow the excess. Under para 15 a person must disregard any capital loss to the extent that the assets concerned are used for purposes other than the carrying on of a trade. One such asset under para 15(c) is any fiduciary, usufructuary or other similar interest, the value of which decreases over time. It is considered that a life right is not a fiduciary, usufructuary or other similar interest the value of which decreases over time. For example, a life right comprising an interest-free loan would probably maintain a constant face value, and its actual value would tend to increase as it approaches the maturity date. The value on disposal of a life right acquired for an initial consideration is determined by the formula in the purchase agreement, and its value may in fact increase over time owing to an increase in the value of the dwelling.

The deceased estate acquires the life right at market value on date of death under s 25(2)(a) and any capital gain or loss on its disposal when the actual proceeds are received must be accounted for by the deceased estate. Paragraph 40(3) provides that for the purposes of the Eighth Schedule, the disposal of an asset by the deceased estate of a natural person must be treated in the same manner as if that asset had been disposed of by that natural person. Under para 48(d) a natural person or beneficiary of a special trust is deemed to be ordinarily resident in a residence for a continuous period not exceeding two years if that person did not reside in that residence as a result of the death of that person. The effect of para 48(d) read with para 40(3) is to make the primary residence exclusion applicable to the deceased estate (see **11.7.4**), which will become relevant if the actual proceeds received by the deceased estate differ from the base cost of the life right.

Chapter 17 – Insolvent estates and companies in liquidation

Sections 1(1), 25C, 66(13)(a) and para 83

The first two parts of this chapter (**17.1** and **17.2**) cover the insolvent estates of natural persons (individuals). Companies are dealt with in **17.3**.

17.1 Application of the sections of the Act

17.1.1 The three entities

Upon sequestration of an individual's estate three distinct taxable entities arise, namely,

- the individual before date of sequestration,
- the insolvent estate, and
- the individual on or after date of sequestration.

These three entities must each be taken on register as separate taxpayers with their own tax reference numbers. In practice SARS will bring an insolvent estate on register as a special trust. This treatment ensures that the insolvent estate will be taxed at the same rates of tax applicable to natural persons, and will not be granted the primary rebate under s 6(2)(a) or interest exemption under s 10(1)(i).

Following the decision in *Thorne & Molenaar NNO v Receiver of Revenue, Cape Town*⁸⁰⁶ in which it was held that the trustee of an insolvent estate was not its representative taxpayer, the definitions of 'person' and 'representative taxpayer' were appropriately amended.

Paragraph (a) of the definition of 'person' in s 1(1) includes an insolvent estate. Paragraph (f) of the definition of 'representative taxpayer' in s 1(1) provides that the representative taxpayer in respect of the income of an insolvent estate is its trustee or administrator. The proviso to the definition states that

'for the purposes of this definition income includes any amount received or accrued or deemed to have been received or accrued in consequence of the disposal of any asset envisaged in the Eighth Schedule'.

17.1.2 Date of sequestration

Section 1(1)

The term 'date of sequestration' is defined in s 1(1) and is summarised in the table below.

Table 1 – Date of sequestration

Type of sequestration	Date of sequestration
Voluntary surrender	Date of voluntary surrender if accepted by the court.
Application for provisional sequestration	If the court grants a final order of sequestration, the date of provisional sequestration of an estate.

⁸⁰⁶ 1976 (2) SA 50 (C), 38 SATC 1.

17.1.3 Submission of returns [proviso to s 66(13)(a)]

Section 66 prescribes the returns of income that must be submitted by the three entities mentioned above. The insolvent estate will have to be brought on register as a separate taxpayer and its first period of assessment will commence on the date of sequestration and end on the last day of February.

The second and subsequent years of assessment will commence on 1 March and end on the last day of February, or on the date on which the estate is finally wound up. The individual must file separate returns for the periods before and after the date of sequestration. The above is summarised in the table below.

Table 2 – Returns required to be submitted in the year of sequestration

Section 66(13)	Taxable entity	Period begins on	Period ends on
(a), para (b)(i) of proviso	Individual before sequestration	First day of year of assessment	Date preceding date of sequestration
(a), para (b)(ii) of proviso	Individual on or after date of sequestration	Date of sequestration	Last day of year of assessment
(a)	Insolvent estate	Date of sequestration	Last day of year of assessment

17.1.4 Person before sequestration and insolvent estate – the one and the same person rule

Section 25C

For the purposes of the Act (which includes the Eighth Schedule), and subject to any adjustments as may be necessary, s 25C deems the

- estate of a person before sequestration, and
- that person's insolvent estate,

to be one and the same person for the purpose of determining

- the amount of any allowance, deduction or set-off to which the insolvent estate may be entitled,
- any amount which is recovered or recouped by or otherwise required to be included in the income of the insolvent estate, and
- any taxable capital gain or assessed capital loss of the insolvent estate.

On sequestration a person's assets pass to that person's insolvent estate and this change of ownership would normally trigger a disposal under para 11. However, the 'one and the same person' principle prescribed in s 25C brings the two entities together, and since a person cannot dispose of something to his- or herself, there is no disposal of the individual's assets on the date of sequestration. Capital gains and losses are therefore determined in the insolvent estate when the assets are disposed of to third parties. Section 25C also has the effect of permitting an assessed loss or assessed capital loss to be carried forward from the person before sequestration into that person's insolvent estate.

17.1.5 Setting aside of sequestration order

Section 98 of the TA Act [formerly addressed in s 79B(1A) which was repealed with effect from 1 October 2012]

Under s 98 of the TA Act when an order of sequestration is set aside, the Commissioner must withdraw any assessment issued in respect of

- the estate of a person for the period before the date of sequestration, and
- the insolvent estate of that person.

The Commissioner will then have to issue a fresh assessment in respect of the person concerned as if the sequestration never took place.

The effect of the setting aside of the order of sequestration is to terminate the existence of the insolvent estate *ab initio*. It follows that any transactions that took place in the insolvent estate while it was in existence must be accounted for in the hands of the individual who has been released from sequestration.

17.1.6 Rehabilitation

Section 98 of the TA Act caters for the setting aside of a provisional order of sequestration and the setting aside of a final order of sequestration on appeal. It does not apply to a person who has become rehabilitated through an application for rehabilitation (s 124 of the Insolvency Act 24 of 1936) or through the effluxion of time (s 127A of that Act). Although in the latter cases the sequestration comes to an end under s 129 of the Insolvency Act, the original order remains a *fait accompli* and is not set aside.

17.2 Treatment of assets and assessed capital losses (para 83)

Paragraph 83

The purpose of para 83 is to provide for

- the treatment of assets in the insolvent estate of a natural person, and
- the forfeiture of an assessed capital loss by an insolvent.

Under para 83(1) the disposal of an asset by an insolvent estate is treated in the same manner as if that natural person had disposed of that asset. This treatment 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 assets of the insolvent, such as

- a primary residence (when the capital gain is less than R2 million – see para 45); and
- personal-use assets referred to in para 53 such as furniture and effects and private motor vehicles.

It also confers the same 40% inclusion rate on the insolvent estate.

Paragraph 83(2) makes it clear that any assessed capital loss in the hands of the insolvent before sequestration is forfeited. In other words, it may not be carried forward by the insolvent after date of sequestration. Note, however, that under s 25C an assessed capital loss may be carried forward to the insolvent estate on the basis that the person's estate before sequestration and the insolvent estate are treated as one and the same person for the purpose

of determining an assessed capital loss. However, any assessed capital loss remaining in the insolvent estate at the time it is finally terminated will be lost.

As noted earlier, when the order of sequestration is set aside, the assessments that were raised on the individual and the insolvent estate in the year of sequestration must be withdrawn and a new assessment must be raised as if the sequestration never took place. In such event any assessed capital loss must be determined *de novo*.

The CGT implications of a compromise benefit are dealt with in para 12A for years of assessment commencing on or after 1 January 2013. For earlier years of assessment, the release from an obligation could have given rise to a capital gain under para 12(5).

The practical effect of s 25C and para 83

As noted above, the insolvent estate is a new taxable entity that comes into existence from the date of sequestration and it is quite separate and distinct from the insolvent person before that date. Although s 25C deems the insolvent person before sequestration and that person's insolvent estate to be 'one and the same person', this treatment is only for the limited purposes of determining the amount of any deduction, allowance, set-off, recoupment, taxable capital gain or assessed capital loss of the insolvent estate. For other purposes the insolvent estate and the person before sequestration remain separate entities. The intention of s 25C is, therefore, not to interfere with the separate identity of the estate as a tax paying entity in its own right, but rather to ensure, amongst other things, that

- assessed losses can flow into the insolvent estate,
- assessed capital losses can flow into the insolvent estate,
- allowances claimed by the insolvent person before sequestration can be recouped in the estate, and
- debts included in the income of the person before sequestration can be claimed as bad debts under s 11(i) by the insolvent estate.

The table below summarises some of the more important tax consequences affecting the three entities.

Table 1 – Tax consequences affecting the three entities on sequestration

Entity	Type and period of assessment in year of sequestration	Consequence
Person before sequestration	Original from beginning of year of assessment to day preceding date of sequestration.	Section 6 rebates apportioned in year of assessment preceding sequestration – s 6(4). Annual exclusion – R40 000 (2017 to 2020). Primary residence exclusion – R2 million (2013 to 2020).
Insolvent estate	Original from date of sequestration to end of year of assessment	No s 6 rebate – applicable to natural persons only [s 6(1) and (2)]. Assessed loss and assessed capital loss brought forward from the insolvent person before sequestration (s 25C).

Entity	Type and period of assessment in year of sequestration	Consequence
		Annual exclusion must be reduced by any portion used by the person before sequestration (para 83(1) read with s 25C). 40% inclusion rate [para 83(1)]. Primary residence exclusion – R2 million [para 83(1)] Gains and losses on personal-use assets are excluded [para 83(1)].
Person after sequestration	Original from date of sequestration to end of year of assessment	The following may not be brought forward from the pre-sequestration period: <ul style="list-style-type: none"> • assessed loss • assessed capital loss [para 83(2)]. Section 6 rebates apportioned for periods of less than a year – s 6(4). Annual exclusion – R40 000 (2017 to 2020). Primary residence exclusion – R2 million (2013 to 2020).

The annual exclusion

The estate and the person before sequestration will have to share the annual exclusion. To the extent that the insolvent person has not used it before sequestration, any excess will be available for set-off against capital gains and losses arising in the estate. This treatment is consistent with the one and the same person concept prescribed by s 25C.

The person after date of sequestration will be registered as a new taxpayer. However, that person remains the same natural person as before and the annual exclusion in the year of sequestration must be shared between the person before sequestration, the insolvent estate and the person after sequestration in that order.

Example 1 – Treatment of person before sequestration and insolvent estate*Facts:*

Cecil ran a small garage as a sole proprietorship under the style of Cecil's Motor Mania. After he had lost most of his customers as a result of the passing trade being diverted by the erection of a new freeway, he was unable to pay his debts and his creditors applied to court for his sequestration. The court granted a provisional order of sequestration on 31 August 2019 which was made final on 31 October 2019. The Master appointed his trustee, Bob Brinkman, who immediately set about winding up the estate. He summarised the position as follows:

	R
Net loss from trade (1 March 2019 to 31 August 2019)	(100 000)
Assessed loss brought forward from 2019 year of assessment	(250 000)
Capital gain on listed shares – sold 31 July 2019	150 000
Assessed capital loss brought forward from 2019 year of assessment	(50 000)
Interest income (after exempt portion)	15 000
<i>1 September 2019 to 29 February 2020</i>	
Net loss from trade 1 September 2019 to 29 February 2020	(5 000)
Capital gain on sale of garage property (sold 31 October 2019)	1 800 000
Capital gain on sale of primary residence (before exclusion) (sold 31 January 2020)	2 100 000

*Result:**Cecil**Taxable income to date of sequestration (1 March 2019 to 31 August 2019)*

Capital gain – listed shares	150 000
Less: Annual exclusion	(40 000)
Less: Assessed capital loss brought forward	(50 000)
Net capital gain	<u>60 000</u>
Taxable capital gain 40% × R60 000	24 000
Net loss from trade	(100 000)
Assessed loss brought forward	(250 000)
Assessed loss carried forward	<u>(326 000)</u>

Cecil will be issued with an original assessment up to and including the day before the date of sequestration.

Cecil's insolvent estate

	R
Capital gain on disposal of garage	1 800 000
Capital gain on disposal of primary residence before exclusion	2 100 000
Primary residence exclusion	(2 000 000)
Annual exclusion	=
Net capital gain	<u>1 900 000</u>
Taxable capital gain 40% × R1 900 000	760 000
Taxable interest income	15 000
Net loss from trade	(5 000)
Assessed loss brought forward	(326 000)
Taxable income	<u>444 000</u>

Had Cecil been liable for tax at date of sequestration, his primary rebate would have been apportioned (halved), because his year of assessment ended on 31 August 2019. Cecil's estate is not entitled to the annual exclusion during the year ended 29 February 2020 because the full exclusion of R40 000 was used by Cecil in the period up to date of sequestration. Since Cecil and his insolvent estate are treated as one and the same person for the purpose of determining a taxable capital gain or assessed capital loss, the annual exclusion may not exceed R40 000 in the year of sequestration. Since Cecil had used the full exclusion, there was nothing left over for his estate.

Paragraph 83 also ensures that Cecil's estate qualifies for the primary residence exclusion.

Example 2 – Treatment of the person after date of sequestration

Facts:

The saga continues. With effect from 1 September 2019 Cecil was taken on register by SARS as a new taxpayer and received his new tax number. Using funds borrowed from his father he purchased some listed shares as a long-term investment at a cost of R1 million on 31 October 2019. On 29 February 2020 he was forced to sell the shares, as he needed the funds to pay medical bills after his son had become seriously ill. He realised proceeds of R1,2 million. The only other income derived by Cecil was a salary of R120 000 (R20 000 a month × 6).

Result:

Cecil's taxable income is determined as follows:

	R
Capital gain on disposal of listed shares R1,2 million – R1 million	200 000
Less: Annual exclusion	<u> -</u>
Net capital gain	200 000
Inclusion rate	40%
Taxable capital gain	80 000
Salary	<u>120 000</u>
Taxable income	<u>200 000</u>

Cecil's rebates must be halved under s 6(4). His annual exclusion is nil because it was used by him before sequestration.

17.3 Companies in liquidation

A company in liquidation remains the same taxable entity⁸⁰⁷ until it is finally dissolved. No special measures are therefore needed to deal with capital gains and losses arising in such companies. Any income tax payable in respect of the post-liquidation period by a company in liquidation (for example, as a result of capital gains arising during that period) qualifies as a cost of administration under s 97(2)(c) of the Insolvency Act 24 of 1936.⁸⁰⁸ There is no procedure for proving such claims,⁸⁰⁹ which enjoy a higher degree of preference than claims for income tax in respect of the pre-liquidation period under s 101. The liquidator in his capacity as public officer⁸¹⁰ must simply lodge the relevant returns of income and settle the taxes owing before distributing any surplus to the remaining creditors in their order of preference.

⁸⁰⁷ *Van Zyl NO v CIR* 1997 (1) SA 883 (C), 59 SATC 105.

⁸⁰⁸ See the *van Zyl* case above at SATC 113/114. See also the House of Lords decision in *Re Toshoku Finance UK plc (in liquidation) Kahn & another v IRC* [2002] 3 All ER 961 and M Seligson 'Realisation of Secured Immovable Property in the Winding-up of Insolvent Estates' (June 2012) 3 *Business Tax and Company Law Quarterly* 1.

⁸⁰⁹ E Bertelsmann *et al Mars: The Law of Insolvency in South Africa* 9 ed (2008) Juta & Co Ltd in § 22.6 at page 479. 5 at 400.

⁸¹⁰ Section 248 of the Tax Administration Act.

The distribution of an asset *in specie* by a company in liquidation is deemed to be made at market value under para 75(1). An exception to this rule is, however, provided under s 47 to qualifying subsidiary companies that distribute assets to their holding companies. Such assets are deemed to be disposed of to the holding company at their base cost, resulting in neither a gain nor a loss. Any unrealised gain or loss is rolled over into the holding company and is effectively deferred.

Chapter 18 – Company distributions

PART XI: COMPANY DISTRIBUTIONS

Part XI of the Eighth Schedule incorporates the special rules that apply when a company distributes cash or other assets in relation to previously existing shares.

18.1 Company distributions – definitions

Paragraph 74, s 1(1)

Paragraphs 75 to 77 use a number of definitions contained in s 1(1) and para 74 which are considered below.

18.1.1 Definition – ‘date of distribution’

‘ “[D]ate of distribution”, in relation to any distribution, means—

- (a) to the extent that the distribution does not consist of a distribution of an asset in specie—
 - (i) where the company that makes the distribution is a listed company, the date on which the distribution is paid; or
 - (ii) where the company that makes the distribution is not a listed company, the earlier of the date on which the distribution is paid or becomes due and payable; or
- (b) to the extent that the distribution consists of a distribution of an asset in specie, the earlier of the date on which the distribution is paid or becomes due and payable.’

The above definition applies with effect from 1 April 2012.

It is used in para 75 to determine the date of disposal by a company of an asset distributed *in specie* to a holder of shares and the corresponding date of acquisition of that asset by that holder. It is also used in para 75 to fix the date on which the market value of the asset must be determined for the purposes of determining the amount deemed to be received by or accrued to the company and the amount of expenditure deemed to be incurred by the holder of shares.

The term is also used in para 76 which sets out the rules for dealing with a pre-1 April 2012 return of capital or foreign return of capital.

The definition of ‘date of distribution’ mirrors the rules for determining the date of payment of a dividend for the purposes of dividends tax under s 64E(2).

18.1.2 Definition – ‘dividend’ [s 1(1)]

‘ “[D]ividend” means any amount, other than a dividend consisting of a distribution of an asset *in specie* declared and paid as contemplated in section 31(3), transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company, whether that amount is transferred or applied—

- (a) by way of a distribution made by; or
- (b) as consideration for the acquisition of any share in,

that company, but does not include any amount so transferred or applied to the extent that the amount so transferred or applied—

- (i) results in a reduction of contributed tax capital of the company;
- (ii) constitutes shares in the company; or
- (iii) constitutes an acquisition by the company of its own securities by way of a general repurchase of securities as contemplated in subparagraph (b) of paragraph 5.67(B) of section 5 of the JSE Limited Listings Requirements, where that acquisition complies with any applicable requirements prescribed by paragraphs 5.68 and 5.72 to 5.81 of section 5 of the JSE Limited Listings Requirements or a general repurchase of securities as contemplated in the listings requirements of any other exchange, licensed under the Financial Markets Act, that are substantially the same as the requirements prescribed by the JSE Limited Listings Requirements, where that acquisition complies with the applicable requirements of that exchange;

The definition in its current form was introduced with effect from 1 January 2011 and has undergone some amendment since then. Unlike the previous definition, it does not depend on the availability of profits before a dividend can be declared. Since a dividend is included in para (k) of the definition of ‘gross income’ in s 1(1), it is excluded from proceeds under para 35(3)(a), for example, upon a share buy-back (other than a buy-back done on the open market by a listed company). Dividends which are exempt from normal tax and dividends tax can result in the reduction of a capital loss on disposal of shares under para 19 or in the inclusion in proceeds on disposal of shares under para 43A. The base cost of a dividend in specie is determined under para 75. The focus of paras 76, 76A and 77 is, however, on returns of capital and foreign returns of capital rather than on dividends. Accordingly, for the purposes of Part VI the definition of ‘dividend’ is more significant for what it excludes since the exclusions may well have implications under Part XI.

The word ‘amount’ has been judicially considered in relation to the definition of ‘gross income’ to mean market value (see 9.1.1.1). It is submitted that an ‘amount’ in the context of a dividend refers to the market value of property awarded to a holder of shares.

The exclusion from an ‘amount’ of ‘a dividend consisting of a distribution of an asset *in specie* declared and paid as contemplated in section 31(3)’, refers to the secondary adjustment made under the transfer pricing rules.⁸¹¹ In most instances such an adjustment would in any event have been excluded because it would not be ‘in respect of’ a share. The purpose of the exclusion is to address the other instances in which the adjustment can in fact be linked to a share. While the secondary adjustment is excluded from this definition, it is included in the definition of ‘dividend’ in s 64D and hence will potentially be subject to dividends tax.

The word ‘transferred’ covers a transfer of ownership of an asset, while the word ‘applied’ would cover the payment of the debt of a holder of shares or a payment to a person providing a service to a holder of shares.

The amount must be for the ‘benefit’ of the holder of shares. A holder of shares would benefit from the payment of a dividend or a return of CTC. But a holder of shares who pays a market-related consideration for an asset of the company does not derive a ‘benefit’.

⁸¹¹ The amendment came into operation on 1 January 2019 and applies in respect of years of assessment commencing on or after that date.

The amount must be derived ‘in respect of’ a share in the company. The words ‘in respect of’ in this context, it is submitted, connote a close causal relationship between the amount transferred or applied and the share.⁸¹² It follows that an amount which is unrelated to a taxpayer’s holding of shares will not be derived ‘in respect of’ a share. For example, the purchase by a taxpayer of an asset from the company at an arm’s length price on the same terms that it is offered to the public would not be derived in respect of the holder’s shares in the company.

Inclusions

Distribution [para (a)]

Paragraph (a) of the definition of ‘dividend’ includes a distribution. Since the word ‘distribution’ is not defined, consideration must be given to its ordinary grammatical meaning, taking into account the context in which it appears and the purpose to which it is directed. In *CIR v Legal & General Assurance Society Ltd* Steyn CJ stated the following regarding the meaning of ‘distributed’ in the context of the definition of ‘dividend’:⁸¹³

‘In my view, effect can be given to this apparent intention of the legislature by ascribing to “distribute”, in the relevant context, the wider meaning of apportion, appropriate, allocate or apply towards.’

In the definition of ‘dividend’ the term would appear to refer to something given without the expectation of a *quid pro quo*.

Share buy-backs (para (b))

The definition specifically includes consideration given by the company in respect of a share buy-back, since such an acquisition is not a distribution. While para (b) includes all buy-backs, para (iii) excludes open market buy backs (see below).

Exclusions

Contributed tax capital [para (i)]

The exclusion of CTC from the definition of ‘dividend’ means that a return of CTC will generally comprise a return of capital with consequences under paras 76, 76A, 76B and 77.

The definition of ‘dividend’ must be read in conjunction with the definition of ‘contributed tax capital’ because any amount that does not comprise CTC will be a dividend unless it is otherwise excluded. The definition of ‘dividend’ is not concerned with the presence or absence of profits, accounting treatment or company law considerations. It is an artificial tax concept.

Example 1 – Dividend despite the absence of profits

Facts:

A company has share capital of R100, share premium of R200 and profits of nil. The directors pay R200 to the shareholders and do not elect that the amount must be paid out of CTC.

Result:

The payment of R200 is a dividend.

⁸¹² For commentary on the expression ‘in respect of’ see AP de Koker & RC Williams *Silke on South African Income Tax* [online] (My LexisNexis: October 2019) in § 25.7A.

⁸¹³ 1963 (3) SA 876 (A), 25 SATC 303 at 315.

Shares in the company [para (ii)]

The definition excludes a distribution of a company's own shares, For example, by way of a capitalization issue. Shares issued for no consideration are dealt with under s 40C.

Open market buy-backs [para (iii)]

A company listed on an exchange approved under the Financial Markets Act can buy back its own shares in several ways but only a general repurchase is specifically excluded from the definition of 'dividend' when the company complies with the JSE listings requirements or substantially the same requirements of another approved exchange. This counterintuitive term refers to a buy-back on the open market. General repurchases on the open market are excluded from the definition of 'dividend' because the holders of shares in question would not be aware that it is the company that has bought back their shares. They would therefore not be in a position to obtain a split between the dividend and non-dividend elements of the purchase consideration. The result would have been that they would have declared the full consideration as proceeds for CGT purposes while the company would have had to withhold dividends tax from any dividend element.

Other types of share buy-backs which will require a split between the dividend and non-dividend elements of the consideration include the following:

- A buy-back from a dissenting holder of shares under s 164 of the Companies Act 71 of 2008 [para 5.67(A) of the listings requirements].
- A *pro-rata* repurchase by a company from all the holders of its shares [para 5.67 (B) of the listings requirements].
- A specific repurchase, which includes a buy-back from option holders and an offer to named sellers [para 5.69 of the listings requirements].
- An odd-lot repurchase [para 5.123 of the listings requirements].

Share buy-backs are dealt with under the core rules and not under Part XI. In other words, the proceeds in respect of the buy-back will be determined under para 35 with the dividend element being excluded by para 35(3)(a). It will be observed that para 76B(1) and (2) refer to a return of capital or foreign return of capital received or accrued 'prior to disposal of that share' which would exclude amounts received or accrued as part of a share buy-back, since such amounts will normally coincide with the disposal rather than be derived before the disposal.

18.1.2 Definition – 'contributed tax capital' [s 1(1)]

- ‘ “[C]ontributed tax capital”, in relation to a class of shares in a company, means—
- (a) in relation to a class of shares issued by a company, in the case of a foreign company that becomes a resident on or after 1 January 2011, an amount equal to the sum of—
- (i) the market value of all the shares in that company of that class immediately before the date on which that company becomes a resident;
 - (ii) the consideration received by or accrued to that company for the issue of shares of that class on or after the date on which that company becomes a resident; and
 - (iii) if the shares of that class include or consist of shares that were converted from another class of shares of that company to that class of shares—
 - (aa) any consideration received by or accrued to that company in respect of that conversion; and

- (bb) the amount contemplated in subparagraph (cc) that was determined in respect of shares of the other class of shares that were so converted, reduced by so much of that amount as—
- (aa) the company has transferred on or after the date on which the company becomes a resident for the benefit of any person holding a share in that company of that class in respect of that share;
- (bb) has by the date of the transfer been determined by the directors of the company or by some other person or body of persons with comparable authority to be an amount so transferred; and
- (cc) in the case of a convertible class of shares some of the shares of which have been converted to another class of shares, so much of the amount contemplated in this paragraph in respect of that convertible class of shares immediately prior to that conversion as bears to that amount the same ratio as the number of shares so converted bears to the total number of that convertible class of shares prior to that conversion; or
- (b) in relation to a class of shares issued by a company, in the case of any other company, an amount equal to the sum of—
- (i) the stated capital or share capital and share premium of that company immediately before 1 January 2011 in relation to shares in that company of that class issued by that company before that date, less so much of that stated capital or share capital and share premium as would have constituted a dividend, as defined before that date, had the stated capital or share capital and share premium been distributed by that company immediately before that date;
- (ii) the consideration received by or accrued to that company for the issue of shares of that class on or after 1 January 2011; and
- (iii) if the shares of that class include or consist of shares that were converted from another class of shares of that company to that class of shares—
- (aa) any consideration received by or accrued to that company in respect of that conversion; and
- (bb) the amount contemplated in subparagraph (cc) that was determined in respect of shares of the other class of shares that were so converted, reduced by so much of that amount as—
- (aa) the company has transferred on or after 1 January 2011 for the benefit of any person holding a share in that company of that class in respect of that share;
- (bb) has by the date of the transfer been determined by the directors of the company or by some other person or body of persons with comparable authority to be an amount so transferred; and
- (cc) in the case of a convertible class of shares some of the shares of which have been converted to another class of shares, so much of the amount contemplated in this paragraph in respect of that convertible class of shares immediately prior to that conversion as bears to that amount the same ratio as the number of shares so converted bears to the total number of that convertible class of shares prior to that conversion:

Provided that the amount transferred by a company as contemplated in paragraph (a) or (b) for the benefit of a person holding shares of any class of shares of that company must not exceed an amount that bears to the total of the amount of contributed tax capital attributable to that class of shares immediately before the transfer the same ratio as the number of shares of that class held by that person bears to the total number of shares of that class;'

This definition was originally introduced on 1 January 2011 although it has since been amended. Its introduction coincided with the simultaneous introduction of a completely revised definition of 'dividend' in s 1(1), which is not dependent on the presence of profits available for distribution. As with the definition of 'dividend' the concept is an artificial one unrelated to what happens in reality for accounting or company law purposes. A company could elect to reduce its CTC yet pay the amount out of profits. Conversely, a payment out of the company's share premium account will not represent a reduction of its CTC unless the directors elect that the company's CTC be reduced by an equivalent amount. A company's CTC cannot become a negative figure. Once the CTC is reduced to nil any further payments to shareholders will represent dividends.

Section 8G deals with the determination of CTC when shares are issued to a group company. This section is not discussed in this guide.

Basic rules: additions, starting amounts and reductions

The CTC of a company is a notional amount derived from the value of any contribution made to a company as consideration for the issue of shares by the company. CTC will be reduced by any part that is allocated by the company in a subsequent transfer to one or more shareholders.

As a general rule, the CTC of a company is based on amounts received by or accrued to a company as consideration for the issue of shares by the company. For instance, if an individual contributes an asset worth R100 to a public company in an offer of shares to the public, R100 is added to CTC. Applying basic principles, an amount received by or accrued to a company as consideration for the issue of shares would not only include cash or the value of an asset received by or accrued to the company. CTC would also include the value of services provided by a person to the company as consideration for a share issue or the cancellation of a loan account owed by the company as consideration for the issue of shares.

As a transitional measure, the share capital and share premium of a company immediately before 1 January 2011 will generally operate as the 'starting' CTC. However, amounts of share capital and share premium that would have constituted a dividend had they been distributed immediately before 1 January 2011 are excluded from 'starting' CTC. In other words, 'starting' CTC does not include 'tainted' share capital or share premium (that is, capitalised profits). Any portion of the equity share capital and share premium of a resultant company that was deemed to be a profit not of a capital nature available for distribution under s 44(9A) will also not form part of CTC.

In order for a transfer from a company to a shareholder to constitute a reduction of CTC and accordingly not comprise a dividend, the definition of CTC requires that the directors or persons with comparable authority determine that the transfer constitutes a transfer of CTC. Without this determination, which could, for example, take the form of a company resolution, no reduction of CTC can occur and the amount transferred will constitute a dividend potentially subject to dividends tax. In effect, the rules amount to a unilateral company election. In order for this determination to be valid, it must be made by the date of the transfer by the company to the shareholders. On or after 1 April 2012 shareholders must be notified of the amount of any CTC under para 76(4) – see **18.6**. The determination of what constitutes CTC or a dividend may well be divorced from reality and is done independently of any accounting or company law considerations. A company may, for example, be able to return share premium to its shareholders as a dividend and profits to its shareholders as CTC.

Example 1 – Determination of opening balance of CTC on 1 January 2011*Facts:*

On 31 December 2010 Company X's capital employed comprised the following:

	R
100 000 shares of R1 each issued for cash	100 000
50 000 capitalisation shares of R1 each paid up out of revenue reserves	50 000
Share premium account (includes R60 000 of capitalised profits)	200 000
Retained income	<u>500 000</u>
	<u>850 000</u>

Result:

Company X's opening balance of CTC at 1 January 2011 comprises the following:

Share capital contributed in cash	100 000
Share premium contributed in cash (R200 000 – R60 000)	<u>140 000</u>
CTC	<u>240 000</u>

If the capitalisation shares and the tainted portion of the share premium account had been distributed to shareholders immediately before 1 January 2011, they would have comprised a dividend. They must therefore be excluded from CTC along with the retained income.

Class-by-class and pro-rata shareholder rules

A company that has issued several classes of shares must maintain a separate record of CTC on a per-class basis. Therefore, CTC created by virtue of an ordinary share issue cannot be allocated or reallocated to preference shares. Similarly, distributions in respect of preference shares cannot be used to reduce the CTC associated with ordinary shares. If a company makes a distribution out of CTC in respect of a given class of shares, the CTC distributed will be allocated *pro rata* to the shareholders of that class of shares.

Example 2 – Allocation of CTC between shareholders in the same class*Facts:*

Company Y has two ordinary shareholders (A and B) and one preferred shareholder (C). A, B and C are individuals. A owns 25 ordinary shares, and B owns the other 75 ordinary shares. Company Y has CTC of R150 in respect of its preference shares and R380 in respect of its ordinary shares. As part of a written company resolution when making a distribution to its ordinary shareholders of R200, Company Y decided to allocate R60 of the ordinary share CTC to shareholders A and B.

Result:

Shareholder A received a distribution of $R200 \times 25\% = R50$, while shareholder B received a distribution of $R200 \times 75\% = R150$.

The amount of CTC transferred to shareholders A and B is calculated as follows:

CTC transferred to A = $R60 \times 25\% = R15$
 CTC transferred to B = $R60 \times 75\% = R45$

Hence, shareholder A received a dividend of R35 (that is, R50 less R15 of CTC). Shareholder B received a dividend of R105 (that is, R150 less R45 of CTC). The dividend portion of the distribution is subject to dividends tax, while the CTC portion comprises a return of capital.

Example 3 – Allocation of CTC to shares of another class

Facts:

Company Z has one ordinary shareholder (A) and one preferred shareholder (B). Company Z has CTC of R380 for its preference shares and R150 for its ordinary shares. As part of a written company resolution when making a distribution to its ordinary shareholders of R200, Company Z decided to allocate the full R150 of ordinary share CTC and R50 of the preference share CTC to shareholder A.

Result:

Only R150 is a distribution of CTC to shareholder A, and will comprise a return of capital for that shareholder. The balance of R50 is a dividend because it relates to CTC of another class of shares. After the distribution the ordinary share CTC is reduced to nil, while the preference share CTC remains intact at R380.

Example 4 – Notional nature of CTC

Facts:

Company X elected to pay an amount to its shareholders by reducing its CTC. For accounting purposes and in reality, however, the payment was paid out of the company's profits.

Result:

The payment comprises a return of capital in the hands of Company X's shareholders. The fact that in reality the payment took the form of a common law dividend is irrelevant.

18.1.3 Definition – 'foreign return of capital'

‘ “[F]oreign return of capital” means any amount that is paid or payable by a foreign company in respect of any share in that foreign company where that amount is treated as a distribution or similar payment (other than an amount that constitutes a foreign dividend) by that foreign company for the purposes of the laws relating to—

- (a) tax on income on companies of the country in which that foreign company has its place of effective management; or
- (b) companies of the country in which that foreign company is incorporated, formed or established, where that country in which that foreign company has its place of effective management does not have any applicable laws relating to tax on income,

but does not include any amount so paid or payable to the extent that the amount so paid or payable—

- (i) is deductible by that foreign company in the determination of any tax on income of companies of the country in which that foreign company has its place of effective management; or
- (ii) constitutes shares in that foreign company;’

This definition applies to amounts paid or that become payable on or after 1 January 2011.

18.1.4 Definition – ‘return of capital’

‘ “[R]eturn of capital” means any amount transferred by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company to the extent that that transfer results in a reduction of contributed tax capital of the company, whether that amount is transferred—

- (a) by way of a distribution made by; or
- (b) as consideration for the acquisition of any share in,

that company, but does not include any amount so transferred to the extent that the amount so transferred constitutes—

- (i) shares in the company; or
- (ii) an acquisition by the company of its own securities by way of a general repurchase of securities as contemplated in subparagraph (b) of paragraph 5.67(B) of section 5 of the JSE Limited Listings Requirements, where that acquisition complies with any applicable requirements prescribed by paragraphs 5.68 and 5.72 to 5.81 of section 5 of the JSE Limited Listings Requirements or by way of a general repurchase of securities as contemplated in the listings requirements of any other exchange, licensed under the Financial Markets Act, that are substantially the same as the requirements prescribed by the JSE Limited Listings Requirements, where that acquisition complies with the applicable requirements of that exchange;’

This definition came into operation on 1 January 2011 although it has since been amended. A return of capital will be received by or accrued to a holder of a share when the company reduces its CTC, regardless of whether the reduction is occasioned by a distribution or a share buy-back (other than a share buy-back by a listed company on the open market). A share buy-back by a listed company made on the open market will not give rise to a return of capital, and any consideration received by or accrued to the shareholder will in such event simply comprise proceeds on disposal of the share, assuming that they are of a capital nature. Although other forms of share buy-back made out of the company’s CTC will give rise to a return of capital, their treatment will be the same, that is, they will also be dealt with as proceeds on a full disposal of the share under para 35. A return of capital otherwise than from a share buy-back will have implications for the holder of the share under paras 76, 76A, 76B or 77.

As with CTC, accounting and company law concepts are not determinative of whether an amount comprises a return of capital or something else such as a dividend or a receipt or accrual of a capital or revenue nature.

18.2 Distributions *in specie* by a company

Paragraph 75

Paragraph 75 regulates the impact of distributions of assets *in specie for the company and holders of its shares*. This rule exists as a matter of tax parity within the corporate tax system – the distribution of an asset should have the same tax impact as a company sale of the asset followed by a distribution of after-tax cash proceeds. It applies regardless of whether the distribution occurs during the lifetime operations of the company, during liquidation, or otherwise. A distribution of an asset *in specie* by a resident company by way of a dividend will potentially result in the company becoming liable for dividends tax under s 64EA(b). However, if the holder of shares makes a declaration to the company that the dividend would have been exempt in the hands of the holder had it been made by way of a cash dividend, the dividend will be exempt from dividends tax under s 64FA. Such a declaration could typically be made by a resident company shareholder since distributions of dividends between domestic companies are exempt from dividends tax under s 64F(1)(a).

Under para 75 a company that makes a distribution of an asset in specie to a person holding a share in that company is treated as having disposed of that asset to that person on the 'date of distribution' as defined in para 74 for an amount received or accrued equal to the market value of the asset on that date.

Distribution of trading stock

Trading stock distributed *in specie* is included in the distributing company's income under s 22(8)(b)(iii) at market value under s 22(8)(B). Since trading stock is an asset for CGT purposes (see 4.1.2), it must also be dealt with under para 75. However, double taxation is avoided under para 35(3)(a) by reducing the amount deemed to be received or accrued under para 75 by the amount recouped under s 22(8)(b)(iii).

Recoupment of capital allowances

Section 8(4)(k) applies for the purposes of s 8(4)(a). It provides that a company that transferred in whatever manner or form any asset to any holder of a share in that company in respect of which a deduction or an allowance was granted to that company under any of the provisions referred to in s 8(4)(a) is deemed to have disposed of that asset for an amount equal to the market value of that asset as at the date of that transfer. In other words, s 8(4)(k) triggers an inclusion in income in respect of capital allowances that are recovered or recouped as a result of the deemed disposal of the allowance asset at market value. Under para 35(3)(a) the amount deemed to have been received by the company under para 75 must be reduced by any amount deemed to be recovered or recouped under s 8(4)(a).⁸¹⁴

Connected person relationship not required under para 75

The deemed disposal of an asset at market value which is distributed *in specie* applies regardless of whether the holder of shares is a connected person in relation to the company. Nevertheless, the clogged loss rule in para 39 will apply to capital losses on assets distributed to holders of shares who are connected persons in relation to the company.

Treatment of the recipient

The holder of shares is correspondingly treated as having acquired the asset on the same date for expenditure actually incurred for the purposes of para 20(1)(a) equal to the same market value.

This rule does not apply to assets acquired before the valuation date because the Eighth Schedule applies only to disposals on or after the valuation date. The expenditure incurred on an asset of this nature must be determined according to common law principles having regard to the extinction of the personal right to claim delivery of the asset. The application of these principles may well provide the same result as para 75 – see 8.5A. This outcome is relevant for determining 'B' in the time-apportionment base cost formula for such assets.

Pre-CGT unbundling of shares

The unbundled company shares

A holder of shares who received shares under an unbundling transaction before the valuation date would usually acquire them for an expenditure equal to their market value under the principles discussed in 8.5A. If the holder of shares elects to use the time-apportionment base cost method to determine the valuation date value of the unbundled company shares, the

⁸¹⁴ Before 22 December 2003 the provision simply deemed the amount to be 'proceeds'. However, proceeds is the amount arrived at after applying para 35 and reliance therefore had to be placed on the general presumption against double taxation to overcome the fact that no provision was made to exclude amounts that had already been taxed as ordinary income.

expenditure before valuation date ('B' in the time-apportionment base cost formula) will be the market value determined under **8.5A**. The date of acquisition for the purposes of determining 'N' (period before valuation date) in the formula will be the date on which ownership of the shares was acquired. By not retaining the date of acquisition of the old shares, the value of 'N' in the time-apportionment base cost formula (period before valuation date) will be lower. As a result, a higher proportion of any capital gain or loss will be subject to CGT when the unbundled shares are disposed of.

The unbundling company shares

Despite a pre-CGT unbundling dividend having been exempt from STC under the old unbundling legislation,⁸¹⁵ it nevertheless falls outside the definition of 'return of capital' in s 1(1). It follows that there is no means to reduce the expenditure on the unbundling company shares under para 76(1)(a).⁸¹⁶ From the *fiscus's* point of view this is a somewhat perverse situation, since by rights a portion of the expenditure on the unbundling company's shares should be allocated to the unbundled company's shares. The problem arises only when time apportionment is used for determining the valuation date value of the unbundling company shares. If market value were used, the price of the shares on valuation date would reflect the fact that the unbundling company no longer held an interest in the unbundled company. Holders of shares may adopt market value or time apportionment for the purposes of determining the valuation date value of the unbundling company shares.

For the post-CGT unbundling of shares, s 46(3) makes provision for a pro-rata reduction in the base cost of the unbundling company shares and also enables the date of acquisition of the old shares to be carried across to the new shares.

Meaning of 'distribution'

The term 'distribution' is not defined but would typically include the transfer of an asset to a holder of shares without the payment of any *quid pro quo*, for example, by the distribution of a dividend or a reduction of CTC. Paragraph 75 does not apply to the issue of shares or options on such shares in the company making the distribution. The issue by a company of its own shares or the granting of an option to acquire them is not a disposal under para 11(2)(b). The issue by a company of its own shares for no consideration is dealt with under s 40C.

Example – Company level consequences of distributions of assets *in specie*

Facts:

Ay (Pty) Ltd has 100 issued ordinary shares of which Kevin owns 90 and Leoni owns 10. Amongst other assets, Ay (Pty) Ltd owns shares in Zulu (Pty) Ltd, an unconnected company, as well as land. The Zulu (Pty) Ltd shares have a market value of R180 000 and a base cost of R200 000. The land has a market value of R20 000 and a base cost of R7 000. Ay (Pty) Ltd distributed the shares in Zulu (Pty) Ltd to Kevin and the land to Leoni. Both distributions came partly from CTC and partly from non-CTC sources.

⁸¹⁵ Section 60(5)(a)(i) of the Income Tax Act 113 of 1993 deems the distribution not to be a dividend for the purposes of Part VII of Chapter II. STC falls under Part VII.

⁸¹⁶ Section 60(5)(b) permits the allocation of a part of the cost of the old shares to the new shares only when the old shares were held as trading stock.

Result:

The distributions of shares and land qualify as disposals at market value. Ay (Pty) Ltd realised 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. Since Kevin is a connected person⁸¹⁷ in relation to Ay (Pty) Ltd, Ay (Pty) Ltd may set off the capital loss of R20 000 only against capital gains arising from transactions with him [para 39(2)].

Paragraphs 76 to 77: Consequences for holders of shares

Paragraphs 76, 76A, 76B and 77 address the consequences for holders of shares of various distributions.

Paragraph 76 contains a number of transitional rules for dealing with a return of capital or foreign return of capital by way of a distribution of cash or an asset *in specie*. These rules are necessary, in part, because returns of capital and foreign returns of capital have been dealt with in three different ways since CGT was introduced. Paragraph 76(4) imposes a duty on resident companies to notify holders of their shares of the amount of any returns of capital.

Paragraph 76A contains the rules for triggering a part-disposal of a share when a return of capital or foreign return of capital by way of a distribution of cash or an asset *in specie* referred to in para 76 is received by or accrues to a holder of shares on or after 1 October 2007 but before 1 April 2012. It also contains transitional rules for dealing with a return of capital or foreign return of capital received or accrued before 1 October 2007, the date on which part-disposal treatment was implemented. Part-disposal treatment of a return of capital or foreign return of capital was discontinued on or after 1 April 2012 and replaced by the base cost reduction method under para 76B.

Paragraph 76B applies to a return of capital or foreign return of capital received or accrued on or after 1 April 2012. The terms 'return of capital' and 'foreign return of capital' are defined in s 1(1) and serve as replacements for the definition of 'capital distribution' which was deleted from para 74 from 1 April 2012. Under para 76B(2) such amounts are treated as a reduction in the expenditure in respect of a share. If the return of capital or foreign return of capital exceeds the expenditure, the excess is treated as a capital gain [para 76B(3)]. If a return of capital or foreign return of capital is received or accrued from a pre-valuation date share, it is necessary to determine the base cost of the share in order to apply the base cost reduction method [para 76B(1)].

Paragraph 77 contains time of disposal rules which apply when a company is liquidated or deregistered. They specify when a share is deemed to be disposed of under such circumstances, and also deal with returns of capital which may arise after the date of deemed disposal.

⁸¹⁷ See the definition of 'connected person' in s 1(1). Paragraph (d)(iv) of that definition includes any person, other than a company as defined in s 1 of the Companies Act, that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20% of the equity shares or voting rights in the company.

18.3 Returns of capital – Historical developments and international comparison

Three different methods, as summarised below, have applied to the treatment of a return of capital or foreign return of capital (formerly known as a capital distribution) since the introduction of CGT.

- *1 October 2001 to 30 September 2007* – During this period a capital distribution was treated as proceeds on disposal of a share except when the weighted-average method was adopted, in which event it was deducted from the base cost of the share.
- *1 October 2007 to 31 March 2012* – During this period a capital distribution was treated as a part-disposal of the share [para 76A(1)]. Special transitional rules applied to a pre-1 October 2007 capital distribution in respect of a share which was not disposed of by 30 September 2007 and for which the weighted-average method had not been adopted. A pre-1 October 2007 capital distribution is brought to account as proceeds on disposal of the share, or if the share has not been disposed of by 1 April 2012, as a reduction in base cost on 1 April 2012 [para 76A(1A) read with para 76B(2)] under para 76B. No adjustment is required for a pre-1 October 2007 capital distribution when the weighted-average method has been adopted because it would already have been deducted from the base cost of the shares. However, if the weighted average base cost of the shares is negative at the end of 31 March 2012, the negative amount is deemed to be a capital gain on that date and the base cost is reset to nil [para 76A(2)].
- *1 April 2012 onwards* – A return of capital or foreign return of capital reduces the expenditure on the share. To the extent that it exceeds the expenditure, the excess is treated as a capital gain. A special rule converts pre-valuation date shares to post-valuation date shares before the receipt or accrual of the return of capital or foreign return of capital.

Each of the three methods has its advantages and disadvantages. The treatment as proceeds provided a simple method but was open to abuse because of the deferral of the capital gain. For example, even if the return of capital exceeded the base cost of the share, it would be brought to account only when the shares were eventually disposed of which could be many years later.

The part-disposal treatment had the advantage of finalizing the CGT consequences of a return of capital in the year of assessment in which it was received or accrued but it was complex and gave rise to unfair results under certain circumstances when a company was liquidated or deregistered (for example, it could give rise to a capital gain followed by a capital loss if a return of capital occurred before a dividend). The United Kingdom follows this method, with a part-disposal being triggered each time a capital distribution occurs.⁸¹⁸

The base cost reduction method defers any capital gain until the earlier of when the share is disposed of or until the base cost becomes negative. This treatment provides a significant benefit to holders of shares, particularly since the directors are able to return all the company's CTC to them while the company is operating as a going concern – in other words in reality a company might have its share capital and share premium intact but for tax purposes it might all have been distributed to holders of shares. In some situations, this could prejudice new holders of shares some of whose CTC might be distributed to old holders of shares who contributed far less by way of CTC. The base cost reduction method is used by the United States and Australia. In the United States a distribution other than a dividend is treated as a reduction in 'adjusted basis' (base cost). If the adjusted basis turns negative, the excess is

⁸¹⁸ See s 122 of the Taxation of Chargeable Gains Act, 1992. The United Kingdom does, however, permit small capital distributions to be credited against base cost.

treated as a gain from the sale or exchange of property.⁸¹⁹ Likewise, in Australia a gain is triggered when the 'cost base' (base cost) turns negative.⁸²⁰

18.4 Returns of capital – Summary and overview of paras 76, 76A and 76B

Table 1 – Treatment of a return of capital or foreign return of capital

When return of capital or foreign return of capital received or accrued	Paragraph	Identification method adopted	Treatment
Before valuation date	76(1)(a)	Specific identification or first in, first out	Reduce pre-valuation date expenditure on the share (but not below nil). This rule applies if the time-apportionment base cost method is used to determine the valuation date value of the share.
	N/A	Weighted average	Not relevant (ignore).
On or after 1 October 2001 but before 1 October 2007 and share has been disposed of on or before 31 March 2012	76(1)(b)	Specific identification or first in, first out	Treat the amount of cash or market value of the asset <i>in specie</i> as proceeds when the share is fully disposed of.
	76(2)	Weighted average	Deduct the amount of cash or market value of the asset <i>in specie</i> received or accrued by way of a return of capital from the base cost of the shares when received or accrued.
On or after 1 October 2007 but before 1 April 2012	76(1)(c) ⁸²¹	Specific identification, first in, first out or weighted average	Treat as proceeds when a share is partly disposed of under para 76A.
On or after valuation date but before 1 October 2007 and shares not disposed of before 1 April 2012	76A(1A), 76B	Specific identification and first in, first out	The return of capital is treated as having been distributed on 1 April 2012 [para 76A(1A)]. It must therefore be deducted from the base cost of the share on 1 April 2012 under para 76B(2). The base cost of pre-valuation date shares will first have to be determined under para 76B(1) before the deduction is made.
	76A(2)	Weighted average	If the base cost of the shares is negative at the end of 31 March 2012 the negative amount is deemed to be a capital gain on 31 March 2012 and the base cost is reset to nil.

⁸¹⁹ Section 301(3) of the Internal Revenue Code, available online at <<http://www.fourmilab.ch/ustax/www/t26-A-1-C-I-A-301.html>> [Accessed 2 November 2020].

⁸²⁰ See CGT event G1 – s 104–135(4) of the Income Tax Assessment Act, 1997. This approach has now been adopted by South Africa under para 76B.

⁸²¹ Paragraph 76(1)(c) inserted by the Taxation Laws Amendment Act 3 of 2008, and deemed to have come into operation on 1 October 2007.

When return of capital or foreign return of capital received or accrued	Paragraph	Identification method adopted	Treatment
On or after 1 April 2012	76B	Specific identification, first in, first out and weighted average	Under para 76B(2) the holder of shares must reduce the expenditure in respect of the share by the amount of cash or market value of an asset <i>in specie</i> received or accrued by way of a return of capital or foreign return of capital. To the extent that the return of capital or foreign return of capital exceeds the expenditure, the excess is treated as a capital gain under para 76B(3) at the time of receipt or accrual. If the share was acquired before the valuation date, the base cost of the share must first be determined under para 76B(1).

18.5 Returns of capital –transitional measures (para 76)

Paragraph 76

Paragraph 76(1) and (2) contain a number of transitional rules which apply to a return of capital or foreign return of capital received by or accrued to holders of shares before 1 April 2012. The need for transitional rules arises because a Return of capital or foreign return of capital (referred to as a capital distribution before 1 April 2012) has been dealt with in three different ways since the introduction of CGT on 1 October 2001.

Paragraph 76(1) and (2) do not deal with the following situations:

- The surrender by a holder of shares of shares held in a company in exchange for cash or assets from that company (that is, a share buy-back). Since a share buy-back involves a full disposal of a share, it is dealt with under the core rules (paras 11 and 35).
- The receipt or accrual by a shareholder of a return of capital after the shares have been deemed to be disposed of under para 77 (which deals with deregistered or liquidated companies).
- The receipt or accrual of a return of capital or foreign return of capital comprising a share in an unbundled company as a result of an unbundling transaction contemplated in s 46(1). Had the Eighth Schedule applied to an unbundling transaction, the unbundling company would have had to determine a capital gain or loss on the distribution under para 75 and the holder of shares in the unbundling company would have had to reduce the base cost of the unbundling company shares under para 76B(2). Instead, the unbundling company must disregard the disposal under s 46(2) and the holder of its shares must allocate a part of the para 20 expenditure or market value on 1 October 2001 of the unbundling company's shares to the unbundled company's shares under s 46(3).⁸²²

⁸²² The exclusion from para 76(1) of shares acquired under an unbundling transaction was effected by s 81(1) of the Revenue Laws Amendment Act 31 of 2005, came into operation on 1 February 2006 and applies in respect of any distribution on or after that date.

