ANALYSIS OF THE INTERACTION BETWEEN THE INCOME TAX AND CAPITAL GAINS TAX PROVISIONS APPLICABLE TO SHARE DEALERS

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ANALYSIS OF THE INTERACTION BETWEEN THE INCOME TAX AND CAPITAL GAINS TAX PROVISIONS APPLICABLE TO SHARE DEALERS

The interaction between the income tax provisions contained in sections 9B, 9C, 11(a) and 22 of the Income Tax Act No. 58 of 1962 (the Act), and the capital gains tax (CGT) provisions of the Eighth Schedule of the Act, are complex and share dealers should approach the tax consequences of share dealing profits with caution.

The objective of the assignment was to ensure that the share dealing profits of share dealers (who transact on revenue account) are taxed correctly, with specific reference to the interaction between the aforementioned provisions. This was achieved by considering tax cases, the interpretation notes of the South African Revenue Services (SARS) and commentary of tax writers. Examples of share disposals were incorporated to illustrate that consistency is required between the calculation of profits for income tax and CGT purposes.

The guidelines laid down by case law to determine the revenue nature of share disposals were investigated. It was concluded that share dealing profits which are designedly sought for and worked for, either as part of a business operation or not, are of a revenue nature and taxable as such.

The method of identification of shares sold as trading stock is important when calculating the income tax profit, since it is used in order to determine both which shares are sold as well as the cost of the shares sold. It was concluded that the method of identification applied in terms of generally accepted accounting practice (GAAP) is generally also acceptable from an income tax perspective.

Section 9C of the Act provides a share dealer income tax relief when a ‘qualifying share’ is disposed of. Any amount received or accrued as a result of the disposal of a qualifying share is deemed to be of a capital nature, regardless of the revenue intention of the share dealer. Prior to 1 October 2007, section 9B of the Act provided similar relief to the disposal of an ‘affected share’. It was concluded that

section 9C of the Act has a wider scope of application compared to section 9B of the Act.

Because the proceeds received on the disposal of affected or qualifying shares are excluded from gross income, the acquisition costs previously incurred and deducted in respect of such shares must be included in taxable income. It was determined that the amount to be included in income is the actual cost of such shares and not the opening trading stock value determined in terms of GAAP and claimed in terms of section 22(2) of the Act.

It was concluded that the first-in-first-out (FIFO) method of identification should be applied to determine which affected or qualifying shares have been disposed of. From a CGT perspective, it was illustrated that a share dealer loses the opportunity to choose which identification method to apply and is obliged to also apply the FIFO method in calculating the CGT base cost of the shares.

It is concluded that the Eighth Schedule of the Act should be amended to clarify that the FIFO method should be applied for CGT purposes where sections 9B or 9C of the Act find application. Only then will the tax profits of a share dealer be in sync with his or her cash benefit.

ANALISE VAN DIE INTERAKSIE TUSSEN DIE INKOMSTEBELASTING- EN KAPITAALWINSBELASTINGBEPALINGS VAN TOEPASSING OP AANDELEHANDELAARS

Die interaksie tussen die inkomstebelastingbepalings vervat in artikels 9B, 9C, 11(a) en 22 van die Inkomstebelastingwet No. 58 van 1962 (die Wet), en die kapitaalwinsbelastingbepalings (KWB bepalings) van die Agtste Bylae tot die Wet is kompleks en aandelehandelaars moet die belastinggevolge van aandelewinste met omsigtigheid benader.

Die doelwit van die werkstuk was om te verseker dat die winste van aandelehandelaars (wat aandele verkoop op inkomsterekening) korrek belas word, met spesifieke verwysing na die interaksie tussen die voorgenoemde bepalings. Dit is bereik deur die oorweging van hofsake, uitlegnotas van die Suid-Afrikaanse Inkomstediens en kommentaar deur belastingskrywers. Voorbeelde van aandeleverkope is gebruik om te illustreer dat konsekwentheid tussen die berekening van winste vir inkomstebelasting en KWB-doeleindes ‘n vereiste is.

Die riglyne wat deur regspraak daargestel is om die inkomste-aard van aandeleverkope vas te stel, is ondersoek. Daar is bevind dat aandelewinste wat opsetlik nagejaag word en voor gewerk word, ongeag of dit deel van die bedryf van 'n besigheid is al dan nie, van ‘n inkomste-aard is en aldus belasbaar is.

Die metode van identifikasie van aandele wat as handelsvoorraad verkoop word is belangrik by die berekening die inkomstebelastingwins aangesien dit gebruik word om vas te stel watter aandele verkoop is en wat die koste van die verkoopte aandele is. Daar is bevind dat die metode wat ingevolge algemeen aanvaarde rekeningkundige praktyk (AARP) toegepas is, gewoonlik ook vir inkomstebelastingdoeleindes toelaatbaar is.

Artikel 9C van die Wet verskaf aan ‘n aandelehandelaar inkomstebelastingverligting met die verkoop van 'n 'kwalifiserende aandeel' deurdat die bedrag ontvang of toegeval geag word van 'n kapitale aard te wees, ongeag die inkomstebedoeling van die aandelehandelaar. Voor 1 Oktober 2007 het artikel 9B van die Wet soortgelyke verligting verskaf met die verkoop van n 'geaffekteerde aandeel’. Daar is vasgestel dat artikel 9C van die Wet 'n wyer toepassing het in vergelyking met artikel 9B van die Wet.

Omrede die opbrengs ontvang met die verkoop van geaffekteerde of kwalifiserende aandele uitgesluit word van bruto inkomste, moet die vorige aankoopskostes wat voorheen ten opsigte van die aandele aangegaan en afgetrek is, by belasbare inkomste ingesluit word. Daar is bepaal dat die bedrag wat by belasbare inkomste ingesluit word, die werklike koste van die aandele is en nie die AARP openingswaarde van handelsvoorraad wat ingevolge artikel 22(2) van die Wet geëis nie.

Daar is bevind dat die eerste-in-eerste-uit (EIEU) metode van identifikasie gebruik moet word om te bepaal watter geaffekteerde of kwalifiserende aandele verkoop is. Vir KWB doeleindes verloor 'n aandelehandelaar ook die geleentheid om te kan kies watter identifikasiemetode toegepas moet word. Hy of sy is verplig om die EIEU metode toe te pas in die berekening van die KWB basiskoste van die aandele.

Daar word tot die gevolgtrekking gekom dat die Agtste Bylae van die Wet gewysig moet word om te bevestig dat die EIEU metode toegepas moet word vir KWB doeleindes waar artikels 9B of 9C van die Wet van toepassing is. Slegs dan is die belasbare wins van 'n aandelehandelaar in lyn is met sy of haar kontantvoordeel.

TABLE OF CONTENTS

CHAPTER 1
INTRODUCTION 11
1.1 Background and problem statement 11
1.2 Literature study 13
1.3 Research objective 14
1.4 Research method 15
1.5 Framework of the study 15
1.5.1 Revenue or capital nature of share disposals 15
1.5.2 Income tax treatment of trading stock in terms of sections 11(a) and 22 of the Act 16
1.5.3 Deemed capital treatment in terms of sections 9B and 9C of the Act 17
1.5.4 Capital gains tax in terms of the Eighth Schedule of the Act 17
1.5.5 Conclusion 18
CHAPTER 2
REVENUE OR CAPITAL NATURE OF SHARE DISPOSALS 19
2.1 Introduction 19
2.2 The guideline of the intention of a taxpayer 20
2.3 The guideline of realisation of capital assets at enhanced values 23
2.4 The business guideline 23
2.5 The scheme of profit-making guideline 26
2.6 Conclusion 27
CHAPTER 3
INCOME TAX TREATMENT OF TRADING STOCK IN TERMS OF SECTIONS 11(A) AND 22 OF THE ACT 29
3.1 Introduction 29
3.2 General deduction formula in section 11(a) of the Act 30
3.3 Special trading stock provisions in section 22 of the Act 32
3.3.1 Closing trading stock held on year end 32

3.3.2 Opening trading stock held at the beginning of the year 33
3.4 Methods of identification of trading stock 34
3.5 Weighted average method of identification 36
3.6 Conclusion 38
CHAPTER 4
DEEMED CAPITAL TREATMENT IN TERMS OF SECTIONS 9B AND 9C OF THE ACT 39
4.1 Introduction 39
4.2 Affected share in section 9B of the Act 40
4.3 Qualifying share in section 9C of the Act 43
4.4 FIFO method of identification in determining which shares have been disposed of 46
4.5 Income inclusion provisions in sections 9B(6) or 9C(5) of the Act 49
4.6 Conclusion 55
CHAPTER 5
CAPITAL GAINS TAX IN TERMS OF THE EIGHTH SCHEDULE OF THE ACT 57
5.1 Introduction 57
5.2 Eighth Schedule building blocks 58
5.2.1 Asset 59
5.2.2 Disposal 60
5.2.3 Proceeds 60
5.2.4 Base cost 61
5.3 Interplay of the income tax and CGT methods of identification 63
5.3.1 FIFO method of identification 65
5.3.2 WA method of identification 66
5.3.3 Conclusion on the interplay of the methods of identification 67
5.4 Conclusion 68

CHAPTER 6
CONCLUSION 70
CHAPTER 7
BIBLIOGRAPHY 74
7.1 List of books 74
7.2 List of electronic sources 74
7.3 List of state publications 75
7.4 List of articles 76
7.5 List of case law 77

LIST OF TABLES

Table 1: **Illustrative example…………………………………………….. 31**

Table 2: **Calculation of taxable income in terms of the WA method of identification (before applying sections 9B and 9C of the Act)…………………….……………………………………… 36**

Table 3: **Closing trading stock values under different methods of identification……………………………………………………... 47**

Table 4: **Affected or qualifying shares disposed of in terms of the FIFO method of identification…………………………………… 51**

Table 5: **Illustration of income tax deductions claimed……………….. 52**

Table 6: **Taxable income as a result of the application of sections 9B or 9C of the Act (before considering CGT)……………….. 53**

Table 7: **Taxable income where the WA cost is included as the sections 9B(6) or 9C(5) income inclusion (before considering CGT)………………………………………………….. 54**

Table 8: **Taxable income under the FIFO method of identification (including CGT)………………………………………………….. 65**

Table 9: **Taxable income under the WA method of identification (including CGT)………………………………………………….. 66**

CHAPTER 1

INTRODUCTION

1.1 Background and problem statement

With the progressive exposure of the South African economy to the global markets over the past 20 years, the occurrence of share dealing activities has become more common. The increased availability of information and accessibility to local and international stock exchanges has made dealing in shares an increasingly attractive business venture.

The development and expansion of dealing in equity markets have been significant. This expansion can best be illustrated by the increase in the number of deals done on a monthly basis on the Johannesburg Stock Exchange (JSE), as well as the increase in the overall equity market capitalisation on the JSE. For instance, for the month January 1994, 83 682 trades were done on the JSE while the total market capitalisation of the equity market was R723 billion (JSE Monthly Bulletin, 1994:4). In December 2012, the number of monthly trades increased more than twenty five-fold to 2 109 834, while the total equity market capitalisation increased more than tenfold to R8 384 billion (JSE Monthly Bulletin, 2012:6). The booming stock market has thus created favourable investment opportunities for taxpayers.

The concept 'share dealer' is not defined in the Income Tax Act No. 58 of 1962 (the Act). According to Huxham and Haupt (2013:56), there is no such thing as a share dealer for tax purposes, as the intention has to be established in the case of each share sold. The Online Oxford Dictionary provides the following definition of a 'dealer': 'a person who buys and sells shares, securities, or other financial assets as a principal (rather than as a broker or agent)'. In this study 'share dealer' thus refers to a taxpayer who buys and sells shares with the sole intention of making a profit.

As a general rule, the full gains made by a share dealer on the disposal of shares held as trading stock (on revenue account) are included in taxable income. Where shares are held on capital account (by a non-share dealer), only a portion (66.6% in the case of companies and 33.3% in the case of individuals) of the gains are taxable, as provided for in the capital gains tax (CGT) provisions in the Eighth Schedule of the Act.

