

SHARE VALUE SHIFTING: A COMPARISON BETWEEN THE ANTI-AVOIDANCE PROVISIONS IN SOUTH AFRICAN AND AUSTRALIAN TAX LEGISLATION*

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1 Introduction

For as long as countries have imposed capital gains tax (CGT),¹ taxpayers have been looking for ways of transferring economic value without becoming liable to pay it. Since CGT is usually triggered by the realisation of an asset, taxpayers soon realised that if they could shift economic value from their assets without selling or otherwise realising the assets, they could avoid, or at least defer, CGT. This led to the notion of share value shifting, which achieves this objective in relation to shares. Taxation authorities in turn recognised the danger which this form of tax avoidance holds for the integrity of a CGT regime and the need for measures to counter it.

At the outset the article provides some background on what share value shifting is and how anti-avoidance measures generally aim to prevent this form of tax avoidance. It also explains the scope of the anti-avoidance measures in the South African and Australian tax legislation and the manner in which the measures are incorporated in the general South African and Australian CGT regimes.

The article then focuses on the special rules in the South African tax legislation that govern the calculation of CGT in respect of share value shifting and considers some of the difficulties that arise from the fact that these measures fail to interact properly with the general CGT provisions. In the second part of the article, it considers which kinds of share value shifting are targeted by the value shifting anti-avoidance measures in the South African tax legislation and criticises the limited scope of these measures.

The issues of how to integrate the value shifting provisions in the general CGT regime and how far-reaching the anti-avoidance measures should be are not unique to South Africa. The article thus aims to provide some insight into how another jurisdiction with a comparable CGT regime, namely Australia,

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¹ In some jurisdictions, share value shifts hold other (non-CGT) tax advantages. See, eg, *The Commissioner of Taxation of the Commonwealth of Australia v Peabody* 1994 28 ATR 344 where share value shifting was used to reduce an income tax liability.

has addressed some of the difficulties that currently exist under the South African regime. In drawing the comparison between the South African and Australian value shifting anti-avoidance measures, the aim is not to present the latter regime as the only or even preferred one. (In fact, the Australian regime has been subjected to harsh criticism, mainly because of its extraordinary complexity and the compliance burden that it creates.)² The aim is rather to consider whether some of the approaches followed by the Australian regime may work equally well in the South African context.

Lastly, it should be noted that this article only considers value shifting relating to shares, and not to interests in trusts or partnerships or to any other assets. It also only considers the implications for shares held on capital account, not as trading stock or as revenue assets. Non-CGT tax consequences that may be relevant, such as donations tax, stamp duty or secondary tax on companies, or consequences flowing from a breach of legislative provisions outside the Income Tax Act 58 of 1962, are beyond the scope of the article and so is section 103 (the general anti-avoidance provision) of the Income Tax Act 58 of 1962 (which could, depending on the facts of a particular case, apply to share value shifts).³

2 What is “value shifting” and what are the objectives of value shifting anti-avoidance measures?

The notion of what constitutes value shifting differs from one tax jurisdiction to another. In South Africa⁴ it has been described as

“the effective transfer of value from one person to another without [such transfer] constituting an ordinary disposal for CGT purposes”.

The Australian⁵ notion of a value shift is general and refers to

“transactions and other arrangements which result in the value of an asset being reduced with a consequential increase in the value of another asset”.

The latter notion thus not only foresees the shifting of value from one person to another, but also between assets held by the same person. This difference is reflected in the countries’ respective legislative definitions of what constitutes value shifting.

Paragraph 1 of the Eighth Schedule to the Income Tax Act 58 of 1962 defines a “value shifting arrangement”⁶ as:

“an arrangement by which a person retains an interest in a company, trust or partnership, but following a change in the rights or entitlements of the interests in that company, trust or partnership (other

² See, eg, Dirkis “The Nuts and Bolts of Value Shifting” 2003 *The Tax Specialist* 168

³ Since the writing of this article s 103 has been replaced by s 80A–80L

⁴ South African Revenue Service *Draft Comprehensive Guide to Capital Gains Tax* 459 available at <http://www.sars.gov.za/cgt/Historical%20Development/CGT%20-%20Comprehensive%20Guide%2013%20January%202006.pdf> (accessed on 31 January 2006)

⁵ Review of Business Taxation *A Tax System Redesigned More Certain, Equitable and Durable* Report (1999) 261 available at www.rbt.treasury.gov.au (accessed on 31 January 2006)

⁶ The concepts of “value shifting arrangements”, “value shifts” and “value shifting” are used interchangeably throughout the article

than as a result of a disposal at market value as determined before the application of paragraph 38), the market value of the interest of that person decreases and—

- (a) the value of the interest of a connected person in relation to that person held directly or indirectly in that company, trust or partnership increases; or
- (b) a connected person in relation to that person acquires a direct or indirect interest in that company, trust or partnership”.

The first requirement for a value shifting arrangement is thus that the taxpayer must hold an interest in a company and must retain that interest.⁷ The second requirement is that there must be a change in the rights or entitlements of the interests in that company. This change must in turn result⁸ in a reduction in the market value of the taxpayer’s interest in the company, and must also result in a connected person in relation to that taxpayer either experiencing an increase in the value of his or her interest in the company, or acquiring an interest in the company.⁹ No tax avoidance purpose is required.

The scope of the Australian Income Tax Assessment Act 38 of 1997 (1997 ITAA)¹⁰ differs in a number of important aspects.¹¹ For example, the 1997 ITAA has no requirement that there must be a change in the rights or entitlements of the interests in the relevant company. Instead, as long as a person holding an interest in the company¹² experiences a decrease in the value of his or her interest “under a scheme”¹³ and the company issues interests at a discount, or there is an increase in the market value of the interests in the company, it will constitute a value shift.¹⁴ It is important to note that there is no requirement that the shares be issued to *another* person, or that the shares that increased in value be held by *another* person, and it is thus possible to shift value between shares held by the same person. The scope of the 1997 ITAA share value shifting regime is reduced by excluding value shifts that are likely to be reversed within four years (unless the interest is realised before the four year period),¹⁵

⁷ Although the definition is potentially applicable to interests other than shares in a company, this article only considers the definition in this context

⁸ It is submitted that the words “following the change” do not connote a mere chronological sequence, but rather a causal link

⁹ The word “and” before subparagraph (a) of the definition suggests that subparagraph (a) or (b) must happen because of the change in the rights or entitlements of the interests in the company: in other words, subparagraph (a) or (b) must be causally linked to the change in the rights or entitlements of the interests in the company

¹⁰ The share value shifting anti-avoidance measures of the 1997 ITAA are found in Division 725. See n 39 *infra* for a brief overview of Division 725’s place within the broader value shifting regime of the 1997 ITAA

¹¹ See s 725-145. See also Dirkis 2003 *The Tax Specialist* 172 and Fisher “Shifting Sands: The New Value Shifting Rules” 2003 *Taxation in Australia* 521 for a discussion of all the conditions that must be met before a scheme will be caught by the value shifting provisions in Division 725

¹² In terms of s 725-80, the person must control the company (see s 725-55 and the definition of “control (for value shifting purposes)” in s 995-1); or be an associate of the controller of the company (as defined in s 995-1); or must be an active participant in the scheme (if the company has less than 300 members; see s 725-65(2))

¹³ The decrease in value must be reasonably attributable to the scheme. See s 725-145(1)(b). See also s 725-65 and the definition of a “scheme” in s 995-1

¹⁴ The holder of the interest that increased in value, or to whom shares were issued at a discount, must be the controller of the company (see n 12 *supra*); or an associate of the controller (see n 12 *supra*); or an associate of the holder of the interest that decreased in value (if the holder of the interest that decreased in value qualified as such because he or she was an associate of the controller of the company); or an active participant in the scheme (see n 12 *supra*). See s 725-80

¹⁵ S 725-90

as well as value shifts that resulted in decreases in interests' market values of less than AU\$150,000.¹⁶ The latter rule is aimed at reducing compliance and administration costs.¹⁷

In order to gauge the effectiveness of value shifting anti-avoidance measures (as is done in part 5 *infra*), they should be assessed in the light of their objectives. These measures usually have two objectives in mind. The first is to create a trigger for the calculation of capital gains (or losses). Typically, capital gains only arise when assets are realised, for example by sale or exchange. Consequently, if it were possible to transfer economic value without realising any assets in the process, no immediate capital gain would arise and the capital gain would be deferred until such time as the assets, to which economic value was transferred, are realised. To counter this, the anti-avoidance measures treat the transfer of economic value as a realisation event that triggers a capital gain (or loss).¹⁸ This ensures that two of the traditional criteria for a good tax system, that of equity and efficiency, are adhered to, since the transfer of value is taxed consistently, irrespective of whether a taxpayer effected the transfer by way of conventional realisation (for example by sale) or by value shifting.¹⁹

A second objective of the anti-avoidance measures is to restore distortions caused by a value shift between an asset's tax cost and market value. Capital gains are, generally speaking, calculated as the difference between an asset's cost and its market value at realisation. Shifting economic value from an asset would distort the relationship between the asset's market value and its tax cost and this would in turn result in a smaller capital gain on the realisation of that asset.²⁰ The anti-avoidance measures thus aim to undo this distortion between an asset's market value and tax cost.

