**INTERPRETATION NOTE: NO. 43 (Issue 4)**

DATE: 6 June 2012

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| **ACT** | **:** | **INCOME TAX ACT NO. 58 OF 1962 (the Act)** |
| **SECTION** | **:** | **SECTION 9C** |
| **SUBJECT** | **:** | **CIRCUMSTANCES IN WHICH CERTAIN AMOUNTS RECEIVED OR ACCRUED FROM THE DISPOSAL OF SHARES ARE DEEMED TO BE OF A CAPITAL NATURE** |

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***Preamble***

In this Note –

- **"CGT"** means capital gains tax, being the portion of normal tax attributable to the inclusion in taxable income of a taxable capital gain;
- **"Eighth Schedule"** means the Eighth Schedule to the Act;
- **"JSE"** means the JSE Limited, licensed as an exchange under the Securities Services Act No. 36 of 2004;
- **"section"** means a section of the Act unless otherwise indicated; and
- unless the context otherwise indicates, any word or expression in this Note bears the meaning ascribed to it in the Act.

## 1. Purpose

This Note provides clarity on the interpretation and application of section 9C, which deems the amount derived from the disposal of certain shares held for a continuous period of at least three years to be of a capital nature.

Interpretation Note No. 43 (Issue 2) "Circumstances in which Amounts Received or Accrued on Disposal of Listed Shares are Deemed to be of a Capital Nature" (31 August 2010) deals with section 9B, the predecessor to section 9C. Section 9B applies to the disposal of JSE-listed shares before 1 October 2007, and issue 2 therefore remains relevant to such disposals. It can be found on the SARS website under Legal & Policy/Interpretation Notes/Archive.

Section 9C was inserted into the Act by section 14(1) of the Revenue Laws Amendment Act No. 35 of 2007. It was deemed to have come into operation on 1 October 2007, and applies to any disposal of a "qualifying share" on or after that date.

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## 2. Background

The first step in determining a person's income tax liability in respect of the disposal of shares is to determine whether the amount received or accrued is of a capital or revenue nature. Any amount received or accrued of a capital nature is specifically excluded from a person's "gross income" as defined in section 1.

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 amount received or accrued on the disposal of a share falls on capital or revenue account is often a contentious matter which can lead to costly and protracted legal disputes. For a discussion on the capital *versus* revenue issue, see the *Tax Guide for Share Owners (Issue 3)*[1] and the *Comprehensive Guide to Capital Gains Tax (Issue 4)*,[2] both of which are available on the SARS website at **www.sars.gov.za**.

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[1] Issued on 27 March 2012.
[2] Issued on 22 December 2011.

While section 9C eliminates uncertainty as to the capital nature of qualifying shares, it does not apply to all types of shares, nor does it apply to disposals of shares within three years of acquisition. Accordingly, it does not provide absolute certainty on whether income tax or CGT should be levied in all circumstances.

## 3. Effective date

Section 9C came into operation on 1 October 2007 and applies to the disposal of qualifying shares on or after that date.

## 4. Definitions [section 9C(1)]

### 4.1 The law

**Section 9C(1)**

> **9C. Circumstances in which certain amounts received or accrued from disposal of shares are deemed to be of a capital nature.**—(1) For the purposes of this section—
>
> **"connected person"** means a connected person as defined in section 1, provided that the expression "and no shareholder holds the majority voting rights of such company" in paragraph (*d*) (v) of that definition shall be disregarded;
>
> **"equity share"** includes a participatory interest in a portfolio of a collective investment scheme in securities;
>
> **"qualifying share"**, in relation to any taxpayer, means an equity share, which has been disposed of by the taxpayer or which is treated as having been disposed of by the taxpayer in terms of paragraph 12 of the Eighth Schedule, if the taxpayer immediately prior to such disposal had been the owner of that share for a continuous period of at least three years excluding a share which at any time during that period was—
>
> (*a*) a share in a share block company as defined in section 1 of the Share Blocks Control Act, 1980 (Act No. 59 of 1980);
>
> (*b*) a share in a company which was not a resident, other than a company contemplated in paragraph (*a*) of the definition of "listed company"; or
>
> (*c*) a hybrid equity instrument as defined in section 8E.

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### 4.2 Definition – connected person

The definition of a "connected person" in section 9C(1) expands paragraph (*d*)(v) of the definition of a "connected person" in section 1 in relation to a company. More specifically, corporate shareholders will be viewed as connected persons in relation to the company in which they hold 20% of the equity shares (even if a shareholder holds the majority voting rights). This definition is applied for purposes of enforcing the three-year immovable property/bare *dominium* anti-avoidance rule in section 9C(3) – see **7**.

### 4.3 Definition – qualifying share

Section 9C applies to a "qualifying share" as defined in section 9C(1). This definition contains a number of requirements, which are discussed in the paragraphs below.

#### 4.3.1 Equity share requirement

A share will be a "qualifying share" as defined in section 9C(1) if, amongst other things, it is an equity share as defined in section 9C(1). The definition of an "equity share" in section 9C(1) expands the definition of the same term in section 1 to include a participatory interest in a portfolio of a collective investment scheme in securities.

A participatory interest in a "portfolio of a collective investment scheme in property" as defined in section 1 falls outside section 9C since it represents an interest in a vesting trust and is neither an "equity share" nor is it deemed to be an equity share.

The term "equity share" is defined in section 1 as follows:[3]

> **"[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 could take the form of a distribution of a dividend, foreign dividend, return of capital or foreign return of capital. As long as the right to participate in either a dividend/foreign dividend or a return of capital/foreign return of capital is unrestricted the share will be an equity share. But if both the right to dividends and the right to capital are restricted the share will not be an equity share.

A share with restricted distribution rights that is convertible to one with unrestricted rights will not be an equity share until the date of conversion.

A "share" is defined in section 1 as follows:

> **"[S]hare"** means, in relation to any company, any share or similar equity interest in that company;

The definition of a "company" in section 1 includes amongst other things a close corporation.[4] A member's interest in a close corporation comprises a "similar equity interest" to a share for the purposes of the above definition.

The issued share capital of a company may consist of ordinary shares and preference shares. Preference shares with limited dividend rights and rights to return of capital on liquidation (non-participating preference shares) do not comprise qualifying shares under section 9C since their right to participate in the distribution of dividends and capital is restricted. A participating preference share will be a qualifying share if its right to participate in dividends is unrestricted even though its right to a return of capital on liquidation may be limited to, say, its issue price (that is, it contains at least one unrestricted right).

In some cases the right to participate in dividends may be limited to profits from a particular source. For example, a holding company may have three subsidiaries, A, B and C. The A class shares of the holding company are entitled to participate in the dividends from A, the B class shares are entitled to participate in the dividends from B and the C class shares are entitled to participate in the dividends from C. This does not mean that the right to participate in dividends is restricted to a particular amount.

Both listed and unlisted equity shares comprise qualifying shares for the purposes of section 9C.

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[3] The definition was substituted by section 7(1)(*i*) of the Taxation Laws Amendment Act No. 24 of 2011 and comes into operation on 1 April 2012 under section 7(4) of that Act.
[4] Paragraph (*f*) of the definition of a "company" in section 1.

Options and other rights to acquire qualifying shares are not equity shares and fall outside section 9C. Likewise convertible debt (for example, a convertible debenture) does not comprise a share until conversion has occurred and is also not a "qualifying share".

### 4.3.2 Disposal requirement

A qualifying share is one that has been –

- disposed of, or
- deemed to be disposed of under paragraph 12 of the Eighth Schedule.

*Disposed of*

The expression "disposed of" is not defined in section 9C or section 1. According to the *New Shorter Oxford English Dictionary on Historical Principles*[5] "dispose" means, amongst other things –

> "3 Bestow, make over; deal out, dispense, distribute.
>
> …
>
> "11 Get rid of; deal conclusively with, settle; *colloq.* kill."

*TheFreeDictionary* (online) contains the following meanings of "dispose of" appropriate to the context of section 9C:[6]

> "2. To transfer or part with, as by giving or selling.
>
> "3. To get rid of; throw out."

