Tax Brochure for Share Owners

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TAX BROCHURE FOR SHARE OWNERS

FOREWORD

This document provides a general guideline regarding the taxation of share owners and should not be used as a legal reference. It 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 brochure is based on legislation as at 1 February 2006.

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 your own advisor
- Visit the SARS website http://www.sars.gov.za

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Glossary

CGT:	Capital gains tax
FIFO:	First in, first out
NPL:	Renounceable nil paid letter of allocation
SA:	Republic of South Africa
SPID:	Specific identification
STC:	Secondary tax on companies
TAB:	Time-apportionment base cost method
Tax year:	Year of assessment (i.e. any year or period of assessment ending on the last day of February)
the Act:	Income Tax Act, 1962

1. Introduction

With the lowering of interest rates, the booming stock market and the increasing number of broad-based employee share incentive schemes, more and more people are becoming share owners. This brochure 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 brochure 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 where appropriate the more obvious differences in the treatment of these entities have been highlighted.

2. Income tax or CGT?

If you hold a share as trading stock (i.e. 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 (i.e. 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 R10 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 your other 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 where your taxable income falls below the level at which tax becomes payable. The 10% rate would apply where your marginal tax rate is 40% (i.e. 40% x 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 = 14,5% (29% x 50 %). If the capital profit is distributed as a dividend, the effective company tax rate rises to 24% (14,5% normal tax + 9,5% 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	(76,00)
Less: STC 12,5% x R76	(9,50)
Retained income after tax	-

A trust which is not a special trust has an effective CGT rate of 20% (40% x 50%). A special trust is subject to the same tax rates as for individuals.

3. Capital vs 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 rule in respect of listed shares covered in **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 of the Act). 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 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 (i.e. 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

Where 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 where the taxpayer who purchased shares cum div (i.e. 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, 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 where 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, where 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

Where 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) of the Act. 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. It should be noted that this concession is only available to individuals, and will not apply if you hold your shares in a company or close corporation. The amount included in income as closing stock becomes deductible as opening stock for the following year.

Example – Shares held as trading stock

Facts: In November of year 1 A 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 A sold the shares for R1,20 per share. Determine the amounts to be deducted from or included in A'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	80
Loss to be deducted in arriving at taxable income	(20)

Year 2

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

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 of the Act. These rules are complex and a full discussion thereof is beyond the scope of this brochure. 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. Where 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 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 2006 he exercised the options when the market price was R5,00 per share, and on 30 June 2008 he sold his shares at R8,00 per share.

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

- 2006 tax year – an ordinary income gain in terms of section 8A
- 2009 tax year – a capital gain.

These gains will be determined as follows:

Section 8A gain

		R
Market value of shares at date option exercised (1000 x R5)		5 000
Less:	Cost of options 1000 x 10 cents	(100)
	Cost of shares 1000 x R1,00	(1 000)
Section 8A gain included in income		3 900

Capital gain

	R
Proceeds 1 000 x R8,00	8 000
Base cost 1 000 x R5,00	5 000
Capital gain	3 000

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 where at least 90% of the employees in the company 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 5 years, the gain on disposal will most likely be of a capital nature and subject to CGT. But if you dispose of the share within 5 years, any gain will be taxed as income in your hands. This serves as an incentive for you not to dispose of such shares within 5 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 in terms of section 8C.

Example 1 – Broad-based employee share incentive plan: Employee disposing of shares within 5 years

Facts: On 5 January 2005, 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 2009 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 2006. Under the terms of the plan, she sold her shares back to XYZ Ltd (through the trust) on 21 December 2006 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 2006 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 5 years

Facts: The facts are the same as Example 1, except that Y left XYZ Ltd in 2012 and subsequently sold the shares in the open market for R4 500.

Result: The disposal in 2012 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 where the revenue gain was frozen at the time of acquisition of a share and 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 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 2005 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 2006. On 31 May 2006 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 2009 at which time the market price was R190 per share. She eventually sold the shares on 1 March 2010 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
Cost of option	10	
Strike price	100	110
Section 8C gain included in income		80

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
Deemed base cost	190
Proceeds	210
Capital gain	20

4.3 Taxation of dividend income

Dividend income that you receive from SA resident companies is exempt from tax in terms of section 10(1)(k) of the Act.

However, dividends from non-resident companies must be included in your income. There are a few exceptions to this rule. For example, the following types of foreign dividends are exempt from tax:

- Dividends from certain dual-listed shares where more than 10% of the equity shares of the company are collectively held by SA residents. Some well-known examples include SABMiller PLC and Old Mutual PLC.
- Dividends received from a controlled foreign company (CFC).
- Dividends declared out of profits that have been subject to tax in SA. This exemption does not apply if a lower rate of SA tax on the profits in question is payable in terms of a double taxation agreement.
- Dividends declared out of dividends received from a SA-resident company.
- Dividends declared by a foreign company in which you own more than 25% of the total equity share capital. However, on or after 8 November 2005 dividends will be exempt from tax if at least 20% of the total equity share capital and voting rights are held in that foreign company. This is known as the "participation exemption".