The following example illustrates a typical value shift and how a taxpayer would have benefited, had no anti-avoidance measures existed. In January 2002, Adam incorporated SACo (Pty) Ltd with issued share capital of R200, consisting of ten ordinary shares. By August 2005 the market value of the ten ordinary shares had increased to R500 (that is R50 per share). Adam wanted to give his daughter Beth a 50% interest in SACo (Pty) Ltd. If he had sold (or donated) five of his shares to her, he would have been liable for CGT on the increase in the value of these shares. Instead, Adam arranged with SACo to issue ten shares to Beth at a total subscription price of R50 (that is R5 per share). Because of the discount at which the new shares were issued to Beth, the market value of Adam's shares decreased to R275 (that is R27,50 per share).²¹ He thus shifted some R225 worth of economic value from his shares to Beth's shares. Despite this transfer of value, if no anti-avoidance measures

¹⁶ S 725-70

¹⁷ See, eg, Review of Business Taxation *A Platform for Consultation Discussion Paper 2 Building on a Strong Foundation* Report (1999) 623 available at www.rbt.treasury.gov.au (accessed on 31 January 2006)

¹⁸ *A Tax System Redesigned More Certain, Equitable and Durable* 261

¹⁹ *A Tax System Redesigned More Certain, Equitable and Durable* 261

²⁰ Dirkis 2003 *The Tax Specialist* 168

²¹ Calculated as follows: [R500 (value in August 2005) + R50 (issue price of the shares issued to Beth)]/20 (total number of SACo (Pty) Ltd shares) = R27,50 per share. The value of Adam's shares thus decreased from R500 to R275, a decrease of R225

existed, Adams would not be liable for CGT, since he had not realised any of his shares. The benefit is first one of timing: any capital gain would be deferred until Beth were to sell her shares in the future. A second benefit to the family is that any capital gain that Beth would make on a later realisation of her shares may be taxed at a lower tax rate than Adam would have been taxed at (for example because she is taxed at a lower marginal tax rate than Adam, or because of a reduction in the progressive tax rates in later years).

3 Integrating the value shifting anti-avoidance measures with the general CGT regime

Whilst the need for value shifting anti-avoidance measures is apparent, the question as to how to integrate them with the general CGT regime has proven to be a real dilemma. The difficulty lies in the fact that a value shift does not fit the usual CGT mould of a capital gain arising on *realisation* of a *CGT asset* and the *proceeds* from the realisation exceeding the *tax cost* of the asset. In the case of value shifting, these elements are often not present. In the first place, no realisation takes place. Secondly, even if a value shift is deemed to be a realisation event, there is often no *asset* that is realised in terms of the deemed realisation and thus also no tax cost and market value (proceeds) that can be compared to calculate the capital gain or loss. The South African and Australian legislators have implemented different solutions to deal with these difficulties.

3 1 The South African approach

Under the Eighth Schedule, a capital gain only arises if a taxpayer *disposes* of an *asset* and the *proceeds* from that disposal exceed the *base cost of the asset*.²² There are thus three conditions that must be met before a capital gain arises: there must be a *realisation event* (a “disposal”), an *asset* must be realised and the *proceeds* must be more than the *base cost* of the asset that was realised. The value shifting anti-avoidance measures, which has the objective of triggering CGT on the happening of a value shift, should thus meet each of these conditions.

3 1 1 Value shifting arrangements as “disposals”

The first condition is that a realisation event must take place. This condition is met, since a value shifting arrangement is expressly deemed to be a “disposal”, which is defined as follows:

“[A] disposal is any event, act, forbearance or operation of law which results in the *creation, variation, transfer or extinction of an asset*, and includes—

- (a) the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of *an asset*;
- (b) the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of *an asset*;
- (c) the scrapping, loss, or destruction of *an asset*;
- (d) the vesting of an interest in *an asset* of a trust in a beneficiary;

²² Par 3 of the Eighth Schedule

- (e) the distribution of *an asset* by a company to a shareholder;
- (f) the granting, renewal, extension or exercise of an option; or
- (g) *the decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement.*²³ (emphasis added)

3 1 2 *The "asset" that is disposed of in terms of a value shifting arrangement*

The definition of a "disposal" in paragraph 11 also reiterates the second condition, namely that an *asset* must be the object of the disposal. It describes a "disposal" with reference to an "asset" that is "created", "varied" or "transferred" or that becomes extinct. Except for sub-paragraphs (f) (which refers to an option, which is clearly an "asset") and (g) (which deals with value shifting arrangements), all the other sub-paragraphs in the definition also incorporate the requirement that an "asset" must be the object of the disposal.

This begs the question of what constitutes the "asset" that is disposed of in the case of a value shifting arrangement. It seems from the wording of paragraph 11(1)(g) that the legislator recognised the fact that no "asset"²⁴ may be disposed of in the case of a value shifting arrangement.²⁵ The sub-paragraph simply refers to the "value" that was shifted from the interest that decreased in value (the decreased interest or decreased share(s))²⁶ and, since the value that was shifted is clearly neither property nor a right or interest in property, no "asset" is the object of, or deemed to be the object of, a disposal by way of a value shifting arrangement. It thus seems that the legislator intended for a disposal by way of a value shifting arrangement to be an exception to the rule that a disposal must have an "asset" as its object.

However, a number of other provisions in the Eighth Schedule seem to imply that an "asset" is disposed of under a value shifting arrangement without giving any clear indication of what such an asset may be. The first example of these provisions is paragraph 23(a). This provision deals, according to its heading, with the base cost of a value shifting arrangement. It lays down the formula for calculating "the base cost of a *person's interest to which paragraph 11(1)(g) applies*" (emphasis added). At first glance, this wording suggests that the formula determines the base cost of the decreased share. This in turn suggests that the decreased share is regarded as the object of the disposal. However, such an interpretation is not supported by the formula that follows these words. This formula does not calculate the base cost of the decreased share, but rather that part of the base cost of the decreased share that can be attributed to the value that was shifted from the share. In light of the obvious rationale

²³ Par 11(1) of the Eighth Schedule

²⁴ See the definition of "asset" in par 1 of the Eighth Schedule

²⁵ There may be a number of examples of value shifting arrangements where an "asset" is in fact "disposed" of as contemplated in any one of the other subparagraphs of par 11(1). However, these kinds of arrangements create fewer interpretational difficulties and are thus not specifically addressed in this article. See also n 33 *infra* regarding the view of the Australian Taxation Office and Australian authors regarding whether an "asset" can be said to be disposed of in the absence of specific value shifting anti-avoidance measures

²⁶ Division 725 of the 1997 ITAA uses the terminology of a "down interest". The Eighth Schedule does not have any specific term for the interests that decrease in value due to the value shifting arrangement

behind the formula, the phrase “the base cost of a person’s interest to which paragraph 11(1)(g) applies” should rather read “the base cost in respect of a value shifting arrangement” (as per the heading to paragraph 23). If read in this way, the provision is neutral as to whether or not an asset is disposed of under a value shifting arrangement and does not assist in solving the issue regarding what “asset”, if any, is regarded as the object of a disposal by way of a value shifting arrangement.

An equally perplexing provision is paragraph 20(h)(iv), which provides that “the base cost of *an asset* acquired by a person is the sum of ... (h) in the case of ... (iv) a value shifting arrangement, an amount determined in accordance with paragraph 23” (emphasis added). This subparagraph suggests that, in the case of a value shifting arrangement, the person whose interest in the company increased in value (the increased interest or the increased share(s))²⁷ acquires an asset. Yet no mention is made as to what this asset may be.²⁸

These provisions create a very confusing picture, which can be summarised as follows: paragraph 3 of the Eighth Schedule provides that a capital gain only arises on the disposal of an *asset*. However, paragraph 11(1)(g), which deems a value shifting arrangement to be a disposal, suggests that no asset is disposed of (or is deemed to be disposed of) and that value shifting arrangements are thus an exception to this rule. On the other hand, some of the general provisions (such as paragraph 20(h)(iv)) and provisions that deal specifically with value shifting arrangements (such as paragraph 23(a)) suggest that some sort of asset is disposed of, without making it clear what that asset may be. Importantly, the Eighth Schedule does not explicitly deem a value shifting arrangement to be a part disposal of the decreased share.

