The ABC

of Capital Gains Tax for Companies

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The ABC of Capital Gains Tax for Companies

FOREWORD

This guide deals with some of the basic principles of Capital Gains Tax (CGT) in order to contribute to a broader understanding of the tax. It should, therefore, not be used as a legal reference.

Please note that the deadline for preparation of CGT valuations as at 1 October 2001 expired on 30 September 2004.

Should you require additional information concerning any aspect relating to Capital Gains Tax (CGT), you may:

- Contact any South African Revenue Service (SARS) office
- Visit SARS online at http:/www.sars.gov.za
- Contact your own advisor

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1. INTRODUCTION

In his Budget Speech of 23 February 2000 the Minister of Finance, Mr Trevor Manuel, announced the introduction of Capital Gains Tax (CGT) in South Africa. Internationally, the idea of such a tax is not uncommon, with many of our trading partners having implemented CGT decades ago.

Before the implementation of CGT, companies and close corporations were not taxed on profits of a capital nature, nor were losses of such a nature allowable. The effect of CGT is to bring such capital profits and losses into the tax net, unless specifically excluded.

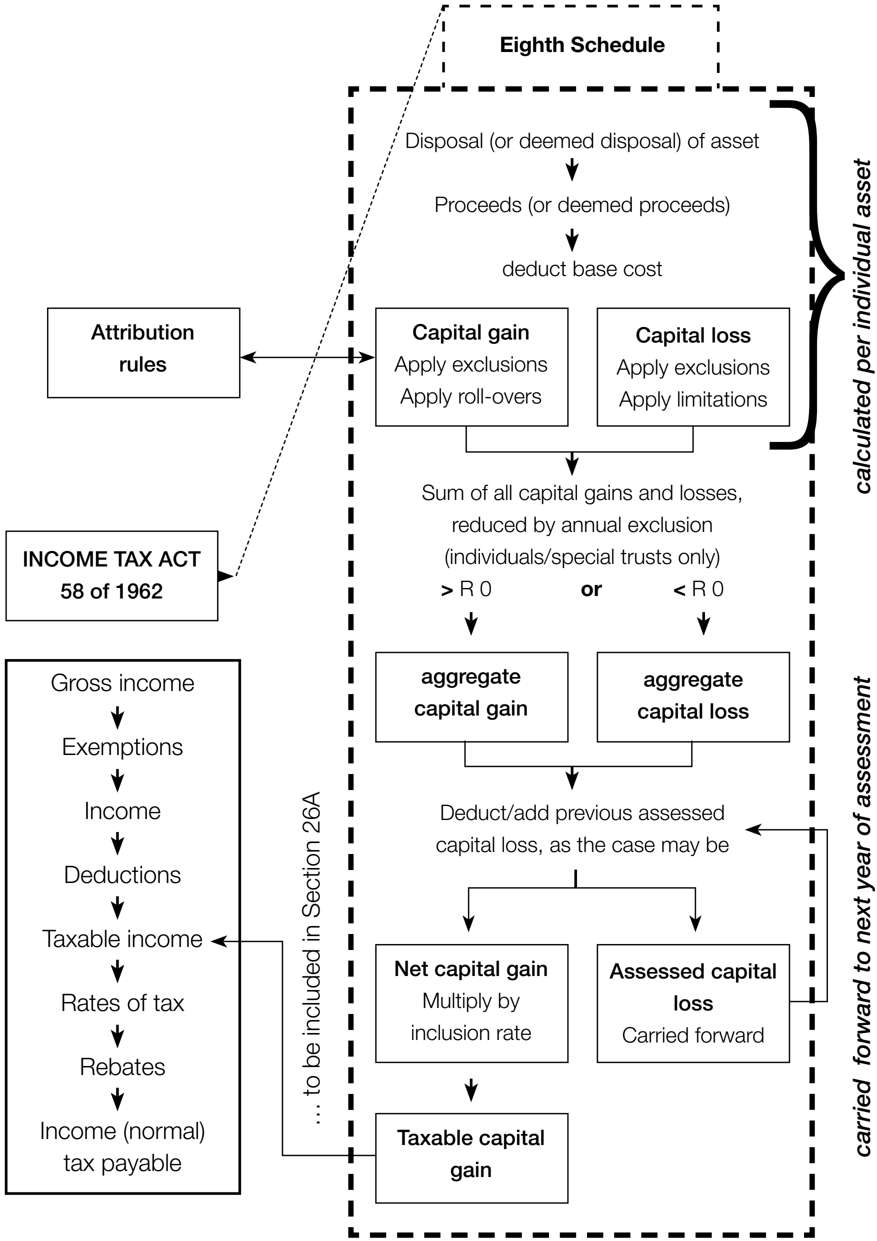
In order to give effect to the proposals relating to CGT, an Eighth Schedule was added to the Income Tax Act, 1962 (the Act). This Schedule determines a taxable capital gain or assessed capital loss and section 26A of the Act provides that the taxable capital gain must be included in taxable income. The date from which capital gains are taxed is 1 October 2001.

