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CAPITAL GAINS TAX IN SOUTH AFRICA WITH SPECIFIC REFERENCE TO EMPLOYEE SHARE OWNERSHIP PROGRAMMES (ESOP's)

by

MARLISE LöTTER

SHORT DISSERTATION

submitted in partial fulfilment of the requirements for the degree

MAGISTER COMMERCII

in

SOUTH AFRICAN AND INTERNATIONAL TAXATION

in the

FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES

at the

RAND AFRIKAANS UNIVERSITY

SUPERVISOR: PROF. T.L. VOOGT

OCTOBER 2001

SYNOPSIS

KAPITAALWINSBELASTING IN SUID-AFRIKA, MET SPESIFIEKE VERWYSING NA WERKNEMERSAANDEELSKEMAS

deur

MARLISE LöTTER

STUDIELEIER: PROF. T.L. VOOGT

GRAAD: M. COMM. (SUID-AFRKAANSE & INTERNASIONALE BELASTING)

Inleiding

Die doelwit van die studie is om op 'n duidelike en sistematiese wyse die basiese beginsels van die kapitaalwinsbelasting begrip, insluitende die basiese berekening daarvan asook die toepassing op transaksies deur 'n werknemersaandeelskema uiteen te sit

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Kapitaalwinsbelasting

Kapitaalwinsbelasting is nie 'n nuwe belasting op sig self nie, maar 'n metode waartydens 'n gedeelte van 'n kapitaalwins wat gegeneer is vanuit die verkoop van 'n bate, ingesluit word in die belasbare inkomste van belastingpligtiges.

Die Minister van Finansies het in sy begrotingstoespraak van 23 Februarie 2000 aangekondig dat kapitaalwinsbelasting in Suid-Afrika geïmplimenteer gaan word. Na verskeie wysigings aan die voorgestelde wetgewing, is kapitaalwinsbelasting goedgekeur, en effektiewelik van toepassing vanaf 1 Oktober 2001.

In die strukturering van hierdie werk het die outeur gepoog om 'n teks te voorsien oor die *illustrasie van die kapitaalwinsbelasting begrip en die moontlike uitwerking op sekere werknemersaandeelskemas* wat beide inhoudelik en wat aanbiedingstyl betref, geredelik toeganklik sal wees vir sowel die belastingspesialis en die praktisyn wat by die dag-tot-dag bestuur van hul ondernemings betrokke is. Bronverwysings word in die teks self vervat, soos ook tersaaklike aanhalings wat onontbeerlik is vir 'n duidelike begrip van die onderwerp. Elke hoofstuk word voorafgegaan deur 'n opsomming van rubriek- en paragraafinhoud.

Gevolgtrekking

Kapitaalwinsbelasting het ten doel om die bestaande belastingvermydingsskemas waartydens gewone winste van 'n inkomste-aard herklassifiseer word as kapitaalwinste om sodoende die belastingnet vry te spring, aan te spreek.

Die implementering van kapitaalwinsbelasting sal Suid-Afrika ook in lyn bring met die meerderheid ander lande waarvan sommiges al reeds 'n geruime tyd een of ander vorm van kapitaalwinsbelasting toepas.

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Werknemersaandeelskemas het toegeneem in populariteit en een van die hoof motiverings was die belastingvrye kapitaalwinste wat genereer is indien die werknemer na verloop van tyd die aandele verkoop. Die implikasies van kapitaalwinsbelasting moet dus ernstig oorweeg word om die totale belastingaanspreeklikheid van werknemers met deelname in werknemersaandeelskemas te bepaal.

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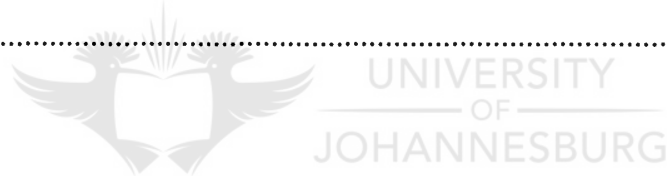

CHAPTER ONE

Introduction

1.1 The topic of the study

Limited tax implications of capital gains tax in South Africa is addressed in this study with reference to the Eighth Schedule of the Income Tax Act (hereafter the Act). Various publications by the South African Revenue Service (hereafter SARS) and leading tax specialist's publications available on the website www.cgtsa.co.za were also consulted.

Employee Share Ownership Schemes (hereafter ESOP's) are defined and the most commonly used schemes in South Africa are explained with reference to various internal publications by PricewaterhouseCoopers. The Income Tax implications as well as the capital gains tax implications on selected schemes will be discussed.

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The implications of capital gains tax on all transactions in South Africa falls outside the scope of this study, as this study focuses on the basic explanation of the core capital gains tax provisions in South Africa, with specific application to certain employee share ownership programmes (hereafter ESOP's) used in South Africa.

1.2 Background and purpose of the study

Capital gains tax was implemented with effect from 1 October 2001 in South Africa. The implications of capital gains tax are far-reaching and offer various opportunities for tax consultants.

The capital gains tax legislation is incorporated into the existing Act via a new schedule, the Eighth Schedule. The purpose of this study is to explain the basic principles of capital gains tax in South Africa with reference to various examples. The provisions of the Eighth Schedule is

applied to currently used ESOP's to illustrate the far-reaching tax implications of implementing capital gains tax on previously tax free capital gains from transaction on capital account.

This study reaches its goal by:

- Providing background information on the implementation of capital gains tax in South Africa, and the rationale behind the introduction of capital gains tax (see chapter 2).
- The core provisions of capital gains tax is discussed, and explained in various examples to illustrate the provisions of the Eighth Schedule (see chapter 3).
- ESOP's are defined, and the most well known schemes operating in South Africa are discussed, including the existing Income Tax implications applicable to these transactions (see chapter 4).
- The capital gains tax implications on selected ESOP's used in South Africa are discussed (see chapter 5).

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1.3 The motivation for the study

In 1969, the Franzsen Commission proposed a limited form of capital gains tax, while the Margo Commission in 1986 recommended that capital gains should not be taxed. In 1995, the Katz Commission considered the merits of implementing capital gains tax in South Africa, but did not make recommendations due to the lack of capacity of the Inland Revenue at that time (National Treasury's Tax Policy Chief Directorate, 2001:2).

During the 2000 Budget Speech, the Minister of Finance announced that the time has come to implement capital gains tax in South Africa. By not taxing capital gains, taxpayers convert otherwise taxable income into tax-free capital gains. The result is erosion of the income tax base and a reduction in the efficiency and equity of the overall tax system.

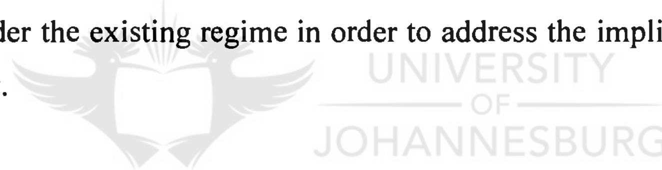
Capital gains tax is not uncommon amongst South Africa's trading partners and by implementing capital gains tax in South Africa our tax system will be comparable with various international jurisdictions.

When capital gains tax was first implemented in the United Kingdom in 1965, the following comment was made:

> *"The failure to tax capital gains is widely regarded...as the greatest blot on our existing system of direct taxation. There is little dispute nowadays that capital gains confer much the same kind of benefit on the recipient as taxed earnings more hardly won. Yet earnings pay tax in full while capital gains go free. This is unfair to the wage earner. It has in the past been one of the barriers to the progress of an effective income policy...Moreover, there is no doubt that the present immunity from the tax of capital gains has given a powerful incentive to the skilful manipulator of which he has taken full advantage to avoid tax y various devices which turn what is really taxable income into tax-free capital gain"*

(Department of Finance and South African Revenue Service, 2000:4).

The implementation of capital gains tax in South Africa has far-reaching effects on various transactions and tax planners will have to reassess various schemes and transactions that provided tax relief under the existing regime in order to address the implications of capital gains tax in an effective way.



In this study, the background and calculation of capital gains tax will be discussed. As capital gains tax will affect numerous capital assets, the implications will best be illustrated through a case study. As employee share schemes are gaining popularity in South Africa, especially in listed companies, the implications of capital gains tax on South African employee share schemes will be discussed.

1.4 The sources and structure of the study

The motivation and purpose of the study, which was documented above, can not be accepted without detail consideration. In the study, the following sources are used:

- Explanatory memorandum on the Taxation Laws amendment Bill, 2001
- Schedule Eighth of the Income Tax Act
- Guide to Capital Gains Tax, issued by SARS in 2000

- Internal publications by PricewaterhouseCoopers Inc.
- Briefing by the National Treasury's Tax Policy Chief Directorate to the Portfolio and Select Committees on Finance, 2001;
- Various electronic articles available on the website www.cgtsa.co.za

The study can be divided into 6 chapters. Firstly this is a literature study where the rationale and background regarding capital gains tax is investigated in chapter two, including reference to the fact that the introduction of capital gains tax in South Africa is in line with other international jurisdictions. The rest of the study is divided into the following chapters:

Chapter 3

In this chapter the basic principles of capital gains tax is explained, and illustrated via various examples. Specific attention is given to matters e.g. the definition of an asset, the calculation of base cost of assets and the determination of the market value of assets, as these matters are important in assessing the capital gains tax implications on ESOP's. The purpose of this chapter is not to provide a detailed explanation of all the capital gains tax provisions applicable in South Africa, but rather focuses on the core provisions relevant when assessing the capital gains tax implications on ESOPS's.

Chapter 4

Well known ESOP's e.g. Share Purchase Schemes, Share Option Schemes, Deferred Delivery Schemes, Deferred Delivery Schemes, Convertible Debenture Schemes and Offshore Share Schemes are explained. The Companies Act requirements and applicable Income Tax provisions to these schemes are discussed.

Chapter 5

The implications of capital gains tax on Share Purchase Schemes, Share Option Schemes and Deferred Delivery Schemes are discussed with reference to the relevant provisions of the Eighth

Schedule and applicable case law.

The findings of this study are summarised in chapter 6.

CHAPTER TWO

Introduction to capital gains tax

2.1 Introduction

In the Budget Speech, delivered in Parliament by Finance Minister Trevor Manuel on February 23, 2000 the introduction of capital gains tax in South Africa was announced (Katz, 2001:1).

The introduction of capital gains tax is part of a wider tax reform effort aimed at enhancing the integrity, efficiency and equity of the South African income tax regime (National Treasury's Tax Policy Chief Directorate, 2001:2). Capital gains tax is aimed at addressing some existing avoidance opportunities whereby ordinary profits of a revenue nature is reclassified as capital revenue in order to escape the tax net.

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The implementation of capital gains tax in South Africa is not a surprise. In 1969, the Franzsen Commission proposed this type of taxation on limited transactions and in 1995 the Katz Commission considered the merits and demerits of capital gains tax in South Africa. The implementation was not recommended partly due to the lack of capacity of Inland Revenue at that time.

2.2 Rationale for taxing capital gains

The main reason why capital gains tax was introduced is to a large extent to achieve horizontal and vertical equity. In the third interim report of the Katz Commission (1995:37) the following was said on the topic:

> *"Some developed countries have imposed capital taxation for more than 70 years. Likewise their capital gains tax regimes have survived many tax reforms during these last decades. Worldwide, the current debates regarding the taxation of capital gains focus largely on aspects relating to the*

equitable distribution of a tax burden, revenue effects, impacts on savings and on the economic competitiveness of the relevant tax jurisdictions. Of particular importance is the question of the benefits which accrue to certain taxpayers from the preferential tax treatment of capital gains."

By taxing capital gains, the tax base is broadened, and the existing base is secured, as tax avoidance activities are limited. By excluding tax on capital gains, taxpayers are encouraged to convert ordinary taxable income into tax-free capital gains to reduce their total tax burden. A fundamental weakness in the South African tax system will be rectified, as it will minimize the arbitrage opportunities that exit for avoiding tax through the reclassification of ordinary taxable income into untaxed capital gains (National Treasury's Tax Policy Chief Directorate, 2001:4). The implementation of capital gains tax will also bring South Africa in line with the majority of other countries and major trading partners that have investment relations with South Africa (Katz, 2001:1).

Capital gains tax will therefore be levied on all gains realised, but only to the portion accruing after the 'effective date' (National Treasury's Tax Policy Chief Directorate, 2001:15). The underlying principle of capital gains tax is therefore that it will garner any realised gain which is not subject to income tax, unless the gain in question is disregarded or exempt from capital gains tax. Capital gains tax is therefore a backstop for income tax, which catches any realised gain that has escaped income tax (R Williams, 2001:103).

2.3 International trends and practice

Many jurisdictions accept the taxation of "comprehensive income" as the ideal tax base. This means that the total sum of all revenue streams over the tax period should be included in the income tax base. Capital gains tax is classified as an income stream and should therefore attract income tax on the same basis as other revenue streams. The taxation of capital gains is therefore well known internationally, (National Treasury's Tax Policy Chief Directorate, 2001:4) for example, by 1996, New Zealand was the only OECD country that did not tax capital gains. As Oliver (quoted by National Treasury's Tax Policy Chief Directorate, 2001:4) notes:

> *"It seems a bit simplistic to describe a tax system as one that does or does not tax capital gains. Any income tax that left all capital gains tax-free would be unworkable."*

In the Briefing by the National Treasury's Tax Policy Chief Directorate to the Portfolio and Select Committees on Finance, an analysis of capital gains tax implemented in various jurisdictions was published. In sum it appears that:

- In Africa, 68 % of the jurisdictions opted for the inclusion of some form of capital gains;
- In Asia and the Asian Pacific, 54 % of the jurisdictions elected to tax capital gains;
- In the Americas, 89 % of the jurisdictions tax capital gains; and
- In Europe, 31 jurisdictions saw the need to include realized capital gains into the tax system (National Treasury's Tax Policy Chief Directorate, 2001: 9/10)

The South African tax system should, as far as is possible, be the same as the rest of the world. Foreigners dealing with South Africa will be dealing with a tax system which they understand and the introduction of capital gains tax should therefore not deter investment in South Africa (Katz, 2001:1). Capital gains tax will be levied on South African residents in respect of their worldwide assets and on non-residents on gains resulting from the disposition of immovable property and gains accruing to assets in a permanent establishment, which is in line with international trends (National Treasury's Tax Policy Chief Directorate, 2001: 15). This will be explained further in chapter 3.

