Capital gains tax – method of valuation on the disposal of shares

Authors: Gigi Nyanin and Nicole Paulsen (DLA Cliffe Dekker Hofmeyr)

Capital Gains Tax (CGT) is payable on the disposal of capital assets which were in the seller's possession on, or were acquired after 1 October 2001 (valuation date). A capital gain or loss is determined by calculating the difference between the proceeds and the base cost of the disposed asset.

In relation to pre-valuation date assets, paragraph 25(1) of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Act) provides that the base cost of an asset will be its valuation date value plus allowable expenditure. To determine the valuation date value, paragraph 26(1) gives the taxpayer an election. The following options are available for determining the valuation date value:

- the market value of the asset as at the valuation date;
- 20% of the proceeds from the disposal of the asset, after deducting from those proceeds an amount equal to the expenditure allowable in terms of paragraph 20 incurred on or after the valuation date; or
- the time-apportionment base cost of the asset.

Paragraph 26(3) of the Eighth Schedule to the Act further provides that where a person has adopted the market value as the valuation date value of an asset and the proceeds from the disposal of the asset do not exceed that market value, that person must substitute for the valuation date value of that asset, the proceeds received or accrued in respect of the asset less any expenditure allowable in terms of paragraph 20 of the Eighth Schedule to the Act incurred on or after the valuation date. This effectively prevents the claiming of losses in respect of such assets.

Having regard to the legal principles set out above, it is important to take note of the recent case of *ITC 12466*, decided on 12 March 2014 in the Tax Court (Cape Town). In this case the court was asked to determine whether the valuation of certain shares disposed of, and for purposes of determining a capital gain, were in fact reasonable.

By way of background, the appellant (taxpayer) was an entity incorporated in 1996, with its main business described as 'investments in all aspects by the principal'. Prior to the 2002 and 2003 years of assessment, the taxpayer acquired a shareholding in an entity D.

The value of those shares held by the taxpayer in D as at the valuation date was determined by obtaining a valuation of the total share value of D as at that date, based on the 'discounted cash flow methodology'. The taxpayer's shares in D constituted 23.73% of the total shares in D, and thus the value of the taxpayer's shares could easily be deduced.

During the 2002 and 2003 tax years, the taxpayer disposed of 4.37% of the shares it held in D. The taxpayer disposed of 2.37% of its shares during the 2002 year of assessment for R2 million and the remaining 2% during the 2003 tax year, for R2,2 million.

The taxpayer argued that the aggregate market value of D as at the valuation date was an amount of approximately R198 million. The taxpayer disposed of 4.37% of the shares in D. Therefore the market value at valuation date of the shares disposed of was an amount of approximately R8 million.

Since proceeds of only R4.2 million was received by or accrued to the taxpayer in respect of the shares, and the base cost was R8 million (being the valuation date value), the taxpayer would have made a loss.

However, because the taxpayer elected to use the market value of the shares as its valuation date value, paragraph 26(3) of the Eighth Schedule to the Act applied and limited the valuation date value to the proceeds. The valuation date value of R8 million was greater than the proceeds of R4.2 million and the taxpayer could therefore not claim a loss. The taxpayer accounted for the transaction accordingly and did not claim a loss.

In 2007, the Commissioner of the South African Revenue Service (Commissioner) raised additional assessments in respect of the taxpayer’s 2002 and 2003 years of assessment. The Commissioner adjusted the value at which the shares in D had been valued by the taxpayer from just over R8 million to nil. The Commissioner subsequently assessed the taxpayer for capital gains of R2 million in the 2002 year of assessment and R2.2 million in the 2003 year of assessment in respect of the disposal of the shares in D.

In this regard it is important to note that the Commissioner was of the view that the discounted cash flow method should not have been used to value the shares, but rather a ‘net asset value’ method of evaluation should have been used.

The taxpayer objected to the additional assessment raised by the Commissioner in respect of the 2002 and 2003 years of assessment on the grounds that the Commissioner’s rejection of the valuation furnished by the taxpayer was misguided and flawed in material respects. The Commissioner disallowed the taxpayer’s objection and the taxpayer lodged an appeal against the disallowance of its objections.

The issues for determination before the Tax Court were as follows:

- whether the Commissioner was correct in disallowing the taxpayer’s objection;
- whether the taxpayer had established the market value,

as at 1 October 2001, of the shares disposed of; and
- whether the valuation of the assets disposed was reasonable.

The court noted that each of the shares disposed of by the taxpayer were pre-valuation date assets and consequently, the taxpayer had an election regarding the valuation date value of an asset. The taxpayer chose the market value and obtained a valuation.

The court referred to paragraph 29(1)(c) of the Eighth Schedule to the Act and held that the market value of the shares disposed of by the taxpayer ought to have been the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller at arm’s length in an open market, as at the valuation date.

The court had regard to the ‘discounted cash flow methodology’ used by the taxpayer to value the shares in D and held that two essential elements emerged in the methodology used in the evaluation of the market value of the shareholding in D, these being a determination of:

- the future forecast free cash flows; and
- the appropriate discount factor.

The court determined that the valuation compiled on behalf of the taxpayer was inadequate in relation to the two essential elements mentioned above, in that:

- the future forecast free cash flows were not established by any admissible evidence; and
- the person who prepared the evaluation did not establish that an appropriate discount factor was applied by him.

The figures used by the taxpayer were prepared by an independent third party for purposes of an application for a temporary licence which would have enabled D to operate a temporary casino. The Commissioner assessed the taxpayer on the disposal of shares using a nil base cost value on the shares sold in 2002 and 2003. However, this value of shares, according to the court, had not been determined by looking at the reasonableness of the figures submitted by the taxpayer but rather at the method used to arrive at a value. Further, the taxpayer was not asked to submit any information to support the reasonableness of the figures used in the valuation submitted.

