A CRITICAL ANALYSIS OF THE CAPITAL GAINS TAX SYSTEM FOR SOUTH AFRICA

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DECLARATION

I, the undersigned, hereby declare that the work contained in this assignment is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

Signature:

Date: 13 December 2002

SUMMARY

Capital gains tax has been introduced into the South African tax system for the first time, on all capital gains arising on or after 1 October 2001. The issue of whether a capital gains tax will be a suitable tax for South Africa has already been addressed in the form of Commission Reports. In these reports, the idea of adopting this tax system was not recommended for the South African tax system or only a limited capital gains tax was recommended. This study, however, investigates whether the legislation passed by government is in line with the basic principles of an efficient and effective tax system.

Firstly, the principles of an efficient and effective tax system are set out as those originally proposed by Adam Smith as well as those that have been adapted to modern tax theory. The factors that impact on capital gains tax are identified and specific criteria are formulated against which the legislated capital gains tax is evaluated.

The mechanics of the capital gains tax is discussed, classified into the factors that impact a capital gains tax and evaluated against the abovementioned criteria.

It has been held that the introduction of this new form of tax to the South African tax system addresses many inefficiencies and deficiencies in the current tax system. It is the writer's opinion that an investigation as to the degree to which this tax system adheres to the principles of an effective and efficient tax system, was thus necessary.

For the purposes of this investigation, the legislated capital gains tax was evaluated against the principles of neutrality, certainty and simplicity, administrative efficiency, flexibility, invisibility and equity (fairness, horizontal and vertical equity). It was found that the principles of flexibility, fairness and horizontal equity are achieved. To a lesser extent, the principles of neutrality, certainty and simplicity, and administrative efficiency are achieved, and the principles of invisibility and vertical equity have not been achieved.

OPSOMMING

Kapitaalwinsbelasting is nou vir die eerste keer deel van die Suid Afrikaanse belastingstelsel. Dit affekteer alle kapitale winste wat op of na 1 Oktober 2001 realiseer. Die vraagstuk oor die geskiktheid van kapitaalwinsbelasting vir Suid-Afrika is alreeds voorheen in die vorm van Kommissieverslae aangespreek. Geen, of slegs 'n beperkte kapitaalwinsbelasting is in hierdie verslae aanbeveel vir die Suid-Afrikaanse belastingstelsel. Die studie wat volg, ondersoek die mate waarin die wetgewing ten opsigte van kapitaalwinsbelasting aan die basiese beginsels van 'n effektiewe en doeltreffende belastingstelsel voldoen.

Eerstens word die beginsels van 'n doeltreffende en effektiewe belastingstelsel uiteengesit as dié soos oorspronklik voorgestel deur Adam Smith, asook dié wat deur moderne belastingteorie aangepas is. Tweedens word die faktore wat kapitaalwins beïnvloed geïdentifiseer en laastens word spesifieke kriteria geformuleer waarteen die kapitaalwinsbelasting geëvalueer sal word.

Die werking van die kapitaalwinsbelasting word bespreek, geklassifiseer in faktore wat 'n kapitaalwinsbelasting beïnvloed en teen die bogenoemde kriteria geëvalueer.

Daar is beslis dat die toevoeging van hierdie vorm van belasting tot die Suid Afrikaanse belastingstelsel die ondoeltreffendheid en ander gebreke in die huidige belastingstelsel aanspreek. Dit is die skrywer se mening dat 'n

ondersoek ten opsigte van die mate waartoe hierdie belastingstelsel die beginsels van 'n effektiewe en doeltreffende belastingstelsel nakom, dus nodig was.

Vir die doeleindes van hierdie ondersoek, is kapitaalwinsbelasting geëvalueer teen die beginsels van neutraliteit, sekerheid en eenvoudigheid, administratiewe doeltreffendheid, aanpasbaarheid, onsigbaarheid en billikheid (regverdigheid, horisontale en vertikale billikheid). Daar word tot die gevolgtrekking gekom dat daar aan die beginsels van aanpasbaarheid, regverdigheid en horisontale billikheid voldoen word. Tot 'n minder mate, word daar aan die beginsels van neutraliteit, sekerheid en eenvoudigheid, en administratiewe doeltreffendheid voldoen. Daar word nie aan die beginsels van onsigbaarheid en vertikale billikheid voldoen nie.

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CHAPTER 1

INTRODUCTION

1.1 Introduction to the research problem

In the Budget Speech delivered by the Minister of Finance, Mr. Trevor Manuel, on 23 February 2000, it was announced that a capital gains tax would be implemented in South Africa. It was stated that the introduction of capital gains tax would bring South Africa in line with its major trading partners and would make the overall tax regime more efficient.

The issue of whether a capital gains tax will be a suitable tax for South Africa has already been addressed in the form of Commission Reports dating back to 1968, the Franzsen Commission, 1986 the Margo Commission and lastly in 1995, the Katz Commission. However, in these reports, the idea of adopting this tax system was not recommended for the South African tax system or only a limited capital gains tax was recommended.

Capital gains tax has been introduced in the Taxation law and Amendment Act 5 of 2001 as the Eighth Schedule to the Income Tax Act.

The question arises whether the legislature is in line with the basic principles of an efficient and effective tax system. Another aspect that needs to be examined is whether the recommendations made by the above mentioned Commission Reports have been taken into account in the legislation.

1.2 Defining the research problem

A critical analysis of the Capital Gains Tax system for South Africa.

The study project will address the following issues:

- What are the criteria which the capital gains tax is going to be evaluated against, taking into account the principles of a good tax and the impact determining factors that influence the mechanics of a capital gains tax?

- What is the degree to which the impact determining factors of the Capital Gains Tax for South Africa confirm the predetermined criteria set up?

1.3 The specific aims and objectives of the study

The purpose of this study is to determine the degree to which the various aspects of the legislated capital gains tax for South Africa confirms the principles of a good tax.

1.4 Research design and methodology

This non-empirical study comprises a literature review. The data that will be consulted is primarily textual, including the amended Income Tax Act, historical studies, on both national and international levels, together with opinions stated in articles by tax and legal experts.

The writer has selected a literature review as the research method, because the nature of the research problem is to take prior theories and opinions with regard to a capital gains tax, and to analyse whether the legislated capital gains tax for South Africa is in fact in line with those theories.

1.5. Definitions

The following concepts have been elaborated on, to gain a full understanding of the material presented:

Effective date / implementation date – The date from which the capital gains tax is effective (Stein, 2000:97).

Net capital gain – the amount by which a person's aggregate capital gain for that year exceeds that person's assessed capital loss for the previous year of assessment (South Africa, 1962: Schedule VIII, paragraph 8).

Realisation principle of taxation – Capital gains may accrue constantly over the life of an asset, but the tax thereon is only due when the owner of an asset exchanges it for cash (Burman, 1999).

Resident - The following persons are defined as being resident:

- a natural person who is ordinarily resident in the Republic;

- a natural person who is not at any time during the year of assessment ordinarily resident in the Republic , but who is physically present in the Republic for certain periods;
- a person other than a natural person which is incorporated, established or formed in the Republic; or
- a person other than a natural person that has its place of effective management in the Republic (De Koker et al., 2002:A10).

Roll over relief – This occurs in certain circumstances when, the capital gains tax liability does not arise upon the disposal or transfer of the asset, but is deferred until a subsequent event. The original base cost is then 'rolled over'. When assets are exchanged, for example, when property is contributed to a business in exchange for shares, both the assets retain the original base cost of the contributed asset (Stein, 2000).

Transitional period – The period 23 February 2000 until and including the day before the valuation date (South Africa, 1962: Schedule VIII, paragraph 86).

Valuation date – 1 October 2001 (South Africa, 1962: Schedule VIII, paragraph 1).

CHAPTER 2

SPECIFIC REQUIREMENTS THE LEGISLATED CAPITAL GAINS TAX SHOULD MEET

2.1. Introduction

The purpose of this chapter is to define and give an outline of the generally accepted principles of taxation and to formulate specific criteria, against which the legislated capital gains tax is going to be evaluated.

Adam Smith originally proposed the four canons of taxation that form the basis of modern theory of taxation, namely: equity of sacrifice, certainty, convenience in assessment and collection, and economy (Schabort, 1992). These maxims have been adapted to modern tax theory, which has given rise to an elaborate set of principles, but in substance are still the same as the original canons. These modified principles will be used to evaluate the legislated capital gains tax.

