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Capital Gains Tax- Capita Selecta on capital losses

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Contents

Capital Gains Tax: Capita Selecta on capital losses

1. Introduction

The taxation of capital gains was introduced into the South African taxation law with the promulgation of the Taxation Laws Amendment Act, No. 5 of 2001, in terms of which the Income Tax Act, 58 of 1962 ("the Act") was amended to introduce capital gains tax ("CGT") in Section 26A and the new Eighth Schedule. The implementation date for this new tax was extended from 1 April 2001 to 1 October 2001.

The above legislation has to a greater or lesser extent been influenced by vigorous public debate, which Government invited since publication of the Guide to Capital Gains Tax in February 2000. The Draft Taxation Laws Amendment Bills followed in December 2000 and March 2001, respectively, and the final Bill was published in April 2001. Discussion in the press and in tax circles focused on the advisability of introducing a tax that according to Sacob has "fallen into disrepute in the world"[1], and is perceived as operating as a threat to economic efficiency by reducing the level of savings, investment and economic growth and impinging on entrepeneurial activity[2]. The latter comment is based on the "lock-in effect": since CGT is levied on disposal (or deemed disposal) of an asset, it benefits the conservative taxpayer who retains his asset, above the business-minded taxpayer who might realise an asset to best advantage.

Criticism has further been levelled at certain aspects of the version of CGT that has been decided on, specifically roll-over provisions on death and the interface of these provisions with estate duty. In terms of the provisions of paragraph 40 of the new Eighth Schedule, a deceased taxpayer is deemed to have disposed of all of his or her assets on the day before death at market value. The capital gain on the assets, less the exemption of R50 000 is payable by the estate, unless assets are transferred to the taxpayer's surviving spouse. Estate duty at the decreased rate of 20% is levied on the

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[1] Quoted in The Independent Online, Business Report, 15 January 2001

[2] Briefing by the National Treasury's Tax Policy Chief Directorate to the Portfolio and Select Committees on Finance on 24 January 2001: Capital Gains Tax in South Africa; www.sars.gov.za at 2.

gross estate less the amount of CGT due. When each asset is transferred to the heir or legatee, CGT is again levied on the gain since the date of death.

Cases may occur where CGT is payable by the estate although the net estate is not large enough to be liable for estate duty[3]. In such a case[4], SARS makes a half-hearted gesture to the beneficiaries of the illiquid estate by allowing an asset to be distributed to a beneficiary along with a portion[5] of the tax liability that must be paid within three years[6].

These draconian measures contrast with those in place in *inter alia* the UK, United States and Australia. In the last-named jurisdiction, for example, the death of the owner of an asset does not give rise to a capital gain or loss unless the asset is bequeathed to a tax exempt person[7].

The legislation does not make provision for the effect of inflation, which renders gain on assets held over time to be imaginary, nor for the effect of "bunching" (although capital gain usually accumulates over several years, the sale of a capital asset typically increases the taxpayer's income dramatically in a single tax year).

The Ministry of Finance has responded that the benefits to the taxpayer of

i) deferral of tax from the tax year in which accrual took place, to the year of realisation, and

ii) the inclusion rate of 25% of capital gain realised by individuals and special trusts, and of 50% of other entities' capital gain

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[3] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2001 at 74.

[4] Specifically where the CGT exceeds 50% of the net value of the estate as determined for purposes of the Estate Duty Act, 1955, before taking into account that tax

[5] Where the executor would have had to sell an asset in order to pay CGT, a heir or legatee may pay the portion of the CGT exceeding 50% of the net value of the estate (as determined for purposes of the Estate Duty Act before taking into account that tax) plus interest and may then receive the asset he or she is entitled to.

[6] Paragraph 41 Eighth Schedule

[7] Lehmann, G. and Coleman, C. 1989; "Taxation Law in Australia"; Butterworths at p. 317.

compensate sufficiently for any hardship suffered by the taxpayer[8].

The stated[9] purpose of the introduction of CGT is as "part of a wider tax reform effort", addressing "some of the existing tax avoidance opportunities, such as recharacterising ordinary (taxable) revenue into capital revenue, thereby escaping the tax net." CGT is intended to enable "the fiscus to broaden the tax base and ultimately reduce the rate structure for a given revenue requirement." Whether this will take place, remains to be seen.

By far the majority of other tax jurisdictions have implemented a tax on capital gains and in the light of globalisation, this development, along with the switch from a source-based to a residence-based system of taxation brings South Africa in step with its major trading partners.

CGT, along with all of its benefits and drawbacks is a fait accompli and taxpayers and, especially, their advisers should be acquainting themselves with the workings of this tax.

2. The Mechanics of CGT

Capital gains tax differs significantly from income tax, since it may be described as a tax on transactions[10]. Once an asset is disposed of (or deemed to be disposed of), a capital gain or capital loss is triggered. Gains realised after 1 October 2001 on the world-wide assets of South African residents will be taxed. Only immovable property and permanent establishment assets of non-residents will be affected.

An asset for CGT purposes is defined as widely as possible to include

"(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any 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".

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[8] Briefing by the National Treasury op. cit. at 33.

[9] Briefing by the National Treasury op. cit. at 15.

[10] Costa Divaris and Michael Stein in a seminar on Capital Gains Tax, May 2001.

