



Legal Counsel

Income Tax

Tax Guide for Share Owners (Issue 5)



South African Revenue Service

Tax Guide for Share Owners

Preface

This guide provides general guidance on the taxation of share owners. It does not go into the precise technical and legal detail that is often associated with tax, and should not, therefore, be used as a legal reference. It is not an “official publication” as defined in section 1 of the Tax Administration Act 28 of 2011 and accordingly does not create a practice generally prevailing under section 5 of that Act. It is also not a binding general ruling under section 89 of Chapter 7 of the Tax Administration Act. Should an advance tax ruling be required, visit the SARS website for details of the application procedure.

The guide examines –

- the tax consequences of holding shares as trading stock compared to holding them as capital assets;
- how to distinguish between profits of a capital and revenue nature using common law principles and statutory rules;
- the determination of a taxpayer’s liability for capital gains tax;
- how dividends are taxed; and
- various corporate actions that can impact on the determination of a person’s liability for tax.

This guide is based on legislation as at 19 January 2017 and primarily focuses on the 2017 year of assessment although much of the commentary will also apply to earlier years of assessment.

For more information you may –

- visit the SARS website at www.sars.gov.za;
- visit your nearest SARS branch;
- contact your own tax advisor or tax practitioner;
- contact the SARS National Contact Centre –
 - if calling locally, on 0800 00 7277; or
 - if calling from abroad, on +27 11 602 2093 (only between 8am and 4pm South African time).

Comments on this guide may be sent to policycomments@sars.gov.za.

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Glossary

In this guide unless the context indicates otherwise –

- “**dividends tax**” means dividends tax levied under section 64E;
- “**Eighth Schedule**” means the Eighth Schedule to the Act;
- “**income tax**” means the portion of normal tax attributable to the inclusion in taxable income of income (that is, excluding any taxable capital gain);
- “**paragraph**” means a paragraph of the Eighth Schedule;
- “**section**” means a section of the Act;
- “**the Act**” means the Income Tax Act 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

All guides and interpretation notes referred to in this guide are available on the SARS website at www.sars.gov.za.

Acronyms

CFC	Controlled foreign company as defined in section 1(1)
CGT	Capital gains tax, being the portion of normal tax attributable to the inclusion in taxable income of a taxable capital gain
JSE	The securities exchange operated by JSE Ltd

1. Introduction

In recent years an increasing number of persons have become share owners. Many investors have turned to participation in the stock exchange either directly through share ownership or indirectly through collective investment schemes in an attempt to derive a return that beats inflation. The proliferation of broad-based employee share incentive arrangements has also contributed to share ownership among South Africans.

This guide summarises some of the key aspects holders of shares need to be aware of in computing their liability for income tax and CGT. It is primarily aimed at resident individuals who own shares in their own names. However, many of the principles covered apply equally to companies and trusts, and when appropriate the more obvious differences in the treatment of these entities have been highlighted.

Non-residents are generally not subject to CGT on the disposal of shares except shares in companies holding immovable property in South Africa. More specifically, under paragraph 2(2), 80% of the market value of the equity shares at the time of disposal must be attributable directly or indirectly to immovable property in South Africa held otherwise than as trading stock. In addition the person holding the shares, together with any connected person in relation to that person, must hold at least 20% of the equity shares in the company. If these criteria are not met, the non-resident will not be liable for CGT on disposal of the shares. This guide will therefore have limited application to non-residents.

2. Income tax v capital gains tax

Shares held as trading stock are bought for the main purpose of resale at a profit. Any gain or loss made on disposal of a share held as trading stock will be of a revenue nature.

Revenue gains of a natural person are subject to income tax at the marginal tax rate, which may vary between 18% (but effectively 0% if tax rebates are taken into account) and 41%, depending on the level of taxable income.

By contrast, if a share is held as a capital asset (that is, as a long-term dividend-producing investment), any gain or loss upon its disposal will be of a capital nature.

Capital gains are subject to tax at a lower effective rate than income gains. For the 2017 year of assessment, a natural person must disregard the first R40 000 of the sum of capital gains and losses in the year of assessment for CGT purposes (2016: R30 000). This exclusion is known as the “annual exclusion”. For a natural person dying during the 2017 year of assessment, the annual exclusion is increased to R300 000 (2016: R300 000). Of the balance remaining after applying the annual exclusion, and any assessed capital loss brought forward from the previous year of assessment, 40%¹ is included in taxable income and taxed at the marginal tax rate in the same way as, for example, salary or pension income. The effective rate of tax on a natural person’s capital gain in a year of assessment can thus vary between 0% and 16,4%. The 0% rate would apply when –

- the sum of capital gains and losses does not exceed the annual exclusion;
- the sum of capital gains is less than or equal to the sum of capital losses; or
- taxable income falls below the level at which normal tax becomes payable.

The 16,4% rate would apply when a natural person’s marginal tax rate is 41%² (that is, 41% (marginal rate) × 40% (inclusion rate) = 16,4%).

Companies and trusts, other than special trusts, pay CGT at a higher rate than natural persons. They do not qualify for the annual exclusion, and must include 80% of any net capital gain³ in taxable income.

The effective tax rate on a capital gain for a company is 28% × 80% = 22,4% for years of assessment commencing on or after 1 March 2016 (years of assessment commencing on or after 1 March 2015: 28% × 66,6% = 18,65%).

A trust that is not a special trust has an effective CGT rate of 41% × 80% = 32,8% for the 2017 year of assessment (2016: 40% × 66,6% = 26,64%).

A special trust is subject to the same marginal tax rates (on a sliding scale) and inclusion rate (40%) as a natural person. A special trust created solely for the benefit of a person or persons having a disability as defined in section 6B(1) which incapacitates them from

¹ This percentage is known as the inclusion rate. For natural persons and special trusts it is 40% and for companies and other trusts it is 80%. For years of assessment commencing before 1 March 2016 the inclusion rate was 33,3% for natural persons and special trusts and 66,6% for companies and other trusts.

² For the 2017 year of assessment the 41% tax rate applies to taxable income in excess of R701 300.

³ A net capital gain arises when the sum of capital gains and losses in a year of assessment less any assessed capital loss brought forward from the previous year of assessment is a positive figure.

earning sufficient income for their maintenance, or from managing their own financial affairs, qualifies for the annual exclusion. But a special trust created on death solely for the benefit of relatives of the deceased person, including a beneficiary under the age of 18 years does not qualify for the annual exclusion although it does qualify for the 40% inclusion rate.⁴

3. Capital v revenue

The first step in computing a person's tax liability on a disposal of shares is to determine whether the gain or loss is of a capital or revenue nature.

Apart from the three-year holding rule in section 9C (see 5.2), the Act does not provide objective rules to distinguish between amounts of a capital and revenue nature. This task has been left to the South African courts, which over many years have laid down guidelines for making this distinction. The more important of these are listed below.

A person will have to discharge the onus of proving that a particular amount is of a capital or revenue nature.⁵ In order to discharge the onus, a case must be established on "a balance or a preponderance of probabilities" (*CIR v Middelman*⁶).

3.1 Criteria for distinguishing between revenue and capital profits

A taxpayer's intention is the most important factor in determining the capital or revenue nature of a particular profit or loss. Establishing a taxpayer's sole or main intention is not always an easy task, since taxpayers can sometimes have more than one intention in relation to an asset. The courts have held that a taxpayer's evidence as to intention must be tested against the surrounding circumstances of the case, which include, amongst other things, the frequency of transactions, method of funding and reasons for selling.

3.2 Intention

3.2.1 Intention

The most important factor in determining whether a profit is of a capital or revenue nature is the intention of the person when the shares were bought and sold (*Elandsheuwel Farming (Edms) Bpk v SBI*⁷). If they were bought as a long-term investment to produce dividend income the profit is likely to be of a capital nature. But if the shares were bought for the purpose of resale at a profit, the profit will be of a revenue nature.

In order for a profit to be of a capital nature the "slightest contemplation of a profitable resale" need not be excluded (*SIR v The Trust Bank of Africa Ltd*⁸).

3.2.2 Mixed intentions

If shares were acquired with mixed intentions (that is, they were bought either to sell at a profit or to hold as an investment), the person's intention will be determined by the dominant or main purpose (*COT v Levy*⁹).

⁴ See the *Guide to the Taxation of Special Trusts* for more information on special trusts.

⁵ Section 102(1)(a) and (c) of the Tax Administration Act 28 of 2011.

⁶ 1991 (1) SA 200 (C), 52 SATC 323 at 325.

⁷ 1978 (1) SA 101 (A), 39 SATC 163.

⁸ 1975 (2) SA 652 (A), 37 SATC 87.

⁹ 1952 (2) SA 413 (A), 18 SATC 127.

3.2.3 Secondary purpose

A profit will be of a revenue nature when a person has a secondary or alternative purpose of making a profit (*CIR v Nussbaum*¹⁰). An example of such a secondary purpose can be found in *CIR v Tod*¹¹ in which the taxpayer who purchased shares cum div (that is, ripe with dividends), received the dividends and then sold the shares ex div. The court held that the resulting profits were of a revenue nature.

3.2.4 Change in intention

A change in a person's intention can result in a share held as a capital asset becoming trading stock, and in a share held as trading stock becoming a capital asset.

It has been held that something more is required to effect this change in character than a mere decision to sell the asset.¹² For cases in which shares held as trading stock became assets of a capital nature, see *New Mines Ltd v CIR*¹³ and *CIR v Modified Investments (Pty) Ltd*.¹⁴

What are the implications of such a change in the character of shares? A change from trading stock to a capital asset will trigger an income inclusion equal to the market value of the shares.¹⁵ A change of a capital asset to trading stock will trigger a disposal for CGT purposes at market value.¹⁶

A change in intention is not taken into account once equity shares falling within section 9C have been held for at least three years (see 5.2). A deemed disposal of shares held as trading stock is not triggered after the three-year period because the shares technically remain trading stock despite being able to produce only proceeds of a capital nature.¹⁷

3.3 Some general principles

3.3.1 Scheme of profit-making

Any profit or loss on disposal of shares will be of a revenue nature if they were purchased for resale as part of a scheme of profit-making, (*Californian Copper Syndicate (Limited and Reduced) v Harris (Surveyor of Taxes)*¹⁸).

3.3.2 Fortuitous gains

A profit on sale of shares is more likely to be of a revenue nature if it was not fortuitous, but designedly sought for and worked for (*CIR v Pick 'n Pay Employee Share Purchase Trust*¹⁹).

¹⁰ 1996 (4) SA 1156 (A), 58 SATC 283 at 291.

¹¹ 1983 (2) SA 364 (N), 45 SATC 1.

¹² *John Bell & Co (Pty) Ltd v SIR* 1976 (4) SA 415 (A), 38 SATC 87.

¹³ 1938 AD 455, 10 SATC 9.

¹⁴ 1982 (1) SA 331 (T), 43 SATC 257.

¹⁵ Section 22(8)(b)(v).

¹⁶ Paragraph 12(2)(c).

¹⁷ The shares fall within paragraph (a)(i) of the definition of "trading stock" in section 1(1) because they were purchased for the purposes of sale.

¹⁸ 41 Sc LR 694, 5 TC 159.

¹⁹ 1992 (4) SA 39 (A), 54 SATC 271.

3.3.3 The “for keeps” test

The usual badge of a fixed capital investment is that it is acquired for better or for worse, or, relatively speaking, for “keeps”, and will be disposed of only if some unusual, unexpected, or special circumstance, warranting or inducing disposal, supervened (*Barnato Holdings Ltd v SIR*²⁰).

More recently it has been noted by the tax court that the holding of shares “for keeps” is reflective of an old, static economic order that no longer exists (ITC 1867²¹).

3.4 Surrounding circumstances

3.4.1 The transaction-by-transaction approach

Just as an occasional swallow does not make a summer, so an occasional sale of shares yielding a profit does not of itself make a seller of shares, a dealer in them (*CIR v Middelman*²²).

3.4.2 Shares acquired for dividend income

Shares bought for the dominant, main and overriding purpose of securing the highest dividend income possible will be of a capital nature when the profit motive is incidental (*CIR v Middelman*²³).

3.4.3 Scale and frequency of transactions

The scale and frequency of share transactions is of major importance, although not conclusive (*CIR v Nussbaum*²⁴).

3.4.4 Forced sales shortly after purchase

The fact that an asset is sold for a substantial profit very soon after acquisition is, in most cases, an important one in considering whether a profit is of a revenue nature. However, it loses a great deal of its importance when an event occurs that was not previously contemplated (ITC 1185²⁵). In the context of shares this principle may apply, for example, when a holder of shares is forced to dispose of shares in order to facilitate a merger or acquisition.