2.4 The capital versus revenue distinction

The distinction between capital and revenue profits was always of the utmost importance in South Africa, as capital gains were exempt from taxation. According to Katz (2001: 1), the introduction of capital gains tax does not eliminate the distinction between capital and revenue. A gain must still be examined in the light of the traditional tests to determine the nature thereof and if, on these tests, a gain is revenue in nature, it is taxable at full rates, if not, it will be subject to capital gains tax.

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Currently there is no statutory definition of capital or revenue, but the South African courts have laid down principles and tests to distinguish capital and revenue items.

A well-established objective test is to determine if a gain made by a transaction was carried out in a scheme of profit making. If this was the case, a gain is of a revenue nature, if not, it is capital, as determined in Overseas Trust Company v CIR (1926 AD 444). In applying this test, the courts relied heavily on a subjective test, namely the intention of the taxpayer when entering into the transaction.

The court will not rely solely on the taxpayer's *ipse dixit* but will still apply objective tests of the circumstances in order to determine the taxpayer's intention. In ITC 1185 35 SATC 122, the court set out the appropriate approach to ascertaining a taxpayer's intention as follow:

> *"....It is necessary to bear in mind...that the ipse dixit of the taxpayer as to his intent and purpose should not be regarded as decisive ... Not the least important of the facts will be the course of conduct of the taxpayer in relation to the transactions in issue, the nature of his business or occupation and the frequency or otherwise of his past involvement of participation in similar transactions. ...But direct evidence of intent and purpose must be weighed and tested against the probabilities and inferences normally drawn from the established facts."*

The proposal of capital gains tax leaves the current capital versus revenue distinction of case law fully in place. Individuals will include 25% of net capital gains and companies will include 50% of net capital gains in taxable income, which will be taxed at ordinary rates. As a result, the effective capital gains tax rate for individuals will vary between 0% and 10,5% and for companies it will be 15% (National Treasury's Tax Policy Chief Directorate, 2001: 15). This will be discussed further in chapter 3.

According to Katz (2001:1), the introduction of capital gains tax will produce greater certainty regarding the capital vs. revenue issue, as SARS is less likely to contest a taxpayer's claim that a gain is capital when it will collect tax even on capital gains. However, this statement can be contested. It is difficult to believe that SARS will be content to collect capital gains tax of 10.5% made by an individual on the reduced rate, when it could collect income tax of 42% on the same

gain (Stein, 2001a:1). It is also important to note that an annual exclusion provision for natural persons of R 10 000 is specified in paragraph 5 of the Eighth Schedule. Therefore, the first R 10 000 of a capital gain or a capital loss is ignored in determining an individual's aggregate capital gain or aggregate capital loss. The purpose of the annual exclusion is to reduce compliance costs, simplify administration and underpin the SITE system (R Williams, 2001: 106/107). An effective capital gains tax rate of 10,5% is therefore only applicable to individuals, which are taxed at the highest current tax rate applicable to individuals on net capital gains after applying the annual exclusion rate. It may be noted that where SARS does attempt unsuccessfully to claim income tax it will be able to fall back on a claim for capital gains tax. Therefore, the fact that SARS chose in the first instance to treat the taxpayer's profit as being of a revenue nature, would not prevent it from claiming capital gains tax because of the failure of the first claim (Anon., 2001b:81/82). As long as a differential exists between capital gain and ordinary rates, taxpayers will try to characterize their gains as capital.

Another important aspect of the capital gains legislation, is the increased disclosure requirements set out in tax returns, which will now force taxpayers to make comprehensive disclosures of all pertinent facts relating to capital income. Many taxpayers might have to consider obtaining the help of a tax expert before submitting a tax return in order to avoid a letter from the revenue service to the effect: "*Income returned as capital considered to be revenue and taxed at full marginal rate of 42%. Assessment to follow*" (Lester, 2001a:1).

2.5 Conclusion

It seems that capital gains tax is here to stay. The implications are far reaching. Tax planning will have to change rapidly in order to effectively address the implications of capital gains tax. However, capital gains tax is not the only tax problem taxpayers have to face. By making decisions simply to save on capital gains tax, taxpayers can become exposed to income tax, estate duty, donations tax and retirement funds tax. The statement by Lester (2001b:1) is very true:

> "*Capital gains tax has the lowest rate of all, yet taxpayers are giving it all their attention. One*

must work with all forms of taxation at the same time."

In the following chapter, the capital gains tax process and workings will be discussed.

CHAPTER THREE

Capital gains tax in South Africa

3.1 Introduction

Capital gains tax will be imposed to all assets of a South African resident which is disposed of on or after 1 October 2001 (the valuation date), whether or not the asset was acquired by that person before, on or after the valuation date. However, only the capital gain or loss will be taken into account (Van Rooyen, 2001:1).

Capital gains will be calculated under the provisions of a new Schedule, the Eighth Schedule and a portion of gains are included in taxable income. Capital gains tax is regarded as a tax on income and therefore it is incorporated as an integral part of the Income Tax Act (Anon., 2001a:61). Section 26A of the Act provides that capital gains as determined according to the Eighth Schedule, will be subject to tax. By not treating capital gains tax as a separate tax, but as part of the Act, additional provisions regarding assessments, payment and recovery of tax, objections and appeals are not necessary (Anon., 2001a: 61).

3.2 Overview of the core provisions of capital gains tax

Until 1 October 2001, a taxpayer will still be taxed on the income derived from owning assets, but tax will not generally be levied on profits arising from the disposal of the income-producing assets. After 1 October 2001, all capital gains or losses made on the disposal of capital assets will be subject to capital gains tax provisions, unless specifically excluded by specific provisions in the Eighth Schedule. However, where assets were acquired before 1 October 2001 and disposed of thereafter, capital gains tax will only be payable on the capital gain which accrued after 1 October 2001 (Department of Finance and South African Revenue Service, 2000:5).

The definitions of "capital gains" and "capital losses" refer to aggregate capital gains and losses, therefore once individual capital gains and losses have been determined, it is added together to

determine the taxpayer's capital gain or loss of the year of assessment. Once the amount of capital gains or losses or determined, the amount is reduced by the annual exclusion of R 10 000 for natural persons or R 50 000 in the case of the death of a taxpayer. After the deduction of any assessed capital loss brought forward from the previous year of assessment, the net:

- Assess capital loss is carried forward to the next year of assessment; or
- Capital gain is multiplied by an inclusion rate to determine the relevant portion that is included in the taxable income of the taxpayer in terms of Section 26A of the Act, taxable at the taxpayer's marginal tax rate.

Consequently, assessed capital losses are ringfenced.

The inclusion rates of various categories of taxpayers, their marginal tax rates and effective rate of capital gains tax is set out in Table 3.1 below

Type of taxpayer	**Inclusion rate %**	**Statutory rate %**	**Effective rate %**
Individuals	25	0 – 42	0 – 10,5
Unit trust	N/A	30	N/A
Special trusts	25	0 – 42	0 – 10,5
Other trusts	50	32 or 42	16 – 21
Companies	50	30	15
Small business corporations	50	15 or 30 or both	7,5 – 15
Employment companies	50	35	17,5
Permanent establishments (branches)	50	35	17,5

Table 3.1: The inclusion rate and effective tax rates applicable to different taxpayers (PricewaterhouseCoopers, 2001a:3).

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3.3 Who is liable to pay capital gains tax?

Any natural person (individual) or legal person who is a "resident" of the Republic of South Africa is subject to capital gains tax on worldwide asset, therefore assets held both in the Republic and outside of the Republic (PricewaterhouseCoopers, 2001a:2).

The term "resident" is defined in the Act and includes:

- An individual or natural person, which is ordinarily resident in South Africa or physically present in South Africa for a specified number of days in specified periods; and
- A legal person who is incorporated, formed, established of has his of her effective place of management in South Africa.

Difficulty arises in interpreting the term "ordinarily resident" as this term is not defined in the Act (Danziger, 1991:38). Case law provides limited guidance on this matter. In the case of Soldier v COT (1943 SR 131), a distinction was drawn between "residence" and "ordinary residence", and ordinary residence was said to be a narrower concept than residence. In the well-know case of Cohen v CIR (1946 AD 174), judge Schreiner JA remarked that it must be decided if an individual can be ordinarily resident for tax purposed in more than one country. Although the learned judge Schreiner confirmed that a person may be resident in more than one country, he can only be "ordinarily resident" in one. He described a taxpayer's ordinary residence as:

> *"the country to which he would naturally and as a matter of course return from his wanderings; as contrasted with other lands it might be called his usual or principle residence and it would be described more aptly than other countries as his real home."*

The above approach was confirmed in the case of CIR v Kuttel (54 SATC 28) where it was decided that a person is "ordinarily resident" where he/she normally resided, apart from temporary/occasional absences (South African Revenue Service, 2002:2).

In summary, the courts have ruled that the term "ordinarily resident" means that, if it is part of a

person's ordinary regular course of life to live in a particular place with a degree of permanence, he/she must be regarded as ordinarily resident (Levene v Inland Revenue Commissioner [1928] ALL ER Rep. 746 (HL). According to the ruling in H v COT (24 SATC 738), a taxpayer's permanent place of abode was, where his/her belongings were stored, which he/she left for temporary absences and to which he/she regularly returned after such absences (South African Revenue Service, 2002:3).

Where a natural or legal person is not resident in South Africa, capital gains tax will be levied on the disposal of:

- Immovable property situated in South Africa or an interest or right in or to such property; and
- Assets of a permanent establishment through which a trade is carried on in South Africa during the tax year (South Africa, 1962:Eighth Schedule, par 2).

An interest in immovable property is defined as a direct or indirect interest of at least 20% held by a person alone or together with a connected person in the equity share capital of an entity, when, at the time of the disposal of interest, at least 80% of the value of the net assets is attributable to immovable property situated in South Africa (South Africa, 1962:Eighth Schedule, par 2(2)).

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The term "permanent establishment" is also defined in the Act and refers to any establishment, branch, fixed base or agency in South Africa through which a trade, profession or vocation is being carried on (South Africa, 1962:s1).

3.4 Which assets attract capital gains tax?

In terms of the Eighth Schedule, capital gains tax is levied on the disposal of an asset, therefore the meaning of the term "asset" is of vital importance. The term is defined in paragraph 1 of the Eighth Schedule (South Africa, 1962:Eighth Schedule, par 1) as:

- Property of whatever nature, whether movable or immovable, corporeal or incorporeal,

excluding any currency; and

- A right or interest of whatever nature to or in such property.

A right or interest includes any right in or to property including any fiduciary, usufructuary, beneficial or like interest in property (Department of Finance and South African Revenue Service, 2000:8)

It is important to note that certain assets are held on revenue account e.g. "trading stock". If a gain is realized on the disposal of trading stock the proceeds will be taxed under the normal income tax regime and not under the capital gains tax regime (Department of Finance and South African Revenue Service, 2000:8).

3.5 When is capital gains tax triggered?

Capital gains tax is only payable once a capital asset is disposed of. The term "disposal" is also defined in the Eighth Schedule as includes any event, act, forbearance or operation of law that results in the creation, variation, transfer or extinction of an asset. The definition includes:

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- Events where assets are alienated or transfer of ownership takes place e.g. a sale, donation, cession etc;
- Events which include the expiry or abandonment of an asset;
- The scrapping, loss or destruction of an asset;
- The vesting of an interest in an asset of a trust in a beneficiary;
- The distribution of an asset by a company to a shareholder;
- The granting, renewal, extension or exercise of an option;
- The decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement (South Africa, 1962:Eighth Schedule, par 11)).

A value shifting arrangement is described in paragraph 1 of the Eighth Schedule as:

> *"...an arrangement by which a person retains an interest in a company, trust or partnership, but*

following a change in the rights or entitlements of the interests in that company, trust or partnership...the market value of the interest of that person decreases and –

(a) *the value of the interest of another person held directly or indirectly in that company, trust or partner ship increases; or*

(b) *another person acquires a direct or indirect interest in that company, trust or partnership"*

(South Africa, 1962:Eighth Schedule, par1).

A value shifting arrangement therefore involves the effective transfer of value from one entity to another in a manner that does not constitute a "disposal" as defined. Therefore, if this anti-avoidance rule was not present, entities would be able to manipulate the value of assets in order to achieve a capital gains tax benefit. These transactions can take place between persons e.g. family members, or within a group of companies.

However, there are exclusions contained in the Eighth Schedule regarding transactions that are classified as disposals. There are numerous transactions that are excluded from disposals, but the one relevant for this study is:

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- The issuing by a company of its shares and the granting of an option by that company to acquire shares or debt in that company (South Africa, 1962:Eighth Schedule, par 11 (2)(b)).

The implications of capital gains tax on employee share ownership programmes will be discussed in later paragraphs, but it is important to note that the sale of shares between the company and a share trust does not attract capital gains tax, as a disposal did not take place. The only transaction in an employee share ownership program that is relevant for capital gains tax purposes is if the shares are sold by the employee after acquiring them from the company.