This definition[11] contrasts with the practice in many other jurisdictions where only a numerus clausus of assets are subjected to CGT.

A disposal is defined as "any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset"[12].

SARS has provided a flowchart[13] depicting the process of calculation of a capital gain or loss as the case may be, which has been reproduced on page 20 and may be referred to. A capital gain is calculated by deducting the base cost[14] of each asset disposed of by the taxpayer in the relevant year of assessment from the proceeds (or deemed proceeds) received on disposal. Any allowable capital losses[15] are deducted from the capital gain and (in the case of a natural person or special trust) the annual exclusion of R10 00.00[16] is deducted to form the aggregate capital gain (or loss). Any available assessed loss carried over from the previous tax year is deducted and the amount arrived at is the taxpayer's net capital gain (or assessed capital loss). The net capital gain is multiplied by the inclusion rate of 25%[17] or 50%[18], respectively, and this amount, the taxable capital gain, is included in the taxpayer's taxable income.

Assuming that an individual taxpayer is taxed at the maximum marginal rate, the effective rate of taxation of his net capital gain is 10.5% (25% of the gain is included in his taxable income and taxed at 42%). A company or close corporation's effective rate is 15% and that of a trust where the maximum marginal rate applies, 21%.

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[11] Paragraph 1 Eighth Schedule of the Act

[12] Paragraph 11 Eighth Schedule of the Act

[13] Explanatory Memorandum at 8

[14] i.e. costs directly incurred in respect of the acquisition, improvement and disposal of an asset

[15] See Capital Losses below for further particulars

[16] The annual exclusion for a natural person who dies during the year of assessment is increased to R50 000 for that year.

[17] In respect of a natural person or special trust; or an insurer regarding an individual policy fund- Paragraph 10 Eighth Schedule

[18] In respect of all taxpayers not mentioned in footnote 17. Paragraph 10 Eighth Schedule

Certain assets are exempt or partially exempt from CGT, notably an individual taxpayer's primary residence, which is exempt from CGT in respect of the first R1 million of the value thereof[19].

3. Capital losses

Assessed capital losses have been ring-fenced by the Legislator, in that capital loss can be set off against capital gains, but not against revenue. However, revenue loss can be set off against capital gain.

3.1 Provisions of the Act

Paragraph 4 of the Eight Schedule to the Act:

The taxpayer's capital loss equals

- the base cost[20] less the proceeds received by or accrued to the taxpayer in consequence of the disposal of an asset **during the year of assessment**[21] (where the base cost exceeds the proceeds); or

- that portion of the proceeds previously taken into account in calculating a capital gain or capital loss, to which the taxpayer is no longer entitled[22] or which has become irrecoverable[23] or which has become repayable or been repaid[24] in respect of **disposal of an asset in a previous year of assessment**; or

- the amount paid or payable in the present tax year in respect of the base cost, which has not been taken into account in calculating the

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[19] See paragraphs 52 to 64 of the Eighth Schedule

[20] See paragraph 20 Eighth Schedule

[21] Paragraph 4(a) Eighth Schedule

[22] Paragraph 4(b)(i)(aa) Eighth Schedule

[23] Paragraph 4(b)(i)(bb) Eighth Schedule

[24] Paragraph 4(b)(i)(cc) Eighth Schedule

capital gain or loss in respect of **disposal of an asset in a previous year of assessment**[25].

Paragraph 7 of the Eighth Schedule of the Act:

The aggregate capital loss of a taxpayer equals

- the sum of the taxpayer's capital losses for the year,
- less: the sum of the taxpayer's capital gains for the year,
- less: (in the case of a natural person or special trust) the annual exemption of R10 000[26]. The purpose of the annual exemption, which applies to both capital gains and capital losses, is to decrease the administrative burden of the taxpayer and SARS[27].

Paragraph 9 of the Eighth Schedule of the Act:

The taxpayer's assessed capital loss is the previous tax year's capital loss carried over to the present tax year and added to the present year's aggregate capital loss or set off against the present year's aggregate capital gain.

3.2 The Capital vs. Revenue Conundrum

The question arises whether the significance of the distinction between capital and revenue in the South African tax law is affected by the introduction of a tax on capital gain. The distinction, it is submitted, is often based on artificial and contradictory considerations, since a proliferation of hard cases argued on this point have given rise to some bad law. This has been the result of SARS's view that taxpayers "hide" revenue gains by characterising income as capital gain. This suspicious attitude, which in certain cases, is of course justified,

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[25] Paragraph 4(b)(ii) Eighth Schedule

[26] Paragraph 5 Eighth Schedule. If the taxpayer is a natural person and dies during the year of assessment, the annual exclusion for that year is increased to R50 000.

[27] Minutes of the Finance Portfolio and Select Committee meeting, 24 January 2001; www.cgtsa.co.za at 3.

has led to a proliferation of litigation – SARS reports that 20% of cases involve the capital versus revenue question[28].

