PRELIMINARY RESPONSE TO THE REPRESENTATIONS MADE TO THE PCOF AND THE SCOF ON THE PROPOSED INTRODUCTION OF CAPITAL GAINS TAX

1 Introduction

As undertaken, I shall now respond to some of the issues raised during the hearings on Capital Gains Tax (CGT). The intention is to inform your Committee on what our thinking is on some of the issues raised in order to facilitate the Committee's deliberations during the hearings.

2 Specific Issues

2.1 Definitions

Last year a definition of "spouse" was introduced into the Estate Duty Act. The same definition will be required for CGT purposes.

The definition included permanent same sex relationships in order to remove discrimination on the basis of sex. The issue was then raised whether marital-like heterosexual relationships should not be included as well, otherwise the definition might still be discriminatory on the basis of marital status. Legal opinion was sought from a prominent senior counsel on the matter who expressed the view that the definition could indeed be attacked on constitutional grounds unless a strong case could be made out in terms of the limitation clause.

Hence the phrase "in a permanent marital-like relationship" will be inserted in the definition of "spouse" in the proposed new Bill.

The point was also made that the position of customary marriages has not been properly catered for in the Bill. The definition of "spouse", however, includes all marriages in terms of the laws of the Republic. The Recognition of Customary Marriages Act, 1998, now recognises customary marriages as part of South Africa's law and they now fall within the definition.

2.2 Averaging

A number of representations referred to the issue of averaging/bunching. The point made was that by including the capital gain in the taxpayer’s other taxable income, such as salary income, the effect is that the taxpayer's combined taxable income pushes that person into a higher tax bracket and therefore increases that person's overall tax liability and will also, therefore, affect the rate of tax imposed on the person’s salary. Our response is as follows:

Gains on key assets held by individuals (virtually all their personal non-investment property and a R1 million gain on their homes) are exempt from tax subject to very generous limits. In addition, each year the first R 10 000 of gains on other assets are exempt from tax and three-quarters of gains above that amount are also not liable to tax because of the low inclusion rate. What is left after all these exemptions, is added to a taxpayer’s taxable income. The normal rate scale applies to that taxable income. The South African rate structure for individuals is a progressive rate scale. Even if the capital gain does push a taxpayer into a higher tax bracket, the higher rate will only apply to that part of the capital gain that falls above the threshold for the higher bracket. Salaries, etc. that formed part of taxable income before the addition of the taxable capital gain are therefore unaffected.

It is, however, conceded that a capital gain which is realised by a person in his or her year of retirement, may have a negative impact on the taxable portion of a person's lump sum from a retirement fund which is subject to the existing averaging provisions contained in section 5(10) of the Income Tax Act.

It is, therefore, proposed that a capital gain should be excluded from taxable income in determining the average tax rate to be applied to the taxable portion of a lump sum benefit received by a person from a pension, provident or retirement annuity fund in that person's year of retirement. The provisions of section 5(10) will therefore be amended accordingly.

2.3 CGT and Controlled Foreign Entities (CFE’s)

Much has been said about CGT and CFE’s. The same principles which apply to income of a revenue nature will apply to capital gains. Gains made by a CFE will be imputed into the hands of a resident subject to the same exclusions / exemptions that apply to normal revenue income. Thus the same country list exemptions will also apply in most cases. In essence, the system is designed so that business income, including capital gains, generated in acceptably taxed jurisdictions is exempt. Gains will only be imputed and taxed as they arise where-

- there is no proper business establishment
- there is a proper business establishment, but the asset is the subject of a diversionary transaction; or

- there is a proper business establishment and the passive income of the CFE together with gains on assets producing passive income, exceed 5 per cent of total income.

In this case a CFE enjoys an advantage over a domestic investor should the Rand continue to depreciate. A capital gain is determined in the foreign currency of the country in which the CFE is resident or does business and then converted into Rands. Any Rand foreign currency gain between the date the CFE acquired the asset and the date it disposed of it is thus ignored. This concession will have to be monitored to determine if it is abused by domestic investors.

Concern has been expressed that the assets in a CFE may have been acquired before the CFE was acquired by a South African resident or otherwise became a CFE. This could mean that the capital gains imputed to the resident would be overstated. It is, therefore, proposed that the valuation date for assets held by a CFE on 1 April 2001 be that date and in the case of a foreign entity qualifying as a CFE only after 1 April 2001 the date from which it so qualifies. However, in both cases it is proposed that the taxpayer will not have the option to value on valuation date, but only the time based apportionment method will be applied to calculate the gain or loss. The reason therefor being that it would be administratively difficult to dispute or challenge the values of off-shore assets.

2.4 CGT and deemed foreign dividends

The question was raised whether CGT will take preference over a deemed foreign dividend arising from the disposal of shares in a CFE.