The failure by the South African legislator to deal consistently and comprehensively throughout the Eighth Schedule with the issues of whether “an asset” is disposed of (or is deemed to be disposed of), and if so, what that “asset” is (or is deemed to be), creates several interpretational difficulties, as highlighted in part 4 *infra*.

3 1 3 *The base cost and proceeds in respect of a value shifting arrangement*

The third condition that must be met before a capital gain arises is that the *proceeds* from the realisation event must exceed the *base cost of the asset*. However, since no asset may be disposed of in the case of a value shifting arrangement (see the discussion in part 3 1 2 *supra*), it would be impossible to determine the base cost of “the asset”. Also, the general rule to determine proceeds cannot be used for value shifting arrangements, since the holder of the decreased shares often does not become entitled to either money or property

²⁷ Division 725 of the 1997 ITAA uses the terminology of an “up interest”. The Eighth Schedule does not have any specific term for the interests that are issued at a discount or that increase in value due to the value shifting arrangement.

²⁸ See also par 13(1) of the Eighth Schedule, which provides that the “time of disposal of an *asset* by means of... (f) the decrease of a person’s interest in a company... as a result of a value shifting arrangement” (emphasis added).

from the value shift.²⁹ For these reasons, special rules apply to determine the proceeds and base cost in the case of value shifting arrangements. There are also special rules for restoring distortions that may have been caused by the value shifting arrangement between the shares' tax costs and market values. However, as will be seen in part 4 3 *infra*, these rules are incomplete.

3 2 The Australian approach

The tricky issue of how to integrate the value shifting provisions with the general CGT regime has also been troubling the Australian legislator for some time. The CGT regime was first introduced in Australia in the Australian Income Tax Assessment Act, 1936 (the 1936 ITAA). Similar to the Eighth Schedule, capital gains only arose under the CGT regime of the 1936 ITAA if a taxpayer *disposed* of an *asset* and the *proceeds* from the disposal exceeded the asset's *base cost*.^{30 31} Over time the definition of "disposal" was extended to include transactions and events that went far beyond the traditional view of a "disposal" as a transfer of ownership of an asset.³² Due to considerable debate as to whether a value shift would fall within this extended definition, and more specifically whether it could be said that an *asset* is disposed of under a value shift,³³ specific value shifting provisions were introduced in 1994.³⁴ In terms of these provisions a value shift was explicitly deemed to be a part-disposal of the decreased share³⁵ and special rules were created to calculate the base cost of the part being disposed of and the proceeds arising from such part-disposal. This approach thus ensured that all the conditions for the making of a capital gain were met, which in turn ensured that the value shifting provisions interacted well with the general CGT provisions.

A comparison between the integration approaches followed by the Eighth Schedule and the 1997 ITAA is more difficult, since the structures of their CGT regimes differ somewhat. Rather than having a central definition of a "disposal", the CGT regime of the 1997 ITAA contains several, separate realisation events, called "CGT events". A taxpayer makes a capital gain (or loss) only if

²⁹ See par 35 of the Eighth Schedule

³⁰ S 160AY of the 1936 ITAA

³¹ The 1997 ITAA (like the 1936 ITAA) adopts the terminology of "cost base" of a CGT asset and, in the case of Division 725, the "adjustable value" of an interest (as explained in s 725-240) and the "notional adjustable value" of a value shift. For the sake of simplicity, the terminology of the Eighth Schedule, that is the "base cost" of a CGT asset and the "base cost" in respect of a value shift, is used throughout the article, even when reference is made to the Australian tax legislation

³² Under s 160M of the 1936 ITAA a change in beneficial ownership of an asset constituted a disposal. However, several subsections in s 160M extended the definition of a "disposal" to also include other transactions and events. Some arrangements that were entered into before the introduction of Division 19B (which dealt with share value shifting) might have been caught by the extended definition of a "disposal" in s 160M, as illustrated by Commissioner of Taxation *TR94/30 Public Ruling* (1994)

³³ See, eg, Owen "The Capital Gains Tax Treatment of Share Value Shifting: Division 19B Under Scrutiny" 1997 *Australian Business LR* 161 163 and Westbrook "Capital Gains Tax Implications of Variations of Rights Attaching to Shares" 1994 *Australian Tax Review* 37. The view of the Australian Taxation Office, as expressed in *TR94/30*, was that, bar some very limited circumstances, it could not constitute either a disposal or a part-disposal of an asset and hence the need for specific value shifting provisions

³⁴ Division 19B of the 1936 ITAA

³⁵ See, eg, ss 160ZZRP and 160ZZRQ of the 1936 ITAA

a transaction fits into one of these CGT events.³⁶ Each event lays down its own requirements (for example whether or not a “CGT asset” must be the object of the event), exceptions and the mechanism for calculating the capital gain or loss arising from that specific event. This new structure thus recognises the fact that it is extremely difficult to have only one, universal set of conditions that all transactions must meet before a CGT liability can arise.

CGT event K8 is the relevant CGT event that deals with share value shifts.³⁷ It does not set out the exact manner in which a capital gain arising from a value shift is to be calculated, but instead refers to Division 725.^{38,39} Division 725 then determines which kinds of value shifting will give rise to CGT, how the capital gain arising from these value shifts is to be calculated and which adjustments are to be made to the base costs of the shares involved in the value shift. Since there is no central requirement under this new regime that an “asset” be disposed of for a capital gain to arise, the issue regarding what “asset” is being disposed of in the case of a value shifting arrangement generally does not arise. However, for some purposes (for example to give concessional treatment to value shifts involving shares acquired prior to 20 September 1985),⁴⁰ the value shift is treated comparable with a part-disposal of the decreased share.⁴¹

4 CGT consequences of a value shift

As discussed in part 2 *supra*, value shifting anti-avoidance measures have two main objectives: to ensure that a value shift is treated as a realisation event that will trigger CGT and to restore any distortions that may have been caused by the value shift between the asset’s tax cost and market value. To meet these objectives, value shifting arrangements give rise to the following CGT con-

³⁶ S 102-20 S 104-5 contains a list of all the CGT events

³⁷ S 104-250

³⁸ Incidentally, Division 275 uses its own terminology, which differs from the terminology used in Part 3 of the 1997 ITAA (ie the part that deals with CGT), to determine the CGT consequences of a value shift

³⁹ The value shifting provisions were initially contained in Division 19B of the 1936 ITAA. During the rewrite of the 1936 ITAA under the Tax Law Improvement Project, Division 19B was rewritten as Division 140 of the 1997 ITAA. See the Tax Law Improvement Act (No 1) 46 of 1998 (*The Draft Comprehensive Guide to Capital Gains Tax* n 426 still refers to this division). Other value shifting rules were found in Divisions 138 (dealing with value shifting by asset stripping) and 139 (dealing with value shifting through debt forgiveness) of the 1997 ITAA, but these forms of value shifting are beyond the scope of this article. In 1999, the Review of Business Taxation recommended a rewrite of the value shifting regime. The core provisions of the new value shifting regime, called the “General Value Shifting Regime”, were enacted by the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 90 of 2002 and special rules relating to the consolidation regime in Australia were enacted by the New Business Tax System (Consolidation and Other Measures) Act 16 of 2003. The new regime is contained in three divisions: Division 725 (dealing with value shifting between equity and loan interests in unconsolidated companies and trusts), Division 723 (dealing with the realisation of a non-depreciating asset at a loss where the loss arose because of a right created over the asset in an associate and the market value of the right was not taxed in full on creation) and Division 727 (dealing with value shifting between entities in circumstances where they have not dealt at arm’s length and this impacts indirectly on the value of the interests held in those entities). The forms of value shifting dealt with under the latter two Divisions are beyond the scope of this article. The General Value Shifting Regime applies generally to arrangements entered into after 1 July 2002. See s 725-1 in respect of value shifts that are governed by Division 725. See also Dirkis 2003 *The Tax Specialist* 169.

⁴⁰ See part 5.2 *infra* for background on how shares acquired prior to 20 September 1985 are treated under the Australian CGT regime.