In the budget tax proposals for 2006/7 (SA, 2006b:9) it was announced that a review of the revenue versus capital distinction began in 2006. This review led to the replacement of section 9B of the Act with section 9C in 2007 (SA, 2007b:20). Sections 9B and 9C of the Act deem the proceeds on the disposal of certain shares to be of a capital nature (even if held on revenue account). While the proceeds are thus excluded from gross income, CGT is still payable on these share profits. The interaction between the income tax and CGT provisions is however not clear.

Sections 9C (and previously section 9B) of the Act provide taxpayers with certainty that if they hold equity shares for a certain period the gains and losses on disposal will be of a capital nature regardless of the intention with which the shares were originally acquired. There is however uncertainty about how the capital gain should be calculated for these shares, the proceeds of which has been deemed to be capital in nature. More specifically:

- Does the calculation of the base cost of the shares for CGT purposes have to align with how the cost of trading stock was determined for income tax purposes, or can the Eighth Schedule of the Act operate in isolation?

- Sections 9B and 9C of the Act provide for a so-called ‘first-in-first-out’ method of identification in determining whether the share proceeds are deemed to be capital in nature. Is a share dealer therefore also required to apply this method for purposes of identifying and determining the base cost of these shares for CGT purposes?

- Sections 9B and 9C of the Act also provide for an income inclusion of share related expenditure when the proceeds are deemed to be capital, but give no guidance about how the income inclusion should interact with the base cost calculation for CGT purposes. If the interaction is not considered in conjunction, the result could be that a share dealer calculates the base cost for CGT purposes incorrectly and pays to much tax.

It is therefore necessary to carefully analyse the interaction between the income tax and CGT provisions applicable to share dealers to ensure that share dealers are paying the correct amount of tax on their share dealing profits.

1.2 Literature study

Gross income is defined in section 1 of the Act and includes the total amount, in cash or otherwise, received by or accrued to a taxpayer during a year of assessment, excluding receipts or accruals of a capital nature. The phrase 'receipts or accruals of a capital nature' is, however, not defined in the Act and it has over the years been left to the South African tax courts to develop various guidelines which can be used to determine when a share is held on revenue account and the receipt or accrual therefore not 'of a capital nature'.

Before 1 October 2007, section 9B of the Act intended to provide a so-called 'safe haven' for shares listed on a South African-registered stock exchange held for a period of at least five continuous years. Section 9B was enacted in 1990, with the purpose of bringing more certainty regarding the capital or revenue nature of investments in 'affected shares' as defined. Although section 9B does not refer to share dealers, De Koker & Williams (2013:17.25A) submits that section 9B is in principle aimed at taxpayers who hold affected shares for speculative purposes such as share dealers.

Section 9C of the Act replaced section 9B with effect from 1 October 2007 and applies to disposals after that date. Section 9C of the Act applies to a wider range of assets and the required holding period decreased from 5 years (in section 9B) to

3 years in section 9C. Although section 9B of the Act therefore no longer applies, it is still important to investigate the provisions of section 9B in order to understand the history, development and interpretation of section 9C of the Act.

CGT was introduced in South Africa in 2001 when the Eighth Schedule of the Act was inserted by the Taxation Laws Amendment Act No. 5 of 2001 with effect from 1 October 2001. The South African Revenue Services (SARS) issued Interpretation Note No. 43 in 2012 to provide clarity on the interpretation and application of section 9C (SA, 2012b:3). A tax guide for share owners was also released in 2012 to provide general guidance on the taxation of share owners (SA, 2012a:ii). Both these documents, however, only deal with the interaction between section 9C and the Eighth Schedule of the Act at a high level. A more basic detail analysis is therefore required.

1.3 Research objective

The overall objective of the research is to ensure that the share dealing profits of share dealers are taxed correctly, with specific reference to the interaction of the income tax provisions contained in sections 9B, 9C, 11(a) and 22 of the Act, with the CGT provisions of the Eighth Schedule to the Act.

The overall objective can be divided into the following specific objectives:

- To provide more certainty as to when a share disposal is on revenue account by investigating the guidelines applied by our courts in determining whether share disposals is on revenue or capital account. The tax consequences for share dealers holding shares as trading stock are then considered.
- To clarify the calculation of the CGT base cost of shares where sections 9B or 9C of the Act have deemed the proceeds to be capital in nature. The effect of the income inclusion and method of identification in sections 9B or 9C on the CGT calculation in terms of the Eighth Schedule are specifically determined.

- To provide interpretation guidelines for the interaction between the income tax and CGT provisions of the Act.

The correct taxation of share dealing profits is imperative in an increasing equity market where large amounts are invested by share dealers. It is thus appropriate and necessary that further research be done on the taxation of profits made by share dealers from both an income tax and CGT perspective.

1.4 Research method

The research method used is mainly the historical method, although practical illustrative examples of share dealing transactions are also incorporated in this study.

Although ample case law exists on the revenue or capital nature of share disposals, there is only as yet few South African tax case law related to the Eighth Schedule of the Act which can provide a precedent in any interpretation for CGT purposes. Where applicable, reference is thus made to the available practice notes, SARS Guides and commentary of tax writers.

1.5 Framework of the study

1.5.1 Revenue or capital nature of share disposals

Before the specific tax provisions applicable to share dealers are analysed, the general guidelines developed by our courts in establishing whether any disposal is on revenue or capital account, are discussed in Chapter 2. These guidelines apply to all assets and not only to shares. This analysis is required as only once it is established that a share disposal is on revenue account, is it necessary to consider the aforementioned tax provisions applicable to share dealers.

The discussion in Chapter 2 is made with reference to the definition of ‘gross income’ in section 1 of the Act, which specifically excludes receipts and accruals of a capital nature. The specific guidelines applied by our courts in determining

whether a receipt or accrual from a share dealing activity is of a revenue nature are discussed.

The development and interpretation of the abovementioned guidelines are discussed in order to provide more certainty as to when a share disposal is on revenue account.

1.5.2 Income tax treatment of trading stock in terms of sections 11(a) and 22 of the Act

Where the intention of a taxpayer is revenue in nature, which is normally the case for a share dealer, the shares form part of the taxpayer's trading stock for which an income tax deduction in terms of section 11(a) of the Act is claimable. In this regard section 22 of the Act also provides special provisions for the valuation and taxation of trading stock.

Chapter 3 considers the provisions of section 22 as an important link in determining the correct interaction of sections 9B or 9C of the Act with the provisions in the Eighth Schedule of the Act. Chapter 3 first examines the provisions for calculating the value of closing trading stock for purposes of section 22(1) of the Act. Opening trading stock is also considered due to the fact that an income tax deduction is claimable in terms of section 22(2) of the Act for the prior year's closing trading stock value included in income.

The different allowable methods of identification for shares held as trading stock are investigated. The allowable methods of identification are discussed with reference to the generally accepted accounting practice (GAAP) of trading stock. The Eighth Schedule of the Act also has its own allowable methods of identification, which will be compared in Chapter 5 to the GAAP methods of identification.

1.5.3 Deemed capital treatment in terms of sections 9B and 9C of the Act

Chapter 4 investigates the provisions of sections 9B and 9C of the Act in more detail. Specifically, the application of the rather controversial definition of 'affected share' in section 9B of the Act, as well as the required election to be made by share dealers, are explained. This is then compared to the wider scope of application introduced in section 9C of the Act, which applies to a 'qualifying share'.

The application of the seemingly prescribed FIFO method of identification in sections 9B(7) or 9C(6) of the Act to determine whether a share constitutes an affected or a qualifying share is investigated. The application of the provisions contained in sections 9B(6) or 9C(5) of the Act, which provide for an inclusion of the previous income tax deduction in relation to such affected or qualifying share, is then considered.

The correct application of the prescribed FIFO method of identification and income inclusion provisions in sections 9B or 9C of the Act is an important link to the CGT base cost calculation in Chapter 5.

1.5.4 Capital gains tax in terms of the Eighth Schedule of the Act

In Chapter 5 the Eighth Schedule of the Act is applied to those affected or qualifying shares the proceeds of which are deemed to be of a capital nature in terms of sections 9B or 9C of the Act.

The general principles provided for in the Eighth Schedule of the Act for the calculation of a taxable capital gain on the disposal of an affected or qualifying share, are explained firstly. The definitions of 'base cost' and 'proceeds' for CGT purposes, as well as the allowable methods of identification provided for in paragraph 32 of the Eighth Schedule, where identical assets are disposed of, are specifically discussed.

The calculation of the CGT base cost of affected or qualifying shares, where sections 9B or 9C have deemed the proceeds to be capital in nature, is then examined. The question of how the income tax inclusion and FIFO method of identification in sections 9B or 9C of the Act should link with the CGT calculation in terms of the Eighth Schedule of the Act is specifically addressed.

It is concluded, by way of illustrative examples, that if the interaction between sections 9B or 9C of the Act and the Eighth Schedule of the Act is not considered in conjunction, a share dealer could end up paying too much tax.

1.5.5 Conclusion

The final chapter (Chapter 6) contains a brief summary of the various conclusions reached in the previous chapters. These conclusions comprise suggested guidelines for the interpretation of the interaction of the income tax provisions contained in sections 9B, 9C, 11(a) and 22 of the Act, with the CGT provisions of the Eighth Schedule of the Act.

CHAPTER 2

REVENUE OR CAPITAL NATURE OF SHARE DISPOSALS

2.1 Introduction

In this chapter the general guidelines developed by our courts in establishing whether any share disposal is on revenue or capital account are investigated. This is required as it is only necessary to consider the tax provisions specifically applicable to share dealers once it is established that a share disposal is on revenue account.

The definition of gross income in section 1 of the Act excludes receipts or accruals of a capital nature. The South African tax courts have developed various guidelines which can be applied in this regard to determine what is meant by 'of a capital nature'. The tax courts have in the past, however, not applied the various guidelines consistently. According to Broomberg (1972:450), what seems to have been lacking, is an attempt to organise the data available from the countless reported cases into a body of useful knowledge so that the law could at least gain, and not lose, by past experience.

The specific guidelines applied by our courts in determining whether a receipt or accrual from a share dealing activity is of a revenue nature include:

- the guideline of the intention of a taxpayer;
- the guideline of realisation of capital assets at enhanced values;
- the business guideline; and
- the scheme of profit-making guideline.

The development and interpretation of the abovementioned four guidelines are discussed in more detail below in order to provide more certainty as to when a share disposal is on revenue account.

2.2 The guideline of the intention of a taxpayer

In an unreported judgement of the Special Court for Hearing Income Tax Appeals (De Koker & Williams, 2013:3.42), the court held that transactions in shares are, for tax purposes, essentially the same thing as dealings in any other kind of property. The question whether the profits or losses are of a capital or revenue nature is therefore resolved in the same way as is done, for instance, with transactions in fixed property.

In *ITC 1412* (48 SATC 157) the court held that, for a taxpayer who buys and sells shares, it is possible for his or her intention to differ with regard to different shares acquired. In other words, the mere fact that a taxpayer is dealing in shares listed on the JSE does not mean that all the shares he or she acquires and sells are necessarily treated as revenue in nature. It is necessary to look at the purpose for which a taxpayer acquires each share and the circumstances under which he or she decides to sell that particular share. There is thus no such thing as a 'share dealer' for tax purposes and the intention has to be established in the case of each share sold (Huxham & Haupt, 2013:56).

The following factors are relevant when considering the intention of a taxpayer:

- The intention of a taxpayer must be determined both at the time of acquisition of an asset and at the time of disposal. This is due to the fact that a taxpayer's intention can change over time (*Natal Estates Ltd v SIR* 37 SATC 193). The mere fact that a taxpayer decides to sell a capital investment does not constitute a change of intention from capital to revenue and render the profit taxable. Something more is required in order to metamorphose the character of the asset and so render its proceeds gross income (*John Bell and Co (Pty) Ltd v SIR* 38 SATC 87). It has, however, been difficult in the past to convince a court that there has been a change of intention, especially when changing from a revenue to capital intention. It has been compared to being as difficult as passing a rope through the eye of a needle (*Yates Investments (Pty) Ltd v CIR* 20 SATC 368).