18.5.1 Pre-valuation date return of capital or foreign return of capital [para 76(1)(a)]

A return of capital or foreign return of capital by way of a distribution of cash or an asset *in specie* received by or accrued to a holder of shares before valuation date must be applied to reduce the expenditure contemplated in para 20 actually incurred before valuation date on the share. The expenditure in question must be reduced by the amount of cash or the market value of the asset *in specie*. On the meaning of market value, see para 31.

The use of the word 'reduced' means that when a pre-valuation date return of capital or foreign return of capital exceeds the expenditure incurred before valuation date, the excess must be disregarded in the absence of any provisions to the contrary. The view is held that pre-valuation date expenditure cannot be 'reduced' below zero. The purpose of this treatment is to prevent the taxing of a pre-CGT capital gain.

Persons who adopt the time-apportionment base cost method need to bear in mind that if the pre-CGT expenditure is reduced to zero, and they have any post-CGT expenses (for example, one-third of interest paid to acquire listed shares), the proceeds formula in para 30 will result in the entire gain being allocated to the post-CGT period. This outcome also applies to selling expenses in respect of assets disposed of during years of assessment ending before 8 November 2005.

Holders of shares adopting the specific identification or first-in-first-out asset identification methods under para 32 will need to have maintained a record of pre-valuation date returns of capital or foreign returns of capital in order to comply with para 76(1)(a). Such record-keeping is necessary for determining

- 'B' in the time-apportionment base cost formula; and
- the variables used in the kink tests in paras 26 and 27. For example, the 'expenditure incurred before valuation date' referred to in paras 26 and 27 is the expenditure so incurred reduced by any pre-CGT return of capital or foreign return of capital under para 76(1)(a).

Paragraph 76(1)(a) does not apply when the weighted-average method has been adopted to determine the base cost of JSE-listed shares under para 32(3A), since the starting point under that method is the market value of the shares on valuation date and pre-valuation date expenditure is not taken into account.

18.5.2 Pre-1 October 2007 return of capital or foreign return of capital when shares disposed of on or before 31 March 2012 [para 76(1)(b)]

A return of capital or foreign return of capital by way of a distribution of cash or an asset *in specie* received by or accrued to a holder of shares on or after valuation date but before 1 October 2007 must be treated as proceeds on disposal of the share if the share is disposed of on or before 31 March 2012. It is the amount of cash or the market value of an asset *in specie* that must be added to proceeds under para 35. For the meaning of the term 'market value' see para 31. This rule does not apply when the holder of shares has adopted the weighted-average method for determining the base cost of JSE-listed shares under para 32(3A). Such amounts would already have been deducted from the base cost of the shares under para 76(2).

This rule merely extends the same treatment applied to returns of capital or foreign returns of capital received or accrued on or after valuation date but before 1 October 2007 when the shares were disposed of before 1 October 2007. If the shares were still held on 31 March 2012, these pre-1 October 2007 returns of capital and foreign returns of capital are deemed to be distributed on 1 April 2012 and will at that point have to be dealt with as a reduction in base cost under para 76B.

18.5.3 Return of capital or foreign return of capital received or accrued between 1 October 2007 and 31 March 2012 [para 76(1)(c)]

A return of capital or foreign return of capital received by or accrued to a holder of shares on or after 1 October 2007 but before 1 April 2012 must be treated as proceeds when that share is partly disposed of under para 76A. The amount that will comprise proceeds upon that part-disposal is the amount of cash or the market value of the asset *in specie*. On the meaning of the term ‘market value’ see para 31. This rule applies regardless of the asset-identification method adopted by the holder of shares, and also applies to holders of shares using the weighted-average method.

Any capital loss determined under the part-disposal method will be subject to possible limitation under the kink tests in paras 26 and 27 except when the weighted-average method has been used.

18.5.4 Return of capital or foreign return of capital received or accrued before 1 October 2007 when the weighted-average method is used [para 76(2)]

For the purposes of applying the weighted-average method, para 76(2) provides that any return of capital or foreign return of capital received or accrued on or after the valuation date but before 1 October 2007 must be deducted from base cost.

This rule does not apply to shares distributed under an unbundling transaction in s 46(1). Under an ‘unbundling transaction’ the base cost is not reduced. Instead, a portion of the para 20 expenditure or if applicable, market value on valuation date, of the shares in the unbundling company must be allocated to the unbundled company shares under s 46(3).⁸²³

A return of capital or foreign return of capital received or accrued on or after 1 October 2007 but before 1 April 2012 is treated as proceeds on a part-disposal under para 76(1)(c) read with para 76A. In other words, part-disposal treatment applies whether a person uses the weighted-average, first-in-first-out, or specific-identification method.

Paragraph 76(2)(a) states that the weighted-average base cost must be determined by ‘deducting’ the return of capital or foreign return of capital from the base cost. The use of the word ‘deducting’ is intended to permit the base cost to become a negative amount when a return of capital or foreign return of capital exceeds the previous base cost of the shares on hand.

If the base cost is negative at the end of 31 March 2012, the negative amount is deemed to be a capital gain on that date under para 76A(2) and the base cost is reset to nil.

On or after 1 April 2012 a return of capital or foreign return of capital is dealt with in a similar manner to para 76(2) under para 76B.

⁸²³ The exclusion of an unbundling transaction from para 76(2) was inserted by s 84 of the Revenue Laws Amendment Act 35 of 2007 and came into operation on 1 October 2007. The same treatment should, however, also be adopted for unbundling transactions before this date on the basis that under s 41(2) the corporate restructuring rules apply ‘notwithstanding any provision to the contrary contained in the Act’, barring some exceptions not relevant here.

Example 1 – Holder of shares receiving distribution comprising dividend and CTC*Facts:*

Martin owns all the shares in Yankee (Pty) Ltd which he acquired on 1 October 2002. Amongst other assets, Yankee (Pty) Ltd holds land with a market value of R120 000 and cash of R50 000. The base cost of Martin's shares is R100 000. After valuation date Yankee (Pty) Ltd distributed the land and the cash to Martin. R90 000 of the distribution is a dividend and the remaining R80 000 is a return of CTC. The amount of R90 000 is subject to STC. What are the implications for Martin if the amounts are distributed on

- 30 September 2007, or
- 1 January 2011?

Result:

In both instances para 76 does not apply to R90 000 of the distribution because this portion is a dividend. The remaining R80 000 is a return of capital of an asset in *specie*. If distributed on 30 September 2007, the amount must be treated as proceeds when Martin disposes of his shares. If he has not disposed of them by 1 April 2012, the amount of R80 000 is deemed to be distributed to him on that date under para 76A(1A). Under para 76B(2) the amount of R80 000 must be deducted from the base cost of the shares, that is, R100 000 – R80 000 = R20 000.

If distributed on 1 January 2011, the amount must be treated as proceeds on an immediate part-disposal under para 76A(1).

Example 2 – Pre-CGT return of capital exceeding expenditure before valuation date*Facts:*

On 1 November 1982 Martin acquired the entire share capital of Yankee Ltd at a cost of R100 000. In 1998 the company distributed an amount of R125 000 to Martin, made up as follows:

	R
Cash (dividend)	15 000
Assets (return of capital)	<u>110 000</u>
	<u>125 000</u>

The market value of the shares on valuation date was R30 000.

On 29 February 2020 Martin disposed of his shares for proceeds of R50 000. He incurred selling expenses of R3 000.

Determine Martin's capital gain or loss using the time-apportionment and market-value methods.

*Result:**Time apportionment**Step 1 – Determine pre-CGT expenditure*

	R
Acquisition cost	100 000
Less: Pre-CGT return of capital [para 76(1)(a)]	<u>(110 000)</u>
	<u>(10 000)</u>
Limited to	Nil

Paragraph 76(1)(a) does not permit the expenditure incurred before valuation date to become negative, and it is therefore limited to nil.

Step 2 – Determine post-CGT expenditure

The post-CGT expenditure comprises the selling expenses of R3 000, which do not trigger the proceeds formula.

Step 3 – Apply time-apportionment formula

$$\begin{aligned} Y &= B + [(P - S - B) \times N / (N + T)] \\ &= R0 + [(R50\,000 - R3\,000 - R0) \times 19 / 38] \\ &= R23\,500 \end{aligned}$$

Step 4 – Determine capital gain or loss

$$\begin{aligned} \text{Capital gain} &= \text{Proceeds} - [\text{VDV} + \text{post-CGT expenditure}] \\ &= R50\,000 - [R23\,500 + R3\,000] \\ &= R23\,500 \end{aligned}$$

Market value

$$\begin{aligned} \text{Capital gain} &= \text{Proceeds} - [\text{VDV} + \text{post-CGT expenditure}] \\ &= R50\,000 - [R30\,000 + R3\,000] \\ &= R17\,000 \end{aligned}$$

Applying the kink tests:

	R
Expenditure before valuation date	-
Expenditure after valuation date	3 000
Market value on valuation date	30 000
Proceeds	50 000

There is an overall historical gain of R47 000. Paragraph 26 therefore applies. Since there is a gain on market value, Martin has a choice of three methods: Time-apportionment, market value or 20% of proceeds under para 26(1). Market value gives the most tax-efficient result.

Note: Had Martin sold the shares before 1 March 2005, the result using time-apportionment would have been different, since selling expenses triggered the proceeds formula for disposals during years of assessment ending before 8 November 2005.

18.6 Reporting of a return of capital to shareholders [para 76(4)]

Paragraph 76(4) provides as follows:

‘(4) Every—

(a) company that makes a distribution to any other person; and

(b) person that pays a distribution to any other person on behalf of a company,

on or after 1 April 2012 must, by the time of the distribution or payment, notify that other person in writing of the extent to which the distribution or payment constitutes a return of capital.’

This provision was inserted in tandem with the introduction of dividends tax in Part VIII of Chapter II of the Act which replaced STC on 1 April 2012. A key element of the dividends tax is the definition of CTC in s 1(1). In order for a transfer of CTC to shareholders to be valid, the definition of that term requires the amount to be determined by the board by the date of the

transfer. This requirement would be met if holders of shares and other intermediaries are informed of the transfer of CTC.

18.7 Return of capital triggering Part-disposal of shares (para 76A)

Paragraph 76A

Paragraph 76A was deemed to have come into operation on 1 October 2007.⁸²⁴ It introduced part-disposal treatment for a return of capital or foreign return of capital referred to in para 76. The part-disposal approach was terminated with effect from 1 April 2012 in favour of the base cost reduction method described in para 76B.

Pre-1 October 2007 return of capital or foreign return of capital [paras 76(1)(b), 76(2), 76A(1A) and 76A(3)]

A return of capital or foreign return of capital received or accrued on or after valuation date but before 1 October 2007 is treated as proceeds on disposal of the share if the share is disposed of before 1 April 2012 [para 76(1)(b)]. If the share is not disposed of before 1 April 2012, the following rules apply:

- When the specific identification or first-in-first-out method is adopted, a return of capital or foreign return of capital is deemed under para 76A(1A) to have been distributed on 1 April 2012. This rule has the effect of bringing the return of capital or foreign return of capital within the ambit of para 76B(2) which treats the amount as a reduction of base cost on 1 April 2012. If the relevant shares were acquired before 1 October 2001, the base cost reduction must be preceded by a determination of the base cost of the shares under para 76B(1).
- A holder of shares adopting the weighted-average method under para 32(3A) would have deducted any return of capital or foreign return of capital received or accrued on or after valuation date but before 1 October 2007 from the base cost of the shares under para 76(2). If the base cost is a negative amount at the end of 31 March 2012, the holder of shares must treat that negative amount as a capital gain on 31 March 2012 and the base cost of the shares is reset to nil [para 76A(2)].

Return of capital or foreign return of capital received or accrued on or after 1 October 2007 but before 1 April 2012 [para 76A(1) and (3)]

A person adopting the specific identification, first-in-first-out or weighted average method for a share will have a part-disposal upon receipt or accrual of a return of capital or foreign return of capital of cash or an asset *in specie* on or after 1 October 2007 but before 1 April 2012.

A part-disposal will not be triggered under any of the identification methods if a return of capital or foreign return of capital is received or accrues on or after 1 October 2007 in the form of a share distributed under an unbundling transaction contemplated in s 46(1). Under s 46 a portion of the base cost of the unbundling company's shares is allocated to the unbundled company shares.⁸²⁵

⁸²⁴ Paragraph 76A was inserted by s 85 of the Revenue Laws Amendment Act 35 of 2007.

⁸²⁵ Paragraph 76A(1)(b) amended by s 61(1)(b) of the Taxation Laws Amendment Act 3 of 2008, deemed to have come into operation on 1 October 2007.

The part-disposal calculation

The portion of the base cost disposed of when para 76A applies is determined under para 33(1) read with para 76A(3) using the following formula:

$$A = \frac{B}{C} \times D$$

in which

A = The portion of the cost of the shares, market value on 1 October 2001 or weighted average base cost to be allocated to the part-disposal.

B = The market value of the return of capital or foreign return of capital received or accrued [para 76A(3)].

C = The market value of the shares immediately before the return of capital or foreign return of capital is received or accrues.

D = The cost of the shares, market value on 1 October 2001 or weighted-average base cost to be allocated to the part-disposal, when applicable.

Example 1 – Return of capital triggering part-disposal on or after 1 October 2007 but before 1 April 2012

Facts:

Tanya acquired a share in 2002 at a cost of R120. On 31 January 2012 she received a return of capital of R20 in cash. The market value of the share at the close of business on 30 January 2012 was R200.

Result:

The return of capital triggers a part-disposal. An amount equal to 10% of the R120 expenditure is allocated to the part-disposal (R20 return of capital divided by R200 market value). Tanya will therefore have a capital gain of R8 (R20 proceeds less R12 allocable expenditure). The base cost of the share going forward is R120 – R12 = R108.

Example 2 – Return of capital before 1 April 2012 and the weighted-average method

Facts:

Dolores adopted the weighted-average method for base cost and identification purposes for her listed shares. The following is a summary of her weighted-average base cost of shares in ABC Ltd, a JSE-listed company:

		No of Shares	Price per share R	Base cost R
01.10.2001	Opening balance	200	1,00	200,00
30.06.2004	Buy	100	1,50	150,00
28.02.2007	Return of capital			(20,00)
	Subtotal	300	1,10	330,00
31.07.2007	Sell	(100)	1,10	(110,00)
	Subtotal	200	1,10	220,00
31.12.2007	Buy	300	2,00	600,00
	Subtotal	500	1,64	820,00
30.06.2008	Sell	(100)	1,64	(164,00)
	Subtotal	400	1,64	656,00

The shares sold on 31 July 2007 realised R1,80 a share.

The shares sold on 30 June 2008 realised R3,00 a share.

On 1 March 2012 Dolores received a return of capital of R60 from the 400 shares held at the time. The market value of the shares at close of business on 28 February 2012 was R3,00 a share.

Result:

Return of capital – 28 February 2007

No capital gain or loss arises on the receipt of this return of capital. Since the amount was received before 1 October 2007, it is deducted from the base cost of the shares.

Sale – 31 July 2007

	R
Proceeds 100 × R1,80	180,00
Less: Base cost	<u>(110,00)</u>
Capital gain	<u>70,00</u>

Sale – 30 June 2008

Proceeds 100 × R3,00	300,00
Less: Base cost	<u>(164,00)</u>
Capital gain	<u>136,00</u>

Return of capital – 1 March 2012

Proceeds	60,00
Less: Base cost R60 / R1 200 × R656	<u>(32,80)</u>
Capital gain	<u>27,20</u>

The base cost of Dolores's shares after the return of capital is as follows:

	No of Shares	Price per share R	Base cost R
Subtotal	400	1,64	656,00
01.03.2012 Return of capital			<u>(32,80)</u>
Subtotal	<u>400</u>	1,56	<u>623,20</u>

Disposal before 1 April 2012 of a share carrying a pre-1 October 2007 return of capital

Under the specific identification or first-in-first-out method, if a person disposes of a share on or before 31 March 2012 in respect of which returns of capital or foreign returns of capital were received or accrued on or after valuation date but before 1 October 2007, those returns of capital or foreign returns of capital must be added to the proceeds on disposal of the share under para 76(1)(b) read with the core disposal rules in paras 11, 12 and 77. If the weighted-average method has been adopted, such returns of capital or foreign returns of capital will be reflected in the reduced base cost of the share under para 76(2).

Example 3 – Distributions preceding dissolution of a company (dividend subject to STC distributed first)*Facts:*

Joe acquired all the shares in ABC (Pty) Ltd at a cost of R100 in 1995. The market value of the shares on 1 October 2001 was R400. The company was placed in voluntary liquidation on 31 July 2011 at which time its market value was R620 before any contingent liability for STC.

The value of R620 was represented by

	R
Share capital (CTC)	100
Share premium (CTC)	300
Profits	<u>220</u>
	<u>620</u>

The company made the following distributions:

28 February 2012 – R200 dividend.

31 March 2012 – R300 CTC

On 31 July 2012 the liquidator issued a notice confirming that there were no reasonable grounds to believe that the shareholder would receive any further distributions and at the same time paid out the remaining CTC of R100.

The company was finally dissolved on 31 October 2012.

Joe adopted the market-value method to determine the base cost of the shares.

Result:

The CGT consequences of each of the amounts received by Joe are as follows:

28 February 2012 – no impact on Joe as this is a dividend. STC of R20 at 10% of the dividend of R200 is payable. After this distribution the market value of the company falls from R620 to R400 (that is, by the amount of the dividend plus the STC)

31 March 2012 – The amount of R300 is a return of capital which triggers a part-disposal under para 76A:

The base cost of the part disposed of is determined under para 33(1)(b) as follows:

Market value of asset on 1 October 2001 × return of capital / market value immediately before disposal

$$= R400 \times R300 / R400$$

$$= R300$$

Capital gain = Proceeds – base cost of part disposed of

$$= R300 - R300$$

$$= \text{Nil}$$

31 July 2012 – The return of paid up share capital is a full disposal dealt with under para 35 read with para 77(1). The time of disposal is the date on which the liquidator declared that there were no reasonable grounds to believe that there would be any further distributions, namely, 31 July 2012.

Capital gain = Proceeds – remaining base cost
 = R100 – R100
 = Nil

The date of dissolution of 31 October 2012 is of no consequence since the disposal of the shares had already occurred on 31 July 2012.

Example 4 – Distributions preceding dissolution of a company (CTC distributed first)

Facts:

The facts are the same as Example 3 except that the return of capital of R300 occurs first, on 28 February 2012 and the dividend of R200 is declared next, on 31 March 2012. The date of the repayment of the remaining CTC and simultaneous declaration by the liquidator of there being no further prospect of a distribution on 31 July 2012 and the date of dissolution of 31 October 2012 remain unchanged.

Result:

28 February 2012

	R
Proceeds (return of capital)	300
Less: Base cost of part disposed of R300 / R600 × R400	(200)
Capital gain	<u>100</u>

It is assumed that the market value of the shares immediately before the return of capital is R620 less the contingent liability for STC of R20 = R600.

31 March 2012 – Dividend – no impact except STC of R20.

31 July 2012 – Deemed disposal of shares under para 77

	R
Proceeds (para 35)	100
Less: Remaining base cost (R400 – R200)	(200)
Capital loss	<u>(100)</u>

The capital loss is disallowed under para 26(3) because there is an historical gain on cost but a loss on market value:

The remaining expenditure is R100 original cost less R50 (part disposed of on 28 February 2012 of R100 × R300 / R600).

The remaining market value on 1 October 2001 is R200 (R400 less part disposed of on 31 March 2012 of R200).

The proceeds are R100.

18.8 Returns of capital – Reduction in base cost of shares (para 76B)

Paragraph 76B

Paragraph 76B(2) treats a return of capital or foreign return of capital received by or accrued to a holder of a share on or after 1 April 2012 but before disposal of a share as a reduction in the expenditure on a share. It replaces the part-disposal method for dealing with returns of capital or foreign returns of capital which was addressed in para 76A and applied between 1 October 2007 and 31 March 2012. The introduction of the base cost reduction method resolves a number of difficulties which were associated with the part-disposal method amongst them being complexity of administration and differing results upon winding up of a company depending on the order in which dividends and returns of capital were distributed. The base cost reduction method had to be adapted to deal with pre-valuation date shares [para 76B(1)] and pre-1 October 2007 returns of capital [para 76A(1A)].

In applying para 76B it must be kept in mind that each share is a separate asset with its own base cost and incorrect calculations can result if the cost prices of identical shares acquired on different dates are added together. Such incorrect calculations can arise when there are pre- and post-valuation date shares because a special rule applies for the purposes of determining the base cost of pre-valuation date shares under para 76B(1). In addition, the base cost of shares bought on or after the valuation date at different times will inevitably vary with the result that a capital gain will arise under para 76B(3) if the base cost of a particular share is inadequate to absorb a return of capital. Yet, if the base cost of the share is sufficient to absorb the return of capital a capital gain or loss will not arise. Shares bought on the same date at the same unit cost can, however, be lumped together for the purposes of applying para 76B. The problem of shares acquired on different dates does not arise when the weighted-average base cost method is adopted, since the return of capital will simply reduce the base cost of the pool.

Disproportional distributions of CTC

Section 37(1) of the Companies Act provides as follows:

‘All of the shares of any particular class authorised by a company have preferences, rights, limitations and other terms that are identical to those of other shares of the same class.’

Each share in a particular class will therefore be entitled to the same amount of any distribution. It can happen that shares in the same class are issued at different times and the amount of CTC attributable to the different batches can vary greatly. It is, however, unacceptable to allocate a return of capital among shares of the same class based on the amount of CTC contributed by a particular share in order to prevent capital gains on the shares that contributed a lower level of CTC. This situation is specifically dealt with in the proviso to the definition of ‘contributed tax capital’ which reads as follows:

‘Provided that the amount transferred by a company as contemplated in paragraph (a) or (b) for the benefit of a person holding shares of any class of shares of that company must not exceed an amount that bears to the total of the amount of contributed tax capital attributable to that class of shares immediately before the transfer the same ratio as the number of shares of that class held by that person bears to the total number of shares of that class;’

In other words, if there are 200 shares in issue in a particular class and there is CTC of R400 available for transfer to that class, each share in that class may not be awarded more than R2

of CTC ($R400 / 200 = R2$). Should some shares in the class be awarded, say, R3, the excess of R1 will not qualify as a transfer of CTC and will default to being treated as a dividend.

Example – Allocation of return of capital on a per share basis

Facts:

Company A is a wholly owned subsidiary. It was formed in 2002 at which time it issued 1 000 shares of R1 each at a premium of R10 000. In 2007 the company issued another 1 000 shares of R1 each at a premium of R30 000. On 31 January 2020 the company distributed CTC of R30 000.

Result:

The holding company will receive a return of capital of $R30\,000 / 2\,000 = R15$ a share. Therefore, each batch of shares issued by Company A will derive a return of capital of R15 000 ($1\,000 \times R15$). Consequently, the first batch of shares will produce a capital gain of R15 000 (return of capital) – R11 000 (base cost) = R4 000 under para 76B(3). Going forward the base cost of this batch of shares will be reduced to nil. The second batch of shares will have a reduced base cost of $R31\,000 - R15\,000 = R16\,000$ under para 76B(2).

18.8.1 Pre-valuation date shares [para 76B(1)]

Two difficulties arise when trying to apply base cost reduction to a pre-valuation date share. First, the base cost of such a share includes as its starting point a valuation date value which is not 'expenditure'. Secondly, the time-apportionment and 20%-of-proceeds methods can be applied only when the share is disposed of and not when a return of capital or foreign return of capital is received or accrues.

Paragraph 76B addresses these problems by converting a pre-valuation date share to a post-valuation date share when the first return of capital or foreign return of capital is received by or accrues to a holder of a share on or after 1 April 2012. In other words, the rule is not automatically triggered on 1 April 2012 but only if and when a return of capital is received or accrued for the first time on or after that date.

It does this by deeming the share to be disposed of and reacquired for an amount equal to its market value immediately before the receipt or accrual of the return of capital or foreign return of capital. The deemed market value reacquisition cost is deemed to be expenditure actually incurred for the purposes of para 20(1)(a).

A special rule applies in determining the market value of listed shares. It provides that the market value of a share listed on a recognised exchange and for which a price was quoted on that exchange is equal to the sum of

- the ruling price of that share at the close of business on the last business day before the accrual of the return of capital or foreign return of capital; and
- the amount of the return of capital or foreign return of capital.

This rule is required because the ruling price on the day before the receipt or accrual of the return of capital or foreign return of capital is an 'ex div' price which excludes the value of the return of capital or foreign return of capital. For example, on the JSE the share will trade cum div up to and including LDT (last day to trade cum div) and then ex div up to record date (the date on which the return of capital or foreign return of capital accrues). Under the JSE Listings Requirements 'record date' falls on a Friday or if the Friday is a public holiday, on the last

trading day in the week and is three business days after LDT (T + 3). LDT is determined by counting backwards from record date.

Example 1 – Determination of base cost of pre-valuation date listed shares when return of capital received

Facts:

Emma owns 100 ABC Ltd shares listed on the JSE which she purchased before valuation date. The company announced that it would be distributing a return of capital to its shareholders at the rate of R1 a share. The relevant dates were as follows:

Last day to trade cum div (LDT: Tuesday 25 February 2020

Record date: Friday 28 February 2020

Pay date: Monday 2 March 2020

The ruling price at the close of business of Emma's shares on LDT was R1 100, on Thursday 27 February 2020 R995 and on record date R980. Determine the market value of Emma's shares for the purposes of para 76B(1).

Result:

The market value at which Emma's shares are deemed to be disposed of and reacquired for purposes of para 76B(1) is R995 (ruling price on day before record date) + R100 (return of capital) = R1 095.

The deemed disposal under para 76B(1) requires the determination of a capital gain or loss which in turn requires the determination of the base cost of the share. The base cost of a pre-valuation date share is equal to its valuation date value plus any qualifying post-valuation date expenditure (para 25).

Subject to paras 26 and 27 any of the three methods for determining the valuation date value of a share can be used. The kink tests in paras 26 and 27 will apply and may reduce capital losses or limit the choice of a valuation method.

The deemed reacquisition cost described above must be reduced by any capital gain and increased by any capital loss. Should the base cost become negative, the excess is recognised as a capital gain under para 76B(3).

After a pre-valuation date share is converted to a post-valuation date share, any further returns of capital or foreign returns of capital will simply reduce the expenditure on the share under para 76B(2). In other words, the determination of the base cost of a pre-valuation date share and its simultaneous reconstitution as a post-valuation date share under para 76B(1) involve a once-off procedure.

The capital gain or loss that arises under para 76B(1) is determined solely for the purpose of determining the expenditure forming part of the cost of acquisition of a share and its date of acquisition. It is not taken into account in determining a person's aggregate capital gain or loss for the year of assessment.

Paragraph 76B(1) also applies to a pre-valuation date share for which the weighted average method has been adopted under para 32. While the adoption of the weighted-average method will have no impact on the base cost of the share before the receipt or accrual of a return of capital, it will have the effect of converting the shares into post-valuation date shares and in converting the base cost of the shares from a mix of valuation date values and expenditure

into a base cost comprised solely of expenditure. Such a conversion is necessary in order that para 76B(2) can be applied because that provision applies only to a reduction of expenditure.

Example 2 – Return of capital on pre-valuation date shares

Facts:

Salomi acquired 100 shares in DEF Ltd on 1 October 1992 at a cost of R50 000. The market value of the shares on valuation date according to the *Government Gazette* prices was R150 000.

On record date of Friday 27 September 2019 Salomi became entitled to a return of capital of R10 000 from DEF Ltd which was paid out of its CTC on Monday 30 September 2019. The market value of the shares at close of business on 26 September 2019 was R490 000.

Result:

The market value of the shares immediately before the accrual of the return of capital is deemed to be R490 000 (closing price on Thursday 26 September 2019) + R10 000 (return of capital) = R500 000, and this figure must be used as the proceeds in the various base cost calculations which follow.

The time-apportionment base cost of the shares is determined as follows:

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R50\,000 + [(R500\,000 - R50\,000) \times 9 / (9 + 18)] \\
 &= R50\,000 + (R450\,000 \times 9 / 27) \\
 &= R200\,000
 \end{aligned}$$

The 20%-of-proceeds method gives a valuation date value of R500 000 × 20% = R100 000.

Salomi therefore has a choice of any one of the following three valuation date values:

	R
• Market value on valuation date	150 000
• Time-apportionment base cost	200 000
• 20% of proceeds	100 000

The time-apportionment method therefore gives the highest base cost out of the three methods available to Salomi to determine the valuation date value of the shares and hence the lowest capital gain.

The capital gain is R500 000 (proceeds) less R200 000 (base cost) = R300 000.

The adjusted base cost before the return of capital is R500 000 (deemed reacquisition cost) less the capital gain of R300 000 = R200 000.

Under para 76B(2) the return of capital of R10 000 is deducted from the deemed reacquisition cost of R200 000 to give a base cost of R190 000 on 27 September 2019.

18.8.2 Pre-1 October 2007 return of capital [para 76A(1A)]

Between 1 October 2001 and 30 September 2007, a return of capital or foreign return of capital was treated as proceeds on disposal of a share. This treatment changed with the introduction of the part-disposal method for dealing with such distributions with effect from 1 October 2007.

A transitional rule was introduced to deal with a return of capital received or accrued between 1 October 2001 and 30 September 2007 on shares which had not been disposed of before 1 October 2007. It was initially provided that such a return of capital would be accounted for as proceeds on the earlier of the date of disposal of the shares or on 1 July 2011, at which point they would be treated as proceeds on a part-disposal of the shares under para 76A. However, with the introduction of the base cost reduction method the deemed part-disposal treatment on 1 July 2011 was withdrawn and instead para 76A(1A) was inserted. It provides that such a return of capital is deemed to be distributed on 1 April 2012. The effect is to bring such a return of capital within para 76B, assuming that the shares were still held on 1 April 2012. Should the shares have been disposed of between 1 October 2007 and 31 March 2012 (both dates included), the return of capital is treated as proceeds on disposal of the shares.

If the shares are pre-valuation date shares, their base cost must be determined under para 76B(1) on 31 March 2012. The pre-1 October 2007 return of capital will then reduce the deemed reacquisition cost under para 76B(2) on 1 April 2012.

A pre-1 October 2007 return of capital on a post-valuation date share must simply be deducted from expenditure on the share under para 76B(2) on 1 April 2012.

No action is required if the weighted-average method has been used because the weighted average base cost of the shares would already have been reduced under para 76(2). If the base cost was negative at the end of 31 March 2012, the negative amount is treated as a capital gain on 31 March 2012 under para 76A(2) and the base cost is reset to nil.

18.8.3 Base cost reduction [para 76B(2)]

Paragraph 76B(2) requires that the expenditure on a share be reduced by the amount of a return of capital or foreign return of capital comprising cash or an asset *in specie* received by or accrued to a holder of a share on or after 1 April 2012 but before disposal of the share. The reduction occurs on the date on which the cash or asset is received by or accrues to the holder of the share. Previously SARS has taken the view that the word ‘reduced’ means that an amount cannot be reduced below nil. In line with this interpretation, if the return of capital or foreign return of capital exceeds the expenditure, the expenditure will be reduced to nil. The amount that exceeds the expenditure is dealt with under para 76B(3).

The receipt or accrual of unbundled shares as a return of capital under an unbundling transaction under s 46 falls outside para 76B because s 46 takes precedence under s 41(2). In other words, part of the base cost of the unbundling company shares will be allocated to the unbundled company shares under s 46(3) and this treatment overrides any base cost reduction under para 76B.

Example – Return of capital applied in reduction of base cost

Facts:

Mercury owns 100 shares in XYZ Ltd which were acquired on 31 March 2009 at a cost of R100. On 6 January 2020 Mercury received a return of capital of R60 which was paid out of the company’s CTC.

Result:

	R
Base cost – 31 March 2009	100
Less: Return of capital	<u>(60)</u>
Base cost – 6 January 2020	<u>40</u>

18.8.4 Return of capital exceeding base cost [para 76B(3)]

If the return of capital or foreign return of capital applied in reduction of the expenditure on the share under para 76B(2) exceeds that expenditure, the excess is treated as a capital gain of the holder of the share for purposes of determining the aggregate capital gain or loss for the year of assessment in which the amount is received by or accrues to that holder.

Example – Return of capital exceeding expenditure on a share

Facts:

Hildegard owns 100 shares in ABC Ltd. The shares were acquired on 30 June 2005 at a cost of R100. On 31 August 2012 she received a return of capital of R120 paid out of the company's CTC. On 31 January 2020 she received a further return of capital of R40.

Result:

Base cost

Cost of shares – 30 June 2005 [para 20(1)(a)]	R 100
Less: Return of capital of R120 on 31 August 2012, limited to expenditure [para 76B(2)]	(100)
Base cost – 31 August 2012	<u>Nil</u>
Less: Return of capital of R40 on 31 January 2020, limited to nil	(Nil)
Base cost – 31 January 2020	<u>Nil</u>

Capital gains

Hildegard had a capital gain of $R100 - R120 = R20$ on 31 August 2012 which is equal to the amount by which the return of capital exceeded the expenditure on the share.

On 31 January 2020 she had a capital gain of $R40 - 0 = R40$ which is equal to the amount by which the return of capital of R40 exceeded the remaining expenditure on the share.

18.9 Returns of capital included in income

18.9.1 Share-dealers

For the position affecting share-dealers before 1 January 2009, see issue 3 of this guide.

CTC received by or accruing to a share-dealer comprises gross income in that share-dealer's hands when the relevant shares are held as trading stock. At the same time a distribution of CTC constitutes a return of capital or foreign return of capital, which can trigger a part-disposal of the share under para 76A(1) (if received or accrued between 1 October 2007 and 31 March 2012, both dates included) or a reduction in base cost under para 76B(2) (if received or accrued on or after 1 April 2012). The receipt of such a return of capital by a share-dealer raises the issue of double taxation.

A return of capital or foreign return of capital that is dealt with under para 35 will not result in double taxation by virtue of para 35(3)(a). Transactions falling within para 35 include a full disposal such as a share buy-back, or a disposal under para 77 in which the proceeds coincide with the terminating event (that is, dissolution, issue by a liquidator of a certificate confirming that there will be no further distributions or deregistration).

However, with a part-disposal under para 76A or a reduction in base cost under para 76B, Part XI contains no explicit method for eliminating double taxation. Since there is a necessary implication against double taxation in the Income Tax Act,⁸²⁶ it is accepted that such amounts must not again be taken into account for CGT purposes, and their treatment as ordinary income will take precedence.

Example 1 – Return of capital derived by a share-dealer

Facts:

On 1 March 2018 Jane acquired shares in X Ltd as trading stock at a cost of R100. Two years later on 29 February 2020 X Ltd distributed CTC to Jane of R10.

Result:

The return of capital constitutes gross income in Jane's hands.

The base cost of Jane's shares before the return of capital is nil, determined as follows:

	R
Cost of shares [para 20(1)(a)]	100
Less: Amount allowed under s 11(a) [para 20(3)(a)]	<u>(100)</u>
Base cost under para 20	<u>—</u>

The return of capital is disregarded because it has already been accounted for in gross income and there is a necessary implication against double taxation. It will therefore not be accounted for as a capital gain under para 76B(3).

Example 2 – Return of capital derived by a share-dealer after three years when s 9C applies

Facts:

On 1 March 2017 Alexa acquired equity shares as defined in s 9C(1) in Y Ltd as trading stock at a cost of R100. Three years and one day later, on 1 March 2020 Y Ltd distributed CTC to Alexa of R10. On 30 June 2020 she sold the shares for R120.

Result:

On 29 February 2020 Alexa had held the shares for three years. Any return of capital received or accrued on or after that date in respect of an equity share as defined in s 9C(1) is deemed under s 9C(2) to be of a capital nature. At the time of receipt or accrual of the return of capital on 1 March 2020, the base cost of the shares was nil, arrived at as follows:

	R
Cost of shares [para 20(1)(a)]	100
Less: Amount allowed under s 11(a) [para 20(3)(a)]	<u>(100)</u>
Base cost at 29 February 2020	<u>—</u>

Since the return of capital of R10 exceeds the expenditure in respect of the share of nil, it constitutes a capital gain under para 76B(3).

⁸²⁶ *CIR v Delfos* 1933 AD 242, 6 SATC 92 at 112.

On 30 June 2020 Alexa must include R100 in income under s 9C(5), being the amount allowed as a deduction under s 22(2) for the cost price of opening stock on 1 March 2020. Under para 20(3)(a)(ii) the expenditure incurred under para 20(1)(a) of R100 must be reduced only if it was not included in taxable income under s 9C(5). Since the amount of R100 was included in income under s 9C(5), it is not reduced with the result that the base cost of the shares is restored to R100. The capital gain on disposal of Alexa's shares is therefore R120 (proceeds) less R100 (base cost) = R20.

Example 3 – Return of capital derived by a share-dealer in respect of pre-valuation date shares after three years when s 9C applies

Facts:

Anne acquired equity shares contemplated in s 9C(1) in 1995 at a cost of R100 as trading stock. On 1 October 2001 the shares had a market value of R140 under para 29(4). On 1 March 2020 she received a return of capital of R10. She elected to use market value on 1 October 2001 for the purposes of determining the base cost of the shares under para 76B(1). The market value of the shares immediately before the return of capital was received was R300. She sold the shares on 30 June 2020 for R350.

Result:

Under para 76B(1) for the purpose of determining the base cost of the shares, the shares are deemed to be disposed of at market value and reacquired at the same market value immediately before the receipt of the return of capital.

	R
Deemed proceeds	300
Less: Base cost	(140)
Capital gain	<u>160</u>
Reacquisition cost	300
Less: Capital gain	(160)
Base cost	140
Less: Return of capital	(10)
Base cost after receipt of return of capital	<u>130</u>

Under s 9C(5) Anne must include R100 in gross income, being the opening stock brought forward under s 22(2).

The capital gain on disposal of the shares is as follows:

	R
Proceeds	350
Less: Base cost	(130)
Capital gain	<u>220</u>

18.9.2 Returns of capital received on s 8C restricted equity instruments

Under s 8C(1A)⁸²⁷ the receipt or accrual by a taxpayer of a return of capital or foreign return of capital (other than by way of a distribution of an equity instrument) from a restricted equity instrument must be included in the taxpayer's income for the year of assessment during which the amount is received or accrues.

⁸²⁷ Section 8C(1A) was inserted by s 11(1)(a) of the Revenue Laws Amendment Act 60 of 2008 deemed to have come into operation on 21 October, 2008 and applicable in respect of a capital distribution received by or accrued to a taxpayer on or after that date.

For the same reasons discussed in **18.9.1** such a return of capital or foreign return of capital should be disregarded for CGT purposes.

18.10 Distribution in liquidation or deregistration received by holders of shares (para 77)

Paragraph 77

18.10.1 Purpose

The purpose of this paragraph is to provide rules for holders of shares in companies that are being liquidated or deregistered, namely,

- a disposal rule,
- a time of disposal rule, and
- a rule dealing with a return of capital or foreign return of capital received or accrued after the date on which the holder of a share has disposed of it.

18.10.2 Returns of capital before disposal

Holders of shares in companies that are to be liquidated or deregistered that receive returns of capital before disposal of their shares must deal with those returns of capital under paras 76, 76A and 76B. In other words, for a company being liquidated or deregistered on or after 1 October 2007, returns of capital must be treated as follows:

- Pre-valuation date returns of capital reduce expenditure, but not below nil (not applicable if the weighted-average method is used).
- Returns of capital received or accrued on or after 1 October 2001 but before 1 October 2007 must be accounted for as proceeds on disposal of the shares, which will occur on the date specified in para 77(1). If the date of disposal falls after 1 April 2012 the return of capital is deemed to be distributed on 1 April 2012 under para 76A(1A) with the result that the return of capital must be treated as a reduction in expenditure on the share under para 76B(2). If the weighted-average method is used, these returns of capital must be deducted from the base cost of the shares and a capital gain or loss will simply be determined on the date of disposal specified under para 77(1). A capital gain will be deemed to arise on 31 March 2012 if the base cost is negative at the end of that date [para 76A(2)].
- Returns of capital received or accrued on or after 1 October 2007 but before 1 April 2012 trigger part-disposal treatment under para 76A(1)(b).
- Returns of capital received or accrued on or after 1 April 2012 must be applied to reduce the expenditure on the share under para 76B(2). To the extent that the return of capital exceeds the expenditure, the excess is treated as a capital gain under para 76B(3).

18.10.3 Disposal and time of disposal [para 77(1)]

Holders of shares in a company that is being wound up or deregistered are deemed to have disposed of their shares at the earlier of

- the date of dissolution or deregistration, or
- with liquidation or winding-up, the date when the liquidator declares in writing that no reasonable grounds exist to believe that the holder of shares in the company (or

holders of shares holding the same class of shares) will receive any further distributions in the course of the liquidation or winding-up of that company. This rule allows a holder of a share to crystallise a loss without having to wait until the liquidation process is complete.⁸²⁸ The date referred to in para 77(1)(b) is the date on which the liquidator issues the relevant notice to shareholders and not an earlier date specified in such a notice.⁸²⁹

A capital loss arising under para 77 would not be clogged under para 39 because the shares are deemed to be disposed of to no one in particular (see **9.5.2**).

18.10.3.1 Date of dissolution

Under s 83(1) of the Companies Act 71 of 2008 a company is dissolved as of the date its name is removed from the companies register unless the reason for the removal is that the company's registration has been transferred to a foreign jurisdiction, as contemplated in s 82(5) of that Act.

18.10.3.2 Date of deregistration

The date of deregistration of a company occurs on the date on which its name is removed from the companies register. The company is regarded as being dissolved as of that date (s 83(1) of the Companies Act 71 of 2008).

The dates of dissolution and deregistration mentioned above apply to companies registered in South Africa. The date of dissolution or deregistration of a company registered in another country must be determined under the law of the relevant country.

18.10.4 Distributions after date of disposal [para 77(2)]

If a holder of a share receives a further return of capital or foreign return of capital after the date of disposal determined in para 77(1), the distribution is treated as a capital gain without a base cost deduction.

Example – Returns of capital by company in liquidation

Facts:

Ophelia owns 20 shares in Uniform Ltd with an aggregate base cost of R500. The company ran into financial difficulty and the directors placed the company into liquidation on 31 December 2018. On 31 January 2019 the liquidator distributed R100 in cash to Ophelia. At the same time, he declared that all remaining proceeds would be paid to creditors and shareholders should not expect any further distributions. Following some investigation, the liquidator came across some hidden assets belonging to the company and was able to make a final distribution to Ophelia of R30 in cash on 30 June 2019. The company was finally dissolved on 30 November 2019. All the distributions described constitute CTC.

⁸²⁸ The Australian legislation contains a similar provision. Under s 104–145 of the Income Tax Assessment Act, 1997 the liquidator can make a declaration that the shares are worthless (CGT event G3) and the taxpayer can elect to realise a loss. The United Kingdom also has a worthless share provision enabling a loss to be crystallized where the shares are of negligible value – s 24(2) of the Taxation of Chargeable Gains Act, 1992.

⁸²⁹ In *Swart v Vosloo* 1965 (1) SA 100 (A) at 105 the court held that the word 'declare' means 'to make known'.

Result:

Since the return of capital of R100 on 31 January 2019 was not received or accrued before the disposal, it cannot be dealt with as a reduction in base cost under para 76B(2). Under para 77(1)(b) Ophelia is deemed to have disposed of her shares on 31 January 2019. In the 2019 year of assessment she will have a capital loss of R400 (R100 proceeds under para 35 less R500 base cost).

Under para 77(2) she will have a capital gain of R30 in the 2020 year of assessment.

18.11 Share buy-backs

Paragraphs 11(1)(a) and (b), 35, s 1(1) definitions of 'dividend', 'foreign dividend', 'gross income' and 'return of capital'

The consequences for holders of shares who dispose of their shares through a share buy-back are fully taken into account under the basic disposal rules and are accordingly not covered by Part XI. The proceeds on disposal must be determined under para 35 read with the definition of 'dividend' in s 1(1).

This conclusion follows from the following:

- Disposal – para 11(1)(a) includes as a disposal the sale of an asset while para 11(1)(b) includes the redemption, cancellation or surrender of an asset;
- Proceeds – para 35. Since dividends and foreign dividends are included in the definition of 'gross income' by virtue of para (k) of that definition, they will be excluded from proceeds under para 35(3)(a). What remains in proceeds is the non-dividend portion of the consideration received for the buy-back. Such non-dividend portion may comprise a return of capital, foreign return of capital or an amount derived in respect of an open-market buy-back of shares on the JSE. On or after 1 January 2011 an open-market buy back of shares listed on an exchange licensed under the Financial Markets Act is excluded from the definitions of 'dividend' and 'return of capital' in s 1(1). In such event the full consideration received by or accrued to a holder of shares who holds them on capital account will comprise the proceeds and there will be no reduction for any dividend element. A company buying back its own shares through an open-market buy-back on an exchange licensed under the Financial Markets Act is also not required to reduce its CTC.
- Paragraph 76B does not apply because that provision applies only to a return of capital or foreign return of capital received by or accrued to a holder of a share on or after 1 April 2012 made *prior to* the disposal of a share.

Example 1 – Buy-back of shares**Facts:**

Phoebe owns 20% of Tango (Pty) Ltd's shares. The base cost of her shares is R3 million. On 29 February 2020 Phoebe surrendered all of her shares in the company for an amount received or accrued of R4,5 million. The directors of the company notified Phoebe at the time of the buy-back that R1,2 million represented a return of capital paid out of the company's CTC and that R3,3 million was a dividend.

Result:

Phoebe is subject to dividends tax at 20%⁸³⁰ on the dividend of R3 300 000. She derived a capital loss determined as follows:

	R
Amount received or accrued on disposal of shares	4 500 000
Less: Dividend [para 35(3)(a)]	<u>(3 300 000)</u>
Proceeds	1 200 000
Less: Base cost	<u>(3 000 000)</u>
Capital loss	<u>(1 800 000)</u>

Under para 19(1)(a) a person must disregard so much of a capital loss on shares disposed of by way of a share buy-back to the extent that the loss does not exceed any 'exempt dividends' as defined in para 19(3). Exempt dividends are dividends not subject to either dividends tax or normal tax under s 10 (1) (k)(i) or s 10B(2)(a) or (b). Paragraph 19 will not apply in this instance because the dividend was not exempt from dividends tax.

Under para 39 the capital loss will be clogged because Phoebe and Tango are connected persons in relation to each other.⁸³¹

Example 2 – Open-market buy-back of shares*Facts:*

In 2005 Celeste bought 100 000 shares in ABC Ltd, a JSE-listed company at a cost of R200 000. She disposed of them for proceeds of R500 000 on 30 June 2019. The sale was conducted by her stockbroker through the STRATE system and she was unaware that ABC Ltd had purchased the shares.

The directors of ABC Ltd resolved under s 48(2) of the Companies Act, 2008 to buy back 5% of the company's shares from time to time on the open market. The acquisition of the 100 000 shares from Celeste through their stockbrokers was one such purchase.

The directors of ABC Ltd did not make any decision to pay the amount out of the company's CTC.

Result:

After acquisition by ABC Ltd the 100 000 shares became part of ABC Ltd's authorised capital under s 35(5) of the Companies Act, 2008 and were extinguished by merger (*confusio*), which under para 11(2)(b) is not a disposal. ABC Ltd's CTC remains unchanged.

The sale of the shares by Celeste is a disposal under para 11(1)(a). No part of the proceeds of R500 000 comprises a dividend or a return of capital because the definitions of these terms exclude consideration given by a company for an open-market buy back. The capital gain must be determined under the core rules as follows:

	R
Proceeds (para 35)	500 000
Less: Base cost (para 20)	<u>(200 000)</u>
Capital gain	<u>300 000</u>

⁸³⁰ Under s 11 of the Rates and Monetary Amounts and Amendment of Revenue Laws Act 14 of 2017 the rate was increased from 15% to 20%. The increase was deemed to come into operation on 22 February 2017 and applies to any dividend paid on or after that date.

⁸³¹ Paragraph (d)(iv) of the definition of 'connected person' in s 1(1).

18.12 Issue of shares or options for no consideration (s 40C)

Section 40C

Section 40C was introduced with effect from 1 January 2011 and substituted with effect from 1 January 2013.⁸³²

For the period between 1 January 2011 and 31 December 2012 s 40C dealt with the issue of shares for no consideration while para 78(1) dealt with the distribution of shares for no consideration. From 1 January 2013 para 78(1) was deleted⁸³³ and s 40C now deals with the issue of shares for no consideration.

Section 40C determines the base cost of capitalisation shares, whether held on capital account or as trading stock.

Under s 47 of the Companies Act 71 of 2008, except if a company's memorandum of incorporation provides otherwise, a company may issue capitalization shares on a pro-rata basis to shareholders of one or more classes of shares. At the time the board passes the necessary resolution to award such shares, it may, subject to certain solvency requirements, resolve to permit any shareholder entitled to receive such an award to elect instead to receive a cash payment, at a value determined by the board (this type of capitalisation share is commonly referred to as a scrip dividend). Scrip dividends enable a company to retain cash for future investment and also have the benefit that no dividends tax is payable upon issue of the shares.⁸³⁴

Capitalisation shares issued before 1 January 2011

The treatment of capitalisation shares issued before 1 January 2011 was regulated by para 78(1) read with the pre-1 January 2011 definition of 'dividend' in s 1. Under that definition, the issue of a capitalisation share which comprised an equity share did not constitute a dividend. But the issue of a non-equity capitalisation share (for example, a non-participating preference share) comprised a dividend and was subject to STC.

Under para 78(1) equity capitalisation shares were deemed to be acquired for an expenditure incurred and paid of nil on the 'date of distribution' as defined in para 74, while non-equity capitalisation shares were deemed to be acquired on the 'date of distribution' for an expenditure incurred and paid equal to the amount of the dividend. The purpose of granting a step-up in base cost for the non-equity capitalisation share was to prevent economic double taxation on the same amount (that is, STC at the company level and CGT at the shareholder level).

Capitalisation shares issued before 1 January 2011 that constituted dividends were rare, since unlike normal capitalisation shares, they were subject to STC.

With the introduction of the revised dividend definition from 1 January 2011, the need to distinguish between equity and non-equity capitalization shares fell away because para (ii) of the definition of 'dividend' excludes any amount transferred or applied to the extent that it

⁸³² Section 40C was inserted into the Act by s 47(1) of the Revenue Laws Amendment Act 60 of 2008 and came into operation on 1 January 2011. The effective date of 1 January 2011 was introduced by s 139(1) of the Taxation Laws Amendment Act 7 of 2010, which amended s 47(2) of the Revenue Laws Amendment Act 60 of 2008. It was substituted by s 70(1) of the Taxation Laws Amendment Act 22 of 2012 with effect from 1 January 2013 and applies to distributions and issues made on or after that date.

⁸³³ Repealed by s 136(1) of the Taxation Laws Amendment Act 22 of 2012 with effect from 1 January 2013.

⁸³⁴ Paragraph (ii) of the exclusion to the definition of 'dividend' in s 1(1) excludes any amount transferred or applied by a company that 'constitutes shares in that company'.

constitutes shares in the company. As a result, a non-equity share will also be deemed to be acquired for an expenditure of nil under s 40C.

Example – Base cost of capitalisation shares issued before 1 January 2011 constituting a dividend

Facts:

On 30 November 2010 Ronen (Pty) Ltd issued 100 000 7% redeemable preference shares of R1 each to its existing ordinary shareholders on the basis of one preference share for each ordinary share held. The preference shares were issued out of retained income. Christine holds 1 000 ordinary shares and received 1 000 preference shares. Christine immediately disposed of her preference shares at the market value of R1 a share.

Result:

Christine's preference shares have a base cost of R1 000. Ronen (Pty) Ltd is liable for STC of $10\% \times R100\,000 = R10\,000$ in respect of the preference share issue, since it constitutes a dividend. Christine will accordingly make neither a capital gain nor a loss.

Capitalisation shares issued on or after 1 January 2011

Section 40C in its current guise applies when a company

- issues a share in that company; or
- grants an option or other right in respect of the issue of a share in that company,

to a person for no consideration. In such event, s 40C deems the person to have acquired the share, option or right for expenditure of nil.

Section 40C is silent on the date of acquisition of capitalisation shares, but it is submitted that this would occur on the date when the shareholder becomes unconditionally entitled to them.