3.4.5 Insufficient funds

It may be inferred that shares were bought for the purpose of resale at a profit if a person is forced to sell them because the person had insufficient funds to enable them to be held for the long term. For example, this situation could apply if the purchase of shares was financed by an overdraft and the person was later forced to sell them because of an inability to afford the repayments (*CIR v Lydenburg Platinum Ltd*;²⁶ *Yates Investments (Pty) Ltd v CIR*;²⁷ *Ropty (Edms) Bpk v SBI*²⁸).

²⁰ 1978 (2) SA 440 (A), 40 SATC 75.

²¹ (2013) 75 SATC 273 (WC) at 296.

²² 1991 (1) SA 200 (C), 52 SATC 323 at 327.

²³ 1991 (1) SA 200 (C), 52 SATC 323 at 328.

²⁴ 1996 (4) SA 1156 (A), 58 SATC 283 at 292.

²⁵ (1972) 35 SATC 122 (N).

²⁶ 1929 AD 137, 4 SATC 8.

²⁷ 1956 (1) SA 612 (A), 20 SATC 368.

²⁸ 1981 (A), 43 SATC 141.

3.4.6 Low or nil return

The proceeds are more likely to be of a revenue nature when the type of share purchased does not produce dividends, or the business carried on by the company is highly risky. The sale of futures contracts is likely to be on revenue account, even if used as a hedge against losses on underlying shares held as capital assets (ITC 1756;²⁹ *Wisdom v Chamberlain (Inspector of Taxes)*³⁰).

3.4.7 A once-off venture can comprise a trade

A once-off venture involving the acquisition of shares can comprise a trade resulting in the shares becoming trading stock. It will be easier to classify such an isolated acquisition as being on capital account if the taxpayer holds other shares as capital assets (ITC 1849³¹).

4. Income tax

4.1 Shares held as trading stock

The cost of shares acquired as trading stock is allowable as a deduction under section 11(a).

The cost price of shares held at the end of the year of assessment must be taken into account as closing stock in determining taxable income.³²

If the market value of shares has fallen below their cost price at the end of a year of assessment, it is no longer permissible to include the lower market value in closing stock thus effectively claiming a deduction for the difference.³³

The amount included in income as closing stock becomes deductible as opening stock for the following year of assessment.³⁴

With the introduction of section 9C, the proceeds on disposal of equity shares (including shares in foreign companies listed on a South African exchange) held as trading stock for at least three years are treated as being of a capital nature. Any expenditure or losses claimed against income during the period that the shares were held as trading stock will be recouped on disposal. For more on section 9C, see **5.2**. Despite this recoupment, one-third of any interest incurred on borrowings used to acquire listed shares or a participatory interest in a portfolio of a collective investment scheme qualifies as an addition to the base cost of the shares or participatory interest in determining any capital gain or loss for CGT purposes – see **5.6.2**.

²⁹ (1997) 65 SATC 375 (C).

³⁰ (1969) (1 All ER 332 (CA).

³¹ (2010) 73 SATC 176 (P).

³² Section 22(1).

³³ Section 22(1)(a) excludes a financial instrument from the write-down rule. Paragraph (a) of the definition of “financial instrument” in section 1(1) includes a share. For the 2011 and earlier years of assessment, it was permissible for an individual or trust to write down the value of closing stock below cost to its market value but this was never permitted for companies.

³⁴ Section 22(2).

Example 1 – Equity shares held as trading stock

Facts:

References in this example to year 1 and year 2 are to years of assessment.

In November of year 1, which fell after the 2011 year of assessment, L, an individual, purchased 100 shares in XYZ Ltd at a cost of R1 per share for the purpose of resale at a profit. At the end of year 1 the market value of the shares had dropped to 80 cents per share. In July of year 2 L sold the shares for R1,20 per share. Determine the amounts to be deducted from or included in L's taxable income in years 1 and 2.

Result:

Year 1

	R
Cost of shares allowable as a deduction	(100)
Closing stock at cost price	<u>100</u>
Net amount deducted from or included in taxable income	<u>0</u>

Year 2

Proceeds included in gross income	120
Less: Opening stock	<u>(100)</u>
Net amount included in taxable income	<u>20</u>

4.2 Employee share incentive schemes

A person may be subject to income tax when acquiring shares from an employer or from an employee share purchase trust set up by an employer. Any gain or loss on shares so acquired is determined in accordance with special rules contained in sections 8A, 8B and 8C. These rules are complex and a full discussion of them is beyond the scope of this guide. An employer will usually determine the gain or loss and deduct the required amount of employees' tax (PAYE). The gain or loss will be reflected on the employees' tax certificate (IRP 5).

Set out below is a brief overview of sections 8A, 8B and 8C.

4.2.1 Shares or options acquired before 26 October 2004 (section 8A)

Section 8A applies to shares or options acquired by an employee (including a director) from his or her employer before 26 October 2004. Any revenue gain determined under section 8A will be included in income. Such a gain usually arises when the employee exercises an option to acquire shares from his or her employer and the price paid for the shares is less than the market price at the time of acquisition. When an employer does not allow an employee or director to sell the shares before a certain date, the employee or director can elect to delay the taxation of the gain until that date.

Once a person has been subject to income tax under section 8A on the shares acquired from an employer, a further gain or loss may arise when the person disposes of the shares. The capital or revenue nature of this further gain or loss is determined in the normal way; that is, shares held as capital assets will be subject to CGT, while shares held as trading

stock will be subject to income tax in full. For CGT purposes the base cost of the shares will be the market value that was taken into account in determining the section 8A gain.³⁵

Example 2 – Shares acquired under section 8A

Facts:

On 1 October 2004, T was granted an option to acquire 1 000 shares in T's employer, ABC Ltd at a price of R1,00 per share when the market price was R1,50 per share. T paid 10 cents per share for the options. On 28 February 2013 T exercised the options when the market price was R5,00 per share, and on 30 June 2016 T sold the shares at R8,00 per share.

Result:

The following gains will arise in T's hands:

- 2013 year of assessment – an ordinary income gain under section 8A
- 2017 year of assessment – a capital gain.

These gains will be determined as follows:

Section 8A gain

	R
Market value of shares at date option exercised (1 000 × R5)	5 000
Less: Cost of options 1 000 × 10 cents	(100)
Cost of shares 1 000 × R1,00	<u>(1 000)</u>
Section 8A gain included in income	<u>3 900</u>

Capital gain

Proceeds 1 000 × R8,00	8 000
Less: Base cost 1 000 × R5,00	<u>(5 000)</u>
Capital gain	<u>3 000</u>

Note: The actual cost of the shares comprises the option cost of R100 and the purchase price of the shares of R1 000. These amounts are excluded from base cost for CGT purposes, since they have been taken into account in determining the section 8A gain. It is simply the market price of the shares that was taken into account in determining the section 8A gain that constitutes the base cost. The market value taken into account as base cost is the same as the actual cost of R1 100 plus the section 8A gain of R3 900 = R5 000.

4.2.2 Broad-based employee share plans (section 8B)

Section 8B applies to qualifying broad-based employee share plans when at least 80% of the employees in the company are entitled to participate.³⁶ In order for an employee to qualify, the market value of the shares given to him or her in the current and immediately preceding four years of assessment must not exceed R50 000.³⁷ A share acquired under such a plan which is held for at least five years will produce a gain on disposal of a capital nature and be subject to CGT. But if the share is disposed of within five years, any gain will be taxed as income, and section 9C, which deems shares held for at least three years to be on capital account, will not apply. This long-term holding requirement serves as an

³⁵ Paragraph 20(1)(h)(i).

³⁶ Paragraph (b) of the definition of "broad-based employee share plan" in section 8B(3).

³⁷ Definition of "qualifying equity share" in section 8B(3).

encouragement for employees to hold their shares for at least five years. The benefits of section 8B do not apply if an employee was a member of any other employee share incentive scheme at the time of receipt of the shares.³⁸ In such event the employee will be taxed under section 8C.

Example 3 – Broad-based employee share incentive plan: Employee disposing of shares within five years

Facts:

On 5 January of year 1, under a qualifying broad-based employee share incentive plan, Y received 2 500 shares in Y's employer, XYZ Ltd at no cost. The shares were trading at R1 each at the time they were awarded to Y. No restrictions apply to the shares, except that they may not be sold before 5 January of year 4 unless an employee is retrenched or resigns. An employee who resigns or is retrenched must sell the 2 500 shares back to XYZ Ltd for the market value of the shares on the last day of employment. XYZ Ltd appointed a trust to administer the shares under the plan.

Y resigned from XYZ Ltd on 21 December of year 1. Under the plan rules Y sold the shares back to XYZ Ltd (through the trust) on 21 December of year 1 at market value of R3 750 (R1,50 per share).

Result:

Y is not subject to tax upon the granting of the shares in the year of assessment ending on 28 February of year 1.³⁹ In the subsequent year of assessment ending on 28 February of year 2, R3 750 will be taxed as ordinary income in Y's hands when the shares are sold back to XYZ Ltd and the company will withhold the appropriate amount of employees' tax.

Example 4 – Broad-based employee share incentive plan: Employee disposing of shares after five years

Facts:

On 5 January of year 1, under a qualifying broad-based employee share incentive plan, Y received 2 500 shares in Y's employer, XYZ Ltd at no cost. The shares were trading at R1 each at the time they were awarded to Y. No restrictions apply to the shares, except that they may not be sold before 5 January of year 4 unless an employee is retrenched or resigns. XYZ Ltd appointed a trust to administer the shares under the plan.

Y resigned from XYZ Ltd on 30 June of year 6 and sold the shares on 31 January of year 7 in the open market for R4 500.

Result:

Since the shares have been held for more than five years, they are no longer subject to a potential income inclusion under section 8B(1) and any proceeds will be of a capital nature under section 9C(2) upon their disposal.

The disposal in year 7 will thus result in a capital gain of R4 500 (proceeds R4 500 less base cost of nil).

³⁸ Paragraph (b) of the definition of "broad-based employee share plan" in section 8B(3).

³⁹ Paragraph 2(a)(iii) of the Seventh Schedule to the Act.

4.2.3 Shares and options acquired on or after 26 October 2004 (section 8C)

Section 8C replaced section 8A and applies to “equity instruments” (shares and options) acquired from an employer on or after 26 October 2004. A revenue gain or loss will arise when a share or option “vests”. Vesting will usually happen when the share is acquired with no restrictions, or when all restrictions are lifted. If the employee or director is restricted from disposing of the share, the revenue gain or loss will be determined when the restriction is lifted. This rule differs from section 8A in which the revenue gain was frozen at the time of acquisition of a share and on election deferred until the restriction ended.

Once an employee or director has been subject to income tax under section 8C on the shares acquired from the employer, a further gain or loss may arise when the shares are disposed of. The capital or revenue nature of this further gain or loss is determined in the normal way; that is, shares held as capital assets will be subject to CGT, while shares held as trading stock will be subject to income tax in full. For CGT purposes the base cost of the shares will be the market value that was taken into account in determining the section 8C gain.⁴⁰

Example 5 – Section 8C gain and capital gain

Facts:

On 30 June of year 1 B acquired an option from B’s employer to purchase 100 shares in ABC Ltd at a price of R100 per share. B paid R10 per share for the option, which was exercisable before 30 June of year 2. On 31 May of year 2 B exercised the option at a time when the share price was R160 per share. Under the arrangement with the employer, B was not permitted to sell the shares before 30 June of year 5 at which time the market price was R190 per share. B eventually sold the shares on 1 March of year 6 for R210 per share. Determine B’s section 8C gain and capital gain per share.

Result:

Section 8C gain

	R	R
Market value on date restriction lifted		190
Less: Cost of option	(10)	
Strike price	<u>(100)</u>	<u>(110)</u>
Section 8C gain per share included in income		<u>80</u>

Capital gain

B has held the shares for more than three years and the consideration received or accrued on their disposal will therefore be of a capital nature under section 9C (see 5.2). Section 9C does not apply while the shares are restricted⁴¹ but since they were unrestricted at the time of disposal this prohibition does not apply.

For CGT purposes the base cost of the shares will be the market value that was taken into account in determining the section 8C gain.

	R
Proceeds	210
Less: Deemed base cost	<u>(190)</u>
Capital gain per share	<u>20</u>

⁴⁰ Paragraph 20(1)(h)(i).

⁴¹ Section 8C(1)(a) applies “notwithstanding” section 9C.