Should this guide not answer your specific questions, you should contact your local SARS office or make use of the e-mail facility, namely cgt@sars.gov.za.

2. OVERVIEW OF THE CORE PROVISIONS OF CAPITAL GAINS TAX

The **CGT Flowchart** below sets out the core steps in determining a taxable capital gain to be included in taxable income or an assessed capital loss to be carried forward to a subsequent year of assessment.

CGT Flowchart



3. DETERMINING A CAPITAL LOSS

The Eighth Schedule provides for four key definitions (Asset, Disposal, Proceeds and Base Cost) which form the basic building blocks in determining a person's capital gain or loss.

Asset

An asset is widely defined and includes any property of whatever nature and any interest therein. CGT applies to all assets of a person disposed of on or after 1 October 2001 (valuation date), whether or not the asset was aquired by the person before, on or after that date.

However, only the gain accruing from 1 October 2001 will be subject to CGT.

Disposal

The concept of disposal covers any event, act, forbearance or operation of law which results in a creation, variation, transfer or extinction of an asset. It also includes certain events treated as disposals, such as the change in the use of an asset.

Proceeds

Once an asset is disposed of the amount which is received by or which accrues to the seller of the asset constitutes the proceeds from the disposal.

Base Cost

The base cost of an asset is generally the expenditure actually incurred in acquiring the asset together with expenditure directly related to its improvement and direct costs in respect of its acquisition and disposal and certain holding costs. The base cost does not include any amounts allowed as a deduction for income tax purposes. Some of the main costs that may form part of the base cost of an asset are:

- **Direct costs of acquisition and disposal**

  Expenditure directly related to the cost of acquisition, creation or disposal of an asset:
  - Cost of acquisition
  - Cost of creating an asset
  - Cost of obtaining a valuation for CGT purposes
  - Remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor
  - Transfer costs
  - Stamp duty, transfer duty or similar duty
  - Advertising costs to find a seller or to find a buyer
  - Moving costs - but only in acquiring or disposing of an asset
  - Installation costs including foundations and supporting structures
  - Cost of an option to acquire or dispose of an asset
  - VAT paid and not claimed or refunded in respect of an asset
  - Costs of establishing, maintaining or defending a legal title or right in the asset

- **Cost of improvements or enhancements**
  The improvement or enhancement must be reflected in the state or nature of the asset at the time of disposal. For example, if a car port was erected against the side of a building at a cost of R20 000, but was later irreparably damaged and as a result removed, R20 000 may not be included in the cost of the building.

- **Holding costs**
  These costs must have been wholly and exclusively incurred for business purposes, but must not have been claimed as a deduction for income tax purposes:
  - Repairs and maintenance, insurance and protection
  - Rates and taxes on immovable property
  - Interest on loans used to directly finance the cost of acquiring an asset and any improvements thereto
  - Interest on amounts used to repay existing loans. However, where the assets being financed comprise listed shares or participatory interests in collective investment schemes, the amount of interest that may be added to the base cost is limited to one-third.

4. WHAT IS THE BASE COST OF AN ASSET HELD ON 1 OCTOBER 2001?

In order to exclude the portion of the gain relating to the period before 1 October 2001, the base cost of the asset as at that date must be determined according to one of the following methods:

a) 20% x (proceeds less allowable expenditure incurred on or after 1 October 2001) (where no records have been kept and no valuation was obtained at 1 October 2001)
   OR
b) Market value of the asset at 1 October 2001 (the “valuation date”)
   OR
c) Time-apportionment base cost method

Market value method on 1 October 2001

The Act lays down various requirements that apply when the market value method is used.

- **Time limit for performing valuations**
  All valuations must have been done by 30 September 2004. Failure to do so will mean that this method cannot be used. Valuations must be performed as if done on 1 October 2001.

- **Who may perform valuations?**
  The Act does not prescribe who may perform valuations. This is the responsibility of the company and the onus of substantiating a valuation rests with the company. The company may, however, appoint a professional person to assist with the valuation.