To broaden the application of capital gains tax and to counter negative tax planning, certain events are treated as deemed disposals. These events are:

- When a person emigrates or ceases to be a resident, all that person's assets except immovable property situated in the Republic or assets of a permanent establishment through which that

person carries on a trade in the Republic;

- Assets of non-residents which become assets of a permanent establishment in the Republic otherwise than by way of acquisition or assets that cease to be assets of that person's permanent establishment in the Republic otherwise than by way of a disposal;
- Assets that are held by a person otherwise than as trading stock, when they commence to be held by that person as trading stock;
- Personal-use assets which ceases to be personal use assets otherwise than by way of a disposal; and
- Assets, which are not held as personal use assets, which commences to be, held as personal-use assets (South Africa, 1962:Eighth Schedule, par 12).

These deeming provisions are applicable to all taxpayers, not only individuals. If a South African resident company therefore ceases to be a South African resident, capital gains tax is payable on the market value of all its assets (PricewaterhouseCoopers, 2001a:3/4).

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Paragraph 13 of the Eighth Schedule also contains provisions regarding time when the capital gain or loss will be brought into account. This paragraph proposes different time rules for the different forms of disposal (South Africa, 2001:38).

According to paragraph 13, the time of disposal is laid down and these timing rules differ between different types of disposals. Paragraph 13 contains an extensive list of timing rules, but for the purposes of this study, the following rules are applicable:

- An agreement subject to a suspensive condition, is the date that condition is satisfied;
- An agreement which is not subject to any condition, is the date that the agreement is concluded;
- A donation of an asset, the date of compliance with all the legal requirements for a valid donation;
- The granting, renewal or extension of an option, the date that option is granted, renewed or extended;
- The exercise of an option, the date the option is exercised;

- The termination of an option granted by a company to acquire a share, is the date of the event when the option terminates; or
- Any other case, the date of change of ownership (South Africa, 1962:Eighth Schedule, par 13).

Subparagraph (2) of paragraph 13 of the Eighth Schedule proposes that where an asset is disposed of to a person, the person to whom the asset is disposed of, is treated as having acquired that asset at the time of disposal of that asset as contemplated in subparagraph (1) (South Africa, 1962:Eighth Schedule, par 13(2).

Once it is determined that an asset is disposed of and the date of disposal is certain, capital gains tax is triggered. It is important to note that if the date of the disposal is determined by applying the rules of par 13 of the Eighth Schedule, a capital gains tax liability only occurs if the date of disposal is after 1 October 2001 (R Williams, 2001:115).

The next point to consider is the determination of the base cost of the asset in order to calculate the capital gain or loss.

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3.6 Determination of capital gain or loss

A capital gain should be determined for each asset disposed of during a year of assessment. The capital gain is calculated by deducting the "base cost" of the asset from the proceeds from the disposal of the assets, where the proceeds exceed the base cost. Similarly, a capital loss is determined by deducting the proceeds from disposal of the asset from the "base cost" where the base cost exceeds the proceeds (South Africa, 2001:34-35).

Paragraph 3 (b)(i) of the Eighth Schedule also addresses situations, where an asset was disposed of in a previous year of assessment, but part of the proceeds on the disposal were received or accrued, not in the year of disposal, but in the current year. These amounts would not have been brought into account in the year of disposal, and are therefore brought into account in the current year. Paragraph 3 (b)(ii) deals with situations where part of the base cost of assets have been

recouped in the current year, and the recouped amount must be added to the taxpayer's capital gain for the current year (South Africa, 1962:Eighth Schedule, par 3).

Paragraph 3 of the Eighth Schedule therefore garners any realised gain, which is not subject to income tax, unless the gain is exempt from capital gains tax. Any realised gain that has escaped the income tax net is therefore subject to capital gains tax, unless the gain is specifically exempt from capital gains tax. This is proven by the wording of paragraph 3 which does not predicate an inquiry into whether the asset in question was or was not 'of a capital nature' (R Williams, 2001:103).

3.7 Determination of the base cost of an asset

3.7.1 Introduction

One of the most complicated issues is the determination of the base cost of an asset. Different rules apply for disposals of assets acquired before 1 October 2001 and those acquired after 1 October 2001. The provisions for assets acquired before 1 October 2001 will be discussed in later paragraphs. The Eighth Schedule, paragraph 20, does contain provisions regarding expenditure that may be deducted for capital gains tax purposes, as part of the base cost (PricewaterhouseCoopers, 2001a:6).

3.7.2 What is included in the base cost of capital assets?

Paragraph 20(1) (a) to (c) of the Act stipulates which amounts actually incurred form part of the base cost of capital assets. The general rule is that the base cost includes those costs actually incurred in acquiring, enhancing or disposing of a capital asset. The following are example of costs that are specifically included:

- Cost of acquisition of the asset;
- Cost of creating an asset;
- Cost of obtaining a valuation for capital gains tax purposes;

- Remuneration of professional advisors;
- Transfer costs;
- Stamp duty and transfer duty; and
- Cost of exercising an option to acquire an asset (South Africa, 1962:Eighth Schedule, par 20).

Apart from the costs mentioned above, certain other costs are specifically included in the base cost of an asset. These costs are:

- The expenditure actually incurred in establishing or defending a legal title to the particular asset (South Africa, 1962:Eighth Schedule, par 20 (1)(d)); and
- Costs of improving or enhancing the asset can also be added to the base cost of the asset, if the improvement is reflected in the state of the asset at the time of disposal (South Africa, 1962:Eighth Schedule, par 20 (1)(e)).

It is important to note that although the cost of improving or enhancing an asset can be added to the base cost, it is subject to the further provision of paragraph 20 (3)(a) which states that such expenditure is not deductible for income tax purposes (South Africa, 1962:Eighth Schedule, par 20).

Paragraph 20 (1)(f) of the Eighth Schedule of the Act deals with options, more specifically, where an option was acquired before 1 October 2001, but the asset was only acquired after 1 October 2001 (South Africa, 2001: par 20). It was mentioned in earlier paragraphs that the cost of an option that is exercised forms part of the base cost of the asset. In the case of an asset that was acquired after 1 October 2001 as a result of an option acquired before that date, the market value of the option as at 1 October 2001 is included in the base cost of the asset (South Africa, 2001:46).

The provision of paragraph 20 (1)(f) is illustrated in the following example:

On 1 July 2001 Kosie paid R 10 000 for a six-month option to acquire a beach cottage at a price of R 30 000. On 1 October 2001 the market value of the option was R 5 000. He exercised the option on 1 December 2001 and paid R 300 000 for the cottage. The base cost of Kosie's cottage will therefore be R 300 000 + R 5 000 = R 305 000."

Table 3.2: The application of paragraph 20(1)(f) of the Eighth Schedule (R Williams, 2001:130)

Costs that are specifically excluded from the base cost of assets are current costs, for example, borrowing costs, expenditure on repairs, maintenance, insurance and rates and taxes other than costs and expenditure contemplated in paragraph 20(1)(g). Under paragraph 20(1)(g), the base cost of an asset includes certain categories of expenditure 'directly related to the cost of ownership' of an asset that is used wholly and exclusively for business purposes. This provision seems to contemplate not the cost of acquiring the asset, but the on-going cost of ownership, the holding costs of the assets. These costs include repairs and maintenance, insurance, rates and taxes and interest (R Williams, 2001:131). This implies that Value Added Tax ("VAT") that can be claimed as an input deduction, are excluded from the base cost of assets.

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Further guidance regarding interest on money borrowed to finance expenditure incurred in the cost of acquiring or creating an asset is provided in paragraph 20 (g)(iii). According to this provision, interest as contemplated in section 24J incurred in respect of the cost of acquiring or creating an asset, or interest incurred in effecting an enhancement of the value of the asset, provided the improvement is still reflected in the state of the asset at the time of disposal, is included in the base cost of assets. This provision must be read in conjunction with paragraph 20(2) of the Eighth Schedule, which provides that the base cost of an asset excludes borrowing costs other than borrowing costs summarised in paragraph 20 (g)(iii) (R Williams, 2001:131/132).

Therefore, in order to be included in base cost, such expenditure must meet the criteria laid down in paragraph 20 (1)(g) and even if the expenditure qualifies for inclusion in base cost, it is deducted from base cost if it falls within paragraph 20 (3). Paragraph 20 (3) of the Eighth Schedule contains specific exclusions from the base cost of assets. It is proposed that the base

cost of assets must be reduced in the following cases:

- If the expenditure was already claimed in determining the taxable income for normal income tax purposes. This prevents the double deduction of expenditure;
- Expenditure that was recovered or recouped; and
- An anti-avoidance measure, that excludes all expenditure unpaid and not due and payable when the asset is disposed of (South Africa, 1962:Eighth Schedule, par 20(3)).

The contents of par 20 (1)(h) states that certain costs that are included in gross income as a result of the acquisition of the asset, may be added to the base cost of the asset. These gains are:

- Where an option is granted to an employee under section 8A of the Act; and
- Taxable fringe benefits in terms of the Seventh Schedule of the Act.

The implications of par 20 (1)(h) will be discussed in future chapters.

Anti-avoidance measures are also set out in paragraph 21 of the Eighth Schedule. The principles of paragraph 21 resembles the provisions of Section 23 B of the Act and states that if an amount qualifies as allowable expenditure in determining the capital gain or capital loss under more than one provision of the Eight Schedule, the amount shall not be taken in to account more than once as an anti double-count provision (South Africa, 1962:Eighth Schedule, par 21).

Paragraph 21 also states that no expenditure shall be allowed as a deduction under paragraph 20 which states the amounts to be included in the base cost of assets if the amount to be included in the base costs has been limited under any other provision of the Eighth Schedule (South Africa, 1962:Eighth Schedule, par 21).

3.7.3 Determination of the base cost of assets acquired before 1 October 2001

As mentioned in paragraph 3.7.1, the determination of the capital gain for assets acquired before 1 October 2001 is different from assets acquired after 1 October 2001. The determination of the base cost of an asset acquired before 1 October 2001, is the sum of the valuation date value as at 1 October 2001, determined in accordance with paragraph 26 or 27 of the Eighth Schedule of the

Act and the expenditure allowable in terms of paragraph 20 which was incurred *after* 1 October 2001 in respect of that asset (South Africa, 1962:Eighth Schedule, par 25).

Where assets that were acquired prior to 1 October 2001 are disposed of, and the proceeds from the disposal of the assets exceed the expenditure allowable in terms of paragraph 20 of the Eighth schedule, incurred both before and after 1 October2001, the taxpayer may adopt any of the 3 options as the valuation date value of the asset:

- The market value of the asset on 1 October 2001;
- 20 per cent of the proceeds form the disposal of the asset, after deducting the expenditure allowable under paragraph 20 of the Eighth Schedule incurred after the valuation date; or
- the time-apportionment base cost of the asset, as described in paragraph 30 of the Eighth Schedule (South Africa, 1962:Eighth Schedule, par 26).

Paragraph 26 of the Eighth Schedule of the Act addresses the question of determining the base cost of an asset where the where the expenditure incurred before 1 October 2001 in respect of the asset can not be determined. Under these circumstances, the taxpayer may elect any of the following methods for determining the value of the asset as at 1 October 2001:

- The market value of the asset as at 1 October 2001; or
- Twenty per cent of the proceeds from disposal of the asset, after deducting from the proceeds the allowable expenditure in terms of paragraph 20, incurred *after* 1 October 2001 (South Africa, 1962:Eighth Schedule, par 26).

If a taxpayer adopted the market value as the base cost of the asset, acceptance of this method depends on whether the ultimate disposal proceeds, exceed the market value. If the proceeds from the disposal of the asset do not exceed the market value, the taxpayer must substitute the higher of the following amounts as the valuation date of the asset:

- The expenditure allowable in terms of paragraph 20 of the Eighth Schedule incurred *before* 1 October 2001; or

- The proceeds less the expenditure allowable in terms of paragraph 20 of the Eighth Schedule incurred *after* 1 October 2001 (South Africa, 1962:Eighth Schedule, par 26).

An example of the application of paragraph 26 is presented in table 3.3 below:

Werner disposed of a pre-valuation date asset after the valuation date. He had elected to adopt market value at the valuation date and proceeds do not exceed market value. Details of the transaction are as follow:

Expenditure before valuation date	R 100 000
Expenditure after valuation date	R 25 000
Market value at valuation date	R 200 000
Proceeds upon disposal	R 150 000

The valuation date value of the asset is determined as the higher of

- The expenditure allowable in terms of paragraph 20 of the Eighth Schedule incurred *before* 1 October 2001 (R 100 000); or
- The proceeds less the expenditure allowable in terms of paragraph 20 of the Eighth Schedule incurred *after* 1 October 2001(R 125 000).

Therefore the valuation date value equals R 125 000.

The base cost of the asset disposed of equals R 150 000 (R 125 000 + R 25 000). No capital gain/loss arises from this transaction, as the proceeds (R 150 000) equal the base cost (R 150 000).

Table 3.3: The application of paragraph 26 of the Eighth Schedule (R Williams, 2001:143/144)

The above rule is in effect a loss limitation rule, which eliminates "phantom" capital losses where the market value has been adopted at valuation date but proceeds exceed actual or historic

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cost (South Africa, 2001:53).

The time-apportionment base cost of a capital asset is described in paragraph 30 of the Eighth Schedule of the Act. Paragraph 30 proposes a formula to be used in order to determine the time-apportionment base cost of an asset. The time-apportionment method involves the apportionment of the difference between the proceeds on disposal of the capital asset and the acquisition costs of the asset on a straight-line basis between the period the asset was held prior to 1 October 2001 and after 1 October 2001 (PricewaterhouseCoopers, 2001a:9). Two variations, catering for different circumstances, are discussed. The first variation is used when an asset was acquired before 1 October 2001, and no additions or reductions to that asset occurred for more than one period of assessment prior to 1 October 2001. The first variation is therefore used when no further expenditure, apart from the initial cost of acquisition of the asset, was incurred.