Events comprising a disposal in the ordinary sense of the word include the extinction, sale, donation, conversion, cession, exchange, termination, redemption or cancellation of a share.[7]

Shares will be disposed of in the ordinary sense when a company is –

- dissolved following its liquidation or winding-up; or
- deregistered.

The placing of a company into liquidation does not result in a disposal of its shares because it remains a taxable entity until it is finally dissolved.[8] The date of dissolution is the date on which the company's name is removed from the companies register unless the reason for its dissolution is a transfer of its registration to a foreign jurisdiction.[9]

The distribution of a dividend in anticipation of the liquidation of a company does not result in a disposal of its shares.[10]

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[5] Lesley Brown 4 ed (1993) Oxford University Press Inc., New York, United States of America in vol 1.
[6] http://www.thefreedictionary.com/dispose [Accessed 1 June 2012].
[7] These events also comprise a disposal for CGT purposes under paragraph 11 of the Eighth Schedule.
[8] *Van Zyl NO v CIR* 1997 (1) SA 883 (C), 59 SATC 105.
[9] Section 83(1) of the Companies Act No. 71 of 2008.
[10] *Defy Ltd v C: SARS* 2010 (5) SA 416 (SCA), 72 SATC 99 at 109.

The deregistration of a company –[11]

> "puts an end to the existence of the company. Its corporate personality ends in the same way that a natural person ceases to exist on death."

It follows that the extinction of the rights attaching to a share occur on the date of deregistration. This corresponds with the date of disposal for CGT purposes under paragraph 77(1)(*a*) of the Eighth Schedule.

Yet, the time of disposal of an equity share for the purposes of section 9C may not always correspond with the time of disposal of an asset under the Eighth Schedule. Paragraph 77(1) of the Eighth Schedule provides that the shares in a company that is being liquidated or wound up will be deemed to be disposed of on the earlier of –

- the date of dissolution; or
- the date when the liquidator declares in writing that no reasonable grounds exist to believe that the shareholder of the company (or shareholders holding the same class of shares) will receive any further distributions in the course of the liquidation or winding-up of that company.

The above declaration by the liquidator will thus trigger a disposal for CGT purposes, but will have no impact for the purposes of section 9C. One implication of this timing difference is that the earlier CGT disposal will not trigger a recoupment of previously allowed expenditure under section 9C(5). Such a recoupment will only occur on dissolution of the company – see **9**.

The sequestration of the estate of a natural person does not trigger a disposal under section 9C – see **14**.

The death of a natural person does not trigger a disposal for the purposes of section 9C, although death is a disposal event for CGT purposes – see **15**.

*Deemed disposal under paragraph 12 of the Eighth Schedule*

A deemed disposal under paragraph 12 of the Eighth Schedule would occur, for example, when a taxpayer –

- that is not a resident removes a share from a permanent establishment of that taxpayer in South Africa, or transfers a share to such a permanent establishment [paragraph 12(2)(*b*) of the Eighth Schedule];
- commences to hold shares as trading stock [paragraph 12(2)(*c*) of the Eighth Schedule]; or
- ceases to hold shares as trading stock [paragraph 12(3) of the Eighth Schedule].

For a detailed discussion of when paragraph 12 will be applicable, see paragraph 6.2 of the *Comprehensive Guide to Capital Gains Tax* (Issue 4) available at **www.sars.gov.za**.

Some of the implications of a deemed disposal under paragraph 12 of the Eighth Schedule include a deemed recoupment of previously allowed expenditure under section 9C(5) (see **9**), and the switching off under section 9C(7) of the deemed

[11] *Miller & others v Nafcoc Investment Holding Company Ltd & others* [2010] 4 All SA 44 at 49.

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inclusion in income under section 22(8) when shares cease to be held as trading stock (see **12**).

### 4.3.3 Three-year ownership requirement

A taxpayer must have been the owner of a share for a continuous period of at least three years immediately before its disposal in order for it to comprise a qualifying share.

Given that the Act is generally only concerned with beneficial ownership,[12] the word "owner" must be taken as referring to the beneficial owner. For example, when a trustee vests a share in a beneficiary, the share would remain registered in the name of the trustee, but the beneficiary would become the beneficial owner from the date of vesting.

The word "year" is not defined in either section 9C or section 1. Therefore the ordinary meaning ascribed to the word will apply in interpreting its meaning. The word is also not defined in the Interpretation Act.[13]

*LAWSA*[14] states the following on a period expressed in years:

> "By natural computation a period of a year beginning at any moment of time on a specific calendar date will end at the equivalent moment on the corresponding calendar date in the succeeding year."

A share will thus become a qualifying share when the period of holding reaches exactly three continuous years.

### 4.3.4 Partnerships

Under South African law a partnership is not a separate legal *persona* distinct from its members. Should a partnership acquire shares, the continuous three-year holding period applies to the individual partners and not the partnership. In other words, the date of acquisition of a share by a partner held in partnership occurs when that partner acquires a fractional interest in the share.

### 4.3.5 Trusts and their beneficiaries

Section 9C(2) applies to shares held by a discretionary trust. The trust's continuous three-year holding period is measured from the date of acquisition of the share until the date on which it is disposed of. Typically, the trust will dispose of its shares by selling them to a third party or by vesting them in a beneficiary.

A beneficiary's three-year holding period is measured from the date of vesting (the date of acquisition of the share by the beneficiary) until the date on which the beneficiary disposes of the share.

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[12] See, for example, *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 the term "gross income" that the word "received" meant "received by the taxpayer on his own behalf for his own benefit". See also *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.

[13] Act No. 33 of 1957.

[14] E Cameron "Period Expressed in Years" Volume 27 (First Reissue Volume) *The Law of South Africa* (*My LexisNexis*: 31 October 2001) LexisNexis Butterworths, Durban in paragraph 441.

A *bewind* is a type of trust under which the beneficiaries remain the owners of the trust assets and the trustee acts merely as an administrator of those assets. Accordingly, the transfer of administrative control of equity shares by a beneficiary to a *bewind* will not interrupt the beneficiary's continuous holding period for the purposes of section 9C.

### 4.3.6 Non-residents

The amount received by or accrued to a non-resident from the disposal of an equity share will only be included in gross income if the amount is neither of a capital nature nor deemed to be of a capital nature and is derived from a source within or deemed to be within South Africa. Thus if a non-resident trades in shares on the JSE it will first be necessary to determine the source of the amounts derived on disposal of the shares. If the amounts are from a source outside South Africa section 9C will not apply. In determining the source of income derived from the disposal of shares, South African courts have considered it to be the place where the share-dealing business is being carried on. This may be where the capital is employed or where the taxpayer's wits and labour are exercised.

In *Overseas Trust Corporation Ltd v CIR*[15] the appellant carried on a business in South Africa of buying and selling shares and other securities. The company sold certain shares through brokers in Germany. The brokers received instructions from Cape Town to find buyers and to sell the shares at a certain price. The share certificates were forwarded to the German brokers. The court found that the company had acquired the shares in South Africa where its capital was employed and that it did not carry on a business in Germany. The transactions were fully controlled from South Africa and the brokers were merely agents of the appellant acting on its instructions. Accordingly the profit was held to be from a source within South Africa.

In *CIR v Black*[16] the taxpayer, a Johannesburg-based stockbroker, carried on a business of buying and selling shares through a London broker. The broker was entitled to deal in shares without consulting the taxpayer. The court held that the source of the profits was in London because that was where a distinct business of buying and selling shares was being carried on.

In ITC 1779[17] the appellant, a South African resident based in Cape Town, carried on a part-time business of dealing in foreign exchange. Although the taxpayer deposited certain funds in the United States of America with the organisation through which he conducted his activities, the court held that he exercised his wits and labour in South Africa, and it was therefore in South Africa that he carried on his business.