A distinction should be drawn between a capital gain determined where a CFE disposes of an asset and the case where a resident shareholder disposes of the resident's interest in the CFE. A deemed foreign dividend will only arise where an interest in a CFE is disposed of and the proceeds represent undistributed profits of the CFE which were available for distribution to the resident. The deemed foreign dividend provisions were introduced as an anti-avoidance measure.

The CGT will take over this anti-avoidance role over time and take preference over the deemed foreign dividend provisions. Therefore, the amount of deemed foreign dividends will be reduced by the amount taken into account in determining a taxable capital gain in respect of the disposal of shares in a CFE.

2.5 CGT and Trading Stock

A request was made for an amendment to the trading stock rules in section 22 of the Income Tax Act following the deemed disposal rules with regard to the conversion of:

- Trading stock to non-trading stock; and

- Non-trading stock to trading stock

Amendments will be made to regulate these conversions, i.e.-

- Assets ceasing to be held as trading stock will have a closing value equal to market value; and

- Assets commencing to be held as trading stock will have an opening value equal to market value.

2.6 Record-keeping

Various people were concerned about the record-keeping provisions and expressed the view that they are too onerous (The proposed new sections 70A and 70B). These rules are more specifically related to the Unit Trust Industry, the LISP Industry, the Long Term Insurance Industry and Portfolio Managers.

Some of the points made in the representations are valid and adjustments will be made to the rules.

A very constructive discussion took place with the LISP Industry on 9 February 2001. The discussion mainly centred around the information a LISP can provide to SARS in respect of each disposal of a unit. Once all the rules are clear the LISP's will change their systems to capture the appropriate information. One challenging issue is the problems the valuation date pose as LISP's do not necessarily have all the historic information to calculate a gain. From the gist of the discussion I am convinced that a practical solution can be achieved. The LISP industry will during the course of the week provide us with further suggested amendments to the record keeping provisions as well as paragraph 23 which regulates the valuation of assets.

Further discussions with the LOA and the Unit Trust Industry have been scheduled for later this week in order to find solutions to their problems.

2.7 The Long-Term Insurance Industry

The issues raised by the long-term insurance industry mainly concern the following:

- **The deduction formula**

You will remember that during 1999 legislation was brought before this Committee to amend the provisions regulating the taxation of long term insurance companies to address a number of deficiencies which were the cause for a substantial decrease in the tax paid by the industry.

One of the deficiencies addressed was the excessive amount of expenses an insurer could claim against its relatively small taxable income base (investment income) in its policy holder funds. This problem was solved by way of the introduction of a formula in terms of which the expenses not directly attributable to investment income (i.e. selling and administration expenses) should be determined. This formula limited the expenses on the basis that dividends and capital gains were not taxable.

As certain dividend income (foreign dividends) and capital gains will now become taxable the request has been made that a bigger portion of expenses should now be allowed.

This is acceptable in principle and during our further discussions later this week we will endeavour to come to an arrangement on how and to what extent the formula should be adjusted to allow for the deduction of a greater portion of expenses.

- **Second hand policies**

The CGT legislation provides that where an endowment or life policy is held by the original owner until maturity or death the proceeds from the policy will not be subject to CGT. The reason being that a long term insurer is taxed on the trustee principle, i.e. tax is paid by the insurer on behalf of the policyholder as the income is earned in the insurer.

The Industry wants the same exclusion to apply to second hand policies, i.e. where a policy is taken over (purchased/ceded) by another person from the original owner. The industry's argument is that the principle remains the same as the income earned in the insurer remains taxable in the insurer. A further argument is that a second hand market in policies is good for the industry as it, for example, prevents the lapsing of policies.

The view is held that gains on these transactions should be taxable for the following reasons:

- The individual policyholder fund is taxed at 30% while the maximum marginal rate for individuals is 42%. When the four-fund approach and the trustee principles were agreed to, they were agreed to as a package. One of the principles was that an average rate of 30% would apply as the maximum marginal tax rates of many policyholders could fall in the lower tax brackets, i.e. below 42%. The lower rate was also allowed as persons would be locked into the investment for a minimum period of 5 years. By allowing people to exit the investment instrument, this longer term investment objective is broken.

- Secondly, who are the people who can afford to buy policies in the secondary market? The large majority of these people are high income earners paying tax at 42%. Why should they be granted the option to enter an investment instrument of this nature on a short term basis and enjoy the low preferential tax rate of 30%, i.e. 12 percentage points lower than what would have been paid in the case of any other investment. Levying CGT on second hand policies closes this gap to a large extent.

- Thirdly, these policies are normally purchased at a discount and then sold or held until maturity. This discount applies both to returns that had accumulated up to the date of purchase and future returns. As far as returns up to the date of purchase is concerned the discount compensates the purchaser for the delay in payment. This discount is effectively interest income and should be taxed in full.