Regardless of whether the shareholder is given the option of taking a dividend instead of a capitalisation share, the tax treatment for dividends tax and CGT purposes is identical.

Issues of capitalisation shares have no base cost impact on previously held shares that carry the rights to participate in the capitalisation shares.

Shares acquired under a dividend reinvestment scheme are not capitalization shares. In such event the shareholder merely uses the proceeds from the dividend (after dividends tax when applicable) to acquire further shares in the company for consideration.

Example 1 – Issue of capitalisation shares

Facts:

Sierra (Pty) Ltd has 100 000 issued ordinary shares, each of which has a market value of R60. Rae holds a single Sierra (Pty) Ltd share with a base cost of R50. Sierra (Pty) Ltd distributed one new ordinary share to its shareholders for each ordinary share held.

Result:

The issue of the additional ordinary share falls under s 40C because no previously held shares are surrendered in substitution. Rae retains the R50 base cost in the pre-existing ordinary share, while the new share is deemed under s 40C to have a base cost of nil. The capital gain or loss on disposal of each share depends on whether Rae disposes of the share under the first-in first-out method, weighted-average method, or specific identification method under para 32.

Capitalisation shares acquired before valuation date

A shareholder has the option of adopting the market value, time-apportionment or 20%-of-proceeds method for determining the valuation date value of capitalisation shares acquired before the valuation date. These choices prevent the shareholder from being subjected to CGT on a pre-CGT gain.

Weighted-average method

Under the weighted-average method capitalisation shares must be added to the pool with an expenditure of nil. After being added to the pool, the shares will 'acquire' a negative or positive base cost from the pool.

Time-apportionment base cost method

A holder of shares wishing to adopt the time-apportionment base cost method needs to exercise caution with capitalisation shares disposed of before years of assessment ending on or after 8 November 2005, since any selling expenses incurred will result in the application of the proceeds formula in para 30(2). Since there would be nil expenditure before valuation date and the selling expenses after valuation date, the effect will be to allocate the overall gain into the post-CGT period. The proceeds formula is no longer triggered by selling expenses when capitalisation shares are disposed of during years of assessment ending on or after 8 November 2005 because the time-apportionment formula was amended to treat selling expenses as a reduction of proceeds (see **8.34.10**).

Example 2 – Base cost of pre-valuation date capitalisation shares sold during years of assessment ending on or after 8 November 2005*Facts:*

John acquired 10 capitalisation shares in lieu of dividends from MVK Limited on 1 November 1982. He sold them on 15 February 2020 for R100 a share, and incurred selling expenses of R5 a share. The market value of the shares on valuation date was R60 a share.

Result:

The effect of adopting the three valuation date value methods is shown below.

Market value

Capital gain = proceeds – VDV – post-1 October 2001 expenditure
 = R1 000 – R600 – R50
 = R350

Time-apportionment base cost

Y = B + [(P – B) × N / (N + T)]
 = R0 + [(R1 000 – R50) × 19 / 38]
 = R475

Capital gain = Proceeds – VDV – post-1 October 2001 expenditure
 = R1 000 – R475 – R50
 = R475

20% of proceeds

Proceeds = R1 000
 Post-CGT expenditure = R50
 Proceeds less post-1 October 2001 expenditure = R950
 VDV = 20% × 950 = R190

Capital gain = Proceeds – VDV – post-CGT expenditure
 = R1 000 – R190 – R50
 = R760

18.13 Substitutive share-for-share transactions (s 43)

Section 43

Section 43 introduced the legislation governing substitutive share-for-share transactions and came into effect in its original form on 1 January 2013 and applied to transactions entered into on or after that date.⁸³⁵ It was then substantially amended with effect from 24 October 2013.⁸³⁶

1 January 2013 to 23 October 2013

For the period 1 January 2013 to 23 October 2013 s 43 provided a form of roll-over treatment when one type of equity share was substituted for another type of equity share. The provision did not place any restriction on the type of substitution that could occur besides not allowing equity shares to be replaced with non-equity shares.

Roll-over treatment was also provided for the substitution of non-equity shares for other non-equity shares but only in relation to the subdivision or consolidation of such shares.

Since a share must be disposed of before s 43 can apply, s 43 cannot apply to a consolidation or subdivision of shares when the underlying rights and interests in the shares remain unchanged and no additional consideration is given by the company. A share is a bundle of rights and a disposal can occur only when those rights are changed. It follows that the purported roll-over relief conferred by s 43 on a subdivision or consolidation was therefore both unnecessary and ineffective.

Before 24 October 2013 pre-valuation date shares were inappropriately treated⁸³⁷ but this issue was addressed on or after 24 October 2013 through the insertion of s 43(1A).

Similarly, s 43 did not apply to a conversion of par value shares to shares of no par value when the underlying rights and interests in the shares remained unchanged. For the sake of providing clarity para 11(2)(j) has been introduced with effect from 4 July 2013 to confirm that such share substitutions do not give rise to a disposal.

On or after 24 October 2013

⁸³⁵ Inserted by s 75(1) of the Taxation Laws Amendment Act 22 of 2012.

⁸³⁶ The previous effective date for the substantial amendments was 4 July 2013 but this was substituted for 24 October 2013 by s 124(1) of the Taxation Laws Amendment Act 43 of 2014.

⁸³⁷ Replacement shares were incorrectly treated as having a base cost equal to the expenditure incurred on the previously held shares and were also deemed to be acquired on the date of acquisition of the most recently acquired previously held shares. Such treatment ignored the fact that the previously held shares could have had a valuation date value which cannot be equated with expenditure.

The ambit of s 43 has been significantly curtailed with effect from 24 October 2013 and in its current guise it deals only with the substitution of linked units in a company for equity shares in that company. The term ‘linked unit’ refers to a financial instrument consisting of shares and debentures issued by a company that are linked and are traded as a single unit. Such linked units are typically created by property loan stock companies listed on the JSE although they can be issued by unlisted companies and companies that do not hold immovable property.

The JSE has published transitional rules to facilitate the conversion of property loan stock companies to REITs. In this conversion process REITs may consider delinking their units by issuing shares in substitution for their linked units although such a delinking is not a requirement in order to trade as a REIT.

Non-tax reasons why such a substitution would occur are to simplify the REIT’s capital structure and bring it in line with REIT international best practice. For tax purposes the problem of excessive interest deductions potentially not qualifying as a deduction under s 24J(2) and the advent of ss 8F and 8FA which deem interest on tainted debt to be a dividend should act as an incentive for property loan stock companies to convert linked units to equity shares.

Section 43 does not, however, require that the company be listed or that it must hold immovable property and its provisions are therefore applicable to linked units held in any company regardless of whether it is a REIT.

18.13.1 Definitions

The following definitions apply for the purposes of s 43:

‘ “[E]quity share” includes a linked unit;’

The term ‘linked unit’ is defined in s 1(1) as follows:

‘ “[L]inked unit” means a unit comprising a share and a debenture in a company, where that share and that debenture are linked and are traded together as a single unit;’

The term ‘share’ is defined in s 1(1) as follows:

‘ “[S]hare” means, in relation to any company, any unit into which the proprietary interest in that company is divided;’

The term ‘debenture’ is not defined in the Act and must accordingly bear its ordinary meaning taking into account the context in which it is used. In the context it refers to debt issued by a company. While the debenture and the share must be traded as a single unit, they are in fact separate assets each with their own characteristics, with the share bearing dividends and the debenture bearing interest.⁸³⁸

‘ “[S]ubstitutive share-for-share transaction” means a transaction between a person and a company in terms of which that person disposes of an equity share in the form of a linked unit in that company and acquires an equity share other than a linked unit in that company.’

Before a substitutive share-for-share transaction the person would hold equity shares plus a debenture in the company and after the transaction only equity shares. The term ‘equity share’ is defined in s 1(1) as follows:

⁸³⁸ *Burman v CIR* 1991 (1) SA 533 (A), 53 SATC 63.

“**[E]quity share**” means any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution;’

In other words, if either the right to capital or the right to dividends is restricted, the share will still be an equity share. To be a non-equity share both such rights must be restricted.

18.13.2 Disposal of pre-valuation date equity shares [s 43(1A)]

Before 24 October 2013 no rule existed to convert pre-valuation date linked units (equity shares and linked debentures) to post-valuation date linked units immediately before a substitutive share-for-share transaction. Such a rule is necessary because para 25 provides that the base cost of a pre-valuation date asset comprises its valuation date value plus any expenditure incurred on or after the valuation date. Since s 43 provides roll-over relief based on ‘expenditure’ and not a ‘valuation date value’, no relief would be possible for the valuation date value of the linked units without first reconstituting their base cost as expenditure.

Under s 43(1A) when a person disposes of a pre-valuation date linked unit in a company and acquires another equity share in that company under a substitutive share-for-share transaction, that person must, for the purposes of determining the date of acquisition of the pre-valuation date linked unit and the expenditure in respect of the cost of acquisition of that linked unit, be treated as having

- disposed of that linked unit at a time immediately before that substitutive share-for-share transaction, for an amount equal to the market value of that linked unit at that time; and
- immediately reacquired that linked unit at that time at an expenditure equal to that market value.

What is meant by ‘immediately before’? Does it mean one second before or the day before? The purpose of the rule is to obtain the most recently available market price for the linked unit before the transaction. If the most recent price is the closing price on the last business day preceding the date of the substitutive share-for-share transaction, that price should be acceptable.

One consequence of this base cost determination rule is that the original date of acquisition of the shares will be lost for purposes of s 9C. A person who disposes of the replacement equity shares within three years of the substitutive share-for-share transaction will therefore have to rely on common law principles for justifying the capital nature of the proceeds.

The market value reacquisition cost must be reduced by any capital gain and increased by any capital loss arising from this deemed disposal. The resulting expenditure is treated as having been incurred for the purposes of para 20(1)(a). The capital gain or loss so determined is used for purposes of base cost redetermination only and does not form part of a person’s aggregate capital gain or loss for a year of assessment.

A person would be able to use time-apportionment, market value or 20% of proceeds under para 26 or para 27 to determine the valuation date value of the linked unit.

Before the introduction of ss 8F, 8FA and 25BB which deem interest payments to be dividends under specified circumstances, it could have been argued that the debenture portion of a linked unit was a s 24J instrument and a separate asset from the equity share.⁸³⁹ However, debt that cannot produce interest cannot be a s 24J instrument and it is therefore assumed

⁸³⁹ See *Burman* case above.

that para 28 will not apply for the purposes of determining the valuation date value of the debt portion of a pre-valuation date linked unit.

Example – Substitutive share-for-share transaction involving pre-valuation date linked units

Facts:

Matt owns 100 linked units (100 equity shares and 100 linked debentures) in Propco Ltd which he acquired at a combined cost of R100 000 on 1 March 1984. Propco pays interest twice yearly at the end of February and August. Propco announced that it would be converting its linked units to delinked equity shares on 1 September 2019 as part of its desire to trade as a REIT on the JSE and to avoid the consequences of s 8FA which would result in it becoming liable for dividends tax on its interest payments. The market value of Matt's linked units on 1 October 2001 was R280 000 and immediately before the substitution, R500 000.

Result:

The exchange of the linked units for equity shares is a disposal by Matt which falls to be dealt with under s 43 as a substitutive share-for-share transaction. The first step is to apply s 43(1A) in order to convert Matt's pre-valuation date linked units into post-valuation date linked units having an expenditure for the purposes of para 20(1)(a). Under para 26 Matt has a choice of three alternative methods for determining the base cost of his pre-valuation date linked units, namely, time apportionment, market value or 20% of proceeds.

The time-apportionment base cost of the linked units is determined as follows:

$$\begin{aligned} Y &= B + [(P - B) \times N / (N + T)] \\ &= R100\,000 + [(R500\,000 - R100\,000) \times 18 / 36] \\ &= R100\,000 + R200\,000 \\ &= R300\,000 \end{aligned}$$

Since the time-apportionment base cost of R300 000 is higher than the market value base cost of R280 000 and 20% of proceeds base cost of R100 000 ($R500\,000 \times 20\%$), Matt would adopt time apportionment for the purposes of s 43(1A).

The capital gain is R200 000 (proceeds of R500 000 less base cost of R300 000).

Under s 43(1A) the redetermined base cost of Matt's linked units is thus R300 000 (deemed reacquisition cost of R500 000 less the capital gain of R200 000).

Under s 43(2) Matt is deemed to have proceeds of R300 000 on disposal of his 100 linked units (100 equity shares and 100 debentures), which results in neither a capital gain nor a capital loss. He is deemed to acquire the replacement equity shares on 1 September 2019 at a cost of R300 000.

18.13.3 Deemed proceeds equal to cost or base cost [s 43(2)]

Subject to s 43(4), a person engaging in a substitutive share-for-share transaction is treated as having

- Disposed of the linked unit (equity share and linked debenture) for an amount equal to the expenditure allowable under para 20 or taken into account under s 11(a), 22(1) or (2);

- Acquired the replacement equity share for the same expenditure referred to above on the most recent date on which any of the previously held linked units were acquired; and
- Incurred the cost referred to in the preceding bullet point on the same date on which the latest of the previously held equity shares and debentures were acquired.

The cost attributable to a replacement equity share acquired as

- a capital asset, is deemed to be incurred for the purposes of para 20; and
- trading stock, is deemed to be taken into account for the purposes of s 11(a) or 22(1) or (2).

Any decision to convert linked units held as capital assets to trading stock or vice versa would be undertaken independently of the company's decision to convert its linked units to equity shares and will accordingly carry the normal consequences applicable to such a conversion under s 22(8)(b)(v) or para 12(2)(c). The consequences of such a conversion will take effect before or after the substitutive share-for-share transaction.

18.13.4 Share substitution accompanied by other consideration [s 43(4)]

A linked unit substitution may be accompanied by a distribution of cash or an asset *in specie*, such as shares in another company. In these circumstances the roll-over treatment afforded under s 43(2) will not apply to the extent of the other consideration. Excluded from this rule is consideration in the form of a dividend, foreign dividend, or an equity share acquired as part of the substitutive share-for-share transaction. Dividends and foreign dividends are excluded to prevent capital losses. A capital loss would result because dividends and foreign dividends comprise gross income and are therefore excluded from proceeds under para 35(3)(a).

The portion of the expenditure to be attributed to the proceeds is determined by multiplying the base cost of the previously held linked units by the amount of other consideration divided by the market value of the replacement equity shares and the other consideration. The other consideration must therefore be dealt with as if the linked unit was partly disposed of. A similar apportionment rule applies for the purpose of determining the portion of trading stock that is deemed to be disposed of for the purposes of s 11(a), s 22(1) or s 22(2).

The type of other consideration envisaged by the legislature from a CGT point of view was probably a return of capital or foreign return of capital. Since such consideration coincides with the disposal of the previously held equity shares and debentures, it will not be dealt with under the base cost reduction provisions of para 76B because that provision applies only to a return of capital or foreign return of capital derived prior to the disposal of a share.

Example – Share substitution accompanied by other consideration

Facts:

Mike acquired 100 linked units in ABC Ltd on 1 July 2006 at a cost of R100 000. On 29 February 2020 the company issued him with 100 equity shares with a market value of R300 000 in exchange for the surrender of his 100 linked units which had a market value of R500 000 immediately before the substitution. In addition to the issue of the equity shares, the company returned the CTC attributable to the previously held equity shares which in Mike's case amounted to R200 000.

Result:

The cash payment represents a return of capital which must be dealt with as proceeds on a part-disposal of the linked units.

Mike is deemed to have disposed of 40% ($R200\,000 / (R300\,000 + R200\,000)$) of his linked units for proceeds of R200 000.

The base cost attributable to the part of the linked units disposed of for a cash consideration is R40 000 ($R100\,000 \times 40\%$). Mike therefore has a capital gain determined as follows:

	R
Proceeds – return of capital (para 35)	200 000
Less: Base cost ($R100\,000 \times 40\%$)	<u>(40 000)</u>
Capital gain	<u>160 000</u>

The base cost of the replacement equity shares is R60 000 ($R100\,000 - R40\,000$) and they are deemed to have been acquired on 1 July 2006.

Chapter 19 – Assets disposed of or acquired in foreign currency

Paragraph 43

19.1 Application

Paragraph 43 deals with the determination of a capital gain or loss on disposal of an asset that is acquired or disposed of in a foreign currency. It contains rules for converting the proceeds and base cost into the 'local currency' (that is, rand or a functional currency).

Paragraph 43 applies to an 'asset' as defined in para 1. The definition of 'asset' is framed in wide terms but excludes currency. It follows that para 43 does not apply to foreign bank notes and coins. Part XIII (paras 84 to 96) used to cover foreign notes and coins and other foreign-denominated debt of individuals and non-trading trusts but that Part was deleted with effect from years of assessment commencing on or after 1 March 2011 (the 2012 year of assessment of individuals and trusts).

Debt assets denominated in foreign currency such as foreign bank accounts, treasury bonds and loans held by individuals and non-trading trusts fall within para 43(1) when acquired and disposed of in the same foreign currency. In all other situations they must be dealt with under s 24I (when applicable) and s 25D.

Generally, there are two ways of translating a capital gain or loss into rand, namely, a simple method and a more comprehensive method. Under the simple method the capital gain or loss is determined in the foreign currency and then translated to rand at the time of disposal. Under the comprehensive method the expenditure is translated to rand at the time it is incurred while the proceeds are translated to rand at the time the asset is disposed of. The comprehensive method picks up the effect of currency appreciation or depreciation on the base cost of the asset. Thus, in times of a depreciating rand the comprehensive method will result in a lower base cost and higher capital gain or lower capital loss while the converse will be true in times of an appreciating rand when compared to the simple method.

Example – Comprehensive method v simple method for translating capital gains and losses into rand*Facts:*

An asset was acquired for \$100 in year 1 when the exchange rate was \$1:R1 and sold for \$120 in year 5 when the exchange rate was \$1:R2.

*Result:**Simple method*

The capital gain is \$120 (proceeds) – \$100 (base cost) = \$20 × 2 = R40.

Comprehensive method

The proceeds are \$120 × 2 = R240. The base cost is \$100 × 1 = R100. The capital gain is therefore R140 (proceeds of R240 less base cost of R100).

The difference between the two methods is R100 (R140 – R40) and is attributable to the fact that the base cost under the simple method is \$100 × 2 = R200 using the current exchange rate while the base cost under the comprehensive method is \$100 × 1 = R100 using the stronger exchange rate at the time the expenditure was incurred.

Some significant changes to para 43 were brought about by the Taxation Laws Amendment Act 22 of 2012 with effect from 1 March 2013. Under these amended rules individuals and non-trading trusts will generally determine a capital gain or loss using the simple method unless the asset is acquired and disposed of in different currencies, in which case they must use the comprehensive method. Companies and trading trusts are obliged to use the comprehensive method for all transactions, which is generally in line with the treatment they would use for accounting purposes. For commentary on the previous rules, see the earlier versions of this guide.

19.2 Definitions [para 43(7) and s 1(1)]

Paragraph 43 makes reference to a number of defined terms, some of which are defined in s 1(1), while others are defined in para 43(7).

19.2.1 Definition – ‘foreign currency’ [para 43(7)]

‘ “[F]oreign currency” means currency other than local currency;’

See **19.2.2** for the definition of ‘local currency’.

19.2.2 Definition – ‘local currency’

‘ “[L]ocal currency” means—

- (a) in relation to a permanent establishment of a person, the functional currency of that permanent establishment (other than the currency of any country in the common monetary area);
- (b) in relation to a headquarter company, in respect of amounts which are not attributable to a permanent establishment outside the Republic, the functional currency of that headquarter company;
- (c) in relation to a domestic treasury management company, in respect of amounts which are not attributable to a permanent establishment outside the Republic, the functional currency of that domestic treasury management company;
- (d) in relation to an international shipping company defined in section 12Q, in respect of amounts which are not attributable to a permanent establishment outside the Republic, the functional currency of that international shipping company; or
- (e) in any other case, the currency of the Republic.’

The terms ‘permanent establishment’, ‘functional currency’, ‘headquarter company’ and ‘domestic treasury management company’ are defined in s 1(1). A headquarter company is one referred to in s 9I(1).

Under para (a), the term ‘local currency’ could comprise a currency other than rand. However, the currencies of countries in the common monetary area are excluded because they trade at par with the rand, for example, one Namibian dollar equals one rand). The currencies falling within this category are the Lesotho maloti, Namibian dollar and Eswatini emalangenani.

The term ‘functional currency’, as defined in s 1(1), is discussed in **19.2.3**.

Examples – Local currency*Facts (1):*

A resident has a branch in London which uses pound sterling as its functional currency.

Result (1):

Under para (a) of the definition of ‘local currency’ the local currency of the permanent establishment is pound sterling.

Facts (2):

A resident has a branch in Namibia which uses the Namibian dollar as its functional currency.

Result (2):

Under para (e) of the definition of ‘local currency’ the local currency of the permanent establishment is rand. The Namibian dollar falls outside para (a) of the definition because it is a currency of a country in the Common Monetary Area.

19.2.3 Definition – ‘functional currency’ [s 1(1)]

‘**[F]unctional currency**’, in relation to—

- (a) a person, means the currency of the primary economic environment in which the business operations of that person are conducted; and
- (b) a permanent establishment of any person, means the currency of the primary economic environment in which the business operations of that permanent establishment are conducted;’

For commentary on the definition of ‘functional currency’, see para 7.2 of Interpretation Note 63 (Issue 2) dated 12 August 2015 ‘Rules for the Translation of Amounts Measured in Foreign Currencies other than Exchange Differences Governed by Section 24I and the Eighth Schedule’.

19.2.4 Definition – ‘permanent establishment’ [s 1(1)]

‘**[P]ermanent establishment**’ means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development: Provided that in determining whether a qualifying investor in relation to a partnership, trust or foreign partnership has a permanent establishment in the Republic, any act of that partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor;’

Article 5 of the OECD Model Tax Convention reads as follows:⁸⁴⁰

1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. The term “permanent establishment” includes especially:
 - a) a place of management;
 - b) a branch;

⁸⁴⁰ OECD Model Tax Convention on Income and on Capital (Condensed Version) 21 November 2017.

- c) an office;
- d) a factory;
- e) a workshop, and
- f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;
- f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e),

provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and

- a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or
- b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are

- a) in the name of the enterprise, or
- b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
- c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are

limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

8. For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.'

Under Article 3 the term 'enterprise' applies to the carrying on of any business. One of the most common examples of a permanent establishment is a branch of a company. A foreign company could have a permanent establishment in South Africa, and a South African company could have a permanent establishment in a foreign country.

19.2.5 Definition – 'spot rate' [s 1(1)]

“**[S]pot rate**” means the appropriate quoted exchange rate at a specific time by any authorised dealer in foreign exchange for the delivery of currency;’

Authorised dealers such as banks quote rates (prices) at which they will buy and sell foreign currency. These rates are based on prices quoted on foreign exchange markets which are subject to constant change and are determined by market forces of supply and demand. Rates of exchange are always quoted from an authorised dealer's point of view. In other words, the “buy” rate is the rate at which a dealer will buy foreign currency, while the “sell” rate is the rate a dealer will charge for selling foreign currency.

Thus, a resident that receives an amount expressed in a foreign currency will sell that foreign currency to a local authorised dealer in exchange for rand at the buying rate of exchange, since the dealer is buying the foreign currency from the resident. Conversely, a resident that settles a liability in a foreign currency will buy the required foreign currency from a local authorised dealer at the selling rate of exchange, since the dealer is selling foreign currency to the resident.

An 'appropriate' spot rate will depend on the facts and circumstances of the particular case, for example, banks have different rates depending on the quantity of currency being bought or sold.

19.2.6 Definition – ‘average exchange rate’ [s 1(1)]

‘**“[A]verage exchange rate”** in relation to a year of assessment means the average determined by using the closing spot rates at the end of daily or monthly intervals during that year of assessment which must be consistently applied within that year of assessment;’

The method described in the above definition is a simple average of closing spot rates over the selected interval (365 days or 12 months). For example, if a daily interval is selected, then the average exchange rate will be the total of the 365 daily closing spot rates during the year divided by 365 (assuming it is not a leap year).

Average rates of exchange supplied by the South African Reserve Bank are available on the SARS website under Legal Counsel/ Legal Counsel Publications/ Average exchange rates.⁸⁴¹

19.3 Individuals and non-trading trusts disposing of assets acquired in the same foreign currency [para 43(1)]

Paragraph 43(1) applies when an individual or non-trading trust disposes of an asset for proceeds in a foreign currency after having incurred expenditure in respect of the asset in the same foreign currency. In these circumstances the individual or non-trading trust must translate the capital gain or loss into the local currency by applying the average exchange rate for the year of assessment in which the asset was disposed of or by applying the spot rate on the date of disposal of the asset.

An individual or non-trading trust that buys an asset in one foreign currency and disposes of it in another foreign currency must use para 43(1A) to translate the proceeds and expenditure to the local currency.

A trust that is carrying on a trade falls outside para 43(1) and into para 43(1A). The term ‘trade’ is defined in wide terms in s 1(1). Thus, for example, a trust involved in the letting of property will be carrying on a trade and must determine a capital gain or loss under para 43(1A), even if the asset concerned is not used in the trade of letting.

Further amounts may be received or accrued or expenditure incurred in respect of the asset in a year of assessment subsequent to the year of assessment in which the asset was disposed of. In these circumstances the amounts must be translated to the local currency at the spot rate when the asset was disposed of or at the average exchange rate during the year of assessment in which the asset was disposed of. In other words, the normal rules in para 43(1) apply.

Average exchange rates for a year of assessment are available from the SARS website (see commentary on this term in **19.2.6**).

Under para 43(1) no account is taken of the currency fluctuation between the date of incurral of the expenditure and the date of disposal. This treatment results in a higher base cost during times when the rand or other local currency depreciates because the expenditure incurred in acquiring the asset is effectively translated at the exchange rate prevailing at the time of disposal instead of the exchange rate that prevailed when the expenditure was incurred. Conversely, in times when the local currency appreciates, the base cost will be lower compared to the result achieved had the rate of exchange at the time of incurral of the expenditure been used.

⁸⁴¹ Click on Table A or Table B. The Oanda website is also a useful source for average exchange rates, particularly for earlier years of assessment. Available from: <<http://www.oanda.com/convert/fxhistory>> [Accessed 2 November 2020].

Pre-valuation date assets acquired and disposed of in the same foreign currency by natural persons and non-trading trusts

Three methods are potentially available for determining the valuation date value of a pre-valuation date asset acquired in foreign currency, namely,

- market value on valuation date;
- 20% of proceeds after first deducting post-valuation date expenditure from the proceeds; and
- time-apportionment.

Not all these methods are available under all circumstances. For example, the time-apportionment method will be unavailable when a taxpayer does not have a record of pre-valuation date expenditure, and the market-value method is unavailable if the asset was not valued on or before 30 September 2004 [para 29(4)]. Sometimes a different valuation date value method will be prescribed or substituted, depending on whether the proceeds exceed, are equal to or below the expenditure on the asset (the so-called kink tests). An example of the latter is proceeds less post-valuation date expenditure prescribed under para 26(3) when the market value on valuation date does not exceed the proceeds, and the taxpayer seeks to use the market-value method.

In applying the time-apportionment base cost formulae, the variables in the formulae in para 30 ('P' (proceeds), 'N' (pre-valuation date expenditure) and 'A' (expenditure incurred on or after valuation date) must be determined in foreign currency because the capital gain must be determined in foreign currency and translated to rand in the year of disposal.

The same applies to the 20% of proceeds method – the proceeds and the expenditure incurred on or after the valuation date must also be determined in foreign currency.

The market-value method must be determined using the market value on valuation date in the foreign currency of expenditure [para 43(6)].

The kink tests in paras 26(3) and 27 must of necessity be applied in foreign currency because translation to rand occurs in the year of disposal.

Example 1 – Disposal of asset in respect of which proceeds are derived and expenditure is incurred in the same foreign currency by a natural person or non-trading trust [para 43(1)]

Facts:

In 2005 Deon acquired 100 shares at a cost of \$100 in ABC Ltd, a company listed on the NYSE. On 25 September 2018 Deon sold the shares for \$160. The spot rate on the date of disposal was \$1 : R14,3668 and Deon elected to use the spot rate for purposes of para 43(1).

Result:

The capital gain in foreign currency is \$60 (\$160 – \$100). The capital gain in rand is thus \$60 x 14,3668 = R862 (rounded to the nearest R1).

Example 2 – Disposal of pre-valuation date asset by natural person or non-trading trust in respect of which proceeds are derived and expenditure is incurred in the same foreign currency [para 43(1)]

Facts:

In 1998 Neil purchased a flat in Sydney for AU\$135 000 in order to derive rental income. The market value of the property on 1 October 2001 was AU\$220 000 which Neil determined before 30 September 2004 in accordance with para 29(4). On 31 January 2019 the property was sold for AU\$270 000. The average AU\$/R exchange rate for the 2019 year of assessment was AU\$1 : R9,9360. Neil adopted the market value of the property as the valuation date value and elected to use the average exchange rate for the purpose of translating the capital gain to rand.

Result:

The capital gain on disposal of the asset is determined as follows:

Step 1: Determine capital gain in foreign currency

Proceeds	AU\$ 270 000
Less: Base cost	(220 000)
Capital gain in foreign currency	<u>50 000</u>

Step 2: Translate capital gain in foreign currency to rand

Capital gain in foreign currency as above	AU\$50 000
Average exchange rate	AU\$1 : R9,9360
Capital gain in rand AU\$50 000 × 9,9360	R496 800

Note: Paragraph 43(6), which requires any market value on valuation date to be translated to rand at the spot rate on valuation date, does not apply when para 43(1) applies, since the latter provision sets out how the capital gain or loss must be determined.

Example 3 – Foreign bank accounts

Facts:

In 2005 Carolyn invested \$100 in the Caribbean Islands Shady Bank Inc. All went well until the 2017 year of assessment when the bank manager began speculating in the futures market. As a result, the bank was placed in liquidation, and on 28 February 2019 Carolyn received \$40 in full and final settlement of her claim against the bank. Carolyn elected to use the spot rate on 28 February 2019 of \$1 : R14,0007 to determine her capital loss.

Result:

Under para 43(1) Carolyn must determine her capital loss in foreign currency [\$40 (proceeds) – \$100 (base cost) = \$60 (capital loss)], and translate that capital loss into rand at the spot rate on 28 February 2019 (date of incurral of the loss), that is, \$60 × 14,0007 = R840 (rounded to nearest R1).

Note: Usually foreign bank accounts of individuals and non-trading trusts will not give rise to a capital gain or loss under para 43(1), since the amount invested and accumulated interest will simply be repaid in the same foreign currency.

Example 4 – Loss on disposal of foreign loan involving s 24I and para 43(1)*Facts:*

Greg holds pound sterling-denominated bonds as trading stock. On 1 March 2018 he lent £100 000 to Chelsea PLC, a United Kingdom-based investment company, when £1 = R16,3089. The loan was of a capital nature and unrelated to his bond-trading activities. Chelsea PLC was dissolved on 28 February 2019 when the exchange rate was £1 = R18,6015. Greg lost the entire amount of his investment.

The average exchange rate for the year ending 28 February 2019 was £1 = R17,8338 and Greg wishes to use that rate for the purposes of para 43(1).

Result:

The loan to Chelsea plc and the pound sterling-denominated bonds comprise exchange items under para (b) of the definition of ‘exchange item’ in s 24I(1) because they comprise amounts in foreign currency owed to Greg in respect of debts payable to Greg.

Since Greg holds exchange items (pound sterling-denominated bonds) as trading stock, he must, under s 24I(2)(c) determine his exchange gain or loss under s 24I. The exchange gain or loss comprises the ‘exchange difference’ as defined in s 24I and is determined as follows:

	R
£100 000 × 18,6015 (28 February 2019)	1 860 150
£100 000 × 16,3089 (1 March 2018)	<u>(1 630 890)</u>
Exchange difference	<u>(229 260)</u>

The exchange difference of R229 260 represents an exchange gain which falls to be included in Greg’s income under s 24I(3). However, because the debt became bad, the same amount must be deducted from Greg’s income under s 24I(4).

Greg will have a capital loss under para 43(1), determined as follows:

	£
Proceeds	-
Less: Base cost	<u>(100 000)</u>
Capital loss in pound sterling	<u>(100 000)</u>
Average exchange rate for 2019 year of assessment	£1 = R17,8338
Capital loss £100 000 × 17,8338	R1 783 380

Determining the currency of expenditure for foreign bank accounts

The currency of expenditure of a foreign bank account is a relevant factor in determining whether an individual or non-trading trust falls within para 43(1) or s 25D(1). Some confusion has arisen in this regard when a taxpayer transfers funds from a South African bank account to a foreign bank account, with the view expressed that the expenditure may be incurred in rand. If it was indeed incurred in rand, there would be two different currencies (proceeds in the foreign currency with base cost in rand) and the transaction would fall under para 43(1A). If this interpretation were correct, a capital gain or loss could arise on withdrawals from the foreign bank account because it is unlikely that the exchange rate used to translate the proceeds in the year of disposal will be the same as the rate ruling when the funds were deposited into the foreign bank account. These concerns are, however, unfounded.

Expenditure on foreign bank accounts is determined in the currency in which the account is denominated. The proceeds arising from withdrawals from such accounts are also determined in the foreign currency in which the account is denominated. The position with a hard asset such as immovable property is different, however, since the proceeds will be denominated in whatever currency the parties contractually agree upon. The example below explains the underlying reasoning.

Example – Determination of base cost of a foreign bank account

Facts:

Tracy has a South African bank account denominated in rand and a US bank account denominated in USD. She directed her South African bank to transfer R100 000 to her US account when the exchange rate was \$1 = R10. The South African bank complied with her request and \$10 000 was transferred and deposited into her US bank account. Six months later Tracy withdrew \$5 000 from her US bank account and purchased a machine for \$5 000 when the exchange rate was \$1 = R11.

Result:

When Tracy issued the payment instruction to her South African bank, she acquired an asset in the form of a personal right to claim payment of \$10 000 while at the same time incurring a liability of R100 000. When the South African bank transferred the funds to the US bank account, her personal right against the bank was extinguished and she acquired a new asset in the form of the amount credited to her US bank account. At the same time her indebtedness to the South African bank in the amount of R100 000 was extinguished through set-off by debiting her South African bank account. The position can therefore be summarised as follows:

South African bank account

	R
Proceeds [para 35(1)(a)]	100 000
Less: Base cost (part-disposal)	(100 000)
Capital gain or loss	<u> -</u>

The proceeds are equal to the liability discharged through set-off under para 35(1)(a) ('the amount by which any debt owed by that person has been reduced or discharged').

Right to claim payment of \$10 000 from the South African bank

	R
Proceeds \$10 000 × R10 [para 35(1)]	100 000
Less: Base cost [para 20(1)(a)]	(100 000)
Capital gain or loss	<u> -</u>

The proceeds comprise the amount of \$10 000 credited to the US bank account. This amount is the *quid pro quo* received in exchange for relinquishing the personal right to claim performance from the South African bank. The disposal must be dealt with under para 43(1A) because the proceeds are in USD while the base cost is incurred in rand. However, no capital gain or loss arises because the asset is immediately disposed of and there is no time for a change in exchange rates to occur.

US bank account

	\$
Proceeds [para 35(1)(a)]	5 000
Less: Base cost (part-disposal) [para 43(1)]	<u>(5 000)</u>
Capital gain or loss	<u>—</u>

Under para 43(1) the capital gain or loss must be determined in USD at the time of disposal and translated to rand on that date using the spot rate or the average exchange rate in the year of assessment in which the asset was disposed of. Since there is no gain or loss in USD, no capital gain or loss arises. When Tracy issued the payment instruction to her US bank to pay the supplier of the machine, she acquired a personal right to expect the US bank to make the payment and at the same time became indebted to the bank in a like amount. When the bank effected payment, the personal right was extinguished and her liability to the bank of \$5 000 was extinguished through set-off by the bank debiting her account with \$5 000.

Machine

The machine has a base cost of \$5 000 under para 20(1)(a), being equal to the amount by which Tracy was impoverished when the USD-denominated personal right to expect the bank to pay the supplier was extinguished. If she sells the machine in USD, the transaction will be dealt with under para 43(1). But if she sells it in rand or another foreign currency, any capital gain or loss must be determined under para 43(1A).

19.4 Companies, trading trusts and other persons to whom para 43(1) does not apply

Paragraph 43(1A) applies when para 43(1) does not apply. It applies when an asset is disposed of during a year of assessment and the proceeds are in a foreign currency or expenditure in respect of that asset has been incurred in a foreign currency. It therefore applies to the disposal of an asset by

- A company;
- a trading trust; or
- an individual or non-trading trust that buys and sells an asset in different currencies.

When para 43(1A) applies, the person must determine a capital gain or loss by translating

- the proceeds into the local currency at the average exchange rate for the year of assessment in which that asset was disposed of or at the spot rate on the date of disposal of that asset; and
- the expenditure incurred in respect of that asset into the local currency at the average exchange rate for the year of assessment during which that expenditure was incurred or at the spot rate on the date on which that expenditure was incurred.

Elimination of double taxation and double deductions arising from s 24I

Paragraph 43(1A) contains a proviso which states that

'the amount of any capital gain or capital loss determined under this subparagraph in respect of an exchange item contemplated in section 24I must be taken into account in terms of this paragraph only to the extent to which it exceeds the amounts determined in respect of that exchange item under section 24I'.

The purpose of this proviso is to eliminate double taxation or double deductions between para 43(1A) and s 24I when exchange gains and losses arise on debt assets denominated in foreign currency. In relation to such debt assets, s 24I requires companies, trading trusts and specified natural persons to include exchange gains in their income and to deduct exchange losses on such assets.

The term '**exchange item**' as defined in s 24I(1) means an amount in a foreign currency

- which constitutes any unit of currency acquired and not disposed of by that person;
- owing by or to that person in respect of a debt incurred by or payable to such person;
- owed by or to that person in respect of a forward exchange contract; or
- where that person has the right or contingent obligation to buy or sell that amount in terms of a foreign currency option contract.

Section 24I applies to any

- company;
- trust carrying on any trade;
- natural person who holds any unit of currency or debt as trading stock; and
- natural person or trust in respect of a forward exchange contract or foreign currency option contract.

The application of the proviso is illustrated in the following examples:

Example 1 – Interaction between s 24I and para 43(1A): currency gain plus capital gain*Facts:*

Company B acquired a foreign bond as a long-term investment during its first year of assessment when X\$1:R1 for X\$100. At the end of the first year of assessment the exchange rate was X\$1:R1,40 and at the end of year 2 X\$1:R2. On the last day of year 2 Company B disposed of the bond for an amount received or accrued of X\$120.

Result:

Section 24I

	R
End of first year of assessment X\$100 × R1,40	140
Less: Beginning of first year of assessment X\$100 × R1	<u>(100)</u>
Income inclusion	<u>40</u>
End of second year of assessment X\$100 × R2	200
Less: Beginning of second year of assessment X\$100 × R1,40	<u>(140)</u>
Income inclusion	<u>60</u>

The sum of the exchange gains under s 24I is therefore R40 + R60 = R100.

Paragraph 43(1A)

Proceeds X\$120 × R2 [para 35 read with para 43(1A)]	240
Less: Base cost X\$100 × R1 [para 20(1)(a) read with para 43(1A)]	<u>(100)</u>
Capital gain before adjustment for s 24I	140
Less: Section 24I exchange gains [proviso to para 43(1A)]	<u>(100)</u>
Capital gain	<u>40</u>

Check: The bond was acquired for X\$100 and sold for X\$120 giving a gain of X\$20 × R2 = R40. The currency gain or loss on the base cost of X\$100 has been fully accounted for under s 24I.

Example 2 – Interaction between s 24I and para 43(1A): currency gain plus capital loss

Facts:

Company C advanced a foreign loan to Company D during its first year of assessment when X\$1:R1 for X\$100. At the end of the first year of assessment the exchange rate was X\$1:R1,40 and at the end of year 2 X\$1:R2. On the last day of year 2 Company D was liquidated and Company C received only X\$80 in full and final settlement of the loan.

Result:

Section 24I

	R
End of first year of assessment X\$100 × R1,40	140
Less: Beginning of first year of assessment X\$100 × R1	<u>(100)</u>
Income inclusion	<u>40</u>
End of second year of assessment X\$100 × R2	200
Less: Beginning of second year of assessment X\$100 × R1,40	<u>(140)</u>
Income inclusion	<u>60</u>

Since X\$20 of the debt was bad, Company C is entitled to a deduction of R20 (X\$20 × (2 – 1)) under s 24I(4). The sum of the amounts included or deducted from Company C's income is therefore a net inclusion of R40 + R60 – R20 = R80.

Paragraph 43(1A)

	R
Proceeds X\$80 × R2 [para 35 read with para 43(1A)]	160
Less: Base cost X\$100 × R1 [para 20(1)(a) read with para 43(1A)]	<u>(100)</u>
Capital gain before adjustment for s 24I	<u>60</u>
Less: Section 24I exchange gains less irrecoverable portion [proviso to para 43(1A)]	<u>(80)</u>

Capital loss (20)

Check: The foreign loan was acquired at a cost of X\$100 and disposed of for X\$80 giving a capital loss of X\$20 × R1 = R20. The currency gain on the portion of the loan that was irrecoverable was reversed under s 24I(4) and the capital loss therefore represents the original cost of the portion of the debt that was lost.

Example 3 – Interaction between s 24I and para 43(1A): currency loss plus capital gain

Facts:

Company D acquired a foreign bond during its first year of assessment when X\$1:R1 for X\$100. At the end of the first year of assessment the exchange rate was X\$1:R0,75 and at the end of year 2 X\$1:R0,30. On the last day of year 2 Company D disposed of the bond for X\$150.

Result:

Section 24I

	R
End of first year of assessment X\$100 × R0,75	75
Less: Beginning of first year of assessment X\$100 × R1	(100)
Deduction from income	(25)
End of second year of assessment X\$100 × R0,30	30
Less: Beginning of second year of assessment X\$100 × R0,75	(75)
Deduction from income	(45)

The sum of the deductions from Company D's income is therefore R25 + R45 = R70.

Paragraph 43(1A)

	R
Proceeds X\$150 × R0,30 [para 35 read with para 43(1A)]	45
Less: Base cost X\$100 × R1 [para 20(1)(a) read with para 43(1A)]	(100)
Capital loss before adjustment for s 24I	(55)
Add: Section 24I exchange losses [proviso to para 43(1A)]	70
Capital gain	15

Check: The bond was acquired for X\$100 and sold for X\$150 giving a gain of X\$50 × R0,30 = R15. The currency loss on the base cost of X\$100 has been fully accounted for under s 24I.

Example 4 – Interaction between s 24I and para 43(1A): currency loss plus capital loss

Facts:

Company E acquired a foreign bond during its first year of assessment when X\$1:R1 for X\$100. At the end of the first year of assessment the exchange rate was X\$1:R0,75 and at the end of year 2 X\$1:R0,30. On the last day of year 2 Company E disposed of the bond for X\$80.

Result:

Section 24I

	R
End of first year of assessment X\$100 × R0,75	75
Less: Beginning of first year of assessment X\$100 × R1	<u>(100)</u>
Deduction from income	<u>(25)</u>
End of second year of assessment X\$100 × R0,30	30
Less: Beginning of second year of assessment X\$100 × R0,75	<u>(75)</u>
Deduction from income	<u>(45)</u>

Since X\$20 of the debt was bad, Company E must reverse the portion of the currency losses attributable to the X\$20 loss under s 24I(4) of R14 [X\$20 × (0,3 – 1)]. The sum of the amounts deducted from or included in Company E's income is therefore a net deduction of R25 + R45 – R14 = R56.

Paragraph 43(1A)

	R
Proceeds X\$80 × R0,30 [para 35 read with para 43(1A)]	24
Less: Base cost X\$100 × R1 [para 20(1)(a) read with para 43(1A)]	<u>(100)</u>
Capital loss before adjustment for s 24I	<u>(76)</u>
Add: Section 24I exchange losses net of recoupment [proviso to para 43(1A)]	<u>56</u>
Capital loss	<u>(20)</u>

Check: The bond was acquired for X\$100 and sold for X\$80 giving a loss of X\$20 × R1 = R20. The currency loss on the remaining base cost of X\$80 is R56 [X\$80 × 0,70 (0,30 – 1,00)], and this has been fully accounted for under s 24I.

Treatment of controlled foreign companies

A CFC must determine a capital gain or loss in its functional currency under s 9D(6) (see **23.7.13**).

Meaning of local currency

The term 'local currency' bears five different meanings depending on the circumstances in which it applies. With

- a permanent establishment, it is the functional currency of that permanent establishment, other than a currency of a country in the common monetary area;
- a headquarter company, in respect of amounts which are not attributable to a permanent establishment outside South Africa, it is the functional currency of that headquarter company;
- a domestic treasury management company, in respect of amounts which are not attributable to a permanent establishment outside South Africa, it is the functional currency of that domestic treasury management company;
- an international shipping company defined in s 12Q, in respect of amounts which are not attributable to a permanent establishment outside South Africa, it is the functional currency of that international shipping company;
- in any other case, it is rand.

After a capital gain or loss of a foreign permanent establishment, headquarter company, domestic treasury management company or international shipping company has been determined in the functional currency other than rand it must be translated to rand as part of taxable income using the average exchange rate for the year of assessment. This treatment is spelt out for a foreign permanent establishment in s 25D(2) and for a headquarter company, domestic treasury management company and international shipping company in s 25D(7).

Pre-valuation date assets of companies, non-trading trusts, and individuals disposing of assets in different currencies

Three methods are potentially available for determining the valuation date value of a pre-valuation date asset acquired in foreign currency, namely,

- market value on valuation date;
- 20% of proceeds after first deducting post-valuation date expenditure from the proceeds; and
- time-apportionment.

Not all these methods are available under all circumstances. For example, the time-apportionment method will be unavailable when a taxpayer does not have a record of pre-valuation date expenditure, and the market-value method is unavailable if the asset was not valued on or before 30 September 2004 [para 29(4)]. Sometimes a different valuation date value method will be prescribed or substituted under para 26 or para 27, depending on whether the proceeds exceed, are equal to or below the expenditure on the asset (the so-called kink tests). An example of the latter is proceeds less post-valuation date expenditure prescribed under para 26(3) when the market value on valuation date does not exceed the proceeds and the taxpayer seeks to use the market-value method.

In applying the time-apportionment base cost formulae, the variables in the formulae in para 30 ('P' (proceeds), 'N' (pre-valuation date expenditure) and 'A' (expenditure incurred on or after valuation date) must first be determined in the local currency. In other words, the variables must first be translated to local currency under para 43(1A) before applying the kink tests. Under para 43(1A) the expenditure must be translated to local currency using the spot rate on the date on which it was incurred or at the average exchange rate for the year of assessment in which the expenditure was incurred, while the proceeds must be translated to the local currency using the spot rate on the date of disposal or at the average exchange rate for the year of assessment in which the asset was disposed of. This step is necessary because it would not be possible to perform the time-apportionment calculation were the variables in different foreign currencies. Secondly, unfairness could result if the kink tests were to be applied in foreign currency because of fluctuations in the local currency. For example, the kink tests may substitute a different valuation date value if they were applied in foreign currency, but after translation they may be inapplicable. This outcome could result because the proceeds in local currency may be much higher in relation to the expenditure or market value on valuation date owing to currency depreciation.

The same applies to the 20% of proceeds method – the proceeds and the expenditure incurred on or after the valuation date must also be determined in local currency. The expenditure incurred on or after valuation date must be translated to local currency using the spot rate at the date on which the expenditure was incurred or at the average exchange rate for the year of assessment during which the expenditure was incurred, while the proceeds must be translated to the local currency using the spot rate on the date of disposal or at the average exchange rate for the year of assessment in which the asset was disposed of.

The market-value method must be determined using the market value on valuation date in the foreign currency of expenditure and translated to the local currency using the spot rate on valuation date [para 43(6)].

Example 1 – Company disposing of asset not forming part of a foreign permanent establishment

Facts:

ABC (Pty) Ltd acquired 100 shares in XYZ plc, a company listed on the London Stock Exchange at a cost of £100 on 1 March 2005 when the spot rate was £1 : R11,17. It disposed of the shares for £500 on 29 February 2020 when the spot rate was £1 : R20,0907. ABC (Pty) Ltd elected to use the spot rate rather than the average exchange rate.

Result:

Paragraph 43(1A) applies because ABC (Pty) Ltd is a company. Under para 43(1A) the base cost must be translated to rand at the spot rate when the expenditure was incurred while the proceeds must be translated to rand at the spot rate on the date of disposal.

	R
Proceeds £500 × R 20,0907	10 045
Less: Base cost £100 × R11,17	<u>(1 117)</u>
Capital gain	<u>8 928</u>

The method of translation adopted in para 43(1A) includes currency appreciation or as in this instance, depreciation. In other words, had the translation rule in para 43(1) applied, the capital gain would have been £500 – £100 = £400 × R20,0907 = R8 036, a difference of R892 (R8 928 – R8 036) which is attributable to the fact that under para 43(1) the base cost is translated at the higher rate of £1: 20,0907 instead of the lower historical rate of £1:R11,17. Thus, under para 43(1) the base cost in this example would be £100 × 20,0907 = R2 009 compared to R1 117, the difference being R892.

Example 2 – Individual buying and selling an asset in different currencies

Facts:

Bob acquired a piece of land in Country X for X\$100 000 in 2005 when the spot rate was X\$1 : R2. He sold the land on 29 February 2020 for R500 000.

Result:

Since Bob bought and sold the land in different currencies, he must translate the proceeds and expenditure under para 43(1A). The expenditure must be translated to the local currency (rand in this instance) at the spot rate when it was incurred or at the average rate during the year of assessment in which the expenditure was incurred.

	R
Proceeds (no translation required)	500 000
Less: Base cost X\$100 000 × 2	<u>(200 000)</u>
Capital gain	<u>300 000</u>

Example 3 – Foreign permanent establishment and pre-valuation date asset*Facts:*

XYZ Ltd operates a branch in Country Y from which it operates a fast food franchise. The functional currency of the branch is the Y pound. The company acquired its building in Country Y at a cost of Y£1 million on 1 July 1991 and disposed of it on 29 February 2020 for proceeds of USD100 000. The company's year of assessment ends on the last day of February. The relevant rates of exchange are as follows:

- 1 July 1991 – no rate required because expenditure already in functional currency
- 29 February 2020 – spot rate: \$1:Y£85
- Year of assessment ended 29 February 2020 – average exchange rate: Y£1:R1,50

The company did not value the property on 1 October 2001.

Result:

The proceeds must be translated into the functional currency of the branch: \$100 000 × Y£85 = Y£8,5 million.

Applying the time-apportionment base cost method to determine the base cost of the property:

$$Y = B + [(P - B) \times N / (N + T)]$$

$$Y = Y£1\,000\,000 + [(Y£8\,500\,000 - Y£1\,000\,000) \times 11 / 30]$$

$$Y = Y£1\,000\,000 + (Y£7\,500\,000 \times 11 / 30)$$

$$Y = Y£3\,750\,000$$

	Y£
Proceeds	8 500 000
Less: Base cost	<u>(3 750 000)</u>
Capital gain	<u>4 750 000</u>

Under s 25D(2) the capital gain must be translated into rand at the average exchange rate for the relevant year of assessment. Thus, the capital gain is Y£4 750 000 × 1,50 = R7 125 000.

Example 4 – Application of the kink tests and para 43(1A)*Facts:*

XYZ (Pty) Ltd (XYZ) bought 100 shares in Wilson Ltd, a company listed on the recognised exchange of Country Z at a cost of Z£100 in 1995. On 1 October 2001 the shares had a market value of Z£150, and in the 2020 year of assessment XYZ sold them for Z£120. The average exchange rate in 1995 was R7 = Z£1 and in 2020 was R12 = Z£1. The closing spot rate on valuation date was R10 = Z£1. XYZ elected to use the market-value method to determine the valuation date value of its shares.

Result:

Paragraph 43(6) states that the market value must be determined in the currency of expenditure (Z £).

$$\text{Expenditure} = Z£100 \times R7 = R700$$

$$\text{Market value} = Z£150 \times R10 = R1\,500$$

$$\text{Proceeds} = Z£120 \times R12 = R1\,440$$

This calculation gives a capital loss before applying para 26(3) of R1 500 – R1 440 = R60.

