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C. West J. Roeleveld

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# Attempting to limit the attribution of capital gains

C West

Department of Accounting  
University of Cape Town

J Roeleveld

Department of Accounting  
University of Cape Town

## Abstract

Paragraphs 68 to 72 of the Eighth Schedule to the Income Tax Act No. 58 of 1962 ('the Act') were inserted to perform the same function as that of section 7, namely to attribute income in cases in which the taxpayer has disposed of that source of income by means of donation, settlement or other disposition. Paragraph 73 of the Eighth Schedule to the Act was inserted to limit the total amount that is attributed to the donor in a year in which both income (in terms of section 7) and a capital gain (in terms of the attribution paragraphs 68 to 72) are to be attributed.

The unclear construction of the section and, it is submitted, the inaccurate interpretation of this paragraph by the South African Revenue Services ('SARS') has made it difficult to interpret this paragraph. This article attempts to evaluate prevailing legal precedent and to apply such precedent to the paragraphs on attribution in order to arrive at an appropriate interpretation of paragraph 73. The approach adopted by SARS is also examined in the light of the above interpretation and application of prevailing legal precedent. Lastly, amendments to the legislation are proposed to clarify the legislation and to provide a structured approach in the consideration of the intention of the legislature.

## Key words

*Wouledge*

*Joss*

*Ovenstone*

*Section 7*

*Paragraphs 68 to 72*

*Paragraph 73*

*Interest-free loans*

*Attribution*

*Distribution*

*Capital gains tax*

*Anti-avoidance*

## 1 Introduction

With the introduction of capital gains tax (with effect from 1 October 2001) came provisions to mirror the effects of section 7 of the Income Tax Act No. 58 of 1962 (as amended) (hereinafter 'the Act'). Section 7 attributes the income of one person to another person as a result of a donation, settlement or other disposition by the other person. Paragraphs 68 to 72 serve the same purpose as section 7 with regard to capital gains.

The impact of section 7 has been effectively limited by case law in the case of dispositions such as interest-free loans. Paragraph 73 was enacted with the purpose of limiting attributions in those years of assessment in which both income and capital gains are derived from such donations, settlements or other dispositions. When examined, this provision in the Eighth Schedule to the Act presents certain difficulties.

This article attempts to: (a) discuss the difficulties with the interpretation of paragraph 73 of the Eighth Schedule to the Act in its current form, (b) examine the position that the South African Revenue Service ('SARS') has taken with regard to the attribution of capital gains and (c) propose an alternative formulation to minimise the difficulties in determining limits in respect of the attribution of income and capital gains.

In order to understand the difficulties experienced in respect of paragraph 73, it is first necessary to consider the income equivalent of the paragraphs on the attribution of capital gains, namely section 7 of the Act, and the applicable case law. In essence, Part X of the Eighth Schedule to the Act mirrors the wording of section 7. Therefore the rules for the interpretation of section 7, which are derived from case law, should be examined in the context of those paragraphs to determine how the paragraphs are to be interpreted and therefore applied. Finally, the order in which section 7 and the paragraphs within Part X of the Eighth Schedule are to be applied should be determined before the actual construction of paragraph 73 can be examined.

## 2 Interpretation of and critical court decisions regarding section 7

The anti-avoidance provisions of section 7 of the Act provide for the attribution of income to persons (hereinafter 'the donor') other than the person to whom or by whom the amount is accrued or received (hereinafter 'the beneficiary') in cases in which the income arises as a result of a donation, settlement or other disposition by the donor.

The provisions of this section, particularly section 7(3), have been the subject of significant discussion and case law. The phrases 'donation, settlement and other disposition' and 'by reason of' are critical to the understanding of the provisions of section 7. Both of these phrases have established meanings in terms of the cases of *Ovenstone* (SATC 1980) and *Joss* (SATC 1979).

The more recent case of *Woulidge* (SATC 2001) is of particular interpretative importance as the decision in this case effectively places a limit on the extent to which income can be attributed to the donor. It has previously been submitted that this decision applies equally to the paragraphs in Part X of the Eighth Schedule (West and Surtees 2002:265). This view is discussed and extended in this paper.

While the cases that are considered mainly concern the application of the provisions of section 7(3), it is submitted that the principles derived from these cases apply equally, with regard to the critical phrases that are common to section 7, to the rest of section 7 and the applicable paragraphs of the Eighth Schedule. The principles derived from these cases are extracted and discussed in brief below.

## 2.1 *By reason of*

Due consideration by the courts of the phrase ‘by reason of’ has resulted in the interpretation that a causal link should exist between the income received or accrued and the ‘donation, settlement or other disposition’ (hereinafter ‘gratuitous disposition’) originally made for section 7 to apply (SATC 1979:216). It is apparent from the application of the provisions of section 7 that other phrases that are used in the section (such as ‘in consequence of’) also connote a causal link (SATC 1980:73).

Furthermore, it has been established by the courts that the phrase ‘by reason of’ does indicate that apportionment should be considered when the income is received or accrued as a result of elements of both full consideration and gratuitousness.<sup>1</sup> It is therefore accepted that only income that results from the gratuitous element of the disposition should be considered in terms of the provisions of section 7. It should be borne in mind that, in terms of section 82 of the Act, the taxpayer has the onus of proving the apportionment of the income between the full consideration and the gratuitous element. When the taxpayer fails to discharge that onus, all the income will be allocated to the gratuitous element rather than split between the elements of gratuitousness and full-consideration.