The court criticised the Commissioner for requesting that the valuation provided by the taxpayer should be rejected on the basis that the figures used to prepare the valuation had been prepared by a third party, when in actual fact the Commissioner rejected the valuation because the Commissioner considered that the net asset value method should have been used. This, according to the court, amounted to a 'shifting of goal posts'.

The court held that the taxpayer obtained a valuation of the market value of shares in D as at the valuation date. That valuation was done by an expert in the field and the method used, the assumptions made, the information used and the calculations done, were set in great detail in the valuation. During the course of trial, the Commissioner had conceded that the 'discounted cash flow methodology' applied was the appropriate methodology as opposed to the 'net asset value methodology'.

The court found in favour of the taxpayer and the additional assessments in respect of the 2002 and 2003 years of assessment were set aside.

What is clear from the decision of the Tax Court is that in deciding on a method of valuation for a pre- valuation date asset, a taxpayer should be mindful of the fact that although there may be flaws in the valuation, a court is inclined to look at the specific facts of the case and determine whether the information upon which the valuation is based is reliable and reasonable.

SARS has eye on property taxes

Author: iAfrica.com

Established Cape Law firm, Herold Gie Attorneys, who this year celebrate 120 years of legal expertise, recently held an informative property and tax seminar at the Cape Town Hotel School attended by a number of property professionals from across the city.

Presented by Di Seccombe, National Head of Tax Training at audit and advisory firm Mazars, the seminar delivered a broad analysis of the recent 2014/2015 Budget Speech, as well as recent legislative and administrative changes that impact the SA property industry and real estate agents in particular.

Seccombe said there had been no great surprises delivered in the latest Budget Speech, as Finance Minister Pravin Gordhan instead appeared to tread a fine line (as well as an 'election tightrope') between balancing South Africa's social demands with the need to prove to ratings agencies such as Moody's, Fitch and Standard & Poor's, and thus to international investors, that there is a steady hand on the country's financial tiller. He ultimately stuck fast to the government's plan to reduce spending, grow the economy and cut its budget deficit.

From a real estate point of view, said Seccombe, the budget did not bring any specific tax relief for homebuyers or owners, either by way of a higher transfer duty threshold or by means of providing further tax deductions in respect of homeownership related expenses.

Such relief may have helped to alleviate the current decline in housing affordability, particularly as house prices and interest rates rise, and salary increases fail to keep up with higher household costs. Interestingly, however, the income that government earns from transfer duties surged by 28% in the 2013/2014 tax year, which suggests that the housing market is on its way to a recovery following a five-year slump.

The Minister, stated Seccombe, was also not very specific about the government’s plans to achieve economic growth and specifically to support small business in any meaningful way, as this is always the best creator of jobs and, ultimately, housing demand. However, new spatial plans for cities, upgrading informal settlements, increased social infrastructure and improved public transport, coupled with the aims to deliver more than 200 000 new social housing units over the next two years, all represented positive news for both the economy and the property market, she stated.

Whilst Gordhan’s announcement of R9,3-billion worth of personal tax relief to cash-strapped consumers was met with much public gratification, Seccombe was quick to point out the facts in this regard. She noted that, with consumer incomes under increasing pressure from rising transport, food and utility costs, the household tax relief announcement would not (taking into account moderate salary increases) make a great difference to “take-home pay” and disposable income. With tax brackets essentially being “widened,” this was also likely to result in individuals falling into the same tax bracket as the previous fiscal year, she commented.

However, welcome news to South Africa’s financial (and property) communities, said Seccombe, was that South Africa’s tax collection once again appears to have been exceptionally efficient, bringing in more than anticipated. For the first time since the recession, corporate revenues will exceed the 2008/2009 peak of R1,65-billion. Much of this, she said, can be attributed to the Tax Administration Act and third-party data verification legislation afforded by Government Gazettes 35090 and 36346, which have significantly improved Sars's ability to monitor that taxpayers are making full disclosure of all income in their annual tax returns.

The above legislation has afforded SARS previously unprecedented power and access to information, and substantially increased ability to collect taxes owing. It has thus transformed banks, medical aid schemes and other third-parties into agents of SARS, in terms of verifying tax return information. This third party information includes, among other things, rental income, disposal and buying of shares, interest and dividend income, purchase of retirement funding, medical aid contributions and insurance pay outs on death. In this respect, it is important to note that any rental or managing agent, collecting monies on behalf of a landlord, is now legally required to submit all information in this regard directly to SARS in order to assist with data verification.

With increased rental demand stimulating growth in the "buy-to-let" market, Seccombe warned that expenses claimed for repairs and maintenance, will be scrutinized by SARS. Expenses incurred in respect of repairs have to relate to trade assets that are damaged or have deteriorated. Expenses incurred replacing assets that are serviceable for purely aesthetic reasons will not qualify for a tax deduction. The cost of improvements, reconstructions or additions to a property cannot be deducted as these expenses are of a capital nature. Neither will a deduction be allowed for repairs, if you repair a property which was previously let and which you now want to occupy or sell. You will need to make the repairs whilst your property is being let. Also worth noting, she said, is that there is a fine line of distinction between repairs and maintenance on the one hand, and improvement and reconstruction on the other. Each case is assessed on its’ own merits.