The existing corpus of case law on the distinction remains relevant and, although the taxpayer cannot escape taxation on capital gain, it remains in his or her interest to argue that a gain is of a capital nature and so become liable for a maximum of 10.5% (individuals and special trusts) or 15% (corporate entities) or 21% (trust) CGT, rather than the maximum income tax rate of 42%. Similarly, the taxpayer will argue that a loss is of a revenue nature, since the full value of such a loss may be deducted from his income plus capital gain for the year of assessment, rather than facing the situation where the capital loss, less the annual exclusion[29], if applicable, is only deductible from a capital gain for the year of assessment, and is then included at only 25%. Additionally, the right to deduct capital losses is limited in terms of no fewer than 22 paragraphs of the new Eighth Schedule, as well as the general anti-avoidance section of the Act and its subsection dealing with utilisation of assessed losses.

Several commentators[30], including the Treasury's Tax Policy Chief Directorate[31] have aired the opinion that tax arbitrage in respect of the capital/revenue distinction will decrease after the introduction of CGT. In the light of the previous paragraph, I believe that this is unlikely. Accordingly, a selection of Canadian cases dealing with the question of whether a loss is of a revenue or capital nature will be discussed briefly. In terms of Canadian legislation, the taxpayer is entitled to a maximum deduction of $1 000 per year in respect of capital losses.

Sidney John Becker v. The Queen[32]

The taxpayer owned 90% of the shares of a lumber company. He planned to extend the operations of the company to produce a finished product at the site of the sawmill and loaned money and guaranteed loans to this end. Problems were encountered with obtaining logs and the business failed. The

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[28] Quoted in Briefing by the National Treasury op. cit. at 12.

[29] Of R10 000 for a natural person or special trust, or R50 000 for a natural person who died during the year of assessment.

[30] E.g. Katz, M., 2001; "The Impact of Capital Gains Tax in SA"; www.cgtsa.co.za at 1.

[31] Briefing by the National Treasury op. cit. at 13.

[32] [1981] CTC 184

taxpayer sought to deduct his losses, contending that his intention at the time of acquiring the shares and making the loans and guarantees, was to develop a prototype mill and sell the company at a profit. He also alleged that the expenditure was made to enhance his reputation as an engineer and increase his income. The Minister of National Revenue regarded the amount as a capital loss.

It was held that a single "adventure or concern in the nature of trade", however isolated it may be, might qualify as a business venture in terms of the Canadian Income Tax Act. The transaction in point is the acquisition of shares and the advances made to the company. The taxpayer's intention at the time of acquiring the shares must be considered- if it was to make a profit on resale of the company, it was a business venture. According his advocate, the taxpayer lived in Montreal and never moved to Newcastle, where the mill was situated, since his idea was to keep the operation for only as long as was required to build it up, make it profitable and attract a builder.

The court found that the above argument had to fail, because the word "intention" was used without the proper qualification: "intention" should be 'the motivating intention, the immediate and prevailing purpose or at least one of the immediate and dominant purposes of for which the company had been purchased'. While it was accepted that the taxpayer's intention was to transform the company, make it profitable and eventually sell it, the court held that the intention to dispose of the company eventually, was not one of the motivating factors that led the taxpayer to invest in the particular company. This was found on the basis that "the plaintiff [taxpayer]'s personality, his entrepeneurial skill and desire, his whole course of conduct following the acquisition appear to me inconsistent with the view that his immediate purpose was to speculate."

The court then referred to a dictum stating that the court requires a clearer indication of a business purpose than the once-off purchase of shares, even if the purchase was speculative. A further dictum from a case where the taxpayer had developed a prototype small vehicle in order to sell the prototype for a profit, rather than manufacture cars, was quoted: "a loan made by a person who is not in the business of lending money is ordinarily to be considered as an investment" unless there are exceptional and unusual circumstances present.

As to the contention that the taxpayer made the expenses to enhance his reputation as engineer and so increase his income, it was found that no evidence had been led to indicate that the taxpayer was or at least intended to enter into practice as a mechanical engineer or consultant in engineering

techniques applicable to the forest industry. While he had a mechanical engineering diploma, he had for the 25 years before acquiring the shares never practised as such. The concept devised by the taxpayer for his sawmill had primarily to do with organisational, managerial and marketing skills, rather than engineering know-how.

The loss was found to be of a capital nature.

William A. Johnson and Bernard Kredentser v. Minister of National Revenue[33]

The taxpayers, a medical doctor and a lawyer, were the shareholders of a company, which carried on a restaurant business. This company entered into an agreement with a purchaser (a company) pursuant to which it purchased all of the assets of the company. The taxpayers personally guaranteed the loan the purchaser obtained from the bank to pay the purchase price. In return they received a promissory note for the amount guaranteed, as well as a second promissory note for the amount of $10 000, bearing interest at a rate of 10.75% by way of "bonus". The purchaser carried on the business of the restaurant for one year before it failed and the bank called up the security for the loan to the purchaser. The taxpayers each sought to deduct the amount paid to the bank as a business loss.

It was held that the taxpayers had to show that the payment was not of a capital nature and that it was made for the purpose of producing income. Counsel for the taxpayers argued that since the outlay in question did not bring about an enduring benefit, it must have been made for the purpose of producing income and that the guarantee provided was intended to produce a profit, namely the bonus of $10 000, payable in terms of the second promissory note.

The court commented that counsel for the taxpayers was attempting to view the bank loan and the guarantee as two separate transactions, with the guarantee having been made for the purpose of earning a profit. On the evidence, however, the business could not have been sold without the guarantees. The court implicitly found that the enduring asset created was the business and assets of the restaurant, but that any outlay which has the purpose of preserving, salvaging or even preventing further deterioration of a taxpayer's position in a business would also be classified (in South African terms) as outlay of a capital nature.