Although the above cases involved residents, the same principles can be applied to a non-resident carrying on share-dealing activities in South Africa. Thus, section 9C will apply to a non-resident carrying on a share-dealing business by employing his or her capital or wits and labour in South Africa. Any profits or losses on disposal of shares forming part of the trading stock of that business will be derived from a source in South Africa. Once the shares have been held for a continuous period of at least three years any proceeds on disposal of the shares will be of a capital nature. In order to be subject to CGT the qualifying shares would either have to be attributable to a permanent establishment in South Africa [paragraph 2(1)(*b*)(ii) of the Eighth

[15] 1926 AD 444, 2 SATC 71.
[16] 1957 (3) SA 536 (A), 21 SATC 226.
[17] (2004) 66 SATC 353 (C).

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Schedule] or represent "immovable property" as defined in paragraph 2(2) of the Eighth Schedule.

### 4.3.7 Exclusions – overview

A "qualifying share" as defined in section 9C(1) specifically excludes –

- shares in share block companies;
- shares in a company which was not a resident, other than a company listed on the JSE; or
- a "hybrid equity instrument" as defined in section 8E.

A share will be disqualified from section 9C if at any time during the continuous three-year period preceding its disposal, the share constituted any of the above-mentioned excluded shares.

### 4.3.8 Exclusion – shares in a share block company

The main object of a share block company is to operate a share block scheme in respect of immovable property owned by it. A person that owns a share in a share block company is entitled to use and occupy a specific unit or portion of the immovable property owned by the share block company. Shares in a share block company are excluded from the definition of a "qualifying share" because these types of investments are normally held on capital account.

### 4.3.9 Exclusion – shares in non-resident companies that are not listed in South Africa

Paragraph (*b*) of the definition of a "qualifying share" in section 9C(1) excludes a share in a company which was not a resident, other than a company contemplated in paragraph (*a*) of the definition of a "listed company" in section 1. Paragraph (*a*) of the definition of a "listed company" refers to –

> "an exchange as defined in section 1 of the Securities Services Act, 2004 (Act No. 36 of 2004), and licensed under section 10 of that Act".

Thus, an equity share in a non-resident company will be a "qualifying share" only if it is listed on an exchange in South Africa. Examples of non-resident companies whose shares are listed on the JSE and thus comprise "qualifying shares" include Anglo American plc, BHP Billiton plc, Investec plc, Old Mutual plc and SABMiller plc.

The exclusion of shares in non-resident companies (other than those listed on the JSE) from the definition of a "qualifying share" is justified in that for tax purposes foreign shares are treated differently to local shares. For example, a capital gain or loss on disposal of 10% or more of the shares in a foreign company to a non-resident is excluded from CGT under the participation exemption in paragraph 64B of the Eighth Schedule while local shares can only benefit from being taxed at the reduced CGT effective rate.

### 4.3.10 Exclusion – hybrid equity instruments

Any "hybrid equity instrument" as defined in section 8E is specifically excluded from being classified as a qualifying share because its participation rights (similar to a non-participating preference share) are effectively limited and it is in many ways more akin to debt than pure equity.

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# 5. Amounts deemed to be of a capital nature [section 9C(2)]

## 5.1 The law

**Section 9C(2)**

> (2) Any amount other than a dividend or foreign dividend received by or accrued to a taxpayer in respect of a qualifying share shall be deemed to be of a capital nature.

## 5.2 Application of the law

### 5.2.1 Amount received or accrued on disposal of qualifying shares deemed to be of a capital nature

Section 9C(2) deems any amount (other than a dividend or foreign dividend) received or accrued in respect of a "qualifying share" to be of a capital nature.

Shares which were accounted for as trading stock under section 22 during the three years after their acquisition must nevertheless continue to be accounted for as trading stock until they are disposed of (see **10**). At the time of disposal any expenditure previously allowed as a deduction (including the value of opening stock) will be included in income as a recoupment under section 9C(5) (see **9)**. The qualifying portion of such recouped expenditure will then form part of the base cost of the shares for the purposes of determining a capital gain or loss under the Eighth Schedule (see **10**).

As a result of the introduction of dividends tax on 1 April 2012 the terms "dividend" and "foreign dividend" are now separately defined in section 1. Any dividend or foreign dividend received by or accrued to a person in respect of a qualifying share is specifically excluded from section 9C(2). Such an excluded dividend is one that coincides with, or is derived after, the disposal of a share, since a qualifying share is by definition one that has been disposed of.

Examples include dividends –

- received or accrued upon a share buy-back;
- received or accrued as part of a final liquidation dividend; and
- received by or accruing to a seller after the disposal of a share, that is, the sale of a share "ex dividend".

Since a dividend and a foreign dividend are specifically included in gross income under paragraph (*k*) of the definition of the term "gross income", whether of a capital nature or not, their exclusion from section 9C(2) is technically unnecessary. Nevertheless, their exclusion from being deemed to be of a capital nature does emphasise that such dividends and foreign dividends do remain gross income, and hence will not form part of proceeds for CGT purposes.

### 5.2.2 Mandatory application and impact on gains and losses

A share fulfilling the requirements of section 9C will automatically be on capital account, even if the taxpayer held the shares as trading stock. This result applies to both gains and losses. Thus a share-dealer is unable to elect out of section 9C in order to claim losses on disposal of qualifying shares on revenue account.

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### 5.2.3 Shares disposed of within three years

Section 9C(2) does not regulate the capital or revenue nature of shares disposed of within three years. Whether the disposal of a particular share is on capital or revenue account will depend on the facts and circumstances of the particular case and the application of principles laid down by case law (see **2.1**).

## 6. Venture capital company (VCC) shares [section 9C(2A)]

### 6.1 The law

**Section 9C(2A)**

> (2A) Subsection (2) does not apply in respect of so much of the amount received or accrued in respect of the disposal of a qualifying share contemplated in that subsection as does not exceed the expenditure allowed in respect of that share in terms of section 12J(2).

**Section 12J(2)**

> (2) Subject to subsections (3), (3A) and (4), there must be allowed as a deduction from the income of a taxpayer expenditure actually incurred by that taxpayer in acquiring any venture capital share issued to that taxpayer by a venture capital company.

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### 6.2 Application of the law

Section 12J was inserted into the Act by section 27(1) of the Revenue Laws Amendment Act No 60 of 2008 with effect from 1 July 2009. The section was substantially amended by the Taxation Laws Amendment Act No. 24 of 2011, with most of the amendments applying to years of assessment commencing on or after 1 January 2012.

The deduction under section 12J(2) read with section 12J(3), (3A) and (4) only covers the acquisition of newly issued shares, in other words the deduction does not apply to secondary trading in VCC shares. No deduction will be granted under section 12J for VCC shares acquired after 30 June 2021.[18]

Any amount allowed as a deduction under section 12J(2) is recouped under section 8(4)(*a*) upon the disposal of shares held in an approved VCC. Any amount recouped under section 8(4)(*a*) is automatically included in the gross income of the person disposing of the shares, irrespective of the capital or revenue nature thereof.

Under section 9C(2A) an amount received or accrued on or after 1 July 2009 for the sale of shares in an approved VCC that is recouped under section 8(4)(*a*) will not be deemed to be of a capital nature under section 9C(2). Any amount received or accrued in excess of the amount recouped under section 8(4)(*a*) will, however, be deemed to be of a capital nature under section 9C(2) provided that the shares have been held for at least three continuous years.

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[18] Section 12J(11).

**Example 1 – Application of section 9C(2A) to disposal of VCC shares**

*Facts:*

Company A, which has a financial year that ends on 31 December, acquires shares in an approved VCC on 1 January 2012 for R400 000. On 30 September 2015 Company A sells the shares for R900 000.

*Result:*

*Income tax consequences*

**2012 year of assessment**
Company A qualifies for a deduction of R400 000 under section 12J(2).

**2015 year of assessment**
Upon the disposal of the shares R400 000 is recouped under section 8(4)(*a*) [that is, the amount previously allowed as a deduction under section 12J(2)].

The amount deemed to be of a capital nature under section 9C is equal to the amount received or accrued in excess of the amount recouped under section 8(4)(*a*), namely, R500 000 (R900 000 – R400 000). This amount is subject to CGT.