It is, therefore, proposed that as a general principle these second hand policies should not enjoy the benefit of the exclusion. It is, however, recognised that there are circumstances where valid reasons exist for making an exception to this general rule. Accordingly, gains will not be taxed in the following limited circumstances. Receipts by-

  - the original beneficial owner of the policy or his or her estate;

  - the nominee or dependent of the original owner, provided that no amount has been or will be directly or indirectly paid to the original owner for cession of the policy;

  - the former spouse of the original beneficial owner to whom the policy was ceded in consequence of a divorce order;

  - an employee as a result of a policy taken out on the life of the employee by his employer as contemplated in section 11(w); and

  - a person on whose life a policy was originally taken out in consequence of his or her membership of a pension, provident or retirement annuity fund.

- **Foreign policies**

  Foreign policies present a problem as the trustee principle can not apply because the insurer is based offshore and does not pay any SA tax. This will lead to a bias in favour of foreign policies.

  The proposal in this regard is to tax the proceeds of such a policy in full as normal revenue. Premiums paid will be aggregated and allowed as a deduction at the time when the proceeds are paid out.

- **Rate reduction in the Individual Policyholder Fund (IPF)**

  The argument is that the average rate of tax of 30% should be reduced as the tax rates have been reduced over the last few years as a result of the restructuring of the rate structure of individuals.

  The view is held that the average rate of 30% remains appropriate. A further reduction will lead to a greater differential between the 42% maximum marginal rate and the 30% rate for the IPF, which will lead to greater distortions in the taxation of investment products.

- **Systems**

  The Industry argues that they require more time to adjust their systems. This issue will be addressed by the Minister once he has evaluated all representations for a delay in implementation.

- **Zero rate for Untaxed Policyholder Fund**

  This proposal is accepted.

- **Annual exclusion – IPF**

  The industry argues that if the policyholder was taxed on the investment income earned over the life of the policy in the insurer, the policyholder (individual) would have been entitled to the R10 000 annual exclusion. As the insurer, however, pays the tax as a proxy for the policyholder in terms of the trustee principle, the policyholder will not be able to enjoy the benefit of the exclusion in respect of the gains taxed in the insurers hands. The industry would like some form of benefit to be incorporated into the tax rules governing the IPF, to compensate for this "loss". The industry also argues that this does not level the playing field between them and the unit trust industry.

  The proposal will be difficult to entertain for the following reasons:

  - The policyholder may have other gains as well during a year against which he/she may off-set the annual exclusion. Allowing the annual exclusion for the policyholder in his/her personal capacity, plus a form of benefit in the insurer will grant a double benefit to policyholders.

  - If we allow a complete look-through approach to accommodate all the circumstances of the individual (policyholder) the debate of the rate at which the IPF is taxed will also have to be re-opened.

- **Transfers between funds**

  To clarify the tax treatment of transfers between the funds of an insurer, consideration will be given to whether a provision should be inserted to deem any transfer of assets made or required to be made between the funds to be a disposal for purposes of the Income Tax Act.

2.8 Unit Trust Industry

The original proposals in respect of the unit trust industry were designed so as to minimise the compliance burden on the average unit trust investor and SARS. It is now proposed that unit trust investors be taxed and not the unit trusts themselves. If unit trusts were to be taxed, a reserve for future capital gains tax would have had to be built up in the unit trusts to ensure that all investors bore their fair share of the tax and not only those investors holding units when the underlying assets were sold. In effect, unit trust investors would have had to pay CGT on disposal of their units although the fisc would only have collected the CGT when the unit trusts sold the underlying assets. In order to reduce the record-keeping burden on investors, unit trusts will have to report on the value of units sold, cost, etc. to investors and SARS.

2.9 Property unit trusts

The point was made that no clear provision was made for the tax treatment of unit holders in property unit trusts. The proposal has been accepted that they should be treated on the same basis as equity unit trusts.

2.10 WRAP Funds

Wrap funds purchase and sell investments in unit trusts on behalf of their clients on the basis of a mandate given to them by their clients. This mandate may often stipulate that a certain percentage of the investors' funds be retained in a specific unit trust. As market values change, the percentage held in a particular unit trust will change and it becomes necessary to rebalance the portfolio in order to retain the mandated position. In principle this is no different to any other acquisition or disposal of an asset but, depending on the wrap fund and the mandate, this may occur on a frequent basis. Putting to one side the question of whether or not these transactions are on revenue account, the issue of determining the gains or losses may be an administratively difficult task.

Wrap funds already report comprehensively on the transactions of their client's accounts, but the difficulty is that original costs for the assets traded are not always available and it may be difficult to determine when the assets traded were acquired. That is to say, where a pool of identical assets are held the question is whether the oldest, newest, or a spread of assets are being traded. This problem is not unique to the wrap fund industry and it may therefore be necessary to consider simplified valuation rules for listed securities.

2.11 Closed investment companies

Representations were received from specifically the AHI that closed investment trusts should be treated in the same manner as unit trusts for CGT purposes.