2.2. Defining the principles of an efficient and effective tax system

The principles for an efficient and effective tax system will be classified under six main headings:

2.2.1. Equity

This principle states that taxes should promote an equitable (or "fair") distribution of income (Black et al., 1999).

The Katz Commission made the following remark on the fairness of tax systems (Katz, in Van Schalkwyk, 1997):

"A country whose tax system is perceived by its people to be inequitable will face great dangers irrespective of the economic merits of the measures taken in accordance with established tax precepts."

Equity is defined with regard to the two great traditions in tax theory, namely the ability to pay and the benefit principle.

2.2.1.1. The ability to pay

Adam Smith stated that 'the subjects of every state ought to contribute towards the support of government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state' (Smith, 1977).

Thus, the ability to pay principle calls for people with equal capacity to pay the same amount of tax and for people with greater capacity to pay more (Black et al., 1999).

In addressing the question of ability to pay, it is customary to distinguish between horizontal equity and vertical equity (Margo,1986).

- Horizontal equity

To attain horizontal equity, 'similar individuals need to be treated similarly' or that 'individuals and families in similar circumstances bear the same taxes' (Margo, 1986). Thus, people with equal ability to pay should pay the same tax (Burman, 1999).

- Vertical equity

To attain vertical equity, those in different circumstances bear appropriately different tax burden, i.e. that those with a higher level of 'economic well-being' shoulder greater tax burdens than those less fortunately placed (Margo, 1986).

People with greater ability to pay should pay more tax (Burman, 1999). Some would also add that those with greater ability should pay a larger share of their incomes than those with less ability. This belief underlies the progressivity of marginal rates in the income tax (Burman, 1999).

2.2.1.2. Benefit principle

The benefit principle states that that those who benefit from the use of particular commodities or services should be required to pay for them (Margo, 1986).

2.2.2. Neutrality

Neutrality requires that people should not be influenced by the tax system to choose one course of action rather than another solely or predominantly because their tax position is better under one of the options (Margo, 1986).

2.2.3. Certainty and simplicity

The Margo Commission also highlighted the importance that a tax system be certain and simple in concept and collection. Thus it requires that a taxpayer be reasonably certain of what his tax liability will be in any given set of circumstances. A complex tax system should be avoided as it creates uncertainty, resulting in taxpayers incurring costs of consultations with tax advisers. Adam Smith said in his Wealth of Nations: "The certainty of what each individual ought to pay is... a matter of so great importance that a very considerable degree of inequality ... is not near so great an evil as a very small degree of uncertainty." (Smith, 1977).

Simplicity requires that a tax should be easily assessed, collected and administered in order to minimize the cost of the tax to both the taxpayer and the state (Margo, 1986). This brings to the next consideration of administrative efficiency.

2.2.4. Administrative efficiency

Adam Smith identified the importance of operating costs when he stated that "every tax ought to be so contrived as both take out and to keep out of the pockets of the people as little as possible over and above what it brings to the treasury of the state " (Smith, 1977).

The costs of collecting a particular tax should always be related to the tax yield, the principle being that the costs of collection should not be a disproportionately high percentage of yield (Margo, 1986).

Administrative efficiency entails minimising the collection costs, i.e. administrative and compliance costs (Black et al., 1999). Administrative costs are the costs of establishing and maintaining a tax collection agency, the cost of dealing with offenders, etcetera; and compliance costs are the costs for taxpayers in terms of the time, money and effort spent in order to fulfill their obligation (Margo, 1986).

There are two phenomena that are closely related to these costs: tax avoidance and tax evasion. Tax avoidance is perfectly legal and includes the actions by taxpayers to take advantage of so called 'tax loopholes' in the tax code in order to reduce their tax liability. However it gives way to taxpayers making choices based on tax considerations rather than economic considerations and thus entails high opportunity costs. Tax evasion is illegal and is as a result of actions in contravention of the tax laws. It is usually difficult to trace such evasions and results in loss of revenue collected. Thus, good tax administration requires that tax evasion and avoidance be kept at a minimum, coming back to the need of a simple tax design (Black et al., 1999). If it is difficult to enforce a tax, aggressive or dishonest taxpayers may receive more tax benefits than others, thus violating horizontal equity (Burman, 1999).

2.2.5. Flexibility

This principle requires that the taxes and tax rates need to adjust as economic circumstances change, as taxes can influence economic activity from both the supply side and the demand side (Black et al., 1999).

2.2.6. Invisibility

The Margo Commission Report states that an ideal tax should be as inconspicuous as possible, in that it subtly takes spending power out of the private sector before it has accrued too obviously to the individual. Examples of such 'invisible' taxes are Value Added Tax, Pay As You Earn and source taxes.

2.3. Identifying factors that impact on Capital Gains Tax

In order to formulate specific criteria that the legislated capital gains tax is to be evaluated against, it is necessary to identify the factors of such a tax that have an impact on the taxpayer. These impact determining factors will evaluated against the six principles set out in 3.2. . Fölscher (1993) identified seven factors that determine the impact of a capital gains tax, namely:

- the **scope** of the tax – that determines which taxpayers will be taxed on their capital gains;
- the **base** - this determines on which capital gains the tax will be charged;
- the **method of implementation** – that determines whether the gains that originated before the commencement, will be taxed or not;
- The **rate** at which capital gains will be taxed;
- the **timing provisions** – which determines whether the realisation of a capital gain is a prerequisite for taxability;
- **inflation adjustments** – that aims to limit taxation to real gains; and
- **special** concessions and exemptions.

2.3.1. An evaluation of the impact determining factors – How they confirm the principles of an effective and efficient tax system

2.3.1.1. Scope

In order to be neutral, the nature of the person making the capital gain, a natural or legal person, should not influence the taxability of the capital gains (Fölscher, 1993). In looking at the issue whether non-residents should be taxed on capital gains, it has been the practice that non-residents that make capital gains on assets that are situated in the country imposing the capital gains tax, be subject to capital gains tax in that country (Fölscher, 1993). Therefore both resident natural and legal persons as well as non-residents owning property situated in the Republic, should be taxed in the Republic. The Franszen Commission (1968) recommended that persons who specifically enjoyed complete exemption from normal taxation also be exempted from the tax on capital gains.

2.3.1.2. The tax base

The broadness of the tax base has a direct influence over the efficiency and neutrality of the system (Fölscher, 1993).

By limiting the tax base of a capital gains tax, two issues arise. By excluding certain items from the tax base that are for example difficult to administer, administrative efficiency is increased as the system has less complicated items to deal with. However, neutrality in an economy is prejudiced if the tax base is limited, as the holding of excluded items will be encouraged.

It has been concluded that the tax base of the capital gains tax be as broad as possible to not affect the economic decisions of the taxpayer (Fölscher, 1993).

2.3.1.3. The method of implementation

When introducing a capital gains tax for the first time, a decision needs to made whether the capital gains, that arose before the implementation date of the capital gains tax, are to be taxed or not.

When looking at the scenario that only capital gains arising from assets that were purchased *after* the implementation of the capital gains tax legislation were to be taxed, there would not be many administrative inconveniences. The taxpayer would only need to keep record of the purchase price that was paid for the asset and that would need to accompany the tax return when the asset is sold. This approach fulfills the criteria of administrative efficiency; the administrative costs of the state, as well as the compliance cost of the taxpayer would be minimal. The criteria of simplicity and certainty would also be fulfilled. Both the taxpayer and the state know exactly what the cost of the asset is and what the capital gain is, that is made on realisation of the asset. The system is simple because no complicated calculations need to be made to determine the deemed cost. This approach is followed in Australia (Fölscher, 1993).

The scenario needs to be looked at of how the capital gains that arise from assets that are acquired before the implementation date of the capital gains tax are taxed. Fölscher (1993) states that the taxing of capital gains that originated before the implementation date is unfair to the taxpayer because it comes down to retrospective taxation. Retrospective taxation violates the realisation principle, as tax is due in advance of a realisation (Burman, 1999).

The implementation method that the United Kingdom used when it introduced a capital gains tax was that the tax would not be applied retrospectively to capital gains that accrued, but were not realised before the implementation of the tax (Di Palma, in Erasmus, 1994). However the capital gains arising after the implementation date were subject to the tax. It was necessary to determine the base cost of the capital assets on the implementation date. There were two alternatives that the taxpayer could choose between (with a few exceptions), namely:

a) assets were deemed to be acquired at market value on the implementation date of the capital gains tax legislation; or
b) on sale of the asset, the profit is proportionately apportioned on a straight-line basis between the period before and after the implementation of the legislation (Clarke, in Erasmus, 1994).