⁴¹ See, eg, s 725-45 that refers to the value shift as a “partial realisation” (although the section does not indicate what the object of this partial realisation is). See also s 725-240.

sequences under the Eighth Schedule: first, it is regarded as a disposal and will thus result in either a capital gain or loss for the taxpayer whose interest decreased in value;⁴² secondly, the base cost of the interest that increased in value, or that was obtained by the connected person as a result of the value shifting arrangement, is adjusted.⁴³ Both these consequences are discussed below.

4 1 Calculating the capital gain or loss arising from a value shifting arrangement

The calculation of the capital gain (or loss) arising from a value shifting arrangement is governed by a set of special rules that determine the proceeds and base cost in respect of the value shifting arrangement. The proceeds are determined in terms of paragraph 35(2) and are defined as the market value of the decreased interest immediately prior to the value shifting arrangement, less its market value immediately thereafter: in other words, the proceeds are equal to the value that was shifted. The base cost is in turn calculated in accordance with the following formula in paragraph 23(a):⁴⁴

$$\frac{\text{market value of the decreased interest immediately before the value shift} - \text{market value of the decreased interest immediately after the value shift}}{\text{market value of the decreased interest immediately before the value shift}} \times \text{base cost of the decreased interest immediately before the value shift}$$

The example in part 2 *supra* can be used to illustrate how a capital gain arising from a value shifting arrangement is calculated. The facts were as follows:⁴⁵ Adam incorporated SACo (Pty) Ltd in January 2002 with issued share capital of R200, consisting of ten ordinary shares. In August 2005, when the value of the shares had increased to R500, Adam arranged for SACo (Pty) Ltd to issue ten shares to his daughter Beth at a total subscription price of R50. Because of the discount at which the new shares were issued to Beth, the market value of Adam’s shares decreased to R275.⁴⁶ Since this arrangement falls within the

⁴² The time of the disposal is the date on which the decrease in value occurs. See par 13(1)(f) of the Eighth Schedule

⁴³ Par 23(b) of the Eighth Schedule

⁴⁴ The formula in paragraph 23(a) is:

$$“Y = \frac{(A - C)}{A} \times B”$$

where—

- i) ‘Y’ represents the amount to be determined;
- ii) ‘A’ is the market value of that person’s interests immediately prior to the disposal;
- iii) ‘B’ is the person’s base cost of the interests calculated immediately prior to the disposal; and
- iv) ‘C’ is the market value of that person’s interests immediately after the disposal.”

⁴⁵ In all the examples used in the article, specific identification, as contemplated in par 32(3)(a) of the Eighth Schedule, is used to determine the base cost of the shares concerned

⁴⁶ [R500 (value in August 2005) + R50 (issue price of the shares issued to Beth)]/20 = R27,50 per share

definition of a “value shifting arrangement”, Adam will realise a capital gain.⁴⁷ The gain, which amounts to R135, is calculated as follows:

Step 1: Calculate Adam’s proceeds in respect of the value shift:⁴⁸ market value of the decreased shares immediately prior to the value shift – market value of the decreased shares immediately after the value shift

$$= R500 - R275 = R225$$

Step 2: Calculate Adam’s base cost in respect of the value shift:

market value of the decreased shares immediately before the value shift – market value of the decreased shares immediately after the value shift	x	base cost of the decreased shares immediately before the value shift
market value of decreased shares immediately before the value shift		shift
$= \frac{R500 - R275}{R500} \times R200 = R90$		

Step 3: Calculate Adam’s capital gain from the value shift:

$$\text{Proceeds} - \text{base cost} = R225 - R90 = R135$$

4 1 1 Decreased shares acquired before 1 October 2001

The application of these special rules is problematic in those cases where the decreased shares are pre-valuation date assets (pre-CGT assets).⁴⁹ Generally, if pre-CGT assets are disposed of, the tax cost of these assets are adjusted so that (at least in theory) only increases in the value of these assets after 1 October 2001 are subject to CGT. The adjustments are set out in paragraphs 25 to 28 of the Eighth Schedule. Paragraph 25(1) provides that the base cost of a pre-CGT asset is the sum of the value of the pre-CGT asset on 1 October 2001 and expenditure incurred on/after 1 October 2001. The 1 October value is determined in terms of paragraphs 26 to 28. Paragraph 26(1) provides that:

“Where the proceeds from the disposal of a pre-valuation date asset ... exceed the expenditure allowable in terms of paragraph 20 ... the person who disposed of that asset must ... adopt any of the following as the valuation date value of that asset...” (emphasis added).⁵⁰

Paragraph 26 thus presupposes that all disposals will involve the disposal of an asset. However, as discussed in part 3 1 2 *supra*, in the case of a value shifting arrangement, no asset may be disposed of and the Eighth Schedule does not give any clear indication that any asset is deemed to be disposed of. A strict reading of paragraph 26 would mean that, if value is shifted from a pre-CGT share, paragraph 26 cannot apply to the calculation of the base cost of the value

⁴⁷ See par 1 of the Eighth Schedule and the discussion on the definition of a “value shifting arrangement” in part 2 *supra*

⁴⁸ For the sake of simplicity only, all the calculations in this article are done on a collective basis, ie by grouping together all the decreased and increased interests respectively

⁴⁹ A “pre-valuation date asset” is defined in par 1 of the Eighth Schedule as “an asset acquired prior to valuation date [1 October 2001] by a person and which has not been disposed of by that person before valuation date”

⁵⁰ Par 27 has similar wording Par 28 is not relevant

shifting arrangement in terms of paragraph 23(a), since no “pre-valuation date asset” (emphasis added) is disposed of. This clearly goes against the objective of paragraphs 25 to 28: since some of the value that has been shifted under the value shifting arrangement relates to the period before 1 October 2001, the value shifted cannot be taxed in full. This is the first of a number of examples that illustrates the problems that arise from the fact that no “asset” has been identified as the object of the disposal by way of a value shifting arrangement. A solution to this problem will be to adopt a similar approach to the 1936 ITAA and to deem a value shift to be a part-disposal of the decreased share. If done in this way, it will be clear that paragraph 26 can apply in those cases where value has been shifted from pre-CGT decreased shares to adjust the base cost in respect of the value shift.⁵¹

This is not the only problem that arises if the decreased shares are pre-CGT assets. Further problems ensue if (despite the interpretational problem highlighted above) one attempts to use the methods prescribed in paragraph 26 to calculate the base cost in respect of the value shifting arrangement. To recap, the formula for the calculation of the base cost in respect of a value shifting arrangement is as follows:⁵²

market value of the decreased interest immediately before the value shift – market value of the decreased interest immediately after the value shift	x	base cost of the decreased interest immediately before the value shift
market value of the decreased interest immediately before the value shift		

Say the taxpayer elects to adopt the time-apportionment method to determine the base cost in respect of the value shifting arrangement.⁵³ How is this method applied to the above formula? The only part of the formula in paragraph 23(a) to which the time-apportionment method can apply is the “base cost of the decreased interest immediately before the value shift”. The relevant formula⁵⁴ for the time-apportionment method is:⁵⁵

⁵¹ Amendments to par 26 will be required too. Eg, the reference to “expenditure allowable in terms of paragraph 20” will have to be broadened to include a reference to par 23(a)

⁵² Par 23(a) of the Eighth Schedule

⁵³ Whether the time-apportionment method will be available, will depend on a number of circumstances. A detailed discussion of these rules is beyond the scope of this article

⁵⁴ Different time-apportionment formulae may apply, depending on the circumstances. For the sake of complicity, the formula in n 55 *infra* is used here

⁵⁵ Par 30(1). The formula is as follows:

$$Y = B + \frac{(P - B) \times N}{T + N}$$

“Where—

- a) ‘Y’ represents the amount to be determined;
- b) ‘B’ represents the amount of expenditure ... in respect of that asset that is attributable to the period from the date that the asset was acquired to [30 September 2001];
- c) ‘P’ represents the proceeds ... in respect of the disposal of that asset. ...;
- d) ‘N’ represents the number of years determined from the date that the asset was acquired to [30 September 2001] [to a maximum of 20 years in certain cases] ...;
- e) ‘T’ represents the number of years determined from [1 October 2001] until the date the asset was disposed of after [1 October 2001]....