Applying para 26(3), the valuation date value is equal to proceeds less expenditure on or after valuation date, that is, R1 440. XYZ will therefore make neither a capital gain nor a capital loss on disposal of its shares. The decline in market value of R60 after 1 October 2001 has two components:

- The decline in the Z£ value of the shares $Z£150 - Z£120 = Z£30 \times R10 = R300$, and
- The decline in the value of the rand [a benefit for XYZ of $R12 - R10 = R2 \times 120 = R240$].

XYZ's market value loss of R60 comprises the difference between these two components, namely, $R300 - R240 = R60$, and this is restricted to nil under para 26(3). It is appropriate that the kink tests be applied in rand and not in foreign currency. The reason is that a person in XYZ's position would otherwise be denied the Z£ loss of R300, while being subject to CGT on a currency gain of R240, which would be unfair.

19.5 Translation of deemed proceeds when expenditure incurred in foreign currency [para 43(5)]

Paragraph 43(5) applies when

- a person is treated as having received an amount of proceeds from the disposal of an asset; and
- the expenditure incurred to acquire that asset is determined in any foreign currency.

In these circumstances

- the person disposing of the asset must treat the proceeds as being denominated in the currency of the expenditure incurred to acquire that asset, and
- the expenditure incurred by a person acquiring that asset must for purposes of s 9HA and 25 and paras 12, 38 and 40 be treated as being denominated in that currency.⁸⁴²

Table 1 – Provisions providing for deemed proceeds and base cost

Provision	Disposal event
Paragraph 12	<p>Events treated as disposals and acquisitions.</p> <ul style="list-style-type: none"> • A person that commences to be a resident • A foreign company that commences to be a CFC • A CFC that ceases to be a CFC as a result of becoming a resident • An asset of a non-resident that becomes part of the person's permanent establishment in South Africa otherwise than by way of acquisition • An asset of a non-resident's permanent establishment in South Africa that ceases to be part of that permanent establishment otherwise than by way of a disposal under para 11.

⁸⁴² Section 25 was added to the list of provisions in para 43(5) by the Taxation Laws Amendment Act 34 of 2019 with effect from 15 January 2020.

Provision	Disposal event
	<ul style="list-style-type: none"> • Non-trading stock that becomes trading stock. • An asset ceasing to be a personal-use asset otherwise than by way of a disposal. • An asset that commences to be held as a personal use asset. • A transfer of an asset from one fund of an insurer to another. • An asset that ceases to be held as trading stock otherwise than by way of a disposal under para 11.
Paragraph 38	<ul style="list-style-type: none"> • Donation • Consideration not measurable in money • Connected person disposal at non-arm's length price
Paragraph 40, ss 9HA and 25	Death

Example – Deemed proceeds when base cost denominated in foreign currency [para 43(5)]

Facts:

John, a resident, passed away on 15 January 2020 leaving behind a flat in London that he had acquired in 2003 for £100 000. The market value of the flat on date of death was £120 000.

Result:

Under s 9HA(1) read with para 43(5)(a) John is treated as having disposed of the flat for proceeds of £120 000. The resulting capital gain of £20 000 must be translated at the average exchange rate in the year of disposal⁸⁴³ or the spot rate on the date of disposal under para 43(1). John's estate is treated as having acquired the property at a base cost of £120 000 under s 25(2) read with para 43(5)(b).

Section 9H(7) contains a similar rule to para 43(5) which applies to the deemed disposal events covered by s 9H, namely,

- a person other than a company ceases to be a resident [s 9H(2)];
- a company ceases to be a resident [s 9H(3)];
- a company becomes a headquarter company [s 9H(3)]; and
- a CFC ceases to be a CFC otherwise than by becoming a resident [s 9H(3)].

⁸⁴³ Since John did not die on the last day of the month, it would be inappropriate to determine the average exchange rate using monthly intervals and a daily average would need to be determined – see Interpretation Note 63 (Issue 2) dated 12 August 2015 “Rules for the Translation of Amounts Measured in Foreign Currencies other than Exchange Differences Governed by Section 24I and the Eighth Schedule” in 4.2.4.

See **6.2.2A**.

19.6 Market value on valuation date [para 43(6)]

A person who has adopted market value as the valuation date value of an asset must

- determine that market value in the currency of the expenditure incurred to acquire that asset; and
- for purposes of applying para 43(1A) translate that market value to the local currency at the spot rate on valuation date.

In other words, if an asset was bought in pounds, it must be valued in pounds.

A natural person or non-trading trust falling within para 43(1) is not required to translate any market value on valuation date to local currency by using the spot rate on valuation date. Under such circumstances the person must simply determine the capital gain or loss in the foreign currency and translate the capital gain or loss to local currency using the average exchange rate in the year of assessment in which the asset was disposed of or the spot rate on the date of disposal under para 43(1). However, para 43(6) applies to a person falling within para 43(1A).

Table 1 – Exchange rates on 1 October 2001

Currency	Spot rate on 1 October 2001
Australian dollar	4.4524
Canadian dollar	5.7274
Euro	8.2228
Hong Kong dollar	1.1590
Indian rupee	0.1886
Japanese yen	0.0755
Swiss franc	5.5617
UK pound	13.3017
US dollar	9.0395

19.7 Exclusions from para 43(1A) [para 43(6A)]

Paragraph 43(6A) was deleted by the Taxation Laws Amendment Act 34 of 2019 with effect from 15 January 2020. As a consequence, a proviso was inserted in para 43(1A) from the same date to eliminate any overlap between s 24I and para 43(1A). This amendment dispenses with the need to resort to s 25D and s 24I(6) in order to eliminate any double taxation or double deductions.

Chapter 20 – Foreign currency assets and liabilities

PART XIII: FOREIGN CURRENCY

Part XIII came into operation on 1 March 2003 and applied in respect of years of assessment commencing on or after that date until its repeal with effect from years of assessment commencing on or after 1 March 2011 (S 124 of The Taxation Laws Amendment Act 24 of 2011).

It contained separate rules for determining capital gains or losses arising from currency transactions. These rules were in addition to the rules for determining capital gains or losses on the disposition of assets within a foreign currency as contemplated in para 43. Part XIII applied only to individuals holding foreign currency assets as capital assets and non-trading trusts. For the commentary on this topic see issue 7 of this guide.

Chapter 21 – Anti-avoidance measures

21.1 Impermissible tax avoidance arrangements

Before 2 November 2006 tax avoidance schemes involving capital gains were dealt with under s 103(1).⁸⁴⁴ On or after that date they must be dealt with under the rules governing impermissible tax avoidance arrangements under Part IIA of Chapter III of the Act (ss 80A to 80L).

21.2 Section 103(2)

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

Example 1 – How a tainted capital gain can arise

Facts:

Widget (Pty) Ltd carried on operations for many years as a manufacturer of widgets until it ceased trading operations in 2016. After that date the company was dormant. It had an assessed capital loss of R1 million that had arisen from the sale of its manufacturing assets. After lying on the shelf of Tickbird and Partners, a firm of accountants, until 2020, it was sold to Mr Shyster for R60 000. Its balance sheet reflected no assets and its only liability was a shareholder’s loan account. After acquiring the company’s shares, Mr Shyster sold a high growth share investment into the company solely for the purpose of using the assessed capital loss. Three years later the company sold the share at a capital gain of R900 000, which it sought to offset against its assessed capital loss.

Result:

The company was informed by SARS that the capital gain was tainted under s 103(2) because it was part of a scheme to use the assessed capital loss.

Example 2 – Ring-fencing of tainted capital gain against capital loss

Facts:

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

Result:

	R
Untainted capital gain	25 000
Untainted capital loss	(200 000)
Sum of untainted capital gains and losses	(175 000)

Taxable capital gain = R100 000 × 80% inclusion rate = R80 000

⁸⁴⁴ Section 103(1) was deleted by s 36(1)(a) of the Revenue Laws Amendment Act 20 of 2006 deemed to have come into operation on 2 November, 2006 and applicable to any transaction entered into on or after that date.

The taxable capital gain of R80 000 will be included in the company's taxable income, and the assessed capital loss of R175 000 will be carried forward to the following year of assessment.

Example 3 – Ring-fencing of tainted capital gain against assessed loss

Facts:

A company has a tainted capital gain of R100 000, an untainted capital gain of R150 000 and an assessed loss before the inclusion of any taxable capital gain of R300 000.

Result:

Taxable capital gain = R100 000 + R150 000 = R250 000 × 80% = R200 000

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

$$\begin{aligned}
 &= \frac{\text{Tainted capital gain}}{\text{Sum of all capital gains and losses}} \times \text{Taxable capital gain} \\
 &= \frac{100\,000}{250\,000} \times 200\,000 \\
 &= R80\,000
 \end{aligned}$$

The untainted taxable capital gain is R200 000 – R80 000 = R120 000

Therefore, assessed loss = R300 000 – R120 000 = R180 000

Two assessments will be issued, one reflecting a taxable income of R80 000 and the other an assessed loss of R180 000.

Section 103(4) imposes a presumption of a tax avoidance purpose on a taxpayer unless the contrary is proven and includes a reference to a capital loss and an assessed capital loss.

21.3 Value shifting

21.3.1 Value-shifting provisions

The Eighth Schedule introduced a new concept into South African tax law – that of value shifting. The value-shifting provisions are directed at a particular type of tax avoidance and are contained in a number of different paragraphs:

Table 1 – Value-shifting provisions

Paragraph	Purpose
1	Defines a 'value shifting arrangement'
11(1)(g)	Deems there to be a disposal when there is a decrease in the interest of a person in a company, partnership or trust as a result of a 'value shifting arrangement'.
13(1)(f)	Fixes the time of disposal as the date on which the value of the person's interest decreases.
20(1)(h)(iv)	Provides that the base cost of the asset must be determined under para 23
23(a)	Specifies the formula to be used to determine base cost in the hands of the person whose interests have decreased.
23(b)	Provides how base cost is to be determined in the hands of the beneficiary of the 'value shifting arrangement'.
35(2)	States how proceeds are to be determined.

These measures are restricted to arrangements between connected persons so as to exclude *bona fide* commercial transactions.

21.3.2 What is value shifting?

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

21.3.3 Why is there a need for value-shifting legislation?

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

21.3.4 Do other countries have such legislation?

Value-shifting anti-avoidance provisions are, for example, contained in the Australian⁸⁴⁵ and United Kingdom⁸⁴⁶ tax legislation. In both countries the primary focus is on shares, though land transactions are also addressed. The provisions in the Eighth Schedule are somewhat different from those found in other jurisdictions, since the core rules and South African common law deal with situations that must be specifically addressed in other jurisdictions. The donations tax and dividends tax implications should not be lost sight of when considering a 'value shifting arrangement'.

21.3.5 When is value shifting most prevalent?

It is found typically between connected persons, for example,

- between parents and their children, and
- within groups of companies.

21.3.6 What are some examples of value shifting?

The following are some examples of value shifting:

- Issue of shares at a discount

⁸⁴⁵ The share value shifting provisions are in Part 3.3, Division 140 of the Income Tax Assessment Act 1997.

⁸⁴⁶ Sections 29 to 34 of the Taxation of Chargeable Gains Act, 1992.

- Variation of rights attaching to shares or interests in land (for example, manipulating voting or dividend rights)

Example – Value shifting by issuing shares at a discount

Facts:

Bongo is the sole shareholder of Why (Pty) Ltd in which he holds 2 shares of R1 each. The retained income in the company amounts to R99 998. The market value of the shares on 1 October 2019 was R100 000 (disregard the impact of dividends tax on the share valuation). The base cost of Bongo's 2 shares on valuation date was R50 000. On 1 October 2019, Why (Pty) Ltd issued a further share of R1 to Bongo's daughter, Cynthia, at a cost of R1.

Result:

The position may be summarised as follows:

	Before R	After R
Share Capital	2	3
Retained income	99 998	99 998
Market Value 1 October 2019	100 000	100 001
Market value for each share	50 000	33 333

Step 1 – Determine whether a 'value shifting arrangement' has occurred

The issue of shares to Cynthia constitutes a 'value shifting arrangement' as defined in para 1 for the following reasons:

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

Step 2 – Determine Bongo's proceeds – paras 11(1)(g) and 35(2)

Paragraph 11(1)(g) includes as a disposal

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

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

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

	R
Market value of Bongo's interest before disposal	100 000
Market value of Bongo's interest after disposal	66 667
Decrease in market value (proceeds on disposal)	33 333

Step 3 – Determine Bongo's base cost under para 23(a)

Applying the formula:

$$\begin{aligned}
 Y &= \frac{\text{Market value of interest before disposal} - \text{market value of interest after disposal}}{\text{market value of interest before disposal}} \\
 &= \frac{R100\,000 - R66\,667}{R100\,000} \\
 &= 33\%
 \end{aligned}$$

Base cost attributable to disposal of Bongo's interest = R50 000 × 33% = R16 500

Step 4 – Determine Bongo's capital gain

Proceeds	R 33 333
Less: Base cost	(16 500)
Capital gain	<u>16 833</u>

Step 5 – Determine Cynthia's base cost under para 23(b)

Cost of Cynthia's share in Why (Pty) Ltd	= R1
Increase in value of Cynthia's interest	= R33 333 (see above step 1)
Revised base cost	= R33 334

21.4 Losses arising from dividend stripping

Paragraph 19

21.4.1 Background

Paragraph 19 is concerned with dividend stripping. When pre-acquisition profits are distributed (that is, profits that existed at the time a share was acquired) and assuming that all post-acquisition profits have been distributed, the effect will be to reduce the value of the share below its base cost. While the share has been realised partly by sale of the shares and partly by stripping out the dividend, the dividend element does not constitute proceeds by virtue of para 35(3)(a) read with para (k) of the definition of 'gross income' in s 1(1). Paragraph 35(3)(a) excludes from proceeds any amount included in gross income while para (k) of the definition of 'gross income' includes a dividend and a foreign dividend in gross income. As a result of the reduced proceeds, a capital loss will invariably arise when the share is disposed of. The capital loss is arguably of an artificial character because economically the holder of the shares has recovered the base cost of the share through the sale proceeds as well as the pre-acquisition dividend.

The theory underlying para 19 is that a person who buys shares for R101 (share capital R1, profits R100) and sells them for R101 should be in a tax-neutral position. If the person realises the shares through receipt of a pre-acquisition dividend of R100 and sale proceeds from the shares of R1 there will be a capital loss of R100 (R1 – R101). To an individual on the maximum marginal rate, this capital loss is worth R18 or R100 × 18% (45% maximum marginal rate for 2020 × 40% inclusion rate). To a trust it is worth R36 or R100 × 36% (45% × 80%) and to a company R22,40 or R100 × 22,4% (28% × 80%). However, for an individual or trust the capital loss comes at the cost of dividends tax which provides some measure of tax neutrality.

But when no dividends tax is payable because of an exemption, the tax position becomes asymmetrical and it becomes necessary to limit the capital loss.

Paragraph 19 will apply to limit the capital loss when the dividend or foreign dividend is subject to neither dividends tax nor normal tax and is thus likely in practice to apply to dividend stripping by resident companies although its application to individuals and trusts cannot be ruled out in all circumstances.

Paragraph 19 has undergone a number of significant changes over the years. These notes focus on para 19 in its current form but it is worth highlighting some of the major changes that occurred in previous years. For the detailed commentary on para 19 in previous years, see issue 4 of this guide.

Before 1 October 2007

Before 1 October 2007 para 19 applied when

- a share was disposed of at a capital loss within two years of date of acquisition, and
- extraordinary dividends were received or accrued during that two-year period.

The focus was therefore on shares held for less than two years. Short-term dividend stripping tends to be done by share-dealers with the result that any base cost and proceeds would be eliminated under paras 20(3)(a) and 35(3)(a) thus eliminating any capital loss. In the result para 19 had limited application before 1 October 2007.

1 October 2007 to 31 March 2012

On or after 1 October 2007 but before 1 April 2012 para 19 applied when

- a share was disposed of at a capital loss, and
- extraordinary dividends were received or accrued within the two-year period before the date of disposal.

In this form the length of time that the shares were held was irrelevant and the focus was placed on the extraordinary dividends received or accrued during the two-year period before disposal. As a consequence, the ambit of para 19 was considerably widened.

On or after 1 April 2012

Significant changes to para 19 were brought about as a result of the introduction of

- dividends tax with effect from 1 April 2012; and
- a system of partial taxation of foreign dividends under s 10B(3) which applies to foreign dividends received by non-corporate persons from 1 March 2012 and companies from 1 April 2012.

The scope of para 19 was considerably changed with the key focus being the question whether the dividend was subject to either normal tax or dividends tax. Generally, if a dividend is not subject to either normal tax or dividends tax, it is likely that para 19 will limit any capital loss on disposal of the shares.

Paragraph 19 is subject to para 43A, which means that para 43A must take precedence. Thus, to the extent that an extraordinary dividend is deemed to comprise proceeds on disposal of a share under para 43A, para 19 will not apply.⁸⁴⁷

⁸⁴⁷ Paragraph 19 was made subject to para 43A by s 55 of the Taxation Laws Amendment Act 34 of 2019, effective on or after 15 January 2020.

21.4.2 Definition – ‘exempt dividend’

The term ‘exempt dividend’ is defined in para 19(3)(b) as follows:

‘“**[E]xempt dividend**” means any dividend or foreign dividend to the extent that the dividend or foreign dividend is—

- (i) not subject to any tax under Part VIII of Chapter II; and
- (ii) exempt from normal tax in terms of section 10(1)(k)(i) or section 10B(2)(a), (b) or (e);’

The definition of ‘exempt dividend’ is used when a share is disposed of through a buy-back or as a result of the liquidation, winding-up or deregistration of a company [see para 19(1)(a)]. It also forms part of the definition of ‘extraordinary exempt dividend’ in para 19(3)(c) which is used in para 19(1)(b).

Exemption from dividends tax

The reference to a tax under Part VIII of Chapter II is to dividends tax. The exemptions from dividends tax for dividends other than dividends *in specie* are contained in s 64F(1) which include dividends paid to

- a resident company;
- the government of South Africa in the national, provincial or local sphere;
- a PBO approved by the Commissioner under s 30(3);
- a closure rehabilitation trust contemplated in s 37A;
- an institution, board or body contemplated in s 10(1)(cA);
- Various retirement funds and a benefit fund;
- CSIR, SANRAL, Armscor and other bodies listed in s 10(1)(t);
- a holder of shares in a registered micro business, as defined in the Sixth Schedule, paying that dividend, to the extent that the aggregate amount of dividends paid by that registered micro business to all holders of shares in that registered micro business during the year of assessment in which that dividend is paid does not exceed R200 000;
- a small business funding entity contemplated in s 10(1)(cQ);
- a non-resident who holds shares in a foreign company listed on an exchange as defined in s 1 of the Financial Markets Act and licensed under s 9 of that Act (the JSE, ZAR X, 4AX, A2X and EESE);
- any person to the extent that the dividend constitutes income of that person;
- any person to the extent that the dividend was subject to STC;
- any fidelity or indemnity fund contemplated in s 10(1)(d)(iii); and
- a natural person or deceased estate or insolvent estate of that person in respect of a dividend paid in respect of a tax-free investment contemplated in s 12T(1).

Section 64FA contains the exemptions from dividends tax for dividends *in specie*. A dividend *in specie* will be exempt from dividends tax if

- the person to whom it is paid would have been exempt from dividends tax under s 64F and the person has submitted the required declaration form to the company before the dividend is paid;
- the person to whom it is paid is a member of a group of companies as defined in s 41;
- the dividend is one contemplated in para 51A which granted roll-over relief in respect of a qualifying residence disposed of before 31 December 2012; and
- the dividend comprises a disposal by a share block company which qualifies for roll-over relief under para 67B.

Exemption from normal tax

Generally, domestic dividends (other than those paid by a headquarter company) are exempt from normal tax under s 10(1)(k)(i) but the following are not exempt under the proviso to that section:

- A dividend distributed by a REIT or controlled company referred to in s 25BB except if distributed to a non-resident or if part of a share buy-back [para (aa) of the proviso].
- A dividend in respect of a restricted equity instrument contemplated in s 8C subject to specified exceptions [para (dd) of the proviso].
- Any dividend received by or accrued to a company in consequence of
 - any cession of the right to that dividend; or
 - the exercise of a discretionary power by any trustee of a trust,unless that cession or exercise results in the holding by that company of all of the rights attaching to a share [para (ee) of the proviso];
- Dividends on shares borrowed by a company and certain other dividends involving securities lending [paras (ff), (gg) and (hh) of the proviso].
- Dividends received by or accrued to a person for services rendered when the person does not hold the shares [para (ii) of the proviso].
- Any dividend in respect of a restricted equity instrument as defined in s 8C that was acquired in the circumstances contemplated in s 8C if that dividend is derived directly or indirectly from, or constitutes
 - an amount transferred or applied by a company as consideration for the acquisition or redemption of any share in that company;
 - an amount received or accrued in anticipation or in the course of the winding up, liquidation, deregistration or final termination of a company; or
 - an equity instrument that is not a restricted equity instrument as defined in s 8C, that will, on vesting be subject to that section [para (jj) of the proviso].
- Any dividend in respect of a restricted equity instrument as defined in s 8C that was acquired in the circumstances contemplated in s 8C(1) if that dividend is derived directly or indirectly from

- an amount transferred or applied by a company as consideration for the acquisition or redemption of any share in that company; or
- an amount received or accrued in anticipation or in the course of the winding up, liquidation, deregistration or final termination of a company [para (*kk*) of the proviso].

Section 10B(2)(a) and (b) exempt a foreign dividend from normal tax if

- the person deriving the foreign dividend (whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10% of the total equity shares and voting rights in the company declaring the foreign dividend; or
- the person deriving the foreign dividend is a foreign company and the foreign dividend is paid or declared by another foreign company that is resident in the same country as that person.

21.4.3 Disregarding of capital loss when shares are bought back or company is terminated

Paragraph 19(1)(a) applies when a person disposes of a share

- by means of a share buy-back; or
- as part of the liquidation, winding-up or deregistration of the company.

In these circumstances the person must disregard so much of any capital loss resulting from the disposal as does not exceed any exempt dividends received by or accrued to that person in respect of that share within a period of 18 months prior to or as part of the disposal. In other words, if the capital loss is R100 and the exempt dividends are R80 then only R80 of the capital loss must be disregarded.

The words ‘as part of the disposal’ were inserted to counter the contention that a dividend declared as part of a share buy-back occurs at the same time as the disposal and not before the disposal.

The time of disposal of a share under para 13 as a result of a share buy-back will depend on the facts of the particular case, for example, whether bought back by agreement or compulsorily. See s 48 of the Companies Act, 2008.

A disposal of a share as a result of the liquidation, winding-up or deregistration of a company will occur at the time specified in para 77.

While para 19 will usually apply to the disposal of a share by a corporate shareholder it can apply to an individual or trust shareholder. One such example was the distribution of a residence to an individual under paragraph 51A which provided a “window of opportunity” for a company or trust to distribute a residence to a natural person free of CGT, transfer duty and dividends tax. Typically, para 19 applied in a multi-tier structure when a trust held shares in a company that held the residence and the residence was disposed of at book value directly to the trust beneficiary. Assuming that the market value of the residence exceeded its book value the disposal would have comprised an exempt dividend to the extent of the difference between market value and book value. Since the company must have been liquidated or deregistered in consequence of the disposal of the residence, the trust must disregard any capital loss on disposal of its shares in the company under paragraph 19 to the extent of the exempt dividend.

Example – Disregarding of capital loss on a share buy-back as a result of the receipt of an exempt dividend

Facts:

Resident Company A owns shares in JSE-listed Company B which it acquired for R100 000 on 1 March 2010. On 29 February 2020 Company B bought back 10% of its shares from all its shareholders and advised them that 75% of the consideration was a dividend while the remaining 25% represented a transfer of contributed tax capital and hence a return of capital. Company A received R20 000 as consideration for the buy-back. Company A's year of assessment ends on the last day of February.

Result:

Company B has engaged in a pro rata repurchase of its shares from all its shareholders (as opposed to a "general repurchase" on the open market through a stockbroker). It is accordingly necessary for Company A to split the consideration it received for the disposal of the Company B shares between the dividend and return of capital elements.

	R
Amount received or accrued	20 000
Less: Exempt dividend [para 35(3)(a)] R20 000 × 75%	<u>(15 000)</u>
Proceeds (return of capital) R20 000 × 25%	5 000
Less: Base cost R100 000 × 10%	<u>(10 000)</u>
Capital loss before applying para 19(1)(a)	<u>(5 000)</u>

Portion of capital loss to be disregarded:

The dividend portion of the consideration of R15 000 is an exempt dividend because it is exempt from normal tax under s 10(1)(k)(i) and dividends tax under s 64F(1)(a). Under paragraph 19(1)(a) the company must disregard the portion of the capital loss that does not exceed the exempt dividends received as a result of the share buy-back. Since the exempt dividend of R15 000 exceeds the capital loss of R5 000, the full capital loss of R5 000 must be disregarded.

Note: Had Company A been a resident individual or trust, no portion of the capital loss would be disregarded under para 19(1)(a) because the dividend of R15 000 would have been subject to dividends tax at 20% and is therefore not an exempt dividend as defined in paragraph 19(3)(b).

21.4.4 Disregarding of capital loss under other circumstances

Paragraph 19(1)(b) applies in circumstances other than when a share is disposed of as a result of a share buy-back or liquidation, winding-up or deregistration of the company. In such circumstances a person must disregard so much of any capital loss resulting from the disposal (other than a disposal deemed to have taken place under s 29B) as does not exceed any extraordinary exempt dividends received by or accrued to that person in respect of that share within a period of 18 months prior to or as part of the disposal. The term 'extraordinary exempt dividends' is defined in para 19(3)(c) as follows:

“**[E]xtraordinary exempt dividends**” means so much of the amount of the aggregate of any exempt dividends received or accrued within the period of 18 months contemplated in subparagraph (1)—

- (i) as exceeds 15 per cent of the proceeds received or accrued from the disposal contemplated in that subparagraph; and

(ii) as has not been taken into account as an extraordinary dividend in terms of paragraph 43A(2).'

An exempt dividend will not be an extraordinary exempt dividend to the extent that the sum of the dividends in the 18 months preceding the disposal does not exceed 15% of the proceeds. Since most of the dividend yields of listed shares are less than 3% a year, the intention of the 15% limit is to prevent para 19 from being triggered by dividends distributed in the ordinary course of business.

Under s 29B insurers were deemed to dispose of and reacquire all the assets (excluding specified assets such as trading stock and s 24J instruments) in their policyholder funds at market value on 29 February 2012. This deemed disposal and reacquisition rule addressed adverse consequences for future policyholders as a result of the change in the CGT inclusion rate. Since the deemed disposal is to the same person, it was excluded from para 19(1)(b).

Example – Disregarding of a capital loss as a result of the receipt or accrual of an extraordinary exempt dividend

Facts:

Company A owns shares in ABC Ltd, a resident JSE-listed company which it acquired at a cost of R100 000 on 1 March 2012. On 31 May 2019 ABC Ltd declared a dividend of R30 000 to Company A. On 31 January 2020 Company A sold its shares for R80 000. Company A's year of assessment ends on the last day of February.

Result:

The dividend of R30 000 is an exempt dividend referred to in para 19(3)(b) because it is exempt from normal tax under s 10(1)(k)(i) and dividends tax under s 64F(1)(a). It was received eight months before the disposal of the shares and thus falls within the 18-month period applicable to tainted exempt dividends.

The capital loss on disposal of the shares before applying para 19(1)(b) is determined as follows:

	R
Proceeds	80 000
Less: Base cost	<u>(100 000)</u>
Capital loss before applying para 19(1)(b)	<u>(20 000)</u>
Extraordinary exempt dividend:	
Exempt dividend	30 000
Less: 15% of proceeds (R80 000 × 15%)	<u>(12 000)</u>
Extraordinary exempt dividend	<u>18 000</u>
Portion of capital loss to be disregarded:	
Capital loss before applying paragraph 19(1)(b)	20 000
Less: Extraordinary exempt dividend	<u>(18 000)</u>
Allowable capital loss	<u>(2 000)</u>

Note: Had Company A been a resident individual or trust, no part of the capital loss of R20 000 would have been disregarded because the dividend of R30 000 would have been subject to dividends tax and would therefore not comprise an exempt dividend as defined in para 19(3)(b). Since it would not comprise an exempt dividend, it would also not comprise an extraordinary exempt dividend under para 19(3)(c).

21.4.5 Disregarding of periods when not at risk

Under para 19(3)(a) the period of 18 months preceding the disposal of shares during which dividends are tainted does not include any days during which the person disposing of a share

- has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially similar financial instruments;
- is the grantor of an option to buy substantially similar financial instruments; or
- has otherwise diminished risk of loss with respect to that share by holding one or more contrary positions with respect to substantially similar financial instruments.

The 18-month period during which dividends will be tainted for purposes of para 19 is thus extended for periods during which the person disposing of the shares is not at risk. This rule aims to make it costly for persons who purposely purchase shares with the intention of realizing their investment through dividend stripping in order to engineer a capital loss. The costs could take the form of interest on monies borrowed to buy the shares or the risk of the value of the shares declining below their cost price.

Example – Extension of 18-month period

Facts:

On 31 August 2018 Company X purchased all the shares of Company Y at a cost of R100 000. Company X borrowed R100 000 on overdraft to finance the acquisition. On 1 September 2018 Company Y declared a dividend to Company X of R80 000 which Company X used to reduce its overdraft. On 2 September 2018 Company Z granted Company X a put option under which Company X was entitled to sell its shares to Company Z at a price of R20 000. The option had to be exercised by 29 February 2020. Company X sold its shares in Company Y on 1 March 2020 for R20 000. The years of assessment of both companies end on the last day of February.

Result:

The exempt dividend was declared on 1 September 2018 and the shares were sold 18 months and one day later on 1 March 2020.

However, the exempt dividend of R80 000 is deemed to fall within the 18-month period because Company X was not at risk during the option period. Company X's capital loss of R80 000 (R100 000 base cost less R20 000 proceeds) will therefore be subject to limitation under para 19(1)(b). The portion of the exempt dividend that comprises an extraordinary exempt dividend is $R80\,000 - R3\,000 [15\% \times R20\,000] = R77\,000$. It follows that R77 000 of the capital loss of R80 000 must be disregarded under para 19 which leaves an allowable capital loss of R3 000. The saving in CGT that Company X hoped to achieve of $R80\,000 \times 22,4\% [80\% \text{ inclusion rate} \times 28\% \text{ corporate tax rate}] = R17\,920$ has therefore been reduced to $R3\,000 \times 22,4\% = R672$ and has cost Company X the interest on R20 000 for 18 months plus any costs incurred in acquiring the put option.

21.5 Transitional period measures

PART XIV: MISCELLANEOUS

Paragraph 97

Paragraph 97 applies to assets acquired during the period from 23 February 2000 until and including the day before the valuation date. It is aimed at preventing persons from artificially

inflating the base cost of an asset for purposes of determining its time-apportionment base cost under para 30. The measure covers all assets acquired during this period

- under a transaction not effected at arm's length; or
- directly or indirectly from a person qualifying as a connected person (either at the time of that acquisition or at any time up to a subsequent disposal of that asset within a period of three years after that acquisition). The term 'connected person' is defined in section 1(1) 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 before that transaction, will be attributed to the person who acquired it should the latter wish to determine and use the time-apportionment base cost of the asset as its valuation date value.

This anti-avoidance measure will also cover any asset which

- is reacquired within a period of ninety days of its disposal, during the transitional period, under a non-arm's length transaction or its disposal directly or indirectly to a connected person; or
- replaces a substantially identical asset that was disposed of during the transitional period either under a non-arm's length transaction or directly or indirectly to a connected person, if the replacement asset is acquired within a period of ninety days from the date of that disposal.

Paragraph 97 does not apply to any disposal of an asset by a fund contemplated in s 29A(4) to any other such fund under s 29A(6) or (7).

South African long-term insurers are required for income tax purposes to create five funds to conduct their business. The funds are regarded as separate persons for income tax purposes and disposals of assets between the funds are regarded as disposals on which CGT is imposed. Under s 29A(6) and (7) an insurer is required to transfer assets between the five funds if there is a change in policyholders or a balancing of assets and liabilities is required. Paragraph 97 does not apply to these disposals as they are involuntary.

Example 1 – Acquisition of asset during transitional period under non-arm's length transaction

Facts:

Jack and Jill are friends. Jack bought an aircraft for R100 000 on 1 March 1990. On 24 February 2000 he sold it to Jill for R200 000 at which stage the market value was R150 000. In 2004 Jill sold the aircraft to a third party for R180 000. Jack and Jill have not claimed any capital allowances on the aircraft. Jill elected to use the time-apportionment method for determining the valuation date value of the aircraft.

Result:

In determining the time-apportionment base cost, Jill is deemed to have acquired the aircraft on 1 March 1990 at a cost of R100 000.

Example 2 – Acquisition of asset during transitional period from a connected person*Facts:*

Andy and Mandy are friends. Andy bought a piece of land for R100 000 on 1 March 1990. On 30 September 2001 Andy sold the land to Mandy for R500 000 which was the market value of the land at the time. On 28 September 2004 Andy and Mandy were married. On 29 September 2004 Mandy sold the land to a third party for R750 000.

Result:

In determining the time-apportionment base cost, Mandy is deemed to have acquired the land on 1 March 1990 at a cost of R100 000. The fact that Mandy paid an arm's length price for the land is irrelevant.

Example 3 – Reacquisition of an asset within 90 days during transitional period from a connected person or under a non-arm's length-transaction*Facts:*

Tim and Kim are husband and wife. Tim purchased a piece of land at a cost of R100 000 on 1 March 1990. On 1 March 2000 he sold it to Kim for R150 000, and on 30 May 2000 he repurchased it from her at a cost of R500 000. Tim sold the land in 2004 for R400 000 and elected to use time-apportionment to determine the valuation date value of the land.

Result:

For the purposes of determining the time-apportionment base cost of the land, Tim is deemed to have acquired it at a cost of R100 000 on 1 March 1990.

Example 4 – Reacquisition of substantially similar asset within 90 days during transitional period from a connected person or under a non-arm's length transaction*Facts:*

Agnes and Zeb are married. They each bought 50 shares (each block of shares representing a 50% stake) in Matabane Catering (Pty) Ltd on 1 March 1990 at a cost of R50 000 (R1000 per share). Agnes held share certificate numbers 1 – 50 and Zeb held 51 – 100.

On 1 March 2000 Agnes sold her shares to Zeb for R100 000, and on 29 May 2000 she reacquired share certificate numbers 51 – 100 from Zeb at a cost of R500 000.

Result:

For the purpose of determining the time-apportionment base cost of her 50 shares, Agnes is deemed to have acquired them at a cost of R50 000 on 1 March 1990.

Chapter 22 – Administrative provisions

22.1 Returns of income (IT12 / IT14)

Section 66(1) of the Act provides as follows:

‘66. Notice by Commissioner requiring returns for assessment of normal tax under this Act.—(1) The Commissioner must annually give public notice of the persons who are required by the Commissioner to furnish returns for the assessment of normal tax within the period prescribed in that notice.’

Section 66(1) must be read with section 25 of the Tax Administration Act.

These annual notices can be found on the SARS website under Legal Counsel / Secondary Legislation / Public Notices.

The notice covering the 2020 year of assessment⁸⁴⁸ contains the following references to capital gains:

‘2. Persons who must submit an income tax return

The following persons must submit an income tax return:

- (a) every company or other juristic person, which was a resident during the 2020 year of assessment that—
 - (ii) held assets with a cost of more than R1 000 or had liabilities of more than R1 000 at any time;
 - (iii) derived any capital gain or capital loss of more than R1 000 from the disposal of an asset to which the Eighth Schedule of the Income Tax Act applies; or
 - (iv) had taxable income, taxable turnover, an assessed loss or an assessed capital loss;
- (b) Every trust that was a resident during the 2020 year of assessment;
- (c) every company, trust or other juristic person, which was not a resident during the 2020 year of assessment that—
 - (iii) derived any capital gain or capital loss from the disposal of an asset to which the Eighth Schedule to the Income Tax Act applies;
- (f) every natural person who during the 2020 year of assessment—
 - (i) was a resident and had capital gains or capital losses exceeding R40 000;
 - (ii) was not a resident and had capital gains or capital losses from the disposal of an asset to which the Eighth Schedule to the Income Tax Act applies;
 - (iii) was a resident and held any funds in foreign currency or owned any assets outside the Republic, if the total value of those funds and assets exceeded R225 000 at any stage during the 2020 year of assessment;
 - (iv) is a resident and to whom any income or capital gains from funds in foreign currency or assets outside the Republic was attributed in terms of the Income Tax Act;’

⁸⁴⁸ The 2020 notice was published in GN 741 GG 43495 of 3 July 2020.

While the R40 000 threshold applicable to resident individuals is equal to the annual exclusion, the requirement to submit a return is not based on whether an individual's sum of capital gains less the sum of capital losses falls below the annual exclusion. Return submission is also required for audit purposes, since SARS needs to ensure that capital gains and losses have been correctly determined.

A natural person is required to submit a return of income if either the sum of capital gains or the sum of capital losses exceeds R40 000 during the 2020 year of assessment.

Example – Threshold for return submission

Facts:

During the 2020 year of assessment Adele had capital gains of R10 000 and R35 000 and a capital loss of R6 000.

Result:

The sum of Adele's capital gains and losses for the year of assessment is R39 000 (R10 000 + R35 000 – R6 000) which is less than the annual exclusion of R40 000. Nevertheless, she must submit a return of income because the sum of her capital gains during the year of assessment (R10 000 + R35 000 = R45 000) exceeded R40 000.

A resident individual will have to submit a return if a capital gain arises in respect of an asset located outside South Africa as long as the capital gain was attributed to the resident. The word 'attributed' would include a capital gain, regardless of its size, attributable to

- a resident donor under paras 68 to 72; or
- a resident beneficiary under para 80.

The trust whose capital gains are subject to attribution could be a resident or a non-resident.

Non-resident individuals are required to submit a return of income no matter the size of the capital gain or loss. However, non-residents are subject to CGT only on the limited range of assets listed in para 2(1)(b) such as immovable property in South Africa, assets of a branch in South Africa and shares in a land-rich company holding South African immovable property.

22.2 Third party returns

Section 26 of the Tax Administration Act

Under s 26(1) of the Tax Administration Act, the Commissioner may by public notice, at the time and place and by the due date specified, require a person who employs, pays amounts to, receives amounts on behalf of or otherwise transacts with another person, or has control over assets of another person, to submit a return by the date specified in the notice.

The notice can be found on the SARS website under Legal Counsel / Secondary Legislation / Public Notices.⁸⁴⁹

The notice requires specified persons to submit third party returns electronically by 31 October (covering 1 March to 31 August) and 31 May (1 March to 28 February). The return for the year ending 28 February 2018 had to be submitted by 31 May 2018. This notice is open-ended, that is, it applies to future years of assessment until it is amended or replaced.

⁸⁴⁹ GN 241 GG 41512 of 23 March 2018.

The persons required to submit these returns include the following:

- Various banks
- Regulated financial institutions
- Listed companies
- State-owned companies
- Organs of state
- Any person (including a co-operative) that purchases any livestock, produce, timber, ore mineral or precious stones from a primary producer other than on a retail basis
- Medical schemes
- Estate agents
- Attorneys
- Persons liable to pay withholding tax on interest
- Persons issuing tax-free investments

For CGT purposes information must be submitted in accordance with SARS Business Requirement Specification (BRS): IT3 Data Submission. The IT3(c) return is used to submit information relating to the purchase and disposal of financial instruments, while the IT3(s) is used to provide information on contributions to, withdrawals from and amounts received or accrued in respect of tax-free investments.

The method of electronic filing depends on the volume of returns to be submitted.

The IT3(c) return can be found on the SARS website by using the 'find a form' search function. The BRS can be found on the SARS website Under Businesses and Employers / Third Party Data Submission Platform / IT3 Data Submission.

The Commissioner has prescribed the weighted-average method under para 32(3A) for reporting purposes. The use of the weighted-average basis for these returns does not prevent financial instrument holders from using one of the other permissible bases⁸⁵⁰ for determining the base cost of identical assets and capital gains or losses, provided that, when applicable, they have retained sufficient records to do so.

22.3 Retention of records

Section 29 of the Tax Administration Act imposes a duty on a taxpayer to keep records. A person must keep the records, books of account or documents that

- enable the person to observe the requirements of a tax Act;
- are specifically required under a tax Act or by the Commissioner by public notice;
- enable SARS to be satisfied that the person has observed these requirements.

⁸⁵⁰ Time-apportionment, market value or 20% of [proceeds less post-valuation date expenditure]. With time-apportionment and market value, the assets that have been disposed of would have to be identified using specific identification or FIFO.

The term 'document' is defined in s 1 of the same Act and means anything that contains a written, sound or pictorial record, or other record of information, whether in physical or electronic form.

A person who has submitted a return of income reflecting a capital gain or loss must retain records, books of account or documents supporting the determination of that capital gain or loss for a period of five years from the date of submission of the return.

A person who is required to submit a return but has not done so will have to retain the relevant records for at least five years after the date on which the return is eventually submitted.

A person who is not required to submit a return under the criteria set out in the annual notice to furnish returns, for example, because the sum of capital gains or sum of capital losses during the year of assessment does not exceed R40 000, must retain the records pertaining to any capital gain or loss for at least five years from the end of the year of assessment in which the asset was disposed of.

Example – Retention of records

Facts:

Karen acquired a holiday home on 1 March 2002. The conveyancing attorney sent her the following documents:

- Copy of the sale agreement.
- Statement showing cost of property, transfer duty and conveyancing fees.

Over the years Karen made a number of improvements to the property for which she received purchase invoices.

On 31 January 2020 Karen sold the holiday home. Her attorney sent her the following documents:

- Copy of sale agreement.
- Statement showing consideration received less estate agent's commission, bond cancellation fee and cost of obtaining an electrical compliance certificate, an electric fence system compliance certificate and a borer certificate.

She reflected the disposal in her 2020 return of income, which she lodged via e-filing on 1 September 2020.

Result:

Karen must retain the purchase and sale documentation as well as the invoices relating to the improvements until 31 August 2025.

22.4 Onus of proof

Under s 102 of the Tax Administration Act a taxpayer bears the onus of proving

- that an amount, transaction, event or item is exempt or otherwise not taxable (for example, that a capital gain must be disregarded);
- that an amount or item is deductible or may be set off (for example, that a capital loss clogged under para 39 is not clogged or that an item of expenditure qualifies to be added to the base cost of an asset under para 20);

- the rate of tax applicable to a transaction, event, item or class of taxpayer (for example, whether a trust qualifies as a special trust in order that it may qualify for a tax rate determined on a sliding scale as opposed to the flat rate of 45% applicable to other trusts);
- that an amount qualifies as a reduction of tax payable (for example, that foreign taxes paid on a capital gain qualify for the *s 6quat* rebate);
- that a valuation is correct (for example, the market value of an asset on valuation date or a market value determined under para 31 for another purpose such as paras 38 or 40); or
- whether a 'decision' that is subject to objection and appeal under a tax Act, is incorrect, for example, the decisions referred to in s 3(4)h).

22.5 Appeals to the tax board

A taxpayer whose objection to an assessment has been disallowed by SARS may lodge an appeal against the decision under s 107 of the Tax Administration Act if dissatisfied with it using the prescribed form (NOA under e-filing or in any other case, ADR – 2). A taxpayer can

- agree with SARS to settle the matter outside court via the ADR (alternative dispute resolution) process (s 103(2) of the Tax Administration Act);
- take the matter to the tax board, provided the tax in dispute does not exceed R1 million (s 109(1)(a) of the Tax Administration Act);⁸⁵¹ or
- take the matter to the tax court.

In determining the R1 million threshold when an assessed capital loss is in dispute, regard must be had to the tax that could become payable in the future. Assuming

- a marginal tax rate of 45%, and
- no other capital gains during the current year of assessment,

an assessed capital loss would have to exceed R5 555 556 before the appeal needs to be referred to the tax court. This amount can be proved as follows:

Future aggregate capital gain	R5 555 556
Inclusion rate	40%
Future taxable capital gain	R2 222 222
Tax saving on future taxable capital gain at 45%	R1 000 000

In other words, by using the assessed capital loss of R5 555 556 against a future aggregate capital gain of the same amount, R1 million in tax would be saved.

⁸⁵¹ As published in GN 1196 GG 39490 of 17 December 2015, and applies in respect of any appeal noted on or after 1 January 2016. Previous limits: R500 000 per GN 271 GG 29742 of 28 March 2007 and applies to any appeal noted on or after 1 May 2007; R200 000 per GN 1429 GG 27070 of 10 December 2004, applicable to any appeal noted on or after 1 January 2005; and R100 000 per GN 1122 GG 21733 of 17 November 2000, with effect from 1 December 2000.

22.6 Discretionary powers

The Eighth Schedule confers a number of discretionary powers on the Commissioner that are set out below. These are subject to objection and appeal under s 3(4)(h).

Table 1 – Discretionary powers of Commissioner under the Eighth Schedule

Paragraph	Description
paragraph (bb)(A) of the proviso to para 12A(6)(e)	This provision gives the Commissioner the power to extend beyond 36 months of a debt reduction the period within which a company must take steps to liquidate, wind up, deregister or terminate its existence under s 41(4).
29(2A)	This provision gives the Commissioner the power to determine the market value of shares listed on the JSE in certain circumstances.
29(7)	This provision gives the Commissioner the power to adjust the market value of an asset.
31(2)	A usufruct must be valued at an annual yield of 12%. The Commissioner, on application by the taxpayer, can amend this percentage when satisfied that the property could not reasonably be expected to yield 12%.
65(1)(d)	This provision relates to the deferral of a capital gain when a person's asset has, for example, been expropriated, stolen or destroyed. The person must conclude a contract for the acquisition of a replacement asset within a year and bring that asset into use within three years. The Commissioner has the power to extend these periods by six months.
66(1)(e)	This provision relates to the deferral and spread of a capital gain arising on the disposal of assets subject to specified capital allowances. The person must conclude a contract for the replacement of the asset within a year and bring that asset into use within three years. The Commissioner has the power to extend these periods by six months.

22.7 Understatement penalty

Section 222 of the Tax Administration Act provides for the imposition of a percentage understatement penalty in the event of an 'understatement' except when the understatement results from a *bona fide* inadvertent error. The term 'understatement' is defined in s 221 and means any prejudice to SARS or the *fiscus* as a result of

- a default in rendering a return;
- an omission from a return (for example, the failure to declare a capital gain);
- an incorrect statement in a return (for example, the overstatement of the base cost of an asset or the failure to disregard a capital loss when required to do so);
- if no return is required, the failure to pay the correct amount of 'tax'; or
- an 'impermissible avoidance arrangement'.

The understatement penalty is equal to the 'shortfall' multiplied by the applicable penalty percentage in the table in s 223.

The 'shortfall' is the sum of

- the difference between the amount of 'tax' properly chargeable for the tax period and the amount of 'tax' that would have been chargeable for the tax period if the 'understatement' were accepted (for example, when a taxpayer has taxable income and omits a taxable capital gain or the taxpayer wrongly sets off a capital loss against a capital gain thus understating a taxable capital gain);
- the difference between the amount properly refundable for the tax period and the amount that would have been refundable if the 'understatement' were accepted (for example, when a taxpayer is due a refund as a result of allowances or deductions claimed and omitted a taxable capital gain); and
- the difference between the amount of an assessed loss or any other benefit to the taxpayer properly carried forward from the tax period to a succeeding tax period and the amount that would have been carried forward if the 'understatement' were accepted, multiplied by the tax rate determined under s 222(5). The reference to any other benefit properly carried forward would include an assessed capital loss.

Section 222(5) specifies that the tax rate applicable to the shortfall is the maximum tax rate applicable to the taxpayer, ignoring an assessed loss or any other benefit brought forward from a preceding tax period to the tax period. Thus, in the case of an individual or any other taxpayer subject to tax on a sliding scale it will be necessary to determine the taxpayer's taxable income before taking into account any assessed loss brought forward from the preceding year of assessment. Since an assessed capital loss is not taken into account in determining taxable income, it will automatically be excluded from taxable income. The 'maximum tax rate applicable to the taxpayer' would depend on the level of an individual's taxable income and is not a general reference to the maximum marginal rate of 45%.

In determining the rate applicable to an overstated assessed capital loss, the taxpayer's marginal tax rate must be multiplied by the inclusion rate.

Example 1 – Imposition of understatement penalty on omitted taxable capital gain

Facts:

For the 2020 year of assessment Zane omitted a capital gain on disposal of listed shares amounting to R300 000. His taxable income for the year before taking into account the omitted taxable capital gain was R600 000. The SARS penalty committee determined that the case was a standard one and that Zane had been grossly negligent in completing his tax return.

Result:

The taxable capital gain omitted by Zane was R300 000 \times 40% (inclusion rate) = R120 000. His revised taxable income is thus R600 000 + R120 000 = R720 000.

According to the tax tables for the 2020 year of assessment, the following taxes before rebates are payable:

	R
Tax on R720 000	212 241
Tax on R600 000	<u>165 207</u>
Difference (at maximum applicable marginal rate)	<u>47 034</u>

The understatement penalty table in s 223 of the Tax Administration Act requires a penalty of 100% to be imposed for a standard case involving gross negligence.

Therefore, the understatement penalty is R47 034 \times 100% = R47 034.

Example 2 – Overstatement of assessed capital loss*Facts:*

In completing his 2020 income tax return, Gary claimed a capital loss of R640 000 on disposal of a pre-valuation date asset. The SARS auditor established that Gary had not applied para 26(3) with the result that the capital loss should have been reduced to nil. Gary's taxable income for the 2020 year of assessment was R500 000. He did not have any other capital gains or losses during the year of assessment. The SARS penalty committee determined that the case was a standard one and Gary had not taken reasonable care in completing his return.

Result:

Gary claimed an assessed capital loss of R640 000 – R40 000 (annual exclusion) = R600 000. Gary's marginal rate of tax is 36% (taxable income falling between R423 300 and R555 600). The effective rate applicable to the overstated assessed capital loss is thus $36\% \times 40\% = 14,4\%$.

According to the table in s 223, a penalty of 25% must be imposed in a standard case when reasonable care has not been taken in completing a return.

Therefore, the understatement penalty is $R600\ 000 \times 14,4\% \times 25\% = R21\ 600$.

22.8 Definition of 'assessment'

Paragraph (d) of the definition of 'assessment' in s 1(1) includes a reference to an assessed capital loss determined under para 9.

22.9 Estimated and additional assessments*Estimated assessments*

Under s 95 of the Tax Administration Act SARS may make an original, additional, reduced or jeopardy assessment based in whole or in part on an estimate if the taxpayer

- fails to submit a return as required; or
- submits a return or information that is incorrect or inadequate.

SARS must make the estimate based on the information readily available to it.

An agreed assessment may be issued if a taxpayer is unable to submit an accurate return. The amount of the tax chargeable must be agreed in writing between the taxpayer and a senior SARS official before the assessment is issued and any such assessment is not subject to objection or appeal.

Typically, s 95 would be applied in situations in which a taxpayer's records have been destroyed or mislaid. For example, the records pertaining to the base cost of a post-valuation date asset may have been destroyed in a natural disaster such as a fire or flood. Similarly, the executor of a deceased or insolvent estate may be unable to trace copies of purchase invoices supporting the base cost of a post-valuation date asset. A taxpayer who does not have a record of expenditure in respect of a pre-valuation date asset may adopt the '20% of proceeds' or market-value method. The three-year limit prescribed in para 29(4) within which a valuation date market value should have been determined does not apply when a taxpayer does not have a record of pre-valuation date expenditure. This consequence follows from para 29(4) which applies only for the purposes of paras 26(1)(a) and 27(3). Nevertheless, the requirement that a taxpayer should have valued an asset by 30 September 2004 does apply to the high-

value assets referred to in para 29(5) even when the taxpayer does not have a record of pre-valuation date expenditure (see **8.33.9**).

Additional assessments

Under s 92 of the Tax Administration Act, if at any time SARS is satisfied that an assessment does not reflect the correct application of a tax Act to the prejudice of SARS or the *fiscus*, SARS must make an additional assessment to correct the prejudice. Such an additional assessment could be raised to increase a taxable capital gain or reduce an assessed capital loss.