- **Methods to be adopted in valuing certain assets**
  In general the Act does not specify the methods to be used in performing valuations, though there are some exceptions, as summarised in the table below:

Market Value on 1 October 2001

General rule	Market value = price based on willing buyer, willing seller acting at arm's length in an open market
SA listed securities	Volume weighted average price for the five business days preceding 1.10.2001[1]
Foreign listed securities	The ruling price (usually the last sell price) on the last business day before 1.10.2001
Participation rights and "property shares" in SA collective investment schemes	Average "sell to management company" price for the last five trading days before 1.10.2001[2]
Participation rights in foreign collective investment schemes	Same as for SA collective investment schemes, except based on last trading day before 1.10.2001
Controlling interest	Control premium determined on listed company disposal and applied to listed price at 1.10.2001
SA Second-hand endowment policies	Greater of • Surrender value • Insurer's market value (assume policy runs to maturity)
Farm land	Land Bank value or market value based on general rule. **Note:** As from 1 February 2006 the market value must be the fair market value as per par (b) of the definition of "fair market value" in sect 1 of the Estate Duty Act, namely, the price that could be obtained between a willing buyer and willing seller dealing at arm's length in an open market, less 30%.

[1] Prices supplied in Government Gazette 23037 dated 25 January 2002 and on SARS online under CGT/Information
[2] Same as footnote 1

- **Submission requirements**
  The prescribed valuation form (CGT 2L if completed after 30 September 2004 or CGT2 / Annexure if completed prior to that date) must generally be lodged together with the relevant return of income for the year of assessment in which the asset was disposed of. However, in the case of certain assets, the valuation forms must be lodged with the first return of income submitted after 30 September 2004, irrespective of whether the relevant assets have been disposed of or not. These categories of assets are set out in the table below:

Type of asset	Applies	Where market value exceeds
Intangible assets (such as goodwill, trade marks, etc)	Per asset	R1 million
Unlisted shares	All shares held by the shareholder in the company	R10 million
All other assets	Per asset	R10 million

  The form to be used for this purpose is available for download from the SARS website at http://www.sars.gov.za/cgt/forms.

- **Loss and gain limitation rules**
  Certain rules, which are beyond the scope of this guide, are in place to limit losses and gains when the market value of the asset on 1 October 2001 has been determined, or has been published in the Government Gazette (e.g. SA listed shares). These rules limit capital losses where the market value of an asset has been adopted or determined. Under certain circumstances capital gains are also limited.

- **Time-apportionment method**
  This method may be used when a company has a record of the date of acquisition and cost of an asset. The following formula is used to determine the time-apportionment base cost of an asset:

$$\text{Original cost} + \left[(\text{proceeds} - \text{original cost}) \times \frac{\text{Number of years held before 1 October 2001}}{\text{Number of years held before 1 October 2001 plus number of years held after 1 October 2001}}\right]$$

  For the puposes of this formula:

  - Improvements or additions made before 1 October 2001 are assumed to have taken place when the asset was acquired.
  - A part of a year is treated as a full year.
  - The period before 1 October 2001 is limited to 20 years where –
    - improvements have been made to an asset before 1 October 2001; and

    - the asset was acquired before 1 October 1981.
- Where no addions or improvements have taken place prior to valuation date, the 20-year limit does not apply.
- Where capital allowances have been claimed on an asset for normal tax purposes –
    - the proceeds must be reduced by the amount of any recoupments; and
    - the expenditure must be reduced by the amount of any capital allowances that have been allowed.
- Additions to an asset after valuation date are added to the base cost (not apportioned).

Examples

Example 1 – Time-apportionment base cost (TAB): all expenditure incurred before valuation date

XYZ (Pty) Limited purchased a machine for R100 000 on 1 October 2000 and sold it for R150 000 on 30 September 2003. At the date of sale capital allowances of R60 000 had been claimed on the machine. Calculate the capital gain.

Solution:

(a) Remove recoupment from amount received or accrued and capital allowances from cost

Consideration received/accrued	R150 000
Less: recoupment	R60 000
Proceeds for CGT purposes	R90 000
Cost	R100 000
Less: capital allowances	R60 000
Cost for CGT purposes	R40 000

(b) Determine time-apportionment base cost ("TAB")

Period before: 1 October 2000 – 30 September 2001 = 1 year
Period after: 1 October 2001 – 30 September 2003 = 2 years
Total period = 3 years

(c) Determine capital gain or loss

TAB = R40 000 + (R90 000 - R40 000) x 1/1+2
= R40 000 + R16 667
= R56 667
Capital gain = Proceeds – base cost
= R90 000 – R56 667 = R33 333

Example 2 – Time-apportionment base cost: expenditure incurred before and after the valuation date

Assume the same facts as in **Example 1** but that the machine was upgraded on 1 July 2002 at a cost of R10 000 and that allowances of R2 000 were claimed on these improvements. Costs incurred before valuation date = R100 000 (**B1**). Costs incurred before valuation date reduced by capital allowances = R100 000 – R60 000 = R40 000 (**B**). Costs incurred after valuation date = R10 000 (**A1**). Costs incurred after valuation date reduced by capital allowances = R10 000 – R2 000 = R8 000 (**A**).

