

INTERPRETATION NOTE NO. 43 (Issue 2)

DATE: 31 August 2010

ACT : INCOME TAX ACT, NO. 58 OF 1962 (the Act)
SECTION : SECTION 9B
SUBJECT : CIRCUMSTANCES IN WHICH AMOUNTS RECEIVED OR ACCRUED ON DISPOSAL OF LISTED SHARES ARE DEEMED TO BE OF A CAPITAL NATURE

Preamble

In this Note –

- unless the context otherwise indicates, any word or expression in this Note bears the meaning ascribed to it in the Act; and
- references to sections are to sections of the Act.

1. Purpose

The purpose of this Note is to provide clarity on the interpretation and application of section 9B. Section 9B relates to “affected shares” disposed of before 1 October 2007. Section 9C, which is the successor to section 9B, deals with the proceeds from the sale of a qualifying share disposed of on or after 1 October 2007.

Practice Note No. 18, issued on 23 April 1993, was withdrawn by issue 1 of this Note on 10 August 2007.

This Note reflects the law as amended by the Revenue Laws Amendment Act, No. 35 of 2007 and applies to affected shares disposed of before 1 October 2007.

2. Background

The distinction between capital and revenue is fundamental to the tax system, but neither concept has proved capable of a satisfactory definition in the Act. The question whether shares are held as trading stock or as an investment will to a large extent depend on the intention of the taxpayer. Despite guidelines laid down by case law the determination of whether the profit or loss on disposal of a share falls on capital or revenue account is often a contentious matter. For a discussion on the capital *versus* revenue issue, see the *Tax Brochure for Share Owners*, and the *Comprehensive Guide to Capital Gains Tax* (Issue 3), both of which are available from the SARS website.

Section 9B is intended to provide a so-called “safe haven” for shares listed on a South African-registered stock exchange held for a period of at least five continuous years. This has the effect that a person considered to have held shares on revenue

account can rely on section 9B to have the profit on disposal of the qualifying shares taxed under the more favourable capital gains tax legislation. It is, however, important to note that an election under section 9B does not mean that the disposal of shares held for a shorter period than five continuous years will automatically fall on revenue account. Section 9B does not dispense with the ordinary rules for determining the nature of the amounts derived when shares are sold; it merely provides that, upon election, a taxpayer can choose that the profit on disposal of shares held for a continuous period of at least five years will be of a capital nature.

This Note focuses primarily on taxpayers who held their shares as trading stock. Those who held their shares on capital account were also able to avail themselves of section 9B should they have required assurance that the profits on disposal of shares before 1 October 2007 which were held for at least five years would be of a capital nature.

3. The law

Section 9B

9B. Circumstances in which certain amounts received or accrued in relation to disposal of listed shares are deemed to be of capital nature.—(1) For the purposes of this section “affected share”, in relation to a taxpayer, means a listed share in a company as contemplated in paragraph (a) of the definition of “listed company”, which has been disposed of before 1 October 2007 by the taxpayer who immediately prior to such disposal had been the owner of such share as a listed share for a continuous period of at least five years: Provided that—

- (a) . . .
- (b) where any other share or shares are issued to such taxpayer by the company in which he holds such share in substitution for any such share by reason of a subdivision of any such share or any similar arrangement, or any capitalization share in relation to such share is issued by such company to such taxpayer, such share and such other share or shares or such capitalization share shall be deemed to be one and the same share if—
 - (i) such taxpayer's participation rights and interests, whatsoever, in such company remain unaltered; and
 - (ii) no consideration whatsoever passes directly or indirectly from such taxpayer to such company in relation to the issue of such other share or shares or such capitalization share;
- (c) the taxpayer shall be deemed to have disposed of a share if the share has been cancelled or redeemed or if the relevant company has been liquidated or deregistered.
- (d) where the taxpayer is a registered insurer in terms of the Insurance Act, 1943 (Act No. 27 of 1943), and has acquired a share in accordance with a transfer of insurance business as contemplated in section 25A of that Act from another insurer who carried on long-term and short-term insurance business, both such insurers shall be deemed to be one and the same insurer [Note: The Insurance Act, 1943 was repealed by section 73 of the Long-term Insurance Act, No. 52 of 1998 and by section 1 of the Taxation Laws Amendment Act, No. 30 of 2002]; and
- (e) where—

- (i) any share has been lent by a lender to a borrower in terms of a securities lending arrangement, such share shall for the purposes of the lender be deemed not to have been disposed of by the lender; and
- (ii) any other share of the same kind and of the same or equivalent quantity and quality has been returned by the borrower to the lender, such share and such other share shall be deemed to be one and the same share in the hands of the lender.