- The possibility of dual or mixed intentions (both capital and revenue) must be investigated. Courts have laid down the principle that the dominant intention will be regarded as the taxpayer's intention in such cases (*COT v Levy* 18 SATC 127 and *CIR v Paul* 21 SATC 1). In *Pyott Ltd v CIR* (1945 AD 128) the court accepted the principle that there can be no half-way house in deciding between revenue and capital. The intention with which a taxpayer acquires a share may for example be to produce investment income in the form of dividends or for speculation purposes, by making a profit on selling the share. In *CIR v Middelman* (52 SATC 323) the taxpayer convinced the court that his purpose in selling his shares was to maintain or to increase his dividend income, which was his overriding, main and dominant intention. According to Broomberg (1972:452) the 'dual purpose' test does, however, seem to be something of a tax hazard as the dominant intention has also been held not to be the intention of the taxpayer. In *CIR v Nussbaum* (58 SATC 283) it was held that a retired teacher was trading in his portfolio of shares because, although his dominant intention was to earn dividend income, he also had a secondary profit-making purpose in his share transactions.

- Intention can be evidenced in different ways. An individual's intention is not necessarily determined by what he or she says his or her intention was (the individual's *ipse dixit*), but by the inference as to the intention drawn from the facts of the case (*CIR v Visser* 8 SATC 271). Where the taxpayer is a company, the intention can be derived from the primary and secondary objects included in its articles of association, as well as the actions of its directors. In *CIR v Richmond Estates (Pty) Ltd* (20 SATC 355), it was held that a company is an artificial person 'with no body to kick and no soul to damn' and the only way of ascertaining its intention is to find out what its directors acting as such intended. The directors' formal acts in the form of resolutions may thus constitute evidence as to the intention of a company. The intention of the shareholders of a company could in certain instances

also be attributed to the company itself, thus piercing the corporate veil (*Elandsheuwel Farming (Edms) Bpk v SBI* 39 SATC 163).

- Contemplation should not to be confused with intention (*CIR v Pick 'n Pay Employee Share Purchase Trust* (54 SATC 271). In *SIR v The Trust Bank of Africa Ltd* (37 SATC 87A) it was held no one buys property if he expects that he or she will eventually have to sell it at a loss and the taxpayer is not required to exclude the slightest contemplation of a profitable resale. Where a taxpayer contemplates making a profit, the fact that he or she does make a profit on disposal, will not subject the profit automatically to income tax. It is a matter of degree depending on the facts of each individual case. In *CIR v Pick 'n Pay Employee Share Purchase Trust* (54 SATC 271) it was held that in a tax case one is not concerned with what possibilities, apart from his actual purpose, the taxpayer foresaw and with which he reconciled himself. One is solely concerned with his object, his aim, his actual purpose.

- The intention of a taxpayer is not necessarily conclusive in deciding whether a receipt for a share disposal of is capital or revenue in nature. In *CIR v Stott* (3 SATC 253) Wessels JA held that it is unnecessary to go so far as to say that the intention with which an article is bought is conclusive as to whether the proceeds derived from the sale were taxable or not. It is sufficient to say that the intention is an important factor and unless some other factor intervened to show that when the article was sold, it was sold in pursuance of a scheme of profit-making, it is conclusive in determining whether it is capital or gross income.

The intention of a taxpayer is thus an important factor in deciding whether a receipt for shares disposed of is revenue or capital in nature, particularly because it is possible for a taxpayer's intention to change over time or to have dual intentions. It is a subjective factor which is not always easily determined. Although importance should be placed on the intention of the taxpayer, intention is not a test or guideline

in its own right. It should rather be viewed as a fundamental or underlying factor to be applied when considering the other three guidelines discussed below.

2.3 The guideline of realisation of capital assets at enhanced values

In *Bloch v SIR* (42 SATC 7) Vos J described capital as something which is held with an element of permanency and with the object that it should produce an economic utility for the holder.

In *CIR v Visser* (8 SATC 271) it was held that 'income' is what 'capital' produces, or is something in the nature of interest or fruit as opposed to principal or tree. The rule is thus fairly simple, namely that income (or fruit) is produced by an income-producing asset (or tree) and that such income is of a revenue nature, while the income-producing asset is of a capital nature (Huxham & Haupt, 2013:43).

It has been held that a taxpayer is entitled to realise an asset to his or her best advantage without having to pay income tax on the profit obtained (*CIR v Stott* 3 SATC 253). In *CIR v Middelman* (52 SATC 323) it was held that just as an occasional swallow does not make a summer, so an occasional sale of shares yielding a profit does not of itself make a seller of shares a dealer therein, liable to be taxed on such profit.

The intention of a taxpayer is an important factor in applying this guideline. Where a taxpayer's intention is to hold a share as an investment which earns dividend income, the share constitutes a capital asset and the disposal of such an asset at an enhanced value will give rise to a receipt of a capital nature. However, where the intention is to generate a profit on disposal, the profit will be 'the fruit' and is income of a revenue nature.

2.4 The business guideline

The business guideline developed from *COT v Booysen's Estate Ltd* (32 SATC 10) when De Villiers quoted from *Californian Copper Syndicate v Inland Revenue* (41 S.L.R. 691). Lord Justice Clerk held in the latter case that the line which

separates the two classes of cases (capital or revenue) may be difficult to define and each case must be considered according to its own facts. The question to be answered being, is the sum of the gain that has been made a mere enhancement of value by realising security, or is it a gain made by an 'operation of business in carrying out a scheme for profit-making'.

The business guideline thus provides that a receipt is revenue in nature where it is received as part of an operation of business in carrying out a scheme for profit-making.

The following two characteristics of the business guideline must be highlighted:

- The business guideline includes both the 'carrying' on of a business, as well as an 'operation' of business. As a general rule, one or two isolated transactions cannot be described as the 'carrying' on of a business but there are exceptions where a single undertaking might be of such a nature that it can be correctly described as a 'business' (*CIR v Stott* (3 SATC 253)). In order to be 'carrying' on a business, some continuity is therefore required, or rather a series of transactions, while an 'operation' of business refers to a single transaction. Although a taxpayer does not need to be carrying on a business, he or she can still be taxed on a transaction (one or more), which has the character of a normal business transaction.

- A profit-making purpose is a specific requirement of the business guideline. In *CIR v Pick 'n Pay Employee Share Purchase Trust* (54 SATC 271) Smallberger JA held that, irrespective of the number of transactions, whether the receipts that flow from the carrying on of a business are revenue, also depends on whether the business was conducted with a 'profit-making' purpose as part of a profit-making venture or scheme. It was held that receipts bear the imprint of revenue if they are not fortuitous, but designedly sought for and worked for.

The proceeds derived from the sale of shares will thus be taxable as income of a revenue nature when a share dealer is carrying on a business, or if the taxpayer enters into a transaction which has the character of a normal business transaction and the purpose of the transaction is to make a profit.

Although not individually decisive and the list not exhaustive, in *Natal Estates Ltd v SIR* (37 SATC 193) it was held that the following are important considerations in evaluating the business guideline:

- The intention of the owner, both at the time of buying the asset and when selling it. In this regard, the activities of the owner in relation to the asset up to the time of deciding to sell can shed light on the owner's *ipse dixit* as to his or her intention;
- The objects of the owner, if a company. Where the primary object of a share dealing company is to buy and sell shares in order to make a profit, it can be accepted that the income earned will be revenue in nature. The secondary object of a company has also been regarded as the business of the company. In *African Life Investment Corporation (Pty) Ltd v SIR* (31 SATC 163), it was held that the dealing in shares was a secondary object of the appellant and therefore part of the appellant's business. It was held that in this case there was not a dominant purpose into which the regular dealing in shares was absorbed as a merely incidental activity;
- The ordinary commercial concept of carrying on a business for profit. It was held in *SIR v The Trust Bank of Africa Ltd* 37 SATC 87 that commercial considerations such as the objects of the company, the business nature of its transactions and the businesses carried on by companies in the same industry may assume greater significance than the intention with which shares are acquired. Although a share dealer in the investment industry can thus acquire and hold shares of a capital nature, the probabilities are heavily in favour of the view that the shares would constitute the trading stock of his business (*'B' Company Investments Ltd v COT* 27 SATC 81).

The court concluded in *Natal Estates Ltd v SIR* (37 SATC 193) that from the totality of the facts of each case one enquires whether it can be said that the owner has crossed the Rubicon and commenced a business of selling such asset for profit, using the asset as his or her stock-in-trade.

Where it is therefore a share dealer's business to buy and sell shares for profit using the shares as trading stock, the intention and nature of the transactions concluded with a profit-making purpose, are all indicative that the proceeds derived from the disposal of shares is taxable as income of a revenue nature.

2.5 The scheme of profit-making guideline

In *CSARS v Wyner* (66 SATC 1) the Supreme Court of Appeal held that the profit made by a taxpayer when she sold her house, was taxable as it was a scheme of profit-making as described in *Elandsheuwel Farming (Edms) Bpk v SBI* (39 SATC 163).

Corbett JA held in his minority view in *Elandsheuwel Farming (Edms) Bpk v SBI* (39 SATC 163) that where a taxpayer sells property, the question as to whether the profits derived from the sale are taxable or not, turns on the enquiry as to whether the sale amounted to the realisation of a capital asset or whether it was the sale of an asset in the course of carrying on a business or 'in pursuance of a profit-making scheme'. Judge Corbett specifically noted that where a single transaction is involved, it is usually more appropriate to limit the enquiry to the simple alternatives of a capital realisation or a profit-making scheme. In its normal and most straightforward form, the latter connotes the acquisition of an asset for the purpose of reselling it at a profit. This profit is then the result of the productive turn-over of the capital represented by the asset and consequently falls into the category of income of a revenue nature.

The scheme of profit-making guideline does not require that a transaction should bear the imprint of a 'business' transaction. Specific circumstances in *CSARS v Wyner* (66 SATC 1) were the fact that the taxpayer sold the property 12

months after buying it, bridging finance was obtained for only a limited period of 12 months and her intention from the start was to sell the property after acquisition. Although the transaction did not have the character of a normal business transaction, the court held that the profit was still taxable. It was not necessary that the taxpayer be characterised as a trader (*CSARS v Wyner* (66 SATC 1).

Similar to the business guideline, objective factors are collectively an indication of a profit-making scheme. A point is reached where a taxpayer's share disposals become so numerous, the amount of money so large, the duration of time during which the shares are held so short and the pursuit of dividends so negligible a factor, that the taxpayer must be regarded as having embarked on a profit-making scheme in the buying and selling of shares (De Koker & Williams, 2013:3.42).

A scheme of profit-making will thus render share proceeds to be revenue in nature.

2.6 Conclusion

The four guidelines developed by our tax courts which apply to share disposals are the intention of the taxpayer, the guideline of realisation of capital assets at enhanced values, the business guideline and the scheme of profit-making guideline.

The business guideline requires an operation of business in carrying out a scheme for profit-making. The scheme of profit-making guideline does not require the business characteristics of the business guideline.

Share dealing profits which are therefore designedly sought for and worked for, either as part of a business operation or not, are of a revenue nature and taxable. If applied correctly, the above guidelines will ensure that the receipts are taxed correctly as either capital or revenue. Each set of facts is however unique and it is important that all the surrounding circumstances are established before applying any of the guidelines.

Chapter 3 considers the availability of an income tax deduction in terms of section 11(a) of the Act for shares acquired by a share dealer as trading stock. The special provisions in section 22 of the Act for the taxation of trading stock are then also investigated in order to determine the correct interaction of sections 9B and 9C of the Act, discussed in Chapter 4, with the Eighth Schedule of the Act discussed in Chapter 5.

CHAPTER 3

INCOME TAX TREATMENT OF TRADING STOCK IN TERMS OF SECTIONS 11(a) AND 22 OF THE ACT

3.1 Introduction

It is concluded in Chapter 2 that the proceeds from the disposal of shares by a share dealer are included in his gross income as income of a revenue nature.

