Determining a taxable capital gain or an assessed capital loss: some problems

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Abstract
Despite the South African legislature’s intention to introduce capital gains tax (CGT) as a simple and clear tax, it is an extremely complex tax. Several provisions of both the Eighth Schedule to the Income Tax Act 58 of 1962 and the Act itself have to be taken into account in determining whether a taxable capital gain or an assessed capital loss has arisen during the year of assessment. The application of these principles is often surrounded by uncertainty. Hence, the purpose of this article is not only to provide an overview of some of the different provisions that have to be taken into account and the interaction between them, but also to highlight some of the problems arising from the application of the principles themselves.

Key words
Assessed capital loss  Interpretation of capital gains tax
Base cost  legislation
Capital gain/loss  Meaning of ‘proceeds’ for CGT-purposes
Capital gains tax  Net capital gain
Capital gains tax building blocks  Proceeds
Consecutive disposals  Taxable capital gain
Inclusion of rights and assets for capital gains tax purposes  Unaccrued amounts – paragraph 39A

1 Introduction

The intention of the legislature in introducing capital gains tax (‘CGT’) with effect from 1 October 2001 was to introduce simple and clear, yet technically correct provisions (McAllister 2005:51). However, CGT is internationally known to be an extremely complex tax. Although the Eighth Schedule to the Income Tax Act 58 of 1962 (‘the Act’) (South Africa 1962), containing the provisions relating to CGT has been in operation for just over five years, these provisions have proven to be extremely complex and often difficult to apply in practice. The problem is exacerbated by the fact that, as it is a new tax, not much guidance can be obtained from domestic court decisions. In addition, the South African Revenue Service (SARS) is often not in a position to provide guidance on its own interpretation and application of complex practical issues, as it does not yet have a standard practice with regard to CGT. SARS (McAllister 2005) has produced a comprehensive CGT
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Guide and made it freely available on its website (www.sars.gov.za), but it is obviously impossible to address all the practical issues in this Guide.

Even the basic exercise of determining a taxpayer’s taxable capital gain or assessed capital loss is often very complicated, because several different provisions have to be taken into account. As these provisions are not all contained in the Eighth Schedule, it is often easy to overlook one or more of the provisions, with significant financial implications for taxpayers. The purpose of this article is not only to highlight some of the different provisions that have to be taken into account in determining a capital gain or capital loss, but also to address some of the complicated and intricate problems that may arise in doing so.

In order for CGT to be levied, the presence of four so-called ‘building blocks’ is presupposed, namely the disposal of an asset for proceeds that exceed its base cost. All four building blocks must be present before a taxpayer has to account for CGT. To determine whether a taxpayer has to account for a capital gain or a capital loss, several steps have to be followed. Firstly, the capital gain or capital loss arising from disposal of property during the year of assessment has to be determined (paragraphs 3 and 4 of the Eighth Schedule – unless otherwise indicated, all further references in this article to paragraphs refer to paragraphs in the Eighth Schedule). Secondly, at the end of the year of assessment, all the capital gains and losses generated during the year of assessment must be added together to determine whether a taxpayer has a so-called ‘aggregate capital gain’ or ‘aggregate capital loss’ (paragraphs 6 and 7). Thirdly, any assessed capital loss from a previous year must be taken into account (paragraph 9). This may show that a taxpayer has either a net capital gain or an assessed capital loss. The final step is to include in a taxpayer’s taxable income the percentage of the capital gain that is taxable, or to carry forward the capital loss (in each case minus the annual exclusion). A taxable capital gain is included in a taxpayer’s taxable income in terms of section 26A and an assessed capital loss is carried forward to be offset against capital gains in future years of assessment.

Before a taxpayer undertakes the exercise of calculating a capital gain or capital loss, he or she must determine whether the particular disposal falls within the South African tax net. It should be noted that this question is not determined solely with reference to South African domestic law. The provisions of a double tax treaty between South Africa and the country in which the disposal takes place is decisive in determining whether South Africa has the right, in principle, to tax the capital gain. The answer to the question of which disposals have to be accounted for in South Africa depends on whether the person disposing of the asset is a South African resident. South African residents pay CGT in principle on the disposal of their worldwide assets (paragraph 2(1)(a)). Non-South African residents pay CGT on the disposal of the following assets:

1. immovable property situated in South Africa or an interest in, or right to (as defined in paragraph 2(2)) immovable property situated in South Africa; and
2. assets of a permanent establishment (as defined in section 1) carrying on a trade in South Africa (paragraph 2(1)(b)).

In addition, section 9(2) was amended to provide for instances in which a capital gain or a capital loss was deemed to have been sourced in South Africa. The purpose of introducing ‘deemed source’ rules for capital gains tax is unclear. Although the definition of ‘gross income’ in section 1 of the Act makes it clear that non-South African residents pay income...
tax on South African sourced income, no such general provision exists in respect of capital gains tax. As indicated, non-South African residents pay income tax in the limited circumstances provided in paragraph 2 only, and not on all South African actual or deemed capital gains.