1 *Ovenstone* at 77 states: ‘Now where the consideration, while not being due consideration, is nevertheless appreciable, it will mean that the income in question under s 7(3) will usually have accrued or been received ‘by reason of’ both elements of gratuitousness and consideration. I see no reason why in those circumstances the income should not then be apportioned between the two elements. The words “by reason of”, themselves suggest some apportionment in order to give proper effect to the real cause of the accrual or receipt of the income. (Cf *Joss v SIR*) If such apportionment is not possible, or if insufficient evidence is adduced to enable the court to effect it (the burden of proof being on the taxpayer under s 82), the composite disposal will usually, because of its appreciable element of bounty, be then simply treated as a gratuitous settlement or disposition, as the case may be, that falls within the scope of the critical phrase of ‘donation, settlement or other disposition.’

## 2.2 Donation, settlement or other disposition

Following the judgments in the cases of *Joss* and *Ovenstone*, sufficient clarity now exists regarding the interpretation of these terms by the courts. In essence, the term 'other disposition' has been interpreted *eiusdem generis* with the terms donation and settlement. The reason for this interpretation was provided succinctly in *Joss* (1979:212). This principle applies equally to transactions between persons other than minor children and parents with regard to the other provisions of section 7.

Because the disposition should be interpreted *eiusdem generis* with the terms donation and settlement, it was furthermore established that the disposition should therefore contain an appreciable element of gratuity before the provisions of section 7 can apply, that is the gratuity that arises as a result of negotiation within a *bona fide* commercial transaction should be ignored (1980:76).

Subject to the onus placed on the taxpayer by section 82 of the Act, the transactions that are proved by the taxpayer, to the satisfaction of the Commissioner or, failing that, to the courts, to be sufficiently close to full money's worth ('market value') should, it is submitted, be excluded from the scope of section 7.

In the case of a sale (at market value) on an interest-free loan account, two dispositions are present, namely the sale at full market value and the subsequent loan of money. It follows that, as Coetzee J made clear in the case of *Joss*, there should be certainty about which disposition is considered in terms of the provisions of section 7. In the above scenario, only the interest-free loan is a gratuitous disposition for the purposes of section 7 to the extent that interest is not charged on the loan account, because the quantum of income received by the purchaser of the asset that is sold is enhanced as a result of that fact that the seller does not charge interest on the loan account. The sale, while being a disposition, is not a gratuitous disposition, because the sale price was an arm's length price (leaving no element of gratuity).

*The case of Ovenstone* provided clarity on the legislative purpose of the provisions of section 7. In this regard Trollip JA stated that:

The transactions which the legislature seems to have had in mind in enacting subsecs (3) – (6) are those in which a taxpayer seeks to achieve tax avoidance by donating, or disposing of income-producing property to or in favour of another under the therein specified conditions or circumstances, thereby diverting its income from himself without his replacing or being able to replace it. But if he receives due consideration for the disposition, theoretically he is able to replace such income, and in practice he often does, by using or investing the consideration.

It is clear from the above statement by Trollip JA that, in the case of a sale (at market value) of an asset on an interest-free loan account, the sale has no gratuitous element. However, the income derived from the asset that had previously been held is not replaced, despite the taxpayer being in a position to replace the income by charging interest on the loan account. Because the donor does not replace the income by charging interest on the loan account, the income (to the extent that the income represents forgone interest – see 2.3 below) is attributable to the donor.

### 2.3 *Limitation of the income attributed in terms of section 7*

After identifying the gratuitous element of the disposition, the quantum of such gratuitousness should then be established to determine the amount of income to be attributed. In *Joss*, Coetzee J provided the first indication of the determination of the quantum of the gratuitous element when he stated that:

It is, however, illogical to suggest that only the interest which normally would have been paid in respect of the tax year in question affects the dividend. Obviously the interest-free loans during the preceding years also affect the quantum of the dividend received by Nicolle and the trust in the tax years under discussion (SATC 1979:216).

At the first reading, this comment by Coetzee J appears to imply that, in a case of a sale on an interest-free loan account, the interest forgone represents the gratuitous element of the transaction and that, in the years in which the income of the asset is less than the notional interest that should have been charged on the loan account, such excess is to be capitalised to create a new notional capital balance on which notional interest is to be determined for the following year of assessment. Such an approach would lead to exponential growth of the identified gratuitous element when the income from the asset sold on an interest-free loan account continues to yield less than a market-related interest rate.

Coetzee J's comment in *Joss* was quoted with approval in the Cape Provincial Division in *C:SARS v Woulidge* in which Davis J considered the application of the *in duplum* rule (SATC 1999:13-14) and was similarly supported by Selikowitz J in the same case (SATC 1999: 14-15).

The statements made by Davis J and Selikowitz J in support of Coetzee J set a disturbing precedent of capitalisation of notional interest that represents the gratuitous element and therefore determines the extent of the income to be attributed in terms of section 7. However, in the judgement of Froneman AJA in the Supreme Court of Appeal in *C:SARS v Woulidge*, the dissenting judgement of Van Reenen J in the Cape Provincial Division was supported and the principle of capitalisation of notional interest found not to apply. In this regard Froneman AJA stated that:

The respondent charged no interest on the loan that he advanced to the trusts. No actual interest thus ever accumulated. A notional commercial arms length transaction would assume a lender who would insist on payment of the interest he charges and a borrower able to pay that interest (SATC 2001:489).

It is therefore clear that, should the asset that was sold on an interest-free loan account yield less than a notional market-related interest rate, the excess notional interest would not be accumulated in the determination of the benefit that is gained by the beneficiary and attributable to the donor.