In the case of a commercial property transaction, stated Seccombe, it is also important to note that if the seller is a VAT vendor, and the sale is in the course and furtherance of the seller’s enterprise, VAT will ordinarily be payable at the rate of 14%. If, however, a commercial property is sold as a going concern, the transaction will be “zero-rated”, provided that:

– the seller and the purchaser are VAT vendors;

– the seller and the purchaser have agreed in writing that the property is sold as a going concern; – the property has income

– earning activity and the parties agree in writing that the property will constitute an income

– earning activity on date of registration of transfer; namely that the rent producing tenants will be sold with the property;

– the sale of the property must include all the assets which are necessary for carrying on the income-earning activity;

– the seller and the purchaser agree in writing that the purchase price is inclusive of VAT at the rate of 0%.

Estate agents and conveyancers also have a duty to inform the purchaser that if a seller is a non-resident, that there may be a withholding tax responsibility for the purchaser when paying the non-resident the purchase price. The estate agents and conveyancers incur this obligation, if either or both are involved in the transaction and are being paid for performing this function.

If they do not inform the purchaser as required, they can be held jointly and severally liable for payment of the tax, up to the amount of their respective fees from the deal. If no agent or conveyancer is involved, and the purchaser knows or should have known that the seller is not a resident, the purchaser then becomes personally liable for the tax that should have been withheld.

The rate of withholding tax is dependent on the legal nature of the seller and will only apply to properties selling for more than R2-million. The withholding tax is an advance payment of the capital gains tax ultimately payable by the non-resident seller when they submit their tax return to SARS.

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Determining the base cost of the repayment of an interest-free loan acquired for less than face value

Author: Okkie Kellerman and Esther Geldenhuys of ENSafrica

Introduction

The Eighth Schedule to the Income Tax Act, 58 of 1962 ("the Act") creates a tax liability known as capital gains tax which applies generally where an asset is disposed of. A loan is regarded as an "asset" in terms of the definition in paragraph 1 of the Eighth Schedule as it is an incorporeal asset whereby the lender acquires a right to claim payment from the borrower. Where part of a loan is repaid it constitutes part of an asset disposed of and it will be necessary to allocate a part of the base cost of the loan to the part of the loan repaid in order to determine the capital gain or capital loss in respect of the disposal of that part. Where a loan is acquired for less than its face value, i.e. the base cost of the loan is less than the amount actually owed by the borrower; the part-disposal method in paragraph 33 of the Eighth Schedule to the Act will apply.

The base cost of the part repaid

Paragraph 33 contains two formulae for determining the part of the base cost repaid, i.e. the market value formula method and the specific identification method. The market value formula method in paragraph 33(1) of the Eighth Schedule provides that the base cost of the entire asset must be apportioned in the ratio that the market value of the part bears to the market value of the whole asset. In terms of this paragraph the base cost of the part of the loan repaid will be calculated as follows:

Base cost of the part of the loan repaid = market value of the part repaid / market value of the total loan x base cost of the total loan

The difficulty with the market value formula method is that it requires the market value of the loan to be determined immediately before each repayment. Should there be numerous repayments it would accordingly be administratively burdensome to apply this method and practically difficult to implement. As an alternative, the specific identification method can be applied to determine the part of the base cost repaid.

The specific identification method in paragraph 33(2) of the Eighth Schedule provides that the market value formula method will not apply where the expenditure as determined in paragraph 20 of the Eighth Schedule or the market value as determined under paragraph 29(4) of the Eighth Schedule can be directly attributed to the part of the asset which is disposed of or which is retained. Therefore, the market value formula method will not apply where the expenditure or market value in respect of the part disposed of can be specifically identified.

The South African Revenue Service’s Comprehensive Guide to Capital Gains Tax (Issue 4) states that the specific identification method recognises the fungible nature of a loan, that is, that all parts of the loan have an equal cost, are indistinguishable and identifiable by nomination. Therefore, in terms of paragraph 33(2) of the Eighth Schedule and following this statement, the base cost of the part of the loan repaid will be calculated as follows:

Base cost of the part of the loan repaid = amount repaid / the total loan x base cost of the loan

Therefore, where a loan with a face value of R100 million is acquired by a company at a cost of R80 million and R10 million is repaid in the first year, the base cost of the part of the loan repaid will be R8 million (i.e. R10 million / R100 million x R80 million). The capital gain will accordingly be R2 million (R10 million less R8 million) with capital gains tax of R373 340 payable at an effective rate of 18,667%. Using the above example and as all parts of the loan have equal cost, R1 of the R100 million loan will accordingly have a cost of 80 cents. This creates a simplified calculation in that should a repayment of R10 million be made on a loan with a face value of R100 million which is acquired for R80 million the base cost of the part of the loan repaid can simply be calculated as follows: R10 million x 80 cents = R8 million.

Conclusion

The specific identification method therefore recognises a simplified calculation in that all parts of the loan will have equal cost. As it will be administratively burdensome to use the market value formula method and since this method is specifically excluded in terms of paragraph 33(2) of the Eighth Schedule where the expenditure or market value in respect of the part disposed of can be specifically identified, the specific identification method will generally be used. It is, however, important to note that where the loan is interest bearing the provisions of section 24J of the Act will apply and the loan repayment should be dealt in the manner prescribed by that section.

Developments in the taxation of collective investment schemes

Author: Toinette Beckert by ENSafrica

Section 25BA prior to 1 January 2014

Prior to the recent amendments in the Taxation Laws Amendment Act No. 31 of 2013 ("the TLAA"), a collective investment scheme ("CIS") was taxed on a semi-flow through regime in terms of section 25BA of the Income Tax Act No. 58 of 1962 ("the Act").

Accordingly, amounts (other than amounts of a capital nature) received by or accrued to a portfolio of a CIS (other than a portfolio of a CIS in property) were deemed to have directly accrued to a person to the extent that the amounts were distributed by the CIS to such person not later than 12 months after its accrual to the CIS and if that person was entitled to the distribution by virtue of holding a participatory interest in the CIS.