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[33] [1980] CTC 2471

As an obiter remark, the judge found that even if the bonus promissory note had been paid, it would exhibit characteristics similar to a delayed and contingent payment *made on account of the sale of the business*. Further, in the light of the financial circumstances of the purchasers at the time of the sale, the taxpayers should have shown that they had a reasonable expectation of being paid in terms of the promissory notes and would not have been required to fulfill their obligations under the guarantee, in order to show that they were involved in a business venture.

Normand Berthold v. Minister of National Revenue [34]

The taxpayer owned shares to the value of $40 723 (and was the sole shareholder) in a company, which went bankrupt. He had agreed to work for the company at $135, instead of $300 per week, the difference constituting an interest-bearing loan to the company, in terms of which a total amount of $7 484 was owed.

In respect of the loan to the company, the court found that on the best evidence of the taxpayer, the interest-bearing advances had in fact been made to the company and that it was reasonable to assume that this was for the purpose of gaining or producing income for his business. Therefore, the amount of $7 484 was allowed as a capital loss.

In respect of the shares, the relevant Quebecois legislation provides that deduction of a loss on shares is only allowed if the shares are sold or cancelled. Since the company was in liquidation, the taxpayer was unable to sell the shares and legislation required that all the company's debts be discharged and its assets divided before a charter could be surrendered. As a result of the bankruptcy, he had lost his rights to vote, call meetings, share in profits and share the assets.

The court found that the taxpayer continued to own his shares and had not disposed of them, even though the liquidator had become depository of them. Therefore no loss could arise, since the event triggering a capital loss, namely disposal of the shares, had not taken place. The fact that the shares were of no value does not equate a disposal. Despite the harshness of the

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[34] [1978] CTC 2760

interpretation, the amount of $40 723 was not allowed as a loss, since "there is no equity in tax matters".[35]

In terms of the provisions of Paragraph 77 of the Eighth Schedule of the South African Act, shareholders receiving a liquidation distribution are treated as having disposed of their shares at that stage, thereby crystallising their loss in respect of those shares.

3.3 Anti-avoidance Provisions

While the provisions dealing with CGT are relatively light on anti-avoidance provisions, the legislation on capital losses is littered with no fewer than 22 paragraphs[36] authorising the SA Revenue Service to disregard a taxpayer's capital loss. The many specific anti-avoidance provisions to a large extent reflect the lessons SARS has learnt from problems arising in jurisdictions with several years' experience of CGT. Additionally, Section 103(2) has been amended to make provision for capital losses, and I submit that the omnipresent "giant ogre"[37] embodied in Section 103(1) may find application in respect of a capital loss. The final deterrent to taxpayers is the courts' principle of giving precedence to the substance of a transaction, rather than the form in which it has been cast.

Section 103(1):

SARS carries the onus to show that the following requirements are met cumulatively:

- a "transaction, operation or scheme" has been entered into or carried out
- with the effect of avoiding or postponing liability for tax or **reducing the amount of liability**[38]

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[35] A similar finding in respect of the issue of disposal of worthless shares in a bankrupt company was made in Dramar Investments Ltd. v. MNR [1978] CTC 2936

[36] Paragraphs 15-19, 45, 53-64, 75, 78, 83 and 85

[37] Broomberg, E.B. 1983; "Tax Strategy" ; Butterworths at 211.

- having regard to the circumstances under which the transaction was entered into or carried out,

  * in the case of a transaction in the context of business, was entered into or carried out in a way that would not normally be used for *bona fide* business purposes, other than the obtaining of a tax benefit; and

  * in the case of any other transaction, was entered into or carried out in a way that would not normally be used in the entering into or carrying out of a transaction of the nature of the transaction in point; or

  * the transaction created rights an obligations that would not normally be created between parties dealing at arm's length under a transaction of the nature of the transaction in point

- the transaction was entered into or carried out solely or mainly for the purpose of obtaining a tax benefit.

Section 103(4) imposes a tax avoidance purpose on a taxpayer unless the contrary is proven.

Silke argues that SARS is entitled to use Section 103(1) to attack an assessed (revenue) loss in an avoidance scheme "in appropriate circumstances"[39], although there is no reported South African case where SARS has challenged deduction of a loss in terms of both subsections simultaneously. I will assume that Section 103(1) does apply to capital losses.

It is suggested that by reason of the newness of the tax, a taxpayer will find it particularly difficult to provide evidence that it has become standard business procedure to approach a transaction of that nature in the way the taxpayer did and so to demonstrate that the normality test has been complied with. A taxpayer carrying out a scheme would, therefore, be well advised to ensure that:

i) the parties acted at arm's length, and, preferably were strangers to each other;

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[39] De Koker, A. et al., "Silke on SA Income Tax"; Loose-leaf; Butterworths at 19-38.

iii) each right and obligation created in terms of the transaction can be justified on commercial grounds;

iv) the scheme is designed, both in substance and form, to achieve other business objectives than the utilisation of a capital loss. The proper test to be applied is an enquiry into the nature of the taxpayer's subjective purpose in both entering into and carrying out the scheme.