The decision of the Supreme Court of Appeal in *C:SARS v Woulidge* therefore provided the taxpayer with a method of limiting the income attributable in terms of the provisions of section 7. It is submitted that the approach of Selikowitz J was partially correct. To identify the gratuitous element, the actual transaction should be considered in terms of normal commercial principles.

However, the caveat added by Froneman AJA is that the circumstances of the actual transaction should not be overlooked and therefore not all normal commercial principles can be applied stringently.

The decision in *Woulidge* concerned the use of interest-free loans and, it is submitted, the method of limiting the attribution of income can only be determined on this basis when interest-free loans are used, i.e. the decision in *Woulidge* does not determine a limit for the income that arises from assets that are donated.

Further support for the decision of Froneman AJA regarding the excess notional interest that falls away can be found in the *Ovenstone* judgement. In *Ovenstone*, Trollop JA made it clear that the section served to prevent the donor from diverting his income. Should the limit (represented by the interest forgone) exceed the actual income produced by the asset that is sold on an interest-free loan account, it is clear that the income to be attributed can only be the maximum of the actual income yielded by the asset that was previously held by the donor. The notional interest that is forgone is not intended to create income where none exists, i.e. the income that is diverted is all that can be attributed. For example, a donor sells shares that yield 6% per annum to a trust at a market value of R2 million on an interest-free loan account. A market-related interest rate for the loan account would be 15% per annum. The trust holds no other assets and has no cash reserves. The limit to be applied to the income would be a maximum of R300 000<sup>2</sup>, which is the interest forgone. However, because the actual income is only R120 000<sup>3</sup>, the actual income is all that can be attributed to the donor. The remaining limit of R180 000 should fall away, because the purpose of section 7 was merely to prevent the donor from diverting his income. Because only R120 000 was diverted, only R120 000 can be attributed to the donor. It should always be borne in mind that the limit is notional and does not represent an actual return on the loan account.

## 2.4 Summary of the principles for the interpretation of section 7

The principles to be applied from the courts' interpretation of section 7 can be summarised as follows:

- The term 'other disposition' refers only to dispositions that have an appreciable gratuitous element.
- Transactions executed at full value in money or money's worth are not included in the scope of section 7.
- Only income that has a causal link to the donation, settlement or other disposition is considered in terms of the provisions of section 7.

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2 R2 000 000 x 15% = R300 000

3 R2 000 000 x 6% = R120 000

- Apportionment between the elements of full consideration and gratuity is permitted.
- The income to be attributed (in the case of a sale at market value on an interest-free loan account) is limited to the lesser of the notional interest on the outstanding balance of the loan account and the actual income yielded by the asset (in the same ratio as that of the outstanding balance of the loan account to the original balance of the loan account).
- Should any limit remain, it falls away, because the purpose of section 7 is to prevent the donor from diverting his income and not to create income where none exists. Furthermore, the transaction assumes that there is a lender who insists on payment and a borrower who is able to pay such interest.

### 3 Rules for the interpretation of section 7 and the Eighth Schedule

Paragraphs 68 to 72 of the Eighth Schedule consider the attribution of capital gains. These paragraphs have been formulated along the lines of the provisions of section 7. It is submitted that the use of similar wording to section 7 has the implication that the critical phrases contained in the paragraphs are used in the same context as those contained in section 7, and should be given the same meaning as that ascribed to those phrases by the court.

It is therefore submitted that the phrase 'donation, settlement or other disposition' refers to a disposition that is appreciably gratuitous (see the discussion in part 2). Instead of the phrases 'by reason of' or 'in consequence of', the paragraphs in the Eighth Schedule use the phrase 'can be attributed to'. The Oxford Paperback Dictionary definition of the word 'attribute' provides the following meaning:

to regard as belonging to or caused by or originated by.

It is submitted that the legislature's intention in using the phrase 'can be attributed to' and in particular the word 'attributed' was to indicate in clear language that there should be a causal link between the donation, settlement or other disposition and the capital gain before the paragraphs on attribution can be applied. Therefore the court's interpretation of the phrases 'by reason of' and 'in consequence of' can, it is submitted, be applied similarly to the phrase 'can be attributed to', which is used in the Eighth Schedule.

A critical question to be addressed in terms of the paragraphs on attribution in the Eighth Schedule is: What is the gratuitous element of a sale on an interest-free loan to which a capital gain may be attributed in terms of paragraphs 68 to 72?

#### 3.1 Identification of the capital gratuitous element

As stated in part 2, Selikowitz J provided guidance on the determination of the gratuitous element of a transaction, namely to compare the actual effects of the

transaction with the effects that the same transaction would have if the normal commercial principles applied. Froneman AJA refined this test by adding that when the normal commercial principles are applied to an interest-free loan regarding repayment, the assumption has to be made of a lender who insists on payment and a borrower who is able to effect such payment, i.e. capitalisation of notional amounts cannot be implied in the application of the normal commercial principles.

If the abovementioned test were to be applied to the sale of a capital-growth asset at market value on an interest-free loan account, it is submitted that the following could be said to be true: A sale took place at full market value in terms of two dispositions, namely the sale and the subsequent provision of loan finance. The sale disposition, it is submitted, contains no gratuitous element for the same reasons as those provided in part 2. This leaves the interest-free loan to be considered. There appears to be no capital gratuitous element that is attributable to the interest-free loan in accordance with the principle applied in the judgement in *Ovenstone*, namely that, because the capital was replaced in full (the asset having been replaced by the loan account), the taxpayer had not diverted his capital and therefore the paragraphs on attribution should not apply. An alternative interpretation may exist, provided that the taxpayer has diverted a capital-growth asset for an asset that has no capital growth and therefore has not replaced the capital in full. This alternative is discussed in a subsequent section of this paper.