The shares held on revenue account therefore qualify as trading stock for the share dealer as the definition of 'trading stock' in section 1 of the Act includes *inter alia* anything purchased or in any other manner acquired by a taxpayer for the purposes of sale by him or her or on his or her behalf, or anything the proceeds from the disposal of which forms or will form part of his or her gross income.

In this chapter:

- The deductibility of trading stock in terms of the general deduction formula provided for in section 11(a) of the Act is discussed.
- The special provisions in section 22 of the Act for the valuation and taxation of trading stock are examined. The income inclusion provision for the value of closing trading stock in section 22(1) of the Act is first examined. Opening trading stock is then considered due to the fact that an income tax deduction is claimable in terms of section 22(2) of the Act for the prior year's closing trading stock value which was included in income.
- The different allowable methods of identification of shares held as trading stock are considered and evaluated. The allowable methods are discussed with reference to the generally accepted accounting practice ('GAAP') of trading stock.
- The application of the weighted average (WA) method of identification in calculating the cost of closing trading stock is analysed. The reason for the

emphasis on this method is that practical experience has showed that share dealers, due to its lesser administrative burden, often apply the WA method of identification.

3.2 General deduction formula in section 11(a) of the Act

Section 11(a) of the Act provides that, for the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived, expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.

In order to determine whether a share dealer qualifies for an income tax deduction for the acquisition expenditure of shares, the following requirements should be met:

- Firstly, a share dealer must be carrying on a trade. 'Trade' is widely defined in section 1 of the Act and includes every profession, trade, business, employment, calling, occupation or venture. It is submitted that as the share dealing profits of a share dealer are designedly sought for and worked for, the requirements of a 'trade' as either a business or venture are met.
- The second requirement of 'expenditure or losses actually incurred' is met once a share dealer has paid for the acquisition of the shares or incurred an unconditional obligation to pay for the acquisition of the shares.
- The third requirement is 'in the production of income'. As already established, the proceeds from the disposal of shares held on revenue account are included in a share dealer's gross income and the third requirement is therefore met.
- The final requirement is that the expense should not be 'of a capital nature'. It was held in *CIR v George Forest Timber Company Limited* (1 SATC 20) that the proceeds of merchandise sold in the course of a trade are not

receipts of a capital nature and similarly the cost of merchandise sold is also not an outgoing of a capital nature. The cost is incurred in producing the income. As the acquisition expenditure of shares is incurred by a share dealer in the production of income, the expenditure is also deductible.

The tax consequences of a share dealer are best explained in this study by way of the following illustrative example which will be used in this chapter as well as in the rest of this study:

Mr X is a natural person who is a dealer in shares. He bought 60 ABC listed shares in year one for R2 a share, 40 ABC shares in year three for R3 a share and 20 ABC shares in year four for R6 a share. In year eight he bought a further 80 ABC shares for R13 a share. He then disposes of 180 ABC shares in year 10 for R10 a share. The example is summarised in Table 1 below.

TABLE 1: ILLUSTRATIVE EXAMPLE

Year	Description	Number of shares	Price/share R	Expenditure R	Proceeds R
1	Buy	60	2	120	
3	Buy	40	3	120	
4	Buy	20	6	120	
8	Buy	80	13	1 040	
10	Sell	180	10		1 800

Due to the fact that Mr X is a share dealer, the shares qualify as trading stock in his hands. Mr X will qualify for section 11(a) income tax deductions for the R120 expenditure actually incurred in each of year one, three and four respectively, while a R1 040 income tax deduction is claimed in year eight.

It is therefore concluded that the expenditure actually incurred by a share dealer in acquiring shares as part of his or her trading stock is deductible in terms of section 11(a) of the Act since all the requirements are met. Special provisions are

however contained in section 22 of the Act regarding the valuation and taxation of trading stock. These provisions are investigated in more detail below.

3.3 Special trading stock provisions in section 22 of the Act

3.3.1 Closing trading stock held on year end

Section 22(1) of the Act provides that, in the determination of taxable income from carrying on a trade, the amount to be taken into account by a taxpayer in respect of the value of trading stock held and not disposed of by him or her at the end of a year of assessment, shall be the cost price to such person of such trading stock. Although not expressly provided in section 22(1) of the Act, it has been held that the effect of section 22(1) is that the value of closing trading stock must be included in taxable income (*Richards Bay Iron and Titanium (Pty) Ltd v CIR* 1996 1 SA 311, *CIR v Nemojim (Pty) Ltd* 1983 4 SA 935).

In terms of section 22(3)(a)(i) of the Act, the cost price for the purpose of section 22(1) shall be the actual cost incurred by such person, whether in the current or any previous year of assessment in acquiring such trading stock, plus, any further costs incurred by him or her in getting such trading stock into its existing condition and location. Section 22(3)(b) of the Act, however, limits such further costs to costs which in terms of GAAP should be included in the valuation of such trading stock.

The cost price may, in terms of section 22(1)(a) of the Act, be reduced by the Commissioner as he may think just and reasonable for the amount by which the value of such trading stock has been diminished by reason of damage, deterioration, change of fashion, decrease in market value or for any other satisfactory reason. With effect from the commencement of years of assessment commencing on or after 1 January 2011, no reduction in cost price is allowed for taxpayers holding ‘financial instruments’ as trading stock (SA, 2010b:70). Previously, only companies were not allowed to reduce the cost price of shares.

In terms of paragraph (b) of the section 1 definition of 'financial instrument', a financial instrument includes *inter alia* any stock, share, participatory interest in a portfolio of a collective investment scheme or similar instrument. No reduction in cost price is thus allowed where the trading stock constitute shares.

Assuming the market value of the ABC shares has not fallen below their cost prices, if section 22(1) of the Act is applied to the example in Table 1, the following amounts must be included in the taxable income of Mr X as closing trading stock:

- In year one an amount of R120;
- In year three an amount of R240 (R120 + R120);
- In year four an amount of R360 (R120 + R120 + R120); and
- In year eight an amount of R1 400 (R120 + R120 + R120 + R1 040).

The different methods of identification, which is discussed in 3.4 below, result in different amounts to be included in income in year 10 after the first disposal has occurred (see also Table 3 in 4.4 for a comparison of the different methods of identification).

The effect of the section 22(1) income inclusion is therefore to counter the section 11(a) deduction until the year of assessment when the shares are disposed of.

3.3.2 Opening trading stock held at the beginning of the year

Section 22(2) of the Act provides for an income tax deduction in respect of the value of any trading stock held and not disposed of by a taxpayer at the beginning of any year of assessment. The deduction is, however, only available if such trading stock formed part of the trading stock of such person at the end of the immediately preceding year of assessment, and the deduction is equal to the amount which was taken into account, in terms of section 22(1) of the Act, in respect of the value of such trading stock at the end of such preceding year of assessment.

Therefore, if section 22(2) of the Act is applied to the example in Table 1, an amount of R120 should be deducted from the taxable income of Mr X in year two, R240 in year four, R360 in year five and R1400 in year nine.

The combined effect of the section 11(a) deduction, section 22(1) closing trading stock income inclusion and section 22(2) opening trading stock deduction is summarised in Table 2 in 3.5 below.

3.4 Methods of identification of trading stock

Section 22(3)(a)(i) of the Act provides that the cost price for the purpose of section 22 shall be the actual cost incurred by such person, whether in the current or any previous year of assessment in acquiring 'such' trading stock. Where shares are acquired on different dates and at different costs, it must be determined what the cost of 'such' trading stock held on year end is. The method of identification of shares therefore requires closer investigation.

Section 22(5) of the Act provides that no person may for the purpose of determining the cost price of any trading stock, adopt the basis of trading stock valuation whereunder the last item of any class of trading stock acquired by him or her on any date is deemed to be the first item of that class of trading stock disposed of by him or her on or after that date. Stated differently, a share dealer is not allowed to apply the last-in-first-out (LIFO) method of identification in determining the cost price of closing trading stock.

Except where the LIFO method is applied for accounting purposes, the method of identification applied in terms of GAAP could also be acceptable for purposes of section 22 of the Act. Reference is also made in section 22(3)(b) of the Act to GAAP in determining the further costs associated with trading stock. An enquiry into the accounting standards is therefore necessary.

The international accounting standards 2 (IAS 2) and 39 (IAS 39) provide the accounting rules for trading stock. IAS 2 (Inventories) contains the rules for the general accounting of inventory, while IAS 39 (Financial instruments: Recognition

and measurement) deals with the recognition and measurement of financial instruments.

IAS 2.23 to 2.27 (IFRS, 2012:A605) provide three different methods for the purpose of assigning costs to items of inventory. The specific identification (SPID) method attributes specific costs to identifiable items of inventory. It is the most accurate method of costing since the cost of each item is based on the actual costs that have been incurred in its purchase. According to IAS 2.27, the underlying assumption of the FIFO method is that items of inventory that are purchased first are sold first. Items remaining in inventory at the end of the period are thus those most recently purchased. Under the WA method, the cost of each item is determined from the weighted average of the cost of similar items at the start of a period and the cost of similar items purchased during the period (IAS 2.27). The expenditure is therefore divided equally among all items. According to IAS 2.25, an entity should use the same method of identification for all inventories that have a similar nature and use to the entity.

In terms of IAS 2.2(b) (IFRS, 2012:A601), IAS 2 does not apply to financial instruments such as shares. However, IAS 39 does not provide guidance on the cost measurement basis for calculating gains or losses upon disposal of shares. Consideration may thus be given to other known methods of cost measurement such as the guidelines provided for in IAS 2. Support for this view is found in IAS 8 (Accounting Policies, Changes in Accounting Estimates and Errors). IAS 8.10 (IFRS, 2012:A637) provides that in the absence of an accounting statement that specifically applies to a transaction, management shall use its judgement in developing and applying an accounting policy that result in information that is relevant to the economic decision-making needs of users and represent financial statements reliably.

IAS 8.12 (IFRS, 2012:A637) also provides that in making the judgement, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices.

In this regard, the United States of America GAAP implicitly permits the use of the SPID, WA or some other method for the accounting of realised gains and losses (FAS115, 1993:10).

In practice, share dealers may thus opt as an accounting policy choice for any one of the SPID, FIFO or WA methods of identification (PwC, 2012:9012). Any of these methods of identification can then also be applied for purposes of applying section 22 of the Act.

3.5 Weighted average method of identification

Practical experience has showed that the WA method is often applied by share dealers. This is due to the fact that the WA method of identification is less complicated in its calculation because share expenditure is divided equally among all shares. The WA method also imposes a lesser administrative burden on accounting systems by not requiring the recordkeeping of the full share transaction history required for the FIFO or SPID methods of identification.

If the WA method of identification is applied to the example in Table 1, Mr X's taxable income for each year of assessment is summarised in Table 2 below (at this stage of the study it is assumed that sections 9B and 9C of the Act do not apply).

TABLE 2: CALCULATION OF TAXABLE INCOME IN TERMS OF THE WA METHOD OF IDENTIFICATION (BEFORE APPLYING SECTIONS 9B AND 9C OF THE ACT)

	Taxable income
Year 1	
Section 11(a) deduction	- R120
Section 22(1) inclusion: WA cost = 60 shares x R2 [R120 ÷ 60]	R120
Taxable income	-

Year 3	
Section 22(2) deduction	- R120
Section 11(a) deduction	- R120
Section 22(1) inclusion: WA cost = 100 shares x R2.4	R240
[(R120 + R120) ÷ (60 + 40)]	
Taxable income	-
Year 4	
Section 22(2) deduction	- R240
Section 11(a) deduction	- R120
Section 22(1) inclusion: WA cost = 120 shares x R3	R360
[(R240 + R120) ÷ (100 + 20)]	
Taxable income	-
Year 8	
Section 22(2) deduction	- R360
Section 11(a) deduction	- R1 040
Section 22(1) inclusion: WA cost = 200 shares x R7	R1 400
[(R360 + R1040) ÷ (120 + 80)]	
Taxable income	-
Year 10	
Section 22(2) deduction	- R1 400
Gross income: 180 shares x R10	R1 800
Section 22(1) inclusion: 20 shares x R7	R140
[(R1 400 – (180 x R7)) ÷ (200 - 180)]	
Taxable income: WA profit [(R10 - R7) x 180]	R540

Where shares bought more recently have higher cost prices than shares held for longer periods, applying the WA method of identification results in an increase in the WA cost of the shares. This is illustrated in Table 2 above where the WA cost of the shares sold in year 10 is R1 260 (R180 x R7) resulting in a tax profit of R540. With the FIFO method, where shares bought first are sold first, the result is a tax profit of R660 [(180 x R10) – (60 x R2) – (40 x R3) – (20 x R6) – (60 x R13)]. The WA profit is therefore lower than the FIFO profit in the current instance.