*CGT consequences*

| | | |
|---|---|---|
| | | R |
| Amount received or accrued | | 900 000 |
| *Less*: Amount recouped under section 8(4)(*a*) | | (400 000) |
| Proceeds | | 500 000 |
| *Less*: Base cost | | (Nil) |
| Cost | 400 000 | |
| *Less*: Deduction under section 12J(2) | (400 000) | |
| Capital gain | | 500 000 |
| Taxable capital gain (66,6%[19] of R500 000) | | 333 000 |

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## 7. Anti-avoidance measures applying to Immovable property and bare *dominium* schemes [section 9C(3)]

### 7.1 The law

(3) The provisions of this section shall not apply to any qualifying share if at the time of the disposal of that share the taxpayer was a connected person in relation to the company that issued that share and—

(*a*) more than 50 per cent of the market value of the equity shares of that company was attributable directly or indirectly to immovable property other than—

(i) immovable property held directly or indirectly by a person that is not a connected person to the taxpayer; or

(ii) immovable property held directly or indirectly for a continuous period of more than three years immediately prior to that disposal; or

[19] Assumed inclusion rate based on the inclusion rate for companies for years of assessment commencing on or after 1 March 2012.

(*b*) that company acquired any asset during the period of three years immediately prior to that disposal and amounts were paid or payable by any person to any person other than that company for the use of that asset while that asset was held by that company during that period.

## 7.2 Application of the law

The effective CGT rate is lower than the effective rate at which other income of a revenue nature is subject to income tax. The potential abuse of section 9C necessitated the introduction of anti-avoidance provisions in order to prevent speculators in immovable property from converting their revenue profits into capital profits.

In the absence of section 9C(3) a person could buy immovable property and place it in a company or close corporation in which that person has held the shares or member's interest for at least three continuous years. The shares or member's interest could then be disposed of and the amount received or accrued on disposal of the shares or member's interest would have been deemed to be of a capital nature under section 9C(2).

Section 9C will not apply if the requirements of section 9C(3) are met. In such event, the capital or revenue nature of the amount derived on disposal of the shares must be determined by applying the general principles laid down by the South African tax courts.

Before section 9C(3)(*a*) or (*b*) can be applied, the taxpayer must be a connected person in relation to the company that issued the shares at the time of their disposal. On the extended meaning of a "connected person" see **4.2**.

### 7.2.1 Companies holding immovable property

For section 9C(3)(*a*) to apply, more than 50% of the market value of the equity shares being disposed of must be directly or indirectly attributable to "tainted" immovable property. The words "immovable property" are not defined for the purposes of section 9C(3), but under Roman-Dutch law includes land, buildings with foundations in the soil, trees, growing crops, real rights over immovable property (for example, a registered usufruct, a registered lease of not less than ten years, old and new order mineral rights, a registered praedial servitude and building restrictions).

The reference to the value of the equity shares being indirectly attributable to immovable property would include, for example, a situation in which the company holds shares in another company which holds immovable property, or when the company is a lessee under a non-registered lease. In the latter case the lease right, which is not itself immovable property, derives its value from the immovable property of the lessor.

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The words "market value" are neither defined in section 9C nor in section 1 and must accordingly be given their ordinary meaning for purposes of interpreting section 9C. The International Valuation Standards[20] define "market value" as –

> "the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion".

In determining whether more than 50% of the market value of shares in a company is directly or indirectly attributable to immovable property, any liabilities in the company must be disregarded. In other words, the determination is made on the basis of the market value of the tainted immovable property compared to the market value of all assets, and not on the basis of net asset values. This interpretation is consistent with SARS's interpretation of paragraph 2(2) of the Eighth Schedule and the OECD's interpretation of article 13(4) of the OECD model tax treaty, both of which contain similar wording.[21]

Certain types of "untainted" immovable property are excluded as immovable property for the purposes of section 9C(3)(*a*), namely, immovable property held directly or indirectly –

- by a person that is not a connected person to the taxpayer; or
- for more than three continuous years immediately before that disposal.

An example of the first bullet point above could arise if the company is a lessee under a non-registered lease and the shareholder of that company is not a connected person in relation to the lessor.

**Example 2 – Company holding tainted immovable property [section 9C(3)(*a*)]**

*Facts:*

In year 1 X acquired all the equity shares of several shelf companies. In year 5, X provided one of these companies, Propco, with a guarantee so that it could acquire a block of flats. Bank Y provided Propco with a mortgage bond to finance the acquisition of the flats.

Six months after Propco acquired the flats X sold the shares in Propco.

*Result:*

X is a connected person in relation to Propco. More than 50% of the market value of X's shares in Propco is directly attributable to immovable property. The immovable property is tainted because it has been held for less than three consecutive years. Section 9C(2) will not apply when X disposes of the shares in Propco. The capital or revenue nature of the amount derived on disposal of the Propco shares must be determined by applying the principles laid down by case law.

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[20] IVS 1 – Market Value Basis of Valuation, Seventh Edition.

[21] See *Comprehensive Guide to CGT* (Issue 4) in 4.2 and the commentary on the OECD's "Model Tax Convention on Income and on Capital" 8 ed (22 July 2010) condensed version in para 28.4.

**Example 3 – Company holding tainted and untainted immovable property [section 9C(3)(*a*)] – Impact of liabilities in the company**

*Facts:*

Z has owned all the shares in ABC (Pty) Ltd (ABC) for ten years. ABC's assets comprise Stand 1 and Stand 2, with market values of R400 000 and R600 000 respectively. The purchase of Stand 2 was financed by a mortgage bond, of which R350 000 is still outstanding.

Stand 1 is debt free. Stand 1 has been owned for four years, while Stand 2 has only been owned for three months. Z disposed of all the shares in ABC to a third party for R650 000.

*Result:*

Z is a connected person in relation to ABC.

Stand 1 is "untainted" since it has been held for at least three consecutive years. Stand 2 has only been held for three months and is, therefore, tainted for the purposes of applying section 9C(3).

The market value of both properties is R400 000 (40% – Stand 1) + R600 000 (60% – Stand 2) = R1 000 000 (100%). Since 60% of the assets of ABC comprise tainted immovable property, 60% of the market value of the equity shares in ABC derive their value from such property. Section 9C(2) will, therefore, not apply when Z disposes of the shares in ABC.

Note that no regard is had to the bond of R350 000 in comparing the market values of the tainted and untainted assets. The capital or revenue nature of the amount derived on disposal of the shares must be determined by applying the principles laid down by case law.

#### 7.2.2 Bare *dominium* scheme

Section 9C(3)(*b*) applies when –

- the company in which the qualifying shares are held, acquired any asset during the continuous three-year period immediately before the disposal; and
- rentals in respect of that asset were paid or payable to a person other than the company for the use of that asset while that asset was held by that company during the three-year period.

**Example 4 –Bare-*dominium* scheme [section 9C(3)(*b*)]**

*Facts:*

K has owned all the equity shares in XYZ (Pty) Ltd (XYZ) for five years. At the beginning of year 5 XYZ purchased the bare *dominium* in a luxury flat for R2 million, fully funded by a mortgage bond. The seller of the flat retained the lease rights for ten years. XYZ's other assets comprise share investments and cash worth R4 million, funded by a shareholder's loan account. The bare *dominium* has a market value at the end of year 5 of R3,5 million. K sells the shares in XYZ at the end of year 5 for R1 500 000 and cedes the loan account for its face value of R4 million.

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*Result:*

K is a connected person in relation to XYZ. Section 9C(3)(*a*) does not apply because R4 million of XYZ's assets of R7,5 million comprise untainted assets. However, section 9C(3)(*b*) applies because the bare *dominium* was acquired within three continuous years of the date of disposal of the shares and the lease rentals were receivable by a person other than XYZ. Section 9C(2) will, therefore, not apply when K disposes of the shares in XYZ. The capital or revenue nature of the amount derived on disposal of the shares must be determined by applying the principles laid down by case law.

## 8. Securities-lending arrangements [section 9C(4)]

### 8.1 The law

**Section 9C(4)**

(4) For purposes of this section, where—

(*a*) 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

(*b*) 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.

### 8.2 Application of the law

A "securities lending arrangement" is defined in section 1 and means a "lending arrangement" as defined in the Securities Transfer Tax Act No. 25 of 2007.