The first option would involve the process that all assets subject to the capital gains tax held at the implementation date of the legislation, be valued on such date and the eventual profit or loss on realisation will be calculated using this value as a basis. The administrative consequences of such a valuation on all taxable assets were unacceptable in the U.K. (Whiteman, in Erasmus,1994).

If the second alternative were selected, the writer puts the question whether the straight line basis of apportionment is the most appropriate, as capital gains do not necessary accrue equally but are usually related to the economic conditions that prevail at certain period during the holding period of such an asset. Another problem would arise in that it would be difficult for the taxpayer to prove the cost of the asset, especially if it were purchased, say, 20 years ago. This creates uncertainty amongst taxpayers on the tax liability that will be payable as the gain calculated is not necessarily accurate.

In the Canadian legislation, the same principle applies in that capital gains or losses that accrue before the implementation of the legislation are not subject to capital gains tax. Only the increase in value after the implementation date will be taxed (Gird, 1986). Two methods (with exceptions) exist to determine the value of assets on implementation date:

a) The "median rule" or "tax free zone rule" method; or

b) The cost price of the assets will be deemed the market value of the asset on implementation date of the law (CCH Canadian Limited in Erasmus, 1994).

The "median rule" or "tax free zone" method states that the original cost of the capital property is deemed to be the average of:

- The actual cost of acquisition;
- The fair market value on valuation date; and
- The proceeds on disposal of the property.

If two or more of the above amounts are the same, then that amount is the deemed original cost (Krisna, in Erasmus, 1994). If the cost of an asset is determined before the disposal takes place, then the proceeds on disposal is replaced with the market value of the asset on that date (CCH Canadian Limited, in Erasmus, 1994).

The second alternative is used when the taxpayer has kept no record of the actual cost of property and will thus value the asset on the implementation date. The exercising of one of these alternatives is irrevocable (CCH Canadian, in Erasmus, 1994).

It is the writer's opinion that the methods followed in the United Kingdom and Canada do not necessarily confirm the principle of an effective tax because of the administrative consequences that have arisen from such an application. Once again the compliance cost of the taxpayer increases, as the taxpayer needs to employ an appraiser to value his assets on the implementation date, if he selects the option that the market value on the date of implementation is deemed to be the original cost. It also limits the taxpayer in his options with regard to the mentioned alternatives as not all records of assets that were purchased, say 20 years ago, are kept. The administrative costs of the State also increase as additional staff is needed to ensure that the valuations made by appraisers are accurate and not biased.

Thus, the writer's opinion is that only capital gains of assets that were acquired after the implementation date be subject to the tax, as it is a simple and administratively efficient method. It creates certainty amongst the taxpayers as the taxpayers know they need to keep record of all capital acquisitions as from the implementation date of the capital gains tax.

2.3.1.4. The tax rate and rate structure

The rate at which capital gains tax will be taxed and the rate structure that will be applied, has an effect on the neutrality, simplicity and equity of the system.

To formulate criteria for an appropriate rate, it is necessary to look at the past experience of other countries that have implemented a capital gains tax. The Katz Commission analysed various approaches that the Organisation for Economic Cooperation and Development (OECD) member countries have followed in determining the rate structure for a capital gains tax. The following main approaches were distinguished (Katz, 1995: 41):

- Different rate structures for companies and individuals
- Different rates dependant on the type of asset involved
- Different rates depending on the long- or short-term nature of capital gains
- A flat rate on all taxpayers

Some tax authorities taxed capital gains as ordinary income at the normal income tax rates, thus making it immaterial to the taxpayer, in the absence of indexation of the capital gain, whether a gain is of an income or a capital nature (Margo,1986). This opinion reiterates the statement made by Nigel Lawson in his Budget Speech in 1988 where he stated that, “Taxing capital gains at income tax rates makes for greater neutrality in the tax system.” (Sutherland et al., 1992).

In the writer's opinion the charging of different rates to different taxpayers can cause tax avoidance, as the taxpayer will most likely transact in a manner so that the most benefit is received. For example, if the rate of capital gains tax for companies is lower than that for individuals, individuals would be inclined to form a company and have the company purchase the asset. When sold later, the company will pay less tax than if the asset were purchased and registered in the name of the individual.

Charging different rates on different types of assets will, in the writer's opinion, be administratively inefficient and will affect neutrality. Not only do the specific assets need to be defined accurately in the legislation, but there also exists the problem of subjectivity in the allocation of suitable rates to different assets. The additional administration involved to ensure that the correct rate is applied to the correct asset can involve a dramatic increase in administrative costs. The taxpayer is more likely to purchase assets for which the tax rate on eventual capital gains is low than assets that are more economically viable. This affects neutrality, as the decisions of taxpayers are affected by the rate at which the capital gain is taxed, rather than by economic reasons.

Charging different rates to assets that are held for different periods of time can also cause administrative inefficiencies. The compliance costs of taxpayers will increase, especially when the taxpayer owns a large number of assets and needs to continually ensure that the capital gain on realisation of such an asset is taxed at the correct rate. The OECD member countries vary in their approach to differentiating between the gains arising from long term assets and short term assets. Some have the same rates, others differ in defining the cutoff period for when an asset will be classified as a long term asset (Katz, 1995). The difference in rates between long and short-term assets could create an incentive to manipulate the timing of gains and losses, by deferring gains until they qualify for long-term rates and by realising capital losses when they would qualify for the short-term rates. This would affect the neutrality of the system. It can be argued that the inclusion of capital gains that have accrued over many years in income in the year of disposal is unfair, but averaging the income in the year in which capital gains accrue will address the bunching of income problem as illustrated in point 2.3.1.5.

Other tax authorities specified a certain percentage of capital gains to be subject to income tax. It is the opinion of the writers of the Katz Commission Report that this approach would increase the opportunity for tax arbitrage and that the differential created between the revenue and capital can be exploited by taxpayers in claiming revenue gains as being capital in nature (Katz, 1995). It is the writer's opinion that this opportunity for arbitrage will result in tax avoidance and will be inequitable.

An alternative would be to charge a flat rate of capital gains tax on all capital gains. It has been submitted that a rate of 15% or 20% would be appropriate (Schabort, 1992). Taxing the capital gains as a separate tax and applying the same rate to all capital assets, irrelevant how long they've been held for, creates certainty as the taxpayer knows beforehand what his tax liability will be. This approach is also simple, as no complex calculations need to be made with regard to calculating the tax liability. By charging at a rate that is low, it can be argued that a large portion of the capital gain has been adjusted for the effects of inflation (Schabort, 1992).

However, by taxing capital gains at a rate different to the rate applied to the taxpayers' income, the principle of horizontal equity is contravened, as the taxpayer is not treated similarly relative to taxpayers in the same set of circumstances (see 2.2.1.1.).

Thus, considering the abovementioned arguments, it is the writer's opinion that the most suitable rate structure to be implemented would be to tax capital gains at income tax rates, but only to include a portion of the capital gains into the tax computation, so as to counter the abovementioned effects of inflation. The principle of flexibility is also adhered to, as the portion of capital gains to be included in the tax computation can be adjusted as economic conditions change.

2.3.1.5. Timing provisions

A crucial problem that needs to be resolved is when to recognise changes in net wealth (Katz, 1995). It can either be recognised as the capital gains accrue or when the capital gain is realised.

Sury stated that, "In the long run, the distinction between unrealised and realised capital gains is not important because unrealised gain is realised at one time or another during the life of an individual or at the time of his death. Because the sums of realised and unrealised gains are equal, the lifetime tax obligation of an individual is said to remain the same provided there are no significant changes in rate structure." (Sury, 1990: 278).

The practical implications of both alternatives will be evaluated.

By taxing capital gains on the realisation basis, tax is deferred from the accrual date to the date of realisation. This reduces the present value of the tax liability, therefore making it worthwhile to hold on to assets rather than to trade them. This causes a lock in-effect, which may interfere with the mobility and optimal use of capital, and thus the principle of neutrality is affected (Anderson, in Katz, 1995).

