Capital Gains Tax

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CAPITAL GAINS TAX

There is an old Mediterranean saying "Get caught in the grip of an octopus and you will soon find out how many tentacles and suckers it has".

The same saying applies to South African Revenue Services (SARS). Income tax, donations, tax, estate duty, value added tax, import and excise tax, taxes on petrol, land tax etc. And while caught up in these "tentacles", you suddenly discover the new Capital Gains Tax (CGT) "tentacle".

Not to panic says the state, all these taxes are, some time in the future going to reduce your marginal rate of tax by 1-2%. So what's wrong with you, why aren't you smiling? There is hope, be optimistic!

This paper will not attempt to give a complete explanation of capital gains tax, but rather give an overview of the issues that you will more commonly be confronted with.

AN OVERVIEW OF CGT

- Announced by the Minister of Finance in his budget speech on 23/02/2000.
- Initial implementation date was 01/04/2001.
- SARS issued a guide on CGT in which the basics of CGT were made known.
- General public was given only 1 month to comment on proposals -over 300 submission were received.

- Following these submissions as well as meetings with interested parties, several changes were made.

- First draft bill was published for comment on 12/12/2000.

- Again over 150 submissions were received.

- It was announced in the 2001 budget speech that the introduction of CGT would be postponed until 01/10/2001

- A second Draft Bill was released on 02/03/2001 for comment

- After a number of changes the Taxation Laws Amendment Bill, 2001, containing the proposed CGT legislation, was tabled in Parliament on 29/03/2001. This Bill was subsequently passed.

- Schedule 8 of the Act covers CGT (including definitions, principles and steps).

HOW IS CGT TRIGGERED?

- It is basically triggered when an *asset* is disposed of, where the *proceeds* are not subject to income tax.

- The difference between the proceeds and the *base costs* need to be determined.

- Where the resulting *capital gain* or *loss* is not subject to exclusion or deferred (in case of a capital gain) by way of a *rollover*, it is aggregated with all other capital gains or losses in the same tax year.

- After deducting any *assessed capital loss* from the previous tax year the resulting:

    - Assessed capital loss is carried forward to the next year or

    - A nett capital gain is multiplied by an inclusion rate

to determine the *taxable capital gain*.

- The taxable capital gain is included in taxable income and taxed at the taxpayer's marginal rate or the institution's statutory rate.

TYPE OF TAXPAYER	INCLUSION RATE %	STATUTORY RATE %	EFFECTIVE RATE %
Individuals	25	0-42	0-10,5
Retirement funds	N/A	25	N/A
Trusts			
▪ Unit	N/A	30	N/A
▪ Special	25	0-42	0-10,5
▪ Other	50	32-42	16-21
Life Assurers	0-50	0-30	0-15
Companies	50	30	15

WHEN IS CGT PAYABLE?

- CGT will be payable after your tax return has been assessed.
- Provisional taxpayers will have to pay CGT with third, top-up provisional tax payment otherwise interest could be levied.

WHAT IS EXCLUDED FROM CGT?

- Primary residence

  In the case of a natural person or a special trust the first R1m of a capital gain or loss on the sale of his or her primary residence is excluded from CGT. It should be noted that multiple interests held by natural persons or special trusts in the same primary residence are collectively limited to R1m.

  A *residence* is defined as "Any structure including a boat, caravan or mobile home, which is used as a place of residence". To be a *primary* residence the natural person or his or her

spouse, beneficiary of the trust or his or her spouse must personally and ordinarily reside in the residence.

- Gains on personal motor vehicles if not used for business purposes.
- Gains on personal effects and jewellery.
- Lump sums from pension, provident, retirement annuity funds and life assurance policies.
- Winnings from lotteries, casino's, horse racing, prizes, etc. (excluding professional gamblers)
- Compensation for injury, illness and defamation.
- Any gains made when exchanging foreign currency for rand when returning from an overseas trip.
- A gain of up to R500 000-00 on the sale of the assets of a business on retirement.
- Unit trust schemes that invest in financial instruments or shares in companies that own immovable property. Instead the investors in these schemes are subject to CGT on disposals.
- R10 000 of capital gain made by a natural person or special trust is excluded annually (not accumulating).

WHAT IS SPECIFICALLY INCLUDED IN CGT?

- Shares, Unit Trusts and other private investments
- Land
- Property not used as a primary residence (including rights to property)
- Aircraft with empty mass exceeding 450kg

- A boat exceeding 10 metres in length
- Coins cast from gold or platinum (e.g. Krugerrands)
- Mineral rights
- All other assets except those specifically excluded.
- Gains made on assets mentioned above (5.1 to 5.8) are subject to CGT, but losses are disregarded.

