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**SOUTH AFRICAN REVENUE SERVICE**

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**TAX GUIDE FOR SHARE  
OWNERS**

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Another helpful guide brought to you by the South  
African Revenue Service



# TAX GUIDE FOR SHARE OWNERS

## FOREWORD

This document provides a general guideline regarding the taxation of share owners. It does not go into the precise technical and legal detail that is often associated with tax, and should not, therefore, be used as a legal reference. It is not a binding ruling in terms of Part IA of Chapter III of the Income Tax Act, 1962. Should an advance tax ruling be required, visit the SARS website for details of the application procedure.

The guide examines

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

This guide is based on legislation as at 8 January 2008.

If an answer to your specific situation is not provided in this document, or you require additional information, you may:

- contact your local SARS branch office,
- contact the SARS National Call Centre on 0860 12 12 18,
- contact your own tax advisor/practitioner, or
- visit the SARS website at [www.sars.gov.za](http://www.sars.gov.za)

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## Glossary

CGT:	Capital gains tax
NPL:	Renounceable nil paid letter of allocation
STC:	Secondary tax on companies
TAB:	Time-apportionment base cost method
tax year:	Year of assessment (that is, any year or period of assessment ending on the last day of February)
the Act:	Income Tax Act 58 of 1962

## 1. Introduction

With the increasing number of broad-based employee share incentive schemes, more and more people are becoming share owners. This guide summarises some of the key aspects shareholders need to be aware of in computing their liability for income tax and capital gains tax (CGT). This guide is primarily aimed at individuals who own shares in their own names. However, many of the principles covered apply equally to companies and trusts, and when appropriate the more obvious differences in the treatment of these entities have been highlighted.

References in this guide to sections and paragraphs are to sections in the Act and paragraphs in the Eighth Schedule to the Act unless otherwise stated.

## 2. Income or CGT?

If you hold a share as trading stock (that is you bought it for the main purpose of reselling it at a profit), any gain or loss on disposal will be of a revenue nature. Revenue gains are subject to income tax at your marginal tax rate, which may vary between 18% (but effectively 0% if your tax rebates are taken into account) and 40%, depending on the level of your taxable income.

On the other hand, if you hold a share as a capital asset (that is, as a long-term dividend-producing investment) any gain or loss upon its disposal will be of a capital nature. Capital gains are subject to tax at a lower rate than ordinary income. In the case of an individual, the first R15 000 of net capital gains or losses in a tax year is exempt for CGT purposes (known as the “annual exclusion”). Of the balance, 25% is included in your taxable income and taxed at your marginal tax rate in the same way as, say, your salary or pension income. The effective rate of tax on an individual’s net capital gains in a tax year can thus vary between 0% and 10%. The 0% rate would apply when the capital gains do not exceed the annual exclusion, or your taxable income falls below the level at which tax becomes payable. The 10% rate would apply when your marginal tax rate is 40% (that is,  $40\% \times 25\% = 10\%$ ).

Companies and trusts pay CGT at a higher rate than individuals. They do not qualify for the annual exclusion, and must include 50% of their net capital gains in their taxable income. Companies also pay secondary tax on companies (STC) on the profits they distribute. The effective tax rate on net capital gains for a company is  $29\% \times 50\% = 14,5\%$ . If the capital profit is distributed as a dividend, the effective company tax rate rises to 22,27% ( $14,5\%$  normal tax +  $7,77\%$  STC). This can be illustrated as follows:

	R
Capital profit	100,00
CGT R100 x 50% x 29%	(14,50)
Amount available for distribution	85,50
Less: Dividend	(77,73)
Less: STC 10% x R77,73	(7,77)
Retained income after tax	—

A trust which is not a special trust has an effective CGT rate of 40% x 50% = 20%. A special trust is subject to the same tax rate as an individual.

### 3. Capital v revenue

The first step in computing your tax liability in respect of a disposal of shares is to determine whether the gain or loss is of a capital or revenue nature.

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

You will have to discharge the onus of proving that a particular amount is of a capital or revenue nature (section 82). To discharge the onus you must establish your case on “a balance or a preponderance of probabilities” (*CIR v Middelman* 1991 (1) SA 200 (C), 52 SATC 323).

#### 3.1 Criteria for distinguishing between revenue and capital profits

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

#### 3.2 Intention

##### 3.2.1 Intention - the most important factor

The most important factor in determining whether a profit is of a capital or revenue nature is your intention at the time when you bought and sold your shares (*Elandsheuwel Farming (Edms) Bpk v SBI* 1978 (1) SA 101 (A), 39 SATC 163). If they were bought as a long-term investment to produce dividend income the profit is likely to be of a capital nature. But if you bought the shares for the purpose of resale at a profit, the profit will be of a revenue nature.

In order for a profit to be of a capital nature you need not exclude the “slightest contemplation of a profitable resale” (*SIR v The Trust Bank of Africa Ltd* 1975 (2) SA 652 (A), 37 SATC 87).

### **3.2.2 Mixed intentions**

If you had mixed intentions (that is, you bought the shares either to sell at a profit or to hold as an investment), your intention will be determined by your dominant or main purpose (*CoT v Levy* 1952 (2) SA 413 (A), 18 SATC 127).

### **3.2.3 Secondary purpose**

When you have a secondary or alternative purpose of making a profit, the profit will be of a revenue nature (*CIR v Nussbaum* 1996 (4) SA 1156 (A), 58 SATC 283). An example of this can be found in *CIR v Tod* 1983 (2) SA 364 (N), 45 SATC 1 in which the taxpayer who purchased shares cum div (that is, ripe with dividends), received the dividends and then sold the shares ex div. The court held that the resulting profits were of a revenue nature.

## **3.3 Some general principles**

### **3.3.1 Scheme of profit-making**

If you purchased your shares for resale as part of a scheme of profit-making, any profit or loss will be of a revenue nature (*Californian Copper Syndicate (Limited and Reduced) v Harris (Surveyor of Taxes)* 41 Sc LR 694, 5 TC 159).

### **3.3.2 Fortuitous gains**

A profit on sale of shares is more likely to be of a revenue nature if it was not fortuitous, but designedly sought for and worked for (*CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271).

### **3.3.3 The “for keeps” test**

The usual badge of a fixed, capital investment is that it is acquired for better or for worse, or, relatively speaking, for “keeps”, and will only be disposed of if some unusual, unexpected, or special circumstance, warranting or inducing disposal, supervened (*Barnato Holdings Ltd v SIR* 1978 (2) SA 440 (A), 40 SATC 75).