Section 103(2):

Described by Broomberg[40] as a "strategic weapon aimed at a limited target", this section provides that whenever "the Commissioner is satisfied that any agreement affecting any company or trust or any change in –

(i) the shareholding of any company; or

(ii) the members' interests in any company which is a close corporation; or

(iii) the trustees or beneficiaries of any trust,

as a direct or indirect result of which-

(A) income has been received by or has accrued to that company or trust during any year of assessment; or

(B) any proceeds received by or accrued to or deemed to have been received by or to have accrued to that company or trust in consequence of the disposal of any asset, as contemplated in the Eighth Schedule, result in a capital gain during any year of assessment,

has at any time been entered into or effected by any person solely or mainly for the purpose of utilising any assessed loss, or any balance of assessed loss, any capital loss or any assessed capital loss, as the case may be, incurred by the company or trust, in order to avoid liability on the part of that company or trust or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof-

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[40] op. cit. at 211

(aa) the set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed;

(bb) the set-off of any such assessed loss or balance of assessed loss against taxable capital gain, to the extent that such taxable capital gain takes into account such capital gain, shall be disallowed; or

(cc) the set-off of such capital loss or assessed capital loss against such capital gain shall be disallowed."

This section was initially aimed at preventing the trafficking in an assessed (revenue) loss, but has been broadened to deal with capital losses and assessed capital losses in the same way: a capital loss cannot be set off against (tainted) capital gain received as a result of a transaction or change in membership entered into for the main or sole reason of utilising a capital loss. The loss is, therefore, ring-fenced- it may be set off against other capital gains, but not against the tainted capital gain[41].

A decision by the Commissioner under Section 103(2) is subject to objection and appeal by the taxpayer[42]. Section 103(4) creates a presumption that where the transaction or change in membership results in tax avoidance, the taxpayer's purpose was the use of the loss for tax avoidance. In respect of Section 103(2), the taxpayer cannot take refuge in the normalcy test- if all requirements are present, SARS may disallow the set-off of the loss against the tainted capital gain.

The problems encountered in respect of losing an assessed revenue loss where the taxpayer company ceases trading or where the loss cannot be set off against income for a tax year as a result of the provisions of Section 103(2)[43], do not appear to affect the transferability of capital losses to the next tax year.

The following cases dealing with assessed revenue losses and the application of Section 103(2) are instructive as to the courts' approach:

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[41] Explanatory Memorandum, op. cit. at 29.

[42] In terms of Section 103(4)

[43] New Urban Properties Ltd. v. SIR 1966 (1) SA 215 (A), 27 SATC 175.

ITC 983[44]

The court held that on the facts, the main purpose for the change in shareholding in the taxpayer company was not to avoid or reduce taxation. The facts were as follows: the entire share capital of the taxpayer, a clothing manufacturer with an assessed loss, was acquired by another clothing manufacturer during a certain year of assessment. In the course of the same year the business was closed down, but in the next year it recommenced manufacturing clothing by producing garments for the holding company. It was found on the evidence that the main purpose of the holding company was to obtain a productive manufacturing unit that could go into immediate production, rather than the utilisation of the assessed loss.

ITC 989[45]

The taxpayer company had traded for some time as a timber merchant and incurred trading losses resulting in an assessed loss. Another company in the timber business purchased all of the shares in the taxpayer. The holding company had used a subsidiary to market the retail products it manufactured to merchants, and tried to use it to sell timber directly to builders as well. However, the merchants complained that the subsidiary was undercutting them and refused to purchase from it. After acquisition of the taxpayer, the holding company sold its timber to the taxpayer at wholesale prices, and it resold the timber to builders at retail prices.

The court held that the taxpayer had shown that neither its main nor sole purpose was the avoidance of tax and that there was good reason to believe that the purchase of the shares would have been advantageous even if there had been no assessed loss and that Section 103(2) was inapplicable.

ITC 1123[46]

The taxpayer company was liquidated and all of its assets disposed of apart from its fixed property. One of the liquidators suggested to the prospective buyer of the property that he purchase the shares of the taxpayer to avoid transfer duty and costs and he did so. He conceived the purpose of

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[44] (1961) 25 SATC 55

[45] (1961) 25 SATC 122

[46] (1968) 31 SATC 48

reactivating the business of the taxpayer, and after some transactions had taken place became the sole shareholder of the company, which had no assets or liabilities and a large assessed loss. The company did not continue with its manufacturing activities, but traded in goods, delivered services and loaned money at interest and produced income, which it sought to set off against its assessed loss.

The Commissioner invoked Section 103(2), arguing that the section applied not only to income diverted from others to the taxpayer, but also to income produced by itself. The court found that this was in fact the case and that the income produced was a direct or indirect result of the change in shareholding. The court further held that the shareholder's only purpose was to utilise the taxpayer's assessed loss to avoid taxation and disallowed set-off.

Glen Anil Development Corporation Ltd. v. SIR[47]

Set-off of an assessed revenue loss was disallowed on the basis that the sole or main purpose of a transaction was the utilisation of an assessed loss. The judgment is based on a previous version of Section 103(2) in terms of which only the avoidance of income tax was outlawed. The taxpayer argued that the savings in undistributed profits tax and future estate duty were the primary motives for entered into the transaction.