A unit trust is a different investment vehicle which is regulated in terms of the Unit Trust Control Act. A unit trust scheme is therefore conceptually totally different to a company and is effectively an arrangement which allows groups of individuals to pool their resources into a unit trust for investment purposes. These assets are, therefore, held in trust on behalf of the unit holders. Such a trust is subject to strict limitations and borrowing is for example prohibited. Furthermore, a unit trust may not exceed certain investment levels in the companies in which they invest. Interests in closely held companies are limited to 5 per cent per company and in widely traded companies to 10 per cent per company.

If we were to concede on this issue we would have to build in similar rules to those contained in the Unit Trust Control Act into the proposed Eighth Schedule to the Income Tax Act. This would effectively mean that SARS would have to fulfil the role of a regulator, which is unacceptable. Apparently this is done in the United Kingdom. We have in the past learnt expensive lessons in this regard when we still had the Sixth Schedule and SARS had to regulate the operation of insurance policies.

Should we allow one form of company structure to utilise these benefits, it would become difficult to decide where to draw the line in the case of other requests for similar treatment. If an entity wants to enjoy the benefits of the unit trust industry, it must operate as a unit trust.

Consequently we cannot entertain this request.

2.12 Deemed disposals

- Emigration

The original proposal in respect of emigration was that all the assets were deemed to be disposed of on emigration. This proposal has been modified to exclude assets, such as fixed property, that would be subject to CGT regardless of residence, as South Africa retains its taxing rights in respect of such assets even though they are owned by non-residents. The assets of persons who become residents of South Africa are treated as being disposed of and reacquired at market value on the date they became residents. This ensures that immigrants need only account for gains and losses that accrue after they become resident in the Republic. This treatment is consistent with that in respect of emigration and contrasts with that of jurisdictions such as the USA where gains are based on the original cost of the asset. In view of the wide exclusions for personal use assets, primary residence, and the modifications set out above, further concessions in this regard are not supported.

- Death

The IMF regards the modified proposal of a deemed disposal at death as "a major strength of the draft legislation." Although CGT and estate duty are in no way conceptually linked, it is proposed that the liquidity concerns arising from the imposition of both taxes at the time of death be addressed by a reduction in the estate duty rate.

The CGT payable will also be allowed as a deduction in determining the dutiable value of the estate. This is so because CGT is a debt due by the estate which will be borne by the estate.

Administrative concerns have been raised in respect of the levying of CGT on the death of an individual with an estate below R1 million. It should be borne in mind that the exclusions for personal use items, the primary residence, and insurance policies should go a long way to addressing these concerns. However, in order to ease administration yet further, an increase in the annual exclusion in the year of death is being considered. That said, the increased exclusion must not be pitched at a level where it undermines the strengths of a deemed disposal at death and causes a lock-in effect until death.

2.13 Partnerships

Requests were made that more rules be provided in the Eighth Schedule regarding the taxation of capital gains and losses made by partnerships.

The only specific rule in the Schedule is paragraph 15 which provides that the proceeds from the disposal of an asset of a partnership shall be treated as having accrued to each partner at the time that the disposal takes place. This is merely to provide certainty as to when the gains or losses accrue.

The Income Tax Act does not presently have comprehensive rules prescribing how the taxable income of partners or partnerships must be determined. There are provisions which were introduced to prevent abuse which occurred as a result of the use of limited partnerships and provisions dealing with submissions of returns and issuing of assessments. These rules also apply to capital gains and losses.

The core rules in the Eighth Schedule which apply to all persons will also apply to partners on the same basis.

While it is accepted that the tax practice applicable to partners needs to be reviewed, the deficiencies currently exist in the present Income Tax provisions. The view is held that these deficiencies must first be addressed from a revenue point of view and the rules regarding capital gains and losses then changed to mirror these revised rules.

2.14 Limitation of certain losses

- Personal Assets

Concerns have been expressed as to why CGT is levied on the gains on certain personal assets while losses are limited. In order to understand the reason for this treatment, it is necessary to start with the theoretically correct treatment of the taxation of personal assets. In theory, there is no reason why gains on all personal assets should not be taxed. The appreciation in the value of personal assets gives rise to income just as the appreciation of any other kind of asset does. A complicating factor is that the value of personal assets tends to decrease as a result of their consumption. Effectively then, what should be done is that the value of the asset should be reduced by that portion attributable to the personal use. Any gain above this reduced value should be taxed and any loss below the reduced value allowed.

Example

A newly designed 15 metre ocean-going yacht was acquired for R500 000 for personal use. Assume that such a yacht has a useful life of five years as designs in respect of these yachts frequently change. Two years later the yacht was sold for (a) R300 000 (b) R550 000.