## **3.4 Surrounding circumstances**

### **3.4.1 The transaction-by-transaction approach**

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

### **3.4.2 Shares acquired for dividend income**

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

### **3.4.3 Scale and frequency of transactions**

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

### **3.4.4 Forced sales shortly after purchase**

The fact that an asset is sold for a substantial profit very soon after acquisition is, in most cases, an important one in considering whether a profit is of a revenue nature. However, it loses a great deal of its importance when an event occurs that was not previously contemplated (ITC 1185 (1972) 35 SATC 122 (N)). In the context of shares this principle may apply, for example, when a shareholder is forced to dispose of shares in order to facilitate a merger or acquisition.

### **3.4.5 Insufficient funds**

If you are forced to sell your shares because you had insufficient funds to enable you to hold them for the long term, it may be inferred that you bought them for the purpose of resale at a profit. For example, this could apply if you financed the purchase of your shares by means of an overdraft and were later forced to sell them because you could not afford the repayments (*CIR v Lydenburg Platinum Ltd* 1929 AD 137, 4 SATC 8; *Yates Investments (Pty) Ltd v CIR* 1956 (1) SA 612 (A), 20 SATC 368; *Ropty (Edms) Bpk v SBI* 1981 (A), 43 SATC 141).

### **3.4.6 Low or nil return**

When the type of share you have purchased does not produce dividends, or the business carried on by the company is highly risky, the proceeds are more likely to be of a revenue nature. The sale of futures contracts is likely to be on revenue account, even if used as a hedge against losses on underlying shares held as capital assets (ITC 1756 (1996) and (1997) 65 SATC 375 (C)).

## **4. Income tax**

### **4.1 Shares held as trading stock**

When you hold your shares as trading stock, the amount you paid for them will be deductible under section 11(a). If you still hold them at the end of the tax year, you must include in your income the cost of the shares as closing stock. If the value of the shares at the end of the tax year has dropped below what you paid for them, you will only be required to include the lower value as closing stock, thereby effectively enabling you to claim a deduction for the loss of value. This concession is, however, only available to individuals, and will not apply if the shares are held by your company or close corporation. The amount included in income as closing stock becomes deductible as opening stock for the following tax year.

With the introduction of section 9C from 1 October 2007, proceeds on disposal of South African shares (including dual-listed foreign shares) held as trading stock for longer than three years are treated as being of a capital nature. Any expenditure or losses claimed against income during the period that you held the shares will be recouped on disposal. For more on section 9C, see [5.2.2](#). Despite this recoupment, in the case of listed shares one-third of any interest incurred on borrowings used to acquire the shares qualifies as an addition to the base cost of the shares in determining any capital gain or loss – see [5.6.2](#).

#### **Example – Shares held as trading stock**

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

*Result:*

Year 1

	R
Cost of shares allowable as a deduction	(100)
Less: Closing stock 80 cents x 100	<u>80</u>
Loss to be deducted in arriving at taxable income	<u>(20)</u>

Year 2

	R
Proceeds included in gross income	120
Less: Opening stock	<u>(80)</u>
Net amount included in taxable income	<u>40</u>

## **4.2 Employee share incentive schemes**

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

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

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

Section 8A applies to shares or options acquired by an employee (including a director) from his or her employer before 26 October 2004. Any revenue gain determined under section 8A will be included in your income. Such a gain usually arises when the employee exercises an option to acquire shares from his or her employer and the price paid for the shares is less than the market price at the time of acquisition. When your

employer does not allow you to sell the shares before a certain date, you can elect to delay the taxation of the gain until that date.

Once you have been subject to income tax in terms of section 8A on the shares acquired from your employer a further gain or loss may arise when you dispose of the share. The capital or revenue nature of this further gain or loss is determined in the normal way; that is, shares held as capital assets will be subject to CGT, while shares held as trading stock will be subject to full income tax. For CGT purposes the base cost of the shares will be the market value that was taken into account in determining the section 8A gain.

#### **Example – Shares acquired in terms of section 8A**

*Facts:* On 1 October 2004, T was granted an option to acquire 1 000 shares in his employer, ABC Ltd at a price of R1,00 per share when the market price was R1,50 per share. He paid 10 cents per share for the options. On 28 February 2007 he exercised the options when the market price was R5,00 per share, and on 30 June 2009 he sold his shares at R8,00 per share.

*Result:* The following gains will arise in T's hands:

- 2007 tax year – an ordinary income gain in terms of section 8A
- 2010 tax year – a capital gain.

These gains will be determined as follows:

##### *Section 8A gain*

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

##### *Capital gain*

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

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

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

This applies to qualifying broad-based employee share plans when at least 90% of the employees in the company are entitled to participate. In order for an employee to qualify, the market value of the shares given to him or her in a three-year period must not exceed R9 000. If you hold a share acquired under such a plan for at least five years,

the gain on disposal will be of a capital nature and subject to CGT. But if you dispose of the share within five years, any gain will be taxed as income in your hands, and section 9C, which deems shares held for at least three years to be on capital account, will not apply. This serves as an encouragement for you to hold your shares for at least five years. The benefits of section 8B do not apply if you were a member of any other employee share incentive scheme at the time you received the shares. In that case you will be taxed under section 8C.

**Example 1 – Broad-based employee share incentive plan: Employee disposing of shares within five years**

*Facts:* On 5 January 2007, in terms of a qualifying broad-based employee share incentive plan, Y received 2 500 shares in her employer, XYZ Ltd at no cost. The shares were trading at R1 each at the time they were awarded to her. No restrictions apply to the shares, except that they may not be sold before 5 January 2010 unless an employee is retrenched or resigns. In the event of retrenchment or resignation, the employee must sell the 2 500 shares back to XYZ Ltd for the market value of the shares on the date of departure. XYZ Ltd appointed a trust to administer the shares under the plan.

Y resigned from XYZ Ltd on 21 December 2007. Under the terms of the plan, she sold her shares back to XYZ Ltd (through the trust) on 21 December 2007 at market value of R3 750 (R1,50 per share).

*Result:* When the shares were granted to her, Y was not subject to tax. However, in the 2008 tax year an amount of R3 750 will be taxed as ordinary income in her hands when she sells the shares back to XYZ Ltd, and the company will withhold the appropriate amount of PAYE.

**Example 2 - Broad-based employee share incentive plan: Employee disposing of shares after five years**

*Facts:* The facts are the same as in Example 1, except that Y left XYZ Ltd in 2013 and subsequently sold the shares in the open market for R4 500.

*Result:* The disposal in 2013 will result in a capital gain of R4 500 (proceeds R4 500 less base cost of nil).