If the remaining 20 shares are disposed of in year 11 for also R10 per share, the profit in year 10 under the WA method will be R60 [(20 x R10) – (20 x R7)]. With the FIFO method there will be a loss of R60 [(20 x R10) – (20 x R13)]. The combined profit of year 10 and 11 will thus be R600 under both methods, but the WA method provides a lower profit on the first disposal. The profits are thus deferred under the WA method of identification until the last shares are disposed of.

3.6 Conclusion

It is concluded in this chapter that the expenditure actually incurred by a share dealer in acquiring shares as part of his or her trading stock is deductible in terms of section 11(a) of the Act since all the requirements are met. The section 11(a) deductions are however countered by the section 22(1) income inclusions until the year of assessment in which the share dealer disposes of the shares.

In order to determine the cost price of shares for purposes of section 22(1) of the Act, the method of identification of shares held as trading stock is an important consideration.

The method of identification applied in terms of GAAP is also acceptable for purposes of section 22 of the Act. In practice share dealers may choose any of the SPID, FIFO or WA methods of identification as an accounting policy. These methods can therefore also be applied for purposes of section 22 of the Act.

The WA method of identification is applied in practice more frequently. In an increasing equity market, where shares bought more recently have higher costs, the taxable profits under the WA method is partially deferred until the last shares are disposed of.

In Chapter 4, the application of the abovementioned methods of identification is further analysed for circumstances where a share dealer has elected for the application of section 9B of the Act or where section 9C of the Act applies.

CHAPTER 4

DEEMED CAPITAL TREATMENT IN TERMS OF SECTIONS 9B AND 9C OF THE ACT

4.1 Introduction

The determination of the capital or revenue nature of a profit on the disposal of a share remains a contentious subject (SA, 2010a:1). This is despite the guidelines laid down by case law as discussed in Chapter 2.

Section 9B of the Act was inserted in 1990 to provide a so-called 'safe haven' for affected shares listed on the JSE (SA, 2010a:1). Although the section provided a degree of certainty on the disposal of affected shares, it required further refinement. Section 9C of the Act was thus promulgated on 8 January 2008 and applies to qualifying shares disposed of on or after 1 October 2007 (SA, 2007b:22) while section 9B only applies to disposals prior to that date.

Although sections 9B and 9C do not specifically refer to share dealers, these two sections are in principle aimed at share dealers who hold shares on revenue account (De Koker & Williams, 2013:17.25A&B).

In this chapter:

- The definition of 'affected share' in section 9B of the Act, as well as the provisos to this definition and the required election by a share dealer, is discussed.
- The definition of a 'qualifying share' in section 9C of the Act and its wider scope of application, compared to section 9B, are examined.
- The application of the seemingly prescribed FIFO method of identification in sections 9B(7) or 9C(6) of the Act is analysed with reference to an illustrative example.

- The income inclusion provision in sections 9B(6) or 9C(5) of the Act, which provides for the recoupment of previous deductions, is considered in conjunction with section 22 of the Act. Different interpretations of the interaction of the WA method of identification, applied for purposes of section 22 of the Act, with the prescribed FIFO method of identification are also illustrated.

4.2 Affected share in section 9B of the Act

In terms of section 9B(1) of the Act, an 'affected share' in relation to any taxpayer, means:

- a listed share in a company as contemplated in paragraph (a) of the definition of 'listed company' in section 1 of the Act;
- which has been disposed of before 1 October 2007;
- by a taxpayer who immediately prior to such disposal had been the owner of such share as a listed share for a continuous period of at least five years.

When section 9B of the Act was initially inserted in 1990, the definition of affected share referred to a holding period of 10 years. This period was shortened in 1992 to a period of five years.

An affected share only includes a share. According to issue 2 of Interpretation Note 43 (SA, 2010a:4), which applies to section 9B of the Act, 'share' should be given its ordinary meaning and a preference share can thus also fall within the definition of an affected share.

An affected share is also only a listed share in a company as contemplated in paragraph (a) of the definition of 'listed company' in section 1 of the Act. In terms of this definition, a 'listed company' refers to a company whose shares are listed on an 'exchange' as defined in section 1, and licensed under section 10, of the Securities Services Act (No. 36 of 2004). 'Exchange' is defined in section 1 of this

act (2004:13) as a person who constitutes, maintains and provides an infrastructure:

- for bringing together buyers and sellers of securities,
- for matching the orders for securities of multiple buyers and sellers, and
- whereby a matched order for securities constitutes a transaction.

At present in South Africa, the only exchange which has been licensed under section 10 of the Securities Services Act (No. 36 of 2004), is the Johannesburg Stock Exchange (JSE) (SA, 2010a:4). Section 9B therefore only applies to shares in companies listed on the JSE. Investments in assets such as debentures, bonds and participatory interests in collective investment schemes do not qualify as affected shares.

The share must have been held as a listed share for at least a continuous period of five years. It is important to note that when listed shares that have not been held for five years, are disposed of, the proceeds will not summarily be subjected to tax on revenue account. The guidelines which have been developed by the South African tax courts and which were discussed in Chapter 2, still need to be applied in determining whether these shares are revenue in nature.

There are four provisos to the definition of 'affected share' in section 9B(1) of the Act:

- The first proviso stipulates that where any other share is issued to a share dealer by the company in which he or she holds such share in substitution for such share, or where any capitalisation share is issued by such company to a share dealer, such share and such other share or capitalisation share shall be deemed to be one and the same share (section 9B(1)(b) of the Act). A share dealer's participation rights and interest in such company should however remain unaltered and no consideration should pass from the share dealer to the company in relation to the issue, for the proviso to apply.

- In terms of the second proviso, a share dealer shall be deemed to have disposed of a share if the share has been cancelled or redeemed or if the relevant company has been liquidated or deregistered (section 9B(1)(c) of the Act).

- Where a share dealer is a registered insurer in terms of the Insurance Act (No. 27 of 1943), and has acquired a share in accordance with a transfer of insurance business as contemplated in section 25A of this act from another insurer who carried on long-term and short-term insurance business, both such insurers shall be deemed to be one and the same insurer (third proviso in section 9B(1)(d) of the Act). As the Insurance Act (No. 27 of 1943) has been repealed, it is submitted that this proviso be amended to rather refer to section 37 the Long-term Insurance Act (No. 52 of 1998) and section 36 of the Short-term Insurance Act (No. 53 of 1998).

- The fourth proviso stipulates that where shares are lent by a lender to a borrower in terms of a 'securities lending arrangement' as defined in section 1 of the Act, the lender will be deemed not to have disposed of the shares, while the shares lent and the same kind of shares received back from the borrower, will be deemed to be one and the same in the hands of the lender (section 9B(1)(e) of the Act).

Where a share dealer disposes of an affected share, he or she may elect in terms of subsections (2) and (3) of section 9B of the Act that any amount received or accrued as a result of the disposal, be deemed to be of a capital nature for purposes of the definition of 'gross income' in section 1 of the Act.

According to issue 2 of Interpretation Note 43 (SA, 2010a:7), the section 9B election is a once-off election and a share dealer is not allowed to make a re-election in the years thereafter. This prevents share dealers from making the election on share profits in one year and then still being able to claim income tax losses in subsequent years.

The argument could be made that any taxpayer holding listed shares on capital account has no need for a section 9B election. However, where a taxpayer previously disposed of shares held for longer than five years on capital account and did not make the section 9B election in the annual tax return, the once-off opportunity for election is lost. This means that when a taxpayer subsequently disposes of shares held for longer than five years on revenue account, the taxpayer will not have the opportunity on the subsequent disposal to make the section 9B election. This is because the first disposal on capital account also constituted 'affected shares', and by not making an express election in the annual tax return, it effectively constituted a negative election for purposes of section 9B of the Act.

Where a share dealer disposes of a JSE listed share and he or she was the owner of the share as a listed share for five years prior to the disposal, then the share will be an 'affected share' for purposes of section 9B of the Act. Once an election is made, all affected shares must be treated in terms of section 9B. The proceeds received on the disposal of affected shares are then deemed to be of a capital nature.

4.3 Qualifying share in section 9C of the Act

Section 9C of the Act applies to a 'qualifying share' but the effect of the section is similar to section 9B of the Act

A 'qualifying share', in relation to any taxpayer, is defined in section 9C(1) of the Act and means an equity share which has been disposed of by a taxpayer or which is treated as having been disposed of by a taxpayer in terms of paragraph 12 of the Eighth Schedule of the Act, if the taxpayer immediately prior to such disposal had been the owner of that share for a continuous period of at least three years, excluding a share which at any time during that period was:

- a share in a share block company as defined in section 1 of the Share Blocks Control Act (No. 59 of 1980);

- a share in a company which was not South African tax resident, other than a JSE listed company contemplated in paragraph (a) of the definition of 'listed company'; or
- a hybrid equity instrument as defined in section 8E of the Act.

An 'equity share' is defined in section 9C(1) of the Act and includes a participatory interest in a portfolio of a collective investment scheme in securities as contemplated in Part IV of the Collective Investment Schemes Control Act (No. 45 of 2002), managed or carried on by any company registered as a manager under section 42 of that act. 'Equity share' is also defined in section 1 of the Act and means any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution.

An equity share in a non-resident company is specifically excluded from the definition of a qualifying share, except if the non-resident company is listed on the JSE. In terms of the 'resident' definition in section 1 of the Act, a company is tax resident in South Africa (except for certain exclusions) if it is incorporated, established or formed in South Africa or has its place of effective management in South Africa.

Qualifying shares therefore include:

- ordinary shares listed on the JSE (resident and non-resident companies);
- ordinary unlisted resident company shares and interests in close corporations; and
- participatory interests in a portfolio of a South African collective investment scheme in securities.

More asset classes are thus included within qualifying shares in section 9C of the Act compared to affected shares in section 9B, which only include shares listed on the JSE. Section 9C of the Act therefore has a wider scope of application.

Section 9C does not apply to shares which at any time during that three-year period were:

- hybrid equity instruments as defined in section 8E of the Act;
- interests in share block companies;
- shares in unlisted non-resident companies;
- shares in non-resident companies listed on foreign stock exchanges;
- participatory interests in collective investment schemes carried on outside South Africa; and
- Preference shares that do not meet the definition of equity shares. According to a response document issued by National Treasury to the 2007 Revenue Laws Amendment Bill (SA, 2007a:14) preference shares that have no participating stake in underlying profits are in many ways more akin to debt than equity, and section 9Cof the Act will not apply to these types of preference shares.

A qualifying share in section 9C of the Act only require a three-year holding period and unlike section 9B, which is elective, section 9C applies automatically. Although not the focus of this study, special rules apply to venture capital company shares (section 9C(2A)), connected person transactions (section 9C(3)), securities lending arrangements (section 9C(4)) and share substitutions or conversions (section 9C(8)).

In terms of section 9C(2) any amount other than a dividend or foreign dividend received by or accrued to a taxpayer in respect of the disposal of a qualifying share shall therefore automatically be deemed to be of a capital nature.