(2) Any taxpayer may elect that any amount received by or accrued to or in favour of him as a result of the disposal on or after 14 March 1990 of an affected share, be deemed to be of a capital nature for the purposes of the definition of "gross income" in section 1: Provided that where the taxpayer is a natural person who dies or is declared insolvent during his ownership in an affected share or is a company which is liquidated during its ownership in such share, the executor of such person's deceased estate or the curator of such person's insolvent estate or the liquidator of such company may exercise the election in terms of this subsection.

(3) The election referred to in subsection (2) shall be exercised in respect of the first affected share disposed of by any taxpayer on or after 14 March 1990, and such election shall be made by such taxpayer in his return of income in respect of the relevant year of assessment in which he disposed of such affected share.

(3A) (a) Any election made under subsection (2) in respect of an affected share disposed of prior to 18 March 1992, may be withdrawn by the taxpayer or the executor, curator or liquidator referred to in the proviso to the said subsection and be replaced by a new election which shall be exercised in respect of the first affected share disposed of by the taxpayer on or after that date.

(b) The provisions of subsections (2), (3) and (4) shall *mutatis mutandis* apply to a new election made under paragraph (a).

(4) An election made under subsection (2) shall be binding upon the taxpayer in respect of each succeeding disposal of an affected share during the year of assessment in which he exercised his election and every succeeding year of assessment.

(5) The provisions of this section shall not apply to any affected shares where such shares constitute shares which were deemed to be trading stock of the taxpayer in terms of section 24A(2)(a) of this Act.

(6) If any taxpayer has elected that the provisions of this section shall apply to him, there shall in the year of assessment in which any affected share is disposed of by him, be included in his income any expenditure or losses (excluding so much of any such expenditure or losses as may be allowable as a deduction in the determination of the taxable income derived by the taxpayer from dividends) incurred in respect of such affected share and allowed as a deduction from the income of such taxpayer during such or any previous year of assessment, and any amount allowed to be deducted from the cost price of such affected share under the provisions of section 22(1) in any such year.

(7) Where the taxpayer holds affected shares in any company which were acquired by him on different dates and he has disposed of any of those shares, he shall for the purposes of this section be deemed to have disposed of the affected shares held by him for the longest period of time.

(8) For the purposes of this section any amount included in the income of any taxpayer in terms of section 22(8)(b) as a result of the application, disposal or distribution of any affected share as contemplated in that section, is deemed to be an amount which has accrued to that taxpayer as a result of the disposal of that affected share.

4. Application of the law

4.1 Affected shares

Section 9B is limited to “affected shares”. Affected shares mean listed shares held for a continuous period of at least five years before the date of disposal.

Example 1 – Affected shares

Facts:

JSE-listed shares are acquired on 1 June 2002.

Result:

The shares will qualify as affected shares as from 1 June 2007.

“Listed shares” are shares held in a company whose shares are listed on an exchange as defined in section 1 of the Securities Services Act, No. 36 of 2004 and licensed in terms of section 10 of that Act. Presently the only such exchange is the JSE Ltd (JSE).

The word “share” is not defined in section 1 and must be given its ordinary meaning. It does not, therefore, include instruments such as debentures, stocks, bonds and participatory interests in collective investment schemes as contemplated in the Collective Investment Schemes Control Act, No. 45 of 2002. However, affected shares include JSE-listed preference shares.

Shares received as a result of a rights issue are new shares and will not be affected shares until they have been held for a period of at least five continuous years.