Section 25BA after 1 January 2014

The provisions of section 25BA have recently been amended in terms of the TLAA which was enacted on 12 December 2013. These amendments apply with effect from 1 January 2014 in respect of years of assessment commencing on or after 1 January 2014. It was stated in the Explanatory Memorandum to the Taxation Laws Amendment Bill 2013, that the tax treatment under section 25BA created a problem in that interest may accrue to the CIS in terms of the provisions of section 24J of the Act, while it may not actually be received by the CIS. It was indicated in the Explanatory Memorandum that the CIS could not distribute to the participants interest which has accrued, but has not yet been received by it. The CIS would therefore be taxable on the interest in the year of assessment that is 12 months after such interest would ordinarily have accrued to it. For example if the interest would, in the absence of section 25BA, have accrued to the CIS in terms of section 24J in year 1 and the interest is not distributed to a participant by the end of year 2 because it has not yet actually been received by the CIS, the interest will be deemed to have accrued to the CIS on the last day of year 2 in terms of section 25BA.

The Explanatory Memorandum then proposed that section 25BA of the Act be amended to tax the holder of the participatory interest in a CIS on interest distributed by the CIS not later than 12 months after the <u>receipt</u> of the interest by the CIS. The CIS will then be taxed on interest not distributed by it within 12 months of the <u>receipt</u> of the interest.

Accordingly, in terms of the amended provisions of section

25BA of the Act, irrespective of when interest accrues in terms of section 24J, a portfolio of a CIS will only be taxed on interest in the year of assessment that is 12 months after its receipt, unless it distributes such interest within 12 months of the receipt to participants, in which case the interest will be deemed to have directly accrued to the participants.

Capital gains tax ("CGT") in a CIS context

In terms of paragraph 61 of the Eighth Schedule to the Act, a holder of a participatory interest in a portfolio of a CIS (other than a portfolio of a CIS in property), must determine a capital gain or capital loss in respect of the participatory interest only upon the disposal of that participatory interest. Any capital gain or capital loss in respect of a disposal by a portfolio of a CIS (other than a portfolio of a CIS in property) must be disregarded.

Accordingly, the portfolio of a CIS will be exempt from CGT in respect of disposals of capital assets made by it and the participant will only be subject to CGT upon a disposal of its interest in the portfolio of a CIS.

Specific considerations in relation to hedge funds

It was furthermore proposed in the Explanatory Memorandum that section 25BA of the Act must be amended to clarify that the CIS tax provisions (and not the partnership taxation provisions) will apply if a hedge fund is in the form of a partnership. This is on the basis that hedge funds will be declared as a CIS in terms of the Collective Investment Schemes Control Act, probably within the first quarter of 2014. To date, hedge funds have not yet been declared a CIS in terms of such Act. In other words, it was proposed that regulated hedge funds in the form of partnerships should be treated the same as a CIS.

The TLAA introduced a new section 25BA(2) which provides that where a portfolio of a hedge fund CIS is constituted as a partnership any amount allocated by that portfolio to the partners in that partnership must be treated as having been distributed by that portfolio to the partners in that partnership by virtue of those partners being holders of participatory interests in that portfolio. This section was also inserted with effect from 1 January 2014 and in respect of years of assessment commencing on or after that date. However, the definition of a portfolio of a hedge fund collective investment scheme in section 1 of the Act (as used in the new section 25BA(2)) is not yet effective. This definition will only become effective with effect from the date on which the Minister (in accordance with section 63 of the Collective Investments Schemes Control Act) declares a hedge fund business, in which a portfolio is held, to be a collective investment scheme.

Determining the Base Cost of the repayment of an interest-free loan acquired for less than face value

Authors: O. Kellerman and E. Geldenhuys (ENS)

Introduction

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The difficulty with the market value formula method is that it requires the market value of the loan to be determined immediately before each repayment. Should there be numerous repayments it would accordingly be administratively burdensome to apply this method and practically difficult to implement. As an alternative, the specific identification method can be applied to determine the part of the base cost repaid.

The specific identification method in paragraph 33(2) of the Eighth Schedule provides that the market value formula method will not apply where the expenditure as determined in paragraph 20 of the Eighth Schedule or the market value as determined under paragraph 29(4) of the Eighth Schedule can be directly attributed to the part of the asset which is disposed of or which is retained. Therefore, the market value formula method will not apply where the expenditure or market value in respect of the part disposed of can be specifically identified.

The South African Revenue Service's Comprehensive Guide to Capital Gains Tax (Issue 4) states that the specific identification method recognises the fungible nature of a loan, that is, that all parts of the loan have an equal cost, are indistinguishable and identifiable by nomination. Therefore, in terms of paragraph 33(2) of the Eighth Schedule and following this statement, the base cost of the part of the loan repaid will be calculated as follows:

Base cost of the part of the loan repaid = amount repaid / the total loan x base cost of the loan

Therefore, where a loan with a face value of R100 million is acquired by a company at a cost of R80 million and R10 million is repaid in the first year, the base cost of the part of the loan repaid will be R8 million (i.e. R10 million / R100 million x R80 million). The capital gain will accordingly be R2 million (R10 million less R8 million) with capital gains tax of R373 340 payable at an effective rate of 18,667%. Using the above example and as all parts of the loan have equal cost, R1 of the R100 million loan will accordingly have a cost of 80 cents. This creates a simplified calculation in that should a repayment of R10 million be made on a loan with a face value of R100 million which is acquired for R80 million the base cost of the part of the loan repaid can simply be calculated as follows: R10 million x 80 cents = R8 million.

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Capital Gains Tax and The effects of inflation

The South African capital gains tax (CGT) regime does not provide for indexation: it does not take into account the effect that inflation may have on capital profits over time.