The first R2 000 of foreign dividends and interest is exempt from tax in terms of section 10(1)(i)(xv) of the Act in respect of the 2006 tax year. The exempt amount is first applied against foreign dividends. Where the foreign country has deducted a withholding tax from your dividend income, you can be taxed in one of two ways.

- First, you can be taxed on the gross dividend and claim a rebate for the foreign taxes withheld in terms of section *6quat* of the Act. The rebate cannot exceed the SA 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 year, but the carry-forward may not continue for more than seven years. For a detailed explanation regarding the rebate for foreign taxes, see Interpretation Note 18 available from the SARS website (Interpretation Notes / Income Tax).

- Alternatively, you can elect to be taxed on the net dividend after deducting the withholding tax. If you elect this alternative you will not be entitled to the section *6quat* rebate.

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 SA resident shareholders, thereby effectively disregarding the company's separate legal existence. These rules, which are contained in section 9D of the Act, are outside the scope of this brochure.

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 R10 000 of the sum of all capital gains and losses in a tax year is excluded in determining the amount that is subject to CGT. Where your net capital loss exceeds R10 000 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 five-year 'safe haven' rule

Section 9B of the Act enables a person to elect that the profit on the disposal of JSE-listed shares will be of a capital nature when those shares are held for more than five years. The election must be made upon the sale of the first share, and will be binding in respect of your entire portfolio of JSE-listed shares. The capital or revenue nature of shares held for less than five years is determined using the general principles laid down by the courts. However, any gain or loss on shares held for longer than five years will in terms of section 9B be treated as being of a capital nature (SARS Practice Note 18 dated 23 April 1993 refers).

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 brochure, this would be the shares or options being disposed of.
Disposal	-	This is the event that triggers a capital gain or loss (e.g. 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; or
- the company in which you invested is liquidated or deregistered.

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 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 resident of South Africa or changed their nature to trading stock.

Capital distributions

The proceeds will also include the amount of any capital distributions that were received by or accrued to you on or after 1 October 2001 in respect of the shares. 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 do not comprise 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 original share capital or share premium account to its shareholders. The company should advise you whether the amount you are receiving is a capital distribution (forming part of proceeds) or a dividend (which is excluded from proceeds for CGT purposes).

5.6 Base cost

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

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 (SPID);
- first in, first out (FIFO); and
- weighted average.

Example – Identification methods

Facts: J owns 1000 shares in ABC Ltd, a company listed on the JSE Securities Exchange SA, which he acquired on the following dates:

Date purchased	Number of shares	Cost
		R
1 March 2002	200	2 000
30 June 2003	100	1 100
30 November 2004	500	6 000
31 July 2005	200	1 800
Total	1 000	10 900

Assume that on 31 December 2005 J sells 200 shares. Determine which 200 shares he has sold using SPID, FIFO and weighted average.
Result: J has three choices:

Specific identification (SPID) – 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 2004, 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 (FIFO) – Under this method, J is deemed to have sold the oldest shares first, namely, the 200 shares he acquired on 1 March 2002.

Weighted average – Under this method, J must first determine the average cost of all his shares – R10 900 / 1000 = R10,90 per share. The base cost of the shares disposed of is therefore R10,90 x 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	(200)	(2 180)
Total after disposal	800	8 720

Any capital distributions received must be deducted from the base cost pool.
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.

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 comprises the following:

- The cost of acquisition
- Uncertificated securities tax or stamp duty
- The cost of any option used to acquire or sell the shares (except shares taxed in terms of section 8A or 8C)
- Broker's fees (whether to buy or sell the shares)
- In the case of listed shares only, one-third of the interest on any loan used to buy the shares

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 where 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 of the Act (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 prior to1 October 2001 (known as the "valuation date"). These rules are necessary to exclude the portion of capital gains or losses that arose prior to 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 brochure. For more information, please consult the Comprehensive Guide to Capital Gains Tax that is available on the SARS website.

The base cost of a share acquired prior to 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).

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 (SPID), first in, first out (FIFO) or weighted average – see 5.6.1); 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 SPID or FIFO 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 2005 and the remaining 50 on 28 February 2006.
B Ltd – sold 100 on 30 June 2005 and a further 100 on 30 June 2006.
All shares were sold above cost and no capital losses will result regardless of the base cost method K selects (i.e. 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 SPID or FIFO 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 2005, he can use TAB, market value or 20% of proceeds, and
- in respect of the 50 A shares sold on 28 February 2006 - 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 x A/(A+B), and
TAB = B + [(P – B) x N/N+T]

Where:

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 the valuation date).
A	=	Allowable expenditure incurred on or after the valuation date (e.g. 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 prior to 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”, parts of a year are counted as a full year.

The proceeds formula applies where 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 (i.e. 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 such costs 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 (e.g. interest incurred in buying the shares) the proceeds formula will still apply and the selling expenses must be deducted from “R” in the proceeds formula.