Returns of capital

Any return of capital or foreign return of capital received or accrued while shares are restricted must be included in income in the year of assessment in which it is received or accrues. In other words, these returns of capital do not receive CGT treatment as discussed in 5.8.⁴² This rule does not apply to a return of capital or foreign return of capital in the form of a distribution of an equity instrument.

4.3 Taxation of dividend income

4.3.1 Local dividends

Normal tax

Dividends from South African resident companies are exempt from normal tax under section 10(1)(k)(i) unless the proviso to that section applies.

Dividends tax

On or after 1 April 2012 dividends from resident companies and non-resident companies listed on a South African exchange are subject to dividends tax, the provisions of which are contained in sections 64D to 64N.⁴³

Dividends tax is a stand-alone tax (that is, it is not part of normal tax). It is levied under section 64E at a rate of 15% on the amount of any dividend paid by any company other than a headquarter company. The tax is withheld by the company paying the dividend or by a regulated intermediary but the persons who are liable for the tax are –

- the beneficial owner of the dividend,⁴⁴ or
- if the dividend comprises a dividend *in specie*, the company paying the dividend.⁴⁵ A dividend *in specie* is a dividend that is paid otherwise than in cash, for example, when the company distributes shares in another company.

SARS has the right to recover dividends tax from a beneficial owner of a dividend if the dividends tax has not been withheld by the company or a regulated intermediary.⁴⁶

Dividends tax must be paid to SARS by the end of the month following the month in which the dividend was paid. Any such payment must be accompanied by the prescribed return.⁴⁷

There are a number of exemptions from dividends tax. For example, it is not imposed on dividends paid to –

- a resident company;⁴⁸
- a public benefit organisation approved by the Commissioner under section 30(3);⁴⁹

⁴² Section 8C(1A).

⁴³ See the *Comprehensive Guide to Dividends Tax* for more information on dividends tax.

⁴⁴ Section 64EA(a).

⁴⁵ Section 64EA(b).

⁴⁶ Section 64K(1)(a).

⁴⁷ Section 64K(1A).

⁴⁸ Section 64F(1)(a).

⁴⁹ Section 64F(1)(c).

- various other tax-exempt persons such as the three levels of government⁵⁰ and retirement funds;⁵¹
- a holder of shares in a registered micro business to the extent that the sum of dividends paid during the year of assessment does not exceed R200 000;⁵²
- a small business funding entity;⁵³
- a non-resident on a dividend paid on a share listed on a South African exchange in a non-resident company;⁵⁴
- a portfolio of a collective investment scheme in securities;⁵⁵ and
- a person to the extent that the dividend constitutes income of that person.⁵⁶

Non-resident holders of shares may qualify for a lower rate of dividends tax under an applicable tax treaty. Whether the lower rate of dividends tax can be obtained will depend on the terms of the particular tax treaty, but typically the lower rate applies only to corporate holders of shares having an interest in the company of between 10% and 25%. A list of withholding tax rates on dividends under South Africa's tax treaties is available on the SARS website. In order to qualify for the lower rate, the holder of shares must submit a declaration to the company or regulated intermediary.⁵⁷

4.3.2 Foreign dividends

Foreign dividends from non-resident companies must be included in a person's gross income but may be wholly or partially exempt from normal tax depending on the applicable exemption provision. Section 10B introduced amended rules for dealing with foreign dividends which took effect as follows:

- Individuals, deceased estates, insolvent estates and trusts – applies to foreign dividends received or accrued on or after 1 March 2012
- Companies – applies to foreign dividends received or accrued on or after 1 April 2012

Complete exemption [section 10B(2)]

Under section 10B(2) a foreign dividend received by or accrued to a person will be exempt under the following circumstances:

- First, the foreign dividend will be exempt if that person (whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10% of the total equity shares and voting rights in the company declaring the foreign dividend (the "participation exemption").⁵⁸

⁵⁰ Section 64F(1)(b).

⁵¹ Section 64F(1)(f).

⁵² Section 64F(1)(h).

⁵³ Section 64F(1)(i).

⁵⁴ Section 64F(1)(j).

⁵⁵ Section 64F(1)(k).

⁵⁶ Section 64F(1)(l). For dividends not exempt from normal tax, see the exclusions to the exemption in section 10(1)(k)(i).

⁵⁷ Sections 64G(3) and 64H(3).

⁵⁸ Section 10B(2)(a).

- Secondly, it will be exempt if that person is a company and the foreign dividend is paid or declared by another foreign company that is resident in the same country as that company.⁵⁹
- Thirdly, it will be exempt if that foreign dividend is derived from a CFC and does not exceed the sum of amounts included in the resident's income under section 9D.⁶⁰
- Fourthly, it will be exempt to the extent that the foreign dividend is received by or accrues to that person from a share listed on a South African exchange and does not consist of a distribution of an asset *in specie*.⁶¹ This exemption applies because dividends paid by non-resident companies listed on a South African exchange are subject to dividends tax unless an exemption applies. But a dividend *in specie* distributed by such a company is subject to normal tax in the recipient's hands because it is not subject to dividends tax.⁶²
- Fifthly, a foreign dividend *in specie* is exempt if received by or accrued to a resident company from a listed share on or after 1 March 2014.⁶³

Note:

- The exemptions in the first two bullet points do not apply to any foreign dividend to the extent that it is deductible by the foreign company declaring or paying it in the determination of any tax on income on companies of the country in which that foreign company has its place of effective management.
- With effect from 1 April 2014 the participation exemption in section 10B(2)(a) will not apply to a foreign dividend received or accrued in respect of a non-equity share even if the person holds at least 10% of the equity shares and voting rights in the company declaring the foreign dividend.

Partial exemption of foreign dividends [section 10B(3)]

Under section 10B(3) a portion of a taxable foreign dividend is exempt from normal tax. The exempt portion of the foreign dividend is determined by multiplying the dividend that is not otherwise exempt under section 10B(2) by a factor so as to generally arrive at a maximum tax rate of 15% thus giving a result similar to that produced by dividends tax. The following proportions of the foreign dividend are exempt from normal tax:

26 / 41	Individuals, deceased estates, insolvent estates and trusts. For the 2015 and earlier years of assessment the ratio was 25 / 40.
13 / 28	Companies and insurers in respect of their company policyholder fund, corporate fund and risk policy fund.
15 / 30	Insurers in respect of their individual policyholder fund.

Exclusions [section 10B(6)]

A foreign dividend will not qualify for full or partial exemption from normal tax under section 10B(2) or (3) if it is received by or accrued to a person in respect of –

- services rendered or to be rendered or in respect of or by virtue of employment or the holding of any office and the person does not hold the underlying share. For example, the exemption will be denied if the recipient is a usufructuary or has

⁵⁹ Section 10B(2)(b).

⁶⁰ Section 10(B)(2)(c).

⁶¹ Section 10B(2)(d).

⁶² See the definition of "dividend" in section 64D.

⁶³ Section 10B(2)(e).

acquired the right to foreign dividends by cession and does not own the shares in the foreign company;

- a restricted equity instrument as defined in section 8C that was acquired in the circumstances contemplated in that section if that foreign dividend is derived directly or indirectly from, or constitutes—
 - an amount derived as consideration for the buy-back of the share or in anticipation of or in the course of the winding up or liquidation, deregistration or final termination of the company; or
 - an equity instrument that is not a restricted equity instrument as defined in section 8C, such as unrestricted shares acquired as a distribution in the form of a foreign dividend *in specie*.

The events described in the last two bullet points represent means of realising restricted shares and the consideration should therefore be fully taxed as employment income.

- Section 10B contains other anti-avoidance rules which are beyond the scope of this guide.⁶⁴

Translation of foreign dividends to rand

Foreign dividends received or accrued in a foreign currency must be translated to rand using the spot rate on the date of receipt or accrual⁶⁵ but natural persons and non-trading trusts can elect to use the average exchange rate for the year of assessment.⁶⁶ The election must be applied consistently to all foreign income derived during the year of assessment.

Example 6 – Foreign dividend received by an individual

Facts:

M, a South African-resident individual, pays income tax at a marginal rate of 41%. M holds 2% of the total equity shares and voting rights in Foreign Company, a company that does not qualify as a CFC and is not listed on a South African exchange. During the 2017 year of assessment, Foreign Company paid a dividend of R1 230 000 to M, which is subject to foreign withholding tax of 8% (that is, R98 400).

Result:

	R
Gross income – foreign dividend	1 230 000
Less: Exempt portion under section 10B(3) (R1 230 000 × 26 / 41)	<u>(780 000)</u>
Income/taxable income (excluding other taxable income)	<u>450 000</u>
Tax on taxable income at 41% (note 2)	184 500,00
Less: Rebate for foreign taxes under section 6quat ⁶⁷	<u>(98 400,00)</u>
Normal tax payable on taxable income, excluding other taxable income	<u>86 100,00</u>

⁶⁴ See Interpretation Note 93 dated 24 November 2016 “The Taxation of Foreign Dividends” for more information.

⁶⁵ Section 25D(1).

⁶⁶ Section 25D(3). Were it not for this rule it would be necessary to disqualify foreign taxes withheld from the exempt portion of foreign dividends.

⁶⁷ Under paragraph (ii) of the proviso to section 6quat(1A) for the purposes of section 6quat(1A) the amount included in the resident’s taxable income is determined without regard to the partial exemption in section 10B(3).

Notes:

1. The participation exemption and the exemption of dividends from a CFC do not apply.
2. The normal tax on taxable income at a rate of 41% translates to an effective rate of 15% on the gross dividend ($15\% \times R1\,230\,000 = R184\,500$). The effective rate will be lower for persons who have a lower marginal tax rate than 41%.
3. Had Foreign Company been listed on a South African exchange, the foreign cash dividend would have been exempt from normal tax under section 10B(2)(d) and the exemption under section 10B(3) would not have applied.

Example 7 – Foreign dividend received by a company*Facts:*

Company P, a South African resident, pays income tax at a flat rate of 28%. It holds 2% of the total equity shares and voting rights in Foreign Company, a company that does not qualify as a CFC and is not listed on a South African exchange. Foreign Company pays a dividend of R1,2 million to Company P, which is subject to foreign withholding taxes of 8% (that is, R96 000).

Result:

	R
Gross income – foreign dividend	1 200 000
Less: Exempt portion under section 10B(3) ($R1\,200\,000 \times 13 / 28$)	<u>(557 143)</u>
Income/taxable income	<u>642 857</u>
Tax on taxable income at 28% (note 2)	179 999,96
Less: Rebate for foreign taxes under section 6quat	<u>(96 000,00)</u>
Normal tax payable	<u>83 999,96</u>

Notes:

1. The participation exemption and the exemption of dividends from a CFC do not apply.
2. The normal tax on taxable income at a rate of 28% translates to an effective rate of 15% on the gross dividend ($15\% \times R1\,200\,000 = R180\,000$).

Prohibition on the deductibility of expenditure incurred in the production of foreign dividends

Section 23(q) prohibits the deduction of any expenditure incurred in the production of income in the form of foreign dividends. This prohibition targets expenditure which would otherwise have been deductible under section 11(a) because it was incurred in the production of income in carrying on a trade.

Section 23(f) prohibits the deduction of any expenses incurred in respect of amounts received or accrued which do not constitute “income” as defined in section 1(1). This prohibition ensures that expenditure incurred in the production of the portion of a foreign dividend which is exempt from tax under section 10B will not be allowed as a deduction.

Examples of expenditure prohibited as a deduction under section 23(f) and (g) include interest on funds borrowed to buy shares in foreign companies and related bank charges.

Claiming of foreign taxes

A person may be able to claim a rebate under section 6quat for foreign taxes withheld from foreign dividend income. A detailed examination of section 6quat is beyond the scope of this guide but the following points are worth noting:

- When determining how much of the foreign taxes qualify for rebate purposes, the proportional exemption under section 10B(3) (26 / 41 for an individual or trust or 13 / 28 for a company) is disregarded and it is assumed that the full amount of the foreign dividend is included in taxable income.⁶⁸ This assumption means that the foreign taxes do not have to be reduced despite only a portion of the foreign dividend being subject to normal tax.
- If the foreign country has a tax treaty with South Africa, foreign taxes may not be claimed to the extent that they exceed the amount stipulated in the tax treaty. For example, if the treaty states that the country concerned cannot impose a withholding tax of more than 15% and the country withholds tax at a rate of 35%, foreign taxes equal to 15% may be claimed and a refund of the excess of 20% must be sought from the foreign country.
- Some countries tax their residents on dividends on a full imputation basis, that is, these countries gross up the dividend to equal a proportional share of the company's pre-tax profits and include the grossed-up amount in the gross income of their resident holders of shares. The company notifies its holders of shares of the amount of the corporate taxes (known in some countries as a "franking credit") attributable to the grossed-up dividend. While these franking credits are claimable by the residents of the country concerned in determining their domestic tax liability, they do not qualify as foreign taxes on foreign dividends for the purposes of section 6quat.
- The rebate cannot exceed the South African normal tax payable on the total income from foreign sources before taking rebates into account. Any portion of the foreign tax not qualifying for the rebate may be carried forward to the following year of assessment, but the carry-forward may not continue for more than seven years (Example 8).
- Foreign taxes payable on dividends included in taxable income during a year of assessment are translated to rand at the average exchange rate during that year of assessment.⁶⁹

For a detailed explanation of the rebate for foreign taxes, see Interpretation Note 18 (Issue 3) dated 26 June 2015 "Rebates and Deduction for Foreign Taxes on Income".