Consider the following example: A company bought an asset on 1 January 2002 for R1 000. The company sold the asset on 1 January 2013. The inflation rate during that period was, for example, 6% compounded annually. The company realised a return of, for example, 10% compounded annually, that is, a return of 4% above inflation compounded annually. Accordingly, the company sold the asset for an amount of R2 853. The company realised a nominal profit of
R1 853 (R2 853 – R1 000). But, taking into account the effect of inflation, the company achieved a real profit of R539 (R1

539 – R1 000).

The company distributed the nominal profit of R1 853 to its shareholders who are natural persons.

The total amount of tax payable effectively borne by the shareholders, the ultimate investors, is determined as follows:

Step 1 – Determine CGT in the hands of the company:

Proceeds	R2 853
Base cost	(R1 000)
Capital gain	R1 853
Apply inclusion rate (66.6%)	R1 234
Apply corporate tax rate (28%)	R346

The CGT amounts to R346.

Step 2 – Determine dividends tax in the hands of the shareholders:

Profit before CGT	R1 853
CGT	(R346)
Profit after CGT	R 1 507
Apply dividends tax rate (15%)	R226

The dividends tax amounts to R226.

The total tax effectively borne by the shareholders amounts to R572 (R346 + R226).

As mentioned above, the real net profit after taking into account the effect of inflation is R539. In other words, in real terms, the shareholders are paying more to the taxman (R572) than they are actually realising on their investment (R539).

When CGT was introduced in 2001, the National Treasury considered the issue of whether or not CGT should provide for indexation, that is, to take the effect of inflation into account.

In a document entitled “Briefing by the National Treasury’s Tax Policy Chief Directorate to the Portfolio and Select Committees on Finance Wednesday, 24 January 2001” the National Treasury considered the issue in detail. Among other things, it made the following statements:

- “The combined benefits of the ‘low inclusion rate’ and deferring accrued capital gains until realisation should more than compensate for the effects of inflation in a moderate-inflation environment”.
- “…[T]he potential impact of inflation was one of a number of considerations (though not the primary factor) that informed the decisions to have moderate (low) ‘inclusion rates’ of capital gains in taxable income, thereby partially adjusting for inflation”.
- “Assuming a constant pre-tax real return, constant

inflation and *constant inclusion rate*, the effective tax rate would fall over time. This suggests that inflation compensation arising from a *constantly low inclusion rate* would increase with time" (emphasis added).

The "low" inclusion rate was only one of the reasons why the National Treasury did not provide for indexation. Notably, "administrative complexity" was one of the motivations.

When CGT was introduced with effect from 1 October 2001, generally speaking, the inclusion rate was set at 25% for natural persons and at 50% for other persons. However, with effect from years of assessment starting on or after 1 March 2012, the inclusion rate was increased to 33,3% and 66,6%, respectively.

In the Budget Speech of 22 February 2012 it was stated that the increase of the inclusion rate was necessary to "reduce the scope for tax arbitrage and broaden the tax base further". The 2012 Budget Tax Proposals stated (at page 3) that CGT: "was introduced in 2001 at relatively modest rates and has remained unchanged for the past 10 years. This reform has helped to ensure the integrity and progressive nature of the tax system. To enhance equity, effective capital gains tax rates will be increased." It appears that no substantive reasons were given for the change.

At the time, most commentators were surprised by the increase in the inclusion rates but there was not much resistance against the increase at the time.

It would appear that the inclusion rate was increased simply to collect more tax. The increase certainly had nothing to do with “equity”. As noted above, in fact, when CGT was introduced the National Treasury implied that the inclusion rate was set at a ‘low’ rate for reasons of equity: to compensate for the effects of inflation. Further, it said that the inflation compensation would increase over time as a result of a constantly low inclusion rate, suggesting that the compensation would only work over a long period of time if the inclusion rate was kept steady. (It is noted that the corporate tax rate at the time was 30% compared to the current rate of 28%, but this does not materially affect the principle.)

When the inclusion rates were increased in 2012, the National Treasury seems to have conveniently forgotten what it had said before about keeping the rates constant. The effect of the increase of the inclusion rate is of course exacerbated by the recent replacement of secondary tax on companies with the dividends tax and the increase of the rate from 10% to 15%.

It is manifestly apparent that the high rate of CGT combined with the dividends tax is eroding the real returns of investors, and is not encouraging taxpayers to invest and save.

It is submitted that, to compensate for inflation, the National Treasury should at a minimum either reduce the CGT inclusion rates or provide for indexation.

(***Editorial comment:*** *What is happening in other countries?*)
Cliffe Dekker Hofmeyr
ITA: Eighth schedule

On South African tax compliance, tax morality and taxpayers' freedom to do tax planning – Canada, Ireland and South Africa are not worlds apart

Tax Planning – PNM Financial Services

The upcoming Budget Speech comes against the backdrop of a depressing South African growth rate, stubbornly high unemployment, a depreciating Rand (with more US tapering still to come), continued strikes in the mining sector, deadly service delivery protests and declining tax revenues.

On a more positive note: In November 2013 Minister Gordhan pointed to the continued growth in tax compliance by South Africans and said: "… the ability to collect tax revenue …to finance the provision of public services and socioeconomic infrastructure has been a cornerstone of our democracy these 20 years."

Commentators question, however, whether such compliance gains are sustainable in light of wide-spread wasteful and fruitless State expenditure. There have been headlines warning that "Taxpayers' pockets are not bottomless" (BusinessDay, 15 Nov 2013), that "Profligacy threatens legitimacy of the tax system" (BusinessDay, 25 October 2013) and that "It is indeed an emergency when government throws away the tax revenue that could be fixing real problems" (Financial Mail, November 22 – 27, 2013).