Provided that for purposes of items (d) and (e) a part of a year must be treated as a full year”

$$\text{pre-1/10/2001 expenses} + \frac{(\text{proceeds} - \text{pre-1/10/2001 expenses}) \times \text{number of years asset was held before 1/10/2001}}{\text{sum of number of years asset was held before and after 1/10/2001 respectively}}$$

“Proceeds” will presumably only include the proceeds in respect of the value shifting arrangement, since this is the only proceeds that are known at that stage. Clearly then, “pre-1/10/2001 expenses” cannot include the entire cost of the decreased share. A common-sense solution would be to include only a portion of the cost in the time-apportionment formula. This portion can be calculated by reference to that portion of the value of the decreased share that is being shifted.⁵⁶

This common-sense approach can be illustrated by way of the following example: Adam incorporated SACo (Pty) Ltd in January 2001 with issued share capital of R200, consisting of ten ordinary shares. In August 2005, when the value of the shares had increased to R500, Adam arranged for SACo (Pty) Ltd to issue ten shares to his daughter Beth at a total subscription price of R50. Because of the discount at which the new shares were issued to Beth, the market value of Adam’s shares decreased to R275.⁵⁷ Adam elected the time-apportionment method to calculate the base cost of the value shifting arrangement. He realises a capital gain of R108, calculated as follows:

Step 1: Calculate Adam’s proceeds in respect of the value shifting arrangement:

market value of the decreased shares immediately prior to the value shift – market value of the decreased shares immediately after the value shift
= R500 – R275 = R225

Step 2: Calculate Adam’s base cost for the value shifting arrangement:

Step 2(a): Calculate the portion of the value of the shares that was shifted:

$$\frac{\text{market value of the decreased shares immediately before the value shift} - \text{market value of the decreased shares immediately after the value shift}}{\text{market value of decreased shares immediately before the value shift}} = \frac{500 - 275}{500} = 0.45$$

Step 2(b): Apply this portion to the expenses incurred in respect of the decreased shares before 1 October 2001:

$$R200 \times 0.45 = R90$$

Step 2(c): Calculate the time-apportionment base cost in respect of the value shifting arrangement:

⁵⁶ Incidentally, this is the method prescribed in the *Draft Comprehensive Guide to Capital Gains Tax* example 2 par 8 27 2 for calculating the time-apportionment base cost in respect of part-disposals of pre-CGT assets

⁵⁷ [R500 (value in August 2005) + R50 (issue price of the shares issued to Beth)]/20 = R27,50 per share

$$\begin{aligned} & \text{pre-1/10/2001 expenses} + \frac{(\text{proceeds} - \text{pre-1/10/2001 expenses}) \times \text{number of years asset} \\ & \quad \text{was held before 1/10/2001}}{\text{sum of number of years asset was held before and after} \\ & \quad \text{1/10/2001 respectively}} \\ = & \text{R90} + \frac{(\text{R225} - \text{R90}) \times 1}{1 + 4} = \text{R117} \end{aligned}$$

Step 3: Calculate Adam’s capital gain from the value shifting arrangement:
 Proceeds – base cost = R225 – R117 = R108

This approach seems to generate a reasonable answer.⁵⁸ It is, however, not supported by the actual wording of paragraph 23(a), since it merges the calculation of the base cost of the decreased interest with the calculation of the portion of the value of the decreased share that was shifted, whereas the formula in paragraph 23(a) requires that these two components of the calculation of the base cost in respect of the value shifting arrangement are calculated separately. This is another example of the problems that arise from the failure to ensure that the specialised value shifting rules are compatible with the general provisions of the Eighth Schedule.

4 1 2 Capital losses arising from value shifting arrangements

Interestingly, a value shifting arrangement under the Eighth Schedule can give rise to a capital loss.⁵⁹ The following example illustrates how such a loss may come about: Adam incorporated SACo (Pty) Ltd in January 2002 with issued share capital of R700, consisting of ten ordinary shares. In August 2005, when the value of the shares had decreased to R500, Adam arranged for SACo (Pty) Ltd to issue ten shares to his daughter Beth at a total subscription price of R50. Because of the discount at which the new shares were issued to Beth, the market value of Adam’s shares decreased to R275.⁶⁰ This is clearly a value shifting arrangement, since Adam retained his shares in SACo (Pty) Ltd, but following the issue of shares to a connected person in relation to him (Beth), the value of his shares decreased and Beth obtained an interest in SACo (Pty) Ltd. Adam will make a capital loss of R90, calculated as follows:

Step 1: Calculate Adam’s proceeds in respect of the value shifting arrangement:
 market value of the decreased shares immediately prior to the value shift – market value of the decreased shares immediately after the value shift
 = R500 – R275 = R225

Step 2: Calculate Adam’s base cost in respect of the value shifting arrangement:

⁵⁸ The total increase in value of Adam’s shares before the value shifting arrangement was R300. Of this, R240 (or 4/5 of R300) is assumed to relate to the period on/after 1 October 2001 and should thus be subject to CGT at some stage. Due to the value shift, Adam transferred 0.45 of the value of his shares, resulting in a capital gain of 0.45 x R240 = R108 from the value shift. If he sold his shares immediately thereafter, the remaining R132 (R240 – R108) would have been subject to CGT.

⁵⁹ Capital losses from share value shifting are disregarded in Australia. See s 104-250(3). See also *A Tax System Redesigned More Certain, Equitable and Durable* 264 and *A Platform for Consultation Discussion Paper 2 Building on a Strong Foundation* 620 where the reasons for the Australian position are briefly mentioned.

⁶⁰ [R500 (value in August 2005) + R50 (issue price of the shares issued to Beth)]/20 = R27.50 per share

market value of the decreased shares immediately before the value shift – market value of the decreased shares immediately after the value shift	x	base cost of the decreased shares immediately before the value shift
market value of decreased shares immediately before the value shift		
$= \frac{R500 - R275}{R500} \times R700 = R315$		

Step 3: Calculate Adam's capital loss from the value shift:

$$\text{Proceeds} - \text{base cost} = R225 - R315 = (R90)$$

A question which arises in this context is whether Adam's loss will be "ring-fenced" or "clogged" under paragraph 39. This provision determines that a taxpayer must disregard any capital loss in respect of the "disposal of an asset" to a connected person, except insofar as such loss may be off-set against capital gains made from future transactions with the same connected person: in other words, the loss is "clogged" or "ring-fenced". This provision thus presupposes the existence of an asset, which is disposed of to a connected person. However, as discussed in part 3 1 2 *supra*, value shifting arrangements may not involve the disposal of an "asset", and the Eighth Schedule also does not give a clear indication that any asset is deemed to be disposed of. On a strict interpretation of paragraph 39, the transfer of value to a connected person will thus not be ring-fenced. Such an interpretation would clearly go against the objective of the provision and may encourage taxpayers to use value shifting rather than conventional ways of realising their shares since the former will not give rise to clogged losses, whilst the latter will. Again, this issue arises due to the failure to integrate properly the value shifting provisions with the general CGT regime that requires an asset to be the object of a disposal. The solution proposed to the issue in part 4 1 1 *supra*, namely to treat a value shifting arrangement explicitly as a part-disposal of the decreased share, could also provide a solution for this issue.

4 2 Adjusting the base cost of the interest that increased in value

The second consequence of a value shifting arrangement is that the base cost of the increased share is lifted. This is necessary to avoid the increase in value, which is taxed in the hands of the holder of the decreased interest under the value shifting provisions, from being taxed again in the hands of the holder of the increased interest on realisation of that interest.

According to paragraph 23(b), the base cost of the increased interest is to be lifted by either of the following amounts:

- “(i) that proportion of the proceeds on disposal contemplated in paragraph 35(2) in respect of the value shifting arrangement which resulted in the increase in market value of [the connected person's] interest; or
- (ii) that proportion of the proceeds on disposal contemplated in paragraph 35(2) in respect of the value shifting arrangement which resulted in the acquisition of [the connected person's] interest”.

The drafting of paragraph 23(b)(ii) is rather clumsy. The words “that proportion of the proceeds...*which resulted in the acquisition* [of the connected person's interest]” (emphasis added) suggest that there must be a causal link

between the proceeds (in other words the value that was shifted from the decreased interest) and the *acquisition* of the increased interest. One would rather expect paragraph 23(b)(ii) to require a causal link between the proceeds (that is the value shifted) and the *discount* at which the decreased interest was acquired by the connected person, in the same way as paragraph 23(b)(i) requires a causal link between the proceeds and the uplift in value of the increased interests.