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

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

Once you have been subject to income tax in terms of section 8C on the shares acquired from your employer a further gain or loss may arise when you dispose of the share. The capital or revenue nature of this further gain or loss is determined in the normal way; that is, shares held as capital assets will be subject to CGT, while shares

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

### Example – Section 8C gain and capital gain

*Facts:* On 30 June 2006 B acquired an option from her employer to purchase 100 shares in ABC Ltd at a price of R100 per share. She paid R10 for the option, which was exercisable before 30 June 2007. On 31 May 2007 she exercised the option at a time when the share price was R160 per share. In terms of the arrangement with her employer, she was not permitted to sell the shares before 30 June 2010 at which time the market price was R190 per share. She eventually sold the shares on 1 March 2011 for R210 per share. Determine B's section 8C gain and capital gain per share.

*Result:*

#### Section 8C gain

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

#### Capital gain

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

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

## 4.3 Taxation of dividend income

Your dividend income from South African-resident companies is exempt from tax under section 10(1)(k). However, dividends from non-resident companies must be included in your income. As a rule, dividends received or accrued in a foreign currency must be translated into rands using the spot rate on the date of receipt or accrual (section 25D(1)). Individuals and non-trading trusts may, however, elect to use the average exchange rate during the tax year (section 25D(3)). The election must be applied consistently to all foreign income derived during the tax year.

However, the following types of foreign dividends are exempt from tax:

- Dividends from certain dual-listed shares when more than 10% of the equity shares of the company are collectively held by South African residents. Some well-known examples include Anglo American plc, BHP Billiton plc, Investec plc, Old Mutual plc and SABMiller plc.
- Dividends received from a controlled foreign company (CFC).

- Dividends declared out of profits that have been subject to tax in South Africa. This exemption does not apply if a lower rate of South African tax on the profits in question is payable in terms of an agreement for the avoidance of double taxation.
- Dividends declared out of dividends received from a company resident in South Africa.
- Dividends declared by a foreign company in which you hold at least 20% of the total equity share capital and voting rights. This is known as the “participation exemption”.

#### *Foreign dividend exemption*

The first R3 000 of foreign dividends and interest is exempt from tax in terms of section 10(1)(i)(xv) in respect of the 2008 tax year. The exempt amount is first applied against foreign dividends.

#### *Deductibility of interest incurred*

Under section 11C(1) you can deduct interest actually incurred in earning taxable foreign dividends. But the deduction is limited to the amount of the taxable foreign dividends. Should the interest expense exceed the taxable foreign dividends, the excess must be reduced by any exempt foreign dividends and carried forward to the next tax year when it will be treated as an expense actually incurred in the earning of foreign dividends (section 11C(2)).

#### *Claiming of foreign taxes*

When a foreign country has deducted a withholding tax from your dividend income, you will be taxed on the gross dividend and may claim a rebate under section 6quat for the foreign taxes withheld. The rebate cannot exceed the South African tax payable on the dividend (before taking rebates into account). Any portion of the foreign tax not qualifying for the rebate may be carried forward to the following tax year, but the carry-forward may not continue for more than seven years. Foreign taxes payable in respect of dividends included in your income during a tax year are translated into rands at the average exchange rate during that tax year (section 6quat(4)).

For a detailed explanation regarding the rebate for foreign taxes, see Interpretation Note 18 available from the SARS website (Legislation / Interpretation Notes / Income Tax).

**Note:** For the 2007 and prior tax years you could elect under section 11C(4) and (5) to deduct any dividend withholding tax from foreign dividend income instead of claiming a section 6quat rebate. With effect from 1 March 2007 this option is no longer available.

#### *Controlled foreign companies*

Special rules relate to the income generated by controlled foreign companies. These rules deem an amount equal to the foreign company’s taxable income to be taxable income in the hands of the South African-resident shareholders, thereby effectively disregarding the company’s separate legal existence. These rules, which are contained in section 9D, are outside the scope of this guide.

## **5. Capital gains tax**

### **5.1 Shares held as capital assets**

When you hold your shares otherwise than as trading stock, that is, as capital assets, any gain will be of a capital nature and is subject to CGT. Capital losses may only be set off against other capital gains. The first R15 000 (known as the “annual exclusion”) of the sum of all capital gains and losses in the 2008 tax year is excluded in determining the amount that is subject to CGT. The annual exclusion increases to R120 000 in the year of death. When your net capital loss exceeds the annual exclusion in a tax year, the excess is carried forward to the following year as an assessed capital loss that may be utilised against future capital gains.

### **5.2 The “safe haven” rules**

#### **5.2.1 The five-year rule**

Section 9B applies to JSE-listed shares disposed of before 1 October 2007. New rules in the form of section 9C take effect from 1 October 2007 (see [5.2.2](#) below).

Section 9B enabled a person to elect that the proceeds in respect of JSE-listed shares disposed of before 1 October 2007 would be of a capital nature when those shares were held for more than five years. The election had to be made upon the sale of the first JSE-listed share held for five years, and was binding in respect of your entire portfolio of JSE-listed shares. The capital or revenue nature of shares held for less than five years was determined using the general principles laid down by the courts. However, any gain or loss on shares held for longer than five years was in terms of section 9B treated as being of a capital nature. If you failed to make the election upon the sale of your first share held for five years you were not allowed another opportunity to make an election in respect of any other JSE-listed share. Section 9B was therefore restrictive in its application. For a detailed explanation of section 9B see SARS Interpretation Note 43 dated 10 August 2007, available on the SARS website (Legislation / Interpretation Notes / Income Tax).

#### **5.2.2 The three-year rule**

Section 9C replaced section 9B and applies to the disposal of any “qualifying share” on or after 1 October 2007. It applies to gains and losses and unlike section 9B does not require an election. Its application is automatic and compulsory.

Under section 9C any gain or loss on disposal of qualifying shares is deemed to be of a capital nature if you held them for a continuous period of at least three years. If section 9C applies to a share any gain or loss will be regarded as a capital gain or loss for CGT purposes.

If you dispose of the shares within three years, the capital or revenue nature of the profit or loss must be determined using the general capital versus revenue tests outlined in [3](#). The profit or loss is not automatically deemed to be of a revenue nature.

### *Qualifying shares*

Section 9C applies to a wider range of shares than section 9B. A “qualifying share” includes

- a share in a listed or unlisted company resident in South Africa,
- a share in a foreign company which is listed in South Africa,
- an interest in a close corporation, and
- a participatory interest in a collective investment scheme.

Excluded as a “qualifying share” are

- a share in a share block company,
- a share in a foreign company (other than a share listed in South Africa),
- a section 8E “hybrid equity instrument” (for example, a preference share redeemable within three years), and
- a share that is not an equity share (for example, a non-participating preference share).