An additional problem is when assets that have been held for a long period of time and increase substantially in relation to the owner's income, a sizeable gain could be realised at the time of sale. If the tax law is such that capital gains are included in income, a "bunching" problem can occur in a progressive tax system. The marginal tax rate applicable to the realised gain might be significantly higher than the marginal rates that would have applied during the years in which the capital gain actually accrued. This system unfairly disadvantages those taxpayers whose incomes are usually below the maximum marginal rate (Katz, 1995).

Allowing a taxpayer to average his income, where his income has exceeded his average over a period of time, could solve this problem (Gird, 1986). Another solution would be to implement a preferential tax rate structure for capital gains to alleviate this tax inequity (Katz, 1995).

By taxing capital gains on the accrual basis, an annual net worth calculation would need to be made which would involve valuing the taxpayer's assets at market prices. This is an expensive method and is an administrative burden. There is also the difficulty in attaching a true value to the price at which the asset would be sold for, as the assessed value is not necessarily the value the taxpayer would receive from it if it were realised and could cause disputes and litigation. This causes uncertainty amongst taxpayers about the tax liability, as the value placed on their assets could be inaccurate (Katz, 1995).

A cash flow problem will arise if capital gains were to be taxed on the accrual basis as the taxpayer might not have free cash available to pay for the tax liability that arises from such an asset. It would force the taxpayer to sell the asset even if it is still useful to him, he would not realise the asset at the value it is worth, only the liquidation value which is usually less, thus affecting neutrality (Katz, 1995).

It is the writer's opinion that the approach of taxing capital gains on the accrual basis is against the principle of fairness and neutrality to the taxpayer and the valuation of the asset would require additional administration for both the taxpayer and the State. Taxing the capital gains on the realisation basis is recommended, as the administration involved is minimal and provides certainty as the capital gain is accurately calculated on the date of sale. It is also important that *realisation* is properly defined to bring about certainty amongst the taxpayers as assets can be acquired and disposed of in different ways (Franzsen, 1968).

2.3.1.6. Inflation adjustments

An ideal income tax would be neutral with respect to inflation (Burman, 1999). It has been contended that capital gains resulting from inflation are illusory, as they do not represent a *real* increase in the taxpayer's spending power. Sury (1990) states that capital gains represent net accretion to spending power. Thus to tax capital gains to merely compensate for the rise in price level is more in the nature of taxes *on* wealth than on increments in the *value* of wealth. Therefore by having an inflation-proof system it is more certain and equitable in an inflationary economy (Sury, 1990). If the capital gains were to be indexed (adjusted for inflation), an appropriate price deflator needs to be selected. It can be problematic to decide which price deflator to use, as it cannot be entirely neutral between taxpayers (Katz, 1995). Four alternative price deflators were proposed in the Katz Commission Report:

a) The Consumer Price Index (CPI). The problem in using this deflator is that it is heavily influenced by food price fluctuations, which does not necessarily reflect price trends in the value of capital assets.

b) The Production Price Index (PPI). This measures the price movements of a representative basket of more than 1 000 capital and intermediate goods as reported by approximately 150 manufacturing establishments, government departments and agricultural control boards. The advantages of using this index is that it is an explicit price index, it is measurable monthly, it is available promptly, it is not revised, and a long time series is available.

c) An index that is specifically designed for capital gains taxation. A "Business Price Index" which would exclude price movements in food and mortgage interest rates but include factors such as business interest rates and stock exchange movements, was proposed in 1992 in an assessment of the potential for a capital gains tax in South Africa (Price Waterhouse Meyernel, in Katz, 1995).

d) Various indices used for different types of assets. This proposal was unacceptable because of the administrative inconveniences it would bring (Katz, 1995).

The price index that is chosen would then be used in the following formula, adapted by Gird (1986), where the inflationary gain is relieved by reference to an indexation allowance.

The allowance would be used for each item of allowable expenditure, other than the cost of disposal:

$$\frac{RD - RI}{RI} \times \text{amount of allowable expenditure}$$

RD would be the index for the month of the disposal and RI the corresponding indexes for the month of expenditure/purchase.

The following problems in an indexed capital gains tax regime would arise:

a) Indexing would require extensive calculations for an asset that is improved over time. Every improvement would have to be treated as a separate asset with a separate indexing adjustment (Burman, 1999).

b) High compliance costs are associated with this system (Burman, 1999).

c) Holders of monetary assets and earners of fixed incomes would be disadvantaged (Katz, 1995).

d) Individual and corporate owners of depreciable capital assets will remain uncompensated for inflation since these assets yield illusory income flows in ordinary use (as most jurisdictions limit depreciation write-offs to historical costs only) (Katz, 1995).

e) Debtors gain when inflation erodes the real value of debt, whereas creditors who lose because of inflation remain uncompensated (Katz, 1995).

The overall argument whether it is appropriate to index capital gains is to consider how other kinds of capital income are taxed. If capital income such as interest, dividends, rents and royalties are not indexed, then indexing capital gains would result in economic inefficiency and unfairness, as taxpayers would favour assets that pay capital gains instead of capital income. This could also be a possible reason for tax arbitrage.

The Katz Commission Report highlighted two approaches to follow with regard to indexing capital gains, in the case of individuals:

a) Capital gains tax must be assessed on an *inflationary-adjusted basis,* as discussed above.

b) Adopt an approach used in the USA, which indirectly compensates for inflation by excluding a fraction of nominal gains from the tax base. By using these exclusions the provisions can, to a certain extent, either over- or under adjust for inflation, but are much easier to administer (Katz, 1995).

It can be deduced from the above, that although a suitable deflator can be found to index the capital gains, inflation complicates the measurement and taxation of capital gains and will lead to an even bigger administrative burden to both the state and the taxpayer (Katz, 1995). In the opinion of the writer it will be better to apply the second approach recommended by the Katz Commission in order to compensate for inflation, as it a simpler alternative.

2.3.1.7. Special concessions and exemptions

2.3.1.7.1. Exemptions

It is submitted that various assets that produce capital gains be exempt from capital gains tax by reason of fairness, simplicity and practical administration:

It has been recommended that the following assets be exempted from capital gains tax:

- Principal private residence – The exemption would apply as long as the taxpayer, spouse, or dependant children are mainly resident in the home (Gird, 1986);
- Moveable and assets such as works of art, household goods and family heirlooms – the valuation of such assets is difficult as it is unlikely that accurate record is kept of their purchase price, and the costs of valuation and compliance would be cost ineffective (Schabort, 1992);
- Gains and losses which qualify for normal taxation – to avoid double taxation (Gird, 1986);

- Life assurance and Retirement Annuity Fund lump sum payments – Any amounts that are received on maturity or surrender of a whole life or endowment policy, and any lump sum payment received from a Registered Retirement Annuity Fund, should not be subject to capital gains tax, unless the proceeds do not accrue to the original beneficial owner or heir (Gird, 1986);
- Transfers between man and wife – this could greatly reduce administrative inconveniences (Gird, 1986);
- Realisation of assets situated outside the Republic (Franszen, 1968);
- Realisation of securities and debentures issued by the State, Local Authorities and other non-profit seeking organisations, which are specifically exempted from normal tax (Franszen, 1968).

2.3.1.7.2. Concessions

It is submitted that certain concessions be granted by reason of fairness, simplicity and practical administration.

It has been recommended that the following concessions be granted:

- Offsetting losses – It has been a general rule amongst countries to offset capital losses against capital gains and the offset has occasionally been limited to the same class of asset (Sutherland, et al, 1992). It is submitted that the offset of capital losses is fair to the taxpayer as the same principle applies in the Income Tax Act, with regard to assessed losses that can be written off against taxable income (South Africa 1962, sec. 20);

- Roll over relief -

- Voluntary realisations -The Katz Commission has stated that is important to have a roll over relief for certain assets, as it will remove the tax incentive to retain ownership of assets beyond their useful or preferred life. It has been submitted that a roll over relief is necessary in the corporate sector as it could otherwise affect the continuity and integrity of capital formation. The reason for this is that obsolete assets would tend to be locked in for a period of time to avoid capital gains tax and thus adversely affecting competition. Many countries have allowed the offsetting of capital gains against the acquisition price of new business assets within a certain period of time. The rationale being that such a policy is one of equity and reasonableness (Katz, 1995);
- Involuntary realisations – If persons are ordered to dispose of their properties to a local authority, provincial or state body, in terms of an appropriation order, roll over relief should be available to the taxpayer. If the taxpayer purchases a replacement asset that is less than the appropriation proceeds, that excess will be subject to capital gains tax. In order for this concession to apply, the replacement must be purchased in a specific period of time (Gird, 1986);