The uplift in the base cost of the increased interest can be illustrated by the example used in part 4 1 *supra*. The facts were as follows: Adam incorporated SACo (Pty) Ltd in January 2002 with issued share capital of R200, consisting of ten ordinary shares. In August 2005, when the value of the shares had increased to R500, Adam arranged for SACo (Pty) Ltd to issue ten shares to his daughter Beth at a total subscription price of R50. In terms of paragraph 23(b), Beth’s base cost is to be increased by that proportion of the proceeds in respect of the value shifting arrangement that is attributable to the discount at which the new shares were issued to Beth, being R225. This restores the balance between the tax cost and market value of her shares, since the new base cost of her shares is equal to their market value immediately after the value shift. Should Beth in future sell her shares, she will only be subject to CGT on a subsequent increase in the value of the shares.

Paragraph 23(b) clearly makes provision for an apportionment if the entire proceeds in respect of the value shifting arrangement did not give rise to the increase in the market value of the increased interest or to the discount at which the shares were issued. This is because of the reference to “*that proportion of the proceeds...which resulted in [the increase in the market value of the increased interest or in the discount at which the new shares were issued]*” (emphasis added). No formula is provided for the apportionment and presumably any fair allocation will be acceptable. The formula provided in the 1997 ITAA for calculating the uplift in the base cost of the increased interest is more prescriptive regarding how such an apportionment should be made:⁶¹

increase in the market value of the increased shares of, or discounts given to, the connected person <hr style="border: 0.5px solid black;"/> either of:	x	decrease in the market value of the decreased shares
<ul style="list-style-type: none"> • if the decrease in the market value of the decreased shares ≥ the increase in the market value of the decreased shares: the decrease in the market value • otherwise: the increase in the market value of the increased shares and/or discounts given 		

The allocation prescribed by the formula thus makes provision for *inter alia* the following contingencies: first, where value has been shifted to both connected and non-connected persons, only value that has been shifted to the connected person is included in his or her base cost for the increased interest. Secondly, to the extent that the reduction in value of the decreased interest is

⁶¹ This is an adaptation of several formulae in s 725-375 of the 1997 ITAA. Furthermore, different formulae may apply depending on the kind of value shift that took place

not reflected in the increased value of the increased interest (or in the discount at which shares were issued), only the part of the reduction in value of the decreased interest which is reflected in the value of the increased interest (or in the discount given) is included in the base cost of the increased interest of the connected person. This may, for example, happen if value is shifted from a majority to a minority holding and the minority holding is worth less per share than the majority holding.

4 3 Adjusting the base cost of the decreased interest

There is a curious oversight in the Eighth Schedule. It contains no special rule to adjust the base cost of the decreased interest because of the value that was shifted from that interest. As a result, a portion of the base cost of the decreased interest will be allowed as a deduction twice: first in calculating the capital gain in respect of the value shifting arrangement, and secondly in calculating the capital gain on realisation of the decreased interest.

This oversight is illustrated by the example of Adam and Beth in part 4 1 *supra*. It will be recalled that Adam incorporated SACo (Pty) Ltd in January 2002 with issued share capital of R200, consisting of ten ordinary shares. In August 2005, when the value of the shares had increased to R500, Adam arranged for SACo (Pty) Ltd to issue ten shares to his daughter Beth at a total subscription price of R50. Adam's capital gain from this value shifting arrangement was R135. If Adam were to sell his shares shortly thereafter at their market value of R275,⁶² the capital gain from the sale will be calculated as follows:

Step 1: Calculate Adam's proceeds in respect of the sale of his shares:

Money received on sale of the shares: R275

Step 2: Calculate Adam's base cost in respect of his shares:

Since no special adjustment is made, the ordinary rules⁶³ apply and his base cost is R200, namely the subscription price of the shares.

Step 3: Calculate Adam's capital gain from the sale:

Proceeds – base cost = R275 – R200 = R75

Adam's total capital gain is thus R135 (from the value shifting arrangement) + R75 (from the subsequent disposal of his shares) = R210, even though the increase in value of his shares before the value shift was R300. Furthermore, if Beth were to sell her shares at the same time, she will not be liable for any CGT, since her base cost was increased by the amount of value that was shifted to her shares, as was discussed in part 4 2 *supra*. Only a portion (R210) of the real increase in value (R300) is thus taxed. To achieve the right outcome, namely that the full increase in the value of the shares (R300) is taxed, Adam's base cost in respect of his shares should have been reduced by the amount that was taken into account as the base cost of the value shifting arrangement (R90). That would have resulted in a capital gain from the sale of his shares of

⁶² $[(R500 \text{ (value in August 2005)} + R50 \text{ (issue price of the shares issued to Beth)})/20 = R27,50 \text{ per share}$

⁶³ These rules are contained in par 20 of the Eighth Schedule

R165 and his total capital gain would have been R135 (from the value shift) + R165 (from the subsequent disposal of his shares) = R300.

As mentioned, there is no special rule that adjusts the base cost of the decreased share. There is also no general CGT provision that performs this function. In the first place, since a value shifting arrangement is not deemed to be a part-disposal of the decreased interest, as was discussed in part 3.1 *supra*, one cannot argue that the base cost of the decreased interest should be decreased because a part thereof has been disposed of. Furthermore, paragraph 21 (the general provision that guards against double deduction of expenses) is unlikely to apply. Paragraph 21 reads as follows:

- “(1) Where, but for the provisions of this subparagraph, an amount qualifies or has qualified as an allowable expenditure or may otherwise be taken into account in determining a capital gain or capital loss under more than one provision of this Schedule, that amount or portion thereof, shall not be allowed as expenditure or be taken into account *more than once in determining that capital gain or capital loss.*
- (2) No expenditure shall be allowed under paragraph 20(1)(a) or (e) where any amount of that expenditure is allowable under any other provision of this Schedule, despite that that other provision imposes any limitation on the amount of the expenditure.” (emphasis added)

Paragraph 21(1) foresees the situation where the same event or transaction results in the base cost (or part thereof) being taken into account twice in calculating the capital gain (or loss) arising from that event or transaction. In the case of a value shifting arrangement, the value shift and subsequent disposal of the decreased shares are different events, happening at different times, and paragraph 21(1) thus does not apply.

Paragraph 21(2) governs the situation where expenditure could be included in the base cost of an asset under more than one provision, but the amount of the expenditure that can be so included is limited under one of these provisions. In such a case, only the amount determined by the provision that imposes the limit can be included in the base cost of the asset.⁶⁴ This clearly does not apply to value shifting arrangements, since neither paragraph 23(a), nor any other provision imposes a limit on the expenditure that can be claimed as the base cost of the decreased interest on its subsequent disposal.

The oversight of not adjusting the base cost of the decreased interest is especially curious in light of the fact that a comparison with the Australian value shifting regimes under both the 1936 ITAA and 1997 ITAA would have highlighted the need for a special rule governing the reduction in the base cost of the decreased interest.⁶⁵ Until such time as this oversight is remedied, there is still a real advantage for taxpayers to use value shifting to reduce their CGT liability. In remedying this oversight, special attention will have to be paid to the question of how to adjust the base cost of pre-CGT decreased shares. Rules similar to those adopted in paragraphs 33(1)(b) and 33(5) of the Eighth Schedule will be required.

⁶⁴ These views regarding the scope of par 21 correspond with the views of the South African Revenue Service. See the *Draft Comprehensive Guide to Capital Gains Tax* 144.

⁶⁵ Both the 1936 ITAA and 1997 ITAA have such special rules. See, eg, ss 160ZZRP(3) and 160ZZRQ(3) of the 1936 ITAA and item 6 of the table in ss 725-250(2) and 725-365 of the 1997 ITAA.

5 Value shifting between assets held by the same taxpayer

In this part of the article, it will be argued that the scope of the South African value shifting anti-avoidance measures is too narrow in that they fail to recognise the fact that value shifting may take place not only between shares held by *different* taxpayers, but also between shares held by the *same* taxpayer. Where value is shifted between shares of *different* taxpayers, the economic effect is comparable with that of a sale and transfer of the shares (or rather parts thereof). That is why, as was discussed in part 2 *supra*, one of the objectives of value shifting anti-avoidance measures is to treat this kind of value shifting as a trigger event for CGT: in other words, it is as if the shares (or rather parts thereof) were sold and transferred. Where value is shifted between shares owned by the *same* taxpayer, the economic effect is different. In such a case, value is not transferred to a different taxpayer and there is thus no need to treat the value shift as if the shares (of rather parts thereof) were sold. Nevertheless, such a value shift creates a distortion between the tax costs and market values of the shares involved, which could lead to tax avoidance on a later realisation of the shares.

Below, two examples of this kind of value shifting, namely between shares held by the same taxpayer, are looked at. These two examples are not recognised as forms of tax avoidance by the South African value shifting anti-avoidance measures,⁶⁶ but are recognised as such by the Australian anti-avoidance measures.