Example 8 – Rebate for foreign taxes

Facts:

Y, a resident individual, derived foreign dividends of R24 600 during the 2017 year of assessment which were subject to foreign withholding taxes of R8 610,00 (35%). South Africa does not have a tax treaty with the country that withheld the foreign taxes.

Y's taxable income for the 2017 year of assessment (including the taxable portion of foreign dividends) is R800 000. Determine the amount of Y's rebate for foreign taxes.

⁶⁸ Paragraph (ii) of the proviso to section 6quat(1A).

⁶⁹ Section 6quat(4).

Result:

Step 1 – Determine qualifying taxes

The foreign taxes of R8 610,00 qualify for rebate purposes despite only 15 / 41 of the foreign dividends being included in Y's income [paragraph (ii) of the proviso to section 6quat(1A)].

Step 2 – Apply the overall limitation formula

The rebate is limited to the amount determined by the following formula:

Taxable income from foreign sources / Taxable income from all sources × Normal tax before rebates

The portion of the foreign dividend included in taxable income is R9 000 (R24 600 × 15 / 41).

The normal tax on a taxable income of R800 000 is R247 431,00⁷⁰ before rebates.

Applying the limitation formula:

$$= R9\ 000 / R800\ 000 \times R247\ 431,00$$

$$= R2\ 783,60$$

The section 6quat rebate is therefore limited to R2 783,60 and the excess of R5 826,40 (R8 610,00 – R2 783,60) will be carried forward to the 2018 year of assessment.

Controlled foreign companies

Special rules apply to the income generated by a CFC. These rules deem an amount equal to the foreign company's taxable income to be taxable income in the hands of qualifying South African-resident holders of shares. These rules, which are contained in section 9D, are outside the scope of this guide.

5. Capital gains tax

5.1 Shares held as capital assets

When shares are held otherwise than as trading stock, that is, as capital assets, any gain will be of a capital nature and is subject to CGT. Capital losses may be set off against other capital gains only and not against ordinary income. For the 2017 year of assessment the first R40 000 (2016: R30 000) of the sum of all capital gains and losses is excluded for an individual and a special trust created solely for the benefit of a person or persons having a disability. This excluded amount is known as the "annual exclusion". The annual exclusion is R300 000 in the year of death (2016: R300 000). When the sum of capital gains and losses in a year of assessment is a loss, the portion of that loss which exceeds the annual exclusion is carried forward to the following year of assessment as an assessed capital loss that must be used against future capital gains.

⁷⁰ Tax on taxable income of R701 300,00 = R206 964,00. Tax on the taxable income in excess of R701 300 = R98 700 × 41% = R40 467,00. Normal tax before rebates = R206 964,00 + R40 467,00 = R247 431,00.

5.2 The three-year rule

Section 9C applies to gains and losses and does not require an election. Its application is automatic and compulsory.

Section 9C(2) deems any amount (other than a dividend or foreign dividend) received or accrued or any expenditure incurred in respect of an equity share to be of a capital nature if that equity share had, at the time of the receipt or accrual of that amount or incurrance of that expenditure, been held for a period of at least three years. It applies to receipts and accruals in respect of a share, which includes a return of capital or foreign return of capital as well as amounts derived on disposal of a share. Expenditure incurred after a share has been held for at least three years will also be of a capital nature and could include expenditure relating to the cost of acquisition of the share (for example, if the amounts were incurred only after three years as a result of the purchase price being subject to an uncertain future event) and recurring costs such as interest and share-dealing expenses. Consequently, any capital gain or loss in respect of a share held for at least three years will be of a capital nature and subject to CGT.

The capital or revenue nature of any profit or loss on disposal of shares held for less than three years must be determined using the general capital versus revenue tests outlined in 3. The profit or loss on disposal of a share held for less than three years is not deemed automatically to be of a revenue nature.

Equity shares

In order to fall within section 9C, a share must comprise an “equity share” as defined in section 9C(1). The term “equity share” includes –

- a share in a listed or unlisted resident company;
- a share in a non-resident company listed on a South African exchange;
- an interest in a close corporation; and
- a participatory interest in a portfolio of a collective investment scheme in securities and a portfolio of a hedge fund collective investment scheme.

A share in a “REIT” as defined in section 1(1) could potentially be an equity share provided it meets the requirements of the definition of that term.⁷¹

An equity share does not include –

- a participatory interest in a collective investment scheme in property which is not a REIT;
- a share in a share block company;
- a share in a non-resident company which is not listed on a South African exchange;
- a “hybrid equity instrument” as defined in section 8E (for example, a preference share redeemable within three years); and
- a share that is not an equity share (for example, a non-participating preference share).

⁷¹ A REIT is a resident company listed on the JSE which meets the JSE Ltd Listings Requirements for listing as a REIT. A collective investment scheme in property that qualifies as a REIT is deemed to be a company for income tax purposes.

Deduction of general share-dealing expenses

A person who carries on a business of share-dealing will typically claim general expenses as a deduction against income under section 11. Such expenses may include bank charges, interest on money borrowed to buy shares, technical analysis software and telephone charges. After equity shares acquired as trading stock have been held for three years it will no longer be possible to claim such expenses in relation to those shares under section 11 because section 9C(2) deems them to be of a capital nature.

Recoupment of expenditure claimed under section 11

Expenses or losses claimed on shares held as trading stock will be included in income as a recoupment when the shares are disposed of.⁷² This recoupment will not apply to the extent that the amount has already been taken into account under section 8(4)(a) or section 19 (as a result of a debt reduction), nor does it apply to equity shares in a REIT or “controlled company” as defined in section 25BB(1), which is a resident.⁷³

Anti-avoidance measures

Section 9C contains a number of anti-avoidance measures that are beyond the scope of this guide.

First in, first out

The first-in-first-out method must be used to determine the length of time shares were held when they are disposed of.⁷⁴ This method is merely for the purpose of applying section 9C and does not affect any identification method adopted for determining the base cost of shares for CGT purposes. Thus if the weighted-average method were adopted (see **5.6.1**) for CGT purposes, the electing party must continue to use that method for determining the base cost of shares. The first-in-first-out method will merely be used to determine whether any shares sold were held for at least three years.

Roll-over of dates of acquisition

Should existing shares be surrendered in exchange for a greater or lesser number of shares in the same company as a result of a share split or consolidation, the dates of acquisition of the old shares will be carried across to the new shares.⁷⁵

This rule does not apply if –

- the new shares carry different rights to the old shares, or
- any other consideration is received as part of the share substitution (for example, a cash payment or shares in another company).

For a detailed review of section 9C, see Interpretation Note 43 (Issue 6) dated 16 February 2017 “Circumstances in which Certain Amounts Received or Accrued from the Disposal of Shares are Deemed to be of a Capital Nature”.

⁷² Section 9C(5).

⁷³ Dividends from a REIT or a controlled company are generally fully taxable and hence expenditure in the production of such dividends should be allowed during the first three years and not recouped when the shares are disposed of.

⁷⁴ Section 9C(6)].

⁷⁵ Section 9C(8).

5.3 Determining a capital gain or loss

For CGT purposes a capital gain or loss is determined as follows:

Capital gain or loss = Proceeds on disposal /less base cost

In determining a capital gain or loss, there are four key prerequisites.

Asset – In the context of this guide, this would be the shares or options being disposed of.

Disposal – This is the event that triggers a capital gain or loss (for example, a sale).

Proceeds – This is the amount received or accrued on the disposal.

Base cost - This is the amount that is allowed as a deduction from proceeds in determining a capital gain or loss.

The concepts of disposal, proceeds and base cost are discussed in more detail in the paragraphs that follow.

5.4 Disposal

A capital gain or loss is triggered when a person disposes of shares. A **disposal** will normally occur when shares are sold, but a person will also be treated as having disposed of them if –

- they are donated;
- a person ceases to be a resident;⁷⁶
- the nature of the shares changes from capital assets to trading stock;⁷⁷
- the shares are still owned at the time of death and were not bequeathed to a surviving spouse or an approved public benefit organisation;⁷⁸
- the company in which the shares are held is liquidated or deregistered;⁷⁹ or
- a return of capital or foreign return of capital is received or accrued on or after 1 April 2012 and exceeds the base cost of the shares.⁸⁰

For more on the return of capital see **5.8**.

5.5 Proceeds

The **proceeds** are normally equal to the amount received or accrued on disposal of shares.

In some circumstances the proceeds will be deemed to be equal to the market value of the shares at the time of the disposal event. This situation would happen, for example, if a person –

- died and did not bequeath the shares to a surviving spouse;⁸¹

⁷⁶ Section 9H(2)(a)(i).

⁷⁷ Paragraph 12(2)(c).

⁷⁸ Section 9HA(1) for persons dying on or after 1 March 2016. Before this date the rules were contained in paragraph 40(1).

⁷⁹ Paragraph 77(1).

⁸⁰ Paragraph 76B(3).

⁸¹ Section 9HA(1) for persons dying on or after 1 March 2016. Before this date, see paragraph 40(1).

- donated the shares;⁸²
- disposed of the shares to a connected person at a consideration that does not reflect an arm's-length price;⁸³
- ceased to be a resident;⁸⁴ or
- changed the nature of the shares to trading stock.⁸⁵

The proceeds are reduced by any portion that is included in gross income or which is otherwise taken into account in determining taxable income.⁸⁶ This reduction would apply, for example, if a portion of the proceeds comprises a dividend as can occur when the company in which the shares are held buys back its own shares – see **6.4**.

A return of capital will form part of proceeds depending on when it was received – see **5.8**.

5.6 Base cost

5.6.1 Identification methods

Before the base cost of shares can be determined, a method to identify the shares that have been disposed of must be adopted. This requirement applies when some of, but not all, the shares held in a company are disposed of. The three permissible identification methods are –⁸⁷

- specific identification;
- first in, first out; and
- weighted average.

Example 9 – Identification methods

Facts:

J owns 1 000 shares in ABC Ltd, a company listed on a South African exchange, which J acquired on the following dates:

Date purchased	Number of shares	Cost per share	Cost
		R	R
1 March of year 1	200	10	2 000
30 June of year 2	100	11	1 100
30 November of year 4	500	12	6 000
31 July of year 5	<u>200</u>	9	<u>1 800</u>
Total	<u>1 000</u>		<u>10 900</u>

On 31 December of year 5 J sold 200 shares. Determine which 200 shares J has sold using the specific-identification, first-in-first-out and weighted-average methods assuming the shares sold were held as capital assets.

⁸² Paragraph 38(1)(a).

⁸³ Paragraph 38(1)(a).

⁸⁴ Section 9H(2)(a)(i).

⁸⁵ Paragraph 12(2)(c).

⁸⁶ Paragraph 35(3)(a).

⁸⁷ Paragraph 32.

Result:

Specific identification

Under this method J can nominate the shares that are being sold, based on their date and cost. In the above example J would probably choose to sell 200 of the 500 shares acquired on 30 November of year 4, since they have the highest base cost of R12 per share. In order to use this method J will have to maintain detailed records of the dates and costs of acquisition of the shares.

First in, first out

Under this method J is deemed to have sold the oldest shares first, namely, the 200 shares acquired on 1 March of year 1 for R2 000.