- Annual exemption – A small annual exemption has been recommended by the Katz Commission, to be granted to individuals of, for example, R15 000, as it could relieve the revenue authorities of the burden of collecting small amounts, as this approach has been practiced in other countries (Katz, 1995). A study in the USA concludes that if gains of less than $10 000 had been exempted from tax 1993, the number of returns with capital gains would have fallen by 72%, but only about 30% of capital gains would've been excluded from tax (Burman, 1999). This annual exemption is also a way to achieve progressivity, where progressivity of taxes adheres to the principal of ability to pay (Burman, 1999);

- Once-off relief – "Gains which arise when a small entrepreneur retires or disposes of a firm, business assets or shares in a family company could be exempted partially or in full, in order to prevent the erosion of capital accumulation in the family business sector by a capital gains tax regime. A once-off or life time relief of, for example, R1 million could be attached to the provision, although at some cost in terms of horizontal equity" (Katz, 1995);
- Life time exclusion – This exclusion would allow taxpayers to realise a limited amount of tax free capital gains over the course of their lives. Canada has adopted this approach. The only disadvantage is that the unused portion would have to be carried over from year to year resulting in additional administration. The lifetime exclusion would have little or no effect on the decisions of taxpayers and would thus satisfy the criteria of neutrality (Burman, 1999);
- Averaging – If capital gains were to be included in taxable income, then a concession can be made to average the taxpayers income (Gird, 1986). The reason being that a dramatic increase in taxable income would otherwise disadvantage taxpayers whose tax threshold is below the maximum marginal rate (Katz, 1995).

2.4. The specific criteria which the legislated capital gains tax must be evaluated against

2.4.1. Neutrality

In order to be neutral, the legislated capital gains tax must be set out as follows:

- The tax base must be as broad as possible to include all defined capital gains;

- There must be no differentiation between the rate at which capital gains of long and short term assets are taxed;
- All assets that give rise to capital gains must be taxed at the same rate;
- If the capital gains are to be included into income, 100% of the capital gains must be included in income and not just a specified percentage;
- If the tax system is such that 100% of the capital gains are included in net income, opposed to implementing a separate tax at a flat rate, the income in the year in which capital gains are made, must be averaged;
- If capital incomes, other than capital gains are not indexed for the effects of inflation, then capital gains must not be adjusted for inflation;
- All taxpayers must be subject to capital gains tax, except for those taxpayers that are specifically exempted from income tax;
- The taxpayer's principal private residence must be exempted;
- Some form of roll over relief must be granted for the transfer of business assets.

2.4.2. Certainty and simplicity

In order to be certain and simple, the legislated capital gains tax must be set out as follows:

- Only assets that are purchased after the implementation date must be subject to capital gains tax;
- Accurate definitions of the 'disposal event' is required;
- The procedures and details regarding the payment of the capital gains tax liability must be accurately laid down;

- Capital gains must be taxed at a flat rate as the taxpayer will be certain of his capital gains tax liability and the calculation of the tax liability is simple.

2.4.3. Administrative efficiency

Administrative efficiency will be achieved if the legislated capital gains tax is set out as follows:

- The complicated calculation for the inflation adjustment is substituted by rather imposing a rate that has been lowered to take the inflation effects into account;
- Taxing capital gains only once they have realised;
- Taxing the capital gains of all assets at the same rate;
- Taxing capital gains of assets with different holding periods at the same rate;
- Taxing only those capital gains of assets that were purchased after the implementation date;
- Annually exempting a certain amount;
- Transfers between man and wife must be exempted;
- Private articles of the taxpayer must be exempted.

2.4.4. Flexibility

Flexibility can be achieved if the legislated capital gains tax rate can be adjusted to suit any change in economic circumstances.

2.4.5. Invisibility

It has been submitted that a capital gains tax is extremely visible in creating vertical equity, where the wealthy are seen to be paying relatively more taxes than those that do not have assets that bring about capital gains (Schabort, 1992), and is thus in contravention of the maxim of invisibilty.

2.4.6. Equity

2.4.6.1. <u>Fairness</u> – Fairness will be achieved if the legislated capital gains tax sets out the following:

- Allow any capital losses that occur during a year to be set off against any capital gains made during such a period, and any excess can be carried forward to the following year;
- Exempt persons from capital gains tax that are exempted under normal tax
- Exclude gains and losses that qualify for normal income tax;
- Exempt proceeds from a pension fund, retirement annuity fund and life assurance.

2.4.6.2. <u>Horizontal equity</u> – Horizontal equity will be achieved if:

- There is an annual exemption;
- The capital gains will be taxed at the income tax rate.

2.4.6.3. <u>Vertical equity</u> – Vertical equity will be achieved in the following instance:

- If the legislated capital gains tax system is such that it includes the capital gains into income, then averaging provisions must exist to allow the averaging of the taxpayer's income in the year of making a capital gain, so that taxpayers do not move up into a higher tax bracket than they usually are.

CHAPTER 3

THE MECHANICS OF THE LEGISLATED CAPITAL GAINS TAX

3.1. Introduction

In the previous chapter, the criteria that the legislated capital gains tax will be evaluated against, were set up. It is necessary to examine the mechanics of the legislated capital gains tax. The key principles and functioning of the tax will be discussed as set out in the Eighth Schedule to the Income Tax Act (South Africa, 1962).

3.2. The Legislated Capital Gains Tax

3.2.1. The scope

The following persons are be liable to pay capital gains tax:

- residents of South Africa (natural persons and legal entities) on their world-wide assets;
- non-residents on the disposal of –
  - (i) any immovable property or any interest or right in immoveable property situated in the Republic; or
  - *(ii)* any asset of a permanent establishment of the non-resident through which a trade is carried on in the Republic (Taxpayer, 2001).

If residency ceases, i.e. by means of emigration, there will be a deemed disposal at the time of the resident's emigration. Immigrants will be liable to pay capital gains tax on the disposal of their world-wide assets after they become residents, unless such assets are sold prior to becoming resident in South Africa (Taxpayer, 2001).

3.2.2. The tax base

The Act defines 'assets' that are applicable to capital gains tax, as follows:

- "property of whatever nature, whether moveable or immovable, corporeal or incorporeal, excluding any currency , but including any coin made mainly from gold or platinum; and
- a right or interest of whatever nature to or in such property." (South Africa, 1962: Schedule VIII, paragraph 1).

Thus, the disposal of cash, for example, a donation or loan, is not subject to capital gains tax. The disposal of Kruger Rands will be subject to tax, unless they are acquired or disposed of in the ordinary course of carrying on a business or embarking on a scheme of profit, in which case the net profits will be subject to normal income tax (De Koker et al., 2002).

3.2.3. The method of implementation

The capital gains tax will apply to all affected capital assets disposed of after the effective date, 1 October 2001. For assets that are acquired after 1 October 2001, the base cost is determined as per definition set out in paragraph 20 in the Eighth Schedule.

The base cost of an asset subject to capital gains tax includes the costs incurred in acquiring, enhancing or disposing of a capital asset (De Koker et al., 2002).

For assets that have been acquired prior to the implementation date and are disposed of after that date, the base cost represents the sum of the valuation date value and expenditures allowable under paragraph 20 as detailed above incurred subsequent to the valuation date in respect of that asset. The valuation date value may be determined in one of three ways (subject to certain exceptions) –

(i) the market value of the asset at valuation date;

(ii) twenty percent of the proceeds; or

(iii) the time-apportionment base cost.

The taxpayer may elect the method that is most appropriate to him/her when the disposal of the asset occurs.

(i) The market value method

This method sets out the valuation date market value for certain assets (in terms of paragraph 28 to 31) as at 1 October 2001.

In terms of paragraph 29, a taxpayer wishing to make use of the market value basis for determining the base cost must have the asset valued by no later than 30 September 2003 (paragraph 29(4)). In the case of the following assets, the market value may be adopted as the valuation date value only if the taxpayer furnishes the

Commissioner proof of the valuation with the first return submitted after 30 September 2003:

Type of asset	**Applies**	**Where market value exceeds**
Intangible assets	Per asset	R 1 million
Unlisted shares	All shares held by the shareholder in the company	R10 million
All other assets	Per asset	R10 million

(Source: Explanatory memorandum, 2001)

When an asset is disposed of, proof of valuation must be submitted with the return reflecting the disposal. The Commissioner may call for further particulars of the valuation if he is not satisfied with the valuation or may adjust the valuation. The period within which all valuations must be performed may be extended by the Minister of Finance.