The SARS Strategic Plan 2013/14 – 2017/18 recognises the risk: "Research and empirical evidence show that taxpayer's attitude towards compliance, and their willingness to comply, is influenced by how they perceive public funds to be utilised.

Concerns about corruption in the public sector remain an issue.

Recent surveys show that corruption has replaced crime as the number one issue concerning South African citizens."

Despite the above, SA taxpayers should expect to hear, during Budget time, continued references to the notion of "tax morality", urging each one to pay his or her "fair share".

As explained by the previous SARS Commissioner: "In SARS, we have for many years promoted the notion that there is a moral component to tax compliance and this has seen us at odds with some tax advisors and professionals who insist tax is simply a cost to be reduced wherever possible."

What should SA taxpayers' take on this be?

A recent Canadian tax case complemented the litigants for sticking to tax fundamentals and for keeping tax morality arguments out of the proceedings.

The judgment in ***Mckesson Canada Corporation (Appellant) and Her Majesty The Queen (Respondent) (heard in the Tax Court of Canada in December 2013 (2013 TCC 404; 2013 Can.Tax Ct. LEXIS 323))*** is both lengthy and complex. It deals with transfer pricing. But it makes the following observations regarding tax morality versus a taxpayer's freedom to do tax planning:

- "The Crown did not directly or indirectly raise any fair share or fiscal morality arguments that are currently trendy in international tax circles. It wisely stuck strictly to the tax fundamentals: the relevant provisions of the legislation and the evidence relevant thereto. Issues of fiscal morality and fair share are surely the realm of Parliament." [par 167].
- "There is certainly nothing wrong with taxpayers doing tax-oriented transactions, tax planning, and making decisions based entirely upon tax consequences (subject only to GAAR which is not relevant to this appeal). The Supreme Court of Canada reminds us regularly that the Duke of Westminster is alive and well and living in Canada." [par 275].

The last quotation might as well have come from SA case law.

In ***CSARS v NWK Ltd [2011] 2 All SA 347 (SCA)*** Lewis JA held: "It is trite that a taxpayer may organise his financial affairs in such a way as to pay the least tax permissible. There is, in principle, nothing wrong with arrangements that are tax effective." [par 42]

The footnote to the abovementioned passage mentions that the SA taxpayers' freedom to do tax planning was based on, and had been affirmed, in the *Duke of Westminster, Ladysmith* and *Conhage* cases.

A reminder: In ***Inland Revenue Commissioners v. the Duke of Westminster (1936) AC 1***, Lord Tomlin proclaimed:

"Every man is entitled, if he can, to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

It seems that the *Duke of Westminster* is alive and well and (also) living in South Africa.

At a major Global Tax Policy Conference (held in Dublin, Ireland during October 2013) Josephine Feehily who is the chair of the Irish Revenue Commissioners and chair of the OECD Forum on Tax Administration opined on the topic of tax morality. She stated that that tax morality was not the issue, but rather the enforcement of the correct tax payable. Such enforcement should be based on the laws made by government, and through reasonable and purposive interpretation of those laws rather than through tax morality that is difficult to enforce. She further said that, should the tax laws be abused, alternatively their intent and purpose not be clear, they should either be amended to clarify them or referred to the courts for interpretation. [Refer Conference feedback as reported in TaxTalk Journal, January / February, 2014 edition, at p. 14].

Clearly Canada, Ireland and South Africa are not worlds apart in saying that 'fair share' and 'tax morality' concepts belong in the realm of Parliament and that a taxpayer's tax liability should be determined with reference to the applicable statutory provisions.

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Capital Gains Tax – Reits, recoupments and assessed losses

Author: Louis van Manen (Grant Thornton)

The Taxation Laws Amendment Bill of 2013 (TLAB) contains a proposed amendment to the newly introduced Real Estate Investment Trust (REIT) legislation which should be welcomed by such trusts. While it is generally assumed that the tax burden associated with income and capital gains of REITs is effectively shifted to shareholder level under the REIT legislation, it will not always be the case under the current legislation. Despite enjoying exemption from Capital Gains Tax (CGT) on most immovable property related asset disposals, REITs are not specifically exempt from the recoupment of past wear and tear allowances deducted on immovable property. This is reflected in the resultant deferred tax liabilities being maintained by reporting REITs.
This obstacle is then made insurmountable by the qualifying distribution deduction formula as it is currently contained in section 25BB(2) of the Income Tax Act No 58 of 1962 (the Act), which effectively requires REITs to utilise any assessed losses before the deduction of qualifying distributions. This is achieved by limiting the deduction of qualifying distributions to the taxable income of a REIT, which is by definition determined after deduction of any assessed loss. Without the ability to maintain or create assessed losses, REITs cannot shield themselves from the tax implications resulting from the recoupments of past wear and tear deductions.

Although the TLAB does not propose the introduction of a recoupment exemption for REITs, it does address the matter to an extent by proposing an amendment to the qualifying distribution deduction mechanism by limiting the deduction to taxable income before deducting any assessed loss of the REIT. The assessed loss deduction will consequently move below the qualifying distribution deduction in a REITs tax calculation, whereas it currently sits above it. By preventing the erosion of assessed losses resulting from qualifying distribution deductions REITs will be able to maintain assessed losses until they can be utilised against taxable recoupments.

As section 25BB(4) prohibits the deduction of immovable property related allowances in terms of sections 11(g), 13, 13bis, 13ter, 13quat, 13quin or 13sex, REITs abilities to create assessed losses are severely hamstrung. The TLAB unfortunately does not alter this position. Section 25BB does not however, prevent REITs from deducting section 11(e) wear and tear allowances on qualifying assets owned and used by REITs. SARS's Interpretation Note 47 lists such assets and write-off periods acceptable to SARS which include assets typically owned by REITs as part of their property investments. Such assets include air-conditioners, communication systems, carports, lift installations, demountable partitions, fire detection systems, fitted carpets, generators, advertising boards, escalators, security systems and shop fittings. These assets often account for fair portions of property development, acquisition or improvement costs and should not be ignored.