4.2 Disposal of affected shares

The word “disposal” has not been defined and must be given its ordinary meaning. The word indicates an event which results in the owner of shares ceasing to be the owner of those shares. Shares are deemed to be disposed of if they are cancelled or redeemed or if the company has been liquidated or deregistered.

In certain circumstances the continuous ownership of affected shares is preserved despite the fact that the original share may have been disposed of. These circumstances are as follows:

- a) Substitution by reason of a share split or similar arrangement or the issue of capitalisation shares in relation to such share if –
 - i) the taxpayer’s participation rights and interests remain unaltered; and
 - ii) no consideration, either directly or indirectly, was given for such shares.
- b) Securities lending arrangements – Where any share has been lent by a lender to a borrower under a “securities lending arrangement” as defined in section 1, the share will be deemed not to have been disposed of by the lender, provided another share of the same kind and of the same or equivalent quantity and quality will be returned by the borrower to the lender. Upon subsequent return of the shares the replacement shares are deemed to be the same as the original shares borrowed.

- c) Distributions by trusts – Where a beneficiary acquires shares by way of a distribution from a trust, the ownership of the shares by the trustee and thereafter by the beneficiary is not considered to be continuous. However, in the case of a “bewind trust” ownership of assets remains vested in the beneficiary while the assets are held by the trust and the trustee merely acts as an administrator. When the shares are distributed to the beneficiary, the period of ownership is considered to be continuous.
- d) Upon sequestration the estate of an insolvent person is deemed under section 25C to be the same person as the estate of that person prior to insolvency. The transfer of the shares between the estates does not give rise to a disposal for purposes of section 9B.

Example 2 – Capitalization shares

Facts:

In year 1, D acquired 1 000 shares in ABC Ltd, a company listed on the JSE. In year 4 the company issued five capitalization shares in respect of every 100 shares held by its shareholders, thereby increasing D’s holding to 1 050 shares. In year 6, D disposed of the 1 050 shares. D had previously made an election under section 9B.

Result:

Under paragraph (b) of the proviso to section 9B(1) the capitalization shares are deemed to be acquired in year 1 despite being received in year 4. Any profit or loss on disposal of the 1 050 shares will therefore be of a capital nature.

Example 3 – Share split

Facts:

In year 1, H acquired 100 shares in XYZ Ltd, a company listed on the JSE. In year 4, XYZ Ltd split its shares, with two new shares being issued for every one share held. In year 6 H disposed of 100 of the 200 XYZ Ltd shares. H had previously made an election under section 9B.

Result:

Under paragraph (b) of the proviso to section 9B(1) the 100 shares disposed of are deemed to have been acquired in year 1 even though they were issued to H in year 4.

4.3 Election

Section 9B(2) enables a taxpayer to elect that any amount received by or accrued to or in favour of that taxpayer as a result of the disposal of an affected share, be treated as being of a capital nature for the purposes of the definition of “gross income” in section 1. Should a taxpayer elect that the deemed capital rule be applied, any profit or loss on disposal of an affected share will be treated as being of a capital nature. As a result, a capital gain or loss must be determined under the Eighth Schedule to the Act for capital gains tax purposes.

4.3.1 Timing of the election

In order to access the safe haven provisions of section 9B a taxpayer must have made an election. The election must have been exercised by the taxpayer in the return of income in respect of the year of assessment in which the *first* “affected share” was disposed of.

When section 9B was first introduced with effect from 14 March 1990 it provided for a 10-year holding period. This was later reduced to five years by section 9(1)(c) of the Income Tax Act, No. 141 of 1992. Taxpayers who had made an election under the original legislation were permitted to make a fresh election which applied to the first affected share disposed of on or after 18 March 1992 [section 9B(3A)].

An election under the current legislation thus applied to –

- persons who were not bound by the original legislation because they did not dispose of shares held for at least 10 years between 14 March 1990 and 18 March 1992, and
- those who were bound by the original legislation but made a fresh election as described above.

Thus, under the current legislation, if a taxpayer has for the first time –

- disposed of JSE-listed shares before 1 October 2007 held for at least five years, and
- failed to make an election in respect of those shares,

that taxpayer may not make an election under section 9B in respect of any future disposal of a JSE-listed share. This applies regardless of whether the first disposal of “affected shares” was on capital or revenue account.