(ii) <u>The twenty percent of the proceeds method</u>

The valuation date value is twenty percent of the proceeds from disposal of the asset after deducting from the proceeds the expenditure allowable in terms of paragraph 20 incurred after the valuation date (Explanatory memorandum, 2001).

(iii) <u>The time apportionment base cost method</u>

Two formulae are used in determining the time apportionment base cost of an asset:

a. *Expenditure incurred in a single year*

If the total expenditure on an asset was incurred in a single year of assessment before valuation date, the formula is as follows:

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

Y = the base cost

B = qualifying expenditure on the asset attributable to the period of ownership before valuation date

P = the proceeds on disposal

N = the number of years, or part thereof, the asset was owned before the valuation date

T = the number of years, or part thereof, the asset was owned after the valuation date

b. *Expenditure incurred during more than one year*

If the expenditure on an asset was incurred during more than one year of assessment, the number of years of ownership before valuation date that may be taken into account is limited to twenty. Furthermore, P in the formula needs to be adjusted as follows:

$$P = \frac{T \times B}{(A + B)}$$

T = Total proceeds of disposal

B = Qualifying expenditure incurred on asset before valuation date

A = Qualifying expenditure incurred on asset after valuation date (De Koker, et al. 2002)

When assets are sold that form part of a holding of identical assets, the base cost is determined by using the following methods: specific identification, first-in-first-out or the weighted average (paragraph 32).

Where part of an asset is disposed of it is necessary to allocate part of the base cost of the asset to the part disposed of in order to determine the capital gain. If the part of the base cost cannot be directly attributed to the part that is disposed of or the part that is retained, then the allocation is done according to the following formula:

$$\frac{\text{Market value of part disposed of}}{\text{Market value of entire asset Immediately prior to disposal}} \times \text{Base cost of entire asset}$$

(Explanatory memorandum, 2001)

When a person disposes of an asset to a creditor in order to reduce or discharge a debt owed to that creditor, that asset must be treated as having been acquired by the creditor at a cost equal to the market value at the time of the disposal (paragraph 34).

3.2.4. The tax rate and the rate structure

As per paragraph 10, a person's taxable capital gain for the year of assessment is:

- In the case of natural persons (individuals and special trusts), 25 per cent,
- In the case of an insurer, in respect of its –
  - individual policyholder funds, 25 per cent; and
  - untaxed policyholder fund, 0 per cent, or
- In any other case, 50 per cent,

of that person's net capital gain for that year of assessment.

The following section has been inserted in the principal Income Tax Act after section 26:

> "Inclusion of taxable capital gain in taxable income
>
> 26A. There shall be included in the taxable income of a person for a year of assessment the taxable capital gain of that person for that year of assessment, as determined in the Eighth Schedule."

In other words, depending on the type of taxpayer, only a percentage of a taxpayer's taxable capital gain will be included in that taxpayer's taxable income.

3.2.5. Timing provisions

The disposal of an asset triggers the liability for capital gains tax purposes. As per paragraph 11, a disposal is any event, act, forbearance or operation of law that results in the creation, variation, transfer or extinction of an asset, and includes-

- the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset,
- events which amongst others include the expiry or abandonment of an asset,
- the scrapping, loss or destruction of an asset,
- the vesting of an interest in an asset of a trust in a beneficiary,
- the distribution of an asset by a company to a shareholder,
- the granting, renewal, extension or exercise of an option,
- the decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement. (Explanatory memorandum, 2001)

The following events give rise to a deemed disposal and a deemed immediate re-acquisition of the asset at a cost equal to market value (paragraph 12):

- When a person emigrates or otherwise ceases to be a resident all that person's assets are deemed to be disposed of except immoveable property or an interest or right in immoveable situated in the Republic and assets of a permanent establishment through which that person carries on a trade in the Republic during the year of assessment;
- The asset of a person who is not a resident which becomes an asset of that person's permanent establishment in the Republic otherwise by way of acquisition or ceases to

be an asset of that person's permanent establishment otherwise than by way of disposal;

- An asset of a person that has not previously held as trading stock, which becomes trading stock;
- A personal use asset held by a natural person otherwise than by disposal, that becomes trading stock;
- Trading stock that commences to be held as a person's personal use asset;
- An asset transferred by an insurer contemplated in section 29A from one fund contemplated in section 29A(4) to any other such fund.

Where debt owed by a person to a creditor has been reduced or discharged, the debtor will be treated as having acquired a claim on that portion of the debt that was reduced or discharged for no consideration and disposed of the claim for an amount equal to the discharge. The base cost is deemed to be nil and the debtor will therefore have a gain equal to the reduction or discharge (paragraph 34).

The time of disposal dictates when the capital gain or loss will be brought into account. In terms of paragraph 13, the time of disposal of –

(i) an agreement subject to a suspensive condition , is the date the condition is satisfied;

(ii) an agreement that is not subject to any condition, is the date the agreement is concluded;

(iii) a donation of an asset, is the date of compliance with all the legal requirements for a valid donation;

(iv) the expropriation of an asset in terms of law, is the date the person receives the full compensation agreed to or finally determined by a competent tribunal or court;

(v) the conversion of an asset, is the date on which that asset is converted;

(vi) the granting, renewal or extension of an option, is the date on which the option is granted, renewed or extended;

(vii) the exercise of an option, is the date on which the option is exercised;

(viii) the termination of an option granted by a company to acquire a share, unit or debenture of that company, is the date on which that option terminates;

(ix) in any other case, is the date of change of ownership;

(x) the extinction of an asset including by way of forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment, is the date of the extinction of the asset;

(xi) the scrapping , loss or destruction of an asset is the date-

a) when the full compensation in respect of the scrapping is received; or

b) if no compensation is received, the later of the date when the scrapping, loss or destruction is discovered or the date on which it is established that no compensation will be payable;

(xii) the vesting of an interest in an asset of a trust in a beneficiary, is the date on which the interest vests;

(xiii) the distribution of an asset by a company to shareholder, is the date on which the asset so distributed is approved by the directors.

(xiv) the decrease of a person's interest in a company, trust or partnership as a result of a value shifting arrangement, is the date on which the value of that person's interest decreases;

(xv) events such as emigration, assets that commence to be held as trading stock and *vice versa*, is the date before the event occurs;

(xvi) the transfer of assets between funds of an insurer, is the date the transfer occurs.

Where an asset is disposed of to a person, the person to whom the asset is disposed of, is treated as having acquired the asset at the time of disposal of the asset, as contemplated above.

Thus, it can be concluded that the capital gains are taxed when realised or deemed to be realised and not on the accrual basis, or "profit emerging basis" (Department of Finance, 2000,a).

3.2.6. Inflation adjustments

Indexation, to counter the effects of inflation on capital gains tax are absent from the capital gains tax model (Davis, 2001).

3.2.7. Special concessions and exemptions

3.2.7.1. Exemptions

The following will be exempt from capital gains tax (paragraphs 19,44 to 64):

- The primary residence of a natural person, to the extent that the capital gain or loss does not exceed one million Rand. Where the size of the property qualifying for exclusion as a primary residence exceeds two hectares, a reasonable apportionment is required as any gain attributable to the property in excess of two hectares would be subject to capital gains tax;
- Personal-use assets that are used by a natural person or special trust, other than in the carrying on of a trade. This does not include- a coin made mainly from gold or platinum, immoveable property, an aircraft (where the empty mass exceeds 450 kilograms), a boat exceeding ten metres in length, a financial instrument, a fiduciary or like interest, the value of which decreases over time and the right or interest of whatever nature to or in a asset envisaged as listed above;
- Retirement benefits paid in lump sums (as defined in the Second Schedule and those paid from any fund, arrangement or instrument situated outside the Republic which provides similar benefits to a pension, provident or retirement annuity fund approved in terms of the Income Tax Act);
- Long term insurance policies disposed of by the original owner (disposal of long term policies with foreign long term insurers is not exempted);
- Any capital loss determined in consequence of a disposal, where a creditor disposes of a claim owed by a debtor, who is a connected person in relation to that creditor;
- Compensation for personal injury or illness or defamation;