22.10 Withholding tax on payments to non-resident sellers of immovable property

Section 35A

Commencement date

Section 35A was inserted in the Act by s 30 of the Revenue Laws Amendment Act 32 of 2004 and was initially to come into operation on a date to be determined by the President by proclamation in the *Gazette*. This initial method for determining the effective date was intended to be changed to 1 September 2007 by the Revenue Laws Amendment Act 20 of 2006. However, that Act changed s 62 instead of s 30 with the result that the implementation date of para 35A of the Eighth Schedule was changed in error. Under s 87 of the Taxation Laws Amendment Act 8 of 2007 s 35A came into operation on 1 September 2007 and applies in respect of any disposal on or after that date. In this regard it is submitted that the word 'disposal' should be given its Eighth Schedule meaning and the time of disposal rules in para 13 must be applied. Thus, section 35A did not apply to unconditional sales concluded before 1 September 2007. Section 35A applies to a sale subject to a suspensive condition if the condition is satisfied on or after 1 September 2007.

The term 'immovable property' is defined in s 35A(15), and means

'immovable property contemplated in paragraph 2(1)(b)(i) and (2) of the Eighth Schedule'.

Paragraph 2(1)(b)(i) applies to the following assets of a non-resident:

- Immovable property situated in South Africa held by that person.
- Any interest or right of whatever nature of that person to or in immovable property situated in South Africa including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources.

On the common law meaning of immovable property, see **4.1.2.3**.

The disposal of shares in a share block company by a non-resident seller falls within s 35A. Under s 7(2) and s 10(b) of the Share Blocks Control Act 59 of 1980 the shares in a share block company confer on the holder a right to or an interest in the use of immovable property by means of a use agreement. Such a right or interest is an interest or right in immovable property falling within para 2(1)(b)(i).

For the purposes of para 2(1)(b)(i), para 2(2) deems an interest in immovable property to include equity shares in a company

- in which a person together with connected persons in relation to that person holds at least 20% of those equity shares; and

- 80% or more of the market value of those equity shares is directly or indirectly attributable to immovable property held.⁸⁵²

The 80% market value rule also covers interests in other entities holding immovable property (including a vested interest in a trust). For detailed commentary on para 2(2), see 4.2.

Collection of the CGT on capital gains made by non-residents on the disposal of immovable property can be problematic because they frequently do not have other assets in South Africa that could be attached and their ties to South Africa are often tenuous. The introduction of a withholding tax for CGT purposes on disposals of immovable property in South Africa is designed to facilitate tax collection.

The withholding tax is based on the *selling price* of the immovable property. In other words, it is not directly related to any actual capital gain that may arise. If the amount withheld proves to be excessive (for example, because the property is disposed of at a capital loss or at a relatively small capital gain), the non-resident seller can request a directive from SARS to have a lower amount withheld [s 35A(2)].

Non-residents holding immovable property in partnership or community of property

The question has arisen how s 35A(14) must be applied when immovable property is sold by more than one joint owner of such property. More specifically, the issue is whether the R2 million exemption must be applied to the total purchase price payable to all joint owners or whether it must be applied separately to each joint owner.

The withholding tax under section 35A is imposed on a 'seller'. Separate withholding rates apply to different classes of persons (7,5% for natural persons; 10% for companies and 15% for trusts).⁸⁵³ A partnership is not a "person" for income tax purposes and income tax is imposed only on the individual partners.⁸⁵⁴ This principle is reinforced by para 36 which provides as follows:

'36. Disposal of partnership asset.—The proceeds from the disposal of a partner's interest in an asset of the partnership must be treated as having accrued to that partner at the time of that disposal.'

Since the incidence of income tax falls on the individual partners, any exemption should be applied to each individual partner unless there is a clear indication to the contrary. While persons holding immovable property jointly may not be partners in relation to one another, the principle is the same – the taxpayers are the individual joint owners. The same principle applies to property owned jointly by spouses married in community of property, with each spouse being a separate seller.

Therefore, the reference in s 35A(14) to a seller means the individual joint owner of a property and not a partnership or aggregate of the joint owners. The threshold exemption of R2 million must therefore be applied to each joint owner and not to the total amount payable to all joint owners. The words 'in aggregate' in s 35A(14) refer to the sum of the amounts payable to an individual joint owner.

Taxpayers falling under the R2 million threshold

While the withholding tax does not apply to disposals when the selling price is R2 million or less [s 35A(14)], this does not relieve the non-resident from paying CGT on any resulting

⁸⁵² It is submitted that the immovable property referred to in para 2(2) is immovable property in South Africa, since para 2(2) must be read with para 2(1)(b)(i).

⁸⁵³ These rates took effect on 22 February 2017 and apply to disposals on or after that date.

⁸⁵⁴ *Chipkin (Natal) (Pty) Ltd v C: SARS 2005 (5) SA 566 (SCA), 67 SATC 243.*

taxable capital gain. The amount of CGT payable by a natural person will depend on the person's level of taxable income which includes the taxable capital gain. For the 2021 year of assessment an individual under the age of 65 will begin paying tax if his or her taxable income exceeds R83 100.⁸⁵⁵ Thus, a non-resident individual with no other income from a South African source and no other deductions or rebates would pay no tax if the capital gain amounted to R247 750, arrived at as follows:

	R
Capital gain	247 750
Less: Annual exclusion	(40 000)
Aggregate capital gain	207 750
Inclusion rate	40%
Taxable capital gain R207 750 × 40%	83 100
Other income (assume nil)	-
Taxable income	<u>83 100</u>
Tax on taxable income (18% on first R205 900)	14 958
Less: Primary rebate	<u>(14 958)</u>
Tax payable	<u>Nil</u>

Despite there being no withholding obligation under s 35A when the purchase price is R2 million or less, non-residents are encouraged to have the correct tax withheld on a voluntary basis, since this will make it easier for them to discharge their tax obligations when they are eventually assessed.

Non-residents are unlikely to qualify for the primary residence exclusion, although there may be exceptions – see **11.1.2.4**.

The following forms are available on the SARS website:

- NR02 (Declaration by purchaser for the sale of Immovable property in RSA by a non-resident), and
- NR03 (Application for tax directive by non-resident seller of immovable property in RSA).

These forms can be found on the SARS website by using the 'find a form' search facility.

For information on the procedure for submitting these forms and other supporting documents to SARS, see the SARS website under Types of Tax / Capital gains tax / Non-resident sellers. The documents can be submitted to a dedicated SARS email address, details of which are available on the webpage.

Table 1 – Summary of withholding tax provisions

Section 35A	Subject	Description								
(1)	Rate of withholding tax	Purchaser of immovable property in South Africa must withhold tax at following rates from amount payable to non-resident seller: <table> <tr> <td>%</td> <td>Type of seller</td> </tr> <tr> <td>7,5</td> <td>Natural person [s 35A(1)(a)]</td> </tr> <tr> <td>10</td> <td>Company [s 35A(1)(b)]</td> </tr> <tr> <td>15</td> <td>Trust [s 35A(1)(c)]</td> </tr> </table> a percentage of the amount so payable as the Minister may announce in the national annual budget	%	Type of seller	7,5	Natural person [s 35A(1)(a)]	10	Company [s 35A(1)(b)]	15	Trust [s 35A(1)(c)]
%	Type of seller									
7,5	Natural person [s 35A(1)(a)]									
10	Company [s 35A(1)(b)]									
15	Trust [s 35A(1)(c)]									

⁸⁵⁵ Per the draft Rates and Monetary Amounts and Amendment of Revenue Laws Bill, 2020.

Section 35A	Subject	Description
		contemplated in s 27(1) of the Public Finance Management Act, with effect from a date mentioned in that Announcement [s 35A(1)(d)].
(1A)	Effective date of change in rate announced by Minister and Parliamentary approval	A change in rate announced by the Minister under s 35A(1)(d) comes into effect on the date determined by the Minister in that announcement. The revised rate continues to apply for a period of 12 months from that date. However, Parliament must pass legislation giving effect to that announcement within that period of 12 months.
(2)	Tax directives	<p>Seller may apply to Commissioner in prescribed form for nil or reduced rate of withholding tax. The Commissioner may consider only these factors:</p> <ul style="list-style-type: none"> • Security furnished, for example, a bank guarantee. • Other assets in South Africa. • Whether the seller is subject to tax on the disposal. For example, the disposal may qualify for roll-over relief under ss 41 to 47, be exempt under a tax treaty, or if a foreign embassy, exempt under s 10(1)(a). • Whether actual liability is less than the prescribed withholding rate. For example, when the seller can show that the property has been sold at a capital loss or when an individual is below the tax threshold.
(3)	Advance payment	<p>The tax withheld is an advance payment in respect of seller's normal tax liability.</p> <p>If the seller does not submit a return in respect of the year of assessment in which the property was disposed of within 12 months after the end of that year of assessment, the payment of the amount under s 35A(4) is a sufficient basis for SARS to raise an estimated assessment under s 95 of the Tax Administration Act.</p>
(4)	Payment of tax	<p>Purchaser must pay tax withheld to SARS within</p> <ul style="list-style-type: none"> • 14 days (resident) • 28 days (non-resident) <p>The 14-day and 28-day periods run from the date of payment. Payment in practice will usually occur only once the property has been registered in the name of the buyer.</p>
(5)	Translation of amounts payable in foreign currency	The amount to be withheld from a purchase price payable in foreign currency must be translated into rand at spot rate on the date on which it is paid over to SARS.

Section 35A	Subject	Description
(6)	Submission of declaration by purchaser	Purchaser must submit a return when paying tax over to SARS.
(7)	Personal liability of purchaser	<p>A purchaser is personally liable under the circumstances contemplated in s 157 of the Tax Administration Act, for the amount that must be withheld under s 35A(1) only if the purchaser knows or should reasonably have known that the seller is not a resident and must pay that amount to the Commissioner not later than the date on which payment should have been made if the amount had in fact been withheld.</p> <ul style="list-style-type: none"> •
(8)	Non-liability of purchaser if not notified of seller's status	A purchaser who is assisted by an estate agent or conveyancer will not be held personally liable when not notified of the seller's non-resident status by that estate agent or conveyancer.
(9)	Interest and penalties	<p>A purchaser who fails to pay the withholding tax to SARS within the prescribed period is liable for</p> <ul style="list-style-type: none"> • interest at the prescribed rate, calculated from the day following the date for payment to the date the amount is received by SARS, • a penalty of 10%, plus • any other penalties or charges under the Act.
(10)	Deleted.	
(11)	Notification by estate agent and conveyancer	Before payment is made, both the estate agent and the conveyancer must notify the purchaser in writing that the seller is a non-resident and that s 35A may apply. This requirement applies only to an agent/conveyancer receiving remuneration in connection with the disposal.
(12)	Personal liability of estate agent or conveyancer	<p>An estate agent or conveyancer will be held personally liable for the tax not withheld, limited to the amount of his or her remuneration when he or she</p> <ul style="list-style-type: none"> • knows or should reasonably have known that the seller is a non-resident, and • fails to notify the purchaser.
(13)	Right of recourse against seller	The estate agent or conveyancer who paid an amount under s 35A(12) is deemed to be a withholding agent for purposes of the Tax Administration Act.
(14)	Exemptions	<p>Section 35A does not apply</p> <ul style="list-style-type: none"> • when the total amounts payable do not exceed R2 million; or

Section 35A	Subject	Description
		<ul style="list-style-type: none"> • to any deposit paid to secure the disposal until the agreement becomes unconditional.⁸⁵⁶ The withholding tax on the deposit must be recovered from the first following payments made by the purchaser. <p>If the value of the property exceeds R2 million, the tax applies to the full purchase price without regard to the R2 million limit.</p>
(15)	Definitions	<p>'Conveyancer' – means one defined in s 102 of the Deeds Registries Act 47 of 1937.</p> <p>'Estate agent' – means one defined in s 1 of the Estate Agency Affairs Act 112 of 1976.</p> <p>'Foreign currency' – means currency other than that of the Republic.</p> <p>'Immovable property' – as contemplated in para 2(1)(b)(i) and (2).</p>

Example 1 – Withholding of tax from non-resident individual

Facts:

Manuel, a non-resident, sold a South African residential property to Madeleine, a South African resident, for R10 million. The sale agreement was concluded on 10 January 2020 and there were no suspensive conditions. The property was transferred into Madeleine's name on 30 March 2020 with the funds flowing on that date. Madeleine paid the R10 million using R800 000 of her cash savings and R9,2 million from a mortgage bond.

Result:

Madeleine must withhold R750 000 (7,5% of R10 million) from the amount paid to Manuel on 30 March 2020 and pay it to SARS 14 days later [s 35A(4)(a)].

Example 2 – Withholding of tax from non-resident company

Facts:

Shop Co PLC, a United Kingdom resident company, sold a shopping centre located in Johannesburg to Reddy Cash Ltd, a resident company. The sale was concluded on 31 July 2018 and there were no suspensive conditions. Under the agreement, the local company must pay

- R20 million on transfer (15 September 2018);
- R20 million by 15 September 2019; and
- R10 million on 15 September 2020.

All amounts are paid using bank borrowings.

⁸⁵⁶ In *Corondimas & another v Badat* 1946 AD 548 at 551 the court held that when a contract of sale is subject to a true suspensive condition, 'there exists no contract of sale unless and until the condition is fulfilled'.

Result:

Even though all the proceeds accrue for CGT purposes on 15 July 2018, Reddy Cash Ltd must withhold solely based on its actual payments. It must therefore withhold

- R2 million (10% of R20 million) on 15 September 2018;
- 2 million (10% of R20 million) on 15 September 2019; and
- R1 million (10% of R10 million) on 15 September 2020.

It must pay over the withheld amounts to SARS 14 days after each withholding date.

Example 3 – Purchase price R2 million or less*Facts:*

Cassius, a non-resident, sold a South African commercial property to Jackie, a South African resident, for R1,8 million.

Result:

No withholding obligation applies under s 35A because the total amount does not exceed R2 million. Cassius could, however, request Jackie to withhold the correct CGT (if any) on a voluntary basis.

Example 4 – Purchase price exceeding R2 million*Facts:*

Chris, a non-resident, sold a South African commercial property to Craig, a South African resident, for R2,1 million.

Result:

The withholding obligation of s 35A applies to the full R2,1 million. Craig must withhold R157 500 (7,5% of R2,1 million).

Example 5 – Withholding of tax from deposits*Facts:*

On 1 March 2019 Michael, a non-resident, signed a contract with Costa, a resident, for the sale of Michael's Cape Town holiday home for R5 million. On the same date Costa paid a deposit of R25 000 to secure the property pending financing approval which was specified as a suspensive condition. The financing was subsequently approved on 24 May 2019 and the balance of the purchase price of R4 975 000 was payable on transfer which occurred on 12 July 2019.

Result:

Costa has no obligation to pay any withholding tax on the deposit until the agreement becomes unconditional and subsequent amounts become payable (in this instance on 12 July 2019). On that date, he must withhold 7,5% based on the full R5 million (the R25 000 deposit plus the R4 975 000 balance).

Example 6 – Withholding from non-refundable deposits*Facts:*

On 1 March 2019 Chris, a non-resident, signed a contract with Colin, a resident, for the sale of Chris's Cape Town holiday home for R5 million. On the same date Colin paid a non-refundable deposit of R25 000 to secure the property pending financing approval which was specified as a suspensive condition. The financing was subsequently not approved and Colin forfeited his deposit.

Result:

No withholding obligation arises because the agreement is subject to a suspensive condition which was never fulfilled.

Chapter 23 – Impact of CGT on the rest of the Act

23.1 Provisional tax – taxable capital gain excluded from the basic amount

Provisional taxpayers are required to make an estimate of their taxable income that will be derived for a year of assessment for the purposes of determining their first and second provisional tax payments.

The first provisional tax payment

Under para 19(1)(c) of the Fourth Schedule the estimate for the first period may not be less than the 'basic amount' unless the circumstances of the case justify the submission of an estimate of a lower amount. The basic amount is the taxable income for the year last assessed, subject to a number of adjustments.

If an estimate must be made more than 18 months after the end of the year last assessed, the basic amount must be increased by 8% a year until the end of the year of assessment for which an estimate is being made (proviso to para 19 of the Fourth Schedule). For example, an individual making an estimate for the first period 2021 on 31 August 2020 who has not been assessed for 2020 but has an assessment for the 2019 year of assessment would not have to increase the taxable income for the 2019 year of assessment by 8% a year because the period from 1 March 2019 to 31 August 2020 does not exceed 18 months; it is exactly equal to 18 months. But if the year last assessed was 2018, the taxable income for the 2018 year of assessment would have to be increased by 8% × 3, being 8% for the 2019, 2020 and 2021 years of assessment. The increase in the basic amount arises because 1 March 2018 to 31 August 2020 represents a period of 30 months which is more than 18 months. This rule serves as a strong incentive for provisional taxpayers to submit their returns of income during the filing season.

Under para 19(1)(d)(i)(aa) and (ii) of the Fourth Schedule the basic amount excludes any taxable capital gain included in taxable income during the relevant preceding year of assessment. Since capital gains tend to be irregular, their exclusion from the basic amount is intended to prevent a taxpayer's estimate of taxable income from being distorted by a non-recurring capital gain in the previous year.

The second provisional tax payment

For the second provisional tax payment, para 20(1) of the Fourth Schedule applies separate rules to taxpayers whose taxable income as finally determined is

- more than R1 million, or
- R1 million or less.

Taxpayers whose taxable income is more than R1 million

Taxpayers with actual taxable income as finally determined of more than R1 million must estimate their taxable income at an amount that is 80% or more of the actual taxable income as finally determined.

If their estimate is less than 80% of taxable income as finally determined, they face a penalty of up to 20%⁸⁵⁷ calculated on the difference between

- the normal tax payable after rebates on 80% of actual taxable income, and

⁸⁵⁷ Paragraph 20 of the Fourth Schedule.

- the amount of employees' tax and provisional tax for the year of assessment paid by the end of that year of assessment.

Taxpayers whose taxable income is R1 million or less

Taxpayers with actual taxable income as finally determined of R1 million or less must base their estimate of taxable income on an amount that is

- at least equal to the basic amount; or
- in any other case, at least equal to 90% of the actual taxable income as finally determined.

A taxpayer that estimates below the basic amount is subject to a penalty equal to 20% of the difference between the lesser of

- the amount of normal tax after rebates on 90% of the actual taxable income; and
- the amount of normal tax after rebates on the basic amount,

and the amount of employees' tax and provisional tax for such year of assessment paid by the end of the year of assessment.

A word of caution

While a taxable capital gain is excluded from the basic amount for the purposes of the first provisional tax payment under para 19(1)(d)(i)(aa) and (ii) of the Fourth Schedule, it is not excluded for the purposes of the second provisional tax payment in determining

- 80% of actual taxable income of taxpayers with a taxable income of more than R1 million; and
- 90% of actual taxable income of taxpayers whose taxable income is R1 million or less that choose to base their estimate on an amount that is less than the basic amount.

Caution therefore needs to be exercised to ensure that any actual taxable capital gain arising during the year of assessment is taken into account under these circumstances.

Taxpayers whose taxable income is R1 million or less

Under para 20(2) the 20% penalty can be remitted by the Commissioner if he or she is satisfied that the amount of any estimate referred to in subparagraph (1) was seriously calculated with due regard to the factors having a bearing thereon and was not deliberately or negligently understated, or if the Commissioner is partly so satisfied, the Commissioner may in his or her discretion remit the penalty or a part thereof.

Under para 19 taxpayers are required to submit an estimate of the total taxable income that will be derived during the year of assessment in which provisional tax is payable. While the estimate for the first period may not be lower than the basic amount, that is not to say that it should not be more than that amount. For example, if the taxpayer disposed of an asset at a substantial capital gain in the first period which is likely to result in the taxable income for the year exceeding the basic amount, it would be inappropriate for the taxpayer to simply rely on the basic amount as a default *de minimis* estimate. Under para 19(3) of the Fourth Schedule the Commissioner can call on a taxpayer to justify an estimate and can increase it to an amount considered reasonable.

For more information on provisional tax, see Interpretation Note 1 (Issue 3) dated 20 February 2019, particularly at 4.3.1.

23.2 Provisional tax – capital gains and the third provisional tax payment

For the purpose of the third provisional tax payment, a taxpayer is required to take into account all capital gains arising during the relevant year of assessment. Failure to do so will result in the levying of interest on any underpayment of provisional tax under s 89*quat*.

Such interest may be waived only if

- the Commissioner having regard to the circumstances of the case, is satisfied that the interest has become payable as a result of circumstances beyond the taxpayer's control [s 89*quat*(3)]; or
- an individual became a provisional taxpayer for the first time during the year of assessment and the Commissioner is satisfied that the circumstances warrant such action [s 89*quat*(3A)].

23.3 Provisional tax – can a capital gain make a person a provisional taxpayer?

Paragraph (a) of the definition of 'provisional taxpayer' in para 1 of the Fourth Schedule provides as follows:

‘ “[P]rovisional taxpayer” means—

- (a) any person (other than a company) who derives *income* by way of—
- (i) any remuneration from an employer that is not registered in terms of paragraph 15;
 - (ii) any amount which does not constitute remuneration or an allowance or advance contemplated in section 8(1);’

(Emphasis added.)

Since a taxable capital gain is included directly in taxable income, it does not constitute income as defined. Accordingly, a capital gain cannot make a natural person or a trust a provisional taxpayer.

Example 1 – Capital gain does not make a person a provisional taxpayer

Facts:

During the 2020 year of assessment Kim, who was under the age of 65, derived an annual salary of R200 000 from an employer that was registered for employees' tax under para 15 of the Fourth Schedule. She had no income from other sources. On 31 January 2020 she sold some listed shares, realising a capital gain of R90 000.

Result:

Kim falls outside para (a) of the definition of 'provisional taxpayer' in para 1 of the Fourth Schedule because

- her only source of income is remuneration from a registered employer; and
- the capital gain of R90 000 did not make her a provisional taxpayer because it does not constitute income.

Example 2 – Capital gains and the third provisional tax payment*Facts:*

The facts are the same as in Example 1, except that Kim also earned interest income of R53 801 during the 2020 year of assessment.

Result:

Kim will be a provisional taxpayer because of her interest income. The exclusion in para (dd) of the definition of “provisional taxpayer” in paragraph 1 of the Fourth Schedule applies only to a natural person

- who derives no income from carrying on any business, and
- whose taxable income derived from interest, dividends, foreign dividends, rental from the letting of fixed property and remuneration from an unregistered employer will not exceed R30 000.

In the 2020 year of assessment the interest exemption is R23 800⁸⁵⁸ for a person under the age of 65, which leaves Kim with taxable interest income of R30 001 (R53 801 – R23 800).

When calculating her third provisional tax payment due by 30 September 2020, she will have to take into account the capital gain as follows:

	R	R
Salary		200 000
Interest	53 801	
Less: Exempt portion	<u>(23 800)</u>	30 001
Taxable capital gain (R90 000 – R40 000) × 40%		<u>20 000</u>
Taxable income		<u>250 001</u>

Kim will therefore have to base her topping-up payment on R250 001.

23.4 Impact of CGT on various deductions

Since a taxable capital gain is included directly in taxable income under s 26A, it will have an impact on a number of the deductions that are based on a percentage of taxable income.

23.4.1 Deductions expressed as a percentage of taxable income

Because certain deductions in the sections of the Act are based on a percentage of taxable income, they are affected in different ways by the inclusion of a taxable capital gain in taxable income. They include the following:

- pension, provident and retirement annuity fund contributions – s 11F
- Donations to certain organisations – s 18A(1)

The impact of a taxable capital gain on each of these deductions is discussed below.

⁸⁵⁸ Section 10(1)(j)(ii).

23.4.2 Retirement fund contributions (s 11F)

Section 11F provides a deduction for pension, provident and retirement annuity fund contributions. Under s 11F(2) the deduction is limited to the lesser of

- R350 000 [s 11F(2)(a)];
- 27,5% of the higher of the person's
 - remuneration (other than in respect of any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit) as defined in para 1 of the Fourth Schedule; or
 - taxable income (other than in respect of any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit) as determined before allowing any deduction under s 11F, s 6quat(1C) and s 18A [s 11F(2)(b)];
- the taxable income of that person before
 - allowing any deduction under s 11F, s 6quat(1C) and s 18A; and
 - the inclusion of any taxable capital gain [s 11F(2)(c)].

A taxable capital gain is included in the taxable income determined under s 11F(2)(b) but excluded under the taxable income determined under s 11F(2)(c). To the extent that a taxable capital gain is included in taxable income it will increase the potential deduction and to the extent that it is excluded it will reduce the potential deduction.

Thus, disregarding deductions, assume a taxpayer has remuneration of R20 000 and a taxable capital gain of R100 000. The potential deduction is $27,5\% \times R120\ 000 = R33\ 000$ under s 11F(2)(b). However, under s 11F(2)(c) the deduction for retirement fund contributions will be limited to R20 000 (taxable income before the taxable capital gain).

23.4.3 Additional medical expenses tax credit [s 6B(3)(c)]

Rebates reduce the normal tax payable on taxable income. Two rebates are available for medical costs. Under s 6A a person is entitled to a rebate for medical scheme contributions and under s 6B a person is entitled to a rebate for excess medical scheme contributions plus medical expenses.

Under s 6B(3)(c) the additional medical expenses tax credit for persons under the age of 65 without a disability is restricted and the presence of a taxable capital gain will increase the restriction.

The credit is determined under s 6B(3)(c) as follows:

Step 1 – Determine qualifying expenditure

The qualifying expenditure is equal to the sum of

- the amount by which the person's medical scheme contributions exceed four times the medical scheme fees tax credit contemplated in s 6A; and
- the amount of qualifying medical expenses paid by the person.

Step 2 – Apply the 7,5% limitation

The qualifying expenditure determined above must be reduced by 7,5% of taxable income (excluding any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit).

Step 3 – Convert the remaining expenditure into a credit

Any expenditure remaining after step 2 is multiplied by 25% to convert it to a credit.

The 7,5% rule has the effect of restricting the amount that a person under the age of 65 without a disability can claim as an additional medical expenses tax credit. The threshold will be boosted by 7,5% of any taxable capital gain included in taxable income.

23.4.5 Donations to certain organisations [s 18A(1)]

Section 18A(1) provides that qualifying donations are restricted to so much of the sum of the donations as does not exceed

‘in any other case, ten per cent⁸⁵⁹ of the taxable income (excluding any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit) of the taxpayer as calculated before allowing any deduction under this section or section 6quat(1C): Provided that any amount of a donation made as contemplated in this subsection and which has been disallowed solely by reason of the fact that it exceeds the amount of the deduction allowable in respect of the year of assessment shall be carried forward and shall, for the purposes of this section, be deemed to be a donation actually paid or transferred in the next succeeding year of assessment’.

It follows that taxpayers will be able to claim 10% of any taxable capital gain in determining the allowable portion of any qualifying donations, with any excess being carried forward to the succeeding year of assessment.

23.4.6 Capital development expenditure (para 12(1)(c) to (i) of First Schedule)

Paragraph 12(3) of the First Schedule effectively limits the capital development expenditure in para 12(1)(c) to (i)⁸⁶⁰ of that Schedule to the *taxable income* derived by a farmer from farming operations. It follows that any portion of taxable income that is comprised of capital gains that are unconnected to farming operations will not be available for set-off against CDE. Such capital gains would include, for example, capital gains arising from the disposal of any portion of farmland or houses on the farm used by non-employees.

⁸⁵⁹ Under s 18 of the Taxation Laws Amendment Act 8 of 2007 the previous rate of 5% was replaced with 10% effective on or after 1 March 2007.

⁸⁶⁰ Paragraph 12(1A) of the First Schedule deems specified environmental expenditure falling within para 12(1)(d) and (e) of that Schedule to be expenditure incurred in the carrying on of pastoral, agricultural or other farming operations.

23.4.7 Example

Example – Effect of capital gains on deductions*Facts:*

The following details relate to Piet, an employee under the age of 65 without a disability, for the 2020 year of assessment:

	R
Salary – pensionable	100 000
Bonus – non-pensionable	50 000
Capital gain	130 000
Pension fund contributions	22 500
Retirement annuity fund contributions	52 500
Donation to public benefit organisation (s 18A)	20 000
Medical expenses	15 000

Notes:

1. The pension fund contributions comprise R7 500 contributed by Piet and R15 000 by his employer.
2. Piet had a section 18A receipt for the donation.
3. Piet did not belong to a medical fund and the medical expenses were fully borne by him.

Result:

Piet's taxable income is determined as follows:

Step 1: Determine the taxable capital gain

	R
Capital gain	130 000
Less: Annual exclusion	<u>(40 000)</u>
Aggregate capital gain	90 000
Less: Assessed capital loss brought forward from 2019	=
Net capital gain	<u>90 000</u>
Inclusion rate	40%
Taxable capital gain R90 000 × 40%	36 000

Step 2: Determine taxable income before retirement fund contributions and s 18A donations (s 11F(2)(b))

	R
Salary (excluding fringe benefits)	100 000
Fringe benefit – employer's contribution to pension fund	15 000
Bonus	<u>50 000</u>
Remuneration	165 000
Taxable capital gain	<u>36 000</u>
Taxable income before deductions under ss 6quat(1C), 11F and 18A	<u>201 000</u>

Step 3: Determine allowable retirement fund contributions

Under s 11F Piet is entitled to a deduction equal to the lesser of

- R350 000;
- 27,5% of the higher of remuneration (R165 000) and taxable income (R201 000) (both before fund contributions, s 6quat(1C) and s 18A donations) ($R201\ 000 \times 27,5\% = R55\ 275$); and
- taxable income before fund contributions, s 6quat(1C), s 18A donations and any taxable capital gain (R165 000).

The lesser of the three limits is R55 275 determined under s 11F(2)(b) and this comprises Piet's allowable retirement fund contributions for the 2020 year of assessment. The excess contributions of $R22\ 500 + R52\ 500 = R75\ 000 - R55\ 275 = R19\ 725$ will be carried forward to the 2021 year of assessment.

Step 4: Determine taxable income after fund contributions

	R
Taxable income before fund contributions and taxable capital gain	165 000
Less: Allowable fund contributions	<u>(55 275)</u>
Taxable income before s 18A donation and taxable capital gain	109 725
Taxable capital gain	<u>36 000</u>
Taxable income before section 18A donations	145 725

Step 5: Determine taxable income after allowable section 18A donations

	R	R
Taxable income after fund contributions		145 725
Less: Allowable s 18A donations		
Actual donation	20 000	
Limited to: $R145\ 725 \times 10\%$	<u>(14 573)</u>	(14 573)
Excess carried forward to 2021 year of assessment	5 427	
Taxable income		<u>131 152</u>

The additional medical expenses tax credit is determined as follows:

	R
Medical expenses	15 000
Less: $7,5\% \times R131\ 152$	<u>(9 836)</u>
Allowable portion of medical expenses	5 164
Additional medical expenses tax credit $R5\ 164 \times 25\%$	1 291,00

The tax payable is determined as follows:

Taxable income	<u>131 152</u>
Tax per tables $R131\ 152 \times 18\%$	23 607,36
Less: Primary rebate	(14 220,00)
Additional medical schemes tax credit (see above)	<u>(1 291,00)</u>
Tax payable	<u>8 096,36</u>

23.5 Rating formula

Section 5(10)

The rating formula in section 5(10) used to exclude a taxable capital gain in determining a taxpayer's taxable income for the purpose of determining the average rate of tax. However, following the simplification of the formulae by the Taxation Laws Amendment Act 7 of 2010 the formula no longer makes any adjustment for a taxable capital gain.⁸⁶¹

23.6 Rebate in respect of foreign taxes

Section 6*quat*

Section 6*quat* prevents double taxation of a capital gain of a resident from a source outside South Africa.

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, s 6*quat* applies only to gains from a source outside South Africa. Under s 9(2)(j) and (k) read with s 9(4)(d) a capital gain will be from a source outside South Africa if

- it does not consist of immovable property situated in South Africa;
- it consists of an asset attributable to a permanent establishment situated outside South Africa; or
- the proceeds on disposal of the asset are subject to taxes on income payable to any sphere of government of a country other than South Africa.

International tax norms provide the source country with primary taxing rights over gains from the disposal of assets.

If a person is liable to both South African tax and foreign tax on a capital gain from a source in South Africa, under South Africa's agreements for the avoidance of double taxation and international norms, it will be the responsibility of the foreign jurisdiction to provide a tax credit for South African tax levied on the gain.

For more on the CGT implications of the s 6*quat* rebate, see SARS Interpretation Note 18 [Issue 3] dated 26 June 2015 'Rebates and Deduction for Foreign Taxes on Income'.

23.7 Controlled foreign companies

Section 9D, Paragraph 20

23.7.1 Introduction

Extracts from a document prepared by the National Treasury have been adapted in compiling this section of the guide.⁸⁶² These notes focus mainly on those aspects of s 9D that impact on the determination of capital gains and losses, and do not represent a comprehensive analysis of all aspects of s 9D.

⁸⁶¹ The formula was amended with effect from the commencement of years of assessment ending on or after 1 January 2010. Before this date symbol 'G', which formed part of symbol 'R', excluded a taxable capital gain.

⁸⁶² K Engel 'National Treasury's Detailed Explanation to Section 9D of the Income Tax Act' (June 2002), available online at

23.7.2 What is a controlled foreign company?

The term 'controlled foreign company' is defined in s 9D(1) and comprises two paragraphs. Under para (a) of the definition it means a foreign company in which

- more than 50% of the total participation rights are directly or indirectly held by South African residents other than persons that are headquarter companies, or
- more than 50% of the voting rights in that foreign company are directly or indirectly exercisable, by one or more South African residents other than persons that are headquarter companies.⁸⁶³

In the determination of indirect interests of residents in foreign companies, the effective interest is calculated. A resident holding 80% of the equity shares in a foreign company which in turn holds 80% of the equity shares in another foreign company will have the effect that the indirect interest of the resident in the second foreign company is 64% (80% × 80%).

The proviso to para (a) of the definition of 'controlled foreign company' contains three important rules.

First rule – Disregarding of voting rights in or exercised via listed companies

No regard must be had to any voting rights in any foreign company

- which is a listed company, or
- if the voting rights in that foreign company are exercisable indirectly through a listed company.

Second rule – Voting rights exercisable by CFC deemed to be exercisable by resident

Any voting rights in a foreign company which can be exercised directly by any other CFC in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50% of the voting rights are deemed for purposes of the definition of a 'controlled foreign company' to be exercisable directly by that resident.

Example – Determination of percentage voting rights when exercisable indirectly through a CFC

Facts:

Joy owns 80% of the voting rights in CFC 1. CFC 1 can exercise 60% of the voting rights in Foreign Company 2. Is Foreign Company 2 a CFC?

Result:

Yes, since Joy is deemed to exercise 60% of the voting rights in CFC 2. No regard is had to the indirect interest of $80\% \times 60\% = 48\%$.

<http://www.treasury.gov.za/divisions/epifr/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf> [Accessed 2 November 2020].

⁸⁶³ The 'voting right test' was inserted by s 14(1)(a) of the Revenue Laws Amendment Act 31 of 2005 and came into operation on 8 November 2005 and applies in respect of any foreign tax year which commences on or after that date.

Third rule – Disregarding of de minimis interests held via listed companies and collective investment schemes

A person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50% of the participation rights or voting rights in a foreign company, if

- in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company, that person holds less than 5% of the participation rights of that listed company, or
- in the case of a scheme or arrangement contemplated in para (e)(ii) of the definition of ‘company’ in s 1(1)⁸⁶⁴ or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person
 - holds less than 5% of the participation rights of that scheme or arrangement, and
 - may not exercise at least 5% of the voting rights in that scheme or arrangement,

unless more than 50% of the participation rights or voting rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other.

Under para b) of the definition of ‘controlled foreign company’, a CFC also includes any foreign company the financial results of which are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident, other than a headquarter company. This part of the definition must be read with the further proviso to s 9D(2).

‘Participation rights’ in relation to a foreign company means

- the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature, in that company; or
- in the case in which no person has any right in that company as contemplated above or no such rights can be determined for any person, the right to exercise any voting rights in that company.⁸⁶⁵

The second part of this definition was introduced to enable the net income of certain foreign mutual companies to be imputed to South African residents.

⁸⁶⁴ Paragraph (e)(ii) of the definition of ‘company’ in s 1(1) refers to a ‘portfolio comprised in any investment scheme carried on outside the Republic that is comparable to a portfolio of a collective investment scheme in participation bonds or a portfolio of a collective investment scheme in securities in pursuance of any arrangement in terms of which members of the public (as defined in section 1 of the Collective Investment Schemes Control Act) are invited or permitted to contribute to and hold participatory interests in that portfolio through shares, units or any other form of participatory interest’.

⁸⁶⁵ The voting rights test was inserted by s 14(1)(c) of the Revenue Laws Amendment Act 31 of 2005 and came into operation on 8 November 2005 and applies in respect of any foreign tax year which commences on or after that date.

23.7.3 The minimum shareholding requirement

For the CFC provisions to apply to a resident, that resident, together with any connected persons, must

- hold at least 10% of the participation rights, and
- exercise at least 10% of the voting rights,⁸⁶⁶

in the company.

(Paragraph (A) of proviso to s 9D(2).)

The determination of the 10% threshold is made at the end of the foreign tax year, or if the company ceased to be a CFC, immediately before it ceased to be a CFC.

23.7.4 The need for CFC legislation

With the introduction of the worldwide system of taxation, South African residents became subject to tax on their worldwide income, including foreign capital gains. It would have been a fairly simple matter for South African residents to defer, perhaps indefinitely, taxation on foreign income and capital gains by placing assets in a foreign company. The income would have been taxable only when repatriated as a foreign dividend. Before 1 June 2004 foreign dividends were taxable under s 9E, and on or after that date they were brought within para (k) of the definition of 'gross income' in s 1. The ability to defer the repatriation of foreign dividends necessitated the introduction of CFC legislation in the form of s 9D with consequential amendments to the dividend exemption provisions in s 10, subsequently moved to s 10B.

23.7.5 Imputation of foreign capital gain of CFC to SA resident

Section 9D of the Income Tax Act provides for the imputation of the net income of a CFC to South African residents (other than headquarter companies) that directly or indirectly hold any participation rights in that CFC. It is a look-through measure that pierces the corporate veil and treats the income of the CFC as the income of the shareholder. Under s 9D(2) a portion of the net income of the CFC, which is proportionate to the participation rights of that resident in the CFC, is taxed in the hands of the resident.

23.7.6 Determination of net income

The 'net income' of a CFC in respect of a foreign tax year is an amount equal to the taxable income of the CFC determined in accordance with the Income Tax Act as if the CFC had been

- a taxpayer; and
- a resident for purposes of the definition of 'gross income', ss 7(8), 10(1)(h), 25B, 28 and the paragraphs of the Eighth Schedule set out in the table below.

Table 1 – CGT provisions applicable to CFCs

Paragraph	Description
2(1)(a)	Application of Eighth Schedule to the disposal of any asset of a resident on or after the valuation date.
24	Base cost of assets of a person who becomes a resident on or after the valuation date.

⁸⁶⁶ The reference to voting rights was inserted by s 14(1)(d) of the Revenue Laws Amendment Act 31 of 2005 and came into operation on 8 November 2005 and applies in respect of any foreign tax year which commences on or after that date.

Paragraph	Description
70	Attribution of capital gain subject to conditional vesting.
71	Attribution of capital gain subject to revocable vesting.
72	Attribution of capital gain vesting in non-resident.
80	Capital gain attributed to beneficiary.

(Section 9D(2A).)

Many other provisions of the Eighth Schedule aside from those mentioned in the above table will also apply to a CFC by virtue of the reference to para 2(1)(a). Some provisions of the Eighth Schedule make specific reference to CFCs such as para 12(2)(a)(ii) and (iii), para 12(4), para 20(1)(h)(iii), para 43B and para 64B.

Under s 26A, taxable income includes a taxable capital gain. Section 9D makes specific provision for the way in which the taxable capital gain or assessed capital loss of the CFC is to be determined in calculating the net income of the CFC.

23.7.7 Determination of base cost of pre-1 October 2001 assets

Section 9D(2A) makes para 2(1)(a) applicable to a CFC, which by implication also makes the provisions dealing with the determination of the valuation date value of pre-valuation date assets applicable to CFCs (such as paras 20, 25, 26, 27, 28, 29, 30, 31 and 32). A CFC that was in existence on 1 October 2001 will have a valuation date for CGT purposes of 1 October 2001. In other words, such a CFC must use 1 October 2001 for the purposes of determining any capital gain or loss in respect of the disposal of its pre-valuation date assets. It will therefore have to determine the base cost of its pre-valuation date assets in the same way as any other resident. If it wishes to adopt the market-value method, it must have valued its assets by 30 September 2004 [para 29(4)(a)(i)], except when those assets consist of South African-listed shares or South African participatory interests in collective investment schemes whose prices were published in the *Gazette* [para 29(4)(a)(ii)]. See **8.33.10.6** for the valuation submission requirements.

23.7.8 Valuation of assets on becoming a CFC after 1 October 2001

Foreign tax years ending before 1 January 2007

Before its amendment by s 15(1)(e) of the Revenue Laws Amendment Act 35 of 2007, s 9D(2A)(e) read as follows:

‘[W]here a foreign company becomes a controlled foreign company after 1 October 2001, the valuation date for purposes of the determination of any taxable capital gain or assessed capital loss in terms of the Eighth Schedule, shall be the date that such company becomes a controlled foreign company;’

A foreign company that became a CFC was deemed under para 12(4) to dispose of and reacquire its assets at a cost equal to their market value (other than the assets referred to in para 2(1)(b). Under para 13(1)(g)(i) The time of disposal (and corresponding time of acquisition) of an event referred to in para 12(4) was ‘the date immediately before the day that the event occurs’. The effect of this formulation was to deem the CFC to have acquired its assets on the day before it became a CFC thus resulting in its assets becoming pre-valuation date assets.

Consequently, for foreign tax years ending before 1 January 2007 a CFC was entitled to use any of the valuation methods prescribed for pre-valuation date assets (market value, time-apportionment base cost, '20% of proceeds' or with para 32(3A) assets such as listed shares, weighted average) when it disposed of such assets during such foreign tax years. In other words, for foreign tax years ending before 1 January 2007 the base cost of the CFC's assets held at the time it became a CFC must be determined in accordance with para 25, 26, 27, 28 and 32 and not para 12(4) which permitted only market value.

Foreign tax years ending on or after 1 January 2007

After its amendment by s 15(1)(e) of the Revenue Laws Amendment Act 35 of 2007, s 9D(2A)(e) reads as follows:

'[W]here a foreign company becomes a controlled foreign company after 1 October 2001, the valuation date for purposes of the determination of any taxable capital gain or assessed capital loss in terms of the Eighth Schedule, shall be the day before such company becomes a controlled foreign company;'

The above amendment was deemed to have come into operation on 1 January 2007 and applies in respect of any foreign tax year ending during any year of assessment ending on or after that date. It therefore applies to assets acquired on or after 1 October 2001, including assets acquired during foreign tax years ended before 1 January 2007 when such assets are disposed of during foreign tax years ending on or after that date.

Under para 12(2)(a)(ii) a foreign company that becomes a CFC is deemed under para 12(1) to dispose of and reacquire all its assets except those referred to in para 2(1)(b) for a cost equal to the market value of those assets. Under para 13(1)(g)(i) the time of disposal (and hence acquisition) of an event referred to in para 12(2)(a) is 'the date immediately before the day that the event occurs'. Thus, a foreign company that becomes a CFC is deemed to acquire its assets on the valuation date referred to in s 9D(2A)(e) (the day before it became a CFC) with the result that its assets will not comprise pre-valuation date assets. It follows that the time-apportionment and '20% of proceeds' methods are not available options. It also follows that the three-year valuation time limit in para 29(4) will not apply.

23.7.9 Base cost adjustments [para 20(1)(h)(iii)]

South African residents holding shares in a CFC must adjust the base cost of those shares for net income inclusions as well as certain foreign dividends from that CFC. South African residents receive an upward base cost adjustment in their CFC shares to the extent of any net income inclusions. They also receive a full upward base cost adjustment for their net capital gains (even though those gains are only partially included in income). However, residents must reduce the base cost of their CFC shares to the extent they receive a foreign dividend that is exempt from tax under s 10B(2)(a) or (c).

Example – Base cost adjustments to shares in CFC

Facts:

South African Company owns all the shares of CFC with a R500 base cost. In 2019 CFC generated R100 of active income, R30 of passive interest income, and R40 of passive capital gains. The latter two items are included in South African Company's income by virtue of s 9D. In 2020 CFC distributed all R170 of the previously described profits.

Result:

The base cost of the shares in the CFC is determined as follows:

	R
Opening base cost of shares in CFC	500
2019	
Active income (no adjustment)	-
Passive interest income	30
Passive capital gains	<u>40</u>
Revised base cost	570
2020	
Less: Exempt foreign dividend [s 10B(2)(c)]	<u>(70)</u>
Closing base cost	<u>500</u>

Note:

(1) Under para 20(1)(h)(iii) full credit is provided for the passive capital gains despite the 80% inclusion rate in para 10.

23.7.10 Inclusion rate [s 9D(2A)(f)]

If the resident is a natural person, special trust or an insurer in respect of its individual policyholder fund, the taxable capital gain of the CFC is 40% of the CFC's net capital gain for the relevant year of assessment [s 9D(2A)(f)]. The reason for this rule is that capital gains of companies are subject to CGT at an inclusion rate of 80%. If the CFC's gain is being taxed in the hands of an individual, it is appropriate that it should be taxed at the inclusion rate applicable to individuals of 40%.

If the resident is a company or trust, the CFC must include capital gains in its net income at an inclusion rate of 80%.

A capital loss arising in a CFC can, subject to para 39, be set off only against capital gains arising in the CFC and is not attributed to the resident holder of the CFC's shares.

A capital gain arising in a CFC cannot be set off against a capital loss of the resident holder of the CFC's shares, since what is attributed to the resident is an amount equal to the CFC's taxable income ('net income') and not a capital gain – see **5.9.6**.

23.7.11 Multi-tier CFCs

A foreign company in which a resident has an indirect qualifying interest will also constitute a CFC in relation to that resident [see definition of a 'controlled foreign company' in s 9D(1)]. In other words, not only is the proportional amount of the net income of the holding company imputed to the resident shareholder, but also the proportional amount of the net income of any CFC subsidiaries in which the resident has an indirect qualifying interest. A special rule is contained in para 20(1)(h)(iii)(bb)⁸⁶⁷ to deal with the determination of the base cost of an interest in a subsidiary CFC by a holding company CFC. See **8.13**.

⁸⁶⁷ The multi-tier CFC base cost adjustment was previously in s 9D(2A)(j), which was deleted by s 14(1)(g) of the Revenue Laws Amendment Act 31 of 2005. The deletion came into operation on 8 November 2005 and applies in respect of any foreign tax year which commences on or after that date.

Example – Disposal of subsidiary CFC in multi-tier CFC group*Facts:*

Mark, a resident, owns 80% of Holdco, a CFC in the Channel Islands. Holdco in turn owns 80% of Subco which is also based in the Channel Islands. All Subco's assets generate passive investment income.

Holdco acquired Subco some years before valuation date at a cost of £1 000. The market value of Subco on 1 October 2001 was £1 500. In the years ending 28 February 2002 to 29 February 2020 Subco derived the following taxable income:

Year ending	£
February 2002	240
February 2003	300
February 2004	400
February 2005	500
February 2006	600
February 2007	700
February 2008	800
February 2009	900
February 2010	1 000
February 2011	1 100
February 2012	1 200
February 2013	1 300
February 2014	1 400
February 2015	1 500
February 2016	1 600
February 2017	1 700
February 2018	1 800
February 2019	1 900
February 2020	2 000

During 2005 Subco declared a dividend of £200 out of that year's profits, and in 2006 it declared a dividend of £300 out of 2006 profits.

On 29 February 2020 Holdco disposed of Subco for proceeds of £18 000. The average exchange rates during the 2002 to 2020 years of assessment were as follows:

Year ending	£1=ZAR
February 2002	13,24567
February 2003	15,34491
February 2004	12,1603
February 2005	11,5858
February 2006	11,4750
February 2007	13,0527
February 2008	14,1675
February 2009	15,1200
February 2010	12,7305
February 2011	11,1845
February 2012	11,7894
February 2013	13,2856
February 2014	15,7974
February 2015	17,7890
February 2016	20,4005
February 2017	18,9169

February 2018	17,1664
February 2019	17,8338
February 2020	18,6445

Result:

Mark's indirect 64% effective interest in Subco (80% x 80%) makes Subco a CFC in relation to Mark.

Proportional amount of net income attributable to Holdco's interest in Subco

	R
2002 £100 ⁸⁶⁸ x 13,24567 x 80%	1 060
2003 £300 x 15,34491 x 80%	3 683
2004 £400 x 12,1603 x 80%	3 891
2005 £500 x 11,5858 x 80%	4 634
2006 £600 x 11,4750 x 80%	5 508
2007 £700 x 13,0527 x 80%	7 310
2008 £800 x 14,1675 x 80%	9 067
2009 £900 x 15,1200 x 80%	10 886
2010 £1 000 x 12,7305 x 80%	10 184
2011 £1 100 x 11,1845 x 80%	9 842
2012 £1 200 x 11,7894 x 80%	11 318
2013 £1 300 x 13,2856 x 80%	13 817
2014 £1 400 x 15,7974 x 80%	17 693
2015 £1 500 x 17,7890 x 80%	21 347
2016 £1 600 x 20,4005 x 80%	26 113
2017 £1 700 x 18,9169 x 80%	25 727
2018 £1 800 x 17,1664 x 80%	24 720
2019 £1 900 x 17,8338 x 80%	27 107
2020 £2 000 x 18,6445 x 80%	<u>29 831</u>
	<u>263 738</u>

Tax-free dividends declared to Holdco:

2005 £200 x 11,5858	2 317
2006 £300 x 11,4750	<u>3 443</u>
	<u>5 760</u>

The base cost of Holdco's interest in Subco is determined as follows:

Market value on 1 October 2001 £1 500 x 13,3017 ⁸⁶⁹	19 953
Proportional amount of net income of Subco attributable to Holdco	263 738
Less: Dividends	<u>(5 760)</u>
Base cost	<u>277 931</u>
Proceeds £18 000 x 18,6445	335 601
Less: Base cost (as above)	<u>(277 931)</u>
Capital gain	<u>57 670</u>

Amount to be imputed to Mark

Inclusion rate = 40%

Taxable capital gain = R57 670 x 40% = 23 068

⁸⁶⁸ £240 x 5 / 12 = £100. The net income has been apportioned to include only the post-1 October 2001 portion.

⁸⁶⁹ Exchange rate as at 1 October 2001 available on the SARS website under Types of Tax / Capital gains tax / Exchange rates.

Mark's interest in this gain = 80% × R23 068	18 454
Net income of Subco attributed to Mark in 2020 R29 831 × 80%	<u>23 685</u>
Net income attributable to Mark in 2020	<u>42 139</u>

23.7.12 Definition – 'local currency' and para 43 [s 9D(2A)(k)]

for the purposes of s 24I and para 43, 'local currency' of a CFC otherwise than in relation to a permanent establishment of that CFC, means the functional currency of that company.

Under para (a) of the definition of 'local currency' in para 43(7), local currency in relation to a permanent establishment of a person means the functional currency of that permanent establishment (other than the currency of any country in the common monetary area).

Example – Local currency

Facts:

John is the sole shareholder of Johnco, a London-based investment company. Johnco uses sterling as its functional currency. Johnco has a branch in Bermuda that operates a property rental business. The branch's functional currency is the US dollar.

Result:

In applying para 43, the local currency of the branch is deemed to be the US dollar, and the local currency of Johnco is deemed to be sterling.

23.7.13 Translation of capital gain or loss [s 9D(6)]

The net income of a CFC (which includes any taxable capital gain) must be determined in its functional currency. The relevant foreign currency amount to be included in the income of the resident is then translated into rand at the average exchange rate for that year of assessment. Excluded from this rule is an exchange item of the CFC that is denominated in a currency other than the functional currency of the CFC when that functional currency is a hyper inflationary currency.

23.7.14 Foreign business establishment [s 9D(9)]

23.7.14.1 The general exemption rule [s 9D(9)(b)]

The CFC rules do not apply when the CFC is a company and its net income is attributable to any 'foreign business establishment' (including the disposal or deemed disposal of any assets forming part of that foreign business establishment)⁸⁷⁰ in any country other than South Africa. The definition of 'foreign business establishment' is contained in s 9D(1) and reads as follows:⁸⁷¹

‘ “[F]oreign business establishment”, in relation to a controlled foreign company, means—

⁸⁷⁰ The words in brackets were inserted by s 14(1)(j) of the Revenue Laws Amendment Act 31 of 2005, came into operation on 8 November 2005 and apply in respect of any foreign tax year which ends during any year of assessment ending on or after that date.