However, a part of the transaction involved the children of the property developer, who were the effective shareholders of the taxpayer (by owning the entire shareholding of the holding company of the holding company of the taxpayer) purchasing their shares for an amount in excess of the value of those shares in the light of the lack of assets of the second holding company. It was further found firstly that the saving in estate duty could have been achieved through any company, and secondly that undistributed profits tax could have been avoided by declaring a dividend or converting the company to a public company. The saving in income tax through the utilisation of the assessed loss translated into a far larger saving than those in estate duty and undistributed profits tax.

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[47] 1975 (4) SA 715 (A), 37 SATC 319

ITC 1388[48]

A taxpayer and his wife acquired shares and loan accounts in two companies with assessed losses. It was held that since the assessed loss of the first company was not mentioned during negotiations for its purchase and it was found on the evidence that the taxpayer's dominant motive in purchasing the first company was the acquisition of its goodwill and to continue to trade in its name, the assessed loss could be set off against income.

It was, however found that the second company had no goodwill, no business, no premises- its only advantage was its assessed loss and the provisions of Section 103(2) were upheld.

It is clear that the courts focus on the consideration paid by the taxpayer for the shares in a company with an assessed loss. If more has been paid than the shares are worth in the light of the net asset value of the company or its income-earning potential[49], it is most likely that SARS will be able to successfully invoke Section 103(2).

Anti-avoidance: the doctrine of substance over form

The treatment of CGT transactions in the light of the above doctrine, in terms of which the courts favour the actual substance of a transaction above the form in which it has been cast, is illustrated by the following judgment by the Zimbabwean Supreme Court.

Sommer Ranching (Private) Ltd. v. CoT[50]

The taxpayer was the sole shareholder of a company owning land. A certain Mr. Dudman offered to purchase the land for an amount of $800 000. After the taxpayer had obtained his accountant's advice he decided to sell the shares in the company in order to avoid the payment of CGT[51], the payment of transfer duty and costs by the purchaser and the requirement that the purchaser obtain a certificate under the Zimbabwean Land Acquisition Act.

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[48] (983) 46 SATC 126

[49] Broomberg, E.B. op.cit. at 217

[50] (1999) 61 SATC 472

[51] In Zimbabwe, only specified assets, e.g. land, but not shares, are subject to CGT

Since the benefit to the taxpayer was far greater than that of the purchaser, it was agreed to decrease the price to $750 000.

The sale was structured as follows: the company re-valued the land at $100 000, which allowed for a capital loss of $10 000. The balance of $650 000 in respect of the value of the land was declared as a dividend to the taxpayer, and in order to effect payment, a loan account in the amount of $650 000 was created in favour of the taxpayer. In terms of Zimbabwean provisions, this dividend was inter-company and would attract no taxation. Mr. Dudman then purchased the shares for $100 000 and the loan account for $650 000. In the written deed of sale, however, the agent's commission of 5% is reflected as $37 5000, being 5% of $750 000.

The Commissioner of Taxes issued an assessment in terms of which CGT on the amount of $750 000 was imposed and a 100% penalty was imposed on the taxpayer for misrepresentation.

In the court a quo[52] the equivalent of our Section 103(1) was invoked, but it was found that the requirement of normality had not been met. The Commissioner then invoked Section 14 of the Zimbabwean Capital Gains Tax Act, which provides that the Commissioner may determine the correct market value of an asset sold at a price less than the fair market price. Gubbay, CJ. found that the essential question to be answered was whether 'creative accounting' could be utilised to reduce the real price at which an asset has been purchased for the sole purpose of avoiding in whole or in part the payment of capital gains tax. He held that that could not be the case. The enquiry was to true nature of the transaction, i.e. what the seller and purchaser were trying to achieve. In this regard it was found that the Commissioner was justified in looking beyond the effect of the accounting practice utilised and taxing the full amount of $750 000.

As to the penalty imposed, Gubbay CJ. confirmed the finding of the court a quo, which had decreased the penalty imposed on the taxpayer to 10%, finding that the purpose of the penalty was to punish the offending taxpayer for blindly signing the forms placed before him by his accountant; and act as deterrent to others.

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[52] ITC 1631 (1997) 60 SATC 63

4. Conclusion

This paper was drafted with the purpose of contributing some insights during the process of getting to grips with the fairly sophisticated piece of legislation on capital gains with which government has presented the tax fraternity. The value and applicability of the overseas sources cited will, of course, have to be re-evaluated once contentious issues arise as the legislation is implemented.

By way of conclusion, the following aspects bear mentioning: through the introduction of CGT, SARS has gained the benefit of becoming entitled to full disclosure of a taxpayer's capital assets, allowing it to attack capital income as income of a revenue nature with greater ease.[53] The onus to prove that the Commissioner's classification of an amount as revenue is wrong, is borne by the taxpayer in terms of Section 82[54] and taxpayers are well advised to keep this aspect in mind.

Tax planning in respect of capital gains must ensure that the taxpayer doesn't avoid CGT at 10.5% (individual or special trust), 15% (companies and close corporations) or 21% (trusts), but incurs liability for income tax (at the relevant marginal rate), donations tax at a rate of 25% or estate duty at 20%.