- Capital gains or losses arising from gambling, games and competitions, excluding those that are derived by companies, close corporations or trusts and those in respect of foreign gambling, games and competitions);
- Any capital gain or loss by a unit portfolio comprised in any unit trust scheme managed or carried on by any company registered under section 4 or 30 of the Unit Trusts Control Act 54 of 1981;
- Donations of assets to public benefit organizations;
- The disposal of active business assets of small business (market value of all the business's assets at the date of disposal or interest therein does not exceed five million Rand). These active business assets must be disposed of on retirement by individuals aged over 55 years or retirement due to ill health or infirmity and the assets have been held for at least five years, the owner has been substantially involved in the operations of the business. There is a limit of R500 000 that exists during the lifetime of the taxpayer;
- A capital gain or loss in respect of the termination of an option as a result of the exercise by that person of an option;
- All capital gains or losses in respect of a disposal by a person, body or institution that is exempt in terms of section 10 of the Act;
- Capital gains or losses in respect of the disposal of assets used to produce income that is exempt from income tax in terms of section 10 (excluded are assets used to produce annual interest exemptions, shares from which dividends are received or accrued and a copyright of a person who is the first owner;
- A capital loss on the following assets, to the extent that they are used for purposes other than the carrying on of trade, must be disregarded for capital gains tax purposes:

- an aircraft with an empty mass exceeding 450kg;
- a boat exceeding ten metres in length;
- any fiduciary, usufructuary or other similar interest, the value of which decreases over time;
- any lease of immoveable property;
- time share interest as defined in section 1 of the Property Time-sharing Control Act, 1983;
- shares in a shareblock company, as defined in section 1 of the Share Blocks Control Act, 1980.
- any right or interest of whatever nature to or in the asset listed above;

* Any capital losses on disposal of intangible assets acquired before valuation date from a connected person or as part of a business, either directly or indirectly be disregarded for capital gains tax purposes, but does not apply to self-developed intellectual property;
* A forfeited deposit that was used for the purposes of acquiring an asset that is not intended for use wholly and exclusively for business purposes. It does not apply to gold or platinum coins, immoveable property (excluding a primary residence), financial instruments or any right or interest in these assets;
* Any loss on an option that expires, is abandoned, or is disposed of by a person entitled to exercise that option. It does not apply to an option to acquire or dispose of an asset used wholly and exclusively for business purposes, a coin made of gold or platinum, immoveable property (excluding a primary residence), a financial instrument, a right or interest in the above assets;

- Any capital loss that arises when a person disposes of a share in a company within two years of the acquisition thereof, to the extent that any extraordinary dividends (dividends that exceed 15 per cent of the proceeds received for the disposal of the shares) were received by that person during that period.

3.2.7.2. Concessions

- **Roll over relief**

  The taxation of capital gains arising in a year of assessment may be deferred until a later year in the following circumstances:

  - **Involuntary disposals** - Capital gains arising on the expropriation, loss or destruction of an asset can be held over until the disposal of its replacement asset. The proviso being that, an amount equal to the proceeds from the disposal of the original asset will be used to acquire a replacement asset that is similar to the original asset, a contract exists to acquire the replacement asset within a year of the disposal of the original asset and the replacement asset will be brought into use within three years of the disposal of the original asset. If these provisions are not met, the gain will be taxed at the applicable rate for the year in which the asset was originally disposed of, plus interest at the prescribed rate.

  - **Reinvestment in replacement assets** – Capital gains arising on the disposal of assets that qualifies for a capital allowance or deduction in terms of section 11(e), 12B, 12C, 14*bis* can be held over until the disposal of its replacement asset. The proviso being that, an amount equal to the proceeds from the disposal of the original asset will be used to acquire a replacement asset that qualifies for the same deductions or capital allowances as the original asset, a contract exists to acquire the replacement asset within a year of the disposal of the original asset and the replacement asset will be brought into use within one year of the disposal of the original asset. The capital gains will be held over and will be recognized in five equal annual installments, commencing on the date that the replacement is brought into use. If these provisions are not met, the gain will be taxed at the applicable rate for the year in which the asset was originally disposed of, plus interest at the prescribed rate.

- **Transfers of assets between spouses** – Where a person disposes of an asset to his or her spouse, the person disposing of the asset must be treated as having disposed of the asset for proceeds equal to the base cost of the asset and the spouse acquiring the asset must be treated as having acquired the asset at a cost of the same amount.

* **Offsetting capital losses** – All capital gains and losses for a year of assessment are aggregated;
* **Annual exemption** – An annual exclusion of R10 000 per annum is allowed in respect of net capital gains/loss arising from capital assets disposed of by natural persons and special trusts during a tax year, before any inclusion rate relief is given. Assessed capital losses may be carried forward to the following years of assessment. When a natural person dies during the year of assessment, that person's annual exclusion for that year is R50 000 (South Africa, 1962).

3.2.8. Anti- avoidance measures

The following measures are in place in where transactions that are undertaken for the purposes of avoiding the impact of capital gains tax:

- **Transactions during the transitional period**

  Where a person –

  (a) acquired assets during the transitional period by means of a non-arms length transaction; or

  (b) acquired an asset during the transitional period directly or indirectly from a person qualifying as a connected person at the time of the acquisition, or any time during the period from the date of acquisition up to a subsequent disposal of that asset by that person within three years after that acquisition; or

  (c) replaced a similar asset that was disposed of during the transitional period by means of a non-arms length transaction, or directly or indirectly from a connected person in order to replace the asset so disposed of within ninety days from the date of disposal; or

  (d) reacquired an asset during the transitional period within a period of ninety days after its disposal, by means of a non-arms length transaction, or directly or indirectly from a connected person,

  that person will be deemed to have acquired or reacquired that asset at the time when the person who disposed of that asset or the substantially similar asset and at a cost equal to the base cost of that asset or the substantially similar asset in the hands of the person who disposed of it, should the time apportionment base cost method be used of that asset as its valuation date value (Explanatory Memorandum, 2001).

- **Attribution of capital gains to spouse**

Two scenarios exist. A spouse makes a capital gain during a year of assessment, and the capital gain can be attributed wholly or partly to a donation, settlement or other disposition made by the other spouse, or may be attributed to a transaction, operation or scheme, and was entered into or carried out by that person's spouse. The capital gain will be disregarded in the hands of the recipient spouse and will be taxed in the hands of the other spouse's hands, if the transaction was entered into or carried out mainly for the purposes of the avoidance of any tax administered by the Commissioner.

In the second instance, a capital gain is made by one spouse which is derived from a trade carried on by that person in association or in partnership with that person's spouse, or where it is derived from that spouse or from a partnership or company at a time when that spouse was a member of that partnership or the sole, main or one of the principal shareholders of that company. So much of that person's gain as exceeds the amount of that person's reasonable entitlement to the gain, will be disregarded in the hands of the recipient spouse and will be taxed in the hands of the other spouse's hands (Explanatory Memorandum, 2001).

- **Attribution of capital gain to parent of minor child**

  The amount any capital gain made by a minor child or of a capital gain that has vested in or is treated as having vested in that child during the year in which it arose and that is attributable to a donation, settlement or other disposition made by a parent of that child, is treated as the capital gain of that parent.

- **Attribution of capital gain that is subject to conditional vesting**

  A capital gains arising as a result of a conditional donation or similar transaction made during the year of assessment and which has not vested in any beneficiary will be attributable to the donor, if he/she was a resident throughout the same year of assessment.

- **Attribution of capital gain that is subject to revocable vesting**

  A capital gain arising because of a revocable vesting, will be attributable to the person who retained the power of revocation and disregarded in the determination of the aggregate capital gain or loss of the beneficiary.

- **Attribution of capital gain of vesting in a person who is not a resident**

  When a donation, settlement or similar disposition is made by a resident to any person and a capital gain vested in any person who is not a resident, the capital gain must be disregarded in the hands of the person in whom it vests and be taken into account when determining the aggregate capital gain or loss of the person who made the donation, settlement or other disposition.

- **Attribution of income as well as of capital gain**

When an income and capital gain have been derived form a donation, settlement or other disposition, and the income and capital gain are subject to the attribution rules of section 7 and paragraphs 68 to 72 of the Eighth Schedule of the Income Tax Act, then the total amount of the income and gain are limited to the amount of the benefit derived from that donation, settlement or other disposition.

3.2.9. Record keeping

In accordance with section 73B of the Income Tax Act (1962), the taxpayer is required to do the following:

'73B. (1) A person shall retain all records required to determine the taxable capital gain or loss of that person for a period of four years from the date on which the return for that year of assessment was received by the Commissioner.