⁸⁷¹ The definition was inserted into s 9D(1) by s 9(1)(c) of the Revenue Laws Amendment Act 20 of 2006, deemed to have come into operation on 2 November, 2006 and applicable in respect of any year of assessment ending on or after that date. It replaced the now-repealed definition of 'business establishment'.

- (a) a fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year, where—
- (i) that business is conducted through one or more offices, shops, factories, warehouses or other structures;
 - (ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct the primary operations of that business;
 - (iii) that fixed place of business is suitably equipped for conducting the primary operations of that business;
 - (iv) that fixed place of business has suitable facilities for conducting the primary operations of that business; and
 - (v) that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic:
- Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a controlled foreign company may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subparagraph (iii), and facilities as contemplated in subparagraph (iv) of any other company—
- (aa) if that other company is subject to tax in the country in which the fixed place of business of the controlled foreign company is located by virtue of residence, place of effective management or other criteria of a similar nature;
 - (bb) if that other company forms part of the same group of companies as the controlled foreign company; and
 - (cc) to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the controlled foreign company;
- (b) any place outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside the Republic where mining or production operations of natural resources are carried on, where that controlled foreign company carries on those prospecting, exploration, mining or production operations;
- (c) a site outside the Republic for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude which lasts for a period of not less than six months, where that controlled foreign company carries on those construction or installation activities;
- (d) agricultural land in any country other than the Republic used for *bona fide* farming activities directly carried on by that controlled foreign company;
- (e) a vessel, vehicle, rolling stock or aircraft used for purposes of transportation or fishing, or prospecting or exploration for natural resources, or mining or production of natural resources, where that vessel, vehicle, rolling stock or aircraft is used solely outside the Republic for such purposes and is operated directly by that controlled foreign company or by any other company that has the same country of residence as that controlled foreign company and that forms part of the same group of companies as that controlled foreign company;
- (f) a South African ship as defined in section 12Q engaged in international shipping as defined in that section; or
- (g) a ship engaged in international traffic used mainly outside the Republic;'

Since the net income of a CFC includes capital gains, the exemption also applies to the disposal of capital gain assets attributable to a foreign business establishment. Stated differently, if CFC factory income is exempt, so is any capital gain stemming from that CFC's sale of factory assets.

Section 9D(9) must be read with s 9D(9A) which excludes certain diversionary transactions and passive income and capital gains from s 9D(9).

23.7.14.2 Specific exemption – Amounts included in taxable income of CFC [s 9D(9)(e)]

Section 9D(9)(e) excludes from a CFC's net income any amount included in its South African taxable income.

A CFC is a non-resident and will have a 'taxable income' only in respect of amounts derived from a South African source. Under s 9 an amount will be from a South African source if it is received or accrued from the disposal of an asset and

- the asset comprises immovable property held by the CFC or any interest or right of whatever nature of that CFC to or in immovable property contemplated in para 2 and the property is situated in South Africa [s 9(2)(j)];
- the asset is attributable to a permanent establishment of the CFC which is situated in South Africa [s 9(2)(k)(ii)].

The purpose of this exclusion is to prevent the same amount from being taxed twice, that is, once as taxable income in the non-resident CFC and again for the South African-resident holder of shares in the CFC.

23.7.14.3 Specific exemption – Capital gain attributable to foreign business establishment or controlled foreign company of CFC [s 9D(9)(fB)]

A capital gain will be excluded from a CFC's net income when the asset disposed of was attributable to any foreign business establishment of any other foreign company that forms part of the same group of companies as defined in s 1(1) as the CFC.⁸⁷² The word 'attributable' is commonly found in tax treaties when dealing with profits attributable to a permanent establishment. In the current context it is used in a similar manner in the sense of 'forms part of' and would typically apply to the letting of an asset by one CFC to another CFC when both companies form part of the same group of companies.

The exclusion does not apply to a financial instrument as defined in s 1(1) or an intangible asset as defined in para 16. Paragraph (fB) does not, however, exclude all financial instruments from forming part of a foreign business establishment; it is directed at financial instruments attributable to another CFC's foreign business establishment. Financial instruments attributable to the CFC's own foreign business establishment under s 9D(9)(b) may, however, be excluded from s 9D(9)(b) by s 9D(9A)(a)(iii) (see **23.7.15**).

In order to be part of the same group of companies

- a controlling group company must directly hold at least 70% of the equity shares in at least one controlled group company; and

⁸⁷² The exemption of assets of the CFC itself that are part of a business establishment are addressed by s 9D(9)(b). This exemption was previously in s 9D(9)(fB) but was moved to s 9D(9)(b) by s 14(1)(p) of the Revenue Laws Amendment Act 31 of 2005, which came into operation on 8 November 2005 and applies in respect of any foreign tax year which ends during any year of assessment ending on or after that date.

- at least 70% of a controlled group company's equity shares must be directly held by the controlling group company, one or more controlled group companies or any combination of such holdings.

Example – Exclusion of capital gain attributable to the permanent establishment of another CFC

Facts:

CFC 1 owns 100% of CFC 2's equity shares. For several years CFC 1 let its immovable property comprising a factory building to CFC 2 in return for a monthly rental. CFC 2 carried on a computer manufacturing operation in the factory building. CFC 1 disposed of the property and realised a capital gain.

Result:

Since the factory building was used as part of CFC 2's foreign business establishment, the capital gain realised on its disposal by CFC 1 will be excluded from CFC 1's net income under s 9D(9)(fB).

23.7.15 Exceptions to the business establishment exclusion [s 9D(9A)]

Section 9D(9A) contains seven exclusions to the foreign business establishment exemption, namely,

- goods disposed of directly or indirectly to a resident connected person [s 9D(9A)(a)(i)];
- amount derived from the sale of goods by that CFC directly or indirectly to a resident non-connected person when that CFC initially purchased those goods or any tangible intermediary inputs thereof directly or indirectly from one or more connected persons who are residents [s 9D(9A)(a)(iA)];
- services rendered directly or indirectly to a resident connected person [s 9D(9A)(a)(ii)];
- financial instruments [s 9D(9A)(a)(iii)];
- rental from movable assets [s 9D(9A)(a)(iv)];
- right to use intellectual property [s 9D(9A)(a)(v)];
- capital gain on disposal of intellectual property [s 9D(9A)(a)(vi)]; and
- insurance premiums [s 9D(9A)(a)(vii)].

The exclusions in s 9D(9A)(a)(iii) (financial instruments) and (vi) (intellectual property) which are likely to have CGT implications are discussed below.

Exclusion – Financial instruments [s 9D(9A)(a)(iii)]

An amount must be taken into account in determining the net income of a CFC if it is

- attributable to a foreign business establishment of that CFC; and
- arises in respect of a financial instrument except in three instances discussed below.

The term 'financial instrument' is defined in s 1(1) and includes, amongst others, assets such as loans, bank deposits, shares and participatory interests in collective investment schemes.

The three exceptions to the inclusion in net income of amounts arising from financial instruments are as follows:

First, a financial instrument will qualify for the business establishment exemption if it is attributable to the principal trading activities of a foreign business establishment which comprises the activities of a bank, financial service provider or insurer. Excluded from this concession are activities of a treasury operation or captive insurer.

Secondly, a financial instrument will qualify for the business establishment exemption if the amount is attributable to any exchange difference determined under s 24I in respect of that financial instrument and it arises in the ordinary course of business of the principal trading activities of that foreign business establishment. However, the activities of a treasury operation or captive insurer do not qualify for this concession.

Thirdly, an amount arising in respect of a financial instrument will qualify for the foreign business establishment exemption to the extent that the total of

- those amounts arising in respect of financial instruments attributable to activities of that foreign business establishment; and
- amounts arising from exchange gains determined in terms of s 24I attributable to activities of that foreign business establishment,

exceeds 5% of the total of all amounts received by or accrued to the CFC that are attributable to that foreign business establishment.

Note:

- (1) No account must be taken of the amounts referred to in s 9D(9) (c) to (fB). These amounts include, amongst others, amounts attributed to non-resident policyholders and amounts previously subject to withholding taxes on interest and royalties.
- (2) This exemption does not apply to amounts derived from the activities of a treasury operation or a captive insurer. Financial instrument income from such operations will be attributed to a resident shareholder even if it forms part of the net income of a foreign business establishment and regardless of the amount involved.

Treasury operation

A CFC's principal trading activities forming part of a foreign business establishment will be deemed to comprise a treasury operation when

- less of those principal trading activities are conducted in the country in which the foreign business establishment is located than in any other single country;
- those principal trading activities do not involve the regular and continuous acceptance of deposits from or the provision of credit to clients who are not connected persons in relation to that CFC; or
- less than 50% of the amounts attributable to the activities of the foreign business establishment are derived from those principal trading activities with respect to clients who are not connected persons in relation to that CFC.

Captive insurer

The principal trading activities of a foreign business establishment must be deemed to constitute the activities of a captive insurer when

- less of those principal trading activities are conducted in the country in which that foreign business establishment is located than in any other single country;
- those principal trading activities do not involve the regular transaction of business as an insurer with clients who are not connected persons in relation to that CFC; or
- less than 50% of the amounts attributable to activities of that foreign business establishment are derived from those principal trading activities with respect to clients who are not connected persons in relation to that CFC.

An amount forming part of a foreign business establishment of a CFC which has not been taken into account as part of the net income of a CFC solely as a result of the exclusions relating to financial instruments must nevertheless be taken into account

- to the extent that a deduction is allowed in respect of any other amount incurred by a resident connected person in relation to that CFC; and
- that amount is attributable to that other amount.

The purpose of this rule is to prevent, say, a resident shareholder from claiming a deduction for interest paid to a CFC and then not suffering any imputation of that interest from the CFC as a result of the 5% working capital exemption.

Example 1 – Non-application of *de minimis* rule when no foreign business establishment

Facts:

South African Company owns all the shares of CFC. CFC solely holds portfolio investments generating R200 000 of interest income and R500 000 of capital gains. CFC does not have a foreign business establishment.

Result:

The net income of CFC comprising R200 000 of interest income plus a taxable capital gain of R500 000 \times 80% = R400 000 must be included in the income of South African Company under s 9D(2).

Example 2 – 5% *de minimis* exclusion applicable to a foreign permanent establishment

Facts:

Resident Company owns all the shares in CFC which operates a foreign business establishment manufacturing widgets in a tax haven. CFC's total receipts and accruals for its 2020 foreign tax year which ended on 29 February 2020 were R12 million including receipts and accruals of a capital nature.

The following items arising from financial instruments were attributable to the foreign business establishment of CFC:

	R
Interest income on current account	100 000
Exchange gain under s 24I	300 000

During its 2020 foreign tax year CFC disposed of shares in a property company which held factory buildings in which it carried on part of its manufacturing business. The proceeds on disposal amounted to R2 million and the base cost of the shares was R1,4 million.

Result:

The net income attributable to CFC's foreign business establishment is excluded under s 9D(9)(b). However, under s 9D(9A)(a)(iii) amounts arising in respect of financial instruments are excluded from this relief, subject to a 5% *de minimis* exemption based on the total receipts and accruals of the foreign business establishment. The total tainted receipts and accruals of CFC are arrived at as follows:

	R
Interest income	100 000
Exchange gain	300 000
Proceeds on disposal of shares	<u>2 000 000</u>
Total tainted receipts and accruals	2 400 000
Less: <i>De minimis</i> exemption R12 million × 5%	<u>(600 000)</u>
Receipts and accruals to be taken into account	1 800 000

It follows that 75% (R1,8 million / R2,4 million) of each type of tainted receipt or accrual must be included in CFC's net income, calculated as follows:

	R
Interest R100 000 × 75%	75 000
Exchange gain R300 000 × 75%	225 000
Proceeds R2 million × 75%	1 500 000
Less: Base cost R1,4 million × 75%	<u>(1 050 000)</u>
Capital gain	<u>450 000</u>
Taxable capital gain R450 000 × 80%	<u>360 000</u>
Net income of foreign business establishment [s 9D(9A)]	<u>660 000</u>

Exclusion – Capital gain on disposal of tainted intellectual property [s 9D(9A)(a)(vi)]

A capital gain determined in respect of the disposal or deemed disposal of any intellectual property as defined in s 231 that is attributable to a foreign business establishment must be taken into account in determining the net income of a CFC. However, this exclusion from the foreign business establishment exemption will not apply to a CFC that directly and regularly creates, develops or substantially upgrades any intellectual property as defined in s 231 which gives rise to that capital gain.

Chapter 24 – Treatment of specific types of assets

24.1 Limited interests

24.1.1 Usufructs

A 'usufruct' has been defined as⁸⁷³

'the right to use the thing of another in such a way as to preserve its substantial character'.

The 'bare *dominium*' refers to the right of ownership in the underlying thing that is subject to a usufruct. Examples of assets over which usufructs can be passed include

- land and buildings – the usufruct could be the right to live in the property or the rental income derived from letting the property
- shares – dividend income
- loans – interest income

A 'usufructuary' is the person entitled to a usufruct.

A usufruct is constituted over⁸⁷⁴

- movables *inter vivos* by agreement coupled with delivery to the usufructuary;
- immovables by registration; and
- incorporeals by cession.

A usufruct is a highly personal limited real right.⁸⁷⁵

The very nature of a personal servitude is that the right which it confers is inseparably attached to the beneficiary (*Res servit personae*). The beneficiary cannot transmit it to heirs, nor can it be alienated. When the beneficiary dies, it perishes with the beneficiary.⁸⁷⁶

The bare *dominium* holder may be entitled to dispose of the asset subject to a usufruct provided that it is replaced with another asset. A disposal under these circumstances will trigger a capital gain or loss in the hands of both the bare *dominium* holder and the usufructuary.

When a usufruct is granted, there will be a part-disposal of the asset with the result that para 33(1) must be applied for the purpose of allocating the base cost of the asset to the part disposed of (the usufruct) and the part retained (the bare *dominium*). See Example 2.

A usufruct created under a last will and testament will trigger a part-disposal in the hands of the testator if the usufruct is bequeathed to the surviving spouse while the bare *dominium* is bequeathed to another person, such as a family trust. In these circumstances there will be a disposal of the bare *dominium* to the deceased estate under s 9HA(1), while there will be a roll-over to the surviving spouse under s 9HA(2) read with s 25(4). It will be necessary to allocate the deceased's expenditure on the asset and any market value determined on valuation date between the bare *dominium* and the usufruct. The bare *dominium* portion will

⁸⁷³ *Brunsdon's Estate v Brunsdon's Estate* 1920 CPD 159 at 174.

⁸⁷⁴ *CIR v Lazarus' Estate & another* 1958 (1) SA 311 (A), 21 SATC 379.

⁸⁷⁵ AJ Kerr *et al* *Servitudes/Personal servitudes/Usufruct/Nature/Definition* 24 (second edition volume) LAWSA [online] (My LexisNexis: 31 May 2010) in para 581.

⁸⁷⁶ *Willoughby's Consolidated Co Ltd 267 v Copthall Stores Ltd* 1913 AD 267 at 282.

be used in determining any capital gain or loss under s 9HA(1) in the hands of the deceased person while the surviving spouse will take over⁸⁷⁷ the balance of the deceased's expenditure and any market value and use them to determine the base cost of the usufruct and any resulting capital loss when the usufruct expires.

When the testator directs that a usufruct is to be created on his or her death and neither the usufruct nor the bare *dominium* in the asset are bequeathed to a surviving spouse, there will be a disposal of the full ownership in the asset to the deceased estate under s 9HA(1) and the executor will dispose of the usufruct to the usufructuary and the bare *dominium* to the bare *dominium* holder. The disposal by the executor will require a part-disposal calculation on behalf of the deceased estate under para 33(1). A portion of the estate's base cost will be allocated to the usufructuary, while the balance, representing the bare *dominium*, will either be allocated to an heir or legatee under s 25(3)(a) or be retained by the estate and form part of the estate's base cost under s 25(2)(a) if the executor disposes of it to a third party.

The creation of successive usufructs by the testator will trigger successive part-disposals by the bare *dominium* holder (whether it be the estate or an heir). See Example 5 below.

A usufruct cannot be alienated because it is a personal servitude attaching to the usufructuary and will persist only for so long as the instrument creating the usufruct so provides. However, the usufructuary and the bare *dominium* owner may together agree to alienate the property.⁸⁷⁸ Under Roman-Dutch law a distinction must be drawn between the inalienable usufructuary right and the usufructuary interest (fruits). The usufructuary interest can be sold, let or alienated.⁸⁷⁹

The sale of the usufructuary right by the usufructuary to the bare *dominium* holder will trigger a disposal by the usufructuary. Should the usufructuary dispose of the usufruct for no consideration or for a non-arm's length consideration to a bare *dominium* holder who is a connected person in relation to the usufructuary, the usufructuary will be deemed to have proceeds equal to the market value⁸⁸⁰ of the usufruct under para 38.

When a usufruct ceases, for example, because of the death of the usufructuary, there will be a disposal but there will be no proceeds. Similarly, there will be no acquisition by the bare *dominium* holder and hence no step-up in base cost. The position was summed up by Innes CJ in *Union Government v De Kock* NO when he stated the following:⁸⁸¹

'For a life usufruct in favour of a single individual does not "pass" to anyone upon the death of the holder. It is terminated by that event. It is a personal servitude which ceases to exist at the death of the usufructuary. The benefit which accrues to the *dominus* arises not because the right of user has passed to him but because his property has been released from the burdens of the servitude.'

The CGT treatment of an expiring usufruct differs from that which applies for estate duty purposes. Under s 5(1)(b) of the Estate Duty Act 45 of 1955 when a usufructuary dies, the value of the usufruct based on the life expectancy of the person who takes over the right of use (or when a shorter period is stipulated, that period) is included in the usufructuary's estate.

A capital loss that results upon the cessation of a usufruct must be disregarded under para 15(c) to the extent that the asset is used for purposes other than the carrying on of a trade. The words 'to the extent' mean that an apportionment will have to be made when an asset is used partly for trade and partly for non-trade purposes. A non-trade purpose could

⁸⁷⁷ It is considered that para 33(3)(b) does not prevent the base cost allocation to the surviving spouse because s 25(4), being the more specific provision, must be given effect.

⁸⁷⁸ F du Bois *et al Wille's Principles of South African Law* 9 ed (2007) Juta & Co at page 607.

⁸⁷⁹ AJ Kerr *et al 'Juristic Acts by Usufructuary'* 24 *LAWSA* (second edition Volume) [online] (My LexisNexis: 31 May 2010) in para 591.

⁸⁸⁰ See para 31(1)(d).

⁸⁸¹ 1918 AD 22 at 32.

include private use (for example, a house occupied as a private residence by the usufructuary) or a passive investment (for example, a usufruct in the form of dividends or interest). In the latter regard *Silke on South African Income Tax* states the following:⁸⁸²

'In spite of its wide meaning, the term 'trade' does not embrace all activities that might produce income, for example, income in the form of interest, dividends, annuities or pensions.'

The CGT treatment of usufructuary and bare *dominium* interests is illustrated in the examples which follow.

Example 1 – Usufruct created on death

Facts:

On 31 July 2019 John Brown died and bequeathed his holiday home that he acquired in 2002 to his family trust subject to a usufruct in favour of his spouse over her remaining life. At the time of his death, John's spouse was 72 years old. The base cost of the property in John's hands was R400 000 and the market value of the property at date of death was R1 million.

After 10 years John's wife passed away. The trust then disposed of the property for R1 million.⁸⁸³

What are the CGT implications for

- John,
- John's deceased estate,
- John's wife, and
- The John Brown Family Trust?

Result:

John (the deceased)

John's spouse will turn 73 at her next birthday. According to Table A (see **8.35.7**) she has a life expectancy of 10,24 years, and the present value of R1 a year over her remaining life is 5,72222.

The property is allocated between its component parts as follows:

	R
Market value	1 000 000
Usufruct (R1 million × 12% × 5,72222)	686 666
Bare <i>dominium</i>	313 334

There will be a deemed disposal of the bare *dominium* in John's hands at market value at date of death under s 9HA(1). Since the usufruct has been left to his spouse, there is a roll-over in respect of that asset under s9HA(1)(a) read with s 25(4). The capital gain on disposal of the bare *dominium* will be as follows:

	R
Proceeds	313 334
Less: Base cost R400 000 × R313 334 / R1 000 000	(125 334)
Capital gain	<u>188 000</u>

⁸⁸² AP de Koker & RC Williams *Silke on South African Income Tax* [online] (My LexisNexis: October 2019) in § 7.2.

⁸⁸³ It is assumed that property prices remained unchanged from the time of John's death until the date when the property was disposed of by the trust.

The base cost is apportioned under the part-disposal rule in para 33. John will be entitled to the enhanced R300 000 annual exclusion under para 5(2).

John's deceased estate

Under s 25(2)(a) John's deceased estate will acquire the bare *dominium* at market value of R313 334. Under s 25(3)(b) the heir (in this case the trust) will in turn acquire the bare *dominium* at its base cost to the deceased estate (R313 334). There is therefore neither a capital gain nor a capital loss in the deceased estate.

John's spouse (the usufructuary)

John's spouse (the usufructuary) acquires the usufruct at a rolled-over base cost of R274 666 (R400 000 – R125 334). When she passes away, there is a disposal under para 11(1)(b) (an expiry or termination) of the usufruct without any proceeds. She cannot, however, claim the capital loss of R274 666 if she used the property for non-trade purposes [para 15(c) read with para 53(3)(f)]. Assuming that she let the property, she would be entitled to the loss on the grounds that the asset was used for the purpose of carrying on a trade. If she let the property and used it as a holiday home for say one month a year, she would be entitled to 11/12 of the loss. Paragraph 15(c) limits the loss only *to the extent* that the usufruct is not used for the purposes of carrying on a trade. Upon expiry of a usufruct para 38 will not operate to deem any proceeds to be received by the usufructuary, nor will the bare *dominium* holder obtain a step-up in base cost. There are several reasons for this. First, a bare *dominium* in essence represents the future right of use after expiry of the usufruct. The bare *dominium* holder acquires that future right of use on day one from the person who had full ownership of the asset (the first-dying). On the death of the usufructuary the bare *dominium* holder cannot acquire what he or she already owns. Secondly, an expired usufruct has a market value of nil in the hands of the usufructuary. Once the usufruct expires there is nothing to pass on. Thus, the usufructuary has a disposal as a result of the expiry of the usufruct, but this does not mean that the bare *dominium* holder acquires anything. The expiry of the usufruct is a one-sided disposal, similar to the scrapping of an asset. Paragraph 38 applies only when one person disposes of an asset and another person acquires that asset.

The John Brown Family Trust (the bare dominium holder)

The base cost of the property in the hands of the trust is R313 334 representing the market value of the bare *dominium* at date of death. Assuming that property values remain constant, the property will grow in value each year as the usufruct heads towards expiry. On expiry the property will have regained its full value in the hands of the trust. When the trust subsequently disposes of the holiday home for R1 million, it will accordingly realise a capital gain of R686 666 (R1 000 000 – R313 334). The base cost remains unchanged at R313 334 and is not affected by the expiry of the usufruct.

Some commentators have suggested that the bare *dominium* holder's base cost should be increased as a result of the enhancement in value caused by the expiry of the usufruct. There is no substance in this argument. At the date of acquisition, the bare *dominium* was worth the 'low' value placed on it because of the encumbrance of the usufruct. Also, the enhanced value was obtained for no additional consideration. The bare *dominium* holder never disposed of the future right of use pertaining to the period after expiry of the usufruct in the first place, and cannot therefore be said to have reacquired it. While the usufructuary may have had a disposal by expiry of the usufruct, it is not a disposal that can give rise to a corresponding acquisition in the hands of the bare *dominium* holder. When a usufruct ends, it simply ceases to exist and is incapable of being transmitted to another person. Not all disposals give rise to corresponding acquisitions. For example, the scrapping of an asset does not give rise to an acquisition and the expiry of a usufruct is no different. The reconciliation below proves that the overall tax burden (R600 000) is the same as if the full property had been disposed of by the deceased on the day before he died:

Reconciliation

	John R	John's estate R	John's spouse R	John's Trust R	Total R
Proceeds	313 334	313 334	-	1 000 000	1 626 668
Less:					
Base cost	(125 334)	(313 334)	(274 666)	(313 334)	(1 026 668)
	<u>188 000</u>	<u>-</u>	<u>(274 666)</u>	<u>686 666</u>	<u>600 000</u>

Gain realised if property sold on day before death R1 000 000 – R400 000 = R600 000.

Example 2 – Disposal of bare *dominium* and usufruct on death*Facts:*

Upon his death on 30 September 2019 John bequeathed the bare *dominium* in his holiday cottage to his family trust and the usufruct to his wife Sandy. At her next birthday after the death of her husband Sandy will be 65 years of age.

John had purchased the holiday cottage for R100 000 on 1 June 1984. The market value of the full ownership of the holiday cottage was as follows:

- On date of death – R1 000 000.
- On valuation date – R500 000.

Result:

John has effected a part-disposal of the holiday cottage. A capital gain or loss must be determined for the portion bequeathed to John's family trust. Under s 9HA(1)(a) the usufruct bequeathed to Sandy is subject to roll-over relief, and the para 20 expenditure, market value on valuation date and other details referred to in s 25(4)(b) that are carried across to Sandy must be determined.

The value of Sandy's usufruct on John's date of death is determined as follows:

- Life expectancy – female aged 65 = 15,18 (see **8.35.7**)
- Present value of R1 a year for life = 6,84161
- Market value of property on date of death = R1 000 000
- Annual value of usufruct = R1 000 000 × 12% = R120 000
- Market value of usufruct on John's date of death under para 31(1)(d) = R120 000 × 6,84161 = R820 993
- Market value of bare *dominium* on date of death under para 31(1)(e) = R1 000 000 – R820 993 = R179 007

Apportionment of expenditure

Bare <i>dominium</i> = R100 000 × R179 007 / R1 000 000	R 17 901
Usufruct = R100 000 × R820 993 / R1 000 000	<u>82 099</u>
	<u>100 000</u>

Apportionment of market value on 1 October 2001

Bare <i>dominium</i> = R500 000 × R179 007 / R1 000 000	89 503
Usufruct = R500 000 × R820 993 / R1 000 000	<u>410 497</u>
	<u>500 000</u>

Determination of capital gain on disposal of bare dominium

Using the market-value method:

Deemed proceeds [s 9HA(1)]	179 007
Less: Base cost (market value)	(89 503)
Capital gain	<u>89 504</u>

Using the time-apportionment method:

$$\begin{aligned}
 Y &= B + [(P - B) \times N / (N + T)] \\
 &= R17\,901 + [(R179\,007 - R17\,901) \times 18 / (18 + 18)] \\
 &= R17\,901 + [R161\,106 \times 18 / 36] \\
 &= R17\,901 + R80\,553 \\
 Y &= R98\,454
 \end{aligned}$$

$$\begin{aligned}
 \text{Capital gain} &= R179\,007 - R98\,454 \\
 &= R80\,553
 \end{aligned}$$

John's executor should select the time-apportionment method, since it gives the lowest capital gain.

The expenditure attributable to Sandy's usufruct is R82 099 and its market value on 1 October 2001 is R410 497. These amounts will be used when Sandy dies in determining the capital loss on disposal through expiry of the usufruct. There will be no proceeds, since the usufruct will be worthless on date of her death. If she uses the holiday home for private purposes any capital loss must be disregarded under para 15(c).

Example 3 – Usufruct created by trust after death*Facts:*

On 31 July 2019 John Brown died and bequeathed his holiday home that he acquired in 2002 to his family trust. After acquiring the property, the trustees of the family trust created a usufruct in favour of his surviving spouse over her remaining life. At the time of his death, John's spouse was 72 years old. The base cost of the property in John's hands was R400 000 and the market value of the property at date of death was R1 million.

*Result:**John*

John has a capital gain of R600 000 (R1 000 000 – R400 000).

John's estate

The property simply flows in and out of the estate and no capital gain or loss arises.

The Trust

The trust's base cost is the same as the deceased estate, namely, R1 million. By passing the usufruct over the property, the trust effects a part-disposal. The base cost of the bare *dominium* remaining in the trust is R313 334 (see Example 1 for the calculation). The trust and its beneficiaries are connected persons in relation to one another [para (b) of the definition of 'connected person' in s 1(1)]. As a result, the trust is deemed to have disposed of the usufruct at market value of R686 666 under para 38(1)(a), which is the same as the base cost. The granting of the usufruct therefore results in neither a capital gain nor a capital loss in the trust. Once the usufruct expires, the value of the property returns to its full value of R1 million (assuming no change in price levels) and if the trust sold the property it would realise a capital gain of R686 666.

John's spouse

John's spouse is a connected person in relation to the trust [para (b) of the definition of 'connected person' in s 1(1)]. Paragraph 38(1)(b) dictates that she is deemed to have acquired the usufruct at a base cost equal to its market value (R686 666). When she passes away, she will have a capital loss equal to the base cost. Whether that loss is allowable will depend on whether she used the property for trade purposes [para 15(c)].

Reconciliation

	John R	John's estate R	John's spouse R	John's Trust R	Total R
Proceeds	1 000 000	1 000 000	-	1 000 000	2 000 000
Base cost	<u>400 000</u>	<u>1 000 000</u>	<u>686 666</u>	<u>313 334</u>	<u>2 000 000</u>
	<u>600 000</u>	<u>-</u>	<u>(686 666)</u>	<u>686 666</u>	<u>-</u>

Example 4 – Disposal of assets subject to usufruct*Facts:*

Upon his death Oscar bequeathed the bare *dominium* in his share portfolio to the Oscar Family Trust and the usufruct to Anne, his surviving spouse. The share portfolio consisted of listed shares in two companies, the details of which were as follows on his date of death:

	Market value R	Base cost R
Alpha Ltd	50 000	10 000
Beta Ltd	60 000	16 000

At the date of Oscar's death, Anne was 39 years old.

According to Oscar's last will, the trustees of the Oscar Family Trust are entitled to dispose of the shares, but must replace them with other investments over which Anne will continue to hold a usufruct.

When Anne was aged 44 the trustees sold the shares in Alpha Ltd for R70 000 and used the proceeds to acquire shares in Charlie Ltd for R65 000, while the balance of R5 000 was placed in a call account. Assume that the Commissioner has approved a yield of 3% under para 31(2) for the shares and 9% for the call account.

Determine the CGT consequences for Oscar, the Oscar Family Trust and Anne.

*Result:**Oscar*

At her next birthday, Anne will be 40 years old. According to Table A she has a life expectancy of 35,48 years. The present value of an annuity of R1 a year for 35,48 years at 3% using an Excel worksheet is

$$=PV(0.03,35.48,-1)$$

which gives a result of R21,65.

Value of usufruct over shares:

$$\text{Alpha Ltd } R50\,000 \times 3\% = R1\,500 \times 21,65 = R32\,475$$

$$\text{Beta Ltd } R60\,000 \times 3\% = R1\,800 \times 21,65 = R38\,970$$

Market value of bare *dominium*:

Alpha Ltd R50 000 – R32 475 = R17 525

Beta Ltd R60 000 – R38 970 = R21 030

Base cost attributable to part-disposal of bare *dominium*

Alpha Ltd R17 525 / R50 000 × R10 000 = R3 505

Beta Ltd R21 030 / R60 000 × R16 000 = R5 608

Oscar will therefore have a capital gain determined as follows:

Alpha Ltd

	R
Proceeds	17 525
Less: Base cost	<u>(3 505)</u>
Capital gain	<u>14 020</u>

Beta Ltd

Proceeds	21 030
Less: Base cost	<u>(5 608)</u>
Capital gain	<u>15 422</u>

Since there is a roll-over for the usufruct granted to his wife, Oscar does not have to determine a capital gain for that part of the shares.

Under s 25(3)(b) the Oscar Family Trust acquires the bare *dominium* in the shares at the following base cost:

	R
Alpha Ltd	17 525
Beta Ltd	21 030

Anne's base cost [rolled over from Oscar under s 25(4)] is as follows:

	R
Alpha Ltd (R10 000 – R3 505)	6 495
Beta Ltd (R16 000 – R5 608)	10 392

When the Alpha Ltd shares are disposed of for R70 000, Anne will have a capital gain determined as follows:

Anne's age at next birthday = 45
Life expectancy – Table A = 31,01

Charlie Ltd

Present value of R1 a year at 3% using an Excel worksheet is

=PV(0.03,31.01,-1)

= R20

Annuity R65 000 × 3% = R1 950

Present value of annuity = R1 950 × R20 = R39 000

Call account

Present value of R1 a year at 9% using an Excel worksheet is

=PV(0.09,31.01,-1)

= R10,34

Annuity R5 000 × 9% = R450

PV of annuity = R450 × R10,34 = R4 653

Disposal of usufruct over Alpha Ltd shares

	R
Proceeds (R39 000 + R4 653)	43 653
Less: Base cost	<u>(6 495)</u>
Capital gain	<u>37 158</u>

The base cost of her usufruct is now as follows:

Charlie Ltd shares	39 000
Call account	4 653
Beta Ltd shares (unchanged)	10 392

The Oscar Family Trust will have a capital gain for the disposal of its bare *dominium* in the Alpha Ltd shares as follows:

	R
Bare <i>dominium</i> in Charlie Ltd shares (R65 000 – R39 000)	26 000
Bare <i>dominium</i> in call account (R5 000 – R4 653)	<u>347</u>
Amounts received or accrued in respect of disposal	26 347
Less: Base cost	<u>(17 525)</u>
Capital gain	<u>8 822</u>

The base cost of The Oscar Family Trust's bare *dominium* is now as follows:

Charlie Ltd shares	26 000
Call account	347
Beta Ltd shares (unchanged)	21 030

Example 5 – Part-disposal of full ownership – successive usufructs

Facts:

Upon his death on 31 March 2019 Dave's last will and testament provided that his holiday cottage was to be dealt with as follows:

His eldest son Abe was to be given the usufruct for his lifetime. Upon Abe's death, a usufruct was to be granted to Abe's son Bart for his lifetime. Upon Bart's death the cottage was to be given to Bart's son, Carl. Bart and Carl's inheritance was conditional upon them being alive at the time they were due to inherit, which turned out to be the case. No improvements were made to the cottage from the time of Dave's death until it was sold by Carl.

At his next birthday after the death of his father Abe will be 65 years of age. Abe died on 31 May 2025. On that date, Bart will be 40 years of age at his next birthday. Bart died on 30 June 2055 at which point Carl inherited the cottage.

Dave purchased the cottage for R100 000 on 1 June 2002. The market value of the full ownership of the cottage was as follows:

- On date of Dave's death – R1 000 000.
- On date of Abe's death – R1 500 000.

Carl sold the cottage for R10 000 000 on 1 February 2060.

Determine the CGT consequences for Dave, Dave's estate, Abe, Bart and Carl.

Result:

Dave

Under s 9HA(1) Dave is deemed to have disposed of his holiday cottage for proceeds of R1 million. He has a capital gain as follows:

	R
Proceeds	1 000 000
Less: Base cost [para 20(1)(a)]	<u>(100 000)</u>
Capital gain	<u>900 000</u>

Dave's estate

Under s 25(2)(a) Dave's deceased estate acquires the cottage at a base cost of R1 million. When the executor grants Abe the usufruct he triggers a part-disposal by Dave's deceased estate. The portion of the base cost disposed of by the deceased estate is determined as follows:

Life expectancy – male aged 65 = 11,77 (see **8.35.7**)
 Present value of R1 a year for life = 6,13789
 Market value of property on date of death = R1 000 000
 Annual value of usufruct = R1 000 000 × 12% = R120 000
 Market value of usufruct on Dave's date of death under para 31(1)(d) = R120 000 × 6,13789 = R736 547

The bare *dominium* held by the estate is reduced as follows:

	R
Cost of acquisition of full asset [s 25(2)]	1 000 000
Less: Usufruct granted to Abe	<u>(736 547)</u>
Base cost after first usufruct	<u>263 453</u>

Under s 25(3)(a) Dave's estate makes neither a capital gain nor a capital loss on the part-disposal to Abe, since it is deemed to be made for proceeds equal to its base cost.

The granting of the second usufruct to Bart triggers another part-disposal by Dave's deceased estate as follows:

Life expectancy – male aged 40 = 29,54 (see **8.35.7**)
 Present value of R1 a year for life = 8,0403
 Market value of property on date of Abe's death = R1 500 000
 Annual value of usufruct = R1 500 000 × 12% = R180 000
 Market value of usufruct on Abe's date of death under para 31(1)(d) = R180 000 × 8,0403 = R1 447 254
 Portion of Dave's estate's base cost that is disposed of:
 R1 447 254 / R1 500 000 × R263 453 = R254 189.

The base cost of the bare *dominium* held by Dave's estate is now as follows:

	R
Base cost after granting first usufruct	263 453
Less: Usufruct granted to Bart	<u>(254 189)</u>
Base cost after second usufruct	<u>9 264</u>

Again, there is no capital gain or loss on the granting of the second usufruct, since the proceeds are deemed to be equal to the base cost under s 25(3)(a).

Upon Bart's death the executor of Dave's estate awards the cottage to Carl for proceeds equal to the remaining base cost of R9 264. Under s 25(3)(a) Dave's estate makes neither a capital gain nor a capital loss and Carl acquires the cottage at a base cost of R9 264.

Abe

Under s 25(3)(b) Abe acquires the usufruct in the cottage at a base cost of R736 547. Upon his death the usufruct expires and there are no proceeds. Abe therefore has a capital loss of R736 547. This capital loss must be disregarded under para 15(c) to the extent that the cottage was not used for the purposes of trade.

Bart

Under s 25(3)(b) Bart acquires the usufruct in the cottage at a base cost of R254 189. Upon his death the usufruct expires and there are no proceeds. Bart therefore has a capital loss of R254 189. This capital loss must be disregarded under para 15(c) to the extent that the property was not used for the purposes of trade.

Carl

When Bart dies, Carl acquires the cottage at the remaining base cost of the asset in Dave's deceased estate of R9 264 under s 25(3)(b). Carl's capital gain on disposal of the cottage is determined as follows:

	R
Proceeds	10 000 000
Less: Base cost [s 25(3)(b)]	<u>(9 264)</u>
Capital gain	<u>9 990 736</u>

24.1.2 Fideicommissa

A *fideicommissum* (plural: *fideicommissa*) is an arrangement under which full ownership of the asset is given to a person (the *fiduciary*). The fiduciary's asset includes the bare *dominium* and right of use and enjoyment of the asset. The fiduciary may not dispose of the asset and must care for it. Upon the fiduciary's death or after a fixed period, the asset must be passed on to another person (the *fideicommissary*). While the fiduciary holds the asset the fideicommissary merely has a *spes* (a hope) that he or she will outlive the fiduciary and take ultimate ownership of the asset. Should the fideicommissary die before the fiduciary, his or her estate will receive nothing.

Example – Fideicommissum**Facts:**

Upon his death, Tom's last will and testament stated that his holiday home was to be left to his daughter Katie for her lifetime after which it was to pass to Katie's daughter, Jenny should she survive Katie. At the time of Tom's death

- the asset had a base cost of R100 000,
- a market value of R500 000, and
- Katie was 55 years old.

Katie died at the age of 70 and the asset was passed on to Jenny. Jenny disposed of the residence a few years later for R500 000.

What are the CGT implications for Tom, Katie and Jenny?

*Result:**Tom*

Under s 9HA(1) Tom has a capital gain of R500 000 (proceeds) less R100 000 (base cost) = R400 000.

Katie

The base cost of Katie's fiduciary interest is determined under para 31(1)(d) and (2) as follows:

Age next birthday	56
Life expectancy	21,86 years
Annual value of interest (R500 000 × 12%)	R60 000
PV of R1 a year @ 12% (Table A)	7,63363
PV of fiduciary interest: (R60 000 × 7,63363)	R458 017,80

Upon her death Katie has

- no proceeds (the value of her fiduciary interest expired on her death),
- a base cost of R458 018, and
- a capital loss of R458 018.

The capital loss will be limited under para 15(c) to the extent that Katie used the residence for purposes other than the carrying on of a trade. Should Jenny die before her, Katie would be able to deal with the asset as she pleases and its value will no longer decrease over time. Consequently, the loss-limitation rule in para 15(c) would no longer apply to Katie when she disposes of the asset.

Jenny

Under para 31(1)(e) the base cost of the residence in Jenny's hands is R500 000 – R458 018 = R41 982.

Upon disposal of the asset Jenny will have a capital gain determined as follows:

	R
Proceeds	500 000
Less: Base cost	<u>(41 982)</u>
Capital gain	<u>458 018</u>

24.1.3 Right to income

The vesting of an interest in an asset of a trust in a beneficiary is a disposal under para 11(1)(d). The question therefore arises whether the vesting of a right to the income of a trust is a part-disposal of the trust assets. The vesting of such a right typically occurs upon the death of the settlor when the settlor's assets are placed in a testamentary trust with a stipulation that the net income of the trust is to be awarded to, say, a surviving spouse and upon that spouse's death, to the descendants of the deceased.

In *CIR v Lazarus' Estate & another*⁸⁸⁴ it was held that a right to the income of a trust was a 'like interest', that is, that it was similar to a usufruct.

⁸⁸⁴ 1958 (1) SA 311 (A), 21 SATC 379.

In *Hansen's Estate v CIR* the court held that a right to income from a trust was 'an interest' in the assets of the trust for the purposes of s 10(b) of the Death Duties Act 29 of 1922, and stated the following:⁸⁸⁵

'But, says counsel for the appellant, that is not an interest in any of the particular assets of the trust fund and therefore not an interest in the Union shares. I find myself unable to accept that argument. The net income of the trust fund is derived from all the assets of the fund, and the holder of the right to receive the net income therefore has a financial interest in each and all of those assets. That financial interest is protected by law to this extent that the holder is entitled to prevent, by legal action, any maladministration of any asset by the trustee. In my opinion a financial interest in any property which is of such a nature that the holder has *locus standi* to prevent the maladministration of that property is an interest within the meaning of section 10(b)'.

While a right to income of a trust may be similar to a usufruct, and comprises an asset in its own right, there are important differences between the two types of limited interest. A usufruct is a personal servitude and a highly limited real right. By contrast, a right to income of a trust fund is merely a personal right of action against the trustees and the holder of the right does not have a real right over any assets of the trust. It is of course true that CGT is leviable on the disposal of personal rights and the question therefore arises whether there is a part-disposal of the trust assets when the beneficiary acquires the right to income. The *Hansen's Estate* case was concerned with the valuation of the interest upon the death of the income holder and not with whether the trustees had unconditionally parted with one of the bundle of rights making up individual trust assets at the time of vesting. It is therefore considered that this case is unhelpful in determining whether the granting of a right to income triggers a part-disposal of a trust's assets for CGT purposes. This issue will have to be determined based on the wording of the trust deed.

Usually the beneficiary would be entitled only to the income of the trust and would not have a claim to income from a particular trust asset. Factors which may indicate that a beneficiary is not unconditionally entitled to the future income stream from all the trust assets would include whether the trustees are entitled to borrow money to fund the acquisition of trust assets, whether they must first settle the trust's expenses out of trust income and whether they could dispose of an income-producing investment and replace it with one that produces less income or does not produce any income such as vacant land or a gold coin. If it is established that the beneficiary is not unconditionally entitled to the future income stream from a particular asset, the trust will remain the full owner of its assets and as a result there will be no part-disposal of those assets when the right to the net income of the trust is granted. Under these circumstances, should the trust dispose of any of its assets, it must account for any capital gain or loss, subject to the attribution rules. The beneficiary will have a base cost of nil in respect of the right to income and will be unaffected by any disposal of the trust assets. On the death of the beneficiary the right to income will have a market value of nil with the result that the extinction of the right should not give rise to a capital gain or loss under s 9HA(1). The treatment of a right to income on death of the income holder is, however, different for estate duty purposes. Under s 5(1)(b) of the Estate Duty Act 45 of 1955 when the holder of a 'fiduciary, usufructuary or other like interest' dies, the value of the interest based on the life expectancy of the person who takes over the right of enjoyment of the property (or when a shorter period is stipulated, that period) is included in the deceased's estate.

The donation of the remaining income stream by the holder of the right to income will give rise to a disposal and proceeds under para 38 equal to the market value of the remaining right.

⁸⁸⁵ 1956 (1) SA 398 (A), 20 SATC 246 at 255.

Example 1 – Right to income*Facts:*

Upon Piet's death in April 2019, his assets were placed in a testamentary trust. The trust deed stipulated that the income of the trust was to be provided to his surviving spouse and upon her death it was to go to his children, and upon their death to their children. When the last of the grandchildren had died, the trust capital was to be paid to any surviving great grandchildren in equal shares. The trustees were empowered to borrow money and entitled to use the trust income to discharge any trust expenses.

Result:

The initial base cost of the trust assets was equal to their market value on date of death under s 9HA read with s 25(3)(b), and there was no part-disposal as a result of the coming into force of the right to income in favour of Piet's surviving spouse. Piet's surviving spouse is not a fiduciary since she has no ownership over the trust property. She is also not a usufructuary, since she has no real right in any of the trust's assets.

The surviving spouse is entitled only to the net income of the trust, since the trust must first settle its expenses out of the trust income.

The testamentary trust therefore remains the full owner of the assets under its administration and must account for any capital gains and losses on their disposal, subject to para 80.

24.1.4 Other similar interests

Paragraph 31(1)(d) provides that the market value of a fiduciary, usufructuary or other like interest in any asset is an amount determined by capitalising at 12% the annual value of the right of enjoyment of the asset subject to that fiduciary, usufructuary or other like interest, as determined under para 31(2), over the expectation of life of the person to whom that interest was granted, or if that right of enjoyment is to be held for a lesser period than the life of that person, over that lesser period.

In *Estate Watkins-Pitchford & others v CIR* Centlivres CJ stated the following on the meaning of 'other like interest':⁸⁸⁶

'The words "or other like interest" mean, in my opinion, an interest similar to a usufructuary interest, such as, for example, *habitatio* or *usus*.'

Schreiner JA in the minority judgment of the same case stated the following:⁸⁸⁷

'I do not think that the words "or other like" interests can be restricted to quaint survivals like *usus* and *habitatio*. Certainly a right to receive whatever income might flow from a fund administered by trustees would fall within the description of a usufructuary or other like interest, in the absence, of course, of other indications that the interest was something different as, for instance, that it was fiduciary.'

In *CIR v Lazarus' Estate & another*⁸⁸⁸ it was held that a right to the income of a trust was a 'like interest', that is, that it was similar to a usufruct (see **24.1.3**).

The personal servitudes of *habitatio* and *usus* are limited real rights.

⁸⁸⁶ 1955 (2) SA 437 (A), 20 SATC 127 at 139.

⁸⁸⁷ At SATC 149.

⁸⁸⁸ 1958 (1) SA 311 (A), 21 SATC 379.

Usus

The person who holds a right of use (*usus*) is known as a usuary.

The following description of *usus* has been adapted from *Vairetti v Zardo NO & others*.⁸⁸⁹

A servitude of *usus* resembles usufruct but the usuary's rights are far more limited than those of a usufructuary. The right of *usus* is generally intended to provide for the subsistence needs (*die lewensbehoefes*) of the rightholder. The rightholder's entitlement to use and enjoy the property and the fruits is thus limited to the usuary's own needs (including that of the usuary's family).

The use rights which are not incidental to the usuary's needs remain at the owner's disposal. For example, the owner may attend on a farm subject to a right of *usus* to gather the fruits which remain after the usuary's subsistence needs have been met.

The limited nature of the right carries, as a corollary, a commensurately limited set of obligations, in particular as regards the upkeep of the property. The obligation to provide security for the return of the property *salva rei substantia* (substantially intact) is, however, the same as that of a usufruct.

The right of *usus*, and the obligations it entails, are flexible in the following sense: As the needs of the usuary increase, so the usuary becomes entitled to use the property to a greater extent (and, conversely, the residual rights vesting in the owner diminish).

Logically, such an extension of the usuary's right of use (that is, to cater for increased needs) extends the usuary's obligations. If the usuary makes full use of the property to the complete exclusion of the owner, then the usuary's obligations expand to become commensurate with the obligations of a usufructuary.

With both usufructus and *usus*

- the owner retains (at least) bare *dominium* of the property;
- a right of use is conferred on a party other than the owner; and
- the difference between the two is one of degree. It depends on the extent to which the bundle of use rights (which exists over and above nude *dominium*) is conferred on the right holder, that is, the extent of the subtraction from the owner's *dominium*. Viewed from the right holder's perspective, usufruct confers fuller rights than *usus*. Viewed from the owner's perspective, *usus* subtracts to a lesser extent from the rights of ownership.

A full conferral of use rights is known as a usufruct. A more limited conferral, which confines the right to use to the rightholder's own needs, is known as *usus*. "As one moves along the continuum from a full subtraction of use rights from *dominium* to a lesser subtraction, so one is moving out of the realm of usufruct and into that of *usus*."

The value of a right of *usus* which is granted must be determined under para 31(1)(d) read with para 31(2). A right of *usus* that expires has no value and is not dealt with under para 31(1)(d) because it is not granted to anyone.

Given the limited nature of the right of *usus* compared to a usufruct, it may be inappropriate, depending on the facts, to base the annual discount rate of 12% on the market value of the

⁸⁸⁹ (12423/2007) [2010] ZAWCHC 146 (12 April 2010) in [17] to [30].

entire property as prescribed under para 31(2). Paragraph 31(2) refers to the annual right of enjoyment of any asset, and since the right of *usus* would likely be restricted to only a portion of the entire asset, it would be appropriate to regard the asset for purposes of para 31(2) as only the portion of the whole asset enjoyed by the usufructuary. For example, if a farm has a value of R1 million, and the usufructuary's subsistence needs can be met by 20% of the farm, the 12% rate would be applied to R200 000 (R1 million × 20%), assuming that all parts of the farm have equal value.

A capital loss arising on expiry of a right of *usus* would usually be disregarded under para 15(c) because the usufructuary is generally not permitted to let the property. An exception to this non-letting rule is when the house is too large for one family.⁸⁹⁰

Habitatio

The person holding a right of *habitatio* is known as a habitator.

In *Galant v Mahonga* Sampson J stated the following on *habitatio*:⁸⁹¹

'Now *habitatio* is treated in the authorities as akin to use, and use was restricted to bare enjoyment, and to what is necessary to enable the free use to be enjoyed. Justinian (Inst., 2.5.2.) extended to *habitatio* the right to receive a guest in the house (I presume temporarily) and allowed the owner of the servitude to reside in the house with his wife and children, and such persons as might be in his employ, and by a decision allowed the power to let the right of inhabiting to others.'

...

'One thing, however, seems certain, and that is that grazing rights are not taken to be included. Children may live with the parent enjoying the right of *habitatio* and servants; in domestic employ, for if they were excluded the servitude might be a useless one, but anything approaching *usufructus* of the land is barred.'

The court found that the owner of the right of *habitatio* could not claim to carry on farming operations, and if it were intended to convey such a right, it should have been stated in the will.

The ability to let or sublet the house distinguishes *habitatio* from *usus*. In *Arend v Estate Nakiba*⁸⁹² the court confirmed that the right of *habitatio* terminates on the death of the person who is entitled to it, and that only persons entitled to live in the house who are living are entitled to share in the rent from letting the house.

In *Hendricks v Hendricks & others* the court stated the following:⁸⁹³

'[6] The right to habitation as a servitude is a limited real right which confers on the holder the right to dwell in the house of another, without detriment to the substance of the property.

'The right can historically be traced back to Roman law when the original objective was to provide accommodation to indigent foreigners. In that context it was regarded as a factual, rather than a juridical, institution. But Justinian accepted it as a *sui generis*/⁸⁹⁴ legal concept and he classified it as a personal servitude.

'This was generally accepted by Roman-Dutch authorities.

⁸⁹⁰ *Silberberg and Schoeman's: The Law of Property* 6 ed [online] (My LexisNexis: November 2019) in 14.4.3.

⁸⁹¹ 1922 EDL 69 at 79/80.

⁸⁹² 1927 CPD 8 at 10.

⁸⁹³ [2016] JOL 34783 (SCA) at 5.

⁸⁹⁴ One of a kind, unique.

‘Our courts have long recognised *habitatio* as a personal servitude which is a limited real right. Thus it has been held to be a *jus in re*⁸⁹⁵ which founds an action *rei vindicatio*⁸⁹⁶.’