Does the fact that many of the above transactions of this type do not have fixed-repayment terms, but only a clause referring to repayment on demand, result in the entire interest-free loan being regarded as gratuitous? Is all the capital growth therefore deemed to be attributable to appreciable gratuitousness? In applying the test of Selikowitz J, the normal commercial principles should be examined. A frequent commercial transaction, particularly in smaller companies, is a loan or loans from majority shareholders in which the repayment terms are not fixed, but refer to repayment on demand. It is submitted therefore, if such transactions are part of normal commercial practice, then repayment on demand does not yield appreciable gratuitousness. Froneman AJA's extension of the test is therefore irrelevant, because repayments of capital will be made on demand and it is not necessary to assume notional fixed terms of repayment of capital that are set by a lender or a borrower who is able to meet such capital repayments.

### **3.2 Application of interest foregone to a capital gain**

Despite the above exposition, the question remains whether the interest that is forgone can be applied to the capital gain that is derived subsequent to the sale of an asset at market value on an interest-free loan account. The courts have established that interest that is forgone on an interest-free loan represents the gratuitous portion of that disposition. The interest that is forgone was applied to the income that was earned by the asset that was sold on a loan account and the

lesser of the actual income from that asset and the interest that was forgone was attributed back to the donor. As pointed out in *Ovenstone*, the purpose of section 7 is to prevent the taxpayer from diverting his income 'without his replacing or being able to replace it'. Any excess of interest that was forgone over the actual income of the asset that was sold was disregarded. The query above can be divided into two questions, namely:

- 1 Does interest that was forgone in the year of assessment in which the capital gain is derived apply to such capital gain; or, alternatively
- 2 Does the excess of the interest that is forgone over the actual income that is derived from the asset that was sold on an interest-free loan account accumulate, and does this accumulated excess determine the attribution of the capital gain?

It is submitted that interest forgone on the loan account should first be applied to the income that is derived from the asset that was sold (in terms of section 7) before it may be considered for application against capital gains. Therefore only situations in which the notional interest income exceeds the income from the asset that was sold on an interest-free loan account can be considered.

In the judgements of *Joss*, *Ovenstone* and *Woulidge*, the interest that was forgone was referred to as a 'continuing donation'. Indeed, Froneman AJA referred to the interest that is forgone as an annual donation of the interest that is not charged. Does the use of the word 'donation' in this context provide the answer to the application of the excess notional interest to capital gains?

The decisions in *Widan* and *Berold* established the principle that income-on-income could still be attributed back to the original disposition. In his judgement in *C:SARS v Woulidge* (1999:8), Davis J stated that the test of the causal link was to ask the following question:

[Does the] gratuitous disposal constitute [...] the real, substantive cause of income being received by the minor child. If the answer is in the affirmative, that amount of income so received or which accrues to the minor child will be deemed to be that of the donor parent.

It is submitted that the 'donation' of the interest that is forgone, after being applied to the income of the asset that was sold on an interest-free loan account and resulted in an attribution of income, falls away to the extent of the amount attributed. Should any excess remain, does the 'donation' of this excess notional interest have the effect of being a new gratuitous disposal, which is then the cause of the capital gain? It is submitted that this interpretation has little merit. Section 7 is concerned with actual gratuitous dispositions and not those notionally created.

In ruling against the application of the *in duplum* rule, Froneman AJA showed that capitalisation of the notional interest could not occur if it were assumed that the borrower would be in a position to fund repayments of interest. While caution should be exercised in applying this principle from a case that is distinguishable on the facts (because Froneman AJA was not considering a situation that also encompassed capital gains), it is submitted that this principle still has

merit. It has already been submitted that the capital has been replaced in full and therefore no gratuitous element can be attributed to the capital on the date of sale. It is furthermore submitted that the interest that is forgone can only be applied to the income, following the *ratio decidendi* from Froneman AJA's judgement.

Alternatively, should the use of the phrase 'continuing donation' be applied to consider the interest that is forgone as a new gratuitous disposal, it may then be found that this 'donation' affects the capital growth of the asset directly. It is submitted that an interpretation to this effect would result in complex calculations being made to determine the quantum of the gratuitous element, which is either the notional donation or the notional interest that is forgone on the notional donation or both. It is settled law that one may not shy away from an interpretation merely because it results in complex calculations (SATC 1990:22). However, it is submitted that the former approach, which is outlined below, should, on its merits, be the preferred option.

### **3.3 *The preferred approach***

In summary, the following is submitted to be the preferred approach for the interpretation of paragraphs 68 to 72:

- The term 'other disposition' refers only to dispositions that have an appreciable gratuitous element.
- Transactions at full value in money or money's worth are excluded from the scope of paragraphs 68 to 72.
- Only capital that has a causal link to the donation, settlement or other disposition is considered in terms of the provisions of paragraphs 68 to 72.
- Apportionment between the elements of consideration and gratuity is permissible.
- The capital gain to be attributed is nil in the case of a sale at market value on an interest-free loan account, because the sale itself is at full market value and the asset has been replaced in full (i.e. there is no gratuity in respect of the sale of the asset at market value).
- Upon the donation of a capital asset, the entire capital gain may be attributed back to the donor, because the capital has not been replaced in any way.
- The excess of the interest that is forgone over the actual income of the asset that was sold on an interest-free loan falls away in each year of assessment and cannot be applied to the capital.