2 Building blocks
Each of the four ‘building blocks’ of CGT referred to above has its own complexities.

2.1 Asset
The term ‘asset’ as broadly defined in paragraph 1 of the Eighth Schedule includes
(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding currency, but including any coin made mainly from gold or platinum; and
(b) a right or interest of whatever nature to or in such property.
From the definition it is clear that the word ‘asset’ is synonymous with the word ‘property’ as interpreted in terms of the ‘property clause’ of section 25 of the Constitution of the Republic of South Africa 108 of 1996. Although the word is not defined for purposes of the constitutional guarantee, writers agree that the word should be interpreted ‘widely’ to include everything that has a monetary value. Van der Walt (1999:353) states:

*The end result seems to be that the property concept in section 25 will be interpreted widely, but not completely without any limits. In line with the general approach that is followed in other jurisdictions, it is to be expected that the property concept will be wider than in private law, but is still restricted to rights that are demonstrably vested in the claimant and that have some patrimonial value.*

Also see Kleyn (1996:402-445) in this regard.

Swart (2005:3) argues that the word ‘asset’ bears some resemblance to its Australian counterpart. The core of the definition is derived from an earlier definition of the term by the South African legislature for donations tax purposes, namely ‘any right in or to property movable or immovable, corporeal or incorporeal, wheresoever situated’ (definition of the term ‘property’ in section 55 of the Act). He is of the opinion that all terms in the Eighth Schedule, including the word ‘asset’ should be interpreted within the framework of this Schedule and not with reference to jurisdiction on which the South African provisions are presumably based. Although Swart is probably right in arguing that, because the CGT rules contained in the Eighth Schedule are unique and do not represent merely an adaptation of foreign legislation, the rules have to be interpreted in its own context. Furthermore, it cannot be denied that, in interpreting legislation, section 233 of the Constitution of the Republic of South Africa, Act 108 of 1996, dictates that effect must be given to any reasonable interpretation that is consistent with international law. Obviously, the uniqueness of the South African legislation is decisive in deciding to what extent it would be reasonable to take foreign law into account.

It is submitted that whichever provisions are applied in interpreting the word ‘asset’, it would be very difficult to argue that whatever has been disposed of falls outside the definition of an ‘asset’. A possible exception may be where the thing disposed of is not legally transferable (see discussion below).
Williams (2001:24-25) is of the opinion that the term ‘asset’ does not include the discretionary rights of a trust beneficiary, because such a beneficiary has a mere spes or expectancy. This view appears to warrant further scrutiny. Irrespective of whether beneficiaries have vested or discretionary rights, they always have personal rights against the trustees to comply with the provisions of the trust deed. This statement holds true for trusts other than so-called ‘bewindstrusts’.

Under a bewindstrust, ownership of the trust property is vested in the beneficiaries, and control over the assets is vested in the trustees (paragraph (b) of the definition of a trust in section 1 of the Trust Property Control Act, Act 57 of 1988). Unless a trustee distributes trust assets to beneficiaries, such beneficiaries generally do not have any right to those assets. Instead, they belong to the trustees in their representative capacity (see CIR v MacNeillies’ Estate 1961, 3 SA 833 (A)). In addition, beneficiaries either have discretionary or vested rights of enjoyment to the trust capital and/or income. The fact that the right of enjoyment is merely contingent does not alter the fact that it is a right. Even if this argument is incorrect, beneficiaries with discretionary rights have an interest in the trust property. As such, their interest clearly qualifies as an asset for CGT purposes. This view correlates with that of the legislature, as provided in paragraph 81, that the base cost of the interest of a trust beneficiary is deemed to be zero.

Provided that the discretionary rights have a monetary value (which may not always be the case, as the benefits arising from contingent rights are at the trustees’ discretion), it is submitted that the rights of a discretionary beneficiary do constitute an asset for CGT purposes.

The definition of the term ‘asset’ does not distinguish between transferable and non-transferable property rights. In view of the fact that CGT is only levied once there is an actual or deemed disposal, the question arises as to whether it was the legislature’s intention to include only transferable rights within the CGT net. If so, it would mean that, for example, where compensation was received for defamation, such compensation would not fall within the tax net, as the right to sue for defamation is not legally transferable (see Neethling, Potgieter & Visser 2005:78-79). On the one hand, it may be argued that, as the legislature did not expressly lay down the requirement of ‘transferability’, no such requirement exists. However, on the other hand, it may be argued that the legislature indirectly laid down the requirement, by providing that CGT is only payable on actual or deemed disposals (paragraph 11) and that, in general, the so-called ‘time of supply’ rules, as contained in paragraph 13, presuppose a change of ownership. Although this interpretation is in line with Swart’s (2005:2) view (see argument above) that terms in the Eighth Schedule should be interpreted with reference to that Schedule, Swart does not agree that an asset is only recognised as such if it is transferable. According to Swart (2005), the transferability of the asset merely affects valuation and not the fact that an asset exists. For a more in-depth discussion of this debate, see Cassidy (2004:164) and Swart (2005:15-16).