### *Recoupment of expenditure claimed under section 11*

If you held your shares as trading stock and were allowed expenses or losses in respect of those shares, those expenses and losses must be included in your income as a recoupment when you sell your shares (section 9C(5)).

### *Anti-avoidance measures*

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

### *First in, first out*

The first-in-first-out method must be used to determine the length of time you held shares you have disposed of (section 9C(6)). This is merely for the purpose of applying section 9C and does not affect any identification method you have adopted for determining the base cost of your shares for CGT purposes. Thus if you adopted the weighted-average method for CGT purposes you must continue to use that method for determining the base cost of your shares. First in, first out will merely be used to determine whether any shares you sold were held for at least three years.

### *Roll-over of dates of acquisition*

Should you surrender your existing shares in exchange for a greater or lesser number of shares in the same company as a result of a share split or consolidation, the dates of acquisition of the old shares will be carried across to the new shares. This rule does not apply if

- the new shares carry different rights to the old shares, or

- you receive any other consideration as part of the share substitution (for example, a cash payment or shares in another company).

### **5.3 Determining a capital gain or loss**

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

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

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

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

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

**Proceeds** – This is the amount received or accrued in respect of the disposal;

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

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

### **5.4 Disposal**

A capital gain or loss is triggered when you dispose of your shares. A **disposal** will normally occur when you sell your shares, but you will also be treated as having disposed of your shares if

- you donate them,
- you cease to be a resident,
- the nature of your shares changes from capital assets to trading stock,
- you still own them at the time of your death and did not bequeath them to your surviving spouse or a public benefit organisation,
- the company whose shares you hold is liquidated or deregistered,
- you receive a capital distribution on or after 1 October 2007 (part-disposal),
- you have received a capital distribution between 1 October 2001 and 30 September 2007, have adopted the specific-identification or first-in-first-out method and still hold the shares on 1 July 2011 (the pre-1 October 2007 capital distributions will trigger a part-disposal on 1 July 2011), or
- if you adopted the weighted-average method and the base cost of your shares is a negative amount on 30 June 2011, the negative amount will be treated as a capital gain on 1 July 2011.

For more on capital distributions see [5.9](#).

## 5.5 Proceeds

The **proceeds** are normally equal to the amount that is received by or accrues to you on disposal of the shares. In some cases, however, the proceeds will be deemed to be equal to the market value of the shares at the time of the disposal event. This would happen, for example, if you died, donated the shares for no consideration, ceased to be a South African resident or changed the nature of your shares to trading stock.

### *Capital distributions*

Capital distributions received or accrued are treated as proceeds

- on or after 1 October 2001 if you adopted the specific-identification or first-in-first-out methods, or
- on or after 1 October 2007 if you adopted the weighted-average method (between 1 October 2001 and 30 September 2007 capital distributions were deducted from base cost under this method).

For more on capital distributions, see [5.9](#).

## 5.6 Base cost

The determination of the base cost of shares is more complex, and different rules exist for shares acquired before 1 October 2001 and those acquired on or after that date.

### 5.6.1 Identification methods

Before you can determine the base cost of your shares you need to adopt a method to identify the shares that you have disposed of. This becomes necessary when you dispose of some of, but not all, the shares you hold in a particular company. The three permissible identification methods are

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

#### **Example – Identification methods**

*Facts:* J owns 1 000 shares in ABC Ltd, a company listed on the JSE, which he acquired on the following dates:

<b>Date purchased</b>	<b>Number of shares</b>	<b>Cost</b>
		<b>R</b>
1 March 2003	200	2 000
30 June 2004	100	1 100
30 November 2005	500	6 000
31 July 2006	<u>200</u>	<u>1 800</u>
Total	<u>1 000</u>	<u>10 900</u>

Assume that on 31 December 2007 J sells 200 shares. Determine which 200 shares he has sold using the specific-identification, first-in-first-out and weighted-average methods.

*Result:* J has three choices:

*Specific identification* – Under this method he can nominate the shares that he is selling, based on their date and cost. In the above example, he would probably choose to sell 200 of the 500 shares he acquired on 30 November 2005, since they have the highest base cost of R12 per share. In order to use this method, he will have to maintain detailed records of the dates and costs of acquisition of his shares.

*First in, first out* – Under this method, J is deemed to have sold the oldest shares first, namely, the 200 shares he acquired on 1 March 2003 for R2 000.

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

	No	R
Total before disposal (as above)	1000	10 900
Less: Shares disposed of	<u>(200)</u>	<u>(2 180)</u>
Total after disposal	<u>800</u>	<u>8 720</u>

Any capital distributions received between 1 October 2001 and 30 September 2007 must be deducted from the base cost pool. Capital distributions received or accrued on or after 1 October 2007 are treated as proceeds in respect of a part-disposal.

**Note:** The weighted-average method can only be used for shares listed on a recognised stock exchange (for example, the JSE, London Stock Exchange or New York Stock Exchange). It does not apply to shares in private companies. A list of recognised exchanges can be found on the SARS website (Tax Types / Capital Gains Tax (CGT) / Legislation).

### *Consistency*

Once you have adopted an identification method for the first listed share disposed of on or after 1 October 2001 you must continue to use that method for your entire portfolio of listed shares. You will only be able to switch to a different method once all the shares in your portfolio have been disposed of.

## **5.6.2 Amounts included in base cost**

The base cost of a share includes

- the cost of acquisition,
- uncertificated securities tax or stamp duty paid on acquisition of the share,
- the cost of any option exercised in acquiring or selling the shares (except shares taxed under section 8A or 8C),
- broker's fees (whether to buy or sell the shares, and
- in the case of a listed share only, one-third of the interest on any loan used to buy the share.

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

A special rule exists when you acquired the shares from your employer in terms of an employee share incentive scheme. In that case, the base cost of the shares will be the market value of the shares that was taken into account in determining any amount of the revenue gain to be included in your income under section 8A or 8C (see **4.2.1** and **4.2.3**).

### 5.6.3 Pre-valuation date shares

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

to *Capital Gains Tax* that is available on the SARS website (Tax Types / Capital Gains Tax (CGT) / Comprehensive Guide to CGT).

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

Four methods are available for determining the valuation date value:

- Time-apportionment base cost (TAB).
- Market value on 1 October 2001.
- 20% of proceeds after first deducting any post-valuation date expenditure.
- Weighted average (listed shares only). Shares held on 1 October 2001 are added to the base cost pool at market value on that date.