### **3.4 *Attribution of a capital gain that arises from a donation, settlement or other disposition***

An alternative interpretation of the quote from *Ovenstone* regarding a taxpayer who diverts income, when applied to capital, could be read as follows:

The transactions which the legislature seems to have had in mind in enacting [paragraphs 68 to 72 of the Eighth Schedule] are those in which a taxpayer seeks to achieve tax avoidance by donating, or disposing of [a capital growth] property to or in favour of another under the therein specified conditions or circumstances, thereby diverting its [capital gain] from himself without his replacing or being able to replace it. But if he receives due consideration for the disposal, theoretically he is able to replace such [capital gain], and in practice he often does, by using or investing the consideration' (square brackets represent substituted words).

There are inherent difficulties in reading 'capital gain' for 'income' in the above context to derive a purpose for the paragraphs on attribution. Firstly, it would appear from the above that unless a taxpayer changes to another investment that has capital growth, the paragraphs on attribution would apply. However, this interpretation ignores the possibility of legitimate changes of investment when a taxpayer sells a capital-growth asset for an asset that has little or no capital growth but yields a steady income stream. An extreme example of this nature would be the sale of Krugerrands and the use of the proceeds to make a loan that yields interest. The capital gain in this scenario is not replaced, but rather an income stream is introduced. It is acknowledged that such a transaction would not fall within the scope of Part X of the Eighth Schedule, because there is no gratuitous element in the transaction in that scenario. However, the example of a capital-growth asset that is replaced by an asset that has no capital growth in this context demonstrates that it could not have been the intention of the legislature to apply the paragraphs on attribution to the disposal of any asset that has capital growth in cases in which the capital is replaced but the capital growth is not.

### 3.5 *A final argument*

There is a further argument for the non-application of Part X to sales on an interest-free loan at full market value. The decision in *Woulidge* held that income that is earned from an asset that was previously held by the donor could be attributed back to the donor up to a maximum of the lesser of the actual income from the asset that was previously held or the notional market-related interest on the balance of the loan account. In applying the same principle to the capital gain, it is submitted that the capital gain that may be attributed back to the donor should be a maximum of the lesser of the actual capital gain of the asset that was previously held and the notional capital gain on the interest-free loan (which is nil). It is therefore submitted that no capital gain may be attributed back to the donor on a sale at market value on an interest-free loan account, irrespective of whether any portion of the notional limit that is applied to income remains. Because the capital has been replaced in full, there is no gratuitous element that may be applied to the capital gain.

## 4 Steps to be followed in the application of section 7 and part X of the Eighth Schedule

Having discussed section 7 and paragraphs 68 to 72 in isolation above, it is necessary to determine the order in which these provisions are to be applied.

Paragraph 73 is of some assistance in respect of determining the order in which section 7 and paragraphs 68 to 72 are to be applied. Paragraph 73 is concerned with the limitation of the amount to be attributed to a donor in a year of assessment in which both income and a capital gain arise. Once the order of application for the above-mentioned provisions has been determined, the provisions of paragraph 73 may be examined.

Paragraph 73(1) provides some guidance in this regard. The paragraph provides that:

Where both an amount of income and a capital gain are derived by reason of or are attributable to a donation, settlement or other disposition, the total amount of that income and gain—

- (a) that is deemed in terms of section 7 to be that of a person other than the one to whom it accrues or by whom it is received or for whose benefit it is expended or accumulated; and
- (b) that is attributed in terms of this Part to a person other than the one in whom it vests, shall not exceed the amount of the benefit derived from that donation, settlement or other disposition.' It is apparent from the above quotation that the provisions of section 7 and paragraphs 68 to 72 should first be considered before paragraph 73 may be applied.

It is submitted that the provisions of section 7 should necessarily apply before the provisions of paragraphs 68 to 72. This approach is derived from the basis of the calculation of taxable income. In terms of this calculation, the taxpayer should first determine his gross income, exempt income, and deductions against such income, arriving at his taxable income before the addition of capital gains to such taxable income in terms of s26A is considered. Therefore paragraph 73 is only considered after the appropriate tests, which are considered in section 7 and paragraphs 68 to 72, have been applied.

## **5 Limitation of the attribution of capital gains – paragraph 73**

Silke (De Koker 2002:24.195) and Stein (2002:11.10) both state that the provisions of paragraph 73 are designed to provide relief to the taxpayer in the years in which income and capital gains arise as a result of a donation, settlement or other disposition. SARS also states in its Explanatory Memorandum that accompanied the introduction of capital gains tax that paragraph 73 limits the total amount of income and capital gains that may be attributed to donations, settlements or other dispositions in terms of the provisions of section 7 and paragraphs 68 to 72 of the Eighth Schedule.

Paragraph 73 provides that:

- (1) Where both an amount of income and a capital gain are derived by reason of or are attributable to a donation, settlement or other disposition, the total amount of that income and gain—
  - (a) that is deemed in terms of section 7 to be that of a person other than the one to whom it accrues or by whom it is received or for whose benefit it is expended or accumulated; and

(b) that is attributed in terms of this Part to a person other than the one in whom it vests,

shall not exceed the amount of the benefit derived from that donation, settlement or other disposition.

- (2) For the purposes of this paragraph, the benefit derived from a donation, settlement or other disposition means the amount by which the person to whom that donation, settlement or other disposition was made, has benefited from the fact that it was made for no or an inadequate consideration, including consideration in the form of interest.