A "lending arrangement" as defined in section 1 of the Securities Transfer Tax Act, 2007 applies to a "listed security", which is defined in section 1 of that Act as "any security listed on an exchange". A "security" is defined in the same Act under section 1 as follows:

**"[S]ecurity"** means—

(*a*) any share or depository receipt in a company; or

(*b*) any member's interest in a close corporation,

(*c*) . . . .

excluding the debt portion in respect of a share linked to a debenture;

In reality when a share is lent under a securities lending arrangement, ownership of the share passes from lender to borrower upon delivery of the share. In order to prevent income inclusions and capital gains and losses from arising under such transactions, the Act contains non-disposal and acquisition rules. These rules cover trading stock [section 22(4A) and (9)] and capital gains tax (paragraph 11(2)(*h*) of the Eighth Schedule). For the purpose of determining the three-year continuous holding period under the definition of a "qualifying share" in section 9C(1), the lender is deemed to have enjoyed uninterrupted ownership of the shares during the lending period.

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More specifically,

- a share lent under a securities lending arrangement is deemed not to be a disposal in the hands of the lender [section 9C(4)(*a*)]; and
- a share of the same kind and same or equivalent quantity and quality returned by the borrower as a replacement for the share originally borrowed is deemed to be one and the same share in the hands of the lender [section 9C(4)(*b*)].

In order to qualify as a "securities lending arrangement", the borrower must, amongst other things, return the securities (qualifying shares in this context) to the lender before the expiry of a 12-month period from the date the securities were initially transferred from the lender to the borrower.

**Example 5 – Securities-lending arrangement resulting in deemed uninterrupted ownership**

*Facts:*

On 2 January of year 1 Company A acquired 20 000 class B equity shares in Listco.

On 1 June of year 2 Company A lent the 20 000 Listco shares to Company B under a securities lending arrangement. Company B gave Company A collateral in the form of cash, government securities and a letter of credit and undertook to compensate Company A for any distributions from the Listco shares that Company A would have been entitled to receive during the lending period had the arrangement not been entered into.

On 30 May of year 3, Company B returned 20 000 class B equity shares in Listco to Company A.

On 3 January of year 4 Company A disposed of the 20 000 Listco shares.

*Result:*

The lending arrangement will not be deemed to be a disposal of shares because the transaction qualifies as a "securities lending arrangement" as defined in section 1, that is, the shares were returned within 12 months from the date of transfer to the borrower and are of the same kind and quality and Company B is contractually bound to compensate Company A for any distributions received during the lending period.

Company A is accordingly regarded as having held the shares for an uninterrupted period of at least three years and the amount received or accrued on disposal of the shares on 3 January of year 4 is deemed to be of a capital nature under section 9C(2).

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## 9. Recoupment of expenditure or losses [section 9C(5)]

### 9.1 The law

**Section 9C(5)**

(5) There shall in the year of assessment in which any qualifying share is disposed of by the taxpayer be included in the taxpayer's income any expenditure or losses incurred in respect of such qualifying share and allowed as a deduction from the income of the taxpayer during that or any previous year of assessment in terms of section 11.

### 9.2 Application of the law

Under section 9C(5) any expenditure or losses allowed as a deduction to a taxpayer in respect of a qualifying share under section 11, must be recouped in the hands of the taxpayer in the year of assessment in which the share is disposed of.

This recoupment also includes any reduction in the cost price of a share allowed under section 22(1)(*a*) read with section 11(*x*) in determining the value of trading stock held at the end of a year of assessment. Section 11(*x*) allows as a deduction –

> "any amounts which in terms of any other provision in this Part, are allowed to be deducted from the income of the taxpayer".

"This Part" refers to Part I (Normal Tax) of Chapter II (The Taxes), covering sections 5 to 37H, and thus includes any write-down of a qualifying share by a natural person or trust under section 22(1)(*a*) during years of assessment commencing before 1 January 2011. For years of assessment commencing before 1 January 2011 section 22(1)(*a*) allowed natural persons and trusts to write down the cost price of shares held as closing stock if their value fell below cost. This deduction did not apply to shares held by any company in any other company. With effect from years of assessment commencing on or after 1 January 2011, it is no longer possible for any taxpayer to claim a deduction for the write-down of a financial instrument. The recoupment under section 9C(5) will accordingly cover any write-down by a natural person or trust of shares during years of assessment commencing before 1 January 2011.

The amount of the deemed recoupment is made with reference to the amounts previously allowed as a deduction against income, and bears no relationship to any amount derived on disposal of the share. Thus, even if a share is disposed of at a capital loss, the recoupment remains unaffected.

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**Example 6 – Non-resident taxpayer removing a share from a permanent establishment after holding shares for three years**

*Facts:*

ABC Plc operates a branch in South Africa for the purpose of carrying on share-dealing activities. At the beginning of year 1 the manager of the branch acquired 100 shares in XYZ Ltd, a JSE-listed company at a cost of R100. In year 4 ABC Plc decided to close down the branch and effectively manage the share-dealing activities from offshore. The XYZ Ltd shares had a market value of R120 at the time they ceased to form part of the branch.

*Result:*

**Year 4**

| | R |
|---|---|
| Opening stock [section 22(2)] | (100) |
| Recoupment [section 9C(5)] | 100 |
| Proceeds | 120 |
| *Less:* Base cost | (100) |
| Capital gain | 20 |

**Example 7 – Recoupment of share-dealing expenditure previously allowed under section 11(*a*)**

*Facts:*

At the beginning of year 1, Z bought shares in ABC Ltd, a JSE-listed company with the intention of selling them at a profit. Z incurred the following expenditure 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 | 1 300 | 1 150 | 1 500 | 1 600 | 1 250 | 1 300 |

Z sold the shares during year 6.

*Result:*

The expenditure incurred in years 1 to 3 is allowable as a deduction under section 11(*a*).

The expenditure incurred in years 4 to 6 is not allowable under section 11(*a*) read with section 23(*f*) since it is incurred in the production of a receipt or accrual which will be of a capital nature.

The expenditure allowed in years 1 to 3 of R3 950 (R1 300 + R1 150 + R1 500) is recouped under section 9C(5) and must be included in Z's income in year 6.

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**Example 8 – Recoupment of expenditure despite disposal of shares at a capital loss**

*Facts:*

At the beginning of year 1, X acquired 100 shares in ABC Ltd, a JSE-listed company at a cost of R100 000 with the intention of selling them at a profit. During years 1 to 3 X claimed interest expenditure of R60 000 on funds used to purchase these shares as a deduction under section 11(*a*). At the end of year 4 the shares were sold for proceeds of R70 000.

*Result:*

In year 4 there will be a recoupment under section 9C(5) of R160 000, being the deduction for opening stock of R100 000 plus the interest expenditure claimed under section 11(*a*) of R60 000.

The capital loss on disposal of the shares is determined as follows:

| | | R |
|---|---|---|
| Proceeds | | 70 000 |
| *Less:* Base cost | | (120 000) |
| Cost of acquisition (paragraph 20(1)(*a*) of the Eighth Schedule) | 100 000 | |
| Interest expense (paragraph 20(1)(*g*) of the Eighth Schedule) R60 000 x 1/3 | 20 000 | |
| Capital loss | | (50 000) |

**10. Share-dealers**

Section 9C draws no distinction between a share-dealer who carries on a distinct business of buying and selling shares for profit and a person who invests in shares as a long-term investment but speculates in some shares from time to time. The holding of shares by a share-dealer or the occasional speculator for at least three continuous years converts the amount derived on disposal from income to an amount of a capital nature. Amounts previously allowed as a deduction (for example, opening stock or interest on monies borrowed to buy shares) must be recouped on disposal of the shares and a capital gain or loss determined as if the shares had been held on capital account from the date of acquisition.

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Both categories of persons are subject to section 9C and do not have an option to elect out of the provision in order, for example, to claim revenue losses on shares held for three years or longer.

In the year of acquisition a share-dealer will be entitled to claim the cost of acquisition of shares under section 11(*a*). At the end of that year of assessment the value of the share must be brought to account as closing stock under section 22(1). With effect from years of assessment commencing on or after 1 January 2011 the amount to be included in closing stock is the cost price of the shares, and no reduction is permissible if the market value of the shares is lower than cost.[22] Before the amendment to section 22(1)(*a*)[23] only corporate shareholders were prevented from writing down the value of shares held as closing stock.