Section 9B is restrictive in its application and the timing of the election was critical. Persons who had never previously made an election under section 9B were unable to do so unless they had –

- not previously sold JSE-listed shares; or
- previously sold JSE-listed shares, but always within five years of acquisition.

Example 4 – Failure to make an election at the time of the first disposal

Facts:

In 1991 C acquired shares in ABC Ltd and XYZ Ltd, both JSE-listed companies, for the purposes of resale at a profit. Between 1991 and 2006 C bought and sold various other JSE-listed shares all within two years of purchase.

In 1997 C sold the ABC Ltd shares at a loss of R80 000 which was claimed against C’s taxable income. C did not make an election at the time under section 9B as doing so would have prevented C from claiming the loss. In 2006 C sold the XYZ Ltd shares at a profit of R500 000 and sought to make an election under section 9B in order to have the profit classified as being of a capital nature.

Result:

C is not permitted to make the election. Had C wished to take advantage of section 9B, C should have made the election at the time when C disposed of the first “affected shares”, namely, those in ABC Ltd which C had held for more than five years.

Once exercised, the election under section 9B(2) is final and binding on the taxpayer.

4.3.2 Effect of making an election

Once an election has been made in respect of an “affected share” it is binding for all future years of assessment. The election is also binding on the curator of an insolvent estate or the executor of a deceased estate if the election was made by a person before insolvency or death. If no election has previously been made the curator of an insolvent estate, executor of a deceased estate or liquidator of a company in liquidation, as the case may be, may make the election [proviso to section 9B(2)].

Under section 9B(4), the election exercised in terms of section 9B(2) is binding in respect of each succeeding disposal of any affected share during the year of assessment in which the taxpayer exercised the election and every succeeding year of assessment. It is important to note that the election is exercised only once, i.e. when the first affected share is disposed of by the taxpayer. The election is binding in respect of all affected shares disposed of by the taxpayer and not only in respect of the first share disposed of.

Example 5 – Election binding in respect of all JSE-listed shares held*Facts:*

A taxpayer holds 1 000 shares in A Ltd and 2 000 shares in B Ltd for longer than five years and disposes of 500 shares in A Ltd in year 6.

Result:

The taxpayer must exercise an election in year 6 and that election is not only binding in respect of the A Ltd shares, but also in respect of the B Ltd shares.

4.4 Circumstances in which section 9B does not apply

Section 9B does not apply where –

- a taxpayer fails to make an election;
- the shares are deemed to be trading stock in terms of section 24A(2)(a); or
- section 8C applies.

Section 24A deals with shares acquired prior to 1 October 2001 in exchange for shares or fixed property held as trading stock. Section 24A excluded the value of the shares received under the exchange from income but deemed those shares and any capitalization shares in respect of them to be trading stock.

Section 8C deals with the taxation of directors and employees in respect of the vesting of an “equity instrument”. The term “equity instrument” includes a share [section 8C(7)]. The opening words of section 8C(1)(a) provide that gains or losses derived upon vesting of equity instruments must be included in or deducted from income “[n]otwithstanding section 9B . . .”.

4.5 Recoupment of expenditure and losses

Under section 9B(6) any costs or losses allowed to a taxpayer in respect of an affected share must be recouped in the hands of the taxpayer on disposal of an affected share if the taxpayer has made an election under section 9B. This recoupment also includes any reduction in the cost price of the share in terms of section 22(1)(a), but excludes any costs or losses which have been allowed as a deduction in the determination of the taxpayer’s taxable income from dividends.

Example 6 – Recoupment of share-dealing expenditure previously allowed under section 11(a)

Facts:

In year 1, Z bought shares in ABC Ltd, a JSE-listed company with the intention of reselling them at a profit. The following expenditure was incurred by Z in years 1 to 6.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
	R	R	R	R	R	R
Interest	500	700	900	700	500	400
Management fee	200	250	300	400	450	500
Other costs	600	200	300	500	300	400
Total costs	<u>1 300</u>	<u>1 150</u>	<u>1 500</u>	<u>1 600</u>	<u>1 250</u>	<u>1 300</u>

The expenditure incurred in years 1 to 5 had been claimed and allowed as a deduction under section 11(a).