Weighted average

Under this method, J must first determine the average cost of all the shares – $R10\,900 / 1\,000 = R10,90$ per share. The base cost of the shares disposed of is therefore $R10,90 \times 200 = R2\,180$. The base cost of the remaining shares is then determined by reducing the weighted-average base cost by the number of shares disposed of as follows:

	No	R
Total before disposal (as above)	1 000	10 900
Less: Shares disposed of	(200)	(2 180)
Total after disposal	<u>800</u>	<u>8 720</u>

Note: The weighted-average method can be used only for shares listed on a recognised exchange (for example, the JSE, London Stock Exchange or New York Stock Exchange). It does not apply to shares in private companies. A list of recognised exchanges is available on the SARS website.⁸⁸

Consistency

Once an identification method has been adopted for the first listed share disposed of on or after 1 October 2001, that method must continue to be used for the entire portfolio of listed shares. A person will be able to switch to a different method only once all the shares in the portfolio have been disposed of.⁸⁹

5.6.2 Amounts included in base cost

The base cost of a share includes –

- the cost of acquisition;
- stamp duty, securities transfer tax or similar duty or tax paid on acquisition of the share;
- the cost of any option exercised in acquiring or selling the share (except a share taxed under section 8A or 8C);
- broker's fees (whether in buying or selling a share); and

⁸⁸ GG 22723 of 2 October 2001. See also GG 30484 of 16 November 2007 in which the Channel Islands Stock Exchange was recognised.

⁸⁹ Paragraph 32(6).

- one-third of the interest incurred to acquire a share listed on a recognised exchange or a participatory interest in a portfolio of a collective investment scheme, including money borrowed to refinance those borrowings.

Fees paid to a portfolio manager to manage a share portfolio do not qualify as part of the base cost of a share.

A special rule exists when a person acquires a share from an employer under an employee share incentive scheme. In this situation the base cost of the share is usually the market value of the share that was taken into account in determining any amount of the revenue gain to be included in income under section 8A or 8C (see **4.2.1** and **4.2.3**).⁹⁰

5.6.3 Pre-valuation date shares

Special rules exist for determining the base cost of a share acquired before 1 October 2001 (known as the “valuation date”).⁹¹ These fairly complex rules are necessary to exclude the portion of capital gains or losses that arose before the introduction of CGT on 1 October 2001. Although an overview of the rules is presented below, a detailed explanation is beyond the scope of this guide. For more information, please consult the *Comprehensive Guide to Capital Gains Tax*.

The base cost of a share acquired before the valuation date is equal to its valuation date value plus any further allowable expenditure incurred on or after 1 October 2001.

The following four methods are available for determining the valuation date value:

- Time-apportionment base cost
- Market value on 1 October 2001
- 20% of proceeds after first deducting any post-valuation date expenditure
- Weighted average (listed shares only)

Freedom of choice to switch between methods

The freedom to switch between the different methods is limited by –

- the choice of asset-identification method (specific identification, first in, first out or weighted average (see **5.6.1** for commentary on identification methods); and
- the kink tests (see **5.6.4**).

Once adopted, the weighted-average identification method will also serve as the base cost method. In this situation, the weighted-average method must be used for the entire portfolio of listed shares, and the time apportionment, market value or “20% of proceeds” methods may not be used for any of the listed shares. The kink tests do not apply if the weighted-average method has been chosen.

But if specific identification or first in, first out was chosen as the identification method, a person can choose whichever method (time apportionment, market value or 20% of proceeds) gives the best result. Despite this freedom of choice, the kink tests discussed in **5.6.4** may substitute a different valuation date value to the one produced by the method

⁹⁰ Paragraph 20(1)(h)(i). In some situations the amount received or accrued on disposal of the share is taken into account under section 8C and in such event that amount will be added to the base cost of the share rather than the market value.

⁹¹ An approved public benefit organisation or recreational club has a different valuation date falling after 1 October 2001, which depends on the date on which it became subject to the partial taxation system for such entities.

chosen. Generally, the kink tests will apply under specified circumstances only when a capital loss is determined.

Example 10 – Freedom of choice between valuation methods

Facts:

K held the following listed shares on 1 October 2001:

100 A Ltd
500 B Ltd

The following sales of shares occurred:

A Ltd – sold 50 on 30 June 2016 and the remaining 50 on 28 February 2017.

B Ltd – sold 100 on 30 June 2016 and a further 100 on 28 February 2017.

All shares were sold above cost and no capital losses will result regardless of the base cost method K selects (that is, the kink tests do not apply).

Result:

If K chooses the weighted-average method, K must use that method for all the A and B shares that have been sold. K will also have to use the weighted-average method for the remaining 300 B shares when they are sold.

If K chooses either the specific-identification or first-in-first-out method, K has complete freedom of choice between the time apportionment, market-value and 20%-of-proceeds methods. K does not have to be consistent within the same shares, between different shares or within a year of assessment.

Time-apportionment base cost

This method determines the valuation date value by spreading the capital gain or loss evenly over the pre- and post-1 October 2001 periods. There are two formulae:

$P = R \times B / (A + B)$ (the proceeds formula)

$Y = B + [(P - B) \times N / (N + T)]$ (the time-apportionment base cost formula)

in which

Y = Time-apportionment base cost

P = Proceeds used in the time-apportionment formula.

R = Amount received or accrued on disposal of the share.

A = Allowable expenditure incurred on or after the valuation date (for example, one-third of interest on funds borrowed to acquire listed shares).

B = Allowable expenditure incurred before the valuation date reduced by any returns of capital received or accrued before the valuation date.

N = Number of years before 1 October 2001.

T = Number of years after 1 October 2001.

For the purposes of determining “N” and “T”, a part of a year is counted as a full year.

The proceeds formula applies when further expenditure has been incurred on or after 1 October 2001 in respect of the share. Selling expenses such as broker's fees must be deducted from the consideration received on disposal of the share. This treatment means that selling costs of this nature do not trigger the proceeds formula. Assuming no other post-valuation date expenditure was incurred, the selling expenses must be deducted from "P" in the time-apportionment formula. If other post-valuation date expenditure was incurred (for example, interest incurred in buying the shares or the cost of obtaining a CGT valuation in respect of unlisted shares) the proceeds formula will still apply and any selling expenses must be deducted from "R" in the proceeds formula.

A time-apportionment base cost calculator is available on the SARS website which can be used to calculate time-apportionment base cost.

Example 11 – Time-apportionment method

Facts:

J bought 100 ABC Ltd shares on 30 June 1986 at a cost of R9 500 plus broker's fees and marketable securities tax of R500. J sold them on 30 November 2016 for R15 400 less broker's fees of R400. Determine the capital gain on disposal of J's shares.

Result:

Pre-valuation date expenditure ("B") = R9 500 + R500 = R10 000

Post-valuation date expenditure ("A") = Nil (selling expenses reduce proceeds)

P = R15 400 – R400 = R15 000

$Y = B + [(P - B) \times N / (N+T)]$

= R10 000 + [(R15 000 – R10 000) × 16 / (16 + 16)]

= R10 000 + R2 500

= R12 500

Capital gain = Proceeds – valuation date value – post-valuation date costs

= R15 400 – R12 500 – R400

= R2 500

Market value

The market values as at 1 October 2001 of all shares listed on the JSE have been published on the SARS website. Persons wishing to use the market-value method for their pre-valuation date shares must use these values.

Example 12 – Market value method

Facts:

Z acquired 10 000 listed shares in a company upon demutualisation in 1998 at no cost. Z disposed of them at R65 per share after the valuation date. Z adopted the market-value method for determining the base cost of the shares. Ignore any corporate actions which may have occurred on or after the valuation date and which would have resulted in an adjustment of the market value of the shares.

Result:

The market value of the shares on valuation date according to the values published by SARS is 889 cents per share. The capital gain is determined as follows:

	R
Proceeds 10 000 × R65	650 000
Less: Base cost 10 000 × R8,89	<u>(88 900)</u>
Capital gain	<u>561 100</u>

20% of proceeds

Initially the 20%-of-proceeds method was viewed as a method of last resort, often yielding a lower valuation date value than the market value and time-apportionment methods. However, given the time that has elapsed since valuation date and growth in share values, the valuation date value produced by the 20%-of-proceeds method should be considered in weighing up the alternatives. The valuation date value of a share using this method is determined as follows:

20% × (proceeds less allowable post-1 October 2001 expenditure).

Example 13 – 20%-of-proceeds method

Facts:

J inherited 100 ABC Ltd shares in April 2001. On 1 October 2001 the market value of the shares was R50. J sold them after the valuation date for R500. J adopted the 20%-of-proceeds method.

Result:

J's capital gain is determined as follows:

	R
Proceeds	500
Less: Base cost (20% × R500)	<u>(100)</u>
Capital gain	<u>400</u>

Weighted-average method

The weighted-average method is available for shares listed on a recognised exchange. Once adopted, this method must be used for the entire listed share portfolio. A person will therefore not be able to use the time-apportionment, market value or 20%-of-proceeds methods for any listed shares once the weighted-average method has been adopted.

Shares held on 1 October 2001 are added to the base cost pool at market value on that date. The prices published on the SARS website must be used for JSE-listed shares. The market value of foreign-listed shares on valuation date is equal to the ruling price at close of business on the last business day before 1 October 2001. The "ruling price" is the last sale price unless there was a higher bid or lower offer, in which case the latter will prevail.

Further purchases of the same share are added to the base cost pool at actual cost.

A return of capital received or accrued –

- between 1 October 2001 and 30 September 2007 (both dates included) must be deducted from the weighted-average base cost of shares;
- on or after 1 October 2007 and before 1 April 2012 triggers a part-disposal of shares and the portion of the base cost that has been disposed of must be deducted from the weighted-average base cost of the shares; and
- on or after 1 April 2012 must be deducted from the weighted-average base cost of the shares.

For more on returns of capital see **5.8**.

The weighted-average base cost per share is calculated immediately before disposal and is used to determine the base cost of the shares disposed of. The base cost pool is then reduced by the shares disposed of. This method is illustrated in an example in **5.6.1**.

5.6.4 Gain and loss limitation rules (the “kink tests”)

Special rules contained in paragraphs 26(3) and 27, known as “kink tests”, apply under certain circumstances when the time-apportionment base cost and market value methods are used to determine the valuation date value of shares. These rules are primarily aimed at preventing or limiting the claiming of losses when the market value on 1 October 2001 is used as the base cost. In other cases, the kink tests will prevent the use of time-apportionment base cost to determine the valuation date value and will substitute another value such as market value or proceeds less post-valuation date expenditure.

It is beyond the scope of this guide to explore these rules in detail, but some examples of the more common situations in which the kink tests apply are set out in the table below. These rules do not apply when the weighted-average method is used.

Table 1 – Examples of application of gain and loss limitation rules

Cost R	Market value on 1 October 2001 R	Proceeds R	Valuation date value prescribed by kink test
100	150	120	120
100	50	70	70 (time-apportionment base cost method not permitted)
100	50	20	50 (time-apportionment base cost method not permitted)
100	150	50	Time-apportionment base cost

For the purpose of the above examples, post-valuation date expenditure has been ignored.

5.6.5 Distributions *in specie*

A distribution *in specie* occurs when a company distributes an asset in a form other than cash. Distributions *in specie* by listed companies typically take the form of shares in another company, while unlisted companies tend to distribute a wider range of assets. Paragraph 75 contains the core rules for dealing with such distributions. It provides that the company making the distribution is treated as having disposed of the asset at market value on the date of distribution while the holder of the share is deemed to acquire it at a cost equal to

that same market value on the same date. The date of distribution of an asset *in specie* is the earlier of the date on which the distribution is paid or becomes due and payable.⁹² This rule applies regardless of whether the holder of shares is a connected person in relation to the company, that is, regardless of the size of the person's holding of shares.

The core rules described above will, however, be overridden if a company distributes shares under an unbundling transaction (section 46) or under an amalgamation transaction (section 44). Under an unbundling transaction the base cost of the shares acquired will be determined by allocating some of the base cost of the pre-existing shares to the newly acquired shares (see 6.1). Under an amalgamation transaction the newly acquired shares will derive their base cost from the previously held shares (see 6.3).

5.6.6 Base cost of shares in foreign companies

Individuals and non-trading trusts acquiring and disposing of assets in the same foreign currency [paragraph 43(1)]

Under paragraph 43(1) an individual or non-trading trust acquiring a share in a foreign currency and disposing of it in the same foreign currency must –

- determine the capital gain or loss in the foreign currency; and
- translate it to the local currency using either the average exchange rate for the year of assessment in which the share was disposed of or the spot rate on the date of disposal.

For most individuals and non-trading trusts “local currency” refers to the rand. However, if the individual or non-trading trust maintains a permanent establishment (for example, an office) outside South Africa and the assets are effectively connected to that permanent establishment, the local currency will be the functional currency of the permanent establishment. The functional currency of a permanent establishment is the currency of the primary economic environment in which the business operations of that permanent establishment are conducted. The receipts or accruals and expenditure of a permanent establishment which are in its functional currency must be translated to rand by using the average exchange rate for a year of assessment under section 25D(2).