It is submitted that the term 'income' is used in the same context as that in section 7 and therefore does not mean 'income' as defined in section 1 of the Act, but that it is rather interpreted as being commercial revenue profits. 'Capital gain' is defined in the Eighth Schedule and that particular meaning is implied.

The phrase 'donation, settlement or other disposition' again appears. It is submitted that this phrase has the same meaning as that provided in parts 2 and 3 above. This means that only the income and capital gain attributable to the gratuitous element of the donation, settlement or other disposition are considered in terms of this paragraph.

The implication of the preamble to paragraph 73 is that only assets from which income and capital gains are derived by reason of a donation, settlement or other disposition can be considered in terms of this paragraph. Therefore assets that yield no income, e.g. Krugerrands or assets that have no capital growth such as a fixed deposit in respect of which the interest income is not capitalised, are excluded from the scope of the paragraph. It is not known whether this was the intention of the legislature. The exclusion of these types of assets may appear inequitable, but the words of Lord Cairns in the oft-quoted case of *Partington v The Attorney-General*<sup>4</sup> should be borne in mind, namely that:

If a person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be.

Paragraph 73 is clear that both income and capital gains should be present in the same year of assessment before the provisions of the paragraph apply. For the purposes of this paper, it is accepted that paragraph 73 applies only in cases in which both income and capital gains are attributable to a donation, settlement or other disposition.

In terms of paragraph 73, the amount of income and capital gains to be limited by the paragraph is the sum of the income that is attributable in terms of section 7 plus the capital gains attributable in terms of Part X of the Eighth Schedule (i.e. paragraphs 68 to 72). The amount of income to be added to the capital gains is provided as being the amount:

4 Cited in *Commissioner for Inland Revenue v George Forest Timber Company Limited* [1924] 1 SATC 20 at 29

that is deemed in terms of section 7 to be that of a person other than the one to whom it accrues or by whom it is received or for whose benefit it is expended or accumulated.

The amount that is deemed in terms of section 7 is the amount of income to be deemed 'by reason of' or 'in consequence of' the donation, settlement or other disposition. Because the amount that is deemed to be that of the donor should be determined before the application of the Eighth Schedule, it is submitted that the decision in *Woulidge* should be applied to such income. In the case of an interest-free loan, the income to be added to the capital gains for the purposes of paragraph 73 may therefore already be limited in terms of case law.

The amount of capital gains to be added to the income in terms of subparagraph (a) of paragraph 73(1) is provided as being the amount:

that is attributed in terms of this Part to a person other than the one in whom it vests.

It is stated in part 3 above that the amount of the capital gain that is attributed in terms of paragraphs 68 to 72 can only be the portion of the capital gain that is attributable to the donation, settlement or other disposition. In the case of the sale of an asset at market value on an interest-free loan, it is stated that, in terms of the preferred interpretation of the paragraphs, no capital gain attribution may occur, because the capital was replaced in full. Should this be the case, paragraph 73 has no application, because no capital gain is attributable in terms of paragraphs 68 to 72 and therefore no capital gain may be added to any income that is attributed in terms of section 7.

The following example provides an illustration of the preferred interpretation of the paragraphs on attribution on the sale of an asset at market value on an interest-free loan account:

J sells a rent-producing property to a discretionary trust that has been created in favour of his minor children. The property is sold at its market value of R2 000 000 on an interest-free loan account on 1 October 2001. On 28 February 2003, the trust sells the property for R3 000 000. The rental yield on the property is 13% per annum. A market-related interest rate for the loan account is 16%. The year end of the trust is the last day of February. All the income earned by the trust was distributed equally to the two minor children. There are three independent trustees, apart from J, and J does not have any power over the majority decision of the trustees (who each have equal voting power).

**Year ended 28 February 2002**

Total rental income earned by the trust and distributed to the minor children (R2m x 13% x 5/12)	108 333
Maximum attributable to J s 7(3) is the lesser of:	
Actual income	108 333
Notional interest (R2m x 16% x 5/12)	133 333
Income deemed to be J's	108 333
Excess notional interest is disregarded (see part 2 read with part 3)	25 000

**Year ended 28 February 2003**

Total income earned by the trust and distributed to minor children (R2m x 13%)	260 000
Maximum attributable to J s 7(3)	
Actual income	260 000
Notional interest (R2m x 16%)	320 000
Capital gain (R3m – R2 m)	1 000 000
Attributable to J para 69 (refer to the preceding discussion)	0
Excess notional interest is disregarded (see part 2 read with part 3)	60 000

Paragraph 73 has no application, because no capital gain is attributable in terms of paragraph 69.

The question is therefore whether paragraph 73 has any application for transactions other than the sale of an asset at market value on an interest-free loan account, such as the donation of an asset.

If an asset is donated, there is no notional interest to apply. The entire transaction is gratuitous and therefore, it is submitted, all the income that is earned on the asset that was donated is attributable back to the donor, if the provisions of section 7 apply. The capital would also not have been replaced (as the asset was disposed of without any consideration being payable or owing). It is therefore submitted that the entire capital gain is attributable to the donation and as such it would be attributable back to the donor of the asset, if the provisions of paragraphs 68 to 72 apply.

Should both income and capital gains be attributable in terms of the above example, the amounts would be aggregated and it would be left to paragraph 73 to determine the limit to be applied.

The benefit (being the limit) is defined in paragraph 73(2) as:

the amount by which the person to whom that donation, settlement or other disposition was made, has benefited from the fact that it was made for no or an inadequate consideration, including consideration in the form of interest.