The formula is determined as:

$$Y = \frac{B + [(P - B) X N]}{T + N}$$

Where

Y = the base cost of the asset to be determined

B = the allowable expenditure in terms of paragraph 20 of the Eighth Schedule of the Act, which was incurred *before* 1 October 2001.

P = the proceeds on disposal of the capital asset

N= the number of years (or part thereof) that the asset was owned *prior* to 1 October 2001.

T = the number of years (or part thereof) that the asset was owned *after* 1 October 2001

(South Africa, 1962:Eighth Schedule, par 30).

The second formula contained in paragraph 30 of the Eighth Schedule is used when further expenditure, apart from the acquisition cost of the asset, was incurred.

The first formula can still be used to determine the base cost of the asset, but the calculation of the proceeds on disposal of the capital asset ("P" in the above formula) is calculated by applying the following formula:

$$P = \frac{T \times B}{(A + B)}$$

Where

P = the proceeds on disposal of the capital asset

T = the total amount of the proceeds on disposal of the capital asset

A = the allowable expenditure in terms of paragraph 20 of the Eighth Schedule of the Act, which was incurred *on or after* 1 October 2001.

B = the allowable expenditure in terms of paragraph 20 of the Eighth Schedule of the Act, which was incurred *before* 1 October 2001

(South Africa, 1962:Eighth Schedule, par 30).

The application of the formulas as stipulated in paragraph 30 of the Eighth Schedule is illustrated in table 3.4 below:

Susan acquired land in Johannesburg 30 years prior to 1 October 2001 for R 200 000 and disposed of the land 10 years after the valuation date for R 2 000 000. Susan incurred no further expenses in terns of paragraphs 20 of the Eighth Schedule regarding her ownership of the land, and she adopted the time-apportionment basis in determining the valuation date value. The capital gain that arises in Susan's hands is determined as follows: Y = B + [P – B] x (N / (T + N))] = 200 000 + [(2 000 000 – 200 000) x (30 / (10 + 30))] = 200 000 + (1 800 000 x 30/40) = 200 000 + 1 350 000 = R 1 550 000 Therefore the time-apportionment base cost equals R 1 550 000. The capital gain is calculated as R 450 000 (R 2 000 000 – R 1 550 000).

Table 3.4: The application of paragraph 30 of the Eighth Schedule (R Williams, 2001:156).

Another provision of paragraph 30 states that "N" as stipulated in the first formula, cannot exceed 20 years when the second formula is used, in other words, if expenditure was incurred in

more than one year of assessment in respect of the capital asset, the total number of years that may be used to indicate the period that the asset was owned *prior* to 1 October 2001, is 20 (South Africa, 1962:Eighth Schedule, par 30).

Paragraph 27 of the Eighth Schedule proposes a method to determine the valuation date value of an asset disposed of where the proceeds do not exceed expenditure allowable in terms of paragraph 20 of the Eighth Schedule, incurred both before and after that date (South Africa, 1962:Eighth Schedule, par 27).

Under paragraph 27, a taxpayer may determine the valuation date value of the asset as any of the following:

- Where the market value was not adopted on the valuation date, the valuation date value of that asset is the time-apportionment base cost of that asset; or
- Where the market value was adopted on the valuation date, then that market value

(South Africa, 1962:Eighth Schedule, par 27(1)).

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However, if a person adopts the market value, then it is proposed that the valuation date value of that asset disposed of must be determined as the *lower* of:

- The market value, or
- The time-apportionment base cost of that asset

(South Africa, 1962:Eighth Schedule, par 27(1)(b)).

The principle contained in the first bullet-point above, can be illustrated in table 3.5 below:

Xerxes acquired an asset 10 years before the valuation date for R 100 000 which was disposed of 5 years after the valuation date for R 80 000. Market value of R 120 000 had been adopted at valuation date.

Expenditure before valuation date	R 100 000

Market value at valuation date	R 120 000
Proceeds upon disposal	R 80 000

As market value has been adopted, the valuation date value of the asset must be determined as the lower of-

- Market value (MV); or
- The time-apportionment base (TAB) cost of that assets

Therefore, the lower of –

- 120 000; or
- TAB cost =

= 100 000 + [(80 000 – 100 000) x (10/5) +10)]

= 100 000 + (-20 000) x 2/3)

= 100 000 – 13 333

= 86 667

equals R 86 667

Proceeds	80 000
Base cost	86 667
Capital loss	R 6 667

In this example, paragraph 27 is applicable as proceeds do not exceed expenditure allowable in terms of paragraph 20 incurred both before and after the valuation date. As the market value has been adopted and it exceeds expenditure allowable in terms of paragraph 20 (paragraph 27(2) is therefore not applicable), the lower of market value or TABC is the valuation date value to be utilised. The effect is to limit the capital loss to the loss that would be allowable on a time-apportionment basis.

Table 3.5: The application of paragraph 27(1) of the Eighth Schedule (South Africa, 2001:54)

Paragraph 27(2) further states that where the market value method is adopted, and the expenditure allowed under paragraph 20 of the Eighth Schedule incurred before the valuation date in respect of the asset exceeds both he proceeds from the disposal of the asset and the market value of that asset, the valuation date value of the asset is the *higher of*:

- The market value; or
- Those proceeds less the expenditure allowable in terms of paragraph 20 incurred *after the* valuation date in respect of that asset.

An example of the application of paragraph 27(2) is presented in the table 3.6 below:

Expenditure before valuation date	R 100 000
Market value at valuation date	R 90 000
Proceeds upon disposal	R 80 000

The valuation date value of the asset must be determined as the higher of –

- Market value (MV); or
- Those proceeds less the expenditure allowable in terms of paragraph 20 incurred after the valuation date.

Therefore, the higher of –

- R 90 000; or
- R 80 000 (R 80 000 – nil)

Equals R 90 000.

Proceeds	R 80 000
Base cost	R 90 000
Capital loss	(R 10 000)

In this example, paragraph 27 is applicable as proceeds do not exceed expenditure allowable in

terms of paragraph 20 incurred both before and after the valuation date. As the market value has been adopted and it does not exceed expenditure allowable in terms of paragraph 20 incurred before the valuation date, the higher of market value or proceeds less expenditure *after* valuation date is the valuation date value to be utilised.

Table 3.6: The application of paragraph 27(2) of the Eighth Schedule (R Williams, 2001:146/147)

The result of the provisions of paragraph 26 and 27 of the Eighth Schedule of the Act is that, although a taxpayer has a choice of which method to adopt in order to determine the base cost of the capital asset, the choice depends on the proceeds on disposal of the asset being higher than the base cost of the asset and the allowable expenditure incurred *before or after* 1 October 2001. These provisions force the taxpayer to use a method that will ensure that capital gains tax is, for example, not levied where the market value is adopted to determine the base cost and the market value is below original cost and the asset is sold for a price falling between market value and original cost. Likewise, these provisions also ensure that a capital loss is not claimed where the market value on 1 October 2001 exceeds the original cost and the asset is sold for a value falling between the market value and the original cost (Van Rooyen, 2001:1).

For the purposes of paragraph 26 and 27 of the Eighth Schedule, a person may only adopt the market value as the valuation date value of that asset if that person has valued that asset within two years after valuation date (South Africa, 1962:Eighth Schedule, par 29(4)).

Therefore, the valuation must be performed as at 1 October 2001, but the taxpayer has time to value the asset until 30 September 2003. The valuation obtained must be kept until the asset is disposed of in a particular year, except in the following cases where the valuation must be handed in with the first return submitted after 30 September 2003:

- An asset with a market value that exceeds R 10 million;
- An intangible asset with a market value greater than R 1 million; and
- The market value of unlisted shares in a company if the market value of all the shares exceed R 10 million

(South Africa, 1962:Eighth Schedule, par 29(5)).

3.7.4 Determination of market value

The term "market value" is used throughout the Eighth Schedule of the Act and specific rules are set out in paragraph 29 of the Eighth Schedule in order to determine the market value of certain assets. Table 3.7 sets out a summary of what is meant when reference is made to "market value".

Financial instruments listed on a recognized stock exchange	Average of listed buying and selling closing prices at close of business on last trading day before disposal
Long-term insurance policy	The greater of: • Surrender value, or • Insurer's market value
Unit trust and property unit trusts	Management company's repurchase price
Foreign unit trust	Management company's repurchase price, or if not available, selling price on willing buyer and willing seller acting at arm's length in the open market
Fiduciary, usufructuary and other like interest	Present value of future benefits discounted at 12% over the live expectancy of the person entitled to the asset or lesser period of enjoyment. The Commissioner may approve a rate of less than 12% where this is justified.
Property subject to fiduciary, usufructuary or other like interest	Market value of full ownership, less the value of the fideicommissum, usufruct etc as determined above.
Immovable farming property	• Land Bank (as defined in the Estate Duty Act) • Price based on willing buyer/willing seller at arm's length in an open market. On disposal by death, donation, or non-arm's length

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	transaction, the Land Bank value may be used only if it is used in determining the base cost of the disposed on- • Valuation date, or where applicable, • The date acquired by inheritance, donation, or non-arm's length transaction at Land Bank value
Any other asset	Price based on willing buyer and willing seller acting at arm's length in the open market
Unlisted shares	Price based on willing buyer and willing seller acting at arm's length in the open market, ignoring any: • Restriction on transferability • Stipulated valuation method

Table 3.7: The determination of market value according to the Eighth Schedule (South Africa, 1962:Eighth Schedule, par 31).

If a taxpayer has a group of identical assets, it may be difficult to determine the market value of each individual asset. Identical assets are dealt with in paragraph 32 of the Eighth Schedule as a group of similar assets which, if any one of them were disposed of, it would realize the same amount of proceeds as any of the other asset in the group. Another criteria, is that these assets are not individually distinguished, apart from any identifying numbers which they may bear (e.g. share certificates). Under these circumstances, taxpayers can adopt one of three alternative methods to determine the market value:

- Specific identification;
- First in first out (Oldest asset is sold first); or
- Weighted average (South Africa, 1962:Eighth Schedule, par 32).

The weighted average method involves a calculation of the average unit cost after the acquisition of an asset by adding the cost of the newly acquired assets to the cost of the existing assets on hand and dividing this figure by the new total (PricewaterhouseCoopers, 2001a:9). The weighted average method may not be used where the base cost of the asset is determined using the time-based apportionment, as it is necessary to know the date of acquisition of each asset under the

time-based apportionment method. If the assets are pooled, the individual acquisition dates will not be known (South Africa, 2001:65).
The only provision is that, once a method has been adopted, this method must be applied until all the assets in the particular class have been disposed of (South Africa, 2001:66).

If only part of an asset is disposed of in the year of assessment, a formula is used, as stipulated in paragraph 33 of the Eighth Schedule, to determine which part of the base cost of the total asset must be taken into account when determining the capital gain or loss. The formula stipulates that the market value of the part of the asset disposed off as a percentage of the market value of the entire asset prior to disposal must be calculated. This percentage must be multiplied with the base cost of the entire asset to determine the base cost of the part of the asset disposed of (South Africa, 2001:67).

3.8 Proceeds on disposal of assets

The proceeds on disposal of assets is the amount received by or accrued to the taxpayer when the asset is disposed of. Proceeds are reduced by amounts that were already taken into account when the taxpayer's taxable income was determined, e.g. wear and tear recoupments are deducted from the proceeds on the sale of capital assets. Similarly, proceeds are reduced by the amount of proceeds that were repayable to the person to whom the asset was disposed of (South Africa, 1962:Eighth Schedule, par 35).

In paragraph 35, it is also noted that, where a taxpayer has become entitled to any amount which is payable after the last day of the year, the amount must be treated as having accrued to the person during that year (South Africa, 1962:Eighth Schedule, par 35).

An amount is "accrued" when the taxpayer becomes "entitled" to the amount in the sense that the taxpayer has acquired an unconditional right to it, even though the amount may not yet have been paid to the taxpayer. In CIR v Golden Dumps (Pty) Ltd (55 SATC 198), it was held that a liability was "incurred" only when a dispute was actually resolved against him. Therefore, an amount only accrues to the taxpayer if or when the dispute is resolved in his favour. The amount

will accrue to the taxpayer in the year when the agreement is reached, even though the dispute involved the income of several years.
It is therefore submitted that there is no accrual, if there is a genuine dispute as to the entitlement of the amount in question (R Williams, 2001:173).

Disposals by way of donation is also treated as a disposal of asset and paragraph 38 of the Eighth Schedule of the Act proposes that the donation is treated as a disposal of the asset by the donor and an acquisition of the asset by the donee at market value. If the asset was disposed of for a consideration which is not measurable in money, or the disposal was to a connected person for a consideration which does not reflect an arm's length price, the market value of the asset substitutes the actual consideration to which the parties agreed (South Africa, 1962:Eighth Schedule, par 38).

Another rule regarding disposals to connected persons is contained in paragraph 39 of the Eighth Schedule (South Africa, 1962:Eighth Schedule, par 38). Capital losses as a result of disposals of capital assets to connected persons are ring-fenced, so that the capital losses could only be deducted from capital gains determined in respect of other disposals to the same connected persons to whom the disposal giving rise to that loss was made (Stein, 2001b:1). The capital losses as a result of transactions with connected persons may therefore not be brought into account in determine the taxpayer's aggregate capital gains or capital loss for the year of assessment.

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3.9 Exclusions from the capital gains tax net

The main exclusion from capital gains taxation is contained in paragraph 45 of the Eighth Schedule of the Act, which states that the first R 1 million of the capital gain or capital loss realized on the disposal of a primary residence is disregarded for capital gains tax. In other words, where a capital gain or loss exceeds R 1 million, the excess is subject to capital gains tax (South Africa, 1962: Eighth Schedule, par 45).