During year 6, Z sold the shares and made an election under section 9B in his return of income for that year.

Result:

The expenditure allowed in years 1 to 5 which amounted to R6 800 is deemed to be recouped and must be included in Z’s income in year 6. Since the proceeds are deemed to be of a capital nature, the expenditure incurred in year 6 will not qualify as a deduction under section 11(a) read with section 23(f).

4.6 The application of the first-in-first-out (FIFO) method on disposal of affected shares

Section 9B(7) deals with the situation in which a taxpayer has acquired shares in a listed company on various dates and disposes of some of them. It then becomes necessary to identify which shares have been disposed of in order to determine whether they have been held for the qualifying five-year period. For this purpose section 9B(7) prescribes the FIFO method.

Example 7 – Compulsory use of FIFO*Facts:*

Y purchased and sold the following shares in B Ltd:

	Purchases	Sales
Year 1	500	
Year 3	1 000	
Year 7	1 500	
Year 8		400
Year 9		1 400

Result:

If Y made an election under section 9B –

- (a) the 400 shares disposed of in year 8 will represent affected shares under the FIFO method, as they form part of the 500 shares purchased in year 1 and were thus held for a continuous period of at least five years; and
- (b) only 1 100 of the 1 400 shares disposed of in year 9 represent affected shares, namely, the remaining 100 shares which were purchased in year 1 plus the 1 000 shares purchased in year 3. The remaining 300 shares were disposed of within the five-year period and do not qualify for safe-haven status under section 9B.

4.7 Treatment of trading stock

Under section 22(1) any person other than a company may reduce the value of shares to their market value at the end of the year of assessment. For example, if a person bought shares at R100 per share during the year of assessment, and their value decreased to R80 at the end of the year of assessment, the difference qualifies as a reduction in terms of section 22(1) against the value that must be brought to income as representing the cost of the trading stock.

Example 8 – Adjustment in respect of write down of trading stock*Facts:*

In year 1, X an individual, bought 1 000 JSE-listed shares at R200 per share. At the end of the year of assessment the market value of the shares was only R150 per share. During years 2 to 6 the value of the shares increased, and at the end of year 6, X disposed of the shares for proceeds of R300 per share and made an election under section 9B. This was X's first disposal of JSE-listed shares held for at least five years.

Result:

Year 1	R	R
Cost of shares		(200 000)
Closing stock at cost price	200 000	
Less: Reduction in market value	<u>(50 000)</u>	
Value of closing stock included in income		<u>150 000</u>
Reduction in taxable income		<u>(50 000)</u>

Under section 9B(6) allowable expenditure and losses incurred before the disposal must be added back in arriving at taxable income in the year of assessment in which the shares are disposed of.

	R
Opening stock [section 22(2)]	(150 000)
<i>Add:</i> Section 9B(6) adjustments	
Opening stock	150 000
Reduction in trading stock (year 1)	<u>50 000</u>
Increase in taxable income	<u>50 000</u>

For capital gains tax purposes, assuming the shares were acquired on or after the valuation date, the capital gain will be determined as follows:

	R
Proceeds	300 000
<i>Less:</i> Base cost	<u>(200 000)</u>
Capital gain	<u>100 000</u>

Section 22(8)(b) deems a taxpayer to have recouped amounts previously allowed as a deduction in respect of the cost of trading stock disposed of by means other than a normal sale (e.g. by donation, distribution *in specie*, etc). For the purposes of section 9B, section 9B(8) deems the amount so recouped to accrue to the shareholder. This deemed accrual is necessary as section 9B(2) only applies if there is a receipt or accrual.

5. Conclusion

Once an election has been made under section 9B, it is binding and cannot be reversed. Taxpayers are advised to keep a proper record of any expenditure claimed against taxable income in respect of their share-dealing activities.

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Date of first issue: 10 August 2007