Paragraph 43(1) requires the capital gain or loss to be determined in the local currency. However, the return of income requires the proceeds and base cost to be entered in rand. Thus if a share were bought for \$100 and sold for \$120 when the exchange rate was \$1 = R10,000, the capital gain will be \$20 × 10,000 = R200. But for tax return purposes, the proceeds and base cost must be determined in rand. The proceeds will be \$120 × 10,000 = R1 200 and the base cost will be \$100 × 10,000 = R1 000.

If shares were bought in one currency and disposed of in another currency, any capital gain or loss must be translated to rand under paragraph 43(1A) (see below)

Example 14 – Determination of capital gain or loss for an individual under paragraph 43(1)

Facts:

K acquired 100 shares in ABC Plc, a company listed on the London Stock Exchange, at a cost of £100 on 30 June 2006 and disposed of them on 1 March 2016 for £150. K decided to use the average exchange rate to translate the capital gain. The average exchange rate for the year of disposal was £1 = R16,000.

⁹² Definition of “date of distribution” in paragraph 74.

Result:

K has a capital gain of £50 (£150 – £100). Applying the average exchange rate, this amounts to a capital gain of £50 × 16,0000 = R800.

For the purposes of K's tax return the proceeds will be £150 × 16,0000 = R2 400 and the base cost will be £100 × 16,0000 = R1 600.

Companies, trading trusts and certain transactions of individuals and non-trading trusts [paragraph 43(1A)]

Paragraph 43(1A) applies when paragraph 43(1) does not apply. By a process of elimination it can be deduced that paragraph 43(1A) will apply to –

- companies and trading trusts; and
- individuals and non-trading trusts acquiring and disposing of assets in different currencies.

The above persons must translate –

- the proceeds into the local currency at the average exchange rate for the year of assessment in which the share was disposed of or at the spot rate on the date of disposal of the share; and
- the expenditure incurred in respect of the share to the local currency at the average exchange rate for the year of assessment during which the expenditure was incurred or at the spot rate on the date on which the expenditure was incurred.

If the shares are effectively connected to a permanent establishment such as a foreign branch, the capital gain or loss determined in the functional currency of the permanent establishment must be translated to rand at the average exchange rate for the year of assessment under section 25D(2).

Example 15 – Determination of capital gain or loss of a company for an asset not effectively connected to a permanent establishment with a functional currency other than the Rand [paragraph 43(1A)]

Facts:

Company L acquired 100 shares in XYZ plc, a company listed on the London Stock Exchange, at a cost of £100 on 12 July 2012 when the spot rate was £1: R12,8384. It disposed of the shares on 1 January 2017 when the spot rate was £1:R16,6957 for £500. Company L elected to use the spot rate for translation purposes rather than the average exchange rate.

Result:

Paragraph 43(1A) applies because the taxpayer is a company. Under paragraph 43(1A) the base cost must be translated to rand at the spot rate when the expenditure was incurred while the proceeds must be translated to rand at the spot rate when the amount was received or accrued.

	R
Proceeds £500 × 16,6957	8 348
Less: Base cost £100 × 12,8384	<u>(1 284)</u>
Capital gain	<u>7 064</u>

Exchange rates

A list of average exchange rates for a year of assessment is available on the SARS website.

Any market value determined on 1 October 2001 must be translated to rand at the spot rate on that date.⁹³ A list of exchange rates as at 1 October 2001 is available on the SARS website.

5.7 Determining a taxable capital gain or assessed capital loss

5.7.1 The basic computation

A taxable capital gain (which will be included in taxable income) or an assessed capital loss (which will be carried forward to the following year of assessment for set-off against future capital gains) is determined as follows:

Sum of capital gains and losses during the year of assessment, after applying exclusions, roll-overs and limitations

Less: Annual exclusion

= Aggregate capital gain or loss

Less / add: Assessed capital loss brought forward from previous year of assessment

= Net capital gain or assessed capital loss

Multiply a net capital gain by the inclusion rate (40% for individuals and special trusts; 80% for companies and other trusts)

= Taxable capital gain to be included in taxable income.

Any resulting assessed capital loss will be carried forward to the following year of assessment.

5.7.2 Annual exclusion

The first R40 000 of the sum of an individual's capital gains and losses in the 2017 year of assessment is disregarded (2016: R30 000).⁹⁴ This amount is known as the annual exclusion. The amount by which the annual exclusion exceeds the sum of capital gains and losses, is not carried forward to the subsequent year of assessment. The annual exclusion is increased to R300 000 (2017 and 2016) in the year of assessment in which a person dies.

5.7.3 Assessed capital loss

An aggregate capital gain will result if the sum of the capital gains and losses during the year of assessment produces a positive figure and there is still a balance remaining after reducing that sum by the annual exclusion.

⁹³ Paragraph 43(6).

⁹⁴ The annual exclusion also applies to a special trust referred to in paragraph (a) of the definition of "special trust" in section 1(1). This is a special trust created solely for the benefit of a person or persons having a disability as defined in section 6B(1) which incapacitates the person or persons from earning sufficient income for the maintenance of the person or persons or from managing their own financial affairs.

An aggregate capital loss will result if the sum of the capital gains and losses during the year of assessment is a negative figure and there is still a balance remaining after reducing that sum by the annual exclusion.

An assessed capital loss for the year of assessment results when –

- an assessed capital loss brought forward from the previous year of assessment exceeds an aggregate capital gain for the year of assessment; or
- there is an aggregate capital loss for the year of assessment, in which case the assessed capital loss is equal to the aggregate capital loss plus any assessed capital loss brought forward from the previous year of assessment.

The assessed capital loss is carried forward to the next year of assessment in which it will be used in the manner described above. An assessed capital loss reduces an aggregate capital gain or increases an aggregate capital loss and cannot be set off against ordinary income.

Once it is established, an assessed capital loss is not again reduced by the annual exclusion in future years.

Example 16 – Determination of taxable capital gain

Facts:

B is a natural person and made the following capital gains and losses during the 2017 year of assessment:

	R
Capital gain on ABC Ltd shares	50 000
Capital gain on XYZ Ltd shares	70 000
Capital loss on DEF Ltd shares	(18 000)

At the end of the 2016 year of assessment B had an assessed capital loss of R12 000.

Result:

The amount to be included in B's taxable income is determined as follows:

	R
Capital gain on ABC Ltd shares	50 000
Capital gain on XYZ Ltd shares	70 000
Capital loss on DEF Ltd shares	<u>(18 000)</u>
Sum of capital gains and losses during the year of assessment	102 000
Less: Annual exclusion	<u>(40 000)</u>
Aggregate capital gain	62 000
Less: Assessed capital loss brought forward from previous year of assessment	<u>(12 000)</u>
Net capital gain	<u>50 000</u>
Inclusion rate (40% for a natural person)	
Taxable capital gain – to be included in taxable income	<u>20 000</u>

5.8 Return of capital

A return of capital for CGT purposes has been treated in three different ways since 1 October 2001. An understanding of these changes is necessary in order to appreciate the current treatment of these distributions.

1 October 2001 to 30 September 2007

During this period the CGT consequences of a return of capital were deferred until the related shares were disposed of. If the specific-identification or first-in-first-out methods were adopted, a return of capital received or accrued on or after 1 October 2001 was treated as proceeds on disposal of a share, while under the weighted-average method it was deducted from the base cost of the shares.

1 October 2007 to 31 March 2012

A return of capital received or accrued on or after 1 October 2007 but before 1 April 2012 triggered a part-disposal of the shares, regardless of the identification method adopted (specific identification, first in, first out or weighted average).

Any returns of capital accumulated between 1 October 2001 and 30 September 2007 continued to be treated as proceeds on a full disposal of the share provided it was disposed of before 1 April 2012. This rule applied only to the specific-identification and first-in-first-out methods because under the weighted-average method the returns of capital would already have been deducted from the base cost of the shares at the time of receipt or accrual.

On or after 1 April 2012

On or after 1 April 2012 a return of capital or foreign return of capital must be deducted from the base cost of the related share.⁹⁵

If the base cost of the share becomes negative as a result of the deduction of the return of capital or foreign return of capital, the excess is treated as a capital gain.⁹⁶

A special rule applies when a return of capital or foreign return of capital is received on or after 1 April 2012 on a share acquired before 1 October 2001 (a pre-valuation date share). This deemed disposal and reacquisition rule is necessary because the base cost reduction method needs to reduce expenditure. With pre-valuation date shares there is a "valuation date value" (as opposed to expenditure). A valuation date value can be established under the time-apportionment base cost and 20%-of-proceeds methods only once a share has been disposed of and it is therefore not possible to perform the base cost reduction when the return of capital or foreign return of capital is received or accrues. The rule addresses this problem by converting the pre-valuation date share into a post-valuation date share with a re-established base cost comprising post-valuation date expenditure. It does this by deeming the share to be disposed of and reacquired at market value immediately before the receipt or accrual of the return of capital or foreign return of capital. Any capital gain is deducted from the reacquisition cost while any capital loss is added to it.⁹⁷ The capital gain or loss determined in this way is used only to adjust the base cost of the shares and is not otherwise brought to account for CGT purposes.

⁹⁵ Paragraph 76B(2).

⁹⁶ Paragraph 76B(3).

⁹⁷ Paragraph 76B(1).

Should the base cost become negative in this process, a capital gain will be triggered to the extent of the negative amount. Once this base cost adjustment has been done any further returns of capital will simply reduce base cost in the normal way.

Another special rule deemed the accumulated pre-1 October 2007 returns of capital on shares held on 1 April 2012, which were previously dealt with as proceeds on a full disposal of the share, to be distributed on that day.⁹⁸ This deemed distribution must be deducted from the base cost of the shares on 1 April 2012, but not if the weighted-average method was adopted, since this should already have been done at the time of actual receipt or accrual of the return of capital. For pre-valuation date shares for which the first in, first out or specific-identification method was adopted, the deemed distribution on 1 April 2012 will trigger the deemed disposal and reacquisition described in the previous paragraph in order to re-establish a base cost for the share. If the weighted-average method was adopted and the base cost is negative at the end of 31 March 2012 the negative amount is treated as a capital gain on 31 March 2012.⁹⁹

The part-disposal method (1 October 2007 to 31 March 2012)

The formula for determining the portion of the base cost of shares to be allocated to the part-disposal is as follows:

$$A = \frac{B}{C} \times D$$

in which

A = The portion of the cost of the shares, market value on 1 October 2001 or weighted average base cost to be allocated to the part-disposal.

B = The market value of the return of capital received or accrued.

C = The market value of the shares immediately before the receipt or accrual of the return of capital.

D = The cost of the shares, market value on 1 October 2001 or weighted-average base cost immediately before the part-disposal.

The table below summarises the CGT consequences of returns of capital.

Table 2 – Treatment of returns of capital

When return of capital received or accrued	Identification method adopted	Treatment
Before 1 October 2001	Specific identification or first in, first out	Reduce pre-1 October 2001 expenditure on the share (but not below nil). This rule applies if the time-apportionment method is used to determine the base cost.
	Weighted average	Not relevant.

⁹⁸ Paragraph 76A(1A).

⁹⁹ Paragraph 76A(2).

When return of capital received or accrued	Identification method adopted	Treatment
On or after 1 October 2001 but before 1 October 2007	Specific identification or first in, first out	<ul style="list-style-type: none"> • If the shares are disposed of before 1 April 2012, the return of capital is treated as proceeds on disposal. • If the shares were still held on 1 April 2012, the return of capital is deemed to be distributed on 1 April 2012. This deemed distribution means that the return of capital must be deducted from the base cost of the share. Any negative amount resulting from the deduction must be brought to account as a capital gain. The base cost of a pre-valuation date share must be re-established on 31 March 2012.
	Weighted average	<ul style="list-style-type: none"> • A return of capital received or accrued on or after 1 October 2001 but before 1 October 2007 must be deducted from base cost as and when received or accrued. • If the shares were disposed of before 1 April 2012, the capital gain must be determined in the normal way (proceeds less base cost). • If the shares were still held on 1 April 2012 and the base cost is negative as at the end of 31 March 2012, the negative amount is treated as a capital gain on 31 March 2012 and the base cost as at the end of 31 March 2012 is reset to nil.
On or after 1 October 2007 but before 1 April 2012	Specific identification, first in, first out or weighted	Treat as proceeds on a deemed part-disposal.