From a legal perspective, whenever an asset is disposed of, until delivery has taken place, the person to whom the asset has been disposed to merely receives a personal right to claim delivery of the asset. The result is that for CGT purposes, two disposals take place (that is,
consecutive disposals). The first disposal is of the personal right to claim delivery of the asset and the second disposal is the exchange of this personal right for the asset delivered or transferred. If disposal and delivery take place in the same tax year, a taxpayer will obviously only account for a single disposal, that is, the exchange of the personal right to claim delivery for the actual asset. The situation is less clear where delivery only takes place in the following year of assessment. From an academic point of view, a taxpayer is required to account for the disposal of the personal right in the first year and for the disposal of the actual asset in the second year. Where payment is made only once delivery has taken place, a capital loss will arise in the first year. However, this capital loss cannot be deducted in the first year, because paragraph 39A provides that if a capital loss arises due to the fact that proceeds have not yet accrued, such a loss may not be deducted, but must be offset against the proceeds once they accrue (refer to the discussion in Section 3 of this article below). The practical result is thus that although two CGT events occur, only the second event (that is, the disposal on delivery) gives rise to a capital gain or a capital loss. Cassidy (2004:189) maintains that where both disposals are taken into account for CGT purposes, in the absence of reconciling rules, the possibility of double taxation arises. Due to the complexity of the issue, Swart (2005:17) does not address Cassidy’s view in depth, but merely states that the time of supply rules in the Eighth Schedule will prevent such double taxation. It may be argued that the mere fact that in 2004 the legislature introduced paragraph 39A to prohibit the deduction of a capital loss in such circumstances negates Swart’s argument that the current time of supply provision is sufficient to eliminate double taxation.

The reason provided in the SARS CGT guide for the inclusion of rights in the CGT tax net is that an exclusion of these rights would unduly limit the application of CGT (McAllister 2005:40-41). For example, if an amount were to be received as compensation for a breach of contract, it would not then be possible to include the amount in the CGT net if the right to claim damages arising from the breach of contract was not recognised as an asset for CGT purposes.

The question that may then be asked is whether the complexity that arises from the inclusion of rights in the CGT net warrants the additional revenue that may be obtained from such an inclusion. It is submitted that this question should be answered in the negative.

The definition of the term ‘asset’ specifically provides that currency, other than coins made mainly from gold or platinum, does not constitute an asset for CGT purposes. The motivation for the exclusion is, no doubt, to eliminate the deduction of capital loss due, for example, to the theft of money. Foreign currency does fall within the tax net and is specifically dealt with under part XIII of the Eighth Schedule. (A discussion of these provisions is beyond the scope of this article. For a discussion of these provisions, see Olivier 2003:91.) As coins made of gold or platinum are specifically included in the definition of the term ‘asset’, the gain or loss obtained on, for example, the disposal of Kruger rands may result in a capital gain or loss and not a gain or loss of a revenue nature. There are conflicting decisions (ITC 1525 54 SATC 209; ITC 1543 54 SATC 446 and CIR v Nel 59 SATC 349) as to the nature of the proceeds obtained from the disposal of Kruger rands. Therefore, the question arises whether the specific inclusion of these coins as an asset for CGT purposes lays down a general rule which implies that the disposal of Kruger rands will always be of a capital nature. It can be argued that the insertion of a specific provision is a clear indication that the legislature’s intention was to deal with assets falling
within its ambit under such specific provisions. As a result, the proceeds of the disposal of Kruger rands is subject to CGT, unless it is clear, based on the facts of a particular case, that the taxpayer traded in these coins, in other words, that he/she disposed of them as part of a profit-making scheme. In such circumstances the income will not be subject to capital gains tax, but to income tax.

Since Kruger rands do not constitute so-called ‘personal use assets’ as defined in paragraph 53(2), both capital gains and capital losses arising from their disposal have to be accounted for (paragraph 53(2)(a)).

2.2 **Proceeds**

Paragraph 35(2) provides that the proceeds that must be taken into account for CGT purposes are the amount received by or accrued in respect of the disposal. In other words, there needs to be a causal connection between the disposal and the proceeds. Although this connection is clear in most instances, sometimes there may be doubt as to whether proceeds were indeed received in respect of the disposal. This can best be illustrated by a hypothetical example: a lessor and a lessee agree to terminate a lease agreement and to enter into a new one differing from the original agreement in containing a consumer price inflation-linked rental escalation instead of a rate escalation linked to the prime rate. The present value of the five-year rental flow is R2 million under both lease agreements. As the value of the asset (that is, the rights under the new lease agreement) is equal to the value of the asset previously held (that is, the rights under the original lease agreement), it may be argued that no proceeds were received as a result of the termination of the original lease agreement, but that proceeds were received in respect of the continued rental of the building. It should be noted that in circumstances where the value of the present flow of rentals under the new lease agreement exceeds the present flow of rentals under the old lease agreement, it may be argued that the increased value is received as a result of the disposal of the rights under the new lease agreement and has to be accounted for CGT purposes.

