MEMORANDUM ON THE DRAFT TAXATION LAWS AMENDMENT BILL, 2001
INTRODUCTION OF CAPITAL GAINS TAX ("CGT")

As was announced by the Minister of Finance in his Budget Review this year, a CGT will be introduced with effect from 1 April 2001. A guide to the key principles of the proposed CGT was published on 23 February 2000 and public comment 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.

In order to give effect to the proposals relating to CGT it is proposed that an Eighth Schedule be included in the Income Tax Act, 1962. The Eighth Schedule determines a taxable capital gain or assessed capital loss and a new section 26A of the Act provides that the taxable capital gain is included in taxable income. An overview of the relationship between the Eighth Schedule and section 26A is set out below.

Introduction

Applicability

The Eighth Schedule applies to a resident's worldwide assets and to a non-resident's immovable property or assets of a permanent establishment, branch or agency in the Republic. Once an asset has been disposed of the provisions of the Eighth Schedule are triggered and it is for this reason that both the words 'asset' and 'disposal' are defined in wide terms and include a number of deeming provisions.

Capital Gain and Capital Loss

A capital gain or loss is determined for each asset disposed of by taking the proceeds or deemed proceeds accrued from the disposal of that asset and deducting the base cost of the asset. A capital gain or loss may be attributed to a third party under certain circumstances in order to prevent the avoidance of tax, for example where a parent has donated an asset to a minor child.

A capital gain or loss may be disregarded under certain circumstances, for example, on disposal of a primary residence. Certain disregarded capital gains or losses are not completely disregarded but may be recognised at a future date, for example, on disposal of a replacement asset where the capital gain on the disposal of the original asset was disregarded under the involuntary disposal relief provisions.

Aggregate Capital Gain and Aggregate Capital Loss

The net amount of all recognised capital gains and losses for a year of assessment are added together to arrive at a person's aggregate capital gain or loss. It has been proposed that the annual exclusion for a natural person or special trust be increased to R10 000. Accordingly, the first R10 000 of a natural person or special trust's aggregate capital gain or loss will be disregarded for CGT purposes.

Net Capital Gain and Assessed Capital Loss

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

Taxable Capital Gain

Where a person has arrived at a net capital gain for the current year of assessment this is multiplied by the inclusion rate to arrive at a taxable capital gain, which is included in taxable income for the year of assessment and taxed at normal income tax rates.

Inclusion Rate

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

Type of Taxpayer	Inclusion rate %
Individuals	25
Retirement Funds	N/A
Trusts • Unit • Special • Other	 N/A 25% 50%

Life Assurers
• Individual policyholder fund
• Company policyholder fund
• Corporate fund
• Untaxed policyholder fund
  • Retirement fund business
  • Other exempt business
	
	25
	50
	50
	
	N/A
	N/A

Companies	50

It is proposed that the capital gains of retirement funds not be taxed at this stage. This is an interim measure and the issue of the taxation of the retirement industry will be revisited over the next three years, as noted in the Explanatory Memorandum to the Revenue Laws Amendment Act, 2000.

It is also proposed that the capital gains of unit trusts not be taxed but that tax be imposed on the disposal of units by unitholders in such trusts. Reporting requirements by unit trusts have, therefore, been proposed to simplify the calculation of CGT on disposal of units in a unit trust.

Disposal and Acquisition of Assets

It is proposed that a wide meaning be given to the concept of a disposal and that the timing of the recognition of disposals be regulated. Events that are to be treated as disposals and acquisitions of assets include the commencement and cessation of residence in the Republic. This means that a person becoming a resident of the Republic will generally be treated as having acquired his or her assets at the market value on the day before he or she became resident. Conversely a person becoming a non-resident will generally be treated as having disposed of his or her assets at the market value on the day before he or she became a non-resident. In both cases assets that are subject to CGT regardless of the person's residence will not be subject to the deemed disposla on change of residence.

Proposals have also been formulated to deal with the apportionment of part disposals, disposals of partnership assets, and disposals by a person married in community of property.

Disregarded Disposals and Limitations of Losses

It is proposed that a capital loss be disregarded where it reflects a reduction in the value of an asset due to personal consumption. Examples of affected assets are aircraft and boats that are not used for the purposes of carrying on a trade. It is also proposed that a capital loss be disregarded where it arises from the disposal of certain classes of intangible assets that experience has shown to have been subject to manipulation for tax avoidance purposes.

It is proposed that a capital loss on the forfeiture of a deposit in respect of an item that is not intended for the carrying on of a trade be disregarded and that the disposal and acquisition of shares forming part of a securities lending agreement be disregarded.