Calculate the capital gain.

(a) Remove recoupments from proceeds

Proceeds	R150 000 (**R1**)
Less: recoupment	(R62 000)
Proceeds for CGT purposes	R88 000

(b) Remove capital allowances from cost

	Before 1.10.2001	After 1.10.2001	Total
Cost	R100 000 (**B1**)	R10 000 (**A1**)	R110 000
Less: capital allowances	(R60 000)	(R2 000)	(R62 000)
Cost for CGT purposes	R40 000 (**B**)	R8 000 (**A**)	R48 000

(c) Determine portion of proceeds relating to period before valuation date

$P_1 = R_1 \times B_1/(A_1+B_1)$

P_1 = R150 000 x R100 000/R110 000

P_1 = R136 364

(d) Determine time-apportionment base cost ("TAB")

TAB = B + [(P_1 – B_1) x N/(N+T)]

TAB = R40 000 + [(136 364 – R100 000) x 1/(1+2)]

TAB = R40 000 + R12 121

TAB = R52 121

(e) Determine capital gain or loss

Capital gain = proceeds - TAB - cost after valuation date

Capital gain = R88 000 - R52 121 - R8 000

Capital gain = R27 879

5. AGGREGATE CAPITAL GAIN OR LOSS

This is determined by adding the capital gains and losses on individual assets together.

6. NET CAPITAL GAIN OR ASSESSED CAPITAL LOSS

Deduct any assessed capital loss from the previous year to arrive at the net capital gain or assessed capital loss.

7. INCLUSION RATE AND TAXABLE CAPITAL GAIN

Apply the inclusion rate to arrive at the taxable capital gain. In the case of a company, close corporation or trust (not a special trust) 50% of the net gain is included in taxable income.

Example

Example 3: Determination of taxable capital gain

XYZ (Pty) Limited has sold the following assets during the tax year:

	Capital gain or loss
Vacant land	R50 000
Trade mark	R5 000
Truck	(R5 000)
Machine	(R10 000)
Aggregate capital gain	R40 000

XYZ (Pty) Limited does not have an assessed capital loss from the previous year.
Note: An assessed capital loss may only be deducted from capital gains and added to capital losses. It may not reduce ordinary income.

Aggregate capital gain	R40 000
Assessed capital loss b/f	-
Net capital gain	R40 000
Inclusion rate	50%
Taxable capital gain	R20 000 (R40 000 x 50%)

The taxable capital gain will be included in the company's taxable income and taxed at the rate of 29%, i. e. R20 000 x 29% = R5 800. The effective rate of tax on the sum of all the gains and losses is R5 800/ 40 000 x 100 = 14,5%.

8. EFFECTIVE RATES OF CGT

Type of Company	Inclusion rate %	Statutory rate %	Effective rate %
Companies and close corporations	50	29	14,5
Small business corporations	50	0 - 29	0 – 14,5
Employment companies	50	34	17
Permanent establishments (branches)	50	34	17
Tax holiday companies	50	0	0

9. SOURCE CODES

	Capital Gains Tax source
6502	Fixed/ Immovable assets (e. g., land, buildings, mineral rights)
6503	LOSS: Fixed/ Immovable assets
6504	Primary residence (e. g. house, townhouse, flat, houseboat, caravan)
6505	LOSS: Primary residence
6506	Financial instruments: Listed (e. g., shares, collective investment schemes, bonds, futures, options)
6507	LOSS: Financial instruments: Listed
6508	Financial instruments: Unlisted (e. g., shares , debentures, promissory notes, bonds, options, forward contracts, swaps, debt)
6509	LOSS: Financial instruments: Unlisted
6510	Intangible assets (e. g., goodwill, trade marks, patents, copyrights, franchises, licences, fiduciary, usufructuary and other like interests)
6511	LOSS: Intangible assets
6512	Foreign currency
6513	LOSS: Foreign currency
6514	Plant and machinery
6515	LOSS: Plant and machinery
6516	Other movable property used for business purposes (e. g., aircraft, boats, motor vehicles, office furniture and equipment)
6517	LOSS: Other movable property used for business purposes
6518	Other movable property not used for business purposes excluding personal use assets (e. g., Kruger rands, personal use boats > 10 metres and personal use aircraft > 450 kg)
6519	LOSS: Other movable property not used for business purposes excluding personal use assets

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