SOME DEFINTIONS

- A *CGT taxpayers* is a person who is a resident and will be taxed on gains on worldwide assets.
- *Non residents* will only be subject to CGT on the disposal of:
    - Immovable property or an interest or right in or to such property (general speaking if 80% of such property is situated in South Africa)
    - Assets of a permanent establishment through which a trade is carried in South Africa during the tax year.
- *Assets* are widely defined as property (movable or immovable), excluding any currency but including gold and platinum coins and rights or interests to or in such property.
- **Disposals**

  CGT is only payable if a capital asset is disposed of after 01/10/2001. a disposal includes:

    - Scrapping, loss or damage of an asset
    - The distribution of an asset by a company to a shareholder
    - The granting, renewal, extension or exercise of an

option.

A disposal does not include:

- Transfer of an asset as security for a debt
- Issue of shares or debentures
- The distribution of a trust asset to a beneficiary
- In certain cases certain events are treated as *deemed disposals* to counter tax avoidance e.g. when personal assets become trading stock.

- **Proceeds**

    - The basic rule is that proceeds are the actual or deemed amount derived by a person as consequence of the disposal.
    - It is deemed that the proceeds in case of a donation are the market value at the date of the donation.

- **Base cost**

The base cost of an asset is a complex aspect of CGT and probably warrants a paper on its own. The purpose of this paper is not to cover all the eventualities but to give an overview. I will therefore only cover the basics in this paper.

Different rules apply for assets acquired before 01/10/2001 ("the valuation date") and those acquired on or after this date.

Tax payers who dispose of assets acquired before 01/10/2001 may, in principle, determine the base cost of the asset at their market value on the valuation date. However subsequent qualifying cost and the ultimate disposal proceeds might change the base cost.

- **Allowable expenditure**

  Expenditure which forms part of the base cost includes:

  - Cost incurred on acquisition of asset
  - Valuation expenditure
  - Expenditure directly related to the acquisition or disposal of the asset e.g. cost of broker or agent.
  - Expenditure actually incurred in establishing, maintaining or defending legal title in the asset
  - Expenditure actually incurred on improvements
  - Valuation date value of any options acquired before 01/10/2001, but exercised after this date.
  - Holding expenditure incurred on assets held wholly and exclusively used for business purposes e.g. maintenance, repairs or insurance. This expenditure would not be allowed for a personal use asset.
  - VAT not allowed as an input tax credit.

- Cost excluded from base cost

  - Expenditure already claimed in determining taxable income for income tax.
  - Expenditure recovered or recoverable or which has been paid by another person.
  - Expenditure unpaid or not payable when the asset is disposed of.
  - Holding expenditure incurred on assets e.g. repairs, maintenance, insurance, etc. of a primary residence e.g. interest on a bond will be excluded.

  - The inflationary element inherent in virtually every capital gain made.

- Pre-valuation date assets

  These are assets acquired prior to 01/10/2201 and held on that date.

  Where an asset is *disposed of at a profit* or where the expenditure is unknown, the taxpayer may adopt any of the following methods as the base cost of the asset:

  - Market value on valuation day

  - 20% of disposal proceeds after deducting allowable expenditure after valuation date.

  - Time apportionment

  However if *market value* was adopted as base cost but the disposal proceeds do not exceed market value, the base cost on valuation day will be the *higher* of allowable expenditure before valuation date or the proceeds less allowable expenditure on or after valuation date.

Disposal at a loss

Where an asset is *disposed at a loss* and market value on valuation day was *not* adopted as the base cost, base cost must be determined according to the time apportionment.

Where market value was adopted, the base cost is the *lower* of market value or cost as established under the time apportionment rule.

However, should the allowable expenditure incurred before, on or after valuation day exceed the disposal proceeds as well as market value on valuation day, base cost is the higher of market value or proceeds less allowable expenditure incurred on or after valuation date.

The above means that although the taxpayer has a choice of which

method to use to determine base cost, the choice depends on the proceeds being higher than the valuation date value plus allowable expenditure on or after that date.

Valuation date value of instruments is not covered in this paper.

- **Market value**

  The term "market value" is not only used in relation to the value of assets on valuation day, but also in circumstances such as death, donation, emigration and immigration. Market value on valuation day (01/10/200) for the following will be determined as indicated:

  - Shares listed on JSE-average of buying and selling prices for the 5 days 24-28 September 2001. SARS will do the calculations and publish in the Government Gazette.

  - Shares listed on a recognised exchange outside SA the value will be the average of the buying and selling price on the last trading day at close of business before 01/10/2001.

  - SA Unit Trusts

  - This will be determined by using the "sell" price quoted. Again, this will be published by SARS in the Government Gazette.

  - Time apportionment

    This is the apportionment of the difference between the proceeds on disposal and the acquisition cost on a straight line basis between the period the asset was held prior to the valuation date and the period from the valuation date.

  Additional cost incurred after acquisition date may be added to original cost provided that it qualifies as allowable expenditure.

