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Business Law & Tax Review

BUSINESSDAY

www.problemsolved.co.za

September 2007

A review of the Government Gazette and new developments in law

Number VII

Uncertainty with new ruling on gains

ONE of the most hotly contested terrains in tax is the question of whether or not selling assets will result in the gains being treated as normal revenue or capital gains.

The distinction between revenue and capital gains is an important one since it will determine whether your proceeds are taxed at normal income tax rates or at the lower capital gains tax rates.

SA introduced capital gains tax (CGT) with effect from October 1 2001 and it applies to any incremental growth in the value of assets from this date to the date of the disposal of the assets.

Capital gains tax is not separate in its own right, but forms part of the income tax system. The capital gain is the proceeds of an asset sold less its base cost. From the inception of capital gains tax, a 75% discount has been in place for individuals in that only 25% of the capital gain is included for income tax purposes.

For individuals whose taxable income exceed R450 000 and who are therefore liable for income tax at the maximum marginal rate of 40%, their maximum capital gains tax rate would amount to 10%.

Such a low inclusion rate leaves a big differential relative to the ordinary income tax to create significant incentive for tax arbitrage.

For taxpayers who have share portfolios and make changes to it from time to time, the question of whether to treat the gains from the disposal of those shares as capital or revenue is an important consideration in the light of the CGT discount.

Each disposal is taken on its own merits, and taxpayers are unlikely to be treated as share dealers for tax purposes if the primary motive for their share investments is long-term capital growth. This distinction between capital and revenue is often contentious, hence the introduction of section 9B as a "safe haven".

Since 1990, shareholders have been able to ensure capital status for profits on the sale of listed shares by holding the shares for at least five years. Section 9B introduced the so-called "five-year rule" or "safe haven rule" when it comes to the disposal of listed shares. On August 10 this year the South African Revenue Service (SARS) issued an interpretation note regarding section 9B which replaces the previous (1993) note.

While interpretation notes do not hold the same weight as legislation, they do provide guidelines to taxpayers regarding the interpretation and application of the provisions of the various laws administered by SARS. These interpretation notes will ultimately replace all the existing practice notes and internal circular minutes, to the extent that they relate to the interpretation of the various laws. The notes will be amended in line with policy developments and changes in the legislation.

Interestingly, the finance minister in this year's budget speech said that a wider spectrum of shares disposed of after three (not five) years would trigger a capital gains tax event and that this proposal will take effect on October 1.

THE minister said that "(t)he taxation of gains realised from the sale of shares is presently subject to ambiguous procedural treatment. In order to provide equitable treatment and certainty for both taxpayers and SARS, all shares disposed of after three years will trigger a capital gains tax event."

Legislation will be required to give effect to the change in the holding period from five to three years. The interpretation note does not reflect the proposed legislation.

It does seem peculiar that a new interpretation note would be issued at this point reflecting the current legislation when a change in the law appears imminent.

The proposal contained in the budget says that "all shares disposed of after three years will trigger a capital gains tax event". This means that it may also, unlike the existing safe haven provision, apply to the disposal of shares in unlisted companies.

Section 9B, in its current form, only applies to disposals of listed shares; so if a taxpayer held a share in a company which was unlisted for two years and listed for three years then that would not count as a listed share for the purpose of section 9B as this section requires that the taxpayer must have been "the owner of such share as a listed share for a continuous period of at least five years".

A taxpayer must make an election in the first year in which she sells a listed share that she has held for more than five years, as to whether she would like that share disposal and all future qualifying disposals (listed shares held for at least five years, etc) to be treated as capital. If she elects to treat such disposals as of a capital nature, the fact that they might have been of a revenue nature throughout the five-year period doesn't stop them being deemed to be of a capital nature.

If the taxpayer held them for five years, it does raise the question of how much trading one is doing.

If the taxpayer elects not to have them deemed to be capital, then the capital/revenue nature of the share would be tested on its merits having regard to the factual circumstances, as would any disposal of shares that

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Is asset disposal CGT or revenue?

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do not qualify (not listed or not held for five years).

A question that has been posed is what happens if the taxpayer does not necessarily want the proceeds to be treated as capital?

This may appear odd in light of the significant CGT discount. If the taxpayer is a share dealer, it's logical that the taxpayer is trading shares for the purpose of generating income and that the taxpayer is allowed to deduct expenses incurred for the producing that income.

The taxpayer's shares, in this case, are treated as normal trading stock pretty much like stock in a retail store. It is really at this category of taxpayers for whom section 9B is intended. These taxpayers should be mindful though that the election of the five-year safe haven brings with it the recoupment of any costs or expenses allowed to a taxpayer that may have been deducted where the shares were trading stock and which would not have been deductible if the shares were capital, such as interest expenditure.

The interpretation note specifically says that this does not mean that proceeds from shares held for a lesser period are automatically regarded as revenue. The note does not dispense with the ordinary rules for determining the nature of the amounts derived when shares are sold and each case will be treated on its merits, and will be based largely on the taxpayer's intention. It also stands to reason — although not specifically stated in the interpretation note — that the proceeds of a share held for an extended period will not automatically be regarded as capital. This means that a share-dealer who happens to hold a share for a longer period could still have the proceeds treated as revenue by SARS unless the taxpayer has made an election to have such shares treated as capital under 9B.

Further clarity will presumably have to be sought once the amendments proposed in the budget speech are implemented. In particular, the suggested "equality of treatment" for shares will have to be considered as the existing provisions of section 9B read together with the interpretation note do not capture this requirement.

What will happen to those taxpayers who have made the election in respect of the five-year period? Will the new provisions allow for an automatic reduction in time for holding of shares which have been held for a period of three years?

Will there be any interim arrangements to allow for the transition between the five- and three-year period and the inclusion of both listed and unlisted shares?

These are some of the questions if the objective is to reach a level playing field. It is not apparent if there can just be a textual amendment to the provisions of section 9B merely to allow for the change in time period and expansion of the definition of "affected share".

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