5.1 Value shifting between post-CGT shares

The first example of a value shift between assets held by the same taxpayer, is between shares acquired on/after 1 October 2001 (post-CGT shares) that are owned by the same person. The following example illustrates this kind of value shifting and the distortion that it creates: Xavier incorporated Company (Pty) Ltd (Company) in January 2002 with issued share capital of R200, consisting of ten ordinary shares (the initial shares). In August 2005, when the value of the shares had increased to R500 (that is R50 per share), Xavier arranged for Company to issue another ten shares (the subsequent shares) to him at a total subscription price of R50 (that is R5 per share). In December 2005 Xavier sold the initial shares to a non-related third party at market value (R275).⁶⁷

This arrangement is not a “value shifting arrangement” for a number of reasons, two of which are mentioned here. First, in order for an arrangement to constitute a “value shifting arrangement”, the reduction in the market value of the decreased interest must “follow” a change in the rights and entitlements of the taxpayer’s interests in the company: in other words, there must be a causal link between a change in the rights or entitlements of the taxpayer and a decrease in the value of his or her shares.⁶⁸ In the example above, it is clear that the value of Xavier’s initial shares decreased due to the issue of the subsequent

⁶⁶ As mentioned in part 1 *supra*, s 103 (now s 80A-80L of the Income Tax Act 58 of 1962) may apply in these cases, but is beyond the scope of this article

⁶⁷ $[\text{R}500 \text{ (value of the initial shares in August 2005)} + \text{R}50 \text{ (issue price of the subsequent shares)}] / 20 = \text{R}27,50 \text{ per share}$

⁶⁸ See n 8 *supra*

shares at a discount. However, the issue of the subsequent shares were not the result of a change in the rights and entitlements in Company: Xavier had the same rights and entitlements relating to the receipt of dividends, voting, etc in Company before and after the issue of the subsequent shares. The required causal link between a change in the rights and entitlements of the company and the decrease in value of the initial shares is thus not present. Secondly, the third party is not a connected person in relation to Xavier and neither (a) nor (b) of the definition of a “value shifting arrangement” is thus met.

In the example, Xavier will make a capital gain of R75.⁶⁹ Compare this with the capital gain he would have made, had he sold 50% of his interest in Company to the third party without arranging for the issue of the subsequent shares. In such an event, he would have made a capital gain of R150 in respect of the sale of five of the initial shares.⁷⁰ By first transferring value from the initial shares to the subsequent shares, Xavier had thus created a distortion between the tax cost and market value of the initial shares and so secured a tax benefit (a deferral of a portion of his capital gain until such time as the subsequent shares are sold) on the sale of the initial shares.

The value shifting anti-avoidance measures of the 1997 ITAA reduce, but do not eliminate this kind of tax avoidance. In recognition of the fact that the economic effect of this kind of value shifting is different from that of value shifting between assets held by different taxpayers (which has the same economic effect as a sale and transfer), it is not deemed to be a realisation event for CGT purposes.⁷¹ Instead, the only consequence is an adjustment to the base costs of the decreased and increased shares.^{72 73} The adjustments that are made under the 1997 ITAA are illustrated by the following example, assuming the same facts as in Xavier’s example above:

Step 1: Calculate the new base cost of the decreased shares (the initial shares):⁷⁴

$$\begin{aligned} &\text{cost of the initial shares} - \left[\frac{\text{Value shifted}^{75}}{\text{market value of the initial shares immediately before the value shift}} \times \text{cost of the initial shares} \right] \\ &= R200 - \left[\frac{R225}{R500} \times R200 \right] = R200 - R90 = R110 \end{aligned}$$

⁶⁹ Proceeds – base cost = R275 – R200 = R75

⁷⁰ Proceeds – base cost = R250 – R100 = R150

⁷¹ See the list of events that are regarded as realisation events for CGT purposes in s 725-245

⁷² See item 1 of the table in s 725-250(2) for the adjustments to be made to the base costs of the decreased and increased shares

⁷³ For a discussion of the purpose of corresponding provisions in the now repealed Division 19B of the 1936 ITAA, refer to Owen 1997 *Australian Business LR* 170 174. According to Owen, the purpose of these provisions are to make these kinds of value shifts “CGT neutral”, in that the taxpayer should be liable for the same total CGT, irrespective of whether the value shift has taken place or not. It does not, however, prevent a taxpayer from deferring the recognition of capital gains until a later time

⁷⁴ The formula in the example is a simplified version of the one in s 725-365

⁷⁵ R500 (value of the initial shares immediately before the issue of the subsequent shares) – R275 (value of the initial shares after the issue of the subsequent shares) = R225

Step 2: Calculate the new base cost of the increased shares (the subsequent shares):⁷⁶

$$\begin{aligned} & \text{cost of the} \\ & \text{subsequent} \\ & \text{shares} \quad + \quad \left[\frac{\text{Value shifted}}{\text{market value of the initial shares}} \times \text{cost of the} \right. \\ & \qquad \qquad \qquad \qquad \qquad \qquad \qquad \qquad \qquad \qquad \qquad \qquad \qquad \qquad \left. \text{initial shares} \right] \\ & \text{immediately before the value shift} \end{aligned}$$

$$= R50 - \left[\frac{R225}{R500} \times R200 \right] = R50 + R90 = R140$$

If Xavier were to sell the subsequent shares to the non-related third party, he will make a capital gain of R135, which is the difference between his proceeds (R275) and the base cost of the subsequent shares, as calculated in step 2 *supra* (R140).⁷⁷ If one compares this with the R75 capital gain he would have made under the Eighth Schedule, it is clear that he does not get the same tax deferral benefit that is currently available in terms of the Eighth Schedule.

5.2 Value shifting between pre- and post-CGT shares

A second example of value shifting between assets held by the same taxpayer is between pre- and post-CGT shares held by the same person. If value is shifted from the post- to the pre-CGT shares, the value of the pre-CGT shares is increased and the taxpayer can take advantage of the special rules in paragraphs 25 to 28 of the Eighth Schedule to obtain a higher base cost for the value that was shifted. Importantly, this kind of arrangement does not give a mere timing advantage. It results in a permanent reduction in CGT.

This is illustrated by the following example: Yvonne incorporated YCo (Pty) Ltd (YCo) in January 2000 with issued share capital of R5, consisting of one ordinary share (the original share). In January 2002, when the value of the original share had increased to R20, Yvonne subscribed to a further ordinary share (the later share) in YCo at a subscription price of R20. By August 2002 the value of the shares had increased to R50 per share (that is R100 in total). At that stage, Yvonne arranged for YCo to change the share rights attaching to the later share. This caused the value of the later share to decline to R25 and the value of the original share to increase to R75. In September 2002, while the values of the shares were still R25 and R75 respectively, Yvonne sold her shares to an unrelated third party.

This does not constitute a value shifting arrangement for two reasons: first, although the market value of Yvonne's interests (the later share) decreased because of the change in the share rights of the later share, it cannot be said that the third party obtained an interest in YCo because of this change⁷⁸ and, secondly, the third party is not a connected person in relation to Yvonne.

⁷⁶ The formula in the example is a simplified version of the one in s 725-370

⁷⁷ In Australia, Adam would rather sell the subsequent shares first, since they have a higher base cost. If Adam were to sell the initial shares thereafter, and assuming no increase in the value of these shares since August 2005, he will make a capital gain of R165 that is the difference between his proceeds (R275) and the base cost of the initial shares as calculated in step 1 (R110). His total capital gain from the sale of both batches of shares will thus be R300, which is equal to the increase in the value of the initial shares prior to the value shift.