- **20% Rule**

  With this method the valuation date value is determined by taking 20% of the proceeds from disposal (after deducting allowable expenditure incurred after valuation date).

- **Rollovers**

  A rollover is when a capital gain or loss is deferred. The disposal is then disregarded and the disposee takes over the disposer's base cost.

  Rollover relief is granted for:

  - **Involuntary disposals**

    These are capital gains that arise from the expropriation, loss or destruction of an asset. The gain is then held over until the disposal of the replacement asset.

  - **Re-investment in similar assets**

    If an asset that qualify for allowance under Section 11e, 12b, 12c, 14 or 14BIS of the Act is disposed of for more than the base cost, the gain can be rolled over provided that the Commissioner has been satisfied regarding certain conditions.

  - **Disposal between spouses**

    A rollover applies for disposals between spouses as it is deemed that disposal and acquisition occur for an amount equal to the base cost of the asset. When the acquiring spouse eventually dispose of the asset, CGT is payable on the difference between the proceeds and the base cost plus allowable expenditure.

VALUATIONS

Valuations have to be done within 2 years i.e. not later than 30/09/2003 if a taxpayer has elected to use the market value on valuation

day for assets acquired before 01/10/2001.

Where the market value exceeds R10m certain other conditions apply.

OTHER ISSUES

- **Foreign Currency transactions**

  Capital gains and losses in relation to CGT will be dealt with by way of regulations which will be published after due consideration and debate.

- **Disposal to and from a deceased estate**

  - A deceased estate will, in the future be liable for Estate Duty as well as CGT.
  - The estate Duty Act allows a R1m rebate, but no such rebate is available for CGT.
  - A capital gain or loss is realised by the estate through the "fiction" that the deceased "transfers" his assets to his deceased estate upon death.
  - The CGT is paid by the estate and not the beneficiaries.
  - The R10000 per annum deduction is increased to R50000 for the deceased estate.
  - The CGT payable will qualify as a deduction on estates above R1m and will therefore reduce the Estate Duty liability.

- **Company Distribution**

  Only company "Capital distributions" are subject to CGT if the distribution:

  - Does not constitute a dividend

- Constitutes a dividend which is exempt from STC (Secondary Tax on companies)

- **Trust and Beneficiaries**

  Where a trust asset is vested in a beneficiary who is a resident, the capital gain in consequence of the vesting is disregarded in the trust and taken into account in determining the beneficiary's aggregate capital gain or loss.

- **Insolvent Estate**

  When a person becomes insolvent, the disposal of an asset by the insolvent estate is treated as if it was a disposal of the asset by the insolvent.

- **Complianc**e

  - Retention of records

    Taxpayers will be required to retain records required to determine the taxable gain or assessed capital loss for a period of 4 years from the date upon which the return of income for the tax year is received by SARS.

  - Lump Sum Benefit on retirement

    CGT will not affect the average rate at which lump sum benefits in contemplation of termination of service on retirement, and from pension, provident and retirement annuity funds are taxed.

PROBLEM AREAS

Although the Tax Amendment Bill containing the capital gains tax provisions has been passed by Parliament and comes into effect 01/10/2001, there are still many uncertainties relating to the operation of CGT. Listed below are some of the unclear issues. These issues will have to be clarified by a further act of Parliament, a practice

note from the Receiver or a court decision.

Losses carried forward

It is not clear if the aggregate capital loss will be reduced each year by R10 000 if there is no capital gain to set it off against.

Share Valuations

As indicated previously the market value on valuation date of shares listed on the JSE will be the average of their trading values on the JSE for the period 24 - 28 September 2001.

If taxpayers are forced to adopt this value they might lose financially if the shares dropped dramatically in value before the period mentioned above. The following example will illustrate:

Cost price of shares in 1998	R10 per share
Market value 01/10/2001	R5 per share
Sells on 01/10/2002 for	R7 per share

CGT will be payable on R2 per share even though a loss of R3 per share was realised.

Foreign Currency

As indicated previously capital gains or losses in foreign currency will be dealt with by way of regulations. One of the grey areas is the CGT effect when a person who has an offshore bank account in pounds moves that account into dollars.

Personal motor vehicles used for business purposes

Another grey area seems to be where an employee receives a car allowance enabling him/her to buy a car registered in his/her name. Where the vehicle is used mainly for business purposes, any capital gain on disposal should be taxable. The question to be answered is when is the car used mainly for business purposes?

CONCLUSION

This paper attempted to answer some of the questions that normally come up regarding capital gains tax. It is by no means a document that covers all aspects of this complex subject.

It is recommended that readers refer to the Act itself. It is also recommended that the following website be visited where SARS have given answers to some commonly asked questions www.cgtsa.co.za

SOURCES

Pricewaterhouse Coopers (PWC) - Capital Gains Tax 2001
Various Articles by Johan Davel of Profplan Brokers
Moneywel's - Tax Breaks