Acquisition cost	R500 000
Useful life	5 years
Therefore, reduced value at date of sale	R300 000

(a) As a result of the personal consumption of the asset, there is no loss upon disposal, although at first there does appear to be a R200 000 loss.
(b) As a result of the personal consumption of the asset, the excess of proceeds on disposal over the reduced value at the date of sale result in a gain of R250 000.

As can be imagined, this treatment would result in a major compliance burden on taxpayers and SARS if it were to be applied to every personal asset.

It is for this reason that the gains or losses on the bulk of personal assets are excluded from CGT.

However, certain personal assets are likely to show significant gains and cannot be excluded from the system without causing equally significant distortions. It is conceptually possible to apply the treatment described above to these personal assets but it is possible to simplify the system further by dividing the assets into two categories. These are assets that are more likely to show a loss as a result of market forces and assets which are more likely show a loss as a result of personal use.

As far as the first category is concerned, rather than calculate the exact split between losses due to consumption and those due to market forces, the losses are permitted and only gains above the original cost are taxed.

As far as the second category is concerned, rather than calculate the exact split between losses due to consumption and those due to market forces, the losses as a whole are disregarded and only gains above the original cost are taxed. While this may prejudice the taxpayer in some cases, it may be to the advantage of the taxpayer in others. Taking (b) in the example above, the taxpayer should have been taxed on a capital gain of R250 000 but is only taxed on a gain of R50 000.

The decision as to which personal assets should be subject to CGT and which assets should fall into the two categories above is one that must be made bearing in mind available resources, the amount of revenue foregone, and the distortions introduced by excluding assets.

In view of the above, further concessions with regard to loss limitations are not supported.

- Intangible property

The loss limitation on intangible assets purchased before the valuation date has resulted in some criticism. These assets are often subject to manipulation for tax purposes as experience has taught us. Taxpayers have overstated the allocation of costs to these assets when acquiring a business in order to minimise recoupments in the hands of the seller and, in many cases, to maximise deductions in the hand of the buyer. The second abuse was the rationale for the amendments to section 11(gA) in 1999. These abuses were and are extremely difficult to counter given the wide ranges of values possible for an intangible property depending on the assumptions and methods used to value the property.

As a result, it is likely that neither the original cost nor the valuation of an intangible property acquired before valuation date may be relied upon with any degree of confidence. A limitation on the losses on disposal of such intangibles was therefore proposed. As the taxability of the proceeds on the disposal of the intangible property in the hands of the seller will limit the attractiveness of the overstatement of the value of intangible property, this limitation does not apply to intangible property acquired after valuation date. Consideration is also being given to further restricting the application of this limitation to cases where the intangible property was acquired together with a business, as this was the area where the abuses described earlier were most frequently encountered.

Lastly, what should also be borne in mind is that where the intangible property is valued in excess of cost and is sold after valuation date for less than the valuation date value, the taxpayer will not suffer an economic loss as the valuation date value would not have been an actual expense incurred by the taxpayer.

2.15 Definition of financial instrument

A number of representations recommended that the definition be extended.

These proposals have been accepted.

2.16 Securities Lending

The Banking Council raised the issue that a registration requirement should not be introduced with regard to lending arrangements. This problem will solve itself once the STRATE system applies to all listed shares. This will apparently be the case within the next year.

This proposal has been accepted.

2.17 Base Cost

- Recurring costs

  The proposal has been made that recurring costs, such as repairs and interest, should be included in the base cost of an asset. This proposal should be split into two parts, the first dealing with personal assets and the second with business assets.

  As far as personal assets are concerned, the primary reason for acquiring such assets is for their personal use and enjoyment. Just as that use and enjoyment is not taxed in the Republic so the expenditure incurred in respect of that use and enjoyment is not deductible. This treatment also preserves neutrality between purchasing and hiring an asset. Some jurisdictions, such as the Netherlands, tax the use or enjoyment or "imputed rental" of certain classes of property and permit deductions against this imputed income.

On the other hand, one particular class of personal asset, shares, is not acquired for its use and enjoyment and but rather for its recurring income and growth potential. Although these shares must be held primarily for their recurring income in order to be classified as capital assets, consideration is being given to permitting a fraction of the interest incurred to acquire such assets to be added to base cost.

As far as business assets are concerned, most recurring costs should be deductible for income tax purposes. However, consideration is being given to permitting the addition of recurring costs to base costs under certain circumstances where this may not be possible. For example, a manufacturer purchases land to erect a new factory and pays interest on the purchase price and rates. These expenses are not allowed as a deduction as the property is not yet in use. Due to a downturn in the market the property is sold. The interest and rates should be allowed as part of base cost.

- Due and payable principle

The current proposals have been criticised on the basis that the standard for the deduction in the capital gains system is that an expense must be due and payable while under the main Act a taxpayer need only be unconditionally liable for an expense to deduct it. However, it should be noted that the unconditionally liable test has been considerably modified in order to counter tax avoidance schemes over the years. If a comparison is drawn with the requirements for deducting an expense in respect of, for example, trading stock it is apparent that the expense may not be deducted before:

- the trading stock has been received, destroyed, or sold, and
- the consideration for the sale of the trading stock has been received.