⁷⁸ See n 9 *supra*

Yvonne will make a capital gain of R28,33 in respect of the sale of her shares, calculated as follows:

Step 1: Calculate Yvonne’s capital gain in respect of the sale of the decreased share (the later share):

Proceeds: R25

Base cost: R20

Capital gain (proceeds – base cost): R5

Step 2: Calculate Yvonne’s capital gain in respect of the sale of the increased share (the original share):

Proceeds: R75

Base cost: Assume Yvonne elected the time-apportionment method:

$$\text{pre-1/10/2001 expenses} + \frac{(\text{proceeds} - \text{pre-1/10/2001 expenses}) \times \text{number of years asset was held before 1/10/2001}}{\text{sum of number of years asset was held before and after 1/10/2001 respectively}}$$

$$= R5 + \frac{(R75 - R5) \times 2}{2 + 1} = R51,67$$

Capital gain (proceeds – base cost): R75 – R51,67 = R23,33

Step 3: Calculate Yvonne’s total capital gain:

Capital gain from the sale of the later share: R5

Capital gain from the sale of the original share: R23,33

Total capital gain: R28,33

On the other hand, if Yvonne had not arranged for the change in the share rights, her capital gain would have been R45, calculated as follows:

Step 1: Calculate Yvonne’s capital gain in respect of the sale of the decreased share (the later share):

Proceeds: R50

Base cost: R20

Capital gain (proceeds – base cost): R30

Step 2: Calculate Yvonne’s capital gain in respect of the sale of the increased share (the original share):

Proceeds: R50

Base cost: Assume Yvonne elected the time-apportionment method:

$$\text{pre-1/10/2001 expenses} + \frac{(\text{proceeds} - \text{pre-1/10/2001 expenses}) \times \text{number of years asset was held before 1/10/2001}}{\text{sum of number of years asset was held before and after 1/10/2001 respectively}}$$

$$= R5 + \frac{(R50 - R5) \times 2}{2 + 1} = R35$$

Capital gain (proceeds – base cost): R50 – R35 = R15

Step 3: Calculate Yvonne’s total capital gain

Capital gain from the sale of the later share: R30

Capital gain from the sale of the original share: R15

Total capital gain: R45

By changing the share rights in order to shift value from her post-CGT share (the later share) to her pre-CGT share (the original share), Yvonne had thus reduced her capital gain.

Value shifting from post- to pre-CGT assets could have held even more significant tax benefits for Australian taxpayers. That is because a taxpayer under

the Australian CGT regime only makes a capital gain (or loss) if he or she realises⁷⁹ an asset that was acquired after 19 September 1985, the date from which CGT became operative in Australia (post-CGT assets),⁸⁰ subject to a number of exceptions: in other words, if the taxpayer realises an asset that was acquired before 20 September 1985 (pre-CGT assets), no CGT liability arises. If taxpayers could thus shift value from post-CGT to pre-CGT shares and subsequently sell the pre-CGT shares, no CGT would have arisen on the value that was so shifted. To counter this, the value shifting anti-avoidance measures have been drafted in such a way as to include value shifting from post- to pre-CGT shares.⁸¹ The consequences of such a shift are: the holder of the shares is taxed on the value shifted from the post-CGT share to the pre-CGT share,⁸² the base cost of the post-CGT share is reduced by the value shifted⁸³ and the base cost of the pre-CGT share is increased.⁸⁴ The effect is thus that the value shift is treated similarly to a part-disposal of the post-CGT share.

If the Australian approach is applied to Yvonne’s example, with the necessary changes to take into account the differences between the South African and Australian legislation in respect of the calculation of the base cost of pre-CGT shares, the result is as follows:

Step 1: Calculate Yvonne’s capital gain in respect of the value shift (namely the change in the share rights of the later share)⁸⁵

Step 1(a): Calculate the proceeds in respect of the value shift:
 market value of the later share immediately prior to the value shift – market value of the later share immediately after the value shift
 = R50 – R25 = R25

Step 1(b): Calculate the base cost in respect of the value shift:

$$\frac{\text{Value shifted}^{86}}{\text{market value of the later share immediately before the value shift}} \times \begin{matrix} \text{base cost of the later} \\ \text{share immediately before} \\ \text{the value shift} \end{matrix}$$

$$= \frac{R25}{R50} \times R20 = R10$$

Step 1(c): Calculate the capital gain from the value shift:
 proceeds – base cost
 = R25 – R10 = R15

⁷⁹ In other words, if the transaction or event is one of the CGT events listed in s 104-5
⁸⁰ See, eg, s 100-25
⁸¹ Value shifting from pre- to post-CGT shares will also have consequences under the 1997 ITAA. In such a case, the value shifting is not treated as a realisation event, but adjustments are made to the base costs of the decreased and increased interests. See item 3 of the table in s 725-250
⁸² Item 1 of the table in ss 725-245 and 725-365
⁸³ Item 4 of the table in ss 725-250(2) and 725-365
⁸⁴ Item 4 of the table in ss 725-250(2) and 725-375. Although, generally speaking, subsequent disposals of pre-CGT shares do not give rise to capital gains or losses, the base cost of pre-CGT shares is important for some provisions in the 1997 ITAA
⁸⁵ This is a simplified version of the method statement in s 725-365
⁸⁶ R50 (the value of the later share immediately before the change in the share rights) – R25 (the value of the later share immediately after the change in the share rights) = R25

Step 2: Adjust the base cost of the decreased share (the later share):⁸⁷

Cost of the later share – base cost in respect of the value shift (see step 1(b) *supra*)
 = R20 – R10 = R10

Step 3: Adjust the base cost of the increased share (the original share): (This step can only be taken once the original share has been sold (see step 5 *infra*) since the “proceeds” in the formula will only be known at that stage.)

Cost of the original share + value shifted = R5 + R25 = R30⁸⁸

Apply the time-apportionment method:

$$\text{pre-1/10/2001 expenses} + \frac{(\text{proceeds} - \text{pre-1/10/2001 expenses}) \times \text{number of years asset was held before 1/10/2001}}{\text{sum of number of years asset was held before and after 1/10/2001 respectively}}$$

$$= R30 + \frac{(R75 - R30) \times 2}{2 + 1} = R60$$

Step 4: Calculate Yvonne’s capital gain in respect of the sale of the decreased share (the later share):

Proceeds: R25

Base cost: R10 (see step 2 *supra*)

Capital gain (proceeds – base cost): R15

Step 5: Calculate Yvonne’s capital gain in respect of the sale of the increased share (original share):

Proceeds: R75

Base cost: R60 (see step 3 *supra*)

Capital gain (proceeds – base cost): R75 – 60 = R15

Step 6: Calculate Yvonne’s total capital gain:

Capital gain from the value shift: R25

Capital gain from the sale of the later share: R15

Capital gain from the sale of the original share: R15

Total capital gain: R45

Yvonne’s total capital gain of R45 is equal to the increase in value of the later share (R30) and 1/3 (R15) of the increase in value of the original share (this 1/3 represents that part of the increase in the value of the original share (R45) that relates to the period after 1 October 2001).

6 Conclusion

The article argues that the South African value shifting anti-avoidance measures are flawed in two important aspects. The first flaw is the fact that these measures have not been properly integrated with the general CGT regime. The main problem is the lack of a coherent approach as to which “asset”, if any, is disposed of under a value shifting arrangement. As a result, the anti-avoidance measures do not interact well with the general provisions of the Eighth Schedule, which assume that all disposals involve the realisation of an “asset”. In contrast, the Australian anti-avoidance measures have recognised this as a problem and have implemented specific rules governing which “asset” is disposed of under a value shift. For example, under the 1936 ITAA, value shifts

⁸⁷ This is a simplified version of steps 1 to 4 of the method statement in s 725-365

⁸⁸ This is a simplified version of the method statement in s 725-375

were expressly treated as part-disposals of the decreased shares. This ensured a much smoother integration with the general CGT regime. A similar solution will work equally well in South Africa and will solve many of the interpretational problems addressed in the first part of this article.

The second flaw in the anti-avoidance measures is their failure to recognise value shifts between shares owned by the same person. The article illustrates how this may give rise to either timing benefits, or permanent tax savings. In contrast, these kinds of value shifting are recognised as value shifts under the 1997 ITAA and will give rise to either both CGT and adjustments to the base costs of the shares, or to adjustments to the base costs of the shares only.

In light of the threat that share value shifting holds for the integrity of any CGT regime, the South African legislator is urged to address these flaws. This will also provide much needed certainty to taxpayers regarding the law pertaining to this difficult area of CGT.

OPSOMMING

Belastingvermyding in die vorm van waardeverskuiwingsreëlings met betrekking tot aandeel skep 'n bedreiging vir die integriteit van die Suid-Afrikaanse kapitaalwinstbelastingbedeling. As teenvoeter hiervoor bevat die Agtste Bylae tot die Inkomstebelastingwet, 58 van 1961 teenvermydingsbepalings wat daarop gemik is om hierdie vorm van belastingvermyding aan te spreek. Die artikel vergelyk hierdie bepalings met soortgelyke bepalings in die Australiese belastingwetgewing en identifiseer twee tekortkominge in die Suid-Afrikaanse bepalings: eerstens is die bepalings nie na wense met die res van die Agtste Bylae geïntegreer nie en tweedens is die omvang van die bepalings te beperk.