Since the ripple effects of CGT on the broader South African economy, as well as the more subtle effects of taxpayer behaviour are yet to emerge, the real issues in respect of capital gains and losses will become evident as time passes. The hope is expressed that this paper addresses some of these.

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[53] Lester, M. 2001;"Prove it's capital or face paying 42% tax instead of 10.5" ; www.cgtsa.co.za. and Stein, M. 2001; "CGT Misconceptions" ; www.cgtsa.co.za.

[54] As amended by the Taxation Laws Amendment Act, 2001.

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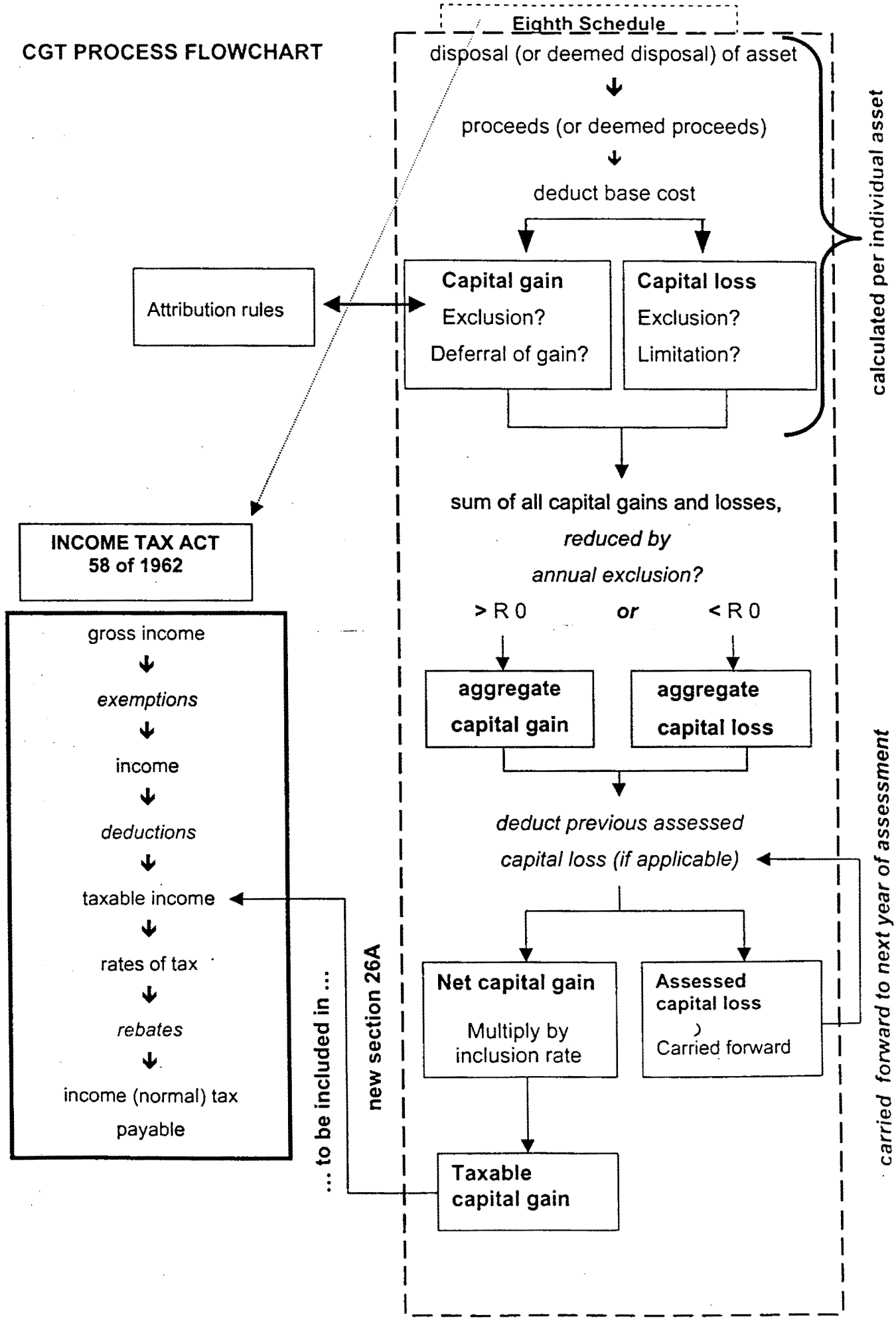
11. The Independent Online, Business Report, 15 January 2001

CGT PROCESS FLOWCHART



CAPITAL GAINS TAX

CGT 1

Schedule regarding capital gains and losses for return in respect of income tax

Name

Postal address

Postal code

Reference number

Year of Assessment

This return is to be submitted together with the annual return of income should a capital gains event have taken place during the period of 2001/10/01 - 2002/02/28.

Please complete the schedule as per this return and make sure that the relevant information where indicated on this return is transcribed to the relevant sections of the annual return of income.