The requirement that the expenditure must be "due and payable, is very similar to the present position in the Income Tax Act, because of the anti-avoidance rules introduced. Under the circumstances a relaxation in this regard is not supported.

2.18 Valuation Rules

Various comments were made as to the complexity of paragraph 23. Although the basic principles of the paragraph work, it is the intention to reword it into a more digestible and understandable form. Slight changes to the principles are required.

Who must do the valuation?

It is proposed that valuations be done by taxpayers, or by any person having expertise in a specific field. It should, however, be noted that the onus remains with the taxpayer who would be responsible for and be able to justify the valuation so determined.

By when must it be done?

Valuations must be performed within a period of two years after the date of implementation of CGT. See next paragraph for details.

When and how must the valuation be submitted

The valuation in respect of intangible assets and high value assets must be submitted to SARS together with the taxpayer's annual return immediately after the expiry of the two year period. For other assets, these valuations must be submitted together with the tax return in which the gain or loss arising from a disposal is declared.

Prescribed forms

SARS has prepared a form which must be completed at the time the valuation is performed. These forms will be made available to taxpayers at all branch offices and will also be available on the SARS web site. Forms not completed within the two-year period as well as forms which are not fully completed will result in the valuation being rejected.

Retention of valuation documents

All documentation pertaining to valuations must be retained by the taxpayer for a period of 4 years after an asset is disposed of. Should a taxpayer not be able to verify how a value was determined, the use of the market value will not be permitted.

Cost of performing a valuation

In terms of the amended paragraph 22 the cost of performing a valuation is allowed as part of the base cost of the asset.

Auditing

SARS is currently developing the framework for auditing the valuations which are received. In terms of the current proposal, the majority of the valuations will only be submitted once a CGT event occurs. It is, however, planned that audits will be performed on a risk basis.

Listed shares

- Local shares
  The market value to be placed on local shares will be the average of the buy and sell price of the shares over the five trading days preceding the introduction of CGT. SARS will publish a list of the market values to be applied in respect of shares listed on the Johannesburg Securities Exchange.

- Controlling interests
  The point is made that valuing controlling interests in listed companies strictly in terms of listed share prices quoted on stock exchanges may not give the correct result, as such interests may carry a premium.

  This proposal is partly accepted. Consideration is being given to permitting a premium on valuation where a controlling interest (more than 50% holding) in listed companies is disposed of as a controlling interest.

- Foreign shares
  The market value of these shares will be determined at the average of the buy and sell price on the last trading day before CGT is introduced.

- Units in unit trusts (Equity trusts, Property trusts, Foreign trusts)
  In the case of units in a South African unit trust, it is the buying price (the lower price) which is regularly published at the close of business for the five trading days prior to the valuation date. In the case of foreign unit trusts the value will be the closing buy price on the last trading day before CGT is introduced.

Non-listed shares

No specific rules are laid down for valuing shares in non-listed companies. Market value will, however, be the guiding principle. It is envisaged that such valuations would be performed by the taxpayer together with the auditor of the company. SARS currently must perform audits on such valuations for Estate Duty purposes. It is envisaged that these resources would be expanded to cover CGT as well.

Intangible assets

As stated above, those taxpayers wishing to submit valuations in respect of intangible assets will have to submit those valuations to SARS within the prescribed period of two years. There are a number of methods which can be utilised for determining the market value of those assets. SARS will not prescribe which method must be used, but the onus to prove that the method used by the taxpayer reflects the market value rests on the taxpayer. It is envisaged that taxpayers would use persons suitably qualified to determine the value of these assets.

Usufructs and fiduciary rights

It is the intention to develop similar rules to those contained in the Estate Duty Act or donations tax provisions for the purposes of the Eighth Schedule.

Insurance policies

The bill as it is currently drafted provides that the surrender value will be regarded as the market value for CGT purposes. The concern is that the surrender value does not truly reflect the market value. The market value would generally be higher than the surrender value. Discussions will be held with the Insurance industry to determine a fair method of determining the market value of policies. These rules would only really apply in the case of second hand policies, where the policy was acquired prior to valuation date.

Farming property

A meeting will be held with Agri South Africa.

- Land bank valuations
  Land bank valuations are in many instances used by SARS in respect of Estate Duty. Those valuations do not reflect the true market value of the properties. Notwithstanding that, the option of a Land Bank valuation is a strong possibility as some infrastructure already exists to do these valuations. If Land Bank valuations are to be allowed it will be a requirement that the same basis of valuation be used on both valuation date and on date of death or donation.

- Homesteads and farm schools
  Certain complexities exist with the proposed 2-hectare rule and the value to apply to farm schools. Discussions are to be held with Agri South Africa in order to resolve these matters.