It is important to note that section 9C (and previously section 9B) does not change the purpose for which the shares were acquired by the share dealer. It merely provides that when the qualifying shares are disposed of, the proceeds will be 'deemed' to be of a capital nature. Shares held as trading stock for longer than 3 years, but not yet disposed of, therefore remain to be treated as trading stock in terms of section 22 of the Act.

4.4 FIFO method of identification in determining which shares have been disposed of

Section 9B(7) of the Act provides that where a share dealer holds affected shares in any company which were acquired by him or her on different dates and he or she has disposed of any of those shares, he or she shall, for the purposes of section 9B of the Act, be deemed to have disposed of the affected shares held by him or her for the longest period of time.

Due to the reference 'any company' in section 9B(7) it is submitted that shares in different companies should be determined or identified separately.

At first glance, the purpose of section 9B(7) of the Act, it seems, is to ensure that the oldest affected shares are sold first. However, on a close reading of the subsection, this is not what the subsection provides. Section 9B(7) of the Act only deems the oldest shares to be disposed of – full stop. It is submitted, however, that the legislator could not have intended that only the oldest share should be deemed to be sold and not any of the other affected shares as well.

A further uncertainty relates to the seemingly prescribed FIFO method of identification. Practice Note 18 (SA, 1993:4) and issue 2 of Interpretation Note 43 (SA, 2010a:8), which replaced Practice Note 18, interpret section 9B(7) as the application of a FIFO method of identification to determine whether a listed share has been held for the qualifying period of five years.

In order to examine the prescribed FIFO method of identification in section 9B(7), the application of the different methods of identification allowable in terms of section 22 of the Act in the illustrative example in Table 1 of Chapter 3, is illustrated in Table 3 below.

TABLE 3: CLOSING TRADING STOCK VALUES UNDER DIFFERENT METHODS OF IDENTIFICATION

Year	Description	Number of shares	Price/share R	Expenditure R	Proceeds R
1	Buy	60	2	120	
3	Buy	40	3	120	
4	Buy	20	6	120	
8	Buy	80	13	1 040	
10	Sell	180	10		1 800
		20		1 400	1 800
Section 22(1) closing trading stock values under the different methods of identification:					
FIFO method		20	13	260	
WA method (R1 400/200)		20	7	140	

Based on the example provided in issue 2 of Interpretation Note 43 (SA, 2010a:9), in applying the FIFO method of identification, in year 10 Mr X will be deemed to first dispose of the 60 shares bought in year one, then the 40 shares bought in year three, the 20 shares bought in year four and then 60 of the 80 shares bought in year eight. 120 of the 180 shares will then have been held for longer than five years.

By electing for section 9B of the Act to apply, R1 200 (120 shares x R10) of the proceeds received on the disposal of the 180 shares will be deemed to be of a capital nature, being the proceeds received for the 120 shares older than five years, while R600 (60 shares bought in year 8 x R10) will be included in gross

income. The closing trading stock will consist of the remaining 20 shares acquired in year eight at R13 per share.

A close reading of the reference to 'affected shares' in section 9B(7) of the Act could suggest that the FIFO method is not used to determine whether the shares are affected shares, but rather that the FIFO method should be applied to the disposal of any affected shares which were acquired on different dates.

An alternative two-step identification approach for purposes of section 9B(7) could then be:

- The method of identification applied for purposes of section 22 of the Act should first be applied in order to determine whether affected shares (which are those listed shares older than five years) have been disposed of.
- Once the affected shares have been identified, the FIFO method of identification must be applied only to the affected shares.

It is however submitted that it was the intention of the legislator that the FIFO method should be applied to both steps and not just once the affected shares have been identified. This intention is supported by issue 2 of Interpretation Note 43 (SA, 2010a:9).

Interpretation notes (previously referred to as 'practice notes') do however not have the force of law unless they set out how the Commissioner intends exercising discretion the Act grants him or her. Aside from notifying taxpayers how the Commissioner's discretion is to be exercised, interpretation notes merely set out SARS's interpretation of the law and may be challenged by taxpayers who disagree with the particular interpretation in any interpretation note (Huxham & Haupt, 2013:14).

Section 9C(6) of the Act provides that where a share dealer holds identical shares in the same company which were acquired by the share dealer on different dates and the share dealer has disposed of any of those shares, the share dealer shall

for purposes of section 9C of the Act be deemed to have disposed of the shares held by him for the longest period of time.

Due to the fact that the reference to ‘affected shares’ in section 9B(7) is now replaced by ‘identical shares in the same company’ in section 9C(6) of the Act, the alternative two-step identification approach discussed above for section 9B(7) is no longer possible under section 9C(6) of the Act. The FIFO method should be applied to all the identical shares in the same company and not only the affected shares.

The FIFO method of identification should thus be applied in terms of sections 9B(7) or 9C(6) of the Act to determine whether an affected or qualifying share has been disposed of.

Once the affected or qualifying shares are identified, it is necessary to determine the costs that were previously deducted in relation to such shares for income tax purposes. This is required in order to apply the income inclusion provisions in sections 9B(6) or 9C(5) of the Act.

4.5 Income inclusion provisions in sections 9B(6) or 9C(5) of the Act

The income inclusion provisions contained in sections 9B(6) or 9C(5) of the Act provides for the recoupment of previous income tax deductions.

Section 9B(6) of the Act provides that where a share dealer has elected that the provisions of section 9B shall apply to him or her, there shall in the year of assessment in which he or she disposes of any affected share, be included in his or her income:

- any expenditure or losses (excluding so much of any such expenditure or losses as may be allowable as a deduction in the determination of the taxable income derived by the taxpayer from dividends) incurred in respect of such affected share and allowed as a deduction from the income of such share dealer during such or any previous year of assessment; and

- any amount allowed to be deducted from the cost price of such affected share under the provisions of section 22(1) of the Act in any such year.

Section 9C(5) of the Act similarly provides that there shall, in the year of assessment in which any qualifying share is disposed of by the share dealer, be included in the share dealer's income any expenditure or losses incurred in respect of such qualifying share and allowed as a deduction from the income of the share dealer during that or any previous year of assessment in terms of section 11 of the Act. Section 9C(5) must however not apply in respect of any expenditure or loss to the extent that the amount of that expenditure or loss is already taken into account in terms of section 8(4)(a) or section 19 of the Act.

As the proceeds received on the disposal of an affected or qualifying share are deemed to be of a capital nature and excluded from gross income, any acquisition expenditure incurred and already deducted in respect of the affected or qualifying shares must therefore be included in a share dealer's income to neutralise the previous deduction.

In order to determine which expenditure was allowed as a deduction, it is necessary to first identify which shares were disposed of. The income tax treatment of such shares in terms of sections 11(a) and 22 of the Act must then be determined.

The following affected or qualifying shares were disposed of in Table 3 by applying the FIFO method of identification:

TABLE 4: AFFECTED OR QUALIFYING SHARES DISPOSED OF IN TERMS OF THE FIFO METHOD OF IDENTIFICATION

Year	Description	Number of shares	Price/share R	Expenditure R
1	Buy	60	2	120
3	Buy	40	3	120
4	Buy	20	6	120
		120		360

Although the actual cost of the 120 shares is R360 in Table 4, the WA cost in Table 3 is R840 (120 shares x R7) in year 10. It should thus be considered whether the income inclusion in sections 9B(6) or 9C(5) of the Act is R360 or R840 in year 10.

Section 9B(6) of the Act refers to expenditure or losses incurred in respect of 'such affected share' and allowed as a deduction from the income of such share dealer during 'such or any previous year' of assessment. Section 9C(5) similarly refers to expenditure or losses incurred in respect of 'such qualifying share' and allowed as a deduction from the income of the share dealer during 'that or any previous year' of assessment in terms of section 11.

The amount of the income inclusion should thus be determined by establishing which income tax deductions were claimed in years one to 10 up to the date of disposal, for the 120 affected or qualifying shares. Table 5 below illustrates the extent of income tax deductions by splitting the 180 ABC shares between the 120 affected or qualifying shares and the 60 other shares.

TABLE 5: ILLUSTRATION OF INCOME TAX DEDUCTIONS CLAIMED

		Affected or qualifying shares	Other shares
Year 1:	Section 11(a) deduction	- R120	
	Section 22(1) inclusion:		
	WA cost = 60 shares x R2	R120	
Year 3:	Section 22(2) deduction	- R120	
	Section 11(a) deduction	- R120	
	Section 22(1) inclusion:		
	WA cost = 100 shares x R2.4	R240	
Year 4:	Section 22(2) deduction	- R240	
	Section 11(a) deduction	- R120	
	Section 22(1) inclusion:		
	WA cost = 120 shares x R3	R360	
Year 8:	Section 22(2) deduction	- R360	
	Section 11(a) deduction		
	(60 shares x R13)		- R780
	Section 22(1) inclusion:		
	WA cost = 120 shares x R7	R840	
	60 shares x R7		R420
Year 10:	Section 22(2) deduction	- R840	- R420
Total deductions in current and previous years		- R360	- R780

The analysis above illustrates that the sections 9B(6) or 9C(5) income inclusion should be the original section 11(a) deduction of R360 and not the WA cost of R840. Section 9C(5) of the Act confirms this interpretation by only referring to section 11(a) of the Act.

Although section 9B(6) of the Act refers to section 22(1) of the Act, it only refers to instances where the cost price of shares was reduced to net realisable value.

Even if there was a reduction in cost due to a decrease in market value (in years prior to the commencement of years of assessment commencing on or after 1 January 2011, no reduction in cost price was allowed for companies holding shares as trading stock) then it would still not affect the amount of the section 9B(6) income inclusion. This is because the section 22(1) income inclusion and the section 22(2) deduction counter each other as illustrated in year 10 in Table 5 above. The deletion of the reference to section 22 in section 9C(5) of the Act also supports this interpretation.

The method of identification applied for purposes of GAAP and section 22 of the Act therefore has no effect on the amount to be included in income in terms of sections 9B(6) or 9C(5) of the Act since the FIFO method must be used to identify which affected or qualifying shares have been disposed of.

To conclude on the application of sections 9B or 9C of the Act, the taxable income of Mr X in year 10 is calculated as follows (before considering CGT, which is discussed in Chapter 5):

TABLE 6: TAXABLE INCOME AS A RESULT OF THE APPLICATION OF SECTIONS 9B OR 9C OF THE ACT (BEFORE CONSIDERING CGT)

Year 10	**Taxable income**
Section 22(2) deduction	- R1 400
Gross income: 60 shares x R10	R600
Section 9B(6) or 9C(5) income inclusion: 120 shares @ actual costs	R360
Section 22(1) inclusion: 20 shares x R13	R260
Taxable income: FIFO loss of R3 per share (R10 – R13) on 60 shares	- R180

Table 6 above illustrates that the application of sections 9B or 9C of the Act has the effect that:

- The proceeds on the 120 affected or qualifying shares are being treated as capital in nature; and
- The revenue loss on the 60 shares held for less than five (or three) years, is not calculated with reference to the WA method of identification, but with reference to the FIFO method of identification.

If the WA cost is incorrectly included as the sections 9B(6) or 9C(5) income inclusion, the taxable income will be calculated as follow (before considering CGT):

TABLE 7: TAXABLE INCOME WHERE THE WA COST IS INCLUDED AS THE SECTIONS 9B(6) OR 9C(5) INCOME INCLUSION (BEFORE CONSIDERING CGT)

Year 10	**Taxable income**
Section 22(2) deduction	- R1 400
Gross income: 60 shares x R10	R600
Section 9B(6) or 9C(5) income inclusion: 120 shares @ WA cost of R7	R840
Section 22(1) inclusion: 20 shares x R7	R140
Taxable income: WA gain on 60 shares (60 x R3 (R10-R7))	R180

It was however concluded above that it is only the actual (FIFO) costs which should be included in income in terms of sections 9B(6) or 9C(5) and not the WA cost of R840.

There is also a clear difference in the results of Table 6 and Table 7 above. A taxable loss of R180 in Table 6 compared to a taxable gain of R180 in Table 7 illustrates that it is to a share dealer's advantage to include the actual cost in income. It is however necessary to also include the CGT calculation (in Chapter 5) to conclude on the tax benefits for a share dealer.