Although the word ‘amount’ is not defined for CGT purposes, it can be safely assumed that as the Eighth Schedule forms part of the Income Tax Act, cases interpreting the word for income tax purposes may be taken into account to determine its meaning for CGT purposes. As early as 1926, the Appellate Division interpreted the word ‘amount’ as follows:

> The word ‘amount’ had to be given a wider meaning and must include not only money but the value of every form of property earned by the taxpayer whether corporeal or incorporeal which had a monetary value. (Lategan v CIR 2 SATC 16 at 19)

This interpretation was confirmed by several other cases. (Refer, for example, to CIR v Butcher Bros. (Pty) Ltd 13 SATC 21 at 34, CIR v Delfos 6 SATC 92 at 251 and CIR v People’s Stores (Walvis Bay) (Pty) Ltd 52 SATC 9 at 21-22). To determine whether whatever is received has a monetary value, an objective test needs to be applied. Whether the taxpayer has indeed received a benefit or not is therefore irrelevant (Ochberg v CIR 5 SATC 93 and Stander v CIR 59 SATC 212).

Similarly, the words ‘received by’ or ‘accrued to’ have been interpreted by the courts for income tax purposes. ‘Received by’ means that a taxpayer must have an unconditional entitlement and that this should be for his/her own benefit and received on his/her own behalf (Geldenhuys v CIR 14 SATC 419 at 430). Based on this principle, any value-added
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tax received by a vendor will not form part of the proceeds as it is not received on behalf and for the benefit of the vendor. The words ‘accrued to’ mean ‘entitled to’ (Lategan v CIR 2 SATC 16 at 20 and People’s Stores (Walvis Bay) (Pty) Ltd 52 SATC 9 at 23-24). As a result, the mere fact that the taxpayer cannot legally enforce the claim, because it is not yet payable does not mean that the proceeds did not accrue.

Apart from the wide definition of ‘proceeds’, certain amounts are specifically included as proceeds. These amounts are

- the amount by which any debt owed by a person has been reduced or discharged (paragraph 35(1)(a)); and
- any amount accruing to the lessee from the lessor for improvements effected to the leased property (paragraph 25(1)(b)).

The second inclusion should not be confused with paragraph (h) of the gross income definition in section 1 of the Act, which provides for an inclusion in the lessor’s gross income. The result is that, where a lessee effects improvements to leased property, the value of the improvements are included in the lessor’s gross income and, where the lessor compensates the lessee for improvements effected, the amount is dealt with as a capital gain or loss in the hands of the lessee.

Paragraph 35(2) contains a specific anti-avoidance rule, dealing with so-called ‘value-shifting arrangements’ as defined in paragraph 1. Where such an arrangement has taken place, the proceeds are the difference between the market value of the interest in the company, trust or partnership before the value-shifting event took place and the market value of the interest after the event took place. In other words, the proceeds are equal to the amount by which the market value of the interest decreased (paragraph 35(2)).

A special provision regulates proceeds if a donation takes place or if a consideration cannot be measured in money or if a transaction takes place between connected persons and the consideration paid does not reflect an arm’s length price. In such circumstances, the proceeds are regarded as the market value of the asset (paragraph 38(1)). Provision is made for exemptions from the general rule (paragraph 38(2)). It should be noted that this deeming provision applies only when the disposal is both between connected persons and the consideration does not reflect an arm’s length price. Where the disposal is not between connected persons, the deeming provision is not applicable, even if the consideration does not reflect market value.

An interesting question arises as to whether paragraph 38 would be applicable in the case of Black Economic Empowerment (BEE) deals where the consideration is lower than the market value of the assets that have been disposed of. The application of paragraph 38 would result in a scenario where the person disposing of the asset is penalised because he/she is obliged to account for CGT on the market value of the asset, despite the fact that his/her aim is to comply with official government policy.

On the assumption that the parties to a BEE deal are not connected persons as defined in section 1, paragraph 38 applies if the sale of an asset constitutes a donation. The term ‘donation’ is not defined for CGT purposes. Although the term is defined in section 55 of the Act for donations tax purposes, this definition is not to be generally applied. Until recently, the belief was held that there was a difference between common law and the statutory definition of the term in section 55 and that, under common law, a donation exists only if it is motivated by pure liberality or disinterested benevolence and not by self-interest or the expectation of a quid pro quo of some kind. No such motivation is required when

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dealing with the statutory definition of the term. This belief was proved to be wrong by a recent decision of the Supreme Court of Appeal. In *Welch's Estate v C:SARS* 66 SATC 303 at 314F-F it was held that there was no difference between the common law and statutory definition, and a donation existed only if it was motivated by pure liberality or generosity. Where the donation was made, for example, to comply with a legal obligation to maintain a family or to comply with a government black empowerment initiative, it cannot be argued that a donation has been made.