2.19 Limitation of losses on disposals between connected persons (Clogged loss rule)

Paragraph 27 is aimed at ring-fencing a capital loss arising from a disposal of an asset to a connected person by allowing it to be set-off only against gains from subsequent disposals to the same connected person. These losses are referred to as clogged losses. This rule prevents a person from engaging in tax avoidance by-

- Firstly, selecting an asset the market value of which has declined below its cost rather than one showing a gain and secondly, by timing its transfer to a connected person so as to show a loss in a tax year in which a gain is to be realised on another asset; or

- Alternatively, by transferring an asset to a connected person which will currently realise a loss, but which is expected to show a large gain in the future.

This would, in the absence of an anti-avoidance provision, have the effect of freeing the loss for use against other gains while creating the possibility of eventually realising the expected gain in a friendly entity. In this way it enables the taxpayer to crystallise a loss asset but manage to retain the asset within his or her control.

It is acknowledged that the potential impact of the proposed clogged losses rule could be quite wide and we will endeavour to reduce it by reformulating the proposed amendment of the definition of "connected person" so as to restrict its ambit.

2.20 Public Benefit Organisations

Concern has been expressed that any capital gain on the disposal of an asset by donation is not exempt if the donation does not qualify for a section 18A deduction. At the outset it should be borne in mind that a capitals gains tax is a tax on income and forms part of the income tax system. All the considerations that apply when determining to what extent donations to a PBO are deductible for income tax therefore apply. Striking an analogy with an ordinary salary earner, exempting capital gains on the disposal of an asset to a PBO is analogous to exempting the salary from which a donation is made.

It should be borne in mind that a person making a donation to a PBO essentially has two options, to sell an asset and donate the proceeds to a PBO or to donate the asset and allow the PBO to sell the asset if it wishes to do so. If the gain on donation is exempt the following situation arises:

	Sell & Donate	**Donate & Sell**
Individual		
Disposal	100 000	N/A
Base cost	20 000	N/A
Gain	80 000	N/A
Included in taxable income	20 000	
Deduction in terms of section 18A (assuming taxable income of R300 000)	15 000	15 000
Net effect on taxable income	5 000	(15 000)
PBO		
Disposal		100 000

Base cost		100 000
Exempt gain		0

The loss to the fisc is significant and must be managed within the constraints that underlie the limited deductibility of donations in terms of section 18A. As a result the exemption has been explicitly linked with the provisions of section 18A.

2.21 Transfers between spouses

Representations were made that the exclusion of gains in respect of disposals between spouses should be extended to—

- Disposals on death
- Disposals pursuant to a court order on divorce.

These proposals are accepted.

2.22 Exempt institutions - par 51 split in two.

The point was made that paragraph 51 does not grant exemption in all circumstances catered for in section 10 of the principle Act and should be expanded.

This proposal is accepted and the paragraph will now be split into two paragraphs:

- The one part will exempt all persons from capital gains tax where all that person's receipts and accruals are exempt for normal income tax purposes.
- The second part will exempt gains arising from the disposal of certain assets which generate exempt income.

2.23 Share incentive schemes

Requests have been made that special concessions be provided for employees in share incentive schemes. In terms of the Income Tax Act at present the ordinary gains that employees make by participating in share incentive schemes are taxed. The proposals in the Eighth Schedule are that any amounts the employees have to pay for the shares are included in the base cost of the shares together with any amounts that have been subject to tax. There is, therefore, no double taxation.

The request is that after the employee has become the owner of the shares with the right to freely dispose of the shares, a further concession be allowed if he or she retains the shares for a longer period.

A further concession does not appear justified. Firstly, the employee is in the same position as any other person who has purchased or can decide to purchase shares. If a capital gain or loss arises in respect of shares held or acquired there are tax consequences. Secondly, if the employer believes it is in the best interest of the company and employees that the shares should be held for a longer period, this condition can be built into the share incentive scheme.

2.24 Trusts

A number of concerns have been raised concerning the tax treatment of trusts and beneficiaries. The matter is still under consideration.

2.25 Forfeited deposits

Deposits made on the purchase of assets are in certain circumstances not allowed as a capital loss and clarity on the provisions has been sought in this matter. After consideration it has been decided that the provisions should be relaxed to allow capital losses of forfeited deposits in more circumstances. The circumstances in which forfeited deposits will be allowed are-

- the deposit was made on an asset intended for use solely in carrying on a business;
- the following personal use assets-
  - a coin of which the value is mainly attributable to the gold or platinum from which it is minted or cast;
  - immovable property other than a primary residence;
  - financial instruments (investments); and
  - any rights to or in these assets.

The decision to exclude other personal use assets is that the reduction in value of such other assets is normally as a result of personal use which should not be taken into account for CGT purposes.