To conclude, the actual expenditure of the affected or qualifying shares, identified by the application of the FIFO method of identification, must be included by a share dealer as the sections 9B(6) or 9C(5) income inclusion in the year of disposal.

4.6 Conclusion

With effect from 1 October 2007, section 9B of the Act has been replaced by section 9C of the Act. Although the two sections are similar in principle, the elective five-year ‘safe haven’ rule provided by section 9B of the Act has been replaced by a mandatory three-year rule in section 9C of the Act.

Section 9B provides for the concept of an ‘affected share’, which only applies to JSE listed shares, while section 9C applies to a wider scope of assets included in the definition of a ‘qualifying share’. Where a share dealer disposes of an affected or a qualifying share, any amount received or accrued as a result of the disposal is deemed to be of a capital nature and is excluded from gross income in section 1 of the Act.

While both sections 9B and 9C refer to the FIFO method of identification, the wording in section 9B(7) is unclear and potentially open for different interpretation. With the insertion of section 9C(6) of the Act, the legislator has however clarified that the FIFO method of identification must be applied in the determination of whether an affected or a qualifying share has been disposed of.

The amount to be included in income in terms of sections 9B(6) or 9C(5) for previous income tax deductions, is the actual cost of such affected or qualifying shares disposed of and not the opening GAAP trading stock value claimed in terms of section 22(2) of the Act. The method of identification applied for purposes of section 22 of the Act will therefore have no effect on the amount to be included in income in terms of sections 9B(6) or 9C(5).

In Chapter 5 the Eighth Schedule of the Act is applied to such affected or qualifying shares the proceeds of which are deemed to be of a capital nature. The calculation of the CGT base cost of the affected or qualifying shares is examined with reference to the FIFO method of identification and the income inclusion provisions in sections 9B and 9C of the Act.

CHAPTER 5

CAPITAL GAINS TAX IN TERMS OF THE EIGHTH SCHEDULE OF THE ACT

5.1 Introduction

The capital gains tax provisions in the Eighth Schedule of the Act is next applied to such affected or qualifying shares the proceeds of which are deemed to be of a capital nature in terms of sections 9B or 9C of the Act.

The following matters are discussed:

- The general principles to be applied in the calculation of a taxable capital gain on the disposal of an affected or a qualifying share. The definition of 'proceeds' and 'base cost' for CGT purposes, as well as the allowable methods of identification provided for in paragraph 32 of the Eighth Schedule of the Act, where identical assets are disposed of, are discussed.

- In calculating the CGT base cost of affected or qualifying shares, the interplay of the allowable methods of identification provided for in the Eighth Schedule of the Act with the FIFO method of identification, provided for in sections 9B(7) or 9C(6) of the Act, is then analysed by way of illustrative examples.

- The link between the income tax inclusion provision in sections 9B(6) or 9C(5) of the Act, with the CGT calculation in terms of the Eighth Schedule of the Act is also illustrated. It is concluded that if the interaction between sections 9B or 9C of the Act and the Eighth Schedule of the Act is not considered in conjunction, a share dealer could end up paying too much tax.

5.2 Eighth Schedule building blocks

The CGT provisions are contained in the Eighth Schedule of the Act and give rise to either a taxable capital gain or an assessed capital loss for a year of assessment.

According to the CGT Guide (SA, 2011:24), the style of drafting used in the Eighth Schedule differs from that used in the rest of the Act. The intention is to strike a balance between simplicity and clarity on the one hand, and technical correctness on the other. Whilst the move towards plain English drafting has assisted in making the tax law more readable, CGT remains a complex tax.

Section 26A of the Act forms the link between the Eighth Schedule and the Act and ensures that a taxable capital gain is included in a taxpayer's taxable income. An assessed capital loss cannot be set off against taxable income but is carried forward to subsequent years for set off against any future capital gains (SA, 2011:24).

In terms of paragraph 10 of the Eighth Schedule of the Act, a share dealer's taxable capital gain for a year of assessment is:

- in the case of a natural person, 33.3% or
- in the case of a company, 66.6%

of the share dealer's 'net capital gain' for that year.

The net capital gain is, in terms of paragraph 8 of the Eighth Schedule of the Act, the amount by which a share dealer's 'aggregate capital gain' exceeds a share dealer's assessed capital loss for the previous year of assessment.

In terms of paragraph 6 of the Eighth Schedule of the Act, the aggregate capital gain is the amount by which a share dealer's capital gains exceed the sum of such dealer's capital losses for a year and, in the case of a living natural person, its annual exclusion of R30 000.

The first step in calculating a share dealer's taxable capital gain is therefore to determine his or her capital gain or loss. A capital gain is determined in paragraph 3(a) of the Eighth Schedule of the Act as the amount by which the proceeds received or accrued in respect of the disposal of an asset exceed the base cost of that asset. A capital loss is determined in paragraph 4(a) of the Eighth Schedule of the Act as the amount by which the base cost of that asset exceeds the proceeds received or accrued in respect of the disposal.

The Eighth Schedule of the Act provides for four key definitions that form the building blocks in determining a capital gain or loss (SA, 2011:26). These four definitions are 'asset', 'disposal', 'proceeds' and 'base cost'.

5.2.1 Asset

An 'asset' is defined widely in paragraph 1 of the Eighth Schedule of the Act and includes:

- property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, and
- a right or interest of whatever nature to or in such property.

The core of the definition of 'asset' is derived from a definition adopted in 1962 by the South African legislature in terms of which property is defined for purposes of donations tax as 'any right in or to property movable or immovable, corporeal or incorporeal, wheresoever situated' (Swart, 2005:3).

Shares in a company are considered a 'bundle, or conglomerate, of personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends' (*Standard Bank of South Africa v Ocean Commodities Inc* 1983(1) SA 276 (A)).

The affected shares in section 9B (held for more than 5 years) and qualifying shares in section 9C (held for more than 3 years) therefore qualify as assets for

purposes of the Eighth Schedule of the Act.

5.2.2 Disposal

The disposal of an asset triggers the liability for CGT. The disposal requirement is a core rule that is fundamental to the application of CGT. It is for this reason that a wide meaning has been given to the term ‘disposal’ (SA, 2011:66).

Paragraph 11(1) of the Eighth Schedule of the Act defines a disposal as any event, act, forbearance or operation of law which results in a creation, variation, transfer or extinction of an asset.

The disposal of shares by a share dealer would thus also fall within the definition of a disposal from a CGT perspective.

5.2.3 Proceeds

The disposal of an asset normally gives rise to ‘proceeds’. In terms of paragraph 35(1) of the Eighth Schedule of the Act, the proceeds from the disposal of an asset are equal to the amount received or accrued to a share dealer in respect of that disposal.

Paragraph 35(3) of the Eighth Schedule of the Act excludes however from proceeds amounts which are included in taxable income. Because the disposal proceeds of shares held for less than five (in the case of section 9B) or three (in the case of section 9C) years by a share dealer are included in taxable income, the disposal of those shares will have no proceeds for CGT purposes. As discussed in more detail below, a similar exclusion applies to the base cost of an asset.

Although all the shares disposed of by a share dealer thus fall within the ambit of the Eighth Schedule of the Act, the Eighth Schedule effectively only applies to the disposal of a share dealer’s affected or qualifying shares.

The proceeds received from the disposal of an affected or qualifying share have

specifically been excluded from gross income in terms of sections 9B(2) or 9C(2) of the Act. The amount received for the affected or qualifying share therefore constitutes ‘proceeds’ for purposes of determining a share dealer’s taxable capital gain.

5.2.4 Base cost

The fourth important building block in the calculation of a capital gain or loss is the ‘base cost’ of an asset, which is covered in Part V of the Eighth Schedule of the Act.

In terms of paragraph 20(1) of the Eighth Schedule of the Act, the base cost of an asset acquired includes the expenditure actually incurred in respect of the cost of acquisition of an asset.

Paragraph 20(3) of the Eighth Schedule of the Act excludes from base cost amounts which are deducted from taxable income and which is not included in taxable income in terms of section 9C(5) of the Act. The acquisition expenditure of shares held for less than five or three years by a share dealer are deducted from taxable income and those shares will thus have no CGT base cost. As discussed above, the Eighth Schedule of the Act therefore effectively only applies to the disposal of a share dealer’s affected or qualifying shares.

Paragraph 32 of the Eighth Schedule of the Act applies to ‘identical assets’, which is defined in paragraph 32(2) as a group of similar assets which:

- if any one of them were disposed of, would realise the same amount regardless of which of them were so disposed of; and
- are not able to be individually distinguished apart from any identifying numbers which they may bear.

According to the CGT Guide (SA, 2011:234), the fact that shares may have unique identifying share certificate numbers, is ignored for the purpose of determining

whether an asset is part of a holding of identical assets. Both affected shares and qualifying shares therefore qualify as identical assets for purposes of paragraph 32 of the Eighth Schedule of the Act.

In terms of paragraph 32(3) of the Eighth Schedule of the Act, the base cost of identical assets must be determined by using either the SPID or FIFO methods of identification. Under the SPID method of identification, the cost of each asset disposed of is individually identified. SARS indicates in the CGT Guide (SA, 2011:235) that shares can be identified by the date of acquisition and cost. Under the FIFO method of identification, it is assumed that the oldest share is sold first (SA, 2011:235).

The WA method may also be used in terms of paragraph 35(3A) of the Eighth Schedule of the Act, but only for certain classes of assets. Financial instruments listed on the JSE and participatory interests in South African collective investment schemes in securities are allowable asset classes in this regard.

The WA method may thus be applied for affected shares contemplated in section 9B of the Act but not for all qualifying shares in section 9C of the Act. For example, the WA method may not be applied to the following qualifying shares in section 9C of the Act:

- South African unlisted private company shares; and
- Interests in close corporations.

For the purpose of determining the base cost of affected or qualifying shares under the WA method of identification, paragraph 32(4) of the Eighth Schedule of the Act provides that the WA base cost be calculated by adding expenditure allowable in terms of paragraph 20 in respect of identical assets to the base cost of identical assets acquired and not disposed of before that expenditure was incurred, and dividing that amount by the number of identical assets acquired and not disposed of after the expenditure was incurred.

The CGT Guide (SA, 2011:236) refers to this method as the moving-average method where an average unit cost is computed after each acquisition of an asset by adding the cost of the newly acquired assets to the cost of the existing assets on hand and dividing this figure by the new total number of assets.

In terms of paragraph 32(6) of the Eighth Schedule of the Act, once a share dealer has adopted a method of identification in respect of a class of identical assets, that method must be used until all those identical assets have been disposed of.

As a general rule, the base cost of identical assets such as affected or qualifying shares could therefore be determined by applying the SPID or FIFO methods of identification. The WA method of identification could also be applied to affected shares but not to all classes of qualifying shares. The interplay of the generally allowable methods of identification for CGT purposes with the FIFO method of identification, prescribed by sections 9B or 9C of the Act, is analysed in more detail below.

5.3 Interplay of the income tax and CGT methods of identification

It is concluded in Chapter 4 that the FIFO method of identification prescribed by sections 9B(7) or 9C(6) of the Act must be applied from an income tax perspective to determine which affected or qualifying shares have been disposed of. The actual cost price of such shares, which was previously deducted in terms of section 11(a) of the Act, must also be recouped in terms of sections 9B(6) or 9C(5) of the Act.

It must now be determined whether the application of the FIFO method of identification in sections 9B and 9C of the Act also require a share dealer to apply the FIFO method of identification for CGT purposes.

SARS issued Interpretation Note 43 in 2012 to provide clarity on the interpretation and application of section 9C (SA, 2012b:3). A tax guide for share owners was also released in 2012 to provide general guidance on the taxation of share owners (SA, 2012a:ii).

The tax guide for share owners (SA, 2012a:18) states that the FIFO method in section 9C(6) of the Act is merely for the purpose of applying section 9C and does not affect any identification method adopted for determining the base cost of shares for CGT purposes. According to the guide, if a share dealer adopted the WA method for CGT purposes he or she must continue to use that method for determining the base cost of shares. The FIFO method is merely used to determine whether any shares sold were held for at least three years.