It is important to note that only one residence of a person may be regarded as the "primary

residence" for any period. The R 1 million exclusion is also applicable "per primary residence" and not on a "per person holding an interest in the primary residence" basis.

An example of the application of paragraph 45 of the Eighth Schedule is presented in table 3.8 below:

Obert purchased a residence to be utilised solely as a primary residence on 1 October 2001 for a total cost of R 1 250 000. Five years later Obert sells this primary residence for R 2 500 000 in order to purchase another primary residence. Assuming Obert pays income tax at the maximum marginal rate of 42% and that he has no other capital gains or losses in the tax year in question, his additional income tax liability as a result of the capital gain realised is determined as follows:

Proceeds	R 2 500 000
Base cost	R 1 250 000
Capital gain	R 1 250 000
Disregarded in terms of par 45(1)	R 1 000 000
Balance subject to CGT	R 250 000
Annual exclusion	R 10 000
Aggregate capital gain	R 240 000
Taxable gain (R 240 000 x 25%)	R 60 000
Tax payable (R 60 000 x 42%)	R 25 200

In this example only 4,8% (R60 000/R 1 250 000) of the total capital gain is finally subjected to taxation.

Table 3.8: The application of paragraph 45 of the Eighth Schedule (R Williams, 2001:187/188).

A primary residence is defined in paragraph 44 of the Eighth Schedule as a residence in which:

- A natural person or special trust holds an interest; and
- The natural person or spouse, beneficiary of the trust or his spouse personally and ordinarily

reside in this residence as the main residence and the residence is used for domestic or private residential purposes (South Africa, 1962:Eighth Schedule, par 44).

This means that a company, close corporation or trust (other than a special trust) owning a residence used as a primary residence by a shareholder, member or beneficiary would not qualify for the exclusion of a capital gain made upon disposal of such primary residence for capital gains purposes (R Williams, 2001:186).

The term "ordinarily resident" was addressed in earlier paragraphs. It is therefore noted that non-residents cannot have a permanent residence in South Africa, as they are not ordinarily resident in South Africa (R Williams, 2001:186).

There are various other implications and rules regarding primary residence stipulated in the Eighth Schedule of the Act, but for the purposes of this study, only the main criteria are discussed.

The Eighth Schedule of the Act does contain certain other provisions regarding transactions that are excluded from capital gains tax. The main reason for transactions falling outside the capital gains tax net, is because the assets are of a personal-use nature. Personal-use assets are all the assets of a natural person or special trust, except to the extent they are used for the purposes of carrying on of a trade (South Africa, 2001:86).

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However, paragraph 53 of the Eighth Schedule contains a list of assets, which, if a gain is realized on the disposal of these assets, the gains will fall into the capital gains tax net, but capital losses realized on their disposal, will be disregarded. The rationale for this decision is contained in the Explanatory Memorandum on the Taxation Laws Amendment Bill which states that certain personal use assets that are likely to generate substantial capital gains as a result of market forces are included. These assets may be subdivided into two categories:

- Assets whose reduction in value is most likely attributable to the personal use and consumption of the asset; and
- Assets whose reduction in value is most likely as a result of the influence of market forces

(South Africa, 2001:40).

Paragraph 15 of the Eighth Schedule deals specifically with the first category of assets. It would be theoretically correct to determine capital gains or losses on the disposal of assets in the first category by reference to a base cost that has been reduced by applying a notional wear and tear allowance to reflect personal use and consumption. As this is a complex calculation for both taxpayers and the tax authorities, it is proposed that capital losses on the disposal of these assets are disregarded and that only capital gains in excess of the base cost be taxed (South Africa, 2001:40).

Therefore, the disposal of the assets listed below will result in taxable capital gains, but any capital losses will be disregarded:

- Aircraft, with an empty mass exceeding 450 kilograms;
- A boat exceeding 10 meters;
- Any fiduciary, usufructuary or other similar interest, the value of which decreases over time;
- Any lease of immovable property; or
- Any right or interest of whatever nature to or interest in an asset contemplated in the items listed above (South Africa, 1962:Eighth Schedule, par 15).

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An example of the application of paragraph 15 is presented in table 3.9 below:

Duncan purchases a light aircraft for R 1 00 000, which he uses to visit his private game farm. He disposes of the aircraft for R 9 00 000 six months later when he disposes of the game farm.	
Proceeds	R 900 000
Base cost	R 1 000 000
Cost	R 1 000 000
Capital allowance	nil
Loss	R 100 000
Disregarded	R 100 000
Capital loss	nil

Table 3.9: The application of paragraph 15 of the Eighth Schedule (R Williams, 2001:118).

Another important exclusion from the capital gains tax net, is contained in paragraph 58 of the Eighth Schedule, which states that the capital gain or loss incurred by a taxpayer as a result of the termination of an option, as a result of the exercise of an option by the taxpayer, be disregarded for capital gains tax. The reason for the exclusion, is that any amount paid for an option, other than a personal-use asset, is allowed as part of the base cost of the asset and therefore qualifies as allowable expenditure in terms of paragraph 20 of the Eighth Schedule (South Africa, 1962:Eighth Schedule, par 58).

An example of the application of paragraph 58 is presented in table 3.10 below:

Geert purchases an option to acquire a farm for farming purposes. He pays R 100 000 for the option to acquire the farm at a price of R 1 million. When the option is exercised, the base cost in respect of the farm will be as follows:

Cost of acquisition (par 20(1)(a))	R 1 000 000
Cost of option (par 20(1)(ix))	R 100 000
Base cost	R 1 100 000

The option, which is an asset and which had a cost of R 100 000, has terminated as a result of the exercising of that option. There is a capital loss of R 100 000. In terms of paragraph 58 of the Eighth Schedule, this loss is disregarded, otherwise the farmer would get a double benefit: the benefit of the capital loss of R 100 000 in respect of the option, and the benefit of having this amount included in the base cost of the farm.

Table 3.10: The application of paragraph 58 of the Eighth Schedule (R Williams, 2001:208).

Other exclusions are contained in Part VIII of the Eighth Schedule (South Africa, 1962:Eighth Schedule, Part VIII), but for the purposes of this study are not discussed in detail. A few examples of these exclusions are listed below:

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- Lump sum benefits from retirement benefit funds;
- Long-term assurance;
- Debt defeasance;
- Disposal of small business assets;
- Compensation for personal injury, illness or defamation;
- South Africa gambling, games and competitions;
- Unit trust funds: gains and losses by a unit portfolio in a unit trust scheme;
- Donations and bequests to public benefit organizations;
- Exempt persons; and
- Assets used to produce exempt income (Coutinho, 2001:7).

3.10 Conclusion

Capital gains tax is an integral part of the income tax system in South Africa. Capital gains will be calculated under the provisions of Schedule Eighth of the Act, and included in taxable income. The result is that a taxpayer's taxable capital gains will be determined separately from his or her income tax. Proceeds taxed under the act are not taxed again under the capital gains tax provisions. Expenses deducted under the act will not form part of the base cost of the assets for capital gains tax purposes.

Section 26A of the Act provides that capital gains, determined in accordance with the Eighth Schedule, will be subject to tax. By introducing capital gains tax as part of the Act the need to deal separately with matters such as returns, assessments, objections, appeals, payments, interest, penalties and recovery of tax fell away. In other words, unless otherwise specified, the general provisions of the Act also apply to capital gains tax.

In the next chapter, the basic employee share ownership schemes used in South Africa will be discussed. These schemes gained popularity in recent years, and the tax benefits associated with these schemes is one of the major contributors for the increase in popularity. The implications of capital gains tax on the historically tax-free capital gains is therefore an important factor to consider when entering into transactions operated by these schemes.

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CHAPTER FOUR

Employee share ownership programmes (ESOPs)

4.1 Introduction

Employee share ownership programmes are gaining popularity in South Africa. It is common for companies to assist employees in acquiring shares in the company. The assistance granted is financial and this enables the employee to acquire the shares of the company at a lower cost than he would have were the employee to acquire the shares with his own funds or borrowed funds.

The benefits of employee share ownership programmes (hereafter ESOPs) can be summarized as follow:

> *"The growth of employee ownership is recent decades has been a significant development in the areas of business competitiveness, employee compensation, corporate finance and business continuation. Though there are several forms of employee ownership, employee stock ownership plans, or ESOPs, have achieved the most widespread acceptance and support. The rapid and continuing growth in the number of ESOP's being established and the breadth of industries covered have important ramifications for employees, corporations and the economy as a whole."*

(ESOP Association; as quoted by The Katz Commission, 1995:155).

According to the Third Interim Report of the Katz Commission (1995:158) the encouragement of employee share ownership has great significance in the South African environment in that:

- There is concern about the high degree of concentration in the South African economy and about the importance of taking steps to encourage deconcentration;
- There is a desire to democratize the ownership of assets, which entails the spreading of ownership among a greater number of individual shareholders in the private sector; and
- There is the desire to promote employee economic empowerment.

The Margo commission (1986:par 6.33) examined employee share schemes and its recommendations were as follows:

> *"The incentives provided by bona fide schemes of that nature are regarded as being of great economic value in encouraging productivity and a healthy relationship between employer and employee through the holding by the latter of an investment stake in the company..."*

The introduction of share incentive schemes has been on the increase internationally since the late seventies. The reason for this is twofold:

- The incentive makes sound business sense, as a well-designed scheme can benefit both the employer and employee. The scheme allows the employee to share in the growth of the company, which improves employee loyalty and well as the relationship between employer and employee; and
- The scheme is linked to tax incentives. This is mainly the reason why the schemes were so popular in the United Kingdom (hereafter UK) and United States (hereafter US), whereby a company's contribution to the employee share incentive trust was tax-deductible.

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If South African companies are not willing to implement one of the more tax-aggressive schemes, for example, deferred delivery (as discussed in paragraph 4.3.3), their reasons for implementing a scheme cannot be for tax purposes. The interest in share incentive schemes is firmly rooted in equity redistribution in South Africa. Dr Louis O Kelso summarized the matter as follows:

> *"...only through widespread capital ownership could modern economies provide for a more equitable distribution of wealth...widespread application of the ESOP concept would thus promote broadened ownership of wealth through free enterprise initiatives rather than resorting to government redistribution (of income) through taxation."*

(Kelso, as quoted by Katz Commission, 1995:157-158).

In the South African context, companies are turning to share schemes in growing numbers in order to attract skilled staff. These schemes entitle employees to purchase shares in a company

at a future date at a price decided when the options are awarded (McLeod & Eedes, 2000:8).

As Joubert (2000:6) puts it:

> *"A share incentive scheme is aimed at incentivising and retaining employees thus brining about various indirect benefits"*

These schemes are intended to operate as an incentive to employees to remain in employment, so that employees' rights to dispose of the shares acquired under the scheme is generally tied to the length of the period of their service, and any premature termination of the service may result in the employee being compelled to sell back the shares to the trust at a loss (Broomberg & Kruger, 1998:233).

Although share incentive schemes are popular tools to motivate personnel, there is a risk attached. The idea of giving employees options is to let them share an investor-type logic; to carry risk. If an employee's shares are repriced, the scheme will no longer motivate staff; the main objective of share schemes. Certain schemes do contain a "stop-loss" provision, which will be discussed in later paragraphs to neutralize the effect of a declining share price (Joubert, 2000:6).

Until recently, the single, simple, one-word reason why share incentive schemes were an attractive way to motivate employees was: tax. By acquiring an equity stake in the employer, an employee obtained tax-free capital growth (Mazansky, 1992:40). This has now changed with the implementation of capital gains tax in South Africa, and the implications on share incentive schemes will be discussed in the next chapter.

Apart from capital gains tax, there are numerous regulations contained in the Income Tax Act affecting employee share schemes. These are discussed in the following paragraphs.

4.2 Regulations affecting employee share ownership programmes

4.2.1 Companies Act requirements

As the assistance to purchase shares in the company is of a financial nature, the requirements of the South African Companies Act (South Africa, 1973:s38) must be adhered to. Section 38 (1) of the Companies Act contains a general prohibition against a company giving financial assistance for the purchase of, or subscription for its or its holding company's shares. The section states:

> *"No company shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares of the company, or where the company is a subsidiary company, of its holding company."*

In summary (Marx & Claassen, 1997:4-8), section 38 therefore prohibits a company to grant financial assistance (whether by means of a loan, security or otherwise) for the purpose of, or in connection with, the purchase of shares in

- The company; or
- It's holding company.

There are exclusions to the general rule, as set out in section 38(2):

- If the main business of the company is the lending of money;
- Lending of money to a trust to purchase shares to be held on behalf of the employees (including salaried directors); and
- Lending of money to employees to purchase shares to be held by themselves in their own names (excluding directors.)

The exclusions provided in the last bullet point is seldom used as most employee share schemes

operate through a trust that borrows money from the company. The trust, using these funds, then acquires the shares in the company, which it then on-sells to the employees of the company. The trust is formed for the sole reason of obtaining shares in the company and selling it again to the employees of the company.

The stipulations of section 38 of the Companies is therefore not violated, as paragraph 38 (2) excludes financial assistance granted by a company to a trust. The Income Tax Act also provides guidance on these transactions.

4.2.2 Income Tax Act requirements

The Income Tax Act contains certain provisions when employees acquire shares under an employee share scheme. There are three ways that the Income Tax Act can impose tax on employees under an employee share scheme.

The first method is the application of section 8A of the Income Tax Act. Section 8A states, that there must be included in an employee's income the amount of any gain made by him:

> *"by the exercise, cession or release during such year of any right to acquire any marketable security..... if such right was obtained by the taxpayer as a director or former director of any company or in respect of services rendered or to be rendered by him as an employee to an employer"*

(South Africa, 1962:s8A).