To prevent the same amount being subjected both to income tax and CGT, specific provision has been made for all amounts already taken into account for income tax purposes to be excluded from proceeds for CGT purposes (paragraph 35(3)(a)). Where proceeds have been repaid or become repayable to the person to whom the asset was disposed of, such repayment must be deducted from the proceeds (paragraph 35(3)(b)). This would occur, for example, if a seller was obliged to refund part of the purchase price due to a latent defect. Proceeds repaid in a subsequent year of assessment must be treated by the person disposing of the asset as a capital loss in that year of assessment (paragraph 4(b)(i)(cc)). In addition, any reduction in the amount accruing to the person who disposed of the asset as a result of the cancellation, termination or variation of an agreement due to the prescription or waiver of a claim or release from an obligation or any other event must be deducted from the proceeds (paragraph 35(3)(c)). This would happen, for example, where a contract was cancelled and *restitutio in integrum* took place. Where the reduction takes place in a subsequent year of assessment, the amount of the reduction may be claimed as a capital loss in that year (paragraph 4(b)(i)(aa)). Similarly, where an asset of a capital nature is disposed of on which an allowance for income tax purposes has been claimed, the part of the proceeds representing a recoupment are dealt with under section 8(4)(a) and the balance under the Eighth Schedule.

### 2.3 Base cost

In essence, the base cost of an asset consists of the cost of acquisition plus certain categories of other expenditure, for example, transfer cost, stamp duty, transfer duty or other similar costs (paragraph 20).

If an asset was obtained prior to the introduction of CGT but disposed of afterwards, the taxpayer has a choice between one of three different methods of determining the base cost of the asset (refer to the discussion in Section 3 of this article below).

To prevent expenditure from being deducted for income tax purposes and added to base cost for CGT purposes, it is specifically provided in paragraph 20(3)(a) that an asset’s base cost must be reduced by the amount already deducted for income tax purposes.

### 2.4 Disposal

In line with the legislature’s desire to cast the tax net as widely as possible, the term ‘disposal’ is widely defined in paragraph 11 as

> any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset ...

Apart from the wide general definition of the term ‘disposal’, certain events are specifically deemed to be disposals (paragraphs 11(1)(a) to 11(1)(g)), and others that fall within the general definition are excluded (see paragraph 11(2)).
A deeming provision regarded as extremely controversial in practice is the provision that a disposal is deemed to have taken place where a creditor releases a debtor from a debt (paragraph 12(5)). In such circumstances, the debtor is deemed to have realized a capital gain to the extent that he/she has been released from the debt. This deeming provision is also applicable when a testator bequeathes an outstanding loan account to his/her debtor in his/her will. As a result, in theory a double CGT liability may arise, namely the deemed disposal from the deceased to his estate (paragraph 40), as well as deemed disposal to the debtor legatee. (However, in practice, a deemed disposal under paragraph 40 will not arise, as the market value of the loan account will in all likelihood not exceed the base cost of the loan account). The question of whether two different CGT disposals arise in theory under these circumstances was answered in the affirmative by the Tax Court in ITC 1793 67 SATC 256 an unreported case of the Gauteng Tax Court, 18 February 2005 (For a more in-depth discussion of the case, see Olivier 2006 Stellenbosch Law Journal “Reduction or discharge of debts: The hidden tax dangers” 302-313)

It is clear that the definition of the word ‘disposal’ bears no relation to what is commercially or even legally regarded as a disposal. For example, on death, subject to certain exclusions, a person is deemed to have disposed of all his/her assets to his/her deceased estate at market value (paragraph 40(1)). Similarly, the transfer of ownership at the end of a fiduciarius term also results in disposal of the asset to the fideicommissarius. Where the fiduciarius and fideicommissarius are connected persons, for example, father and son, the disposal is deemed to have taken place at market value (paragraph 38). Where an asset was held for several years, the CGT liability (that is, the difference between the market value and the base cost) may cause significant hardship for the fiduciarius.

3 Capital gain and capital loss

Although CGT is accounted for not at the time of disposal of the asset but at the end of the taxpayer’s year of assessment, the capital gain or capital loss in respect of each disposal is determined separately (paragraphs 3 and 4). Although the realisation of a capital gain does not result in a taxpayer’s becoming a provisional taxpayer (refer to the definition of the term ‘provisional taxpayer’ in paragraph 1 of the Fourth Schedule to the Act), where the taxpayer is already registered as a provisional taxpayer, the capital gain has to be taken into account when a taxpayer estimates his/her taxable income for the year of assessment.

To understand fully the provisions in the Eighth Schedule relating to the determination of a capital loss or capital gain, the provisions of another section in the Act, namely section 24M, have to be taken into account. This section was introduced to regulate the tax position when an asset is disposed of for an unquantified amount. Section 24M applies, for example, where a business is disposed of for a percentage of the profits of the business for the next ten years. In such circumstances, the seller is taxed only when the profits accrue each year and the purchaser can only claim a deduction if and when he/she pays over the profits. Prior to the introduction of the section, the nature of the payment could have been in dispute. On the one hand, the taxpayer/seller could attempt to argue that the proceeds remained of a capital nature although they were determined with reference to future profits. On the other hand, two counter-arguments would be available to SARS: firstly, that as the proceeds were determined with reference to future profits, an otherwise capital amount had been converted into an amount of a revenue nature; and secondly, that the future payments constituted annuities. As such, the profits were specifically included under paragraph (a) of the gross income definition in section 1 of the Act. The result left no room for the taxpayer to argue...
that, as the amount was of a capital nature, it should have been taxed at the lower rate applicable to capital gains and not at the higher rate applicable to amounts of a revenue nature (paragraph 10). Although section 24M does not expressly regulate the nature of the unquantified amount, it is submitted that it does so by necessary implication. As a result, amounts received for the disposal of an asset retain their original nature, irrespective of the fact that they may have been paid in the form of an annuity.