The closing stock of a previous year of assessment becomes deductible as opening stock under section 22(2). This process continues even after the three-year period has passed, since the shares remain trading stock as defined in section 1. The definition of "trading stock" includes (apart from some exceptions not relevant for present purposes) –[24]

> "anything produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by the taxpayer or on behalf of the taxpayer".

[22] Section 22(1)(*a*) now excludes the write down of financial instruments.
[23] Section 39(1)(*a*) of the Taxation Laws Amendment Act No. 7 of 2010.
[24] Paragraph (*a*)(i) of the definition of "trading stock" in section 1.

Equity shares held as trading stock are normally acquired for the purposes of sale and thus satisfy the above part of the definition.

For income tax purposes a share-dealer is entitled to deduct certain ongoing expenses incurred in respect of shares held as trading stock under section 11(*a*). Examples of such expenditure include –

- technical analysis software to manage trading portfolios;
- monthly download fees incurred for the above-mentioned software;
- bank charges;
- interest incurred on money borrowed to finance the acquisition of shares;
- internet access charges;
- scrip custody fees; and
- cost of telephone calls.

These expenses will be deductible during the three years following the date of acquisition of the shares to which they relate. However, as from the beginning of the fourth year any further expenditure of this nature will no longer qualify for deduction under section 11(*a*) since it will no longer be incurred in the production of income. At the beginning of year 4 any proceeds on disposal of the shares can only be of a capital nature under section 9C(2).

Could these expenses be said to be in the production of the income in the form of the recoupment under section 9C(5) of opening stock in the year of disposal? In order for expenditure to be in the production of income there must be a close causal relationship between the expense and the income to which it relates.[25] The recoupment under section 9C(5) of the value of opening stock finds its originating cause in the deduction of the acquisition cost of the shares at the beginning of year 1. The expenses incurred in year 4 and beyond have no impact on the generation of that recoupment and cannot increase its quantum. The expenses incurred after year 3 can therefore only generate a future receipt or accrual of a capital nature and are disqualified from deduction under section 23(*f*).

In the year of disposal of qualifying shares a share-dealer must include in income under section 9C(5) the value of those shares included in opening stock and any other expenses pertaining to them which have been claimed as a deduction for income tax purposes in that year or any previous year of assessment.

These recouped expenses will form part of the base cost of the qualifying shares for CGT purposes, provided that they meet the requirements of paragraph 20 of the Eighth Schedule. Normally an amount which has been allowed as a deduction against income will not form part of the base cost of an asset, even if that amount has been recouped, because paragraph 20(3)(*a*) of the Eighth Schedule eliminates such amounts from base cost in order to prevent double deductions. However, paragraph 20(3)(*a*)(ii) excludes from this base cost reduction rule amounts recouped under section 9C(5). Not all amounts subject to recoupment under section 9C(5) will qualify to form part of the base cost of qualifying shares. For example, the interest incurred on amounts borrowed to fund the acquisition of shares listed on a recognised exchange or a participatory interest in a portfolio of a collective

[25] *Port Elizabeth Electric Tramway Company Ltd v CIR* 1936 CPD 241, 8 SATC 13.

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investment scheme must be reduced by two-thirds under paragraph 20(1)(*g*) of the Eighth Schedule. While paragraph 20(1)(*c*)(i) of the Eighth Schedule allows broker's costs directly related to the acquisition or disposal of an asset, no provision is made for the inclusion of portfolio management fees in base cost.

A share-dealer may have difficulty in determining which expenses relate to –

- taxable income derived from share-dealing operations of qualifying shares;
- taxable income derived from share-dealing operations of non-qualifying shares; and
- exempt dividends.

In most cases the expenses would be incurred in the production of all the above. The Act does not prescribe a method of apportionment. Accordingly, any apportionment of expenditure must be made on a logical, fair and reasonable basis taking into account the facts and circumstances of the particular case.[26]

A "return of capital" as defined in section 1 constitutes gross income in the hands of a share-dealer, even if received or accrued after the shares have been held for at least three continuous years. Section 9C(2) cannot apply to such an amount because a share only becomes a "qualifying share" once it has been disposed of. In these circumstances the definition of "gross income" in section 1 takes precedence with the result that the amount would not also have to be accounted for as a reduction in base cost under paragraph 76B of the Eighth Schedule.[27]

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## 11. "First-in-first-out" method [section 9C(6)]

### 11.1 The law

**Section 9C(6)**

> (6) Where the taxpayer holds identical shares in the same company which were acquired by the taxpayer on different dates and the taxpayer has disposed of any of those shares, the taxpayer shall for the purposes of this section be deemed to have disposed of the shares held by the taxpayer for the longest period of time

### 11.2 Application of the law

Section 9C(6) deals with the situation in which a taxpayer has acquired identical shares in the same 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 three-year period. For this purpose section 9C(6) prescribes the "first-in-first-out" method (FIFO).

This rule is not in conflict with the identification rules under paragraph 32 of the Eighth Schedule used for CGT purposes for determining the base cost of identical assets. Paragraph 32 permits the use of the specific-identification method, the FIFO method or the weighted-average method. While it is appreciated that two different identification rules may apply for the same set of shares, the rules serve different purposes and need not be aligned. The identification rules in the Eighth Schedule are

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[26] See *SIR v Guardian Assurance Holdings (SA) Ltd* 1976 (4) SA 522 (A), 38 SATC 111 at 126 and *CIR v Nemojim* 1983 (4) SA 935 (A), 45 SATC 241 at 260.

[27] There is a necessary implication against double taxation in the Act (*CIR v Delfos* 1933 AD 242, 6 SATC 92 at 112).

used for purposes of determining the base cost of shares for CGT purposes while the section 9C identification rule is used only for purposes of determining the holding period of shares that have been disposed of. On the question of non-alignment, while CGT allows for the weighted-average method in calculating the base cost of shares, this method cannot be applied for purposes of determining the time period for which shares were held because it disregards specific dates of acquisition and disposal. Consequently it will be necessary for a taxpayer who uses the specific-identification method or the weighted-average method to determine the base cost of shares for CGT purposes to also maintain a record of purchases and sales of shares on the FIFO basis in order to apply section 9C.

**Example 9 – Application of the FIFO method**

*Facts:*

Company X acquires shares in listed Company Z as trading stock in the following sequence:

- 1 February 2006: 20 000 shares @ R185 per share
- 1 January 2009: 10 000 shares @ R120 per share
- 1 February 2011: 15 000 shares @ R205 per share

On 1 March 2011 Company X sold 15 000 shares @ R220 per share.

On 1 April 2011 Company X sold 10 000 shares @ R230 per share.

Company X adopts the specific-identification method for income tax and CGT purposes and nominates the shares with the highest cost / base cost to have been disposed of.

*Result:*

*Disposal – 1 March 2011*

Under section 9C(6) the 15 000 shares sold are deemed to be sourced from the 20 000 shares acquired on 1 February 2006. More than three continuous years have passed from that date, and the consideration received or accrued is therefore deemed to be of a capital nature under section 9C(2).

For the purposes of determining the base cost of the shares disposed of, the taxpayer would nominate the shares to have been acquired on 1 February 2011 at a cost of R205 per share, since this will result in the highest base cost. In other words, section 9C(6) merely determines whether the proceeds on disposal of the shares are of a capital nature. The taxpayer is not bound by section 9C(6) for the purpose of determining its cost / base cost.

Capital gain = (R220 – R205) x 15 000 = R225 000

*Disposal – 1 April 2011*

Of the 10 000 shares disposed of, 5 000 are for the purposes of section 9C deemed under section 9C(6) to be from the shares acquired on 1 February 2006. These shares are therefore deemed to be disposed of on capital account under section 9C(2). After applying the FIFO method, all remaining shares have been held for less than three years. Those remaining shares will be on revenue account because according to the facts they were acquired as trading stock.