Schedule of Capital gains and losses

Proceeds	Base Cost	Portion of base cost	Exclusion	Capital gain	Capital loss	Main asset type
		Total				

The taxable capital gain or loss amount and relevant source code (profit 4250 and loss 4251) must be transcribed to the annual return of income as follows:

IT12SE: Return for Determination of Liability - Part 3.2;
IT12S: Return of Income: Individual - Part 4.2;
IT12BU: Return of Income: Individual - Part 6;
IT12TR: Return of Income: Trusts - Part 8
IT14: Return of Income: Company and Close Corporation - Part 6.9

Any foreign tax credits in respect of capital gains must be declared on the annual return of income tax as follows:

IT12SE: Return for Determination of Liability - Part 5;
IT12S: Return of Income: Individual - Part 6;
IT12BU: Return of Income: Individual - Part 6;
IT12TR: Return of Income: Trusts - Part 8;
IT14: Return of Income: Company and Close Corporation - Part 6.9

For more information regarding capital gains tax, please refer to the SARS web site namely www.sars.gov.za. The legislation (Taxation Law Amendments Act, 2001), explanatory memorandum and guides are contained under the CGT folder. For further information, please contact the local Receiver of Revenue.

Please provide answers to the following questions (where applicable). The answers must be submitted with this return.

Primary residence		
Did you dispose of your residence between 1 October 2001 and the end of the year of assessment?	Yes	No
Did you use any part of the residence for the purposes of trade between 1 October 2001 and the date of disposal e.g. did you claim expenses in respect of a home office?	Yes	No
Did you realise a capital gain for CGT purposes in excess of R1 million?	Yes	No
Were you not ordinarily resident in the residence for any period (after 1 October 2001) during which you held the residence?	Yes	No
Did the land on which the residence was situated exceed 2 hectares?	Yes	No
Did you let the residence for any period between 1 October 2001 and the date of disposal? If so, give details of the period of letting and the reasons for letting.	Yes	No
Investments and certain personal use assets		
Did you dispose of any assets of a capital nature, whether held in or outside the Republic during the year of assessment: e.g. second home, shares, units in a unit trust, gold or platinum coins, second hand policies, a boat in excess of 10 metres in length, an aircraft with an unladen mass exceeding 450 kg?	Yes	No
Gambling, games and competitions		
Did you derive any proceeds from illegal gambling, games or competitions in South Africa, or any such activity, legal or otherwise, in a foreign country?	Yes	No
Compromises		
Were you relieved of the obligation to pay any debt?	Yes	No
Value shifting arrangement		
Did you enter into any 'value shifting arrangement' as defined in the Eighth Schedule (e.g. arrange for a company in which you own shares to issue shares at a discount to you or a connected person)?	Yes	No
Excessive dividends resulting in a loss		
Did you make a loss on the disposal of any shares within two years of acquiring them?	Yes	No
If so, did the sum of dividends received in respect of those shares during the period of ownership exceed 15% of the proceeds on disposal?	Yes	No
Connected persons		
Did you dispose of an asset that was acquired during the period 23 February 2000 to 30 September 2001 from a connected person at a non-arm's length price?	Yes	No
Did you dispose of an asset to a connected person at a price other than market value?	Yes	No
Disposals		
Donations		
Did you donate any asset to any person?	Yes	No
If you donated an asset to an approved section 30 public benefit organization, attach certificate	Yes	No
Transfer to trading stock		
Did you transfer any capital assets to trading stock?	Yes	No
Cessation of SA residence		
Did you cease to be a resident of South Africa during the year of assessment?	Yes	No
Foreign Currency		
Did you own any foreign currency assets (cash, foreign loans, debts) during the year of assessment?	Yes	No
Did you convert any of those assets into SA Rands or any other currency or use it to acquire any asset or finance any expenditure?	Yes	No

Capital Gains tax source

6502 Fixed/Immovable assets (e.g. Land, buildings, mineral rights)

6503 LOSS:Fixed/Immovable assets (e.g. Land, buildings, mineral rights)

6504 Primary residence (e.g. house, townhouse, flat, boathouse, caravan)

6505 LOSS:Primary residence (e.g. house, townhouse, flat, boathouse, caravan)

6506 Financial instruments - Listed (e.g. Shares, units in unit trusts, bonds, futures, options)

6507 LOSS:Financial instruments - Listed (e.g. Shares, units in unit trusts, bonds, futures, options)

6508 Financial instruments - Unlisted (e.g. Shares, debentures, promissory notes, bonds, options, forward contracts,swaps, debt)

6509 LOSS:Financial instruments - Unlisted (e.g. Shares, debentures, promissory notes, bonds, options, forward contracts,swaps, debt)

6510 Intangible assets (e.g. goodwill, trade marks, patents, copyrights, franchises, licenses, fiduciary, usufructuary and other like interests)

6511 LOSS:Intangible assets (e.g. goodwill, trade marks, patents, copyrights, franchises, licenses, fiduciary, usufructuary and other like interests)

6512 Foreign currency

6513 Loss:Foreign currency

6514 Plant and machinery

6515 LOSS:Plant and machinery

6516 Other movable property used for business purposes (e.g. aircraft, boats, motor vechiles, office furniture and equipment)

6517 LOSS:Other movable property used for business purposes (e.g. aircraft, boats, motor vechiles, office furniture and equipment)

6518 Other movable property not used for business purposes excluding personal use assests (e.g. Kruger rands, personal use boats > 10 metres and personal use aircraft > 450kg)

6519 LOSS:Other movable property not used for business purposes excluding personal use assests (e.g. Kruger rands, personal use boats > 10 metres and personal use aircraft > 450kg)