Interpretation Note 43 (SA, 2012b:23) also states that the FIFO method in section 9C(6) of the Act:

> 'is not in conflict with the identification rules under paragraph 32 of the Eighth Schedule used for CGT purposes for determining the base cost of identical assets. Paragraph 32 permits the use of the specific-identification method, the FIFO method or the weighted-average method. While it is appreciated that two different identification rules may apply for the same set of shares, the rules serve different purposes and need not be aligned. The identification rules in the Eighth Schedule are used for purposes of determining the base cost of shares for CGT purposes while the section 9C identification rule is used only for purposes of determining the holding period of shares that have been disposed of. On the question of non-alignment, while CGT allows for the weighted-average method in calculating the base cost of shares, this method cannot be applied for purposes of determining the time period for which shares were held because it disregards specific dates of acquisition and disposal. Consequently it will be necessary for a taxpayer who uses the specific-identification method or the weighted-average method to determine the base cost of shares for CGT purposes to also maintain a record of purchases and sales of shares on the FIFO basis in order to apply section 9C.'

Despite these general statements by SARS, the documents do not practically consider and illustrate from a CGT perspective the combined effect of the income inclusion provision in sections 9B(6) or 9C(5) of the Act, in conjunction with the FIFO method of identification in sections 9B(7) or 9C(6) of the Act. The combined effect is thus investigated in more detail below.

5.3.1 FIFO method of identification

If the FIFO method of identification is applied to the example discussed in Chapter 4 (Table 6: Taxable income as a result of the application of sections 9B or 9C of the Act (before considering CGT)), the taxable income of Mr X in year 10 with the inclusion of the taxable capital gain will be as illustrated in Table 8 below:

TABLE 8: TAXABLE INCOME UNDER THE FIFO METHOD OF IDENTIFICATION (INCLUDING CGT)

Year 10	**Taxable income**
Section 22(2) deduction	- R1 400
Gross income: 60 shares x R10	R600
Section 9B(6) or 9C(5) income inclusion: 120 shares @ actual costs	R360
Section 22(1) inclusion: 20 shares x R13	R260
Taxable income: FIFO loss of R3 per share (R10 - R13) on 60 shares	- R180
CGT calculation:	
Proceeds: 120 shares x R10	R1 200
Base cost: Actual FIFO costs for the 120 shares	- R360
Capital gain	R840
Taxable capital gain (33.3%)	R280
Total taxable income in year 10: (- R180 + R280)	R100

There is a clear tax advantage for a share dealer who elects that section 9B must

apply or who meets the requirements of section 9C of the Act, as the taxable income decreased from R540 in Chapter 3 (Table 2: WA method before applying sections 9B and 9C) to only R100 in Table 8.

5.3.2 WA method of identification

As proposed by Interpretation Note 43 (SA, 2012b:23), an alternative is to rather apply the WA method of identification for CGT purposes.

Table 7 in Chapter 4 illustrated the taxable income of Mr X where the WA cost is incorrectly recouped is terms of sections 9B(6) and 9C(5). If the taxable capital gain is also calculated by incorrectly applying the WA method of identification, the result could be as follows:

TABLE 9: TAXABLE INCOME UNDER THE WA METHOD OF IDENTIFICATION (INCLUDING CGT)

Year 10	**Taxable income**
Section 22(2) deduction	- R1 400
Gross income: 60 shares x R10	R600
Section 9B(6) or 9C(5) income inclusion: 120 shares @ WA price of R7	R840
Section 22(1) inclusion: 20 shares x R7	R140
Taxable income: WA gain of R3 per share (R10 – R7) on 60 shares	R180
CGT calculation:	
Proceeds: 120 shares x R10	R1 200
Base cost: WA costs of 120 shares	- R840
Capital gain	R360
Taxable capital gain (33.3%)	R120
Total taxable income in year 10: (R180 + R120)	R300

The following objections can however be raised against the application of the WA method of identification in the current instance:

- Section 9C(5) provides that there be included in the share dealer's income any expenditure or losses incurred in respect of 'such' qualifying share and allowed as a deduction from the income of the taxpayer during that or any previous year of assessment in terms of section 11 of the Act. The WA cost applied for purposes of section 22 may thus not be included in income in terms of section 9C(5).

- Where share prices increase over time, it is likely that the total taxable income of R300 (Table 9) under the WA method of identification will generally be more than the total taxable income of R100 (Table 8) under the FIFO method of identification. This is due to the fact that under the FIFO method a bigger capital gain (R840 compared to R360 under the WA method) is taxed at the beneficial 33.3% CGT inclusion rate. A share dealer could thus end up paying too much tax by incorrectly applying the WA method.

5.3.3 Conclusion on the interplay of the methods of identification

If the last 20 shares of Mr X are disposed of in year 11 for also R10 per share, Mr X will realise an income loss of R60 ((20 shares x R10) – R260) by applying the FIFO method, while a taxable profit of R60 ((20 shares x R10) – R140) will be realised under the WA method.

If the beneficial effect of the CGT inclusion rate is ignored, the taxable (cash) gain over the entire period for Mr X is then R600 under both the FIFO method and the WA method. This is calculated as follows:

- FIFO method: R180 income loss (Table 8) plus R840 capital gain (Table 8) less R60 income loss on final 20 shares.

- WA method: R180 taxable income (Table 9) plus R360 capital gain (Table 9) plus R60 taxable income on final 20 shares.

If the FIFO method is applied for income tax purposes (in terms of sections 9B or 9C of the Act) and the WA method for CGT purposes, Mr X's taxable gain (ignoring the beneficial effect of the CGT inclusion rate) will however only be R120 (-R180 + R360 - R60) compared to the R600 cash benefit.

Contrary to the statement in Interpretation Note 43 (SA, 2012b:23) that the two different identification rules need not be aligned, it is submitted that the income tax and CGT methods of identification should in fact be aligned. If a share dealer does not apply one method of identification consistently for income tax and CGT purposes, the result will be that a share dealer is not taxed on the cash benefit of the share disposals.

The FIFO method of identification should thus also be applied for purposes of the Eighth Schedule of the Act and it is submitted that a share dealer loses the opportunity to choose which identification method to apply for CGT purposes where sections 9B or 9C find application.

5.4 Conclusion

The application of the Eighth Schedule of the Act to the disposal of affected or qualifying shares results in a taxable capital gain or assessed capital loss for a share dealer.

Due to the requirement in sections 9B(7) or 9C(6) of the Act that a share dealer has to apply the FIFO method of identification, a share dealer loses the opportunity to choose which identification method to apply from a CGT perspective. A share dealer is therefore obliged to apply the FIFO method of identification for CGT purposes.

The combined tax effect of the income inclusion provisions in sections 9B(6) or 9C(5) of the Act in conjunction with the FIFO method of identification, result in the

WA method of identification not being appropriate from a CGT perspective. It could also be to a share dealer's disadvantage to apply the WA method from an income tax and CGT perspective.

The consistent application of the FIFO method of identification for income tax and CGT purposes results in a taxable income amount which is in sync with a share dealer's cash benefits. It must therefore be clarified in the Eighth Schedule of the Act that the FIFO method of identification must also be applied for CGT purposes where sections 9B or 9C of the Act find application.

CHAPTER 6

CONCLUSION

The interaction between the income tax provisions contained in sections 9B, 9C, 11(a) and 22 of the Act, and the CGT provisions of the Eighth Schedule of the Act, are complex and share dealers should approach the tax consequences of share dealing profits with caution.

As a starting point it should be determined whether a share receipt is of a revenue nature. In this regard, our tax courts have developed several guidelines in determining the capital or revenue nature of receipts. The four guidelines applicable to share disposals are:

- the guideline of the intention of the taxpayer;
- the guideline of realisation of capital assets at enhanced values;
- the business guideline; and
- the scheme of profit-making guideline.

If applied correctly, the above guidelines will ensure that such receipts are taxed correctly as either capital or income. Each set of facts is however unique and it is important that all the surrounding circumstances are established before applying the guidelines. The guidelines indicate that share dealing profits which are designedly sought for and worked for, either as part of a business operation or not, are of a revenue nature and therefore taxable as gross income.

The expenditure actually incurred by a share dealer in acquiring shares as part of his or her trading stock is deductible in terms of section 11(a) of the Act since all the requirements are met. The section 11(a) deductions are however countered by the section 22(1) income inclusions until the year of assessment in which the share dealer disposes of the shares.

In order to determine the cost price of shares for purposes of section 22(1) of the Act, the method of identification of shares held as trading stock is an important consideration.

The method of identification applied in terms of GAAP is also acceptable for purposes of section 22 of the Act. In practice share dealers may choose any of the SPID, FIFO or WA methods of identification as an accounting policy. These methods can thus also be applied for purposes of section 22 of the Act.

The WA method of identification is applied in practice more frequently. In an increasing equity market, where shares bought more recently have higher costs, the income tax profits under the WA method is partially deferred until the last shares are disposed of.

With effect from 1 October 2007, section 9B of the Act has been replaced by section 9C of the Act. Although the two sections are similar in principle, the elective five-year ‘safe haven’ rule provided for in section 9B of the Act has been replaced by an automatic three-year rule in section 9C of the Act.

Section 9B provides for the concept of an ‘affected share’, which only applies to JSE listed shares, while section 9C applies to a wider scope of assets included in the definition of a ‘qualifying share’. Where a share dealer disposes of affected shares or qualifying shares, any amount received or accrued as a result of the disposal is deemed in terms of sections 9B or 9C to be of a capital nature and is excluded from gross income in section 1 of the Act.

Both sections 9B(7) and 9C(6) of the Act refer to the FIFO method of identification in determining whether an affected or a qualifying share has been disposed of. The wording in section 9B(7) is however unclear and potentially open for different interpretation. With the insertion of section 9C(6) of the Act, the legislator has however clarified that the FIFO method of identification must be applied in the determination of whether an affected of a qualifying share has been disposed of.

As the proceeds received on the disposal of affected or qualifying shares are excluded from gross income, any acquisition expenditure incurred and deducted in respect of such shares must be included in a share dealer's income in terms of sections 9B(6) or 9C(5) of the Act. In order to determine which expenditure was allowed as a deduction, it is necessary to determine the income tax treatment of those shares in terms of sections 11(a) and 22 of the Act.

It was determined that the amount to be included in income in terms of sections 9B(6) or 9C(5) of the Act for previous income tax deductions, is the actual cost of the affected or qualifying shares and not the GAAP opening trading stock value claimed in terms of section 22(2) of the Act. The method of identification applied for purposes of GAAP and section 22 of the Act will therefore have no effect on the amount to be included in income in terms of sections 9B(6) or 9C(5) of the Act.

The application of the Eighth Schedule of the Act to the disposal of affected or qualifying shares results in a taxable capital gain or assessed capital loss for a share dealer.

Due to the requirement in sections 9B(7) or 9C(6) of the Act that a share dealer has to apply the FIFO method of identification, a share dealer loses the opportunity to choose which identification method to apply from a CGT perspective. A share dealer is therefore obliged to apply the FIFO method of identification for CGT purposes.

The combined tax effect of the income inclusion provision in sections 9B(6) or 9C(5) of the Act in conjunction with the FIFO method of identification, result in the WA method of identification not being appropriate from a CGT perspective. It could also be to a share dealer's disadvantage to apply the WA method from an income tax and CGT perspective.

The consistent application of the FIFO method of identification for income tax and CGT purposes therefore results in a taxable income amount which is in sync with a share dealer's cash benefits. It is thus recommended that it be clarified in the

Eighth Schedule of the Act that the FIFO method of identification must also be applied for CGT purposes where sections 9B or 9C of the Act find application.

It is therefore concluded that careful and in-depth consideration is required by share dealers to ensure the correct interaction between the income tax provisions on the one hand, and the capital gains tax provisions on the other, in order to be taxed on an equitable and correct basis.

CHAPTER 7

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