(Footnotes omitted.)

The value of a right of *habitatio* at the time it is granted must be determined under para 31(1)(d) read with para 31(2). A right of *habitatio* that expires has no value and is not dealt with under para 31(1)(d) because it is not granted to anyone.

Given the limited nature of the right of *habitatio* compared to a usufruct, it may be inappropriate, depending on the facts, to base the annual discount rate of 12% on the market value of the entire property as prescribed in para 31(2). This situation could apply, for example, to the right to live in a farm house. Paragraph 31(2) refers to the annual right of enjoyment of any asset, and when the right of *habitatio* is limited to only a portion of the entire asset, it would be appropriate to regard the asset for purposes of para 31(2) as only the portion of the whole asset enjoyed by the person holding the right of *habitatio*. For example, if a person enjoyed a right of *habitatio* over a farm house, the asset should be regarded as the farm house only and not the entire farm.

Paragraph 15(c) will result in the disregarding of any capital loss on expiry of the right of *habitatio* to the extent that the right was not used in carrying on a trade (for example, a trade of letting).

24.2 Leasehold improvements

The table below sets out the CGT consequences of improvements to leasehold property, principally in the context of land and buildings. The treatment of these improvements is dependent on the answers to the following questions:

- Were the improvements effected under a lease agreement?
- Were they effected before or after the valuation date?
- Was any compensation payable by the lessor?

The legal principle of *accessio* is relevant to leasehold improvements. It occurs when

- things belonging to different persons are mixed,
- the subordinate or less valuable thing accedes to or becomes part of the principal or more valuable thing, and
- as a consequence, becomes the property of the owner of the principal thing.

In particular, this is a phenomenon that occurs when a thing is united with the ground - *superficies solo cedit* – whatever is attached to the land forms part of it. In ITC 1467⁸⁹⁷ Conradie J stated the following:

‘Permanent structures like buildings adhere to the soil upon which they are built. For this reason land and buildings cannot, leaving aside innovations like sectional title ownership, be separately owned. Legally there is only one *res* in existence – the property which comprises land and buildings.’

⁸⁹⁵ A real right.

⁸⁹⁶ A remedy available to the owner of property to reclaim it from wherever it is found and from the person unlawfully holding it. The owner is entitled to exclusive possession.

⁸⁹⁷ (1989) 52 SATC 28 (C) at 31.

If a lessee builds on the ground of a lessor, the building belongs to the owner of the ground, the lessor, unless it is a building of a movable nature, such as a tent. When then does the timing of the disposal of those improvements by the lessee occur?

When a lessee attaches an asset to the land of a lessor, there is an immediate disposal of the bare *dominium* in the asset, while the right of use is retained until the end of the lease. In the absence of compensation, this has the effect of triggering an up-front capital loss. Any compensation received will reduce the expenditure incurred under para 20(3)(b).

In order to prevent this capital loss, para 33(3)(c) provides that there is no part-disposal of an asset by a person in respect of

‘the improvement or enhancement of immovable property which that person leases from a lessor’.

The above wording came into operation on 1 February, 2006 and applies in respect of any improvement or enhancement effected on or after that date. Before this date there are three periods, one during which para 33(3)(c) applied (with slightly different wording) and two when it did not. This confusing situation was caused by the insertion (2003), deletion (2005) and reinsertion (2006) of para 33(3)(c). The effective dates and rules that apply since valuation date are summarised in a table in **8.37.6.3**.

If improvements are undertaken under a lease agreement, the question arises which deduction takes precedence – s 11(g) or the capital loss under the Eighth Schedule. Section 11(g) grants an allowance in respect of the relevant expenditure but restricts the quantum that can be claimed in a single year of assessment. Paragraph 20(3)(a) provides that the relevant expenditure must be reduced by any amount which ‘is or was *allowable* or is deemed to have been allowed as a deduction in determining the taxable income of that person . . . before the inclusion of any taxable capital gain’. It is submitted that the expenditure is ‘allowable’ under s 11(g) in the sense that it is ‘capable of being allowed’ and that s 11(g) must therefore be applied in the first instance. However, with the reinstatement of para 33(3)(c) this issue is only of academic interest, since there is no part-disposal of the base cost of the improvements until the end of the lease.

Table 1 – CGT consequences of leasehold improvements

Factor	Effect on lessor	Effect on lessee
Time of disposal	Disposal occurs when property upon which improvements were effected is disposed of.	The cost of effecting the improvements constitutes the price paid by the lessee for the right of occupation. Period when para 33(3)(c) applies (on or after 1 February 2006 and a period before that date – see 8.37.6.3) Any disposal of the bare <i>dominium</i> in the improvements is deferred until the end of the lease by para 33(3)(c). The time of disposal therefore occurs when the lease expires [para 13(1)(b)].

Factor	Effect on lessor	Effect on lessee
		<p>Period when para 33(3)(c) did not apply (two periods before 1 February 2006 – see 8.37.6.3)</p> <p>The bare <i>dominium</i> in the improvements is disposed of at the time the improvements are affixed to the land of the lessor.</p> <p>The right of use of the improvements is disposed of on expiry of the lease [para 13(1)(b)]. Note: Paragraph 33(3)(c) was deleted by the Revenue Laws Amendment Act 32 of 2004 and reinstated by the Revenue Laws Amendment Act 31 of 2005.</p>
Obligatory improvements effected under lease agreement	<p>Amount of improvements included in gross income (para (h) of the definition of 'gross income'). An allowance is granted under s 11(h).</p> <p>No CGT consequences arise, since there is no disposal of an asset by the lessor, merely an acquisition. The base cost of the improvements under para 20(1)(h)(ii)(cc) is the amount included in gross income [by para (h) of the definition of 'gross income' in s 1(1)] less any allowance granted under s 11(h).</p>	Obligatory improvements are allowable under s 11(g). On disposal the amounts allowed under s 11(g) must be excluded from base cost – para 20(3)(a).
Voluntary improvements effected before valuation date	No expenditure incurred under para 20. Valuation date value (VDV) options include market value, 20% of [proceeds – post-1 October 2001 expenditure] or time-apportionment. Note: time-apportionment would be based on the date the land was acquired, and the improvements would have a zero cost.	No deduction against income. Costs incurred form part of base cost. VDV options in respect of the right of use same as lessor. The market value would be influenced by the remaining period of the lease. The disposal of the bare <i>dominium</i> in pre-1 October 2001 improvements represents a pre-valuation date disposal. The result is that no capital

Factor	Effect on lessor	Effect on lessee
		loss can be claimed in respect of that part of the asset.
Voluntary improvements effected after valuation date	No expenditure will be added to the base cost of the land, since none was incurred.	Expenditure incurred under para 20 = base cost
Compensation paid by lessor	Forms part of base cost under para 20(1)(e). VDV for pre-1 October 2001 improvements determined using market value, time-apportionment or 20% of proceeds.	Compensation included in proceeds under para 35(1)(b). Any compensation in respect of bare <i>dominium</i> disposed of before 1 October 2001 is not subject to CGT, since it relates to a pre-CGT disposal.

24.3 Leasehold rights of lessees

A lessee's rights under a lease may give rise to an asset in the hands of the lessee. How would the value of this asset be determined on valuation date? One way would be to determine the extent to which the future rentals according to the lease agreement are less than the projected market-related rental. For example, assuming no future increases in rentals, if the lease has five years to run at a rental of R5 000 a month and the current market-related rental is R7 000 a month, then the 'asset' is the present value of R2 000 a month over 60 months. As the end of the lease approaches the lease becomes less valuable and when it terminates there would in most cases be no proceeds. It is unlikely that there would be much value in short-term leases, and the CGT implications are more likely to be apparent in a long-term lease such as a 99-year lease.

To summarise:

- On valuation date the market value of a lease could be determined [para 31(1)(g)].
- When the lease expires or the rights to the lease are sold, there will be a disposal [para 11(1)(b)].
- Proceeds would usually be zero when the lease simply runs to the end of its term and expires. Proceeds could be received if the lessor paid an amount to the lessee in order to secure an early termination of the lease.⁸⁹⁸
- A capital loss would usually arise in such cases.
- If the lease was taken out for a non-trade purpose, para 15(d) would operate to disallow the loss.
- The question arises whether a market value loss of this nature arising on termination of a lease taken out by the lessee for the purposes of trade would be allowable. In this regard paras 26 and 27 need to be considered.

⁸⁹⁸ See ITC 175 (1930) 5 SATC 180 (U) in which it was held that a payment by a lessor to a lessee to secure the early termination of a lease was of a capital nature.

Example 1 – Disposal of lease rights on termination of lease*Facts:*

A lease terminates without proceeds.

	R
Amount paid for lease rights	Nil
Market value of lease rights on 1 October 2001	100 000
Proceeds on termination	Nil

What are the CGT implications for the lessee?

Result:

In this instance para 27 applies and the lessee must use the lower of time-apportionment and market value. Time-apportionment is zero resulting in neither a capital gain nor a capital loss. The loss based on market value would therefore not be allowable.

Example 2 – Proceeds received from lessor for early termination of lease*Facts:*

The lessor pays the lessee R20 000 to secure an early termination of the lease.

	R
Expenditure before valuation date	Nil
Market value on valuation date	100 000
Expenditure after valuation date	Nil
Proceeds	20 000

What are the CGT implications for the lessee?

Result:

In this scenario para 26 applies. It dictates that the valuation date value (VDV) is equal to proceeds less post-CGT expenditure. Thus, $VDV = R20\,000 - R0 = R20\,000$, proceeds = R20 000 resulting in neither a capital gain nor a capital loss. The loss based on market value of R80 000 would not be allowable.

24.4 Loans*Asset*

The definition of 'asset' in para 1 is wide and includes

'property of whatever nature, whether movable or immovable, corporeal or incorporeal ...'

Upon making a loan the lender acquires a right to claim payment from the borrower, which is an incorporeal asset.

Base cost

Paragraph 20(1)(a) includes in the base cost of an asset

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

The expenditure actually incurred in acquiring the right to claim payment is the amount advanced by the lender to the borrower plus any incidental costs such as the cost of drawing up the agreement. If a debt arises from a sale of trading stock, the base cost of the debt is equal to the market value of the trading stock disposed of, since this is the amount by which the seller has been impoverished. See **8.5** on the establishment of the base cost of an asset acquired under a barter or exchange transaction.

The treatment of interest accrued on a loan account will depend on the nature of the instrument. A distinction needs to be drawn between non-tradable debt assets such as savings accounts with commercial banks and tradable instruments such as bonds.

Non-tradable debt instruments such as bank accounts

Interest accrued that is added to a bank account balance comprises expenditure actually incurred. When such an interest-bearing debt asset is advanced, the lender acquires a personal right to claim interest from the borrower at a future date. This right would usually have a base cost of nil. When the interest accrues and is capitalised, the personal right to claim the interest accrued is extinguished in exchange for the increase in the bank account. The accrued interest is included in income but is eliminated from proceeds by para 35(3)(a) resulting in neither a capital gain nor a capital loss. The expenditure incurred on the increased loan balance is equal to the amount by which the lender has been impoverished.⁸⁹⁹ The diminution in the value of the lender's assets is equal to the value of the personal right given up (see **8.5**). Should the capitalised interest subsequently become irrecoverable, the lender may be entitled to a deduction under s 24J(4A) for the interest portion of the bad debt.⁹⁰⁰ In that event the base cost of the loan will have to be reduced under para 20(3)(a) by the amount so claimed.

Tradable debt instruments

The periodic coupon payments on tradable s 24J instruments do not necessarily represent interest and may include a capital element, for example, when an instrument is acquired part way through an accrual period. In these circumstances it is appropriate to treat the sum of the coupons less the interest element as proceeds on disposal of the instrument. See **8.32.2**.

Loan repayments

Depending on the circumstances, loan repayments should be dealt with by using either

- the cost-recovery method [para 20(3)(b)];
- the part-disposal method (para 33); or
- with a s 24J instrument, the method prescribed in that section.

The cost-recovery method

The cost-recovery method is appropriate when the loan is advanced or acquired at face value. In this case a capital gain or loss would not normally be anticipated, and the repayments represent a recovery of base cost under para 20(3)(b). Paragraph 20(3)(b) provides that the expenditure in acquiring an asset must be reduced by any amount of that expenditure that

‘has for any reason been reduced or recovered or become recoverable from or has been paid by any other person’.

⁸⁹⁹ ITC 1783 (2004) 66 SATC 373 (G) at 376.

⁹⁰⁰ If s 24J(4A) does not apply, a deduction may be possible under s 11(i) as a bad debt. See Practice Note 31 dated 3 October 1994 ‘Income Tax: Interest Paid on Moneys Borrowed’ in para 2.

Cost recovery has the advantage of simplicity, since a disposal is not triggered each time a loan repayment is received.

The part-disposal method

It can happen that a loan is acquired at less than face value, for example, under an offer of compromise under s 155 of the Companies Act 71 of 2008, or when debtors are disposed of as part of a going concern and the price paid is reduced below face value to account for the possibility of doubtful debts. In such circumstances a capital gain will often be anticipated at the outset and it can no longer be argued that the loan repayments are a recovery of cost. In such cases the repayments are proceeds arising from a part-disposal of the loan. Paragraph 33 contains two methods for determining the portion of the base cost disposed of, namely,

- the market-value formula method [para 33(1)], and
- the specific-identification method [para 33(2)].

A practical difficulty with the market-value method is that it requires the market value of the loan to be determined immediately before each repayment. The market value of a loan, particularly one that is interest-bearing, fluctuates constantly with prevailing interest rates and prospects of recovery. If there are numerous repayments it would be administratively burdensome to apply this method.

Alternatively, the specific-identification method in para 33(2) can be applied to identify the portion of the base cost disposed of. This method recognises the fungible nature of a loan, that is, all parts of a loan have equal cost, are indistinguishable and are identifiable by nomination.

Example – Determination of capital gain or loss on repayment of a loan using the part-disposal method

Facts:

An interest-free loan of R120 is acquired at a cost of R100, and is repayable in 5 equal annual instalments.

Result:

The base cost of each repayment is R20. Each repayment of $R120 / 5 = R24$ represents proceeds on a part-disposal. Each year a capital gain of $R24 - R20 = R4$ will be realised.

Section 24J instruments

The term ‘instrument’ is defined in s 24J(1) as follows:

“instrument” means—

- (a)
- (b)
- (c) any interest-bearing arrangement or debt;
- (d) any acquisition or disposal of any right to receive interest or the obligation to pay any interest, as the case may be, in terms of any other interest-bearing arrangement; or
- (e) any repurchase agreement or resale agreement,

which was—

- (i) issued or deemed to have been issued after 15 March 1995;
- (ii) issued on or before 15 March 1995 and transferred on or after 19 July 1995; or
- (iii) in so far as it relates to the holder thereof, issued on or before 15 March 1995 and was unredeemed on 14 March 1996 (excluding any arrangement contemplated in subparagraphs (i) and (ii)),

but excluding any lease agreement (other than a sale and leaseback arrangement as contemplated in section 23G) or any policy issued by an insurer as defined in section 29A;'

Section 24J sets out what constitutes interest, how it is to be calculated, when it accrues or is incurred and how and *when* an 'adjusted gain or loss on transfer or redemption of an instrument' is to be determined.

Under s 24J(4), the adjusted gain or loss on transfer or redemption of the instrument is deemed to accrue or be incurred, as the case may be, in the year of transfer or redemption. This provision overrides any timing rule in para 13, thus excluding the use of the part-disposal method. The adjusted gain or loss contemplated in s 24J is the equivalent of a capital gain or loss when the instrument is held on capital account and acquired on or after the valuation date. However, the adjusted gain or loss on a pre-valuation date instrument may differ from the capital gain or loss. To the extent, for example, that the adjusted gain exceeds the capital gain the difference represents a pre-valuation date gain that is not subject to CGT.

If a loan is acquired at a discount (for example, a zero coupon bond), the discount is deemed to be interest that must be included in the person's gross income under s 24J(3).⁹⁰¹

Paragraph (a) of the definition of 'interest' in s 24J(1) includes the

'gross amount of any interest or similar finance charges, *discount* or premium payable or receivable in terms of or in respect of a financial arrangement'.

(Emphasis added.)

It is submitted that the word 'discount' must be read *ejusdem generis* with the words 'interest and similar finance charges'. The discount must also arise under a 'financial arrangement'. The facts and circumstances of each case must be considered in determining whether a particular discount is in the nature of interest or related finance charges. Another factor to be considered is whether the term of the instrument can be established. The word 'term' is defined in s 24J(1) and

'in relation to an instrument, means the period commencing on the date of issue or transfer of that instrument and ending on the date of redemption of that instrument'.

The 'yield to maturity' (YTM) must be determined over the 'term' of the instrument. In some situations, the term, and hence the YTM of the instrument may not be determinable. For example, this may apply to a subordinated loan acquired for a nominal consideration under an offer of compromise under s 155 of the Companies Act 71 of 2008. For these reasons all 'discounts' may not be interest as contemplated in s 24J.

In conclusion, when the 'discount' is not in the nature of interest, the capital or revenue nature of the amounts recovered must be determined on the facts. If the loan was acquired as part of a scheme of profit-making it will be trading stock, and the proceeds will have to be included

⁹⁰¹ Section 24J(3) was amended by s 24(1)(i) of the Revenue Laws Amendment Act 32 of 2004 with effect from 1 January 2005 and applies in respect of any instrument issued, acquired or transferred on or after that date.

in gross income. On the other hand, if the loan is of a capital nature, a capital gain or loss must be determined under para 33.

If the discount is 'interest' as contemplated in s 24J, the interest accruals will be excluded from proceeds under para 35(3)(a). An 'adjusted gain or loss' will arise under s 24J only if the instrument is disposed of before maturity, and would be quantifiable only at the time of disposal. It follows that any capital gain or loss must be determined at the time of disposal as specified in s 24J(4). See also **8.31**.

Disposal

If the repayments are treated as a recovery of cost, a disposal will occur upon the loan becoming fully repaid, since there will be a redemption or discharge of the debt under para 11(1)(b).

Under the part-disposal method, a part-disposal occurs each time the loan is repaid [discharge or redemption – para 11(1)(b)].

The time of disposal of a s 24J instrument under s 24J(4) is the time of transfer or redemption of the instrument.

When a loan becomes irrecoverable, there will also be a disposal of the right to claim payment. For example:

Event	Para 11	Type of disposal
• the debtor cannot pay		Not catered for
• the debt prescribes	(1)	Extinction
• the debt is cancelled	(1)(b)	Cancellation

Bad debts

The treatment of a bad debt for CGT purposes depends on several factors which are summarised in the table below.

Table 1 – Treatment of irrecoverable debts

Type of debt	Treatment
Debt arising from the disposal of an asset which is extinguished in the same year of assessment	Reduce proceeds on disposal of asset under para 35(3)(c) except if the agreement is cancelled in the same year of assessment and the asset is reacquired, in which event see para 11(2)(o).
Debt arising from the disposal of an asset which becomes irrecoverable in a subsequent year of assessment	<i>Pre-valuation date asset:</i> Redetermine capital gain or loss under para 25(2) <i>Asset acquired on or after valuation date:</i> Determine capital loss under para 4(b)(i)(bb)

Debt arising otherwise than from the disposal of an asset	Determine capital loss under para 4(a) read with paras 11 [disposal = extinction] and 13(1)(b) [time of disposal]. If debtor and creditor are connected persons in relation to each other, any capital loss will be allowable only if the conditions in para 56(2) are met [for example, if the debtor is required to reduce the expenditure on an asset under para 12A]. If the loan is to a trust or a trust's company, any capital loss on its waiver will be denied under s 7C(2) if the requirements of that section are met (see 12.5A).
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Debt arising from disposal of an asset

When an asset is disposed of on credit, a new asset comes into existence in the form of a debt claim against the buyer of the asset. The Eighth Schedule contains two ways of dealing with that debt claim when it becomes bad or irrecoverable.

- First, there are the core rules in paras 11 and 13 which apply to the debt itself and its disposal through the legal process of extinction. The extinction of all rights against a debtor must not be confused with the impairment of the carrying value of a debt for accounting purposes which is irrelevant for the purposes of determining whether a disposal has occurred. Paragraph 11 does not trigger a disposal every time the value of an asset falls below its cost price.
- Secondly, there are rules contained in paras 4(b)(i)(bb), 25(2)(b) and 35(3)(c) which address the irrecoverable proceeds on disposal of the asset that gave rise to the debt claim.

The 'proceeds adjustment' rules are more specific and must therefore take precedence over the core rules. Furthermore, since a capital loss cannot be created twice in respect of the same amount under para 21, any capital loss arising on disposal of the debt will have to be disregarded when the proceeds are adjusted. It will also become apparent that the method of dealing with a reduction of proceeds in a year of assessment subsequent to the year in which an asset was disposed of is more generous than what would have ensued had the core rules applied. In the latter regard the core rules deal with the extinction of an asset while the 'reduction of proceeds' rules apply the concept of irrecoverability except when a debt becomes irrecoverable in the same year of assessment.

Disposal in the same year of assessment

If the asset was disposed of in the same year of assessment in which the debt is extinguished the proceeds must be reduced under para 35(3)(c) by any amount of those proceeds that are reduced by

'any reduction, as the result of the cancellation, termination or variation of an agreement, other than any cancellation or termination of an agreement that results in the asset being reacquired by the person that disposed of it, or any reduction due to the prescription or waiver of a claim or release from an obligation or any other event during that year, of an accrued amount forming part of the proceeds of that disposal.'

Paragraph 35(3)(c) does not, however, deal with the possible irrecoverability of an accrued amount of proceeds. It will therefore apply only when the right to claim the proceeds has been extinguished through, for example, the final liquidation of the debtor and not when the creditor considers that the proceeds have become irrecoverable.

Disposal in a prior year of assessment

If the debt arose from the disposal of a pre-valuation date asset and the debt becomes irrecoverable in a year of assessment subsequent to the year of disposal, the capital gain or loss on disposal of the asset must be redetermined in the year in which the debt becomes irrecoverable. The prior year capital loss or gain is reversed in the current year under para 3 or 4 respectively and the redetermined capital gain or loss taking into account the reduced proceeds is accounted for in the current year under para 3 or 4 read with para 25(2) (see **8.27.2**).

If the asset giving rise to the debt was acquired on or after the valuation date and the debt becomes irrecoverable in a subsequent year of assessment, a capital loss will arise under para 4(b)(i)(bb) by virtue of the irrecoverable proceeds.

A specific timing rule is not available under paras 4(b)(i)(bb) and 25(2), and it is therefore left to the taxpayer to determine on an objective basis having regard to the facts and circumstances of the case when the debt is incapable of being recovered. In ITC 592⁹⁰² a taxpayer had granted credit to customers on terms that extended over several years before finally writing some of them off as bad. As to when the debts became bad Ingram CJ stated that

‘the taxpayer is entitled to claim the deduction of bad debts up to and as at the time he finally regards the debts to be bad’.

On the Australian Tax Office’s approach as to when a debt becomes bad see Taxation Ruling TR 92/18 ‘Income Tax: Bad Debts’.⁹⁰³ The approach of the IRS in the United States is set out below:⁹⁰⁴

‘A debt becomes worthless when the surrounding facts and circumstances indicate there is no longer any chance the amount owed will be paid. To show that a debt is worthless, you must establish that you have taken reasonable steps to collect the debt. It is not necessary to go to court if you can show that a judgment from the court would be uncollectible. You may take the deduction only in the year the debt becomes worthless.’

SARS accepts that a debt will become irrecoverable when the taxpayer has exhausted all reasonable steps to recover it. As with the IRS approach this does not mean that taxpayers have to exhaust all their legal remedies, such as placing a debtor in liquidation if such action would not yield any recovery or if the cost of taking such action would exceed the likely recovery.

Debt arising otherwise than from the disposal of an asset

If the debt arose otherwise than from the disposal of an asset, the core rules apply. In other words, the asset is the debt and its disposal will be determined under para 11 read with para 13. In most instances, however, debts do arise from the disposal of assets, even if those assets consist of bank accounts from which monies are advanced to a debtor, since a bank account is an asset.

The opening words of para 11 list the extinction of an asset as a disposal event and this would cover a claim in respect of which all rights against the debtor have been extinguished. The irrecoverability of a debt is not listed as a disposal event in para 11 and must be distinguished from the extinction of a debt. For example, a doubtful debt may be completely irrecoverable but until the claim is extinguished the creditor still holds an asset in the form of a right of

⁹⁰² ITC 592 (1945) 14 SATC 243 (U) at 246.

⁹⁰³ Available at <<https://www.ato.gov.au/law/view/document?DocID=TXR/TR9218/NAT/ATO/00001>> [Accessed 2 November 2020].

⁹⁰⁴ Publication 453 ‘Bad Debts Deduction’, available at <<http://www.irs.gov/taxtopics/tc453.html>> [Accessed 2 November 2020].

recovery against the debtor. A disposal is not triggered merely because the value of an asset has diminished. This principle can be seen from para 77(1)(b) which enables a holder of a share to claim a capital loss when the liquidator declares in writing that no reasonable grounds exist to believe that further distributions will be received. Absent such a special rule the holder of shares would have to wait until the company was dissolved or deregistered before a capital loss could be determined. Under para 13(1)(b) the time of disposal in respect of the extinction of an asset is the date of extinction of the asset.

Irrecoverable loans to connected persons (para 56)

Under para 56(1) a creditor who disposes of a debt owed by a debtor who is a connected person in relation to that creditor must disregard any capital loss resulting from that disposal except to the extent that para 56(2) applies. Under para 56(2) the creditor will be allowed the capital loss to the extent that the amount of the debt represents

- an amount which is applied to reduce the expenditure in respect of an asset of the debtor under s 19 (3) or para 12A(3);
- an amount which must be taken into account by the debtor as a capital gain under para 12A(4);
- an amount which the creditor proves must be or was included in the gross income of any acquirer of that debt;
- an amount that must be or was included in the gross income or income of the debtor or taken into account in the determination of the balance of assessed loss of the debtor under s 20(1)(a); or
- a capital gain which the creditor proves must be or was included in the determination of the aggregate capital gain or loss of any acquirer of the debt.

Examples of situations in which a creditor that is a connected person in relation to a debtor will not be allowed to claim a capital loss under para 56(1) include the following:

- A resident creditor claims a capital loss in respect of an irrecoverable loan to a connected person who is not a resident. The debtor did not use the funds to acquire an asset contemplated in para 2(1)(b).
- The debtor and creditor are part of the same group of companies as defined in s 41 and the debtor did not carry on a trade during the year of assessment in which the debt benefit arises nor in the immediately preceding year of assessment, and the exemption in para 12A(6)(d) applies.
- The debtor and creditor are connected persons in relation to each other and the debtor is a company that is being liquidated, wound up, deregistered or finally terminated and the exemption in para 12A(6)(e) applies.

For more on para 56 see **12.5**.

Capital loss on loan, advance or credit provided to trust or trust's company by connected person [s 7C(2)]

Section 7C(2) denies a capital loss on a loan to a trust or a trust's company. The lender must be a natural person or a company that made the loan at the instance of a natural person. The borrower must be a trust with the required connected person relationship to the lender or a company in which such a trust has the required interest. The various connected person

relationships between the various parties are complex and are not repeated here. See **12.5A**. These rules override para 56(2).

Bad debts recovered

Should a creditor have claimed a loss from the disposal of a debt in a previous year, and an amount is subsequently recovered in the current year, that amount will be treated as a capital gain under para 3(b)(ii).

The debtor

For years of assessment commencing on or after 1 January 2013 the reduction of debt for less than its face value may have consequences for the debtor under s 19 or para 12A. These consequences may take the form of a recoupment, a reduction of expenditure incurred in respect of an asset financed by the debt [para 12A(3)] or may result in a capital gain if the debt was cancelled in a year of assessment subsequent to the year in which the asset was disposed of [para 12A(4)].

For commentary on the situation in which the creditor reacquires the asset as a result of the cancellation of a contract see **6.3.6**. In such a case the debt claim may be wholly or partially repaid through the reacquisition of the asset, or the initial disposal may be disregarded under para 11(2)(o) when the sale is cancelled in the same year of assessment.

24.5 Restraint of trade payments

The courts in Australia and the United Kingdom have refused to accept that the right to trade is an asset for CGT purposes. In the Australian case of *Hepple v FCT*⁹⁰⁵ Toohey J stated the following:

'The freedom of a person, in this case the appellant, to compete in the marketplace is not of itself an asset: *Forbes v NSW Trotting Club Ltd* (1979) 143 CLR 242, at 260–1. In *Kirby (Inspector of Taxes) v Thorn EMI Plc.* [1988] 1 WLR 445, at 458; [1988] 2 All ER 947, at 959, Purchas LJ observed of the capital gains tax provisions of the Finance Act 1965 (UK):

'The right to trade in the marketplace is a right which is common to all ... To suggest that it is an incorporeal right ... is wholly unjustifiable within the basic concept of an acquisition of an asset with its accretion in value owing to changes in economic circumstances, etc over a period of inflation followed by disposal with a realisation of a chargeable gain''.

But this view has not been accepted in South Africa. In *ITC 1338*⁹⁰⁶ McEwan J said the following:

'The basic principle is that a company's or a person's right to trade freely is an incorporeal asset and, if he is paid for a restriction upon that right, whether partial or complete, he is being paid compensation for the loss or sterilization of the asset (or part of it as the case may be) and the payment therefore is a capital payment.'

The argument that a restraint of trade is not property was raised in *Taeuber and Corssen (Pty) Ltd v SIR*.⁹⁰⁷ While the court did not comment directly on the contention, it clearly did not accept it, stating that

'the appellant had established an income-producing structure. The structure of appellant consisted not only of premises, personnel and the right to trade but also of certain specific contractual rights and duties ...'.

⁹⁰⁵ (1991) ALR 497 in para 16. The case is available online at <<http://www.austlii.edu.au/au/cases/cth/HCA/1991/39.html>> [Accessed 2 November 2020].

⁹⁰⁶ (1980) 43 SATC 171 (T) at 174.

⁹⁰⁷ 1975 (3) SA 649 (A), 37 SATC 129 at 138.

The debate whether a right to trade is an asset may be academic because in many instances it will not be the right to trade that is being disposed of, but rather some other asset such as goodwill or know how.

The person agreeing to a restraint gives up the right to trade freely (an asset with a base cost of nil) in exchange for an amount of proceeds. By signing the agreement, the restrained party creates an asset in the hands of the other party, thereby triggering a disposal under para 11(1). The asset so created is the right to expect the restrained party to abide by the terms of the restraint agreement. The time of disposal by the restrained party and the time of acquisition by the restraining party is the date on which the asset is created.⁹⁰⁸ The right of the restraining party will be disposed of when the restraint ends, which will result in the extinction of the asset by termination [para 11(1)(b)]. The time of disposal is the date of extinction [para 13(1)(b)].

Despite the common law position, restraint payments made on or after 23 February 2000 to the following persons must be included in their gross income under para (cA) of the definition of 'gross income' in s 1(1):

- A natural person (but see below for the position on or after 1 March 2015)
- A labour broker without an exemption certificate issued under the Seventh Schedule
- A personal service provider
- A personal service company or personal service trust as defined in the Fourth Schedule before s 66 of the Revenue Laws Amendment Act, 2008 came into operation

On or after 1 March 2015 natural persons were deleted from para (cA) and addressed in para (cB), which applies to any amount received by or accrued to any natural person as consideration for any restraint of trade imposed on that person in respect or by virtue of

- employment or the holding of any office; or
- any past or future employment or the holding of an office.

Restraint payments to the above persons will not be subject to CGT because para 35(3)(a) excludes from proceeds any amount included in the gross income of a person.

However, not all restraint payments are deemed under paras (cA) and (cB) to be gross income. Payments to

- companies and trusts which are not personal service providers; and
- natural persons who are not in employment or who do not hold an office,

are excluded and will therefore be subject to CGT.

24.6 Non-refundable deposit when sale subject to suspensive condition

The time of disposal for a sale subject to a suspensive condition is when the condition is satisfied [para 13(1)(a)(i)]. Should the buyer fail to comply with the suspensive condition, the seller will acquire a right to claim the deposit at that time which will give rise to a potential capital gain on the forfeited deposit.

For a sale not subject to a suspensive condition, see **6.3.6**.

⁹⁰⁸ Paragraph 13 does not specify a time of disposal for the creation of an asset. However, it is not an exhaustive provision, and the time of disposal must therefore be deduced from the event itself.

Example – Non-refundable deposit: Sale subject to suspensive condition*Facts:*

In year 1 Varuna signed an agreement for the sale of her holiday home. Upon signing the agreement, the buyer paid Varuna a non-refundable deposit of R10 000. The sale was contingent on the buyer obtaining a bond. In year 2 the buyer failed to obtain the bond and the sale collapsed.

Result:

There is no disposal of the holiday home under para 13(1) because the sale is subject to a suspensive condition which has not been fulfilled.

When the buyer failed to obtain the bond, Varuna acquired a right to claim the deposit from the buyer. The cost of that right is zero. She then disposed of the right for proceeds equal to the amount received of R10 000. Capital gain = R10 000 (proceeds) – R0 (base cost) = R10 000.

24.7 Share block companies and their shareholders

This paragraph examines the CGT implications of some situations that can arise in relation to a share block company as defined in s 1 of the Share Blocks Control Act 59 of 1980.

24.7.1 Conversion to share block company

Under s 10(b) of the Share Blocks Control Act 59 of 1980 any share of the company must confer a right to or an interest in the use of immovable property to the member. The conversion of a company to a share block company consequently triggers a disposal by the company of an indefinite right of use in the property to its members. The company will be left with the residual value of the land and buildings, which will be virtually worthless. Under para 11(1)(e) the distribution of an asset by a company to a holder of shares is a disposal. Under para 75(1)(a) the company is deemed to have disposed of the right of use and occupation for an amount received or accrued equal to its market value on the 'date of distribution' as defined in para 74. To the extent that the distribution comprises a dividend *in specie* (as opposed to CTC) it may also carry dividends tax implications for the company unless an exemption applies under s 64FA. For example, a distribution to a resident company would be exempt if the relevant formalities are complied with.

24.7.2 The impact on the holder of shares

While it could be argued that the conversion of the company to a share block company will trigger a disposal of the pre-existing shares in exchange for shares in a share block company, it is submitted that when viewing the transaction as a whole the legislature did not intend this share conversion to comprise a disposal. There is a parallel disposal of the right to claim a dividend which does not give rise to a capital gain or loss. The right to claim the dividend is acquired for no consideration and the dividend is excluded from proceeds under para 35(3)(a) because it comprises gross income. This parallel disposal should therefore be given precedence over the share conversion. One effect of the conversion is that the member will receive a step-up in base cost of the shares under para 75(1)(b) but this comes at the cost of the share block company potentially having to pay dividends tax and the member incurring a liability to the company equal to the amount of the member's loan account in the company.

The CGT treatment of the receipt or accrual of the right of use and occupation by the holder of shares in the company will depend on whether it comprises

- a return of capital;
- a dividend; or
- an acquisition for consideration.

The amount will constitute a return of capital to the extent that the directors have determined by the date of distribution that the amount is transferred from the company's CTC. Such an amount will have consequences under para 76B in the form of a reduction in the expenditure on the share.

To the extent the amount comprises a dividend *in specie* there will be no CGT consequences for the holder of shares although the company will bear any dividends tax should the holder of shares not be a dividends tax-exempt recipient (see s 64FA). Since a dividend is included in gross income, it is excluded from proceeds under para 35(3)(a).

Section 14(3) of the Share Blocks Control Act provides as follows:

'(3) Any member of a share block company shall be liable to the company in respect of its loan obligation for an amount equal to that portion of the loan obligation, if any, for which he is, at the commencement of this Act, liable in respect of that loan obligation and such portion thereof as may, after that commencement, be allocated to him in terms of subsection (2).'

In other words, as part of the *quid pro quo* for acquiring the right of use or occupation the holder becomes liable to the company for an amount that matches the amount of the pre-existing shareholder's credit loan account in the company. Were it not for this provision, the share block company would effectively be left in an insolvent position.

Example – Conversion of company to share block company

Facts:

ABC (Pty) Ltd owns land and buildings consisting of a block of 10 flats. The shares in the company are owned by Rene who decided to convert the company to a share block company as contemplated in the Share Blocks Control Act. Rene has held the shares in the company from the time of its formation for many years as a capital asset and her intention in converting the company to a share block company is merely to facilitate the realisation of her capital asset to best advantage.

At the time of the conversion, the block of flats was valued at R1 million. After the conversion each of the company's 10 shares of R1 each had stapled to it a right of use and occupation of a designated flat, lock-up garage and servant's quarters for an unlimited period as well as a right to use the common property. The company's balance sheet immediately before conversion appeared as follows:

	R
Share capital	10
Profits	381 600
Shareholder's loan	<u>100 000</u>
	<u>481 610</u>
Land and buildings – at cost	100 000
Cash	<u>381 610</u>
	<u>481 610</u>

Upon conversion of the company to a share block company, Rene did not determine that any of the amount distributed to her came from the company's CTC.

Result:

Upon conversion to a share block company, the company disposed of the indefinite right of use and occupation to Rene for proceeds of R1 million comprising a distribution *in specie* of R900 000 under para 75(1)(a) and R100 000 in the form of a claim against Rene under s 14(3) of the Share Blocks control Act. The disposal gave rise to a capital gain of R900 000 (proceeds of R1 million less base cost of R100 000). The resulting CGT amounted to $R900\,000 \times 80\% \times 28\% = R201\,600$.

The granting of a right of use in the property comprised a dividend as defined in s 1(1) to the extent of R900 000, since it represented an amount transferred for the benefit of a person in respect of a share by way of a distribution. The right of use and occupation received by Rene was worth R1 million, since any residual value left in the company would be negligible. She gave consideration of R100 000 in the form of a debit loan account under s 14(3) of the Share Blocks control Act, while the balance represented a dividend.

Dividends tax on the dividend *in specie* of $R900\,000 \times 20\% = R180\,000$ is payable by the company on the market value of the distribution. The dividend does not trigger a base cost reduction in Rene's hands under para 76B, since it does not represent a return of capital.

The company's shares before the conversion were valued at R900 010 arrived at as follows:

	R
Net asset value before revaluation of property R481 610 (assets)	
less 100 000 (loan)	381 610
Revaluation surplus R1 000 000 (market value) – R100 000 (cost)	900 000
Less: Contingent CGT and dividends tax liability (R201 600 + R180 000)	<u>(381 600)</u>
Market value of shares	<u>900 010</u>

After the conversion the company's balance sheet appeared as follows:

Share capital	10
Shareholder's loan account	<u>100 000</u>
	<u>100 010</u>
Amount owed by shareholder	100 000
Cash R381 610 – R381 600 (taxes)	<u>10</u>
	<u>100 010</u>

Rene's net interest in the company before and after conversion remained the same. Before conversion she owned shares with a value of R900 010 (including the stapled right of use and occupation) and a loan of R100 000 = R1 000 010. After conversion she owns shares with a value of R1 000 010 and a loan account of R100 000 and owes the company R100 000 giving a net interest of R1 000 010.

24.7.3 Conversion of share block company to company

The conversion of a share block company to a company requires the cancellation of the right of use attaching to the shares. In addition, the rights in the shares will change substantially as a result of the company no longer being subject to the restrictions imposed by the Share Blocks Control Act. These two factors result in a disposal of the shares in the share block company and attached right of use in return for shares in a company. The determination of the proceeds for the shareholder and the base cost of the right of use for the company will depend on how the transaction is structured (for example, whether the shareholder's loan account is credited

with the market value of the right of use) and whether the shareholder and company are connected persons in relation to each other (the latter will trigger para 38).

When the right of use in the property is cancelled in order to transfer the immovable property to the persons holding shares in the share block company, para 67B prevents any disposal of the shares by such holder and any disposal by the company of the property to that holder (see **13.6**). However, the normal disposal rules will apply when the right of use is cancelled and the holder of shares does not acquire the property.

24.7.4 Transfer of a unit in a share block company to a member

Under para 67B, the share block company must disregard any capital gain or loss upon transfer of a unit to a shareholder under item 8 of Schedule 1 to the Share Blocks Control Act. The member is given roll-over relief in respect of the transaction. See **13.6**.

24.7.5 The disposal of common property

It sometimes happens that the common property in a share block scheme is surplus to the requirements of the shareholders and is disposed of to a third party. Before the portion of the common property can be disposed of it is necessary to cancel the shareholder's right of use and occupation in the property concerned so that full ownership of the property can be restored to the share block company. The cancellation of the right of use and occupation will trigger a part-disposal in the shareholders' hands under para 33. The proceeds would be equal to the amount credited to each shareholder's loan account (that is, equal to the market value of the right of use and occupation surrendered). Once the full property has been sold to the third party the loan would be repaid to the shareholder. Although the share block company will have a disposal for CGT purposes it should not result in a capital gain or loss because the company's base cost (established through the purchase on loan account) should equal the proceeds received or accrued on disposal to the third party. Paragraph 67B does not apply under these circumstances because the holder of shares is not acquiring the property.

24.8 The disposal of common property under a sectional title scheme

It sometimes happens that the common property in a sectional title scheme is surplus to the requirements of the owners and is disposed of to a third party.

Section 16 of the Sectional Titles Act 95 of 1986 provides as follows:

16. Ownership of common property.—(1) The common property shall be owned by owners of sections jointly in undivided shares proportionate to the quotas of their respective sections as specified on the relevant sectional plan.'

The sectional title holders must therefore account for the CGT consequences of the disposal of common property, and not the body corporate.

The part-disposal rules in para 33 will have to be applied to allocate a portion of the base cost to the common property disposed of. The primary residence exclusion will be unavailable because the residence itself has not been disposed of, which is a requirement of para 45 read with para 46(c). However, to the extent that it has not been used against other capital gains and losses, the annual exclusion will be available.

24.9 Nil paid letters

Companies sometimes raise additional capital on the securities exchange by a rights issue. Under such an arrangement, the company offers its existing shareholders the right to take up its shares at a specified price (usually below the prevailing market price) at a specified date.

The rights that shareholders receive are known as ‘renounceable nil paid letters of allocation’ or more simply as ‘nil paid letters’ (NPLs). These NPLs are listed temporarily for a few weeks on the securities exchange until the close of the offer. A shareholder accepting the offer will simply acquire the shares offered for the stipulated price. A shareholder who decides not to accept the offer may sell the NPLs on the securities exchange. An NPL is an asset as defined in para 1 and the provisions applicable to options apply equally to NPLs. Assuming that the relevant transactions fall on capital account, NPLs are treated as follows for CGT purposes:

- A shareholder who acquired the NPL on or after the valuation date from the company and who disposes of it on the open market must determine a capital gain or loss in the normal way, namely, proceeds on disposal less a base cost of nil, since nothing would have been paid for the NPL.
- A person who acquired the NPL on the open market and does not exercise the right to take up the shares will incur a capital loss when the NPL lapses.
- A person who acquires an NPL on the open market and disposes of it before the exercise date must determine a capital gain or loss in the normal way, that is, proceeds less base cost.
- A person who acquired the NPL on or after valuation date on the open market and who accepts the offer, must add the cost of the NPL to the base cost of the shares acquired under the offer under para 20(1)(c)(ix). Any capital gain or loss on exercise of the NPL is disregarded under para 58.

Note: The receipt of an NPL is not a return of capital for purposes of para 76B.

24.10 Demutualisation shares

When Sanlam Ltd and Old Mutual PLC demutualised and became listed companies in 1998 and 1999 respectively, they issued ordinary shares free of charge to their policyholders. The following should be noted when determining the base cost of demutualisation shares:

- ‘B’ in the time-apportionment base cost formulae will be nil, since no expenditure would have been incurred before valuation date in respect of the shares.
- A person who adopts the market value or weighted-average method must use the relevant prices published on the SARS website to establish a base cost for the shares (Sanlam R8,89 a share; Old Mutual R13,63 a share).
- Depending on the price at the time of disposal, the “20% of proceeds” method may give a better result. For example, if Sanlam’s share price was R80 a share at the time of disposal, the valuation date value would be R16 a share (R80 x 20%) which is higher than the market value of R8,89 a share on 1 October 2001.

24.11 Unpaid shares

Section 40(5) of the Companies Act provides as follows:

‘(5) If the consideration for any shares that are issued or to be issued is in the form of an instrument such that the value of the consideration cannot be realised by the company until a date after the time the shares are to be issued, or is in the form of an agreement for future services, future benefits or future payment by the subscribing party—

(a) . . .

(b) upon receiving the instrument or entering into the agreement, the company must—

- (i) issue the shares immediately; and
- (ii) cause the issued shares to be transferred to a third party, to be held in trust and later transferred to the subscribing party in accordance with a trust agreement.’

A trust that comes into existence for the purposes of s 40(5) would be a *bewind* trust or a vesting trust in which the subscribing party has a vested right in the shares with the result that the trust is a purely administrative vehicle. In such event, the interposition of the trust can be disregarded for CGT purposes because it will merely be acting as a quasi-agent or nominee on behalf of the subscribing party who would be the actual or beneficial owner.⁹⁰⁹ There would accordingly be no disposal when the shares are transferred by the subscribing party to the trust or when the trust transfers the shares to the subscribing party once the subscription price has been fully paid.

Section 40(6)(d)(iv) of the Companies Act provides that shares which are held in trust

- ‘(iv) to the extent that the instrument is dishonoured after becoming negotiable, or that the subscribing party has failed to fulfil its obligations under the agreement, must be returned to the company and cancelled, on demand by the company’.

The beneficiary’s right of enjoyment of the shares is thus subject to a resolutive condition under which the shares must be returned to the issuing company if the subscription price is not paid in full. Such a return and subsequent cancellation of the shares will trigger a disposal in the hands of the subscribing party. Depending on the facts, the proceeds may comprise the amount of the debt extinguished [para 35(1)(a)] plus any monies refunded to the subscriber or may be determined under para 38 if the subscriber is a connected person in relation to the company.

Paragraph 11(2)(a) will not prevent such a disposal, since the trust is not a creditor.

24.12 Payment by surety

It sometimes happens that a person (the surety) will undertake to be responsible for the debt of another (the principal debtor) should the principal debtor default. Should the principal debtor default on the debt, the creditor will look to the surety (the co-principal debtor) for payment. The question then arises whether the surety can claim a capital loss for the payment. In order to claim a capital loss, the surety must dispose of an asset. The asset in this instance consists of the right of recourse which the surety enjoys against the principal debtor. The base cost of that right under para 20(1)(a) is equal to the amount of expenditure incurred in settling the claim of the creditor.

The surety may acquire the creditor’s claim against the principal debtor through an agreement of cession but even if there is no such agreement, the surety enjoys an automatic right of recourse against the principal debtor once the creditor’s claim is settled.⁹¹⁰

⁹⁰⁹ See cases such as *Geldenhuys v CIR* 1947 (3) SA 256 (C), 14 SATC 419 at 430 in which the court held in the context of the definition of ‘gross income’ that the word ‘received’ meant ‘received by the taxpayer on his own behalf for his own benefit’, and *Taxpayer v COT Botswana* (1980) 43 SATC 118 in which the court refused to impose tax on directors’ fees paid to a director who had ceded them in advance to his employer. The legislature also deleted the superfluous para 11(2)(f), which provided that the appointment or termination of the appointment of a trustee, executor, curator or administrator was not a disposal.

⁹¹⁰ JW SCHOLTZ *et al* ‘Surety’s right of recourse’ 26 (Second Edition Replacement Volume) *LAWSA* [online] (My LexisNexis: 31 March 2015) in para 297.

In *Absa Bank Ltd v Scharrighuisen*⁹¹¹ Griesel J summed up the surety's right of recourse against the principal debtor as follows:

'It is trite law that a surety that has paid the debt of the principal debtor to the creditor has a right of recourse against the debtor. He is entitled to recover from the principal debtor whatever he was in law obliged to pay to the creditor. Ordinarily a surety is only entitled to enforce a right of recourse against the principal debtor once he has discharged the principal debt and by such discharge secured the release of the debtor.'

If the surety and the principal debtor are connected persons in relation to each other, the surety will be able to claim a capital loss only if the debtor has suffered one of the consequences listed in para 56(2).

Example – Payment of debt arising from surety

Facts:

Clinton is the sole shareholder of ABC (Pty) Ltd. He was asked to stand surety for one of the company's debts in the amount of R100 000. The company defaulted and the creditor called on Clinton to pay the R100 000 debt which he duly discharged. The company was subsequently placed in liquidation and Clinton did not receive a distribution from the company.

Result:

Clinton acquired an enforceable right of recourse against the company upon settling the creditor's claim against the company. The base cost of that enforceable right under para 20(1)(a) was the amount Clinton paid to the creditor of R100 000. The dissolution of the company resulted in a disposal of Clinton's claim against the company, and since there were no proceeds, Clinton incurred a capital loss of R100 000. Since Clinton and the company are connected persons in relation to each other, Clinton will be able to claim the capital loss only to the extent that the company suffered one of the consequences listed in para 56(2), such as the reduction in the base cost of an asset acquired with the loan from Clinton.

24.13 Employee share incentive trusts

Under s 8C(1) an employee or director must include in or deduct from his or her income any gain or loss determined under s 8C(2) on the vesting of an 'equity instrument' as defined in s 8C(7). The term 'vest' used in s 8C does not bear its common law meaning but under s 8C(3) refers to the time when all restrictions on the equity instrument are lifted. Typically, the employee or director would be restricted from disposing of the equity instrument for a number of years in order to encourage the employee or director to remain with the employer. The term 'equity instrument' includes a share or member's interest in a company, an option, a financial instrument convertible to a share or member's interest and a contractual right or obligation the value of which is determined directly or indirectly with reference to a share or member's interest.

Employee share incentive trusts operate in a variety of ways. For example, an employer may supply shares to an employee share incentive trust which in turn will dispose of the shares to employees. The shares could be sold at market value or for a consideration below market value or be vested in the employee or director for no consideration. Each of these events will trigger a disposal by the trust. Thus, a sale would fall within para 11(1)(a) while a common law vesting would fall under para 11(1)(d). These events will occur regardless of whether the shares are restricted.

⁹¹¹ 2000 (2) SA 998 (C) at 1001.

Depending on the facts and circumstances, para 38 may not apply between the share incentive trust and the employees. For para 38 to apply, the price at which the shares are disposed of must be a non-arm's length price. An arm's length price cannot always be equated with market value. For example, when the terms of an employee share incentive trust apply equally to all employees who are not relatives in relation to the employer, it may be inferred that the employees and the employer are acting at arm's length, each striving to get the most out of the transaction. The inapplicability of para 38 in such circumstances is important in preventing double taxation under both s 8C and the Eighth Schedule.

These notes discuss the law as it applies to years of assessment commencing on or after 1 March 2016. The rules in the Eighth Schedule are designed to

- defer the timing of the recognition of capital gains and losses on the disposal of equity instruments in the trust until the time when the restrictions are lifted [para 13(1)(a)(iiB)] (see **6.3.1**);
- prevent capital gains from being attributed to employees and directors from the share incentive trust [para 80(1) and (2A)] (see **14.11.4** and **14.11.6.1**);
- prevent capital gains and losses when one restricted equity instrument is exchanged for another restricted equity instrument under s 8C(4)(a), when a restricted equity instrument is disposed of at a non-arm's length price or to a connected person under s 8C(5)(a), or to an employer or associated institution at a price below market value under s 8C(5)(c) [para 64C] (see **12.20**);
- prevent a capital gain arising in a trust when the equivalent amount is taxed in the hands of the trust beneficiary (this relates to so-called 'phantom' share schemes) (see **12.16B**); and
- determine the base cost of the equity instruments when the restrictions are lifted [para 20(1)(h)(i)] (see **8.13**).

In an unreported case⁹¹² the appellant, a holding company, sought to claim capital losses incurred in the 2007 to 2013 years of assessment by its employee share incentive scheme trust.

On instruction from the appellant, the trust would grant selected employees of the appellant options to acquire shares in that company at a strike price. When an employee exercised an option to acquire shares, the trust would purchase the shares on loan account from the appellant. When the employee paid the trust the strike price, the shares would be disposed of to the employee. Usually there would be a shortfall in the trust because the strike price would be less than the price paid by the trust. The appellant would make good this shortfall, and in the process would incur losses. The loss in the trust was made good by writing off the balance on the appellant's loan account. The trust itself never suffered any losses because any shortfall was borne by the appellant.