#### *Freedom of choice to switch between methods*

Your freedom to switch between the different methods is limited by

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

If you have adopted the weighted-average identification method for your listed shares, it will also serve as your base cost method. In this case, you must use the weighted-average method for your entire portfolio of listed shares, and you may not use the TAB, market value or “20% of proceeds” methods for any of your listed shares. The kink tests do not apply if you choose the weighted-average method.

But if you chose specific identification or first in, first out as your identification method, you can choose whichever method (TAB, market value or 20% of proceeds) gives you the best result. Despite this freedom of choice, the kink tests discussed in **5.6.4** may substitute a different method to the one you have chosen. The kink tests will only apply under certain circumstances when you determine a capital loss.

### Example – Freedom of choice between valuation methods

*Facts:* K held the following listed shares on 1 October 2001:

100    A Ltd  
500    B Ltd

The following sales took place in respect of the above shares:

A Ltd – sold 50 on 30 June 2006 and the remaining 50 on 28 February 2007.

B Ltd – sold 100 on 30 June 2006 and a further 100 on 30 June 2007.

All shares were sold above cost and no capital losses will result regardless of the base cost method K selects (that is, the kink tests do not apply). Which base cost methods can K use for the shares he has sold?

*Result:* If K chooses the weighted-average method, he must use that method for all the A and B shares he has sold. He will also have to use it for the 300 B shares he still holds when he sells them.

If he chooses either the specific-identification or first-in-first-out method, he has complete freedom of choice between TAB, market value and 20% of proceeds. He does not have to be consistent within the same shares, between different shares or within a tax year. In other words,

- in respect of the 50 A shares sold on 30 June 2006, he can use TAB, market value or 20% of proceeds, and
- in respect of the 50 A shares sold on 28 February 2007, he can use TAB, market value or 20% of proceeds.

### *Time-apportionment base cost (TAB)*

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

$$P = R \times B / (A+B), \text{ and}$$

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

in which:

P = Proceeds used in the TAB formula

R = Amount received or accrued on disposal of the share (including any capital distributions received or accrued on or after 1 October 2001, which have not previously been taken into account as a part-disposal).

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

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

N = Number of years before 1 October 2001.

T = Number of years after 1 October 2001.

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

The proceeds formula applies when further expenditure has been incurred on or after 1 October 2001 in respect of the share. With effect from the commencement of years of assessment ending on or after 8 November 2005 (that is, for individuals this means on or after 1 March 2005), selling expenses such as broker's fees must be deducted from the consideration received on disposal of the share and will no longer form part of "A" in the formula. This means that selling costs of this nature will no longer trigger the proceeds formula. Assuming no other post-valuation date expenditure was incurred, the selling expenses must be deducted from "P" in the TAB formula. If other post-valuation date expenditure was incurred (for example, interest incurred in buying the shares or the cost of obtaining a CGT valuation in respect of unlisted shares) the proceeds formula will still apply and the selling expenses must be deducted from "R" in the proceeds formula.

If all these calculations are too much for you, do not despair. SARS has published a TAB calculator on its website (Tax Types / Capital Gains Tax (CGT) / TAB Calculator), based on a Microsoft Excel spreadsheet. Simply enter the required data in the "input" section and the calculator will determine TAB as well as the capital gain or loss. It applies the kink tests and will tell you whether another method will give a better result.

#### **Example – Time-apportionment method**

*Facts:* J bought 100 ABC Ltd shares on 30 June 1995 at a cost of R9 500 plus broker's fees and uncertificated securities tax of R500. She sold them on 30 November 2007 for R15 400 less broker's fees of R400. Determine the capital gain on disposal of her shares.

*Result:*

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

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

P = R15 400 - R400 = R15 000

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

$TAB = R10\,000 + [(R15\,000 - R10\,000) \times 7/(7+7)]$

$TAB = R10\,000 + R2\,500$

$TAB = R12\,500$

Capital gain = Proceeds – valuation date value (TAB) – post-valuation date costs

Capital gain = R15 400 – R12 500 – R400 = R2 500

(For the sake of simplicity it has been assumed that J incurred no expenditure apart from selling expenses on or after 1 October 2001, thereby avoiding the triggering of the proceeds formula.)

#### *Market value*

SARS has published the market values as at 1 October 2001 of all shares listed on the JSE on its website (Tax Types / Capital Gains Tax (CGT) / Value of Assets on 1 October 2001 / JSE-listed Financial Instruments). If you wish to use the market value method for your pre-valuation date shares, you must use these values.

**Example – Market value method**

*Facts:* Z acquired 1 000 SA Breweries shares before 1 October 2001 at a cost of R25 000. He disposed of them for R75 000 after the valuation date. Determine his capital gain or loss using the market value method.

*Result:* The market value of the SAB shares on valuation date per the SARS website is R53.96 per share. Z's capital gain is therefore R75 000 (proceeds) less R53 960 (base cost of 1 000 shares at R53,96 per share) = R21 040

*20% of proceeds*

For most taxpayers the “20% of proceeds” method is likely to be a method of last resort, since the market value and TAB methods will usually give a better result. The valuation date value of a share using this method is 20% x (proceeds less allowable post-1 October 2001 expenditure).

**Example – “20% of proceeds” method**

*Facts:* J inherited 100 ABC Ltd shares from her late grandmother in April 2001. On 1 October 2001 the market value of the shares was R50. She sold them on 30 June 2010 for R500. Determine her capital gain or loss using the “20% of proceeds” method.

*Result:* The base cost of J's shares is  $R500 \times 20\% = R100$ . Her capital gain is  $R500$  (proceeds) –  $R100$  (base cost) =  $R400$ .

*Weighted-average method*

The weighted-average method is available for shares listed on a recognised exchange. Once you adopt this method, you must use it for your entire listed share portfolio. This means that you will not be able to use the TAB, market value or “20% of proceeds” methods for any of your listed shares. Shares held on 1 October 2001 are added to the base cost pool at market value on that date. In the case of JSE-listed shares you must use the prices published on the SARS website. The market value of foreign-listed shares on valuation date is equal to the ruling price at close of business on the last business day before 1 October 2001. The “ruling price” is the last sale price unless there was a higher bid or lower offer, in which case the latter will prevail. Further purchases of the same share are added at actual cost, while capital distributions received or accrued between 1 October and 30 September 2007 (both dates included) reduce the base cost of the pool. Capital distributions received or accrued on or after 1 October 2007 trigger a part-disposal – see [5.9](#).

Immediately before disposal, the weighted average base cost per share is calculated, and this is used to determine the base cost of the shares disposed of. The base cost pool is then reduced by the shares disposed of. This method is illustrated in an example under [5.6.1](#). The main advantage of this method is simplicity, since portfolio managers report share transactions to SARS (and usually to their clients) using this method. It also avoids the complex gain and loss limitation rules (“kink tests”) that apply when you use the TAB or market value methods.