Upon the donation of an asset, the beneficiary (or recipient) benefits from both the income and the capital as a result of the fact that no consideration is payable. It would appear therefore that paragraph 73 does not limit the attribution of income or capital in a case of this nature. It is not correct to limit the attribution in the case of a donation, because neither the income nor the capital have been replaced, which results in the entire transaction being gratuitous.

It is submitted that the phrase 'including consideration in the form of interest' was designed to include the gratuitous portion of dispositions, such as interest-free loans, in cases in which, for example, assets are sold to trusts at full consideration. It is debatable whether paragraph 73(2) makes the interest that is forgone applicable to both income and capital. It is submitted that by adding income to the capital gain in paragraph 73, the legislature's intention could have been to merely provide the mechanism with which to limit the attribution of income and not necessarily to apply the interest that is forgone to the attribution of capital. It is submitted that the interest that is forgone should only be used to

determine the attribution of income and should not be applied to capital gain. The best illustration of the application of the principles discussed above is that of a sale on an interest-free loan account at inadequate consideration.

The interpretation stated above does, however, differ from that which SARS holds regarding paragraph 73.

## 6 SARS' application of paragraph 73

The extract that follows has been taken from the Draft Comprehensive Guide on Capital Gains Tax, which was prepared by SARS. The extract provides insight into the way in which SARS interprets paragraph 73. Commentary on this interpretation follows the extract.

Where an amount of income as well as a capital gain has been derived from or is attributable to a donation, settlement or other disposition made by a person, the amount of that income as well as that capital gain might be subject to the attribution rules embodied in s 7 and paras 68 to 72, respectively. This might result in the taxation of both amounts in the hands of the person who made the donation, settlement or other disposition. Paragraph 73 limits the total amount of the income and gain that can be taxed in the hands of that person to the amount of the benefit derived from that donation, settlement or other disposition by the person to whom it was made. The quantified benefit to the latter person from, for example, an interest-free or low interest loan will therefore determine the extent to which any resulting income and capital gain can be attributed to the person who provided that benefit.

### Example 1 – Attribution of income and capital gain

On 1 July 1997 Wayne sold a residential building to the Wayne Family Trust for R1 000 000. The purchase price was funded by means of an interest free loan from Wayne. Had the trust funded the acquisition by obtaining a bond from a bank it would have paid interest at the rate of 15% per annum. The market value of the property on valuation date was R1 200 000, and this was adopted by the trust as the valuation date value. On 28 February 2003 the trust sold the property for R1 500 000 and reinvested the funds in another project. The trust did not distribute any portion of the capital gain to the beneficiaries of the trust. The following is a summary of the net rental income derived by the trust, the amount deemed back to Wayne in terms of s 7(5) and the balance that could not be deemed back because the income was insufficient.

The maximum amount that can be attributed back each year is R1 000 000 x 15% = R150 000.

Year ended 28 February	Net rental income	Amount deemed back to Wayne in terms of s 7(5)	Shortfall (R150 000 – amount deemed back in terms of s 7(5))
1998	95 000	95 000	55 000
1999	100 000	100 000	50 000
2000	105 000	105 000	45 000
2001	110 000	110 000	40 000
2002	110 000	110 000	40 000
2003	120 000	120 000	30 000
			260 000

The capital gain derived by the trust is:

	R
Proceeds	1 500 000
Base cost	1 200 000
Capital gain	<u>300 000</u>

The portion of this gain to be attributed to Wayne in terms of para 73 is R260 000. The remaining R40 000 will be taxed in the trust. The period before the introduction of CGT is only taken into account for the purpose of determining in whose hands the gain must be taxed. The gain itself, however, relates entirely to the post-CGT period and there is, therefore, no question of retrospective taxation'.

The amount of the capital gain attributed in the example provided by SARS is an accumulation of 'unused limits' from previous years. It is believed that SARS's rationale in this regard is that if the borrower should default in an economic transaction that is based on the normal commercial terms, the capital would have to be liquidated to fund the payment of interest. Because the capital asset did not have to be liquidated, the notional interest that was not 'paid' creates a capital benefit. It is submitted that the above rationale is incorrect for the reasons that follow.

It can be inferred from court decisions that all the normal commercial principles do not apply in transactions of this nature. For example, Froneman AJA (2001:489) stated that:

the in duplum rule can only be applied in the real world of commerce and economic activity where it serves considerations of public policy in the protection of borrowers against exploitation by lenders.

As illustrated in part 3 above, Froneman AJA extended this principle by providing that when normal commercial principles were to be applied to an interest-free loan to determine the extent of the gratuitous element, the normal commercial principle would assume a lender who insists on the payment of the interest and a borrower who is able to meet such payments. It was therefore submitted that the inference that could be drawn from this comment is that, firstly, there is no capitalisation of notional interest and, secondly, in assuming a borrower who is able to pay the interest charged by a lender, a natural extension of the assumption is that the asset would not be sold to meet such interest payments. Should the sale of the asset not be required in order to meet the interest payments, no capital gain could be attributed to the interest that is forgone. Therefore, in the example above, there should not have been an accumulation of the excess interest that was forgone over the actual income derived from the asset that was sold on an interest-free loan account.

Furthermore, the principles derived from *Joss* and *Ovenstone* appear to be clear. The extent to which the income and/or asset has not been replaced represents

the extent of the gratuity. Therefore in the case of a sale of an asset on an interest-free loan, the asset has been replaced in its entirety. Only the income has not been replaced. The disposition is only gratuitous to the extent of the interest that is not charged, which, it should be noted, relates only to the income of the asset and not the capital. No attribution can be made with regard to any capital gain on the asset, because there is no gratuitous element with regard to the sale, whereas the income can be attributed to the extent that the income is not replaced, but limited by notional interest on the balance of the outstanding loan.