Although such allowances will ultimately also need to be recouped under section 8(4)(a) of the Act when the relevant assets are disposed of (typically when a property is disposed of), the allowances may create assessed losses which could shield REITs from tax costs on earlier recoupments for a period of time.

It should also be borne in mind that despite the fact that most REITs will distribute their net income to shareholders or linked unit holders, which distributions will qualify as tax deductions under s 25BB, they will still often be liable for tax resulting from differences between the calculation of net income for accounting purposes and the calculation of taxable income. Such differences will typically stem from leasing commissions, tenant installation costs, bonus provisions, leave pay provisions and bad and doubtful debts which could lead to tax liabilities in some

years and assessed losses in others. For this reason REITs should take extra care when estimating taxable income for provisional tax purposes to they are not exposed to provisional tax underestimation penalties which can become very expensive and arduous to contest. Maintaining an assessed loss could act as a safeguard against such unwelcome surprises.
REITs, along with all taxpayers, are however cautioned that SARS currently levies understatement penalties under section 222 of the Tax Administration Act No 29 of 2011 regardless of whether or not taxpayers were in assessed loss positions when understatements occur. In light hereof the preparation of accurate provisional tax estimation calculations and annual tax computations must remain an important item on any REITs agenda. REITs seeking to deduct section 11(e) allowances should ensure they are able to substantiate such allowances by keeping accurate records of the assets and deduction calculations. Identifying and valuing qualifying assets on existing properties will require the professional analysis of each property as a whole.

This article first appeared on the Jan/Feb edition of Tax Talk.

Taxation of Issue of shares as consideration

In order for the ownership of assets to pass from a seller to a buyer it is necessary that the parties agree three essential elements: price, terms and structure. These three elements are interdependent in any transaction. For instance, after agreeing the price of a transaction, i.e. the number of rands or rand value of the consideration the seller will receive, the parties will need to agree the terms such as whether the price will be paid by means of cash, debt and/or shares as well as the timing of these payments.

Commercial transactions can be structured on the basis that instead of a cash payment for the acquisition of an asset, shares are issued by the purchaser in favour of the seller, usually referred to as an “asset for share” transaction. The issue of shares as consideration will give rise to a number of tax consequences which should be considered carefully before implementing the proposed transaction. Thus, after agreeing the price and the terms the parties will need to agree the structure of the transaction, namely, whether it should be structured as a taxable or a tax-deferred transaction. That careful consideration should be given to these matters is particularly the case given the ever changing tax legislative provisions.

Of particular relevance in a taxable transaction where shares are issued as consideration for the acquisition of assets are the anti-avoidance provisions addressing value mismatches. Complex tax systems such as South Africa’s, invite taxpayers to carry out certain transactions by according them special tax advantages. Yet, attempts to access these advantages might be susceptible to challenges under the general anti-avoidance rule because the transaction was motivated, at least in part, by the desire to access the tax advantage, or legislative amendments might be enacted to block such tax advantages.

According to National Treasury, schemes which allowed for shares to be issued in exchange for assets where there is a mismatch in their respective values did not trigger the appropriate amount of tax. The Income Tax Act No. 58 of 1962 (the Act) contains a number of provisions stipulating that in specific circumstances the disposal of assets will be deemed to take place at market value. For example, paragraph 38 of the Eighth Schedule to the Act contains a deemed market value provision in circumstances where an asset is disposed of by means of a donation, for a consideration not measurable in money or for a price that is not arm’s length between connected persons. Where a formal connected person relationship is absent the buyer and seller could easily structure their transaction to fall outside the paragraph 38 market value deeming provisions.

However, the anti-avoidance provisions are not limited to the Eighth Schedule. Additional anti-avoidance provisions have been inserted in the Act to address circumstances where value is transferred without triggering the appropriate tax, specifically where the parties concerned are not “connected persons”.

- Section 40CA provides that if a person acquires an asset in exchange for shares, that person is deemed to have incurred expenditure in relation to the acquisition of the asset equal to the market value of the shares issued as consideration immediately after the acquisition.
- Section 24BA applies where a company acquires an asset in exchange for the issue of shares by that company and the consideration differs from the consideration that would have applied between independent persons dealing at arm’s length. If there is any mismatch in market values of the assets disposed of and the shares issued as consideration for the acquisition of the assets, then section 24BA addresses any such mismatch on the basis set out below.
- Where the market value of the assets immediately before the disposal exceeds the market value of the shares issued in consideration immediately after their issue the amount of the excess must be deemed to be a capital gain.
- Where the market value of the shares issued in consideration immediately after that issue exceeds the market value of the assets immediately before the disposal the amount of the excess must be deemed to be a section 64D dividend that comprises a distribution of an

asset *in specie*.

A number of questions arise from the application of the above sections in practice.

How is the market value determined?
The Act does not define market value in any general provision. Instead there is a definition of market value for the specific purpose of capital gains tax. That provision defines market value as the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm’s length in an open market. The South African Revenue Service has indicated that the open market value of an asset is the best price at which an interest in the asset would have been sold unconditionally for a cash consideration assuming, amongst others, that there is no duress, that a period has elapsed for the marketing of the interest and for the sale to be concluded and that both parties to the transaction acted knowledgeably, prudently and without compulsion.