2.26 Coins made from precious metals

Representations have been made that the proposals that coins made from precious metals be taxed, should be changed as they are personal use assets and this will place an unacceptable burden on what for most is a recreational hobby. Coins made from precious metals is one of the personal use assets excluded from this category as the view was held that they are similar to other excluded assets such as financial assets (shares and bonds) and immovable property. After consideration this view is retained, but a proposal to simplify the matter will be considered namely to restrict the taxation to coins mainly made from gold or platinum.

2.27 Prizes

A number of comments have been made with regard to the exclusion of capital gains or losses determined in respect of disposals relating to any form of gambling, game or competition with prizes. The different questions raised were-

- As there is no disposal how can the capital gain or loss fall within the ambit of CGT?
  The ticket that the successful winner of a prize holds is an asset which has a value equal to the value of the prize. When the ticket is exchanged for the prize there is a disposal by the ticket holder.

- Why are the capital gains excluded?
  The gains are excluded for a number of reasons-

  - If capital gains were taxed it would have meant that all losses would have had to be allowed as capital losses. The difficulty of having to verify whether losses had been made would be difficult for both taxpayers and SARS.

  - Gambling in South Africa is subject to VAT and in the case of the lottery a portion of the winnings are used to finance Government approved activities. The profits of companies and casinos which carry on gambling are subject to income tax. Taxes are, therefore, imposed on gambling but not at the point of winnings.

- Why are foreign prizes not disregarded?
  As indicated above gambling in South Africa is subject to different forms of taxation which is paid to the Government. Foreign gambling does not bear this tax and it is, therefore, correct that the foreign winnings of South African residents should be subject to tax in South Africa.

2.28 Options

Some questions have been raised concerning the tax treatment of options and it is briefly set out below.

An option is an asset for CGT purposes and although it could in terms of general principles be regarded as a part disposal of the underlying asset, it is treated as having a base cost equal to the cost of creating it. On granting of the option the amount subject to tax is the amount paid to the grantor for the granting of the option and not the purchase price of the underlying asset.

On the exercise of the option (which is a separate transaction/disposal) the proceeds from the disposal of the underlying asset will be subject to tax in the hands of the seller and brought into base cost in the hands of the purchaser.

2.29 Rebate in respect of foreign tax

It is stated in requests made that it is not unlikely that situations could arise that CGT is payable in South Africa and in a foreign country on an asset situated in South Africa. It is requested that a rebate should be allowed for the foreign tax paid in these circumstances. The provisions of the Act only permit a rebate for foreign tax paid if the asset is situated outside South Africa. International tax principles provide the source country with the primary taxing rights over the gains from the disposal of assets. The source country is the country in which the assets are situated. Where a person is liable to both South African and foreign tax in respect of a capital gain realised on an asset situated in South Africa, under South Africa's tax treaties and international tax principles, it is the responsibility of the foreign tax jurisdiction to provide a tax credit for the South African tax levied on the gain.

2.30 Foreign dividends declared out of foreign capital gains

As the Bill reads, foreign dividends from controlled foreign entities (CFE's) remitted to South Africa would be fully subject to tax in South Africa. It is stated that this would discourage repatriation of these dividends to South Africa and an exemption for dividends declared from such gains should be introduced.

There are a number of situations which could arise:

- If the gain was attributed to the South African shareholder of the CFE and taxed in his or her hands it would be exempt from tax on foreign dividends (Section 9E(7)(e)(i)).

- If the gain was attributed to the South African shareholder and taxed in his or her hands and the CFE was subsequently sold, the amount subject to CGT will be exempted from tax on foreign dividends. CGT, therefore, takes preference (paragraph (v) of the proviso to paragraph (b) to the definition of foreign dividend in section 9E(1)).

- If the gain was part of a business operation and taxed in a listed country at a statutory rate of 27 per cent, the amount will not be included in foreign dividends subject to tax. (Section 9E(7)(d)).

It is, therefore, clear that provision has been made for relief from taxation of foreign dividends on these amounts and there is therefore not a remittance penalty for these amounts.

2.31 Primary Residence – trusts

A concession, which allows the fiscal-free transfer of primary residences from companies to its shareholders if they are natural persons and own all the equity shares of such company, has been proposed. In the case of a trust there is an existing exemption from transfer duty on the transfer of fixed property to beneficiaries.

Representations received complain that the existing transfer duty exemption for trusts to beneficiaries is too narrow as the fixed property is often settled in the trust by the parents and the children are beneficiaries. In unbundling the trust it is their intention to transfer the primary residence to the settlor (parents) and not to the beneficiaries.

The question of whether the transfer duty and stamp duty concessions should be extended to trusts which transfer the residence to the settlor who is presently residing in the residence will be submitted to the Minister for his consideration.

3 The way forward

It is our intention to—

- have further follow-up discussions with certain industry sectors to clear up problem areas; and
- to release a further version of the draft Bill shortly.

J J Louw
General Manager : Law Administration

13 February 2001