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For cost / base cost purposes, the company has already regarded the 15 000 shares acquired on 1 February 2011 as having been disposed of on 1 March 2011. The shares still on hand for cost-identification purposes with the next highest cost are the 20 000 shares acquired on 1 February 2006 at R185 per share.

**CGT**

| | R |
|---|---|
| Proceeds (5 000 x R230) | 1 150 000 |
| *Less:* Base cost (5 000 x R185) | (925 000) |
| Capital gain | 225 000 |

**Ordinary income**

| | |
|---|---|
| Amount received or accrued (5 000 x R230) | 1 150 000 |
| *Less:* Cost of sales (5 000 x R185) | (925 000) |
| Inclusion in taxable income | 225 000 |

## 12. Suspension of section 22(8) on shares ceasing to be held as trading stock [section 9C(7)]

### 12.1 The law

**Section 9C(7)**

(7) The provisions of section 22(8) shall not apply as a result of the disposal of any qualifying share.

### 12.2 Application of the law

Section 22(8) provides for a deemed inclusion in income when trading stock is applied in a manner other than by way of an arm's length sale. For example, this deemed inclusion would apply if shares were donated, disposed of other than in the ordinary course of trade for a consideration less than market value or distributed *in specie*.[28]

Section 9C(7) prevents the application of section 22(8) upon disposal of a qualifying share, thus ensuring that any consideration (including any deemed consideration) will be on capital account.

**Example 10 – Exclusion of application of section 22(8) by section 9C(7)**

*Facts:*

On 1 February 2007, Company A acquired 100 equity shares in Listco for R100 000, which it held as trading stock. On 1 March 2011, Company A distributed the 100 Listco shares as a dividend *in specie* when their market value was R300 000.

[28] See Interpretation Note No. 65 "Trading Stock – Inclusion in Income when Applied, Distributed or Disposed of Otherwise than in the Ordinary Course of Trade" (24 February 2012).

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*Result [in the absence of section 9C(7)]:*

In the absence of section 9C(7) a deemed disposal of trading stock at market value would be triggered on 1 March 2011 under section 22(8)(*b*)(iii). Company A would thus have had a net inclusion in taxable income of R200 000 determined as follows:

| | R |
|---|---|
| Inclusion in income [section 22(8)(*b*)(iii)] | 300 000 |
| *Less:* Opening stock [section 22(2)] | (100 000) |
| Taxable income | 200 000 |

*Result [applying section 9C(7)]:*

**Ordinary income**

| | |
|---|---|
| Recoupment of opening stock [section 9C(5)] | 100 000 |
| *Less:* Opening stock [section 22(2)] | (100 000) |
| Net effect on taxable income | Nil |

**CGT**

| | |
|---|---|
| Proceeds | 300 000 |
| *Less:* Base cost | (100 000) |
| Capital gain | 200 000 |

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## 13. Consolidation and subdivision of shares and conversions under sections 40A and 40B [section 9C(8)]

### 13.1 The law

**Section 9C(8)**

(8) For the purposes of this section, where a company issues shares to a person in substitution of previously held shares in that company by reason of a subdivision, consolidation or similar arrangement or a conversion contemplated in section 40A or 40B, such share and such previously held shares shall be deemed to be one and the same share if—

(i) the participation rights and interests of that person in that company remain unaltered; and

(ii) no consideration whatsoever passes directly or indirectly from that person to that company in relation to the issued shares.

### 13.2 Application of the law

Taxpayers are not required to start a new time count for the period of shareholding when –

- shares are consolidated (for example, one class A ordinary share in Company X is received for every five pre-existing class A ordinary shares in Company X);
- shares are subdivided (for example, two ordinary shares in Company Y are received in return for every one pre-existing ordinary share in Company Y);
- a close corporation is converted to a company under section 40A; and
- a co-operative is converted to a company under section 40B

The rules under section 9C(8) follow similar rules in paragraph 78(2) of the Eighth Schedule, which provide roll-over relief when shares are substituted through a consolidation, subdivision or conversion under section 40A or 40B.[29]

Under section 9C(8) the shares acquired in substitution of the previously held shares take their dates of acquisition from the previously held shares.

**Example 11 – Consolidation of shares acquired on different dates**

*Facts:*

Taxpayer Y acquired the following equity shares in Company Z as trading stock:

- 200 ordinary shares acquired on 1 March 2002
- 100 ordinary shares acquired on 31 December 2010

On 28 February 2011 Company Z issues one new ordinary share in substitution for every four pre-existing ordinary shares. Taxpayer Y surrenders the 300 old ordinary shares and receives 75 new ordinary shares.

On 15 March 2011 Taxpayer Y disposes of the 75 new ordinary shares in Company Z.

*Result:*

50 of the ordinary shares will be deemed to have been acquired on 1 March 2002, while 25 of the ordinary shares will be deemed to have been acquired on 31 December 2010. Section 9C will only apply to the 50 shares with a deemed acquisition date of 1 March 2002.

The section 9C(8) relief will not apply if the substituted shares carry different rights and entitlements to the pre-existing shares or if any consideration passes from the shareholder to the company issuing the shares, whether directly or indirectly.

Capitalisation shares are not addressed by section 9C(8). Such shares will simply be acquired on the date of issue at a cost of nil[30] and the period of holding will run from that date.

## 14. Insolvency

Shares held as trading stock by a natural person on the date of sequestration are included in closing stock under section 22(1) read with the definition of a "year of assessment" in section 1, section 22(6) and paragraph (*b*)(i) of the proviso to section 66(13)(*a*). This applies even if the shares have been held for at least three continuous years on the date of sequestration. Since such shares are not disposed of under the normal meaning of a disposal, section 9C will not apply (see **4.3.2**). Consequently, there will be no recoupment under section 9C(5) of opening stock or the ongoing expenditure claimed under section 11(*a*) during the period that the shares were owned by the taxpayer.

[29] Paragraph 78(2) was inadvertently deleted by section 123(1)(*a*) of the Taxation Laws Amendment Act No. 24 of 2011 from 1 January 2011. Clause 49(1)(*b*) and (3) of the draft Taxation Laws Amendment Bill, 2012 proposes to reinstate it from the same date.

[30] Section 40C.

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Under section 25C(*a*), for the purposes of determining any deduction to which the insolvent estate of a natural person is entitled, that person's estate before sequestration and the insolvent estate are deemed to be one and the same person.

It follows that –

- the insolvent estate must account for any opening stock at the same value that the person before sequestration accounted for it as closing stock; and
- the insolvent estate is deemed to have acquired the trading stock on the same date that it was acquired by the person before sequestration.

Section 9C will thus apply to any disposal by the insolvent estate of shares held as trading stock and the three-year qualifying period will be measured from the date on which the shares were acquired by the person whose estate has been sequestrated. The insolvent estate must account for any recoupment under section 9C(5) of opening stock and any ongoing expenses claimed by the person before sequestration and his or her insolvent estate [section 25C(*b*)].

## 15. Death

### 15.1 Deceased person

On the date of death shares held as trading stock by a natural person are included in closing stock under section 22(1).

The death of a natural person results in the termination of that person's existence as a taxable entity, but does not result in a disposal for the purposes of section 22 because the person continues to hold the shares while he or she is alive.

Under paragraph (*a*) of the proviso to section 66(13)(*a*) a return of income for a person who dies must be made for the period commencing on the first day of the year of assessment and ending on the date of death. This corresponds with the definition of a "year of assessment" in section 1, which includes any period "in respect of which any tax or duty leviable under this Act is chargeable".

Section 22(6) confirms that any reference in section 22 to the beginning or end of a year of assessment must be construed as including a reference to a beginning or end of a period of assessment of less than 12 months.

Section 9C(2) does not apply to shares held on the date of death, even if held for more than three years, because a share can only be a qualifying share if it has been disposed of under the ordinary meaning of a disposal or as a result of a deemed disposal under paragraph 12 of the Eighth Schedule (see**4.3.2**).

Likewise, because death is not a disposal for the purposes of section 9C, there will be no recoupment under section 9C(5) of opening stock or the ongoing expenditure claimed under section 11(*a*) during the period that the shares were owned by the taxpayer.