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

When you use the TAB and market value methods, special rules, known as “kink tests” apply under certain circumstances. These rules, which are contained in paragraphs 26(3) and 27, are primarily aimed at preventing or limiting the claiming of losses when the market value on 1 October 2001 is used as the base cost. In other cases, they prevent the use of TAB when you have sold the shares for less than what they have cost you but the proceeds are greater than the market value on 1 October 2001.

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

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

Cost R	Market value on 1 October 2001 R	Proceeds R	Valuation date value in terms of kink test
100	150	120	120
100	50	70	70 (TAB not permitted)
100	50	20	50 (TAB not permitted)
100	150	50	TAB

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

### 5.6.5 Base cost of shares in foreign-listed companies

Special rules are contained in paragraph 43(4) for the determination of the capital gain or loss on disposal of foreign-listed shares. These rules tell you how to translate the base cost and proceeds into rands when you incur expenditure and receive proceeds from the disposal of those shares in a foreign currency.

The proceeds on disposal must be translated into rands using either

- the average exchange rate during the tax year in which the share was disposed of, or
- the spot rate on the date of disposal.

The expenditure in respect of the share must be translated into rands using either

- the average exchange rate during the tax year in which the expenditure was incurred, or
- the spot rate on the date on which the expenditure was incurred.

A list of average exchange rates for a tax year can be found on the SARS website (Tax Types / Income Tax (IT) / Average Exchange Rates for a Year of Assessment).

Any market value determined on 1 October 2001 must be translated into rands at the spot rate on that date. A list of exchange rates as at 1 October 2001 can be found on the SARS website (Tax Types / Capital Gains Tax (CGT) / Value of Assets on 1 October 2001 / Exchange Rates as at 1 October 2001).

## **5.7 Determining a taxable capital gain or assessed capital loss**

### **5.7.1 The basic computation**

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

Sum of capital gains and losses during the tax year  
 Less: Annual exclusion  
 = Aggregate capital gain or loss  
 Less / add: Assessed capital loss brought forward from previous year  
 = Net capital gain or assessed capital loss  
 Multiply a net capital gain by the inclusion rate (25% for individuals and special trusts; 50% for companies and trusts)  
 = Taxable capital gain to be included in taxable income.

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

### **5.7.2 Annual exclusion**

The first R15 000 (known as the “annual exclusion”) of the sum of an individual’s capital gains and losses in the 2008 tax year is disregarded. To the extent that the annual exclusion is not utilised, it may not be carried forward to the next tax year. If a person dies during the 2008 tax year, the annual exclusion increases to R120 000.

### **5.7.3 Assessed capital loss**

If the sum of the capital gains and losses during the tax year results in a net loss that exceeds the annual exclusion, the excess is carried forward to the next year as an “assessed capital loss”. Once it is established, an assessed capital loss is not again reduced by the annual exclusion in future years. An assessed capital loss may only be set off against current or future capital gains and not against ordinary income.

#### **Example – Determination of taxable capital gain**

*Facts:* B made the following capital gains and losses during the 2008 tax year:

	R
Capital gain on ABC Ltd shares	5 000
Capital gain on XYZ Ltd shares	20 000
Capital loss on DEF Ltd shares	(3 000)

At the end of the 2007 tax year B had an assessed capital loss of R2 000.

Determine the amount to be included in B’s taxable income.

*Result:*

	R
Capital gain on ABC Ltd shares	5 000
Capital gain on XYZ Ltd shares	20 000
Capital loss on DEF Ltd shares	<u>(3 000)</u>
Sum of capital gains and losses during the tax year b/f	22 000
Less: Annual exclusion	<u>(15 000)</u>
Aggregate capital gain	7 000
Less: Assessed capital loss brought forward from prior year	<u>(2 000)</u>
Net capital gain	<u>5 000</u>
Inclusion rate (25% for an individual)	
Taxable capital gain – to be included in taxable income	<u>1 250</u>

## 5.8 Capital distributions

In simple terms a capital distribution is an amount paid to you by the company in respect of which the company did not pay STC (secondary tax on companies). Typically dividends are not capital distributions because they are subject to STC. Capital distributions usually occur on liquidation or deregistration of a company, but can also occur when a company returns a portion of its contributed share capital or share premium account to its shareholders. The company should advise you whether the amount you are receiving is a capital distribution (which will have CGT implications) or a dividend (which is excluded for CGT purposes).

The method of dealing with capital distributions changed on 1 October 2007. Before this date the CGT consequences of capital distributions were deferred until the related shares were disposed of. If you adopted the specific-identification or first-in–first-out methods, capital distributions received or accrued on or after 1 October 2001 were treated as proceeds on disposal of your shares, while under the weighted-average method they were deducted from the base cost of your shares. In terms of the new legislation, capital distributions received or accrued on or after 1 October 2007 now trigger a part-disposal of the share in your hands, regardless of the identification method adopted (specific identification, first in, first out or weighted average). A special transitional rule has been introduced to deal with any capital distributions accumulated from 1 October 2001 to 30 September 2007. The CGT consequences of these amounts will have to be determined on 1 July 2011 (specific identification or first in, first out) or 30 June 2011 (weighted average) should you still hold the relevant shares on those dates.

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

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

in which

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

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

C = The market value of your shares immediately before the capital distribution is received by or accrues to you.

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

The table below summarises the CGT consequences of capital distributions.

**Table 1 - Treatment of capital distributions**

<b>When capital distribution received or accrued</b>	<b>Identification method adopted</b>	<b>Treatment</b>
Before 1 October 2001	Specific identification or first in, first out	Reduce pre-1 October 2001 expenditure in respect of the share (but not below nil). This applies if you use TAB to determine the base cost.
	Weighted average	Not relevant (ignore).
On or after 1 October 2001 but before 1 October 2007	Specific identification or first in, first out	<ul style="list-style-type: none"> <li>• If you dispose of your shares before 1 July 2011, the capital distribution is treated as proceeds on disposal.</li> <li>• If you still hold the shares on 1 July 2011, the capital distributions will be treated as proceeds on a deemed part-disposal on that date.</li> </ul>
	Weighted average	<ul style="list-style-type: none"> <li>• Capital distributions received or accrued on or after 1 October 2001 but before 1 October 2007 must be deducted from base cost as and when received or accrued.</li> <li>• If you have disposed of the shares by 1 July 2011 you must calculate the capital gain in the normal way (proceeds less base cost).</li> <li>• If you still hold the</li> </ul>

		shares on 1 July 2011 and the base cost is negative as at 30 June 2011, the negative amount is treated as a capital gain on 1 July 2011 and the base cost as at 30 June 2011 is reset to nil.
On or after 1 October 2007	Specific identification, first in, first out or weighted average	Treat as proceeds on a deemed part-disposal.