When return of capital received or accrued	Identification method adopted	Treatment
	average	
On or after 1 April 2012	Specific identification, first in, first out or weighted average	<ul style="list-style-type: none"> • Deduct from base cost. • Re-establish base cost for pre-valuation date shares (specific identification and first in, first out only).

Example 17 – Return of capital triggering part-disposal on or after 1 October 2007 but before 1 April 2012

Facts:

T acquired a share in 2002 at a cost of R120. On 31 January 2012 T received a return of capital of R20 in cash. The market value of the share at the close of business on 30 January 2012 was R200.

Result:

The return of capital triggers a part-disposal. Ten per cent of the base cost of R120 is allocated to the part-disposal (R20 return of capital divided by R200 market value). T will therefore have a capital gain of R8 (R20 proceeds less R12 allocable base cost). The base cost of the share going forward is $R120 - R12 = R108$.

Example 18 – Return of capital and the weighted-average method

Facts:

V has adopted the weighted-average method for base cost and identification purposes for V's listed shares. The following is a summary of V's weighted average base cost for shares in ABC Ltd, a JSE-listed company:

	No of shares	Price per share R	Base cost R
01.10.2001 Opening balance	200	1,00	200
30.06.2004 Buy	100	1,50	150
28.02.2007 Return of capital	—		(20)
Subtotal	300	1,10	330
31.07.2007 Sell	(100)	1,10	(110)
Subtotal	200	1,10	220
31.12.2007 Buy	300	2,00	600
Subtotal	500	1,64	820
30.06.2011 Sell	(100)	1,64	(164)
Subtotal	400	1,64	656

The shares sold on 31 July 2007 realised R1,80 per share.

The shares sold on 30 June 2011 realised R3,00 per share.

On 31 December 2011 V received a return of capital of R60 on the 400 shares held at the time. The market value of the shares at close of business on 30 December 2011 is R3,00 per share.

On 31 May 2012 V received a return of capital of R70.

Determine the capital gain or loss arising from the various sales and returns of capital and the base cost after the last transaction.

Result:

Return of capital – 28 February 2007

No capital gain or loss arises on the receipt of this return of capital. Since the amount was received before 1 October 2007, it is deducted from the base cost of the shares.

Sale – 31 July 2007

Proceeds 100 × R1,80	180
Less: Base cost	<u>(110)</u>
Capital gain	<u>70</u>

Sale – 30 June 2011

Proceeds 100 × R3,00	300
Less: Base cost	<u>(164)</u>
Capital gain	<u>136</u>

Return of capital– 31 December 2011

The market value of the 400 shares held on 30 December 2011 was R1 200 (400 × R3 per share). This figure is used in the denominator of the part-disposal formula in paragraph 33(1).

	R
Proceeds	60
Less: Base cost R60 / R1 200 × R656	<u>(32)</u>
Capital gain	<u>28</u>

Return of capital – 31 May 2012

The return of capital of R70 is deducted from the base cost of the shares under paragraph 76B(2).

The base cost of V's shares after the last two returns of capital is as follows:

	No of shares	Price per share R	Base cost R
Subtotal	400	1,64	656
31.12.2011 Return of capital			<u>(32)</u>
Subtotal	400	1,56	624
31.05.2012 Return of capital			<u>(70)</u>
Total	400		<u>554</u>

Example 19 – Return of capital on or after 1 April 2012 on post-valuation date shares

Facts:

B acquired all the shares in Company X on 1 March 2003 at a base cost of R150. What are the CGT implications if Company X makes a return of capital to B on or after 1 April 2012 of –

- R100; or
- R400?

Result:

The amount distributed to B must be applied first in reduction of the base cost with any excess being treated as a capital gain.

Return of capital of R100

	R
Base cost	150
Less: Return of capital	<u>(100)</u>
Base cost going forward	<u>50</u>

Return of capital of R400

	R
Base cost	150
Less: Return of capital	<u>(400)</u>
Capital gain	<u>250</u>

The base cost of the shares going forward will be nil.

Example 20 – Return of capital on or after 1 April 2012 on pre-valuation date shares

Facts:

On 1 June 1987 C acquired 100 shares in ABC Ltd, a JSE-listed company, at a cost of R100. C uses the first-in-first-out method to identify listed shares that have been disposed of. The market value of the shares on 1 October 2001 was R350 and on 15 May 2016 R500. On 16 May 2016 C received a return of capital of R40 and on 31 January 2017 a further return of capital of R30.

Result:

The receipt of the first return of capital on or after 1 April 2012 triggers a re-establishment of the base cost of the ABC Ltd shares. For this purpose C is deemed to have disposed of the shares for proceeds of R500 (market value of the shares immediately before the return of capital) and to have reacquired them at a cost of R500. Any capital gain must be deducted from the deemed expenditure of R500 while any capital loss must be added to that amount.

C can use any method to determine the capital gain or loss (time apportionment, market value on 1 October 2001 or 20% of proceeds).

Time apportionment

$$\begin{aligned} Y &= B + [(P - B) \times N / (N + T)] \\ &= R100 + [(R500 - R100) \times 15 / (15 + 15)] \\ &= R100 + R200 \\ &= R300 \end{aligned}$$

20% of proceeds

	R
Proceeds	<u>500</u>
Base cost (20% × R500)	<u>100</u>

The market-value method gives the highest base cost, namely, R350. C therefore chooses this method since it will give the best result.

The capital gain is determined as follows:

	R
Proceeds	500
Less: Base cost using market value on 1 October 2001	<u>(350)</u>
Capital gain	<u>150</u>

Re-established base cost

	R
Deemed reacquisition cost	500
Less: Capital gain determined above	<u>(150)</u>
Re-established base cost	350
Less: Return of capital – 16 May 2016	<u>(40)</u>
Base cost after first return of capital	310
Less: Return of capital – 31 January 2017	<u>(30)</u>
Base cost going forward	<u>280</u>

Example 21 – Pre-1 October 2007 return of capital with post-valuation date shares still held on 1 April 2012

Facts:

D acquired 100 shares in XYZ Ltd on 1 March 2002 at a cost of R100. On 30 June 2007 D received a return of capital of R40 on the shares. The shares were still held by D on 1 April 2012. D used the specific-identification method to identify shares that have been disposed of.

Result:

The return of capital of R40 must be deducted from the base cost of the shares. The base cost of the shares on 1 April 2012 is thus R100 - R40 = R60.

Note: Had D acquired the shares before the valuation date, it would first be necessary to re-establish their base cost on 31 March 2012 as illustrated in Example 20.

5.9 Anti-loss rules

The Eighth Schedule contains two anti-avoidance rules in paragraphs 19 (extraordinary dividends) and 42 (short-term disposal and reacquisition) which limit capital losses on the disposal of shares under certain circumstances.

5.9.1 Losses arising from extraordinary dividends

With effect from 1 April 2012 paragraph 19 has undergone some significant changes to account for the introduction of dividends tax and the revised method of taxing foreign dividends. The terms “exempt dividend” and “extraordinary exempt dividends” are now defined as follows in paragraph 19(3)(b) and (c) respectively:

An “exempt dividend” is any dividend or foreign dividend to the extent that it –

- is not subject to dividends tax; and
- is exempt from normal tax under section 10(1)(k)(i) (exempt local dividend), section 10B(2)(a) (foreign dividend exempt because the person (whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10% of the total equity shares and voting rights in the company), or section 10B(2)(b) (foreign dividend exempt because it is paid or declared by a foreign company to another foreign company resident in the same country).

The term “extraordinary exempt dividends” means so much of the amount of the aggregate of any exempt dividends received or accrued within the period of 18 months before or as part of the disposal of the shares as exceeds 15% of the proceeds received or accrued from their disposal.

Different rules apply when a person disposes of shares at a capital loss –

- as a result of a share buy-back or as part of the liquidation, winding up or deregistration of the company; and
- in circumstances other than those described in the above bullet point.

Under the first bullet point the person must disregard so much of the capital loss that does not exceed any exempt dividends.

Under the second bullet point the person must disregard so much of the capital loss as does not exceed any extraordinary exempt dividends.

The practical effect of these changes is that paragraph 19 will normally not apply to an individual or trust holding shares in a resident company or non-resident company listed on a South African exchange because dividends from these companies are generally subject to dividends tax.

Paragraph 19 will generally apply to resident companies receiving dividends from resident companies because such dividends are exempt from dividends tax under section 64F(1)(a) and generally exempt from normal tax under section 10(1)(k)(i).

Paragraph 19 will apply to foreign dividends not subject to dividends tax derived by –

- an individual who enjoys the participation exemption in section 10B(2)(a); and
- a company that enjoys the participation exemption in section 10B(2)(a) or the same country exemption in section 10B(2)(b).

Example 22 – Disregarding of capital loss on buy-back of resident company shares from company

Facts:

Resident Company A owns shares in JSE-listed Company B which it acquired for R100 000 on 1 March 2010. On 31 May 2016 Company B bought back 10% of its shares from all the holders of its shares and advised them that 75% of the consideration was a dividend while the remaining 25% represented a transfer of contributed tax capital and hence a return of capital. Company A received R20 000 as consideration for the buy-back.

Result:

Company B has engaged in a pro rata repurchase of its shares from all the holders of its shares (as opposed to a “general repurchase” on the open market through a stockbroker). It is accordingly necessary for Company A to split the consideration it received for the disposal of the Company B shares between the dividend and return of capital elements.

	R
Proceeds (return of capital R20 000 × 25%)	5 000
Less: Base cost R100 000 × 10%	<u>(10 000)</u>
Capital loss before applying paragraph 19(1)(a)	<u>(5 000)</u>

Portion of capital loss to be disregarded:

The dividend portion of the consideration of R15 000 (R20 000 × 75%) is an exempt dividend because it is not subject to normal tax or dividends tax. Under paragraph 19(1)(a) the company must disregard the portion of the capital loss that does not exceed the exempt dividends received as a result of the share buy-back. Since the exempt dividend of R15 000 exceeds the capital loss of R5 000, the full capital loss of R5 000 must be disregarded.

Note: Had Company A been a resident individual no portion of the capital loss would be disregarded under paragraph 19(1)(a) because the dividend of R15 000 would have been subject to dividends tax at 15% and is therefore not an exempt dividend as defined in paragraph 19(3)(b).

Example 23 – Disregarding of a capital loss as a result of the receipt or accrual of an extraordinary exempt dividend

Facts:

Company A owns shares in ABC Ltd, a resident JSE-listed company which it acquired at a cost of R100 000 on 1 March 2009. On 31 May 2016 ABC Ltd declared a dividend of R30 000 to Company A. On 31 December 2016 Company A sold its shares for R80 000.

Result:

The dividend of R30 000 is an exempt dividend referred to in paragraph 19(3)(b) because it is exempt from dividends tax¹⁰⁰ and normal tax.¹⁰¹

	R
Proceeds	80 000
Less: Base cost	<u>(100 000)</u>
Capital loss before applying paragraph 19(1)(b)	<u>(20 000)</u>

¹⁰⁰ Section 64F(1)(a) exempts a resident company from dividends tax.

¹⁰¹ Section 10(1)(k)(i).

Extraordinary exempt dividend:

Dividend	30 000
Less: 15% of proceeds (R80 000 × 15%)	<u>(12 000)</u>
Extraordinary exempt dividend	<u>18 000</u>

Portion of capital loss to be disregarded:

Capital loss before applying paragraph 19(1)(b)	20 000
Less: Extraordinary exempt dividend	<u>(18 000)</u>
Allowable capital loss	<u>(2 000)</u>

Note: Had Company A been a resident individual no part of the capital loss of R20 000 would have been disregarded because the dividend of R30 000 would have been subject to dividends tax at a rate of 15% and would therefore not comprise an exempt dividend as defined in paragraph 19(3)(b). Since it would not comprise an exempt dividend it would also not comprise an extraordinary exempt dividend under paragraph 19(3)(c).

5.9.2 “Bed and breakfast” sales

Paragraph 42 deals with a CGT avoidance scheme known as “bed and breakfasting”. In a literal sense the term refers to a sale of shares on one day (“before bed”), and a repurchase of those same shares the next day (“at breakfast”). The purpose of such a short-term disposal and acquisition is to generate a capital loss for set-off against other capital gains in the year of assessment. Typically one might find “bed and breakfasting” occurring at the end of a year of assessment. The purpose of reacquiring the shares is simply to restore the portfolio to its pre-sale position.