Example – Time-apportionment method

Facts: J bought 100 ABC Ltd shares on 30 June 1997 at a cost of R9 500 plus broker’s fees and uncertificated securities tax of R500. She sold them on 30 November 2005 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) x N/N+T]
TAB = R10 000 + [(R15 000 – R10 000) x 5/10]
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 Securities Exchange SA on its website (www.sars.gov.za). These prices can be accessed on the CGT page under Information / Value of Listed Financial Instruments for Capital Gains Tax Purposes / Equities. 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 prior to 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 x 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 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 using the prices published on the SARS website under CGT/Information.

Further purchases of the same share are added at actual cost, while capital distributions received or accrued on or after 1 October 2001 reduce the base cost of the pool. Immediately prior to 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 of the Eighth Schedule to the Act, 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 where 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 brochure to explore these rules in detail, but some examples of the more common situations where 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) of the Eighth Schedule 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 such shares in a foreign currency. Prior to 8 November 2005 the proceeds had to be translated into rands at the average exchange rate in the year of receipt or accrual, while the expenditure had to be translated into rands at the average exchange rate in the year in which it was incurred. The average exchange rates can be found on the SARS website under Taxes / Income Tax.

Where you disposed of the share on or after 8 November 2005, you must translate the proceeds into rands at either the average exchange rate applicable during the tax year of receipt or accrual, or the spot rate ruling at the time of receipt or accrual. The expenditure must be translated at either the average exchange rate applicable during the year in which the expenditure was incurred or the spot rate ruling when the expenditure was incurred. If you have elected to use the average exchange rate, you must use it for all the shares you disposed of during the relevant tax year. The election is on a year-by-year basis. **Note:** If your foreign shares are held in a SA resident company, the company will not have the option of using the average exchange rate.

Finally, any market value determined on 1 October 2001 must be translated into rands at the spot rate on that date.

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
Equals:	Aggregate capital gain or loss
Less / Add:	Assessed capital loss brought forward from previous year
Equals:	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)
Equals:	Taxable capital gain to be included in taxable income

Where an assessed capital loss results, it will be carried forward to the following tax year.

5.7.2 Annual exclusion

The first R10 000 of the sum of an individual's capital gains and losses in a 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. In the year of death the annual exclusion increases to R50 000.

5.7.3 Assessed capital loss

Where 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 2005 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 2004 tax year she had an assessed capital loss of R2 000.

Determine the amount to be included in her 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	(3 000)
Sum of capital gains and losses during the tax year	22 000
Less: Annual exclusion	(10 000)
Aggregate capital gain	12 000
Less: Assessed capital loss brought forward from prior year	(2 000)
Net capital gain	10 000
Inclusion rate (25% for an individual)	
Taxable capital gain – to be included in taxable income	2 500

6. Corporate restructuring events

Although not covered in detail by this brochure, 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

Where a company distributes shares it holds in another company to you in terms of an "unbundling transaction" contemplated in section 46 of the Act, 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. The allocation must be done in accordance with the following formula:

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

Any market value on 1 October 2001 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 and market value 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. In 2005 A Ltd distributed all its shares in B Ltd to its shareholders as part of an unbundling transaction. J received 20 B Ltd shares with a market value of R20. The market value of his A Ltd shares after the unbundling 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 x R20/(R20 + R140) = R100 x R20/R160 = R12,50

Expenditure attributable to A Ltd shares = R100 – R12,50 = R87,50

Market value attributable to B Ltd shares:

R120 x R20/(R20 + R140) = R120 x R20/R160 = R15

Market value attributable to A Ltd shares = R120 – R15 = R105

6.2 Share-for-share transactions

Where you receive new shares in an acquiring company in exchange for your existing shares in a target company in terms of a "share-for-share transaction" contemplated in section 43 of the Act, you may qualify for roll-over relief. This means that the base cost of your old "target company" shares will be transferred to your new "acquiring company" 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. Where you would have made a loss on exchange of the shares, the roll-over will not apply, and you will simply realise the loss, and acquire the acquiring company shares at their market value at the time of the share-for-share transaction.

Example – Share-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 shares for CGT purposes on 1 October 2001 was R150. On 30 June 2005 L received a circular informing him that Acquiring Ltd would be taking over his shares in terms of a section 43 share-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 in terms of section 43.

L will qualify for roll-over relief because -

- a share-for-share transaction in terms of section 43 has occurred; and
- he would have made a capital gain on disposal of his Target Ltd shares had section 43 not applied, that is, R500 (proceeds equal to market value of Acquiring Ltd shares) – 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, thereby giving rise to no gain / no loss.
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 of the Act 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 cancelled and you will receive Company B shares in exchange. This rule works on a similar basis to the share-for-share transaction rule described under 6.2. Any 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 capital reductions and share buy-backs

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

6.5 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 valuation date.

6.6 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 against the new shares. The same would apply where 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.

6.7 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 would offer 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, a NPL is an asset that has a nil base cost. Any proceeds you receive from its disposal will thus constitute a capital gain.

6.8 Demutualisation shares

When Old Mutual and Sanlam demutualised prior to 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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