The method proposed by SARS, while presented in simplified form in their example, places an onerous burden on the taxpayer in terms of record keeping for any trust. The tax saving achieved will be outweighed by the employment of specialists to keep track of the movements with regard to the various assets year on year (West and Surtees 2002:293). The proposed legislation in part 7 attempts to simplify the approach to yield a more logical and practical approach to the determination of the limits of attribution.

It is therefore submitted that the interpretation advanced by SARS does not take into consideration the order in which the legislative provisions are applied, nor does it consider the implications of prevailing case law. The fact that the definition of benefit in paragraph 73(2) includes the notional interest on the outstanding loan balance does not necessarily mean that the interest that is forgone should be applied to the capital gain. Rather, it is submitted, the interest that is forgone, which is referred to in paragraph 73(2), was merely included to be applied to the attribution of income, which is included in paragraph 73(1). However, as indicated in part 5, the application of the interest that is forgone would have occurred earlier in determining the amount to be included by section 7 and therefore the amount of income for the purposes of paragraph 73(1). The amount of the capital gain being attributed would also have been limited in terms of paragraphs 68 to 72 prior to the inclusion of the attribution for the purposes of paragraph 73(1).

It is submitted that much of the difficulty experienced in respect of paragraph 73 stems from the attempt to determine a single limit that is to be applied to both income and capital.

## **7 Potential revision of legislation**

Legislation could be enacted which provides a more logical and structured approach to prescribing a limit for the attribution of income and capital gains.

Furthermore, it is submitted that the derivation of the limit should be split between the income and the capital components. The insertion of a new section 7(11) and the replacement of paragraph 73 by the following are proposed:

Proposed section 7(11):

- (a) Where income has been derived by reason of any donation, settlement or other disposition, some or all of which will be deemed in terms of this section to be that of the person who made the donation, settlement or other disposition, such income deemed to accrue to that person shall be limited in terms of the following formula.

$$L = \left[ \frac{(M - C)}{M} \times I \right] + [(R - A) \times B]$$

where:

*L* is the maximum income to be deemed to be that of the person who made the donation, settlement or other disposition.

*M* is the market value on the date that the asset was donated, settled or in any other way transferred by the person who made the donation, settlement or other disposition.

*C* is the consideration due on the date specified for *M*.

*I* is the total income that arises from the asset in the current year of assessment.

*R* is a market-related interest rate for any loan account created on the transfer of the donation, settlement or other disposition.

*A* is the interest rate charged on any loan account created on the transfer of the donation, settlement or other disposition.

*B* is the outstanding balance on any loan account created on the transfer of the donation, settlement or other disposition.

- (b) For the purposes of the formula in (a), if *L* is greater than *I*, then *L* is deemed to be equal to *I*.
- (c) For the purposes of the formula in (a), if the market-related interest rate is less than the actual interest rate that is charged, the result of *R* – *A* is deemed to be nil.

The following wording is proposed to replace the current wording of paragraph 73:

Where a capital gain is derived by reason of or is attributable to a donation, settlement or other disposition, the amount of the capital gain that is to be attributed in terms of this Part to a person other than the one in whom it vests shall not exceed the amount determined by the following formula.

$$L = \frac{(M - C)}{M} \times G$$

where:

$L$  is the limit to be determined for the attribution of the capital gain.

$M$  is the market value on the date that the asset was donated, settled or in any other way transferred by the person who made the donation, settlement or other disposition.

$C$  is the consideration due on the date specified for  $M$ .

$G$  is the total capital gain that is determined for the asset that was originally donated, settled or in any other way transferred by the person who made the donation, settlement or other disposition in the current year of assessment.

It is submitted that the above proposed section and paragraph would provide a logical and true reflection of the benefit obtained from the donation, settlement or other disposition in terms of case law.

## 8 Conclusion

This paper demonstrates that there is some difficulty in the interpretation of paragraph 73 in its current form. It appears that the intention of the legislature was to legislate the decision in *Wouldge*. However, the intended effect is not achieved by combining the attribution of income and of capital in paragraph 73.

The intention of paragraph 73, as stated in the Explanatory Memorandum, namely to provide a limit in years in which both income and capital gains are to be attributed in the same year, is noble and should be applauded. However, this intention loses sight of the fact that the donor, had he not disposed of the asset, would have both received the income and accounted for the capital gain in the year of assessment in which the asset was disposed of and would not have been provided with any legislative relief.

The approach adopted by SARS ignores the principles derived from case law, which results in an inappropriate interpretation of the legislation. It has been repeatedly demonstrated in the courts that an inappropriate interpretation or practice with regard to the legislation adopted by SARS would be dismissed if the courts were of the opinion that such interpretation or practice did not correctly reflect the law (see, for example, Frith's Estate case in which the courts dismissed a 60 year old practice of SARS; or Ernst's case in which the court issued a warning against the use of a practice of SARS as being the interpretation of the Act). Although the interpretation adopted by SARS may yield more favourable results for the taxpayer in limited circumstances, it is submitted that the interpretation adopted by SARS would be dismissed in favour of an interpretation that is based on prevailing legal precedent. It is therefore proposed in

this paper that the legislature should separate the application of a limit for income and for capital gains to achieve a more logical and equitable approach. Such an approach would also simplify the determination of the limit that is to be applied.

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