The appellant argued that it acquired an asset in the form of a claim for performance against the trust. This personal right comprised the right to require the trustees of the Trust to make offers to the employees and to deliver the shares upon exercise of the options. The base cost of the right was equal to the amount of the shortfall and when the right was disposed of through performance there would be no proceeds, resulting in a capital loss.

⁹¹² Case 13798/13931/14294, Gauteng Tax Court, 17 September 2019, unreported.

The court noted that personal rights came in two forms, namely

- *Jus in personam ad rem acquirendam* (right to claim delivery of a thing); and
- *jus in personam ad faciendum* (a right to claim performance or an act).

Adams J stated the following:⁹¹³

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

‘A proprietary or real right is often defined as a legally protectable interest which a person has in or to property against other persons, for example ownership, servitude on land or immaterial (intellectual) property rights. As I indicated above, proprietary rights are to be distinguished from personal rights, which are a person’s claim against another to performance on the strength of an obligation which stems from a contract.

‘My understanding of the case of the taxpayer is that the right specified above itself constitutes the asset. I accept that a right, whether personal or real, is an asset if regard is had to our common law principles. However, in my judgment a personal right is not an asset as defined in the Eighth Schedule. It is based on contract and is not in any way attached to or related to property. For this reason alone, the appeal should fail.’

The judge concluded that the personal right (claim for performance) was not an asset for CGT purposes, and that the appellant had failed to prove that it was extinguished through the granting of the option or that expenditure was incurred in respect of the personal right.

On the question of personal rights constituting assets for CGT purposes, see **4.1.2.5**.

In *C: SARS v Spur Group (Pty) Ltd*⁹¹⁴ the respondent, a wholly owned subsidiary of Spur Holdco, made a contribution of R48 million to a share incentive trust. The trust was established for the purpose of incentivising the respondent’s key managerial staff. At the outset Spur Holdco was the sole capital and income beneficiary of the trust, although other beneficiaries were later added. The trust used the contribution to subscribe for preference shares in Newco and Newco used the funds to acquire shares in Spur Holdco. Ordinary shares were then issued by Newco to the participants. At this point the ordinary shares would not have had a high value because the preference shares would have been first in line to be repaid, so in essence the ordinary shares entitled the holders to the future growth in Spur Holdco. Five years later, after substantial growth in the value of the Spur Holdco shares, the preference shares were redeemed by Newco for R48 million by using some of the Spur Holdco shares, and this amount was vested by the trust in Spur Holdco as sole beneficiary together with preference dividends of R22 million. The remaining Spur Holdco shares held by Newco were then sold for cash and presumably distributed to the participants together with ordinary dividends. The respondent claimed the contribution to the trust as a deduction under s 11(a) but spread it over seven years under s 23H. The capital or revenue nature of the contribution was not in dispute but SARS argued that it was not in the production of income because it ended up with the respondent’s holding company, Spur Holdco. In a majority judgment the court dismissed the appeal, holding that the purpose of the contribution was to incentivise the employees of the respondent, and hence was in the production of income. The minority judgment found that the contribution was retained within the group and was not in the production of income.

⁹¹³ In paras [82], [83] and [85].

⁹¹⁴ (2019) 82 SATC 180 (WC).

Example 1 – Determination of s 8C gain on sale of equity instrument*Facts:*

The ABC Employee Share Incentive Trust acquired 100 000 shares in ABC Ltd at a cost of 80 cents a share.

On 1 March 2014 Jackie, an employee of ABC Ltd, acquired 100 ABC Ltd shares from the ABC Employee Share Incentive Trust at a cost of R100. Jackie was not permitted to dispose of the shares before 1 March 2019. On 1 March 2019 the shares had a market value of R150. Jackie sold the shares for R180 on 31 August 2019.

*Result:**ABC Employee Share Incentive Trust*

The ABC Employee Share Incentive Trust realised a gain of R20 [R100 (proceeds) – R80 (base cost)] on the sale of the shares under para 11(1)(a) which must be brought to account on 1 March 2019 under para 13(1)(a)(iiB). This capital gain is not attributed to Jackie under para 80(1) because that provision excludes a person who acquires an asset as an equity instrument as contemplated in s 8C(1).

Jackie

On 1 March 2019 Jackie realised a s 8C gain of R50 [R150 (market value of share when the restriction was lifted) – R100 (cost of shares)] which must be included in her income under s 8C(2). On 31 August 2019 Jackie realised a capital gain of R30 [R180 (proceeds) – R150 (base cost under para 20(1)(h)(i))].

Example 2 – Determination of s 8C gain on sale of equity instrument acquired at a discount*Facts:*

The DEF Employee Share Incentive Trust acquired 100 000 shares in DEF Ltd at a cost of 80 cents a share.

On 1 March 2014 Patricia, an employee of DEF Ltd, acquired 100 DEF Ltd shares from the DEF Employee Share Incentive Trust at a discounted price of 90 cents a share. The market value of the shares at the time was R100. All employees qualified to acquire shares in this manner provided they met specified requirements. Patricia was not permitted to dispose of the shares before 1 March 2019. On 1 March 2019 the shares had a market value of R150. Patricia sold the shares for R180 on 31 August 2019.

*Result:**DEF Employee Share Incentive Trust*

The DEF Employee Share Incentive Trust realised a capital gain of R10 [R90 (proceeds) – R80 (base cost)] on the disposal of the shares under para 11(1)(a) which must be brought to account on 1 March 2019 under para 13(1)(a)(iiB). It is assumed that para 38 does not apply on the basis that the discounted consideration of R90 was an arm's length price negotiated with all employees. The capital gain in the trust is therefore based on the actual discounted consideration of R90.

Patricia

On 1 March 2019 Patricia realised a s 8C gain of R60 [R150 (market value of share when the restriction was lifted) – R90 (cost of shares)] which must be included in her income under s 8C(2). On 31 August 2019 Patricia realised a capital gain of R30 [R180 (proceeds) – R150 (base cost under para 20(1)(h)(i)]. It is likewise assumed that para 38 did not apply to Patricia on the basis that she acted at arm's length.

Example 3 – Determination of s 8C gain on sale of equity instrument acquired for no consideration*Facts:*

The XYZ Employee Share Incentive Trust acquired 100 000 shares in XYZ Ltd at a cost of 80 cents a share.

On 1 March 2014 Joy, an employee of XYZ Ltd, acquired 100 XYZ Ltd shares from the XYZ Employee Share Incentive Trust for no consideration. The market value of the shares at the time was R100. All employees qualified to acquire shares in this manner provided they met specified requirements. Joy was not permitted to dispose of the shares before 1 March 2019. On 1 March 2019 the shares had a market value of R150. Joy sold the shares for R180 on 31 August 2019.

*Result:**XYZ Employee Share Incentive Trust*

The XYZ Employee Share Incentive Trust realised a loss of R80 [RNil (proceeds) – R80 (base cost)] on the disposal of the shares under para 11(1)(d) which must be brought to account on 1 March 2019 under para 13(1)(a)(iiB). This capital loss is not clogged by virtue of para 39(4) (see 9.5.5). It is assumed that para 38 does not apply on the basis that the nil consideration was an arm's length price negotiated with all employees.

Joy

On 1 March 2019 Joy realised a s 8C gain of R150 [R150 (market value of share when the restriction was lifted) – RNil (cost of shares)] which must be included in her income under s 8C(2). On 31 August 2019 Joy realised a capital gain of R30 [R180 (proceeds) – R150 (base cost under para 20(1)(h)(i)]. It is likewise assumed that para 38 did not apply to Joy on the basis that she acted at arm's length.

Example 4 – Contribution to employee share incentive trust*Facts:*

Company X established the X Employee Share Incentive Trust for the benefit of its employees. In accordance with the trust deed, Company X contributed capital of R10 million to the trust in order to enable the trust to buy shares on the open market and to pay its running expenses. The shares so acquired will be awarded to qualifying employees for no consideration. After being awarded, the shares are subject to a restriction in that they may not be disposed of by the employees for five years. During this time the shares are held in the trust.

At the beginning of year 1 the trust purchased shares to the value of R8 million and vested them in qualifying employees. All employees qualified under the terms of the incentive arrangement and the shares were ultimately distributed to them at the end of year 5 when the market value of the shares was R14 million.

Result:

Company X

The contribution by Company X of R10 million to the trust triggers the incurrance of an employment-related expense. While such expenditure is generally deductible under s 11(a), this may not be so if the payment results in an enduring benefit, since this may result in the expenditure being of a capital nature. If the expenditure is not of a capital nature, s 23H may need to be considered.

The withdrawal of the funds from the company's bank account triggers a part-disposal of the bank account (more properly, the right to claim the amount owed by the bank). The consideration takes the form of settled conditions of employment and a contented workforce. It is not possible to accurately measure this consideration, and hence it is not measurable in money. Consequently, para 38(1)(a) deems the company to derive proceeds equal to market value of R10 million. Since the base cost of the bank account is likely to also be R10 million, neither a capital gain nor a capital loss should arise from the part-disposal.

The X Employee Share Incentive trust

The amount deposited into the trust's bank account has a base cost of R10 million under para 38(1)(b).

The withdrawal of R8 million from the trust's bank account to pay for the shares triggers a part-disposal of the bank account (more properly, the right to claim the amount owed by the bank). The proceeds from this part-disposal are equal to R8 million under para 35(1)(a), being equal to the liability discharged in respect of the purchase of the shares. The portion of the base cost allocated to the part-disposal is also R8 million and no capital gain nor capital loss therefore arises.

The shares have a base cost of R8 million, being the expenditure incurred under para 20 on their acquisition.

The time of disposal of the shares under para 13(1)(a)(iiB) is the date of vesting contemplated in s 8C at the end of year 5 when the restrictions are lifted. At this time the trust will realise a capital loss, which is not clogged by virtue of para 39(4), of R8 million as it will receive no proceeds, having awarded the shares for no consideration to the employees who are connected persons in relation to the trust. It is assumed that no consideration is an arm's length price in the circumstances, with all employees having negotiated their conditions of employment at arm's length, and hence para 38 will not apply to the trust.

The employees

The employees collectively must include R14 million in their income under s 8C, being equal to the market value of the shares on that date. Going forward, the shares will have a collective base cost of R14 million for the employees under para 20(1)(h)(i).

24.14 Shares in venture capital companies

Section 12J

For detailed commentary on all aspects of s 12J, see the *Guide to Venture Capital Companies*. These notes address some of the main CGT issues relating to an investment in shares in a venture capital company. As a result of various factors, especially the timing of transactions, the commentary below should be used for general guidance only. Ultimately the facts of a particular instance will need to be considered when determining a capital gain or loss on disposal of venture capital shares.

Treatment of expenditure and amounts received or accrued under s 12J

Under specified conditions a person is entitled to a deduction from income under s 12J(2) for expenditure incurred in acquiring a venture capital share⁹¹⁵ issued by a venture capital company.⁹¹⁶ The deduction is limited to R2,5 million for an individual or a trust and R5 million for a company during a year of assessment.⁹¹⁷

These limits do not apply to venture capital shares acquired before 21 July 2019. For example, an individual could have acquired shares at a cost of R10 million in June 2019 and could then have acquired up to R2,5 million of further venture capital shares on or before 29 February 2020. In subsequent years of assessment, the limits will apply to a full year of assessment.

Should a person subscribe for venture capital shares in excess of these limits during a year of assessment, the first shares acquired on or after 21 July 2019 must be treated as having used the limit for the particular year of assessment. In this regard it must be emphasised that each share is a separate asset. For example, assume that an individual not holding any pre-existing venture capital shares subscribes for R2,5 million shares in Venture Capital Company 1 in January 2020 and then buys a further R1 million shares in Venture Capital Company 2 in February 2020. In these circumstances the shares in Venture Capital Company 1 will qualify for deduction under s 12J(2) while the shares in Venture Capital Company 2 will not qualify.

An individual not owning any pre-existing venture capital shares who subscribes for, say, venture capital shares of R5 million at the same time will need to allocate the shares between those that qualify and those that do not, on the basis that each share is a separate asset. An individual who acquired a single share for R3 million during a year of assessment on or after 21 July 2019 will be able to claim only R2,5 million under s 12J(2), and this fact will need to be taken into account when determining any recoupment should the share be sold before five years has elapsed.

Under s 12J(9) no amount shall be recovered or recouped under s 8(4)(a) in respect of the disposal of a venture capital share or in respect of a return of capital if that share has been held by the taxpayer for a period longer than five years. By default, the deductible expenditure on a venture capital share will potentially be subject to recovery or recoupment under s 8(4)(a) if disposed of on or before the elapse of five years or if a return of capital is received or accrued on or before the elapse of five years.

⁹¹⁵ As defined in s 12J(1).

⁹¹⁶ As defined in s 12J(1).

⁹¹⁷ These limits apply to expenditure incurred by a taxpayer on or after 21 July 2019. See s 12J(3C).

Treatment under s 9C

Section 9C(2) contains a safe-haven rule for equity shares which deems them to be on capital account if they are held for at least three years. More specifically, it provides that any amount received or accrued (other than a dividend or foreign dividend) or any expenditure incurred in respect of an equity share must be deemed to be of a capital nature if that equity share had, at the time of the receipt or accrual of that amount or incurral of that expenditure, been held for a period of at least three years. This rule is, however, qualified by s 9C(2A) which provides that s 9C(2) does not apply in respect of so much of the amount received or accrued in respect of the disposal of an equity share contemplated in that subsection, other than an equity share held for longer than five years, as does not exceed the expenditure allowed in respect of that share under s 12J(2). In other words, during years 4 and 5 s 9C(2) applies only to the portion of the amount received or accrued that exceeds the deductible expenditure, with the portion equal to or less than the deductible expenditure being subject to recoupment under s 8(4)(a). It would seem that s 9C(2A) is unnecessary, since even if s 9C(2) did apply to a disposal of venture capital shares or a return of capital in years 4 and 5, it would not have prevented a recoupment under s 8(4)(a). A recoupment under s 8(4)(a) is included under the special inclusion in para (n) of the definition of 'gross income' and the words preceding the special inclusions apply 'whether of a capital nature or not'.

The table below summarises the position.

Table – Disposal of venture capital shares or receipt or accrual of return of capital

Year disposed of or return of capital received or accrued	Treatment of receipt or accrual
1 to 3	<p>The portion of the amount received or accrued that does not exceed the deductible cost of acquisition is potentially subject to recoupment under s 8(4)(a) and included in income.</p> <p>The portion of the receipt or accrual that exceeds the cost of acquisition could be of a capital or revenue nature, depending on whether the shares were acquired as trading stock or as capital assets. Section 9C does not apply during this period. The capital or revenue nature of the excess must therefore be determined according to common law principles.</p>

4 and 5	<p>The portion of the amount received or accrued that does not exceed the deductible cost of acquisition is subject to potential recoupment under s 8(4)(a) and included in income.</p> <p>The portion of the receipt or accrual that exceeds the deductible cost of acquisition is deemed to be of a capital nature under s 9C(2).</p>
6 and beyond	<p>No further recoupment of the cost of acquisition applies under s 8(4)(a) by virtue of s 12J(9).</p> <p>Any amount received or accrued on disposal of a venture capital share or as a return of capital will be of a capital nature under s 9C(2).</p>

Note: Section 9C applies when an equity share has been held for at least three years (from the last day of year 3 and beyond). Therefore, the reference to years 1 to 3 in the above table excludes the last day of year 3.

By contrast, s 12J(9) applies when an equity share has been held for longer than five years (from the first day of year 6 and beyond).

Base cost of venture capital shares

Paragraph 20(1)(a) includes in the base cost of an asset the expenditure actually incurred in respect of the cost of acquisition of that asset. In the current context this would include the cost of subscribing for venture capital shares.

However, para 20(3)(a) then provides that the expenditure contemplated in para 20(1)(a) incurred by a person in respect of an asset must be reduced by any amount which is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of that person. In other words, the cost of acquiring the venture capital shares will be added to base cost under para 20(1)(a) but must then be reduced to the extent that it has been allowed as a deduction under s 12J(2). For example, an individual who subscribed for venture capital shares at a cost of R3 million on or after 21 July 2019 will have a base cost of R500 000 (R3 million acquisition cost – R2 500 000 amount deductible under s 12J). Before that date the person's base cost would have been nil because the deduction was unlimited.

Proceeds on disposal of venture capital shares

For present purposes the proceeds on disposal of an asset by a person are equal to the amount received or accrued in respect of the disposal reduced by any amount of those proceeds that were included in gross income. A person that disposes of venture capital shares on or before five years has elapsed must recoup the deductible cost of acquisition of the shares under s 12J(2) and include that amount in income under s 8(4)(a). For example, if the person subscribed for shares at a cost of R1 million which qualified for deduction under s 12J(2) and sold them for R1,3 million in year 4, the proceeds will be R300 000 [R1,3 million

received or accrued – R1 million recoupment included in income (para 35(3)(a)). Since the shares have been held for at least three years, the amount of R300 000 is deemed to be of a capital nature under s 9C(2) (see Table 1 above).

Any amount received or accrued in respect of the disposal of venture capital shares after five years will be fully on capital account under s 9C and will comprise the proceeds under para 35. In this regard s 12J(9) turns off the recoupment after the elapse of five years.

A taxpayer that sells venture capital shares that have been held for at least three years but for five years or less will suffer a potential recoupment under s 8(4)(a) of the deductible cost of acquisition under s 12J(2). The amount received or accrued on disposal of the shares less the amount recouped under s 8(4)(a) will be deemed to be on capital account under s 9C(2) and will comprise the proceeds under para 35.

A taxpayer that sells venture capital shares held for less than three years will suffer a potential recoupment of the deductible acquisition cost under s 8(4)(a). The capital or revenue nature of any amount received or accrued in excess of the amount recouped must be determined according to common law principles, since s 9C(2) is inapplicable. To the extent that the excess is of a capital nature, it will comprise the proceeds under para 35, and to the extent it is on revenue account, it must be included in gross income and will be excluded from proceeds under para 35(3)(a).

Example – Application of s 9C(2A) to disposal of venture capital shares

Facts:

Company A, which has a financial year ending on the last day of February, acquired shares in an approved VCC on 1 March 2016 for R400 000. On 30 September 2019 Company A sold the shares for R900 000.

Result:

Ordinary income

2017 year of assessment

Company A qualified for a deduction of R400 000 under section 12J(2).

2020 year of assessment

Upon disposal of the shares, R400 000 was recouped under s 8(4)(a) [that is, the amount previously allowed as a deduction under s 12J(2)].

The amount deemed to be of a capital nature under s 9C is equal to the amount received or accrued in excess of the amount recouped under s 8(4)(a), namely, R500 000 (R900 000 – R400 000). This amount is subject to CGT.

<i>CGT</i>	R	R
Amount received or accrued		900 000
<i>Less: Amount recouped under s 8(4)(a) [para 35(3)(a)]</i>		(400 000)
Proceeds		500 000
<i>Less: Base cost</i>		
Cost	400 000	
<i>Less: Deduction under s 12J(2) [para 20(3)(a)]</i>	<u>(400 000)</u>	-
Capital gain		<u>500 000</u>
Taxable capital gain (80% × R500 000)	400 000	

Note: Had the disposal occurred after the shares had been held for longer than five years, there would be no recoupment under s 8(4)(a) by virtue of s 12J(9). Therefore, if in this example the shares were sold for the same amount on 30 June 2021 (a holding period of five years and four months), there would be a capital gain of R900 000 and a taxable capital gain of R720 000 (R900 000 × 80%).

Returns of capital

A return of capital received or accrued after five years will be on capital account under s 9C(2) and must be dealt with under para 76B as a reduction in base cost. If the base cost is nil, the return of capital will generate a capital gain under para 76B(3).⁹¹⁸

A return of capital received or accrued on shares held for a period not exceeding five years will be subject to potential recoupment under s 8(4)(a) read with s 12J(9). Since s 8(4)(a) takes precedence in this instance, such a return of capital that has been included in income should not be applied in reduction of the base cost of the shares under para 76B.

A return of capital received or accrued once a share has been held for at least three years will be on capital account under s 9C(2), subject to potentially being included in income under s 8(4)(a) before the elapse of five years.¹⁵

24.15 Government grants

The rules relating to the tax treatment of government grants principally involve

- para (1C) of the definition of 'gross income' in s 1(1);
- s 12P;
- the Eleventh Schedule; and
- para 20(3)(b)(ii).

Before the insertion of para (1C) in the definition of 'gross income',⁹¹⁹ it was necessary in the first instance to determine whether a government grant was of a capital nature. If it was, it was excluded from gross income and fell to be dealt with under the Eighth Schedule. Determining whether a government grant was of a capital or revenue nature was not always an easy task, as illustrated by the various foreign cases examined in Interpretation Note 59 dated 10 December 2010 'Tax Implications of the Receipt or Accrual of Government Grants and

⁹¹⁸ This will be the position, for example, when the acquisition cost qualified in full as a deduction, since the base cost would be reduced to nil under para 20(3)(a).

⁹¹⁹ Inserted by s 5(1)(d) of the Taxation Laws Amendment Act 15 of 2016 promulgated on 19 January 2017, which was the effective date of the insertion.

Government Scrapping Payments’ in 3.2.1 to 3.2.5. See also *Volkswagen South Africa (Pty) Ltd v C: SARS*⁹²⁰ which is examined in 2.4.1.21. This case confirmed the principle that the capital or revenue nature of a government grant is established by ascertaining its purpose.

The insertion of the special inclusion in gross income of para (I)C obviated the need to traverse the tricky terrain of the capital or revenue nature of government grants. On or after 19 January 2017 all government grants are gross income and it then remains to determine whether they are exempt from normal tax under s 12P read with the Eleventh Schedule. The Eleventh Schedule comprises a list of tax-exempt government grants.

Paragraph (I)C includes in gross income

‘any amount received by or accrued to a person by way of a government grant as defined in section 12P’.

Section 12P(1) defines a government grant to mean

‘a grant-in-aid, subsidy or contribution by the government of the Republic in the national, provincial or local sphere’.

Paragraph 20(3)(b)(ii) prevents the reduction of base cost under para 20(3)(b) when s 12P applies. This exclusion from para 20(3)(b) is intended to prevent a double reduction in base cost.

Section 12P(2) exempts from normal tax a government grant listed in the Eleventh Schedule or a grant identified for exemption by the Minister in the *Gazette*.

Section 12P(2A) exempts from normal tax an amount granted by the government to enable the fulfilment of a person’s obligations under a public private partnership (PPP). Under the PPP, the person must be required to spend at least an amount equal to the grant on improvements to land or buildings held by any sphere of government or on a servitude held by such sphere. This exemption does not require the grant to fall within the Eleventh Schedule.

Section 12P(3) stipulates how a government grant (other than a government grant in kind) for the acquisition, creation or improvement, or as a reimbursement for expenditure incurred in respect of the acquisition, creation or improvement of trading stock or an allowance asset must be dealt with. Such a grant must be applied, when applicable, in reduction of

- the cost price of trading stock [s 11(a)], including opening stock [s 22(2)] and closing stock [s 22(1)]; and
- the base cost of an allowance asset.

The terms ‘allowance asset’ and ‘base cost’ are defined in s 12P(1) as follows:

‘ “[A]llowance asset” means an asset as defined in paragraph 1 of the Eighth Schedule, other than trading stock, in respect of which a deduction or allowance is allowable in terms of this Act for purposes other than the determination of any capital gain or capital loss;

“base cost” means base cost as defined in paragraph 1 of the Eighth Schedule;’

⁹²⁰ [2018] 1 All SA 716 (SCA), 80 SATC 179.

Example 1 – Receipt of an exempt government grant in respect of an allowance asset*Facts:*

Hilde purchased a machine to be used in a manufacturing process for R5 million in the 2020 year of assessment. Under s 12C(1) she deducted a capital allowance of R1 million (20% of the cost to the taxpayer) for the 2020 year of assessment. Later in the same year of assessment, she was awarded a government grant of R4 million in part-reimbursement of the cost of the machine. This government grant was exempt from normal tax under section 12P(2). The asset was disposed of shortly before the end of the 2020 year of assessment for R4,5 million.

*Result:**2020 year of assessment**Base cost:*

	R
Cost of acquisition	5 000 000
Less: Section 12C allowance R5 000 000 × 20% [para 20(3)(a)]	<u>(1 000 000)</u>
Base cost under para 20 before applying s 12P(3)	4 000 000
Less: reduction in base cost [s 12P(3)(b)]	<u>(4 000 000)</u>
Adjusted base cost	<u>Nil</u>

Recoupment:

Cost of acquisition	5 000 000
Less: Section 12C allowance	(1 000 000)
Tax value	4 000 000
Amount received or accrued on disposal	<u>(4 500 000)</u>
Recoupment under s 8(4)(a)	<u>500 000</u>

Calculation of capital gain:

Proceeds [para 35(1)] (R4 500 000 – R500 000)	4 000 000
Less: base cost	<u>(Nil)</u>
Capital gain	4 000 000

Section 12P(4) limits the deductions or allowances that can be claimed on an allowance asset in respect of which a government grant has been received or accrued for its acquisition, creation or improvement or as a reimbursement for expenditure incurred in respect of its acquisition, creation or improvement. The allowances may not exceed an amount equal to the aggregate of the expenditure incurred in the acquisition, creation or improvement of the allowance asset, reduced by an amount equal to the sum of

- the amount of the government grant; and
- the aggregate amount of all deductions and allowances previously allowed to that person in respect of that allowance asset.

Section 12P(5) provides that if any amount is received by or accrues to a person by way of a government grant contemplated in s 12P(2) or (2A) (other than a government grant in kind) for the acquisition, creation, or improvement of an asset (other than trading stock or an allowance asset) or to reimburse expenses so incurred, the base cost of the asset must be reduced by the government grant to the extent that it is applied for that purpose.

Example 2 – Receipt of an exempt government grant in respect of a capital asset that is not an allowance asset

Facts:

Gigi purchased land for R3 million in the 2019 year of assessment. In the 2020 year of assessment she was awarded a government grant of R2 million in partial reimbursement of the cost of the land. The government grant was exempt from normal tax under s 12P(2).

Result:

The base cost of the capital asset must be reduced by the exempt government grant under s 12P(5) and will then have a base cost of R1 million (R3 million – R2 million).

Section 12P(6) deals with any remaining portion of a government grant (other than a grant in kind) not applied against trading stock, an allowance asset or a capital asset. Such a grant is required to be applied in reduction of any s 11 allowable expenditure. To the extent there is an excess, it is deemed to be a government grant received or accrued in the next year of assessment.

Government grants in kind

A government grant in kind falls within the ambit of the definition of “government grant” in s 12P(1). Under s 12P(2) a government grant in kind is exempt from normal tax if received by or accrued to a person as a beneficiary listed in the Eleventh Schedule or identified by the Minister by notice in the *Gazette*. It is unlikely that s 12P(2A) envisages a government grant in kind, since the amount received or accrued must be expended in effecting improvements to land or buildings.

Section 12P(3), (5) and (6) do not apply to government grants awarded in kind.

A government grant in kind consists of an amount in a form other than cash, for example, an asset given to a taxpayer by the government.

Inclusion in gross income

Paragraphs (i) and (ii) of the definition of ‘gross income’ include the total amount, in cash or otherwise, received by or accrued to a person. The words following these paragraphs exclude receipts or accruals of a capital nature. However, the special inclusions which follow that exclusion include ‘such amounts (whether of a capital nature or not)’. Thus, a government grant in kind referred to in para (1C) of the special inclusions comprises an amount otherwise than in cash for the purposes of the definition of ‘gross income’, and is included in gross income regardless of whether it is of a capital nature.

Expenditure must be actually incurred [s 11(a)]

Section 11(a) provides, amongst other things, that for expenditure to be deductible, it must be 'actually incurred' by the taxpayer. The receipt or accrual of a government grant in kind without any *quid pro quo* does not result in the incurral of an expense by the taxpayer, and the value of the grant in kind will therefore not be allowed as a deduction under s 11(a).

Base cost of an asset received as a government grant in kind [para 20(1)(a)]

The base cost of an asset acquired by way of a government grant in kind must be established under para 20(1)(a) by applying the barter or exchange principles explained in 8.5. Upon approval of the grant, the grantee acquires a personal right to claim the asset at a future date. When the asset is delivered, the personal right to claim the asset is extinguished and it is this extinction which establishes the expenditure for the asset. The market value of the government grant must be included in gross income, which results in the reduction of the proceeds under para 35(3)(a) on disposal of the personal right to claim delivery.

Example 3 – Base cost of an asset received as a government grant in kind*Facts:*

Stanley applied for a government grant in kind comprising a machine. No expenditure was incurred in applying for the grant. The grant was approved and the government subsequently delivered the machine to Stanley. The market value of the machine on the date of delivery was R1 million.

Result:

At the time that the government grant in kind was approved, Stanley obtained a personal right to the asset. This right constitutes an asset for purposes of the Eighth Schedule (definition of 'asset' in para 1). The receipt of the asset triggers the disposal of the personal right to claim delivery of it. The CGT consequences of the disposal of the personal right are as follows:

Proceeds on disposal of personal right to claim delivery:

	R
Market value of machine	1 000 000
Less: Amount included in gross income [para 35(3)(a)]	<u>(1 000 000)</u>
Proceeds for CGT purposes	<u>Nil</u>

Determination of capital gain or loss on disposal of personal right:

Proceeds (paragraph 35)	Nil
Less: Base cost of personal right (no outlay)	<u>(Nil)</u>
Capital gain	<u>Nil</u>

Base cost of machine:

The base cost of the machine is equal to the market value of the personal right to claim delivery of the machine immediately before the personal right is extinguished, namely, R1 million. The personal right is extinguished when delivery occurs.

Appendix A – Transfer of a residence from a company or trust (2002)

These notes relate to certain (now obsolete) CGT, STC and transfer duty relief measures that applied to the acquisition by a natural person of a primary residence from a company or trust between 1 October 2001 and 30 September 2002. The commentary has been retained because it may still be relevant in establishing the base cost of a primary residence which was the subject of such a transfer.

A.1 Introduction

The Eighth Schedule provides that only *natural persons* (individuals) are entitled to exclude the first R1 million of gains on disposal of their primary residences. This exclusion does not apply when the residence is owned by a company, close corporation or trust.

Many individuals have historically purchased their residences in companies or trusts for a variety of reasons, including protection from creditors, avoidance of transfer duty and estate duty and circumvention of the Group Areas Act. These persons now face a potential CGT liability when their company, close corporation or trust disposes of the residence.

In the notes that follow the term ‘company’ will also be used to refer to a close corporation.

Following representations, the draft legislation was amended to allow individuals a window of opportunity to transfer their residences out of their companies or trusts into their own names without incurring any adverse tax consequences. Set out below are details of what is exempt and the conditions that need to be satisfied to secure a tax-free transfer.

A.2 Taxes qualifying for exemption

The relevant provisions offer exemption from

- transfer duty on the transfer of the residence;
- stamp duty on the registration of a mortgage bond and transfer of shares in a share block company;
- secondary tax on companies in respect of any dividend arising in consequence of the transfer; and
- capital gains tax on any gain realised by the company or trust.

A.3 The transfer duty exemption

The transfer duty exemption requirements are in s 9 of the Transfer Duty Act 40 of 1949. Section 9(16) deals with companies and s 9(17) with trusts.

The natural person requirement

An individual must acquire the residence.

The primary residence requirement after acquisition

After acquisition, the residence must constitute the individual’s ‘primary residence’ for CGT purposes.

When can the property be acquired?

Sections 9(16)(a) and 9(17)(a)

The acquisition must take place between

- 20 June 2001 (date of promulgation of the Taxation Laws Amendment Act 5 of 2001; and
- 30 September 2002.

The 100% direct shareholding requirement

Section 9(16)(b)

The individual alone or together with his or her spouse must directly hold all the share capital of the company or member's interest in the close corporation, between

- 5 April 2001; and
- the date of registration in the deeds registry.

The concession, therefore, does not apply when

- the residence is held by a subsidiary company;
- the shares in the company holding the residence are owned by a trust; or
- more than one person holds the shares and those persons are not spouses.

A residence held by a company cannot be transferred into the name of a spouse holding no shares. For example, if the husband holds all the shares, he cannot transfer the residence into his wife's name. But if they each hold some shares which together make up the total issued share capital, the residence can be transferred into either spouse's name or into their names jointly.

Assuming that there are two spouses, A and B who are married out of community of property, the table below shows into whose name the residence may be transferred:

Shareholders	Residence may be transferred into the name of
A owns 100%	A
A and B jointly own 100%	A, B or A and B jointly.

Trusts: The donation or financing requirement

Section 9(17)(b)

The individual must have either:

- disposed of the residence to the trust by way of donation, settlement or other disposition; or
- financed all the expenditure actually incurred by the trust to acquire and to improve the residence.

If only part of the expenditure was financed by the individual taking transfer, the exemption will not apply – as in the example, of a third party paying for the addition of a room to the residence. 'All the expenditure' means 100% of it.

Assuming that there are two spouses, A and B who are married out of community of property, the table below shows into whose name the residence may be transferred:

Spouses who donated the residence or financed all the expenditure	Residence may be transferred into the name of
A only	A, or A and B jointly
A and B jointly	A and B jointly

If a bond was obtained by the trust to finance the acquisition and improvement of the residence, the person who financed the interest on the bond and its repayment will be regarded as having financed that expenditure.

It sometimes happens that taxpayers purchase their residences by taking over a trust. The person and or that person's spouse become the new trustees and beneficiaries. The validity of these schemes, which purport to avoid transfer duty, is not accepted by SARS. Taxpayers who have acquired their residences in this manner will not qualify for the exemption, since they would not be the original financiers of the expenditure.

The residence and use requirement

Sections 9(16)(c) and 9(17)(c)

Between 5 April 2001 and the date of registration the individual or his or her spouse must have

- ordinarily resided in the residence; and
- used it mainly for domestic purposes.

as his or her or their ordinary residence

Individuals acquiring their residences in a company or trust after 5 April 2001 will not qualify for the exemption.

Final date for registration in the Deeds Office

Sections 9(16)(d) and 9(17)(d)

The last day for registration in the Deeds Office is 31 March 2003.

Transfer of land with a residence

Provisos to s 9(16) and (17) read with para 46

The exemption applies in respect of the portion of the land on which the residence is situated and unconsolidated adjacent land that meets these requirements:

The 2-hectare limit

The exemption does not apply to land that exceeds two hectares.

The use requirement

Any land transferred must be used mainly for domestic or private purposes together with the residence from 5 April 2001 to the date of registration.

The simultaneous transfer requirement

Any land transferred must be disposed of at the same time and to the same person as the residence.

A.4 The stamp duty exemption

Schedule 1 to the Stamp Duties Act 77 of 1968 provides exemption for the following:

Mortgage bonds

Item 7(e)

No stamp duty will be payable when

- a new bond is taken out by the individual acquiring the residence;
- the individual takes over an existing bond from the company (substitution of a debtor);
- the bond is ceded from one lender to another (for example, Bank A transfers the bond to Bank B).

Shares in a share block company

Item 15(v)

If

- the residence is held by a share block company, and
- the shares in that share block company are held by a company or trust,

the transfer of those shares from the company or trust to the individual will be exempt from stamp duty.

These stamp duty exemptions are subject to the same conditions as the transfer duty exemption and also came into effect on 20 June 2001.

A.5 The STC exemption

Methods of disposal qualifying for exemption

No STC will be payable when the interest in a residence is

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

Applicable to transfer of shares in a share block company

The distribution of shares in a share block company will also qualify for the exemption.

Timing of distribution

The interest in the residence must have been distributed or disposed of on or before 30 September 2002

The distribution of the capital profits must be completed on or before 31 March 2003.

Other requirements

The other requirements pertaining to the transfer duty exemption apply equally to the STC exemption. For example, the exemption will not apply to the portion of a property that exceeds two hectares. In such a case it may be necessary to liquidate or deregister the company in order to extract any capital profit STC free (s 64B(5)(c) of the Income Tax Act).

Example – The STC exemption [s 64B(5)(k)]*Facts:*

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

	R
Share capital – 2 shares of R1 each	2
Non-distributable reserve	250 000
Shareholder's loan	<u>249 998</u>
	<u>500 000</u>
Property – at market value	500 000

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

Result:

Section 64B(5)(k) should be applied in conjunction with the following provisions:

- Section 9(16) or (17) of the Transfer Duty Act 40 of 1949 – which enables a primary residence to be transferred from a company or trust free of transfer duty.
- Item 7(e) of the First Schedule to the Stamp Duties Act 77 of 1968 – which enables a stamp duty-free transfer of a mortgage bond.
- Paragraph 51 of the Eighth Schedule – which stipulates that the residence must be treated as having been disposed of at market value on 1 October 2001. Since the market value of the property on 1 October 2001 will constitute its base cost, no capital gain or capital loss will arise in the company.
- The company's memorandum and articles of association – which will have to be examined to determine whether there are any restrictions on the distribution of capital surpluses.

Alternative 1: Distribute property in specie – s 64B(5)(k)(i)

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

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

Alternative 2: Sell property – s 64B(5)(k)(ii)

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

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

A.6 The CGT exemption

Paragraph 51

Under para 51(1) when an interest in a residence has been transferred from a company or trust to a natural person

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

Unlike other provisions of the Eighth Schedule, para 51(1)(b) does not deem the market value to be a cost incurred and paid for the purposes of para 20(1)(a). However, this is clearly the intention and SARS accepts that the market value referred to in para 51(1)(b) is the deemed acquisition cost for purposes of determining the base cost of the primary residence.

The effect of this provision is that the capital gain or capital loss on the disposal of the residence by the company or trust will not be subject to CGT.

Any growth or reduction in the value of the property after 1 October 2001 must be accounted for in the hands of the individuals taking transfer should the primary residence become subject to CGT

Paragraph 51(2) provides that para 51(1) applies only when

- that natural person acquires that residence from that company or trust on or after the promulgation of the Taxation Laws Amendment Act 5 of 2001, but not later than 30 September 2002;
- that natural person alone or together with his or her spouse directly held all the equity share capital in that company from 5 April 2001 to the date of registration in the deeds registry of the residence in the name of that natural person or his or her spouse or in their names jointly; or
- that natural person disposed of that residence to the trust by way of donation, settlement or other disposition or made funds available that enabled that trust to acquire the residence;

- that natural person alone or together with his or her spouse ordinarily resided in that residence and used it mainly for domestic purposes as his or her or their ordinary residence from 5 April 2001 to the date of registration.
- the registration of the residence in the name of the natural person or his or her spouse or in their names jointly, takes place not later than 31 March 2003.

This paragraph applies only in respect of that portion of the property on which the residence is situated and adjacent land as

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

A.7 Donations tax

The legislation does not provide a specific donations tax exemption. Under s 58 of the Act the disposal of property for a consideration that is less than an adequate consideration, that is, a sale of property at a consideration (value) less than its fair market value, is deemed to be a donation.

The section, however, provides that the Commissioner must determine that the consideration is inadequate. The Commissioner will not seek to adjust the consideration when

- the transfer is exempt under either s 9(16) or 9(17) of the Transfer Duty Act, and
- the transaction is not entered into for the purposes of tax avoidance, other than that specifically provided for.

Appendix B – Transfer of a residence from a company or trust (2009 – 2010)

These notes relate to certain CGT, STC and transfer duty relief measures that applied to the acquisition by a natural person of a residence from a company or trust between 11 February 2009 and 30 September 2010. The commentary has been retained because it may still be relevant in establishing the base cost of a primary residence which was the subject of such a transfer.

B.1 Background

Paragraph 45 provides that only a natural person (individual) or special trust is entitled to disregard the whole or a portion of the capital gain or loss on disposal of that person's primary residence. Subject to certain exceptions

- if the proceeds exceed R2 million, the first R1,5 million of capital gain or loss must be disregarded, and
- if the proceeds are R2 million or less, the entire amount of any capital gain must be disregarded.

This exclusion does not apply to a company, close corporation or trust (whether discretionary or vesting) which owns a residence. In the notes that follow the term 'company' will also be used to refer to a close corporation.

Historically many individuals purchased their residences in companies or trusts for a variety of reasons, including protection from creditors, avoidance of transfer duty and estate duty and circumvention of the Group Areas Act. A window of opportunity was granted in 2002 which enabled these persons to transfer their residences out of their companies or trusts into their own names without suffering any adverse CGT, STC or transfer duty consequences (see **Appendix A**).

Following the amendment of the Transfer Duty Act 40 of 1949 in 2002, it is no longer possible to avoid transfer duty by disposing of the shares or member's interest in a company holding residential property, or by substituting beneficiaries holding contingent interests in residential property of a discretionary trust.⁹²¹

Before the amendments effected by the Revenue Laws Amendment Act 74 of 2002, the distribution of capital profits in anticipation of liquidation or deregistration or during the course of winding up of a company was exempt from STC. However, since the amendments, any capital profit derived by a company on or after 1 October 2001 is subject to STC, even if distributed in anticipation of liquidation or deregistration or during the course of winding up. Section 64B(5)(c) has been deleted with effect from 1 January 2011, meaning that the STC exemption for pre-CGT capital profits distributed in anticipation of liquidation or deregistration or during the course of winding up of a company has now also been removed.

The extension of the transfer duty provisions and the narrowing and subsequent removal of the STC exemption on the distribution of capital profits have made it costly from a tax point of view for a company or trust to dispose of a residence (see **11.11 for the current tax consequences**). Not only will the company or trust not qualify for the primary residence exclusion, but the company will potentially be liable for CGT and STC. In the case of a trust the CGT consequences will be borne either by the trust (which pays CGT at the rate of 20%) or by a resident beneficiary if the trust's capital gain is attributed to that beneficiary under para 80. A natural person acquiring the residence will be subject to transfer duty.

⁹²¹ See ITC 1829 (2007) 70 SATC 106 (D) for a case in which it was held that the substitution of contingent beneficiaries of a trust resulted in a liability for transfer duty.

It has emerged that many individuals did not avail themselves of the 2002 opportunity with the result that they now face the adverse tax consequences described above when disposing of a residential property from a company or trust.

A further window of opportunity that operates on a roll-over basis, was introduced by the Taxation Laws Amendment Act 17 of 2009.

The Taxation Laws Amendment Act 7 of 2010, which was promulgated on 2 November 2010 inserts para 51A which widens the relief in a number of respects. It comes into operation on 1 October 2010, while para 51 applies to acquisitions not later than 30 September 2010. For more on para 51A see the *Guide to Disposal of a Residence from a Company or Trust*.

B.2 Taxes qualifying for exemption

The relevant provisions offer exemption from

- transfer duty on the transfer of the residence (s 9(20) of the Transfer Duty Act, 1949),
- STC on the distribution *in specie* of the residence [s 64B(5)(k)],
- dividends tax on the distribution *in specie* of the residence [s 64F(i)],
- CGT on any capital gain realised by the company or trust (para 51), and
- income tax on any recoupment of allowances claimed by the company (para 51).

B.3 The transfer duty exemption

The transfer duty exemption requirements are contained in s 9(20) of the Transfer Duty Act 40 of 1949, which reads as follows:

‘(20) No duty shall be payable in respect of any acquisition of any interest in a residence as contemplated in paragraph 51 or 51A of the Eighth Schedule to the Income Tax Act, 1962 (Act No. 58 of 1962), where that acquisition takes place as a result of a transfer or disposal contemplated in either of those paragraphs.’

Section 9(20) in so far as it applies to a disposal under para 51 is deemed to have come into operation on 11 February 2009 and applies in respect of distributions made on or after that date and before 1 January 2012.⁹²² The reference to ‘distributions’ should be read as including a sale.

B.4 The STC exemption

The STC exemption is contained in s 64B(5)(k), which states that there shall be exempt from STC

‘any dividend declared by a company to a natural person which constitutes a transfer of an interest in a residence contemplated in paragraph 51 of the Eighth Schedule’.

Section 64B(5)(k) is deemed to have come into operation on 11 February 2009 and applies to transfers made on or after that date in respect of disposals made before 1 October 2010.⁹²³

⁹²² Section 9(20) added by s 3(1)(b) of the Taxation Laws Amendment Act 17 of 2009 with its commencement date set by s 3(3) of that Act.

⁹²³ Section 68(5) of the Taxation Laws Amendment Act 7 of 2010.

The STC exemption will thus apply only to a distribution of a residence *in specie* to the shareholders. It does not cover the distribution of a profit arising on a *sale* of the residence to the shareholders, as was the case under the 2002 window of opportunity. The entire profit, whether of a capital nature or not, arising on distribution of the residence is exempt from STC. Unlike para 51A, there is no requirement that the company be liquidated or deregistered after the distribution.

B.5 The CGT and income tax exemption

Paragraph 51

Under para 51(1) when an interest in a residence has been transferred from a company or trust to a natural person as contemplated in para 51(2)

- the company or trust is deemed to have disposed of that interest for an amount equal to its base cost on the date of transfer of the interest,
- that company or trust and that natural person must, for purposes of determining any capital gain or loss on the transfer of that interest, be deemed to be one and the same person with respect to
 - the date of acquisition of that interest by that company or trust and the amount and date of incurral by that company or trust of any expenditure in respect of that interest allowable under para 20, and
 - any valuation of that interest effected by that company or trust as contemplated in para 29(4).
- no allowance or deduction allowed to that company or trust in respect of that interest must be recovered or recouped by that company or trust or be included in the income of that company or trust in the year in which the transfer takes place; and
- that company or trust and that natural person must be deemed to be one and the same person for purposes of determining the amount of any allowance or deduction that is to be recovered or recouped by or included in the income of that natural person in respect of that interest.

The effect of para 51(1)(a) is that the capital gain or capital loss on the disposal of the residence by the company or trust will not be subject to CGT.

Paragraph 51(1)(b) has the effect that the transferee steps into the shoes of the transferor for the purpose of determining the transferee's base cost. In other words, in the case of a pre-valuation date residence, the costs and dates of acquisition of the residence and incurral of expenditure are carried across to the natural person. This roll-over will be relevant if the natural person adopts the time-apportionment base cost method for the purpose of determining a capital gain or loss on disposal of a pre-valuation date residence. Also, any valuation of the residence as at 1 October 2001 obtained by the company or trust before 30 September 2004 will be deemed to have been obtained by the transferee.

Paragraph 51(1)(c) ensures that the company will not suffer a recoupment of any allowance or deduction claimed on the residence, including an allowance or deduction granted under

- s 13ter (deduction for residential buildings),
- s 13quat (deductions for the erection or improvement of buildings in urban development zones), and

- s 11(a) (cost price of trading stock) or s 22(2) (deduction for opening stock) for the cost or value of a residence held as trading stock. However, it is likely that a recoupment under s 22(8) would have been triggered when the shareholder first took occupation of the residence as his or her ordinary residence. At that point the residence would probably have ceased to be held as trading stock, thus triggering a recoupment at market value under s 22(8)(b)(v).

Paragraph 51(2) provides that para 51(1) applies only if

- that natural person acquires that interest from the company or trust no later than 30 September 2010 [para 51(2)(a)],
- that natural person alone or together with his or her spouse directly held all the share capital or members' interest in that company from 11 February 2009 to the date of registration in the deeds registry of that residence in the name of that natural person or his or her spouse or in their names jointly [para 51(2)(b)(i)], or
- that natural person disposed of that residence to that trust by way of donation, settlement or other disposition or financed all the expenditure, as contemplated in para 20, actually incurred by the trust to acquire and to improve the residence [para 51(2)(b)(ii)], and
- that natural person alone or together with his or her spouse personally and ordinarily resided in that residence and used it mainly for domestic purposes as his or her or their ordinary residence from 11 February 2009 to the date of the registration contemplated in item (b)(i) [para 51(2)(c)].

Paragraph 51 applies only to that portion of the property on which the residence is situated and adjacent land as

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

Paragraph 51(2)(a) does not stipulate how the residence must be acquired by the natural person. It could therefore be acquired by a distribution *in specie*, or by a sale. While a sale by a company will qualify for CGT and transfer duty purposes, it will not qualify for the *STC* exemption.

Disposal by a company

The natural person taking transfer of a residence from a company must hold all the shares in the company

- directly, and
- alone or together with his or her spouse [para 51(2)(b)(i)]

The concession, therefore, does not apply if

- the residence is held by a subsidiary company,
- the shares in the company holding the residence are owned by a trust,
- more than one person holds the shares and those persons are not spouses, or
- the residence is disposed of to a spouse who is not a shareholder.

Thus, a husband holding all the shares cannot transfer the residence into his wife's name. But if they each hold some shares which together make up the total issued share capital, the residence can be transferred into either spouse's name or into their names jointly.

Assuming that there are two spouses, A and B who are married out of community of property, the table below shows into whose name the residence may be transferred.

Shareholders	Residence may be transferred into the name of
A owns 100%	A
A and B jointly own 100%	A, B or A and B jointly.

Disposal by a trust

Paragraph 51 will not apply to a residence held by a trust if only part of the expenditure was financed by the individual taking transfer. For example, the relief will not apply if a third party paid for the addition of a room to the residence. All the expenditure' means 100% of it.

Unlike para 51(2)(b)(i), para 51(2)(b)(ii) does not state explicitly in whose name the residence must be registered. However, it follows from the wording of the provision that 'that natural person' (the one taking transfer) must be the one that donated the residence to the trust or financed all the acquisition and improvement expenditure in respect of the residence.

Assuming that there are two spouses, A and B who are married out of community of property, the table below shows into whose name the residence may be transferred.

Spouses who donated the residence or financed all the expenditure	Residence may be transferred into the name of
A only	A
A and B jointly	Does not qualify, since para 51(2)(b)(ii) requires that the residence be donated or financed by a natural person. Unlike para 51(2)(b)(i) the words 'alone or together with his or her spouse' are not used.

If a bond was obtained by the trust to finance the acquisition and improvement of the residence, the person who financed the interest on the bond and its repayment will be regarded as having financed that expenditure.

Before the 2002 transfer duty amendments, some taxpayers purchased their residences by taking over a trust. The person and or that person's spouse became the new trustees and beneficiaries. The validity of these schemes, which purported to avoid transfer duty, was never accepted by SARS. Taxpayers who have acquired their residences in this manner will not qualify for the exemption since they would not be the original financiers of the expenditure. In fact, the legal effect is that a new trust comes into existence and the new trust will have acquired the residence from the old trust.⁹²⁴

The residence requirement

Under para 51(2)(c) the natural person taking transfer of the residence must alone or together with his or her spouse have

- personally and ordinarily resided in that residence, and
- used it mainly for domestic purposes as his or her or their ordinary residence

⁹²⁴ ITC 1829 (2007) 70 SATC 106 (D).

from 11 February 2009 to the date of registration in the deeds registry in the name of that natural person, his or her spouse or in their names jointly.

The word ‘personally’ was inappropriately inserted in para 51(2)(c) and seems to find its provenance in an earlier draft definition of ‘primary residence’.⁹²⁵ The word is problematic as it could imply continuous physical presence. It is not the intention that the provision should be construed in such a restrictive manner and it is accepted that the key requirement is that the person or his or her spouse must have ordinarily resided in the residence as his or her or their ordinary residence. A vacation home does not comprise an ordinary residence as it is typically occupied on an occasional basis and is not the place in which a person ordinarily resides.

The residence must be used ‘mainly’ for domestic or private purposes as an ordinary residence. ‘Mainly’ in this context means more than 50%. Thus, if a person used 10% of the residence for trade purposes it will not be disqualified under para 51. The usage of the residence before 11 February 2009 is irrelevant. For example, the fact that a person used the residence as his or her main home for many years before 11 February 2009 is irrelevant. The key question is how the residence was used on or after 11 February 2009 until date of registration. Thus, if the company or trust has let the residence to a third party for any part of the period between 11 February 2009 and the date of registration in the deeds registry, the company or trust will not qualify under para 51. The same adverse result would ensue if the natural person acquired another primary residence during this period and left the residence vacant. There is no requirement that the person must continue to reside in the residence once it has been transferred out of the company or trust. A person is thus free to dispose of the residence after it has been transferred to that person. It is, however, impermissible to transfer the residence directly from the company or trust to a third party purchaser.

⁹²⁵ Draft Taxation Laws Amendment Bill, 2001 dated 12 December 2001.

Appendix C – Transfer of a residence from a company or trust (2010 – 2012)

Paragraph 51A

Paragraph 51A was inserted into the Eighth Schedule by s 105 of the Taxation Laws Amendment Act 7 of 2010 and applied to the disposal of a residence from a company or trust on or after 1 October 2010 and before 1 January 2013. For a detailed commentary on para 51A and the related transfer duty, STC and dividends tax exemptions, see the *Guide to Disposal of a Residence from a Company or Trust* (Issue 3), which was released on 1 November 2012.

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