As black economic empowerment (BEE) deals are often structured with reference to future profits, to a large extent, section 24M eliminates disputes regarding the nature of payments accrued or received. Although the section is contained in the main Act and not in the Eighth Schedule, it is applicable, irrespective of whether the asset disposed of was held on capital or revenue account.

It is thus clear that section 24M postpones the accrual and incurral of unquantified amounts until the amount becomes quantifiable. As such, the principle regarding accruals (as laid down in Commonwealth Aluminium Corporation Ltd v FCT 77 ATC 4151 and RACV Insurance (Pty) Ltd v FCT 4 ATR 610), namely that, where there is no uncertainty regarding the fact that an accrual has taken place, but only regarding the extent of such accrual, tax liability is not postponed, is no longer applicable.

Where an amount had not yet accrued, a different provision, namely paragraph 39A, applies. In terms of this paragraph, a person is prohibited from claiming a capital loss in respect of a disposal where the proceeds do not accrue to him/her. Such a capital loss must be carried forward to the next year of assessment and may only be set off against the amount accruing from the disposal in respect of which the loss arose (paragraph 39A(2)). It is only when it is clear that no further amounts will accrue in respect of the disposal that the entire capital loss may be set off against other subsequent capital gains (paragraph 39A(3)).

Similarly, section 24M(2) provides that where an amount cannot be quantified in a year of assessment, it is deemed not to have been incurred until it becomes quantifiable. For CGT purposes, the result is that where expenditure is incurred on an asset’s base cost after the asset has been disposed of, a capital loss arises under paragraph 4(b)(ii) in the year in which the expenditure becomes quantifiable (see discussion below).

In essence, the entire application of the provisions of the Eighth Schedule rests on paragraphs 3 and 4. Paragraph 3 deals with the determination of a capital gain and paragraph 4 with the determination of a capital loss.

Broadly speaking, a capital gain or capital loss may either arise in the year of disposal or in a subsequent year. A capital gain arises in the year of disposal if the proceeds obtained on disposal exceed the base cost of the asset (paragraph 3(a)). For example, when shares acquired for R50 are disposed of for R100, the capital gain is R50. However, a capital gain may also arise in the next tax year. Provision is made for three different circumstances in which a capital gain may arise in the year subsequent to the year of disposal. Firstly, in a subsequent year, further proceeds may be received (paragraph 3(b)(i)). This may happen, for example, where section 24M is applicable and a payment under an instalment sale agreement in the first year is received in the second year. In addition, a capital gain may arise in a subsequent year of assessment if a recovery or recoupment of the base cost arises in the next year of assessment (paragraph 3(b)(ii)). This may happen, for example, where a person disposes of an asset and in a subsequent year of assessment recoups a portion of the base cost due to successful litigation against the person from whom he/she acquired the asset, due to the existence of a latent defect in the asset (see McAllister 2005:52).
Thirdly, a capital gain may arise in a subsequent year of assessment if a capital gain has to be re-determined on a so-called pre-valuation date asset (paragraph 3(b)(iii)). To understand this provision, clarity must be obtained on the meaning of paragraph 25(2), dealing with the re-determination of a capital gain. Paragraph 25(2) applies only to pre-valuation date assets, in other words, assets that a taxpayer had acquired prior to the introduction of CGT (that is, 1 October 2001, referred to as the ‘valuation date’), but disposed of after this date. As only the gain arising after this date has to be accounted for, the value of the asset on the valuation date has to be determined. One of three methods may be adopted as the valuation date value, namely:

- the market value of the asset on valuation date as determined under paragraph 29 (paragraph 26(a) read with paragraph 29);
- 20% of the proceeds from disposal of the asset after deducting expenditure allowable under paragraph 20, which was incurred on or after the valuation date (paragraph 26(b)); or
- an allocation of the proceeds to the years prior to and after the valuation date, referred to as the ‘time-based apportionment’ (see paragraph 26(c) read with paragraph 30).

To eliminate the possibility of taxpayers’ artificially increasing the market value of an asset, certain loss limitation rules exist under paragraphs 26 and 27. These rules, which are known as the ‘KINK rules’, are aimed at placing a taxpayer in a tax-neutral position where the proceeds, when the asset is eventually disposed of, do not exceed the market value of the asset (base cost). In other words, a taxpayer cannot claim a capital loss but is also not taxed on a capital gain. However, just as the possibility exists that the proceeds on the disposal of a post-valuation date asset may increase in a subsequent year or that the base cost may decrease in a subsequent year (see discussion above), the same may happen when a pre-valuation date asset is disposed of. As a result, it may happen that the loss limitation rules should not have been applied. To address this situation, paragraph 25(2) was introduced. The provisions of paragraph 25(2) are applied when:

(i) additional proceeds are received or accrue;
(ii) previous proceeds become irrecoverable; or
(iii) previous expenditure is recovered or recouped.