Finally, it is proposed that the tax benefits of the selective realisation of a portfolio to achieve capital losses just before the end of the year of assessment and capital gains just after the beginning of the new year of assessment be limited.

Base Cost and Proceeds

Base Cost

It is proposed that, in general, the base cost of an asset be expenditure actually incurred in acquiring an asset together with expenditure directly related to the acquisition or disposal of an asset or to improvements to the asset. The base cost does not include any amount otherwise allowed as a deduction for income tax purposes or any borrowing costs, repairs, etc. The base cost of an asset is therefore reduced by the amount of any wear and tear or capital allowance permitted for income tax purposes. Any expenditure denominated in a foreign currency is to be converted into Rand at the ruling exchange rate applicable on the date that the expenditure either becomes due and payable or is paid.

Valuation Date Assets

In so far as assets held at valuation date are concerned, it is proposed that the period during which a valuation may be obtained be extended from six months to two years and that this period may be extended further at the Minister of Finance's discretion. Proposals have been formulated to extend the option of adopting a time apportionment base cost to all assets, including marketable securities and other financial instruments. A time apportionment base cost may also be calculated with reference to the entire period that an asset was held before valuation date, that is to say, the twenty year limit proposed on this period in the guide has been removed. Where a market value is adopted in respect of financial instruments listed on a recognised exchange, it is proposed that the value to be used be the average closing value for the five trading days before valuation date.

Proposals have also been formulated to ensure that CGT is not levied where a market value is adopted below original cost and the asset is sold for a price falling between market value and original cost. These proposals also ensure that a capital loss is not claimed where an asset is sold for more than its original cost but less than the market value adopted.

Proceeds

It is proposed that, in general, the proceeds on disposal of an asset be the amount received or accrued to a person in respect of the disposal. The proceeds on disposal of an asset do not include any amount otherwise included in gross income for income tax purposes. The proceeds on disposal of an asset are therefore reduced by the amount of any recoupment of wear and tear or a capital allowance taken into account for income tax purposes. Any proceeds denominated in a foreign currency are to be converted into Rand at the ruling exchange rate applicable on the date that the proceeds accrue.

Where a disposal is made to a connected person or by means of a non-arm's length transaction, including a donation or a disposal for a consideration not measurable in money, it is proposed that the disposal be treated as if it were made at the market value of the asset disposed of on the date of disposal. A mechanism for interlinking CGT and donations tax is being sought and it is therefore proposed that donations tax be reduced appropriately. Any capital loss arising from a disposal to a connected person is disregarded and may only be set off against capital gains arising from transactions with the same connected person.

It is proposed that a deceased person be treated as having disposed of all his or her assets at market value on the date of death. This proposal differs from that made in the guide that the original base cost be rolled over to the heir or legatee and is made in view of its conceptual merits and in order to resolve the difficulties inherent in attempting to determine the original base cost over several generations. A mechanism for interlinking CGT and estate duty is being sought and it is therefore proposed that estate duty be reduced appropriately. This reduction in rate and that proposed in respect of donations tax will take into account the fact that estate duty and donations tax are levied on the gross value of assets while CGT is only levied on the taxable capital gain on disposal of the asset.

Where a person retains effective ownership of an asset but disposes of it for a short period of time and then reacquires it or a substantially similar asset in order to claim a capital loss, the disposal is effectively disregarded and the reacquired asset is allocated the base cost of the original asset.

Primary Residence Exclusion

It is proposed that up to R1 000 000 of the capital gain or loss on the disposal of a primary residence be excluded and that the maximum size of the property qualifying for the exclusion be set at two hectares. Proposals have been formulated to permit a period of absence from the primary residence while the residence is offered for sale, let for specified period, refurbished before taking occupation, erected, or rendered uninhabitable. Proposals have also been formulated to permit the apportionment of the exclusion where the property exceeds two hectares, has not been occupied as a primary residence for the entire period of ownership, or has been used for business purposes.

Finally, where a taxpayer's primary residence is owned by a wholly owned company, including a close corporation, a CGT and transfer duty free period of one year is proposed to permit the taxpayer to transfer ownership of the property from the company into his or her hands in order to enjoy the exclusion. No stamp duty will be payable on the hypothecation of a new bond or the substitution of the debtor under these circumstances.