(2) A person who is not required to render a return, must retain the records required to determine capital gains or capital losses for a period of five years from the date of the disposal of each asset. This must occur when all capital gains or capital losses determined in respect of the disposal of those assets exceed R10 000 in respect of the year of assessment and the capital gain or capital loss is not disregarded or excluded in terms of the Eighth Schedule.

(3) For purposes of this section 'records" includes:

(a) any agreement for the acquisition, disposal or lease of an asset together with related correspondence;

(b) details of any asset transferred into a trust;

(c) copies of valuations used in the determination of a taxable capital gain or assessed capital loss;

(d) invoices or other evidence of payment records such as bank statements and paid cheques relating to any costs claimed in respect of the acquisition, improvement or disposal of any asset;

(e) details supporting the proportional use of an asset for both private and business purposes;

(f) details of any continuous absence of more than 6 months from a primary residence, as contemplated in the Eighth Schedule.'

CHAPTER 4

AN EVALUATION OF THE LEGISLATED CAPITAL GAINS TAX

4.1. Introduction

The capital gains tax legislature that has been examined in the previous chapter, is going to be evaluated against the criteria that have been set up, to which a capital gains tax should adhere (see Chapter 3). The purpose is to determine whether the legislated capital gains tax confirms the accepted principles of a 'good' tax.

4.2. Evaluating the legislated capital gains tax

4.2.1. Neutrality

The principle of neutrality is achieved in the legislated capital gains tax as follows:

- The tax base of the legislated capital gains tax is as broad as possible, as all property is included, tangible or intangible;
- The same rate of tax is applicable to all asset disposals that give rise to capital gains;
- There is no differentiation of tax rates between assets that have different holding periods i.e. there is no distinction between long and short term assets;
- The effects of inflation on capital gains have not been taken into account. This is in line with the premise that capital gains must not be indexed for inflation if capital incomes are also not indexed. In the Income Tax Act, no. 58 1962, capital income such as interest, rentals, dividends and royalties are not indexed for inflation;
- All the taxpayers are subject to capital gains tax, except for those institutions exempted under section 10 of the Income Tax Act, no.58 of 1962;

- Sufficient roll over relief is granted for the transfer of business assets. The roll over relief granted is when there is a reinvestment into similar assets, as the continuity of productivity is achieved and the tendency to stagnate the economy is avoided.

The principle of neutrality is not achieved as follows:

- Only a certain percentage of the capital gains has been included in income. It is submitted that 100% of the capital gains should be included in income and that suitable averaging provisions for taxable income be implemented in the year in which disposals resulting in capital gains occur.
- Certain limitations are placed on the exempt portion of capital gains or losses of primary residences.

4.2.2. Certainty and simplicity

The principle of certainty of the legislated capital gains tax is achieved as follows:

- The definition of the events that give rise to the disposal of assets, is accurately defined;
- Assets to be valued according to their market value have been clearly defined so that the valuation of thereof can be easily be determined by both the taxpayer and the Receiver of Revenue without dispute;
- Taxpayers have an option in certain circumstances to choose a valuation method for assets purchased before the effective date, and sufficient guidelines are laid out so that the taxpayer knows beforehand which requirements must be met in order to make use of that method.

The principle of certainty and simplicity is not achieved as follows:

- It has been submitted that a flat rate of capital gains tax be implemented, as it is a simpler model. However, the legislated capital gains tax states that capital gains are to be included in income, and as such, suitable recommendations have been suggested in 4.2.1.

4.2.3. Administrative efficiency

Administrative efficiency of the legislated capital gains tax is achieved as follows:

- The legislated capital gains tax does not make provision for any adjustment of inflation on the capital gains, thus decreasing the administrative inconvenience of making complicated inflation decisions and calculations as illustrated in 2.3.1.6. Tax authorities have stated that the inclusion rate, the taxable portion of capital gains, is low, in order to adjust for the effect of inflation (Gordon, 2000).
- The capital gains are taxed on the realisation basis and thus the administrative problems surrounding the continual valuation of assets on the accrual basis, is eliminated.
- The capital gains of all assets are taxed at the same rate.
- No distinction is made between the rates at which long or short term held-assets are taxed.
- An annual exemption of R10 000 per annum is allowed, reducing the administrative burden of collecting nominal amounts of capital gains. The writer recommends that tax authorities undertake a survey as carried out in the USA to determine the most

appropriate annual exclusion amount based on the level at which the number of tax returns with capital gains is reduced to be administrative efficient (see 2.3.1.7). This can, however, only be done after sufficient data has been collated to draw reasonable conclusions.

- Roll over relief has been granted on transfers between man and wife so that the administration involved is limited to the sale of asset to an 'outside' person.
- Certain personal belongings and effects of natural persons are exempted reducing the administrative burden of valuing and keeping record of smaller assets.

Administrative efficiency is not achieved as follows:

- Assets that were acquired before the effective date are subject to capital gains tax. The methods of valuating assets held on implementation date or the apportionment of the capital gains, if chosen, will dramatically increase the administrative burden on both the taxpayer and the State.
- The taxpayer is must retain detailed records of all the capital assets owned and has to value every capital asset owned prior to the effective date that is subject to capital gains tax, in order to have the choice to use the market value method when disposing of an asset. This places an extensive administrative burden on the taxpayer.

4.2.4. Flexibility

Flexibility can be achieved as the inclusion rate applied to net capital gains can be adjusted to suit any change in economic circumstances.

4.2.5. Invisibility

The legislated capital gains tax will not fulfill the criteria of invisibility as it is the nature of a capital gains tax to be visible.

4.2.6. Equity

4.2.6.1. Fairness

The principle of fairness of the legislated capital gains tax is achieved as follows:

- Capital losses that occur during a year can be set off against any capital gains made during that year, and any excess (net capital loss exceeding R10 000), may be carried forward to the following year;
- Persons exempted from normal income tax under section 10, are also exempted from the legislated capital gains tax;
- Expenditure already claimed in determining taxable income for normal tax purposes are excluded;
- Proceeds from a pension fund, retirement annuity fund and life assurance are exempted from capital gains tax;
- Roll over relief is granted in the case of involuntary disposals;
- At the time of disposal, the taxpayer has certain methods available for determining his/her valuation date value for assets purchased before the effective date and has the choice which method to use to be most beneficial to him/her.

4.2.6.2. Horizontal equity

The principle of horizontal equity is achieved as follows:

- There is an annual exemption of R10 000.
- Capital gains are taxed at the income tax rate.

4.2.6.3. Vertical equity

Vertical equity is not achieved as there are no averaging provisions to allow the averaging of the taxpayers' income in the year of the capital gain.

CHAPTER 5

SUMMARY AND CONCLUSION

All capital gains that accrue from 1 October 2001 are taxed in accordance with the Eighth Schedule to the Income Tax Act no. 58 of 1962. It is stated that the introduction of this new form of tax to the South African tax system addresses many inefficiencies and deficiencies in the current tax system. It is the writer's opinion that an investigation as to the degree to which this tax system adheres to the principles of an effective and efficient tax system was thus necessary.

In Chapter 2, the principles of an effective tax system were set out as those originally proposed by Adam Smith as well as those that have been adapted to modern tax theory. The factors that impact capital gains tax were identified and specific criteria were formulated against which the legislated capital gains tax was evaluated.

In Chapter 3, the mechanics of the capital gains tax was outlined, as it appears in the Eighth Schedule to the Income Tax Act no. 58 no. 1962 and classified into the factors that impact a capital gains tax

In Chapter 4, the legislated capital gains tax was evaluated against the criteria formulated in Chapter 2.

As can be deduced from the above evaluation, the legislated capital gains tax does address the principles of an effective and efficient tax system, but is not entirely in line with all the principles. The principles of flexibility, fairness and horizontal equity are achieved. To a lesser extent, the principles of neutrality, certainty and simplicity, and administrative efficiency are achieved, and the principles of invisibility and vertical equity have not been achieved.

It is the writers opinion that there would always be areas in which the legislated capital gains tax would not meet the predetermined criteria set up, as the institutors of the capital gains tax have set up specific objectives that need to be met and have selected the components necessary to achieve those objectives. It is of importance to note that most recommendations of the Commission Reports were taken into account in the capital gains tax legislation. The legislation that was passed on capital gains tax is all encompassing and clearly defines the requirements and mechanics of the tax.

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