Where the section is applicable, the capital loss or gain has to be determined with reference to the full proceeds or the full base cost. Depending on the facts, the re-determination may result either in a capital gain or in a capital loss in the year of assessment in which the determination takes place.

Principles similar to the determination of a capital gain apply to the determination of a capital loss. As such, a capital loss arises in the year of disposal if the proceeds do not exceed the asset base cost (paragraph 4(a)). A capital loss may also arise in a subsequent year in three different instances: firstly, when the proceeds are lost through cessation of entitlement, are irrecoverable, or become repayable (paragraph 4(b)(i)). This may happen, for example, where the estate of the person to whom the asset is disposed of is sequestrated or placed in liquidation; where the debt prescribed is due to an omission by the creditor to collect it; or where the seller has to repay part of the proceeds due to misrepresentation, a latent defect or overcharging.

Secondly, a capital loss may also arise in a subsequent year of disposal where further expenditure is incurred (paragraph 4(b)(ii)). This may happen where, for example, due to an
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application of section 24M(2), a taxpayer is entitled to add expenditure to an asset’s base cost, which could not be added in a previous year due to the consideration’s being unquantified (see discussion above).

Thirdly, a capital loss may arise in a subsequent year of disposal where a capital gain or capital loss has to be re-determined due to the application of paragraph 25(2) (see discussion above).

4 Aggregate capital gain or aggregate capital loss

At the end of a year of assessment, a taxpayer’s aggregate capital gain or aggregate capital loss has to be determined. This is achieved by adding up all the individual capital gains and capital losses made during the year. In doing so, sight should not be lost of the so-called ‘attribution rules’. Under these rules, gains made by another may in certain circumstances be attributed to a taxpayer. These rules, which are similar to the attribution rules applicable for income tax purposes (section 7), are aimed at countering specific tax planning scenarios and are also applicable when a capital gain arises by reason of a donation, settlement or other disposition made

(a) by a person’s spouse mainly for the purpose of reducing, postponing or avoiding that spouse’s liability for any tax, duty or levy administered by the Commissioner (par. 68);

(b) by a parent to his/her minor child (par. 69);

(c) subject to the condition that the capital gain (or portion thereof) will not vest in the beneficiary of the donation, settlement or other disposition until the occurrence of a fixed or contingent event (par. 71);

(d) subject to the condition imposed by that person that the gain may be revoked and may vest in another person (par. 72); and

(e) by a resident to any other person and as a result of which a capital gain is derived by a non-resident (par. 72)).

However, the attributed gain together with an attributed amount of income cannot exceed the amount of the donation, settlement or other disposition (par. 73). In applying the attribution rules, it should be remembered that only capital gains are attributed and not capital losses. In addition, it is the capital gain that is attributed and not the disposition. This means that the capital gain first has to be determined in the hands of the original disposer. Where the donee is connected to the person who made the donation, settlement or other disposition, the base cost of the asset in the hands of the donee is regarded under paragraph 38 as the market value of the asset at the time of disposal (refer to the discussion in Section 2.2 of this article above). As a result, the capital gain of the donee is always the amount of proceeds that exceed the market value of the asset at the time of donation, settlement or other disposition is made.

For the 2006 and prior years of assessment natural persons and special trusts as defined in paragraph 1 were also entitled to an annual exclusion of up to R10 000 and, in the year in which a natural person dies, the exclusion was increased to R50 000 (paragraph 5). For the 2007 and subsequent years of assessment the annual exclusion increases to R12 500 and R60 000 respectively. The increased exclusion in the year of death is no doubt an attempt to lessen the increased CGT liability arising due to the fact that, under paragraph 40 of the Eighth Schedule, a taxpayer is deemed on death to have disposed of all his/her assets at

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market value at that date and the deceased estate is deemed to have acquired the assets at that market value.

As the annual exclusion is applicable both to capital gains and to capital losses, a taxpayer who makes an aggregate capital loss of less than R12,500 in the year of assessment is not entitled to carry forward any portion of the capital loss to a following year of assessment. In other words, if the sum of the capital gains and losses is a negative figure, the aggregate capital loss must also be reduced by the annual exclusion of R12,500.

The Eighth Schedule provides specifically that certain capital losses may not be deducted (see part IV of the Eighth Schedule), for example, capital losses on so-called personal use assets (as defined in paragraph 15) or intangible assets acquired prior to the valuation date (paragraph 16). In addition, certain capital gains are excluded from the determination of an aggregate capital gain and an aggregate capital loss (see parts VII and VII of the Eighth Schedule).

5 Net capital gain/assessed capital loss
The next step in the process of determining a capital gain or loss is to take any assessed capital loss from a previous year of assessment into account. If an aggregate capital gain for the current year of assessment exceeds the assessed capital loss brought forward from a previous year of assessment, a net capital gain arises (paragraph 8). Similarly, where the assessed capital loss for a previous year of assessment exceeds the current year’s aggregate capital gain, an assessed capital loss arises (paragraph 9). Where, in the current year of assessment, an aggregate capital loss exists, it is added to the assessed capital loss from the previous year to increase a taxpayer’s assessed capital loss (paragraph 9(b)).