Other Exclusions

It is proposed that the personal use asset exclusion be extended to cover all assets of a natural person or a special trust other than those assets used in the carrying on of a trade and certain specified assets. It is also proposed that a lump sum from a pension, provident or retirement annuity fund governed by the Second Schedule, a life insurance benefit, or a lump sum from an endowment policy be excluded in the hands of the original beneficial owner or the nominee or dependent of that owner.

Proposals have been formulated for a once off, lifetime exclusion of capital gains of up to R500 000 in respect of the disposal of a small business by reason of death, reaching the age of 55 or for reasons of ill-health. The disposal must be completed within a period of eighteen months of its commencement and a minimum period of ownership of five years is required to qualify for the exclusion. This exclusion will be revisited as part of the review of the taxation of the retirement industry over the next three years.

Proposals have also been formulated to exclude a capital gain on a donation of an asset to an approved public benefit organisation, which qualifies for deduction in terms of section 18A.

It is also proposed that provision be made for exclusions in respect of:
- Compensation for personal injury or illness, or defamation actions;
- Betting, lotteries, competitions or the disposition of a chance to win a prize, or a right to receive a prize;
- Conversion of foreign legal tender for personal use in international travel; and
- Realisation of assets held to produce exempt income.

Roll-overs and Attribution of Capital Gain

Involuntary Disposals

It is proposed that a capital gain on disposal of an asset be deferred until the disposal of its replacement asset where the asset is damaged or otherwise disposed of involuntarily. In this case, a deferral will be granted where the person who has disposed of the asset can show that the proceeds on disposal will be used to purchase the replacement asset, a contract for the replacement asset will be concluded within a year and the replacement asset will be brought into use within three years of the disposal of the original asset.

Reinvestment Disposals

It is proposed that a capital gain on disposal of an item of plant, machinery, and or other similar assets be deferred and only recognised over a period of five years from the date that the replacement asset is brought into use. In this case, a deferral will be granted where the person who has disposed of the asset can show that the proceeds on disposal will be used to purchase the replacement asset, a contract for the replacement asset has been concluded and the replacement asset will be brought into use within a year of the disposal of the original asset

Spousal and Small Business Roll-overs

It is also proposed that a roll-over of the base cost of an asset from one person to another be permitted in two cases. The first is the transfer of an asset from one spouse

to another. The second is the transfer of active business assets of a small business from a natural person or persons to a company in exchange for shares in the company so that trade may be conducted in an incorporated form.

Group Companies

No proposal has been made in respect of automatic relief in respect of inter-group disposals due to the potential for abuse and the fact that the Republic does not operate a group tax system. Although capital gains on inter-group disposals of assets will be small in the first years of the CGT system further research will be conducted into relief for group transfers. In the interim, the existing provisions for group rationalisation and unbundling relief have been extended to CGT.

Attribution of Capital Gains

A number of anti-avoidance provisions are proposed to ensure that a person's capital gain is taxed in his or her hands despite the fact that the capital gain has been artificially placed in the hands of another person. These provisions are broadly based on the provisions of section 7 of the Act although they have been modified where necessary to take account of the differing context in which they now operate.