Under paragraph 42 if shares are disposed of at a capital loss and bought back within a 45-day period on either side of the disposal, the capital loss must be disregarded. The capital loss is not forfeited, but is added to the base cost of the replacement shares. In this way the use of the capital loss is deferred until the replacement shares are sold without reacquiring them in the short term.

6. Corporate restructuring events

Although not covered in detail by this guide, special rules exist for determining a capital gain or loss when certain corporate restructuring transactions occur. Some of these are mentioned below.

6.1 Unbundling transactions

When a company distributes shares it holds in another company to its holders of shares under an “unbundling transaction” contemplated in section 46, a portion of the expenditure and any market value on 1 October 2001 of the existing shares must be allocated by those holders to the new shares received.¹⁰² Similarly, if the weighted-average method has been adopted, part of the base cost of the existing shares must be allocated to the new shares. The allocation must be done in accordance with the following formula:

$$\frac{\text{Market value of new shares at end of day of unbundling}}{\text{Market value of old and new shares at end of day of unbundling}} \times \text{Cost of old shares}$$

¹⁰² Section 46(3).

Any market value on 1 October 2001 or weighted-average base cost in respect of the old shares must be allocated to the new shares on the same basis.

The amount allocated to the new shares in accordance with the above formula must be deducted from the expenditure, market value or weighted-average base cost relating to the old shares. For more information on the allocation of the expenditure and market value on 1 October 2001 between the unbundling and unbundled company shares, see BGR 29 (Issue 2) dated xx January 2017 “Unbundling Transactions: Meaning of “as at the end of the day after that distribution”.

Example 24 – Unbundling transaction

Facts:

J held 100 shares in A Ltd on 1 October 2001 that J had acquired in 1995 at a cost of R100. The market value of the shares on 1 October 2001 was R120. A Ltd distributed all its shares in B Ltd to holders of its shares as part of an unbundling transaction under section 46. The last day to trade cum div in the A Ltd shares was Tuesday 17 January 2017. The A Ltd and B Ltd shares began trading separately on the JSE on Wednesday 18 January 2017. J received 20 B Ltd shares, which had a market value of R20 at close of business on 18 January 2017. The market value of J’s A Ltd shares at close of business on 18 January 2017 was R140.

Result:

The expenditure, and market value on 1 October 2001 attributable to J’s A Ltd and B Ltd shares is determined as follows:

Expenditure attributable to B Ltd shares:

$$\begin{aligned} &= R100 \times R20 / (R20 + R140) \\ &= R100 \times R20 / R160 \\ &= R12,50 \end{aligned}$$

Expenditure attributable to A Ltd shares:

$$\begin{aligned} &= R100 - R12,50 \\ &= R87,50 \end{aligned}$$

Market value attributable to B Ltd shares:

$$\begin{aligned} &= R120 \times R20 / (R20 + R140) \\ &= R120 \times R20 / R160 \\ &= R15 \end{aligned}$$

Market value attributable to A Ltd shares:

$$\begin{aligned} &= R120 - R15 \\ &= R105 \end{aligned}$$

6.2 Asset-for-share transactions

When equity shares in a new company are received in exchange for existing shares in another company under an “asset-for-share transaction” contemplated in section 42, the recipient may qualify for roll-over relief under which –

- the existing shares are deemed to be disposed of at their base cost thus giving rise to neither a capital gain or loss; and

- the base cost of the shares in the new company will be the same as the base cost of the old shares disposed of.¹⁰³

Roll-over relief is granted only for gain or break even shares. Thus the roll-over relief will not apply if a loss would have been realised on exchange of the shares. In a loss situation, the loss will simply be claimed, and the new shares will be acquired at a cost equal to the market value of the shares disposed of at the time of the asset-for-share transaction.

Example 25 – Asset-for-share transaction

Facts:

L acquired 100 shares in Target Ltd on 1 March 1995 at a cost of R100. The market value of the Target Ltd shares on 1 October 2001 was R150. On 30 June 2016 L received a circular advising that Acquiring Ltd, a listed company, would be taking over L's shares in Target Ltd under an asset-for-share transaction referred to in section 42. In return L would receive 50 shares in Acquiring Ltd. The market value of the Acquiring Ltd shares at the time of the take-over was R500.

Result:

The CGT consequences for L of the disposal of the Target Ltd shares and the acquisition of the Acquiring Ltd shares are as follows:

Step 1: Determine whether L qualifies for roll-over relief under section 42

L will qualify for roll-over relief because –

- an asset-for-share transaction has occurred under section 42; and
- L would have made a capital gain on disposal of the Target Ltd shares had section 42 not applied, that is, R500 (proceeds equal to market value of Acquiring Ltd shares) less R150 (base cost of Target Ltd shares assuming the use of market value as the valuation date value) = R350 (capital gain).

Step 2: Apply the roll-over relief

L is deemed to have sold the Target Ltd shares for an amount equal to their base cost, which results in a tax-free disposal.

L is deemed to have acquired the Acquiring Ltd shares on 1 March 1995 at a cost of R100. The market value of the Acquiring Ltd shares on 1 October 2001 is deemed to be R150.

6.3 Amalgamation transactions

An amalgamation transaction occurs under section 44 when a company (A) transfers all its assets to another company (B) and is then liquidated or deregistered. The holders of shares in Company A give up their A shares and acquire shares in Company B as a result of the amalgamation transaction. This rule works on a similar basis to the asset-for-share transaction rule described under 6.2. Any capital gain or loss on disposal of the A shares is disregarded and the attributes of the A shares are carried across to the B shares, namely –

¹⁰⁴

- dates of acquisition and incurral of expenditure; and
- any market value determined on 1 October 2001.

¹⁰³ Section 42(2).

¹⁰⁴ Section 44(6).

Simply put, the B shares step into the shoes of the A shares.

6.4 Share buy-backs

A disposal will occur when a company buys back its own shares.

For CGT purposes the proceeds received or accrued exclude any portion of the consideration that constitutes a dividend.¹⁰⁵

The consideration received from a JSE-listed company which buys back its listed shares on the open market must not be split between the dividend and non-dividend elements (in any event the seller would be unlikely to know that it was the company that had repurchased the shares hence the need for this rule).¹⁰⁶ In these circumstances the full consideration received will comprise the proceeds.

The latter situation must be distinguished from one in which a JSE-listed company buys back its shares from all its holders of shares on a pro rata basis. In such event it will be necessary to split the consideration between the dividend and non-dividend elements. The company should provide its holders of shares with this information.¹⁰⁷

6.5 Capitalisation shares

Companies often issue “capitalisation shares”¹⁰⁸ to holders of their shares instead of paying dividends.¹⁰⁹ This strategy may be adopted by the company to retain the funds in the company for further expansion of its operations. Capitalisation shares, which are acquired for no consideration, are deemed to have a cost of nil.¹¹⁰ However, if such shares were acquired before 1 October 2001, the holder of shares would be entitled to use the market value of the shares on 1 October 2001 to determine their base cost on that date.

If the weighted-average identification method has been adopted, the capitalisation shares must be added to the base cost pool with a cost of nil. The shares will then assume the average base cost of the pool.

6.6 Subdivision and consolidation of shares

Sometimes companies increase the number of their shares in issue by subdividing the existing shares into a greater number of shares (a share split). For example, a holder of a company’s shares may be asked to surrender a pre-existing holding of 100 ABC Ltd shares and will receive 200 new ABC Ltd shares in return. In this situation the base cost of the pre-existing ABC Ltd shares will simply be allocated between the greater number of replacement shares. The same would apply when a holder is asked to surrender pre-existing shares for a

¹⁰⁵ Under paragraph 35(3)(a) the amount received or accrued must be reduced by any amount that is included in gross income. A dividend or foreign dividend is brought within the definition of “gross income” in section 1(1) either through the opening words of the definition or as a special inclusion under paragraph (k) of the definition.

¹⁰⁶ Paragraph (iii) of the definition of “dividend” in section 1(1) excludes as a dividend the amount given by a company to its shareholders under a “general repurchase” of its own listed shares. A “general repurchase” refers to an open market buy-back. Typically in such a situation the company would instruct its stockbroker to purchase a certain number of shares on the market.

¹⁰⁷ Paragraph 76(4) read with the definition of “contributed tax capital” in section 1(1).

¹⁰⁸ Section 47 of the Companies Act 71 of 2008.

¹⁰⁹ Capitalisation shares are not a dividend, since paragraph (ii) of the definition of “dividend” in section 1(1) excludes an amount transferred or applied by a company that constitutes shares in the company.

¹¹⁰ Section 40C.

lesser number of replacement shares – known as a consolidation. In these circumstances the base cost of the pre-existing shares must be allocated across the lesser number of replacement shares.¹¹¹

Should consideration be received in addition to the replacement shares such as a cash payment, the shares will be partly disposed of and a capital gain or loss on the part-disposal must be determined.¹¹²

6.7 Conversion of par value shares to no par value shares and *vice versa*

Under the Companies Act 71 of 2008, a company formed before 1 May 2011 will be obliged to convert its shares of par value to shares of no par value should it wish to issue shares in excess of its authorised par value shares. When this happens, the shares of par value will have to be surrendered in exchange for shares of no par value. Provided that there is no change in the proportionate rights and interests in the company and no additional consideration is received, there will be no disposal¹¹³ and the base cost of the shares of par value will simply become the base cost of the replacement shares of no par value.

Should consideration be received in addition to the replacement shares such as a cash payment, the shares will have been partly disposed of and a capital gain or loss on the part-disposal must be determined.

6.8 Conversion of linked units to equity shares

Property loan stock companies listed on the JSE typically issue linked units comprising equity shares and debentures. A holder of such units will typically receive a small dividend on the shares with the bulk of the return comprising interest on the debentures. As a result of concerns regarding the admissibility of the interest deductions claimed by these companies for income tax purposes, legislation was passed to facilitate their tax treatment as REITs (real estate investment trusts). Company REITs or trust REITs must comply with the JSE Ltd Listings Requirements in order to trade on the REIT board of the JSE and to qualify for REIT status for tax purposes.

Under section 43 (substitutive share-for-share transactions) the conversion of a linked unit to an equity share will be treated as a roll-over except when the unit holder receives additional consideration such as a cash payment, in which case the additional consideration will trigger a part-disposal.

A special rule is contained in section 43(1A) to deal with the conversion of linked units acquired before the valuation date. Under this rule the linked units are deemed to be disposed of at market value immediately before the substitutive share-for-share transaction and reacquired at the same market value. The deemed reacquisition cost is reduced by any capital gain and increased by any capital loss. The resulting figure will become the expenditure in respect of the acquisition of the replacement equity shares. The capital gain or loss determined in this way is used only to adjust the base cost of the shares and is not otherwise brought to account.

¹¹¹ Under paragraph 11(2)(f) the subdivision or consolidation of shares held by a person is treated as a non-disposal event.

¹¹² The portion of the base cost of the shares to be allocated to the part-disposal must be determined under paragraph 33.

¹¹³ Paragraph 11(2)(f).

6.9 Nil paid letters

Companies sometimes raise additional capital on the securities exchange by means of a rights issue. Under such an arrangement, the company offers existing holders of its shares the right to take up its shares at a certain price (usually below the prevailing market price) at a certain date. The rights that holders of shares receive are known as “renounceable nil paid letters of allocation” or more simply as “nil paid letters” (NPLs). These NPLs are listed temporarily for a few weeks on the securities exchange until the close of the offer. Should the offer be accepted, the shares offered will simply be acquired for the stipulated price. Should the offer be declined, the NPLs may be sold on the securities exchange. From a CGT perspective, an NPL is an asset that has a nil base cost.¹¹⁴ The capital or revenue nature of the amount derived on disposal of an NPL will be determined by applying the normal capital versus revenue principles laid down by case law.

The cost of an NPL purchased on the open market must be added to the base cost of the relevant shares when acquired by exercising the right to take up the shares.¹¹⁵ Should the shares not be taken up, the NPL will be disposed of¹¹⁶ at a loss equal to the cost of the NPL. The capital or revenue character of such a loss will be determined by applying the normal capital versus revenue principles.

6.10 Demutualisation shares

When Old Mutual and Sanlam demutualised before 1 October 2001 and became listed companies, they issued ordinary shares free of charge to their policyholders. The following should be noted when determining the base cost of demutualisation shares:

- “B” in the time-apportionment and proceeds formulae will be nil since no expenditure was incurred before valuation date in acquiring the shares.
- Should the market value or weighted-average method be adopted, the relevant prices published on the SARS website must be used.

¹¹⁴ Section 40C.

¹¹⁵ Paragraph 58 read with paragraph 20(1)(f).

¹¹⁶ Paragraph 11(1)(b).