Unlike assessed losses for income tax purposes, an assessed capital loss may be carried forward to the next year of assessment, irrespective of whether, in the case of the taxpayer’s being a company, the company has traded or received income from that trade (section 20(2A)). Refer also to Interpretation Note 33 of 4 July 2005. The only prohibition is that an assessed capital loss may not be set off against income of a revenue nature. Although no specific paragraph exists that prohibits the set-off of a capital loss against gains that are not of a capital nature, this is clear from the unique wording of section 26A under which taxable capital gains – and not capital losses – are included in taxable income. However, nothing prohibits an assessed loss of a revenue nature from being set off against a capital gain. The result is that an assessed capital loss for a current year of assessment cannot decrease a person’s taxable income or increase a person’s assessed loss of a revenue nature. The assessed capital loss is ring-fenced and can only be set off against capital gains arising during future years of assessment. However, a taxable capital gain may be set off against an assessed loss of a revenue nature brought forward from a previous year. Although no provision expressly authorising such a set off exists, indirect authority exists in the 2001 amendments to section 103(2), which provides that a ‘tainted’ capital gain cannot be set off against an assessed loss. This amendment would not be necessary if a taxable capital gain could not be set off against an assessed loss. The same holds true for an income tax loss incurred in the same year. Since the term ‘taxable income’ is defined in section 1 as the amount remaining after deducting all permissible deductions from income, a capital gain incurred in the current tax year may also be set off against an income tax loss incurred in the same year.
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A net capital gain arises not only where a person’s aggregate capital gain for the year exceeds an assessed capital loss brought forward from the previous year of assessment, but also where a South African resident shareholder disposes of an interest in a foreign company to a connected person for no consideration or for a consideration that does not reflect an arm’s length price. In such circumstances, paragraph 64B(3) in essence provides that the capital gain arising from such a disposal is not exempt under paragraph 64B(2), but the South African resident realises a capital gain under paragraph 8(b).

6 Taxable capital gain

The percentage of the capital gain that is subject to tax depends on the status of the taxpayer. Where the taxpayer is a company, close corporation or trust other than a special trust, 50% of the capital gain is taxable (paragraph 10(c)). Where the taxpayer is an individual or a special trust as defined in section 1, the inclusion rate is 25%. Once the taxable portion of the gain is included, income tax is levied at the normal income tax rates. The result is that the CGT tax rate for natural persons and special trusts varies between 0% and 10%. As companies (other than small business corporations, but including close corporations) and trusts other than special trusts, are taxed at a flat rate of 29% and 40% respectively, the CGT tax rate for these categories of taxpayers is 14.5% (that is, 29% of 50%) and 20% (that is, 20% of 50%).

7 Conclusion

It is clear that CGT is an extremely complex tax. A clear understanding of the basic principles underlying CGT will contribute substantially to solving some of these problems. However, the determination of a taxable capital gain or assessed capital loss is complicated by the fact that several different provisions appearing in different parts of the Act have to be taken into account. Some of these provisions, for example, the deeming source rules for capital gains tax, seem not to have been thought through sufficiently.

Although in theory, CGT is based on four building blocks (namely, asset, disposal, proceeds and base cost), the application of these building blocks is often problematic. The building blocks are specifically defined for CGT purposes. These definitions are generally extremely broad and often do not coincide with their commercial meaning. The result is that taxpayers may often not be aware that they have to account for CGT. For example, as the term ‘asset’ is widely defined to include both personal and real rights, where an asset is disposed of, the disposal of the personal right to claim delivery, as well as for the exchange of this personal right for the asset disposed of (transfer of ownership) has to be accounted for. It is debatable whether the current time of supply rules are sufficient to eliminate the risk of double taxation which may arise in such circumstances.

Although the purpose of such wide definitions is no doubt to broaden the CGT net, it may indeed be asked whether the increased revenue collected from the broadened definitions justifies the complexity created by these definitions.

There is also some uncertainty about the extent to which the foreign law on which the provisions of the Eighth Schedule are based may be taken into account in any interpretation of the provisions of the Eighth Schedule. Although section 233 of the Constitution of the Republic of South Africa dictates where reasonable foreign precedents have to be taken into account in interpreting legislation, in view of the fact that the Eighth Schedule provides for
unique South African provisions, the view is supported that foreign precedents cannot reasonably be applied.

The inclusion of certain specific anti-avoidance rules may also lead to a CGT liability in circumstances where it could never have been intended by the legislature. For example, where in BEE deals disposals take place between connected persons for considerations not reflecting an arm’s length price, paragraph 38(2) provides that CGT has to be accounted for on the market value of the assets.

It is foreseen that most of the complex issues will only be solved by academic writers and court decisions over a number of years. In the interim, some certainty will be obtained if SARS provides guidelines on its interpretation of some controversial issues in the form of Interpretation Notes. Although SARS should be praised for providing a comprehensive CGT Guide, due to the complexity inherent in CGT, it is foreseen that SARS will undoubtedly struggle as much with the interpretation of the Eighth Schedule as taxpayers and their advisors do.

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