Companies and Shareholders

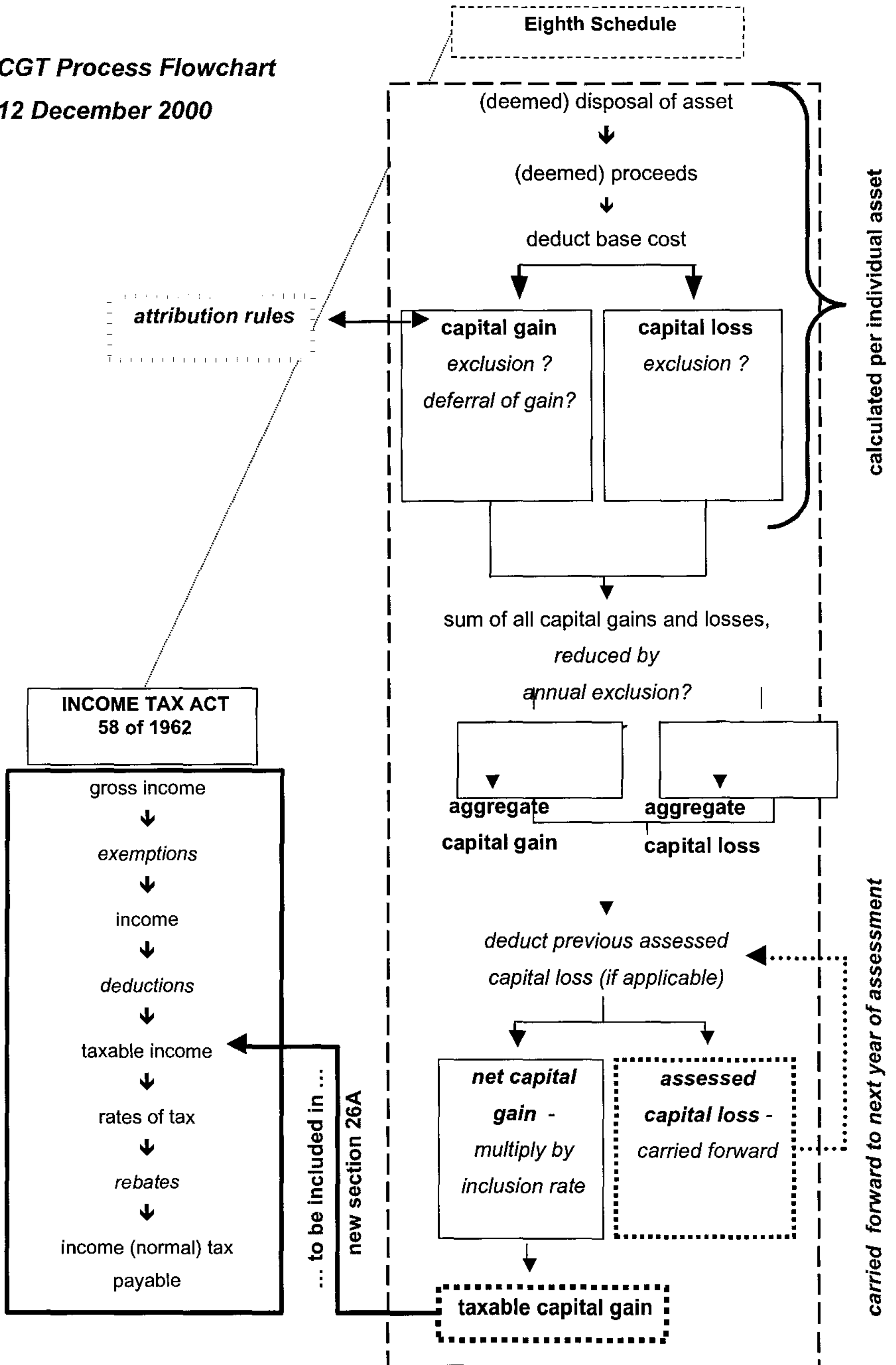
Proposals have been formulated to prevent the creation of non-economic losses where dividends are declared out of profits or reserves existing at the date of acquisition (where time based apportionment has been elected) or at the valuation date (where the valuation basis has been elected). A dividend of this nature effectively amounts to a return of a taxpayer's original investment and it is therefore necessary to reduce the base cost of the relevant share by the amount of the dividend. This reduction is required in respect of shareholdings of at least 10%, together with connected persons, in the share capital of a listed company or any shareholding in a non-listed company. These measures generally mirror the treatment of such dividends for accounting purposes.

Trusts, Trust Beneficiaries and Insolvent Estates

A number of anti-avoidance provisions are proposed to counter the use of trusts to avoid CGT. These include the allocation of capital gains in respect of vested assets in a trust to the person in whom they vest, the limitation of the distribution of capital losses by a trust, and adjustments to the base cost of an interest in a trust under circumstances analogous to those described under Companies and Shareholders.

Anti-Avoidance

Apart from the anti-avoidance provisions described above, it is proposed that the general anti-avoidance provisions of section 103 be amended to cover CGT and that provisions be introduced to prevent the "stepping-up" of base cost of assets during the period from the announcement of the introduction of CGT to valuation date. Additional research will be conducted into the need for anti-avoidance provisions to counter value shifting and other abuses.


CGT Process Flowchart
12 December 2000
Eighth Schedule
(deemed) disposal of asset
(deemed) proceeds
deduct base cost
attribution rules
capital gain
exclusion ?
deferral of gain?
capital loss
exclusion ?
calculated per individual asset
sum of all capital gains and losses,
reduced by
annual exclusion?
aggregate
capital gain
aggregate
capital loss
deduct previous assessed
capital loss (if applicable)
net capital
gain -
multiply by
inclusion rate
assessed
capital loss -
carried forward
carried forward to next year of assessment
taxable capital gain
INCOME TAX ACT
58 of 1962
gross income
exemptions
income
deductions
taxable income
rates of tax
rebates
income (normal) tax
payable
... to be included in ...
new section 26A