Note that the word "option" is not mentioned in section 8A. Although employee share schemes are often referred to as "share option schemes", the terminology is not correct. If an employer offers shares to an employee, the employer does not grant a formal option to the employee, but the employee nevertheless acquires a right. The employee has a right to accept the offer and that right persists until the offer is withdrawn or lapses. Therefore, if an employee accepts a simple offer, a sale will result, and the provisions of section 8A may apply (Broomberg & Kruger, 1998:233).

A number of elements must be present before the right obtained by the employee to acquire the shares falls into the tax net of section 8A. These elements were addressed in the case ITC 1493 (40 SATC 187). The court laid down rules that have to be met before section 8A will apply:

- There must be a right capable of being exercised or ceded or released. The right does not have to be an option, as long as the right would "...bring into existence a contract of sale of allotment by way of the director or employee exercising that right";
- The right, when exercised, must entitle the employee to acquire "marketable securities" as defined. These include shares;
- Some other person must have granted the right to the employee;
- The right must have been granted to the taxpayer as a director or former director, or for services rendered or to be rendered by him as an employee to an employer. This paragraph indicates that shares granted to an independent contractor will not fall into ambit of section 8A. Similarly, if the right was acquired under a general rights issue made to all shareholders, the right was not obtained by the taxpayer in respect of services rendered to the employer, and the provisions of section 8A will not apply; and
- There must be a valid exercise of the right, and a communication of the exercise of the right to the grantor.

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Section 8A also contains an anti-avoidance provision to which the taxpayer should pay attention. If the gain is made by a person other than the employee or director, due to the exercise, cession or release of the right to acquire the shares, the gain will still be taxable in the hands of the employee or director if the right was originally obtained:

- By any person by reason of the director's office or former office or any services rendered by the taxpayer as an employee.

However, if the gain is made by way of exercise of the option, but by reason of a condition imposed by the employer the taxpayer cannot dispose of the marketable security until after the end of the year of assessment, the taxpayer may elect to have the gain included in his income in the year of assessment during which he becomes entitled to dispose of the marketable security

(Meyerowitz, 2000-2001:9-35).

The gain, which constitutes income, is computed as follows:

- If the right is exercised, the gain is the amount by which the market value of the marketable security at the time the right is exercised exceeds the consideration given by the taxpayer for the marketable security and any consideration given by him for such right;
- If the right is ceded or released, the gain is the amount by which the value of the consideration received by the taxpayer for the right exceeds the value of any consideration given by the taxpayer for the right.

"Market value" as referred to in above paragraphs relates to the sum which a person having the right freely to dispose of such security might reasonable expect to obtain from a sale of the security in the open market (South Africa, 1962:s8A (2)(a)).

The Income Tax Act also imposes income tax on employees acquiring shares under an employee share scheme in another way. This provision relates to the financing of the shares acquired and is stipulated in the Seventh Schedule of the Income Tax Act, which relates to taxable fringe benefits granted to employees.

Paragraph 11 of the Seventh Schedule states that where a loan has been granted to an employee and the interest payable by the employee is less than the official interest rate, there is a taxable benefit, the value of which is the difference between the amount calculated at the official rate and the interest payable by the employee (Meyerowitz, 2000-2001:9-30).

A taxable gain therefore arises in the hands of the employee if the employer grants him a loan to acquire the shares, and this loan does not bear interest at a rate of 13% or higher. The amount of the taxable benefit is the excess of the rate of 13% over the rate of interest actually paid by the employee applied to the amount of the loan outstanding. The taxable benefit is added to the employee's other taxable income and taxed in the same manner (PricewaterhouseCoopers, 1999b:2).

4.2.3 Exchange Control regulations

It may happen that an employee of a South African subsidiary of an overseas holding company is entitled to acquire shares in the holding company by means of an employee share scheme. In these circumstances, the rules of Exchange Control must be adhered to.

Without Exchange Control approval, a South African resident may not enter into a commercial or financial arrangement with a non-resident. Approval is generally granted to allow an employee to use the foreign investment allowance of R 750 000 to invest in shares of the foreign company, and retain the shares offshore. Income earned on the retained foreign shares may be retained offshore (PricewaterhouseCoopers, 1999a:2).

4.2.4 Johannesburg Stock Exchange rules

As employee share schemes are gaining popularity among listed companies, the rules of the Johannesburg Stock Exchange must be adhered to. The rules apply to share schemes of companies which are listed on the Johannesburg Stock Exchange as well as the employee share schemes of subsidiaries of listed companies. An employee share scheme requires the approval of a general meeting of shareholders (PricewaterhouseCoopers, 1999b:3).

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The scheme must contain provisions relating to:

- The category of persons to whom or for whose benefit shares may be purchased and issued under the scheme;
- The total number of the securities which may be utilised in the scheme which must be stated together with the percentage of the issued share capital that it represents;
- A fixed maximum entitlement of any one participant;
- The amount payable on application or acceptance;
- The basis for determining the purchase, subscription or option price;
- The period in which payments or loans may be paid or after which payments or loans must be paid;

- The terms of any loan and the procedure to be adopted on termination of employment or retirement of a participant; and
- Voting, dividend, transfer and other rights, including those arising on a liquidation of the company, attaching to the shares and to any option.

Further, the listed company must, in respect of its or its subsidiary company schemes, summarise in its annual financial statements the number, in the case of a listed company, and the percentage in the case of a subsidiary company, of shares which may be utilised for purposes of the scheme at the beginning of the accounting period, changes in such number or percentage during the accounting period and the balance of the shares available for utilisation for the scheme at the end of the accounting period (PricewaterhouseCoopers, 1999b:4).

4.3 Types of employee share ownership programmes in South Africa

There are various types of ESOP's in South Africa, but for the purposes of this study, only selected schemes will be addressed. The basic principle behind all these schemes is to assist employees financially in acquiring shares in the company by providing the shares at a lower cost than the employee would have paid if he were to acquire the shares with his own funds or borrowed funds.

For purposes of this chapter, the following ESOP's are discussed:

- Share purchase Scheme;
- Share Option Scheme;
- Deferred Delivery Scheme;
- Convertible Debenture Scheme; and
- Offshore Share Scheme.

4.3.1 Share Purchase Scheme

Under this scheme, a share trust is formed and funded by the company. The share trust acquires

shares in the company and the subscription price of the shares is funded by a loan from the company to the share trust. The company is entitled to make loans to the share trust to enable the trust to purchases shares in the company for the benefit of employees, as stipulated in paragraph 4.2.1. The trust then sells the shares to the employees on credit, either on an interest-free or low interest basis. The purchase price of the shares is fixed at the current market value of the shares. As mentioned in paragraph 4.2.2, a taxable benefit will arise if the employee acquires the shares at a consideration, which is lower than market value. As the employee acquires the shares at market value, no taxable gain arises. As a loan is granted to the employee, the provisions of paragraph 11 of the Seventh Schedule must be taken into account. As the loan usually carries interest at a low or zero rate, a taxable fringe benefit arises.

According to Broomberg & Kruger (1998:233), share purchase schemes are intended to operate as an incentive to employees to remain in the employment of the company, and the employees' right to dispose of the shares is generally tied to the length of period of their service, and any premature termination of the service may result in the employee having to sell back the shares to the share trust at a cost. This is one of the distinct disadvantages of this scheme, as the employee may have to forfeit the shares. In such a case, the tax on the interest fringe benefit was unnecessary.

These schemes are based on the legal principle that any benefit derived from employment must be taken into account, for tax purposes, on the date that the employee acquires the rights to the benefit (Broomberg & Kruger, 1998:233). Under a share purchase scheme, the only right that the employee acquires, is the right to acquire shares. The date of the accrual of the right is therefore the date that the employee acquires the shares. As the employee purchases the shares at current market value, there is no difference between the consideration paid by the employee and the market value at the date of the exercise of the right, and therefore no taxable gain arises.

This scheme is no longer popular as the avoidance of the taxable gain is outweighed by the tax, which may be wasted, on the interest fringe benefit. If the employee is obliged to pay market-related interest on the loan, his financial benefit will be much less (PricewaterhouseCoopers, 1999a:3).

The interest fringe benefit is not the only disadvantage of share purchase schemes. If the share price declines, the employee might end up paying tax on an interest fringe benefit based on the original debt, which is now in excess of the current market price of the shares. For this reason, many schemes contain a "stop loss" provision. Under this provision, the share transaction between the share trust and the employee may be cancelled if the value of the shares decline to a certain level. As Joubert (2000:6) states:

> *"Obviously (these) objectives are not reached when a decline in the share price causes employees to suffer impoverishment."*

Under these circumstances, an exemption from tax is provided by the Income Tax Act regarding benefits arising to employees from the cancellation of a share incentive scheme.

Par 10 (1)(*n*E) of the Income Tax Act specifically excludes from income tax:

> *"any amount (including any taxable benefit determined under the provisions of the Seventh Schedule) received by or accrued to an employee, as so defined, under a share incentive scheme operated for the benefit of employees of that taxpayer's employer, as so defined, which was derived-*
>
> *(i) upon the cancellation of a transaction under which the taxpayer purchased shares under such scheme; or*
>
> *(ii) upon the repurchase from the taxpayer, at a price not exceeding the selling price to him, of shares purchased by him under such scheme,*
>
> *if in consequence of such cancellation or repurchase the taxpayer has not received or become entitled to receive any compensation or consideration other than the repayment of any portion of the purchase price actually paid by him"*

(South Africa, 1962:s 10(1)(*n*E)).

According to Joubert (2000:6) the stop loss provision contained in the Act presumably has the same purpose of returning employees, from a tax perspective, to the financial position that they were in before participating in the scheme. However, the application of the act achieves the opposite result. The accepted view is that a section 8A gain, which arises due to the exercise of a

right to acquire shares, is a taxable event that cannot be exempted under section 10(1)(nE) in a future year of assessment. Section 10(1)(nE) also only exempts "amounts" which accrued due to either the cancellation or the repurchase of the shares. This definition excludes gains since such gains result from the exercise of the right to acquire such shares in a prior year and not from the cancellation or repurchase of the shares (Joubert, 2000:6).

The principle argument made out to support the exclusion of a section 8A gain from the operation of section 10(1)(nE) is that the gain is not made "upon the cancellation of a transaction" or "upon the repurchase" of the shares. The application of section 10(1)(nE) of the Act clearly provides a more equitable regime for the taxation of the gains made by employees in circumstances where they are impoverished due to declining share prices (Joubert, 2000:7).

If a share trust therefore cancels the transaction and repurchases the shares from the employee, the repayment of the original purchase price does not attract any income tax. However, it is unusual for the share trust to reacquire the scheme shares each time there is a drop in the share price below that at which the shares were disposed of to the employees (Broomberg & Kruger, 1998:234).

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4.3.2 Share Option Scheme

In this scheme, the share trust grants options to employees to acquire shares in the company, normally at current market value. The employees are entitled to exercise the options at any time during a specified period, but are usually prohibited from exercising the options until they have served the company for a certain number of years. Upon the exercise of the options, the employee pays for the shares and it is registered in his name.

This scheme differs from a share purchase scheme, in that the employee pays for the shares with his own funds, so no taxable interest fringe benefit arises. Only the provisions of section 8A of the Income Tax Act are applicable. As mentioned in paragraph 4.2.2, a taxable gain arises if the market value at the date of the exercise of the right, (in this case, the option) exceeds the consideration the employee has to pay for the shares. Usually, due to the time lapse between

granting the options and exercising the options, the market value of the shares exceed the original market value at the time when the options were granted. A taxable gain arises, being the excess of the market value of the shares when the option is exercised over the amount payable by the employee for the shares, which is the market value at the time when the option is granted (PricewaterhouseCoopers, 1999a:4).

The advantage of this scheme is that the employee is not exposed to the risk of market values of shares declining to a level below the option price. If the share prices do not increase, the employee simply does not exercise the option. However, the taxable gain when the option is exercised is a disadvantage.

One of the disadvantages of a share option scheme is that it gives members false expectations. The company's share price may increase and suddenly drop again. If the share price falls to a lower level, members tend to forget that they are still better off. For this reason, share option schemes work well in a rising stock market and for companies that show solid, long-term growth (McLeod D & Eedes, J, 2000:9).

4.3.3 Deferred Delivery Scheme

Deferred Delivery Schemes gained a lot of popularity, which is aimed at avoiding the tax disadvantages of the share purchase and share option schemes. Under a Deferred Delivery scheme, the employee enters into an agreement, usually with the share trust, to acquire the shares at current market value. However, the shares are not registered in the employee's name, and are held by the trust or are not even issued until they have been registered in the name of the employee. The employee is therefore not required to pay for the shares until they are delivered to him at a later date (Broomberg & Kruger, 1998:234).

This scheme is designed to avoid the provisions of section 8A of the Income Tax Act, as the right to acquire the shares is exercised at the date the agreement of sale is concluded. As the price payable for the shares equals the market value at the time of their purchase, no taxable gain arises. It is also argued that section 8A cannot apply on the delivery date when the shares are

registered in the name of the employee and the employee must pay for the shares, because there is no exercise by the employee of a right to acquire shares: both parties are merely fulfilling their pre-existing mutual obligations.

The disadvantage of the interest fringe benefit is also avoided, as no loan or credit is granted to the employee. The shares are not delivered to the employee and there can be no amount owing to the share trust until delivery is effected (Broomberg & Kruger, 1998:234).

According to Broomberg & Kruger (1998:234), it is difficult to have an acquisition of shares and simultaneously no acquisition for the purpose of section 8A and furthermore, no payment for the purpose of the Seventh Schedule.

In the light of the ever increasing tendency on the part of the courts to refuse to be side-tracked by technicalities, the prospects of this scheme surviving an attack, whether under section 103(1) of the Income Tax Act or otherwise, must be considered to be doubtful (Broomberg & Kruger, 190:234).