### Example – Capital distribution triggering part-disposal on or after 1 October 2007

*Facts:* T acquired a share in 2002 at a cost of R120. On 31 January 2008 T received a capital distribution of R20 in cash. The market value of the share at the close of business on 30 January 2008 was R200.

*Result:* The capital distribution triggers a part-disposal. Ten percent of the R120 expenditure is allocated to the part-disposal (R20 capital distribution divided by R200 market value). T will therefore have a capital gain of R8 (R20 proceeds less R12 allocable expenditure). The base cost of the share going forward is R120 – R12 = R108.

### Example – Capital distributions and the weighted-average method

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

		No of Shares	Price per share R	Base cost R
01.10.2001	Opening balance	200	1,00	200,00
30.06.2004	Buy	100	1,50	150,00
28.02.2007	Capital distribution			<u>(20,00)</u>
	Subtotal	<u>300</u>	<u>1,10</u>	<u>330,00</u>
31.07.2007	Sell	<u>(100)</u>	<u>1,10</u>	<u>(110,00)</u>
	Subtotal	200	1,10	220,00
31.12.2007	Buy	<u>300</u>	<u>2,00</u>	<u>600,00</u>
	Subtotal	500	1,64	820,00
30.06.2008	Sell	<u>(100)</u>	<u>1,64</u>	<u>(164,00)</u>
	Subtotal	<u>400</u>	<u>1,64</u>	<u>656,00</u>

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

The shares sold on 30 June 2008 realised R3,00 per share.

On 31 December 2008 V received a capital distribution of R60 in respect of the 400 shares held at the time. The market value of the shares at close of business on 31 December 2008 is R3,00 per share.

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

*Result:*

*Capital distribution – 28 February 2007*

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

*Sale – 31 July 2007*

	R
Proceeds 100 x R1,80	180,00
Less: Base cost	<u>(110,00)</u>
Capital gain	<u>70,00</u>

*Sale – 30 June 2008*

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

*Capital distribution – 31 December 2008*

Proceeds	60,00
Less: Base cost R60/R1 200 x R656	<u>(32,80)</u>
Capital gain	<u>27,20</u>

The base cost of V's shares after the capital distribution is as follows:

	No of Shares	Price per share R	Base cost R
Subtotal	400	1,64	656,00
31.12.2008 Capital distribution			<u>(32,80)</u>
Subtotal	<u>400</u>	1.56	<u>623,20</u>

## **5.9 Anti-loss rules**

The Eighth Schedule contains two anti-avoidance rules which limit capital losses on the disposal of shares under certain circumstances.

### **5.9.1 Losses due to extraordinary dividends**

These notes are based on paragraph 19 as it applies to disposals on or after 1 October 2007.

If you dispose of your shares at a capital loss within two years of receiving "extraordinary dividends", the capital loss must be disregarded to the extent of those extraordinary dividends. This applies even if the dividend is a liquidation dividend. "Extraordinary dividends" are dividends

- received during the two years before you dispose of your shares,
- which in total exceed 15% of the proceeds on disposal of your shares.

### Example – Extraordinary dividends

*Facts:* K bought all the shares in ABC (Pty) Ltd at a cost of R1 million in 2002. On 1 March 2008 the company was placed into voluntary liquidation. On 1 May 2008 K received a liquidation dividend of R1 500 000 out of revenue profits and a return of R10 000 in respect of contributed share capital. The company was finally dissolved on 15 October 2008.

*Result:* Were it not for paragraph 19, K would have a capital loss on 15 October 2008, determined as follows:

	R
Proceeds	10 000
Less: Base cost	<u>(1 000 000)</u>
Capital loss	<u>(990 000)</u>

However, under paragraph 19(1) ABC (Pty) Ltd has distributed an extraordinary dividend within two years of the disposal of the shares. Accordingly, the capital loss of R990 000 must be disregarded to the extent of the extraordinary dividend.

Dividend	1 500 000
Less: 15% of R10 000 (proceeds)	<u>(1 500)</u>
Extraordinary dividend (para 19(3)(c))	<u>1 498 500</u>

Since the capital loss of R990 000 does not exceed the extraordinary dividend, it must be fully disregarded.

### 5.9.2 “Bed and breakfast” sales

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

Under paragraph 42, if you dispose of shares at a capital loss and buy back those shares within a 45-day period on either side of the disposal, you must disregard the capital loss. The capital loss is not forfeited, but is added to the base cost of the replacement shares. In this way the use of the capital loss is deferred until you sell the replacement shares without reacquiring them in the short term.

## 6. Corporate restructuring events

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

## 6.1 Unbundling transactions

When a company distributes shares it holds in another company to you in terms of an “unbundling transaction” contemplated in section 46, you will need to allocate a portion of the expenditure and any market value on 1 October 2001 of your existing shares to the new shares received. Similarly, if you have adopted the weighted-average method you must allocate part of the base cost of the existing shares to the new shares. The allocation must be done in accordance with the following formula:

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

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

The amount allocated to the new shares in accordance with the above formula must be deducted from the expenditure, market value or weighted-average base cost relating to the old shares.

### Example – Unbundling transaction

*Facts:* J held 100 shares in A Ltd on 1 October 2001 that he had acquired in 1995 at a cost of R100. Their market value on 1 October 2001 was R120. On 30 June 2007 A Ltd distributed all its shares in B Ltd to its shareholders as part of an unbundling transaction. J received 20 B Ltd shares, which had a market value of R20 at close of business on 1 July 2007. The market value of his A Ltd shares at close of business on 1 July 2007 was R140. Determine the expenditure and market value on 1 October 2001 attributable to J's A Ltd and B Ltd shares.

*Result:*

Expenditure attributable to B Ltd shares:

$$R100 \times R20 / (R20 + R140) = R100 \times R20 / R160 = R12,50$$

$$\text{Expenditure attributable to A Ltd shares} = R100 - R12,50 = R87,50$$

Market value attributable to B Ltd shares:

$$R120 \times R20 / (R20 + R140) = R120 \times R20 / R160 = R15$$

$$\text{Market value attributable to A Ltd shares} = R120 - R15 = R105$$

## 6.2 Asset-for-share transactions

When you receive new shares in a company in exchange for your existing shares in another company in terms of an “asset-for-share transaction” contemplated in section 42, you may qualify for roll-over relief. This means that the base cost of your old shares will be transferred to your new shares and the exchange of shares will not be treated as a disposal for CGT purposes. You will only be entitled to roll-over relief in respect of gain or break even shares. The roll-over relief will not apply if you would have made a loss on exchange of the shares. In a loss situation you will simply claim the loss, and acquire the new shares at a cost equal to the market value of the shares you have disposed of at the time of the asset-for-share transaction.