The Act does not prescribe which valuation methodology is the most appropriate when valuing unlisted shares. It is nevertheless likely that the South African Revenue Service will expect that a number of factors that may affect the shares’ market value be taken into account as follows:

- The use of a valuation method will have to be explained and demonstrated why it is an appropriate method;
- Adjustments for factors such as liquidity (at the holdings level) and degree of control and to show that these adjustments are appropriate (for instance it might be possible to benchmark a minority interest in an unlisted company against a listed company operating in a similar environment); and
- The rights of other equity and debt holders (which

may influence the market value of an ordinary share).

When will the market value be determined?
Interestingly, section 24BA (in determining the capital gain on issue of shares) refers to the market value immediately before the disposal of the asset and section 40CA (in determining the base cost of the asset acquired) refers to the market value immediately after the acquisition. The taxpayer should therefore appreciate that the timing for determining the market value may be different depending on the relevant section.

Is there any order of preference in the application of the relevant sections?
The latest draft amendments to the Act clarify that if paragraph 38 is applicable, then section 24BA will not be applicable. The taxpayer concerned will therefore have to consider both provisions to determine which will be applicable to the transaction in question.

Taxpayers will be well advised to perform a tax due diligence to ascertain the implications of entering into a transaction of this nature. The taxpayer's commercial requirements will have to be reconciled with the tax consequences. For instance, the taxpayer may seek to minimise any capital gains tax payable or ensure that the base cost of any assets acquired is as high as possible. However, these tax requirements may not always be easily achievable given the surrounding factual circumstances when considered in conjunction with the anti-avoidance provisions contained in the Act.

*(**Editorial comment**: The above article does not cover the tax implications of the base cost of shares for CGT purposes or the cost in terms of section 22 (where shares are acquired as trading stock) in the hands of the person who acquires shares from the company in terms of section 24BA.)*

UK capital gains tax ‘is bad news for SA’

SOUTH Africans with property in the UK will in future be liable for capital gains tax there once they sell their property, following an announcement last month that the tax will be introduced in the UK from April next year.

The South African economy is likely to lose revenue because of the step, as the UK would in future be getting the tax instead of South Africa, Michael Honiball, partner in the tax department of law firm Webber Wentzel, said on Tuesday.

South Africa’s domestic laws, besides its double tax treaties, provide for double tax relief, crediting South African taxpayers for tax paid in a foreign jurisdiction. The rate of capital gains tax on the gains made by nonresidents, such as South Africans, in the UK will be 28%, compared with the 13.3% they are charged in South Africa.

South Africans now pay 13.3% on the gains of property sold in the UK to the South African fiscus. From next year, they will pay 28% in the UK and 13.3% in South Africa, but due to the double tax relief they will only pay capital gains tax in the UK because of the higher rate in the UK, Mr Honiball said.

“Although they will be paying more tax than before, it is doubtful that it would impact on their decision to buy property in the UK .”

The announcement reverses an almost 50-year-old policy that allowed individuals, whether British expatriates or overseas buyers, to invest directly in UK property without paying tax on any gains once the property was sold, said Rupert Worsdale, tax partner with advisory firm Maitland in South Africa on Monday. UK Chancellor of the Exchequer George Osborne made the announcement.

Mr Worsdale said the UK government aimed to increase revenue and to prevent a London property bubble. “A number of commentators are suggesting that the new rules would lead to a reduced appetite for high-end residential property.

“This is doubtful, as London residential property is regarded as a safe-haven asset and the new tax is unlikely to change this.”

Mr Honiball said the decision to introduce capital gains tax on nonresidents in the UK was not unusual. “It has been unusual for them not to have had capital gains tax imposed on foreigners.”

In most foreign jurisdictions Britons pay capital gains tax if they own and sell property. In South Africa they are charged capital gains tax at a rate of 13.3%.

“They are simply conforming to global best practice where gains on immovable property are taxed in the place where it is,” Mr Honiball said. “Therefore, the move is not unexpected .”

Mr Worsdale said there was anecdotal evidence of many South Africans with property in the UK, although the value or number of their assets are unknown. The UK does not keep record of the nationalities of property buyers.

The South African Reserve Bank, which governs exchange control regulations, allows South Africans to invest up to R4m abroad. In addition, up to R1m, within the single discretionary allowance facility, can be transferred abroad.

Mr Worsdale said South Africans with property in the UK would have to have their assets valued before April 6 next year to provide for a base cost from where gains could be calculated.

Mr Honiball said the aim with the tax was to keep property prices down in central London where rich foreigners had been buying up bargains because of the “no (capital gains) tax system”. This had pushed locals out of the property market.

“It will, of course, bring extra revenue, but the stated intention is for it to equal the playing field for foreigners and locals.”

The UK imposed capital gains tax from April 1 last year on high-value residential property (more than £2m) owned by a company or other corporate bodies.

Mr Worsdale said that the latest proposal was likely to apply to all nonresidents, including individuals and trustees. In addition, it would apply to all residential properties, irrespective of their value.

Hugo van Zyl, cross-border tax and exchange control specialist, said he was aware of South Africans with property in the UK, especially London, who were considering selling it before the new capital gains tax was introduced.

He said he was not completely convinced that the proposed new tax would not force foreigners to sell their property before the introduction of capital gains tax.

He has already been asked by some South Africans with property in the UK to do the calculation of the possible effect the introduction of the 28% tax could have on profits if the property was sold now, or when it was sold after April 2015.

He said many South Africans bought property in the UK with the intention of letting it since the rental market in London is quite robust. Some said they would keep the property for this reason, or pass it on to their children who are UK residents. He said they were not affected by the capital gains tax introduced on high-value residential property owned by a company or other corporate bodies last year, but will be affected by the new 28% capital gains tax on all residential property owned by non-residents in the UK.