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However, numerous opinions have been given on the tax implications of this scheme. The consensus is that the tax disadvantages are avoided. The scheme has been in use for at least 10 years, but it is not unlikely that it will be attacked by the Revenue authorities in the future, by appropriate legislative amendments or by testing it in court. In practice, however, the scheme is still extensively used, with appropriate provisions to allow for it to be amended or undone should such an attack materialise (PricewaterhouseCoopers, 1999a:5).

4.3.4 Convertible Debenture Scheme

Under this scheme, instead of the employee acquiring shares, the company issues interest-bearing debentures to the share trust which are convertible into ordinary shares of the company. The date when these instruments can be converted is usually specified e.g. when reaching certain performance targets or after giving so many years of service (PricewaterhouseCoopers, 1999b:6).

The employee is loaned the money to buy the convertible debentures. The interest payable by the employee is deductible from the interest earned on the debentures. As long as the interest paid by the employee equals or is higher than the official interest rate, no interest fringe benefit arises. The only other provision that must be kept in mind, are the requirements of section 8A of the Income Tax Act. It can be argued that a taxable gain arises in the hands of the employee on the conversion of the debentures into shares. When the employee acquires the shares, a taxable gain arises as the difference between the market value of the shares on conversion date and the actual consideration payable for the shares by the employee (PricewaterhouseCoopers, 1999a:6).

4.3.5 Offshore Share Schemes

As mentioned in paragraph 4.2.3, the company might operate a single share incentive scheme for the benefit employees of all the companies in the group, wherever the employees or companies are located. A typical example is when the holding company is situated abroad and it operates a share incentive scheme entailing the acquisition by qualifying employees of its shares. These schemes are usually performance-based, where the performance of a particular employee determines his entitlement to options (PricewaterhouseCoopers, 1999a:8).

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As indicated in paragraph 4.2.3, a South African resident can only benefit from such schemes to the extent of shares costing R 750 000 or less. However, if the shares are acquired at no cost, the R 750 000 limit will not apply, and the employee can obtain all the shares and retain them offshore.

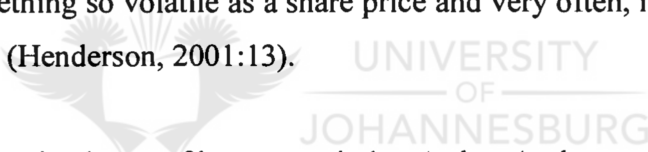
It is important to note that the employee will be taxed in South Africa on any gain realised as a result of his participation in the offshore share scheme, as the employee is a South African resident.

4.4 Performance-based Schemes

As mentioned in the previous paragraph, there is a growing trend to make share schemes performance-based. Under these schemes, an employee's initial participation in the scheme is

dependent upon him achieving stipulated performance targets. This scheme is designed as a long-term incentive tool, but received some criticism. Henderson (2001:13) argues that an increase in incentives will not necessarily lead to increases in profitability of the company, but despite the difficulties, there does appear to be a link between overall executive remuneration levels and company performance. However, share options are extremely useful, but often over- or misused. These schemes should be a part of an organisation's total remuneration scheme, not a substitute for it.

Another disadvantage of performance-based schemes is the effect when share prices drop to very low levels. In the United Kingdom last year, Marks & Spencer shareholders protested over the restructuring of the management share option scheme to take account of the fact that the company's share price had dropped below the option price. The loss of value of options can be a great demotivator at precisely the time when employees most need motivating. It can be suggested that the remuneration package of only the most senior executive level management should be linked to something so volatile as a share price and very often, more stable methods of motivating can be found (Henderson, 2001:13).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As Maureen Hovy, partner in charge of human capital at Arthur Andersen states:

> *"There is no way you can retain staff without a balanced combination of guaranteed pay and incentive schemes. You need to be able to offer a choice and structure people's packages accordingly. These choices would not be limited to cash and benefits, but may include innovative exchanges of salary or cash incentives for share options."*

(McLeod, J & Eedes, J: 2000,11)

4.5 Conclusion

It is apparent that the tax advantages connected to share incentive schemes are numerous, as the employee can obtain tax-free capital growth on his equity stake in the employer. From the employer's point of view, these schemes are popular as well, as they are widely used to motivate personnel and remain in employment as the employees' rights to dispose of the shares acquired

under these schemes is generally tied to the length of the period of their service.

The current tax net will widen with the introduction of capital gains tax, as the disposal of shares held by employees in a share incentive scheme will trigger a further capital gains tax liability.

With the implementation of capital gains tax, the employee will not receive tax-free capital growth, but the proceeds on the sale of the shares might attract capital gains tax. As mentioned in earlier paragraphs of this study, capital gains tax is not a separate tax, but is an integral part of the income tax system in South Africa.

By imposing capital gains tax on the sale of the shares, one of the main advantages of share incentive schemes will be under threat.

In the following chapter, the implications of capital tax on certain ESOP's will be discussed.

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CHAPTER FIVE

Capital gains tax implications on employee share ownership programmes (ESOP's)

5.1 Introduction

Until recently, South Africa did not implement capital gains tax, which was one of the great advantages of share schemes. Employees participated in ESOPs instead of receiving additional remuneration or bonuses. By acquiring an equity stake in the employer, the employee obtained tax-free capital growth (Mazansky, 1992:40).

However, all of this changes with the implementation of capital gains tax in South Africa on 1 October 2001. The capital gain made from the disposal, on or after 1 October 2001, of an asset will be subject to capital gains tax. More correctly, the taxable gain will be subject to income tax, to the extent it is not already so subject (PricewaterhouseCoopers, 2001b:3). As discussed in paragraph 3.5, a sale included in the definition of 'disposal' and capital gains tax will therefore be triggered if the employee decides to sell the shares acquired under an employee share ownership program.

The next consideration is the determination of the base cost of the shares sold, as capital gains tax is calculated by deducting the "base cost" from the proceeds from the disposal of the shares, as discussed in paragraph 3.6 of this study. The essence of this issue is whether the employee can use the market value of the share on 1 October 2001 to determine its deductible base cost in computing the capital gain made on the ultimate disposal by the employee of the share.

In this chapter, the implications of capital gains tax will be discussed with reference to the following types of employee ownership programmes:

- Share Purchase Scheme
- Share Option Scheme
- Deferred Delivery Scheme.

5.2 Capital Gains Tax implications on Share Purchase Schemes

As discussed in paragraph 4.3.1, under this scheme, the employee purchases shares in the share trust on credit, and the purchase price of the shares is fixed at the current market value of the shares. For capital gains tax purposes, it is therefore necessary to determine:

- If the shares constitute an asset for capital gains tax purposes;
- If the subsequent sale of the shares by the employee constitute a disposal for capital gains tax purposes; and
- The determination of the base cost of the shares.

As discussed in paragraph 3.4 of this study, capital gains tax is levied on the disposal of a capital asset, and the term "asset" is defined in paragraph 1 of the Eighth Schedule. "Assets" include property of whatever nature and a right or interest of whatever nature to or in such property. A share in a company therefore meets the definition of an asset.

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The next point to consider is if the sale of the shares by the trust to the employee constitutes a disposal for capital gains tax purposes.

According to paragraph 3.5 of this study, capital gains tax is triggered once an asset is disposed of. The term "disposal" is defined in the Eighth Schedule and includes any event, forbearance or operation of law that results in the creation, variation, transfer of extinction of an asset. Various transactions are stipulated in the Eighth Schedule as examples of "disposals" and the event where transfer of ownership takes place, e.g. a sale, constitutes a disposal for capital gains tax purposes (South Africa, 1962:Eighth Schedule, par 11). When the employee therefore decides to sell the shares acquired under a Share Purchase Scheme, a disposal for capital gains tax purposes take place and capital gains tax may be triggered.

Once it is determined that a disposal for capital gains tax took place, it is necessary to determine the date of disposal. The date of disposal was discussed in paragraph 3.5 of this study. Subparagraph (1) of paragraph 13 of the Eighth Schedule determines the date of disposal. In the

case of a Share Purchase Scheme, the following scenario is relevant:

- When the agreement is not subject to any condition, the date of disposal is the date when that agreement is concluded.

Under a Share Purchase Scheme, the only right that the employee acquires, is the right to acquire shares. The date of accrual of the right is therefore the date that the employee acquires the shares (Broomberg & Kruger, 1998:233). Therefore, from the time a share offer is made or a share option is granted to an employee by the trust, until the share is delivered and released to the employee, he is a beneficiary of the share trust. After the shares were registered in the name of the employee, any gain or loss that is realized on the subsequent sale of the shares will be subject to capital gains tax in the hands of the employee. If the shares sold cannot be physically identified from the share portfolio the taxpayer holds, the rule contained in paragraph 32 of the Eighth Schedule is applied. The application of paragraph 32 of the Eighth Schedule was discussed in paragraph 3.7.4 of this study, and permits the taxpayer to use one of three alternative methods for establishing the base cost of identical assets, namely the specific identification method, the first in first out method or the weighted average method. However, once the employee has selected a method of determining the deductible base cost of the shares, this method will be applied to all the shares sold subsequently (South Africa, 1962:Eighth, Schedule, par 32(6)). However, it is important to note that the weighted average method may not be used where the base cost of the asset is determined using time-based apportionment, as under time-based apportionment, it is necessary to know the date of acquisition of each asset. If assets are pooled, this will not be possible (South Africa, 2001:65).

As mentioned in paragraph 3.7.2 of this study, the base cost of an asset includes those costs actually incurred in acquiring, enhancing or disposing of a capital asset. Different provisions apply to assets acquired before 1 October 2001. Paragraph 25 of the Eighth Schedule states that the base cost of an asset acquired before 1 October 2001 is the sum of the value as at 1 October 2001 and the deductible expenditure in terms of paragraph 20 which was incurred *after* 1 October 2001 in respect of that asset. (South Africa, 2001:60)

According to table 3.2 contained in this study, the market value of listed shares as at 1 October 2001 is the five day average price of the shares on the Johannesburg Securities Exchange for the five days immediately preceding the valuation date (1 October 2001) (South Africa, 1962:Eighth Schedule, par 31(1)(a)).

However, the value of the assets as at 1 October 2001 must be determined in terms of paragraph 26 and 27 of the Eighth Schedule. The provisions of paragraph 26 state that the seller may determine the value of the asset as at 1 October 2001 as the market value on 1 October 2001, 20% of the proceeds from the disposal of the asset or the time-apportionment base cost of the assets, if the proceeds on disposal exceed the expenditure incurred both before and after 1 October 2001, i.e. the asset is sold at a profit. If the assets are sold at a price that is lower than the market value of the shares on 1 October 2001, the value of the shares will be the higher of the expenditure incurred before 1 October 2001 (i.e. the cost price) or the actual proceeds less the expenditure incurred after 1 October 2001. The purpose of this provision is to avoid the recognition of an artificial loss where the shares are sold at or below cost, but below the market price as at 1 October 2001 (South Africa, 2001a:53).

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The market value of shares listed on the Johannesburg Securities Exchange is the quoted price on 1 October 2001. Due to fear that substantial players will manipulate the share prices on 1 October 2001, the average closing value for the five trading days quoted from Monday 24 September 2001 to Friday 28 September 2001 will be used. If the employee therefore elects the market value method of determining the base cost of the shares acquired, the quoted price on 1 October 2001 will be deducted from the proceeds of the shares, if the proceeds exceed the market value (PricewaterhouseCoopers, 2001a:8).

It is also necessary to address the capital gains tax implication on the share trust and the company, prior to the registration of the shares in the name of the employee. In paragraph 3.5 of this study it was mentioned that the issuing by a company of its shares and the granting of an option by a company to acquire shares in that company is exempt from capital gains tax. Therefore the sale of the shares by the company to the share trust does not attract capital gains tax, as per paragraph 11 (2)(b) of the Eighth Schedule (South Africa, 1962:Eighth Schedule, par

11(2)(b)).

The deed for the share trust normally provides that the company is entitled to trust surpluses and bears the trust's losses. It thus may be said that the company is a secondary or residuary beneficiary of the trust. A trust and its beneficiaries are therefore connected persons. (PricewaterhouseCoopers, 2001:8) Paragraph 38 of the Eighth Schedule contains specific provisions regarding the treatment of transactions between related parties (South Africa, 2001:par 38).

Firstly, a capital gain resulting from a disposal of a trust asset to a resident trust beneficiary is to be ignored in the hands of the trust and treated as that beneficiary's gain. A capital gain arising from the disposal of a trust asset will also be taxed in the hands of the beneficiary with no vesting right to that asset if that gain is vested in that beneficiary in the year in which it arises (South Africa, 2001:106).

In summary it can be said that, if a capital gain arises in the trust and the gain vests in the company, as beneficiary, in the same tax year as the gain arose in the trust, the gain must be accounted for in the company and not the trust. This may be beneficial, as the effective capital gains tax rate of a company is lower than that of a trust (PricewaterhouseCoopers, 2001b:8).

As a beneficiary of a trust is a related party (as stipulated in section 1 of the Eighth Schedule), the provisions contained in paragraph 38 and 39 of the Eighth Schedule become relevant (South Africa, 1962:Eighth Schedule, par 38/39). According to paragraph 38, the market value of the asset is substituted for the actual consideration to which the related parties agreed in the case of a disposal, which does not reflect an arm's length price (South Africa, 2001:71). Paragraph 39 of the Eighth Schedule states that capital losses in respect of a disposal of an asset to a connected person is ring-fenced, so that it could only be deducted from capital gains determined in respect of other disposals during that or any subsequent year to the same person to whom the disposal giving rise to the loss was made. The loss is therefore disregarded and carried forward and may only be deducted from future capital gains in respect of the disposal of assets to the same person, if they are still connected persons (South Africa, 2001:72).

