Capital gains tax, savings and inflation

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Consider the following example: A taxpayer bought shares for R100 000 on 1 June 2004, and sold them on 1 June 2014. Assume that:

- the inflation rate during the period the shares were held was 6% per year compounded;
- the value of the shares grew at a (generous) rate of 10% per year compounded;
- the taxpayer has no other capital gains during the tax year ending 28 February 2015 and has no assessed capital loss; and
- the taxpayer pays income tax at the highest marginal rate of 40%.

The actual proceeds in respect of the sale of the shares (at compound annual growth of 10%) will be R259 374.

The tax payable (ignoring brokers' charges and the like) will be determined as follows:

However, the actual return after tax, and taking into account inflation, will be the following:

Put differently, after taking into account inflation and tax, the annual compounded rate of return will be 2.72%.

So, in today's money, the taxman takes an amount equal to about 56% of the actual return!

The cause of this inequitable result is that the effects of

inflation are not taken into account when determining capital gains tax (CGT) – i.e. there is no indexation.

When CGT was introduced in 2001, the National Treasury said that indexation was not appropriate in the light of the "low" inclusion rate of 25%. However, the inclusion rate was recently increased by one third to 33.3% in the case of individuals (and from 50% to 66.6% in the case of companies and trusts).

In addition, a taxpayer is not entitled to set off capital losses against income tax. In other words, if a person has an assessed income tax loss, the person must reduce the assessed loss by the capital gain. But if a person is in an income tax paying position, the person is not allowed to reduce that position by capital losses the capital losses can only reduce future capital gains.

It is submitted that the current CGT system does not encourage savings in South Africa.

The erstwhile Minister of Finance, Pravin Gordhan, does not think that the CGT regime is unfair. In his 2014 Budget Speech, referring to the developments in fiscal policy during the past two decades he stated: "We have also improved the fairness of the tax system by taxing residents on their worldwide income and taxing capital gains."

In the same speech, the Minister did however announce that legislation would be introduced to allow for tax-exempt savings accounts this year, to encourage household savings.

Draft legislation to this effect was published on 17 July 2014 in the Draft Taxation Laws Amendment Bill of 2014. Put simply, what is being proposed is that, with effect from 1 March 2015, persons will be able to contribute R30 000 per year, and R500 000 in aggregate during a lifetime to a tax free investment. The income and capital gains realised in respect of the tax free investment is free of income tax and CGT.

The proposal is a good one. As the famous economist, Milton Friedman said: “I am in favour of cutting taxes under any circumstances and for any excuse, for any reason, whenever it’s possible.” However, at a rate of R30 000 per year, it will take approximately 16 years to fill up the R500 000 limit. In 16 years’ time R30 000 will be worth about one third in today’s money at an inflation rate of about 6% per year. Once again, unless indexation is built in, the concession will not add up to much over time.

It is submitted that the only way to encourage savings is to give taxpayers a proper return on their investments by taking into account the ravages of inflation when determining fiscal policy.