### **Example – Asset-for-share transaction**

*Facts:* L owns 100 shares in Target Ltd that he acquired on 1 March 1995 at a cost of R100. The market value of the Target Ltd shares for CGT purposes on 1 October 2001 was R150. On 30 June 2007 L received a circular informing him that Acquiring Ltd, a listed company, would be taking over his shares in terms of a section 42 asset-for-share transaction. In return he would receive 50 shares in Acquiring Ltd. The market value of the Acquiring Ltd shares at the time of the take-over was R500. Determine the CGT consequences for L in respect of the disposal of his Target Ltd shares and the acquisition of his Acquiring Ltd shares.

*Result:*

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

L will qualify for roll-over relief because

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

*Step 2: Apply the roll-over relief*

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

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

### **6.3 Amalgamation transactions**

An amalgamation transaction occurs in terms of section 44 when a company (A) transfers all its assets to another company (B) in return for shares in B. Company A then distributes the B shares to its shareholders and is thereafter liquidated or deregistered. In essence then, if you were a shareholder of Company A, your A shares will be disposed of and you will receive Company B shares in exchange. This rule works on a similar basis to the asset-for-share transaction rule described under 6.2. Any capital gain or loss on disposal of your A shares is disregarded and the following particulars are carried across to your B shares:

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

In short, the B shares step into the shoes of the A shares.

## 6.4 Share buy-backs

A disposal will occur when a company buys back its own shares from you. For CGT purposes the proceeds received by you exclude any portion of the consideration that constitutes a dividend.

## 6.5 Roll-over relief in respect of forced sale of listed shares

Paragraph 42A applies in respect of any disposal on or after 1 March 2007. It enables you to defer a capital gain when you are forced to sell some of your shares as a result of a court order under section 311 of the Companies Act 61 of 1973. This could occur, for example, because the company requires the shares in order to facilitate a Black Economic Empowerment deal. The deferral relief will only be granted if you replace the shares with shares of the same kind in the same company within 90 days of the forced sale. The relief is provided as follows:

- You are treated as having disposed of your old shares at an amount equal to their base cost (that is, there will be no capital gain on the forced sale).
- You must reduce the expenditure in respect of your replacement shares by the amount of the capital gain that arose on the forced sale of your old shares (this is the base cost of your replacement shares going forward).
- If the capital gain exceeds the expenditure in respect of the replacement shares, the excess is treated as a capital gain on disposal of the old shares and the replacement shares are treated as having a base cost of nil going forward.
- You are treated as having acquired the replacement shares on the same date as the old shares (this is relevant for the purposes of the section 9C three-year “safe haven” rule).

### **Example 1 – Forced sale of listed shares followed by reacquisition of shares of the same kind**

*Facts:* K owns 2 000 ordinary shares in XYZ Ltd, a company listed on the JSE. In terms of a court order issued under section 311 of the Companies Act, K is forced to sell 25% (that is, 500) of those shares to XYZ Ltd in return for a cash payment of R110 000. The shares sold have a base cost of R90 000.

Within 40 days of the buy-back, K repurchases 500 of XYZ Ltd's ordinary shares for R135 000 on the open market.

*Result:* Were it not for paragraph 42A, K would have had a capital gain of R110 000 – R90 000 = R20 000 in respect of the 500 ordinary shares. However, under paragraph 42A K is treated as having disposed of the 500 shares at their base cost of R90 000 and hence no capital gain arises in respect of the disposal. This is because

- the sale occurred as a result of a section 311 court order,
- the shares are listed,
- the sale would have given rise to a capital gain, and

- the repurchase occurred within 90 days.

The base cost of the newly repurchased shares is only R115 000 (R135 000 cost less the R20 000 deferred gain on the buy-back).

**Example 2 – Gain on old “forced sale” shares exceeds expenditure on new shares**

*Facts:* The facts are the same as Example 1, except that K acquires the 500 ordinary shares in XYZ Ltd for R15 000.

*Result:* The capital gain on disposal of the old shares (R20 000) exceeds the expenditure on the new shares (R15 000) by R5 000. As a result

- the base cost of K’s new shares is reduced to nil, and
- the excess of R5 000 is treated as a capital gain.

## **6.6 Capitalisation shares**

Companies often issue “capitalisation” shares to their shareholders instead of paying dividends. The profits are simply transferred to the company’s share capital or share premium account. This is usually done to avoid the payment of STC or to retain the funds in the company for further expansion of its operations. Since you do not pay for such shares, they will have a cost of nil for CGT purposes. However, if you acquired such shares before 1 October 2001 you would be entitled to use the market value to determine their base cost on 1 October 2001.

## **6.7 Share splits / consolidations**

Sometimes companies increase the number of their shares in issue by subdividing the existing shares into a greater number of shares (a share split). For example, you may be asked to surrender your present holding of 100 ABC Ltd shares and will receive 200 new ABC Ltd shares in return. In these cases the base cost of your old ABC Ltd shares will simply be allocated between the new shares. The same would apply when you are asked to surrender your old shares for a lesser number of new shares – known as a consolidation. In this case you will simply allocate the base cost of the old shares across the lesser number of new replacement shares.

## **6.8 Nil paid letters**

Companies sometimes raise additional capital on the stock exchange by means of a rights issue. In terms of such an arrangement, the company offers its existing shareholders the right to take up its shares at a certain price (usually below the prevailing market price) at a certain date. The rights that shareholders receive are known as “renounceable nil paid letters of allocation” or more simply as “nil paid letters” (NPLs). These NPLs are listed temporarily for a few weeks on the stock exchange until the close of the offer. Should you accept the offer, you will simply acquire the shares offered to you for the stipulated price. Should you decide not to accept the offer, you may sell the NPLs on the stock exchange. From a CGT perspective, an NPL is an asset that has a nil base cost. Any proceeds you receive from its disposal will thus constitute a capital gain.

## **6.9 Demutualisation shares**

When Old Mutual and Sanlam demutualised before 1 October 2001 and became listed companies, they issued ordinary shares free of charge to their policyholders. If you acquired demutualisation shares in these companies, you need to note the following when determining the base cost of your shares:

- “B” in the TAB formulae will be nil since you incurred no expenditure before valuation date in respect of the shares.
- Should you adopt the market value or weighted-average methods you will be able to use the relevant prices published on the SARS website to establish a base cost.

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