As a result of the issue of shares to or the acquisition of shares by the trust, the company usually has a claim against or a loan account in the trust, which is an asset of the company. If the company writes down or writes off this loan account on or after the valuation date there will be a disposal by the company to the trust, and the facts discussed in the previous paragraph will apply.

5.3 Capital Gains Tax implications on Share Option Schemes

Under this scheme, the employee is granted an option to acquire shares in the company, normally at current market value. Upon exercise of the options, the employee pays for the shares and they are registered in his name. The capital gains tax implications for the employee after the shares were registered in his name is identical to that of the Share Purchase Scheme.

Again, although the granting of an option is included in the definition of a "disposal" for capital gains tax purposes, the granting of an option by a company to acquire shares in that company is exempt from capital gains tax.

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5.4 Capital Gains Tax implications on Deferred Delivery Schemes

As mentioned in paragraph 4.3.3 of this study, this scheme is very popular as it is aimed at avoiding the tax disadvantages of the Share Purchase Scheme and the Share Option Scheme. Under a deferred delivery scheme, the employee is granted an option, to acquire the shares at their current market value. However, the shares are not registered in the name of the employee, and are held by the trust or are not even issued until they have been registered in the name of the employee. The employee is only required to pay for the shares when they are delivered to him at a later date.

The main capital gains tax issue, which will be dealt with first, covers the situation where the employee acquired the share (i.e. accepted the offer or exercised the option) before 1 October 2001 but the share will only be delivered (registered in his name) after this date.

If an option to acquire shares under a share options scheme was exercised prior to 1 October 2001, difficulties arise regarding the actual asset that should be valued for capital gains tax purposes. When shares held in a share incentive scheme are sold, the issue to consider is whether the asset in this regard is:

- The option (or right to acquire shares); or
- The underlying shares themselves (PricewaterhouseCoopers, 2001b:4).

If an option to acquire shares were exercised prior to 1 October 2001, the option no longer exists. However it is debatable if the option is replaced by the purchase and sale of the share previously subject to the option.

For the option to be replaced by the actual share subject to the option, ownership of the shares had to pass. According to South African law principles, ownership will only pass if;

- The purchase price had been paid for or credit has been granted; and
- Delivery has taken place.

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Depending on the rules of the share incentive scheme, the price owing by the employee will only be paid when delivery of the shares is made. Until such date, the ownership of the shares will not pass on the day that the option is exercised (PricewaterhouseCoopers, 2001b:6).

If the option does not therefore exist any more due to it being exercised, and the actual shares have not been delivered yet, the question arises as to what asset is held by the employee on 1 October 2001? The option is replaced on the day it is exercised with a right to claim delivery of the underlying shares. For capital gains tax purposes, this right is as asset, as the definition of an asset includes "a right or interest' in property.

Therefore, on 1 October 2001, the owner of the shares (the trust) still holds the shares and if it consist of listed shares; it has to be valued according to the five-day rule. The employee merely has a right to demand delivery of the shares.

Paragraph 20 (2) of the Eighth Schedule provides that the base cost of an asset excludes "the valuation date value of any option or right to acquire any marketable security contemplated in section 8A(1)" of the Income Tax Act.

This principle was discussed in the well-know case of Sir v Kirsch (40 SATC 95), where the learned judge ruled that the word "right is not to be construed as solely denoting the correlative of a legal duty or obligation, but must be accorded its wider general meaning.

Another motivation for the fact that the option is not the "valuation date asset" is present in the case of Hersch v Nel, where it was said that:

> "*...an option consists of an offer to sell to the grantee and an agreement to keep this offer open for a stipulated time; prior to the exercise of the option the only agreement between the parties is that the grantor shall not revoke the offer to sell; this is a bilateral agreement but pending the exercise of the option there is a unilateral obligation on the part of the grantor not to revoke the offer to sell; if the offer to sell is accepted by the grantee, a bilateral contract of sale comes into existence.*"

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Another important factor in the determination of the capital gains tax exposure is the definition of assets as at 1 October 2001. The Eighth Schedule refers to assets that were acquired before 1 October 2001 and only sold afterwards as "pre-valuation date assets". These assets must therefore still be held on 1 October 2001.

The definition of the word "held" is not unambiguous (PricewaterhouseCoopers, 2001b:6). According to Meyerowitz (2000-2001:par 9.89), a person may hold without being the owner and a person may dispose of a thing by parting from it but not necessarily the ownership. The word "held', connotes at least possession.

It was held in Bisset Rajak & Co v Taylor (1967 (3) SA 515 (T)), that the word "held' is not unambiguous. It was noted that:

> *"The word "held", when used with reference to shares, connotes at least possession (Cf.*

> *Union Government v De Kock, N.O, 1918 AD at p. 33); and it does not connote a jus in personam ad rem acquiendam ...."*

The Latin expression quoted above means a personal right to acquire ownership, which is what the employee had or held on 1 October 2001.

If this meaning of "held" applied it would mean that the share would not be a pre-valuation date asset of either the employee, as he does not own of possess the share or the trust, as, although the trust would have acquired the share before, and will own and possess it on 1 October 2001, it would have previously been disposed of, before 1 October 2001 (PricewaterhouseCoopers, 2001b:7).

The word "held" can therefore be interpreted as "not disposed of", as it is evident from the Eighth Schedule that the terms "disposal" and "acquisition" predominate for capital gains tax purposes, not possession and ownership. (PricewaterhouseCoopers, 2001b:7).

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It can therefore be concluded that in the circumstances the pre-valuation date asset of the employee is the share, the subject matter of the purchase and sale agreement. If the employee sells it at a later date, the deductible base cost of the shares must be determined in accordance with paragraph 4.3.1 of this study.

According to paragraph 4.3.1, the base cost of an asset includes those costs actually incurred in acquiring, enhancing or disposing of a capital asset. According to paragraph 25 of the Eighth Schedule, the base cost of assets acquired before 1 October 2001 is determined in accordance with paragraph 26 or 27 of the Eighth Schedule, including the expenditure incurred in terms of paragraph 20 of the Eighth Schedule after 1 October 2001 (South Africa, 1962:Eighth Schedule, par 25).

If proceeds from the disposal of the shares exceed the expenditure, the taxpayer may adopt any of the 3 options as the valuation date value of the asset:

- The market value of the shares on 1 October 2001;
- 20 per cent of the proceeds form the disposal of the shares, after deducting the expenditure allowable under paragraph 20 of the Eighth Schedule incurred after the valuation date; or
- The time-apportionment base cost of the shares, as described in paragraph 30 of the Eighth Schedule (South Africa, 1962:Eighth Schedule, par 26).

Shares that are listed on the Johannesburg Stock Exchange for which a price is quoted on 1 October 2001 are to be valued at the average closing value for the five trading days before 1 October 2001 as mentioned in paragraph 3.7.4 of this study.

As 29 and 30 September 2001 fall on a weekend, this means that the prices quoted from Monday 24 September 2001 to Friday 28 September 2001 will be used. The reason for the adoption of averaged prices instead of the quoted price on 1 October 2001 is due to the fear that substantial players will manipulate the market on 1 October 2001 (PricewaterhouseCoopers, 2001:7/8).

It is therefore concluded that the capital gains tax on the eventual sale of shares under a deferred delivery scheme will be calculated as follows:

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Werner disposed of a shares acquired under a deferred delivery scheme after 1 October 2001. He had elected to adopt market value at the valuation date and proceeds do exceed market value. Details of the transaction are as follow:

Expenditure after valuation date	R 25 000
Market value at valuation date	R 200 000
Proceeds upon disposal	R 250 000

The valuation date value of the asset is determined as:

- The market value of the asset on 1 October 2001 as contemplated in paragraph 29 of the Eighth Schedule.

Therefore the valuation date value equals R 200 000.

The base cost of the shares disposed of equals R 225 000 (R 200 000 + R 25 000). The capital gain arising from this transaction is calculated as follows:

Proceeds less base cost	R 250 000 – R 225 000.
Capital gain	R 25 000

Table 5.1: The calculation of the base cost of the sale of shares under a Deferred Delivery Scheme

If the employee elected the market value of the shares as the base cost of the asset, but on disposal, the proceeds received on the sale of the shares do not exceed the market value of the shares, the valuation date value of the shares must be calculated in accordance with paragraph 26 (3) of the Eighth Schedule (South Africa, 1962:Eighth Schedule, par 26(3)).

An example of the application of these circumstances was discussed in table 3.3 of this study.

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5.5 Conclusion

Before 1 October 2001, gains realised on the disposal of shares held under ESOP's were of a capital nature, and therefore not subject to income tax. However, all of this changed as the capital gains made from the disposal on or after 1 October 2001 of shares held under ESOP's will be subject to capital gains tax. More correctly, the taxable gains will be subject to income tax, to the extent that it is not already so subject.

The main capital gains tax issues applicable to ESOP's is the determination of the base cost of the shares. It has been explained in this chapter that, if the shares were acquired via an Option Scheme, the valuation date asset subject to capital gains tax is not the option. The option was exercised before the valuation date and, upon its exercise, it ceased to exist, being replaced by a purchase and sale of the share previously subject to the option (PricewaterhouseCoopers, 2001b:5).

It is therefore apparent from the practical example of the application of capital gains tax on ESOP's that the implications of capital gains tax on previously popular transactions with attractive tax results will have to be reassessed in the light of the newly introduced capital gains tax legislation. In the next chapter, the implications of capital gains tax in South Africa will be summarised, and possible new topics of study on this matter will be introduced.

CHAPTER SIX

Summary

"A modern Midas might complain that everything he touches turns into tax. Many ordinary mortals, unhappily, seem to suffer from the same malaise. In fact, because of the gradual broadening of the tax base, it is no longer easy to call to mind any economic act devoid of tax implications.

If, of course, these fiscal repercussions were certain and immutable, the only responses would be rise in revolt (which used to be the fashion) or to wince and bear it. However, the tax laws do not fall evenly. One result is that timeous tax planning could achieve positive tax savings; however; a failure to maintain tax efficiency could conceivable cause a catastrophe"

(Broomberg & Kruger, 1998:1).

6.1 Introduction

"Fourteen months after its conception in last year's Budget review, and after a long and painful labour and much inter-uterine surgery, the capital gains tax legislation was finally revealed in parliament on 5 April 2001,when the Minister of Finance tabled the Taxation Laws Amendment Bill 2001" (B Williams, 2001:1).

Capital gains tax was implemented in South Africa with effect from 1 October 2001. The Budget Speech delivered in Parliament by Finance Minister Trevor Manual on February 23, 2000 that made the initial announcement was from a taxation point of view the most far-reaching Budget ever delivered in South Africa's history.

An important factor is that this legislation will bring South Africa in line with the majority of other countries. In a world that is characterised by an almost infinite mobility of capital and skills, it is of fundamental importance that our tax system in all of its aspects, including base rates, methods of taxation, concepts and the language of the legislation, should, as far as is possible, be the same as the rest of the world (Katz, 2001:1).

A likely outcome of the introduction of capital gains tax is that it facilitates further tax reform. Since Government will receive a direct yield from capital gains tax as well as an indirect yield from the rounding-off impact that capital gains tax has on ordinary income tax, it makes the ordinary income tax system more effective, further concessions in the personal income tax system will become more affordable and politically attainable. This was already present in the very Budget that introduced capital gains tax containing some fairly extensive reductions in personal income tax, including more specifically, reductions in the maximum marginal rate of tax (Katz, 2001:2).

This study focussed on the application of the core provisions of capital gains tax in South Africa, with specific reference to ESOP's, and has now reached its conclusion. All that remains is to reflect on a number of new topics that may be researched.

6.2 Conclusion

The introduction of capital gains tax is a fundamental inclusion to the existing tax legislation, although not always a welcome one. The implication of capital gains tax on existing popular tax planning structures e.g. ESOP's illustrates the urgency for proper tax planning and the possible reassessment of available structures to reduce tax liability.

This study on capital gains tax in South Africa and the specific reference to ESOP's has researched a number of aspects, highlighted a number of problems and provided suggestions to facilitate their resolution from a South African perspective. There are a number of new topics that may be researched as a result of this study.

6.3 New research topics

This study on capital gains tax could result in a number of related topics. These topics include the following:

- Are South African trusts effective investment vehicles for non-residents? – a CGT

perspective;

- The capital gains tax implications on persons leaving South Africa;
- Capital gains tax implications on Inbound Expatriates; and
- The taxing cost of donations.

6.4 Summary

This study provides South-African based individuals and non-residents with practical guidance on how to interpret the core provisions of capital gains tax. Practical examples of the application of certain core provisions were provided. The far-reaching implications of capital gains tax on transactions with historical tax advantages e.g. ESOP's was discussed in order to illustrate the need to give careful consideration to all the tax implications of financial decisions.

It is therefore of the utmost importance that individuals and companies alike assess current tax structures in order to ensure that they still keep one step ahead of the ever widening tax net to avoid expensive surprises when the next assessment lands on their respective desks.

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It has been said that there are only two sure things in life: death and taxes. The author concludes with an extract from the 1967 song written by the ex-Beatle, George Harrison called "The Taxman":

"...If you drive a car, I'll tax the street.
And if you walk, I'll tax your feet
And if you're cold, I'll tax the heat
And if you sit, I'll tax your seat
98 percent would be too small
Be thankful I don't take it all
Cause I'm the taxman, yeah, I'm the taxman..."

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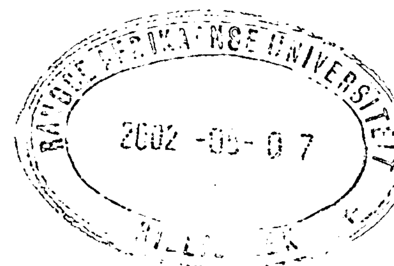

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