Under paragraph 40(1) of the Eighth Schedule the shares are deemed to be disposed of for CGT purposes for an amount received or accrued equal to their market value on the date of death. The proceeds for CGT purposes will be equal to that market value reduced under paragraph 35(3)(*a*) of the Eighth Schedule by the amount included in income as closing stock under section 22(1), but not below nil.

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The base cost of shares acquired on or after the valuation date is likely to be nil, since any expenditure incurred in acquiring the shares must be reduced under paragraph 20(3)(*a*) of the Eighth Schedule by amounts allowed against income. This would be the case if the cost of acquisition of the shares was allowable as a deduction under section 11(*a*).

The base cost of pre-valuation date shares may be determined using market value on valuation date, time apportionment or 20% of proceeds (see paragraphs 26 and 27 of the Eighth Schedule). Alternatively, if the deceased person adopted the weighted average method for listed shares or participatory interests under paragraph 32(3A) of the Eighth Schedule, that method must be used.

### 15.2 Deceased estate

Section 25(1) deems any amount received by or accrued to the deceased estate which would have constituted income in the hands of the deceased person to be income of –

- the deceased estate to the extent that it is not derived for the immediate or future benefit of any ascertained heir or legatee; or
- In any other case, the heir or legatee.

A hypothetical enquiry is, therefore, called for to determine whether an amount realised by the executor on disposal of a share would have been income in the hands of the deceased person. A share reflected in the deceased person's final return of income as closing stock under section 22(1) would have resulted in an inclusion in gross income had it been disposed of by the deceased person. It is therefore necessary to determine whether section 9C(2) would have applied to such a receipt or accrual.

In applying section 9C(2) to an amount realised by the executor, the continuous three-year holding period must be measured from the date on which the deceased person acquired the share, and not from the date on which it was acquired by the deceased estate.

Section 9C(5) simply deems there to be an amount included in the taxpayer's income. Since such an amount is not a receipt or accrual, section 25 cannot deem it to be income in the deceased estate. The disposal by the executor of shares which have been held by the deceased person and his or her deceased estate for a combined period of at least three years will, accordingly, not trigger a recoupment under section 9C(5).

Shares awarded to an heir or legatee by the executor will trigger a disposal by the deceased estate. However, section 25 will not apply because no amount will have been received by or accrued to the deceased estate. There will therefore be no amount to which section 9C(2) can apply.

### 15.3 Heirs or legatees

For the purposes of section 9C, the three-year continuous holding period is measured from the date on which the shares are awarded to the heir, and not from the date of death of the deceased person.

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## 16. Asset-for-share and unbundling transactions

The corporate restructuring rules in Part III of Chapter II of the Act contain roll-over rules which deem the date of acquisition of equity shares to be derived from other assets. These roll-over rules are excluded in determining the date of acquisition of an equity share for the purposes of section 9C in the case of –

- an asset other than an equity share disposed of under an asset-for-share transaction [section 42(2)(*a*)(ii)]; and
- unbundled shares acquired under an unbundling transaction [section 46(3)(*a*)(ii)].

For the purposes of section 9C, the date of acquisition for equity shares acquired under the above circumstances will be the actual date of acquisition.

The general rule is that in an asset-for-share transaction the shares issued to the transferor by the transferee company take on the same date of acquisition as the asset disposed of to the transferee company [section 42(2)(*a*)(ii)]. Section 42(2)(*a*)(ii) overrides this rule for the purposes of section 9C by blocking the date roll-over. The effect is that the date of acquisition of the equity shares issued by the transferee company will be the date of the asset-for-share transaction, except when the asset being transferred comprises equity shares.

This rule prevents the equity shares in the transferee company from immediately becoming capital assets under section 9C(2). Thus, if trading stock such as land held by a developer, which has been held for at least three years, is sold to a company in exchange for shares in that company, any immediate disposal of the shares would not automatically be on capital account. The taxpayer would have to hold the shares for at least three years before section 9C(2) could apply.

The date roll-over under section 42(2)(*a*)(ii) nevertheless applies to a transfer of equity shares in exchange for an issue of equity shares by the transferee company.

The general rule is that in an unbundling transaction the unbundled shares take on the same date of acquisition as the unbundling company shares [section 46(3)(*a*)(ii)]. However, this rule does not apply to the unbundled shares for the purposes of section 9C. Instead, they will for that purpose be regarded as having been acquired on the date of unbundling. This rule prevents an unbundling company (whose shares had been held for at least three years) from acquiring trading stock, transferring it into a subsidiary, and then unbundling that subsidiary. Had section 46(3)(*a*)(ii) not been amended to exclude section 9C, the shares in the unbundled subsidiary would have been deemed to have been acquired on the same date as the unbundling company shares, thus allowing the shares in the unbundled subsidiary to immediately be disposed of on capital account even though the assets represented by those shares comprise trading stock.

## 17. Exclusion of shares acquired under employee share incentive plans

Section 8B (under specified circumstances) and section 8C recognise gains on shares acquired by virtue of a taxpayer's employment as being akin to remuneration. In order to preserve this policy objective, section 9C does not apply when determining an income gain under sections 8B and 8C, despite the shares having been held for at least three years.

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### 17.1 Section 8B

Section 8B deals with amounts derived from broad-based employee share plans. An equity share acquired by an employee under such a plan that is held for at least five years will produce proceeds of a capital nature under section 9C(2) when it is disposed of.

Under section 8B(1) a person must include in income for a year of assessment any gain made by that person during that year from the disposal of any "qualifying equity share" as defined in section 8B(3) or any right or interest in such a share, which is disposed of by that person within five years from the date of grant of that share. This income inclusion does not apply when –

- the qualifying equity share is exchanged for another qualifying equity share as contemplated in section 8B(2);
- the person dies or becomes insolvent.

Section 8B(1) applies "notwithstanding" section 9C, thus overriding section 9C. This means that a share falling within section 8B that is disposed of between three and five years after the date of grant of that share will still result in an income inclusion despite section 9C.

The three exclusions do not have any impact on section 9C because none of the events listed results in a disposal of the shares for purposes of section 9C. Section 8B(2) provides roll-over treatment (that is, the replacement shares are deemed to be acquired on the same date as the previously held shares), while shares held as trading stock are accounted for as closing stock on date of death (see **15**) or date of sequestration (see **14**).

Section 9C will, however, apply once the share has been held for five years and the period for an income inclusion under section 8B has elapsed.

### 17.2 Section 8C

Section 8C(1) provides for an inclusion in income when an "equity instrument" as defined in section 8C(7) "vests" in an employee or director (that is, becomes unrestricted). The income inclusion applies "notwithstanding" section 9C, meaning that a share that vests three years or longer after it was acquired will still produce an income inclusion upon vesting despite section 9C.

Once such a share has become unrestricted, section 9C will apply to a subsequent disposal of the share provided it has been held for at least three years. The date of acquisition for purposes of section 9C will be the date when the taxpayer became the owner of the share. This is a question of fact and will depend on the terms of the particular share plan.

The base cost of the vested share is determined under paragraph 20(1)(*h*)(i) of the Eighth Schedule, which provides that it is equal to the market value of the share or the amount received or accrued upon its disposal, as the case may be, that was taken into account in determining the amount of the income gain or loss (including a situation in which the gain and loss so determined was nil). By granting a step up in base cost paragraph 20(1)(*h*)(i) prevents double taxation of the section 8C income gain and any subsequent capital gain.

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## 18. Conclusion

Section 9C provides taxpayers with certainty that if they hold equity shares for at least three continuous years the gains and losses on disposal will be of a capital nature regardless of the intention with which the shares were originally acquired. Not all types of shares qualify under section 9C; for example, non-participating preference shares, shares in foreign companies (other than JSE-listed shares) and participatory interests in portfolios of collective investment schemes in property fall outside section 9C. Its provisions are now mandatory and no election is required or even possible. The wider ambit of section 9C has necessitated the inclusion of a number of anti-avoidance measures. The capital or revenue nature of shares disposed of within three years of acquisition will continue to be determined according to principles laid down by case law.

Section 9C came into operation on 1 October 2007 and applies to the disposal of qualifying shares on or after that date.

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