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## Chapter 5

# INTRODUCTION TO CAPITAL GAINS TAX LEGISLATION

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### Overview

On 1 October 2001, Capital Gains Tax (CGT) was implemented in South Africa. Up until this date capital gains have not been taxable in South Africa, only income as defined in the Income Tax Act, 1962. To give affect to the proposals relating to CGT, an Eighth Schedule has been added to the Income Tax Act, which determines what constitutes a taxable gain or assessed capital loss. A new section, 26(a), of the Act provides for the inclusion of a taxable gain in taxable income. Gains or losses are therefore not treated in terms of a separate taxation mechanism, but included in the existing income tax mechanism as set out in the Eighth Schedule.

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## 5. Introduction to Capital Gains Tax Legislation

### Learning outcomes

By the end of this section, the learner must be able to: -

- Explain the effects of capital gains tax on collective investments
- Identify the inception date of capital gains tax
- Name events that triggers capital gains tax
- Explain the concepts used in the Capital Gains Tax legislation and their practical implications for the taxpayer.

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### Assessment criteria

The learner will be assessed on the following criteria: -

- The effects of capital gains tax are explained from the view of the small investor.
- The date from which capital gains tax is calculated is identified with examples of how the date affect the disposal of assets.
- Events that trigger capital gains tax are named in terms of disposal.
- The concepts of proceeds, disposals, base cost, capital gain vs. capital loss and annual exclusion rate are explained with examples.



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**Overview**

Capital Gains Tax (CGT) is a complicated subject and the intention of this chapter is to try and simplify the concept of CGT on investments as far as possible.

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**Collective investmentss and CGT**

- Collective investments are exempt from paying CGT and investors will only incur CGT when they sell their units in a collective investment.
- Collective investments and fund of funds investors will only incur a CGT event once - when they sell their units. When a portfolio manager restructures a collective investment portfolio (for example sells underlying assets/shares), capital gains tax will not be incurred.
- Having CGT paid outside of the collective investment means that collective investment portfolio managers can focus on their core business of managing an investment portfolio according to a mandate, rather than being distracted by tax issues.
- CIS investors are empowered to decide when to become liable for CGT, allowing them to defer tax and to plan their investments appropriately. Relief measures such as the R10 000 exemption and the offsetting of losses against gains, can also be used.
- CGT policy for collective investments is transparent. CIS investors will know when CGT is incurred. At the end of the tax year investors will receive a statement (IT3E) reflecting gains or losses incurred during the tax year and it is then up to the investor to submit this with the annual tax return. Managers are obliged to send copies of the IT3E to the Receiver. Money market funds, which have a fixed price and generate income, will be subject to income tax and not CGT.



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**How Gains are included in your Income**

The taxation of capital gains is triggered by your disposal of an asset. In this sense your exposure to this tax is very important. When you decide to sell an asset, such as units in your collective investment portfolio, you are triggering a *CGT* event. It is important to remember that you will only pay tax on the profit you make, not on the proceeds from the sale. This means you can deduct the cost (base cost) of the collective investment or asset from the amount you realise on the sale of the collective investment or asset. If you had the collective investment or asset before *CGT* was implemented on October 1, 2001, you must also exclude the profit that accumulated until then. Remember, as an individual, you will only pay tax on a quarter of this gain.

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**CGT terms**

To understand *CGT* on investments it is important to understand a few key terms and how these terms are applied to collective investments.

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**Base Cost**

This is the basis from which a *cg*t calculation is done. "The cost of an asset, which is deducted from any proceeds upon disposal to determine whether a capital gain or loss has been realised". It is important to distinguish between investments made before 01.10.2001 and after 01.10.2001, to determine what the base cost is. The base cost for investments made before 01.10.2001, was calculated as the average repurchase price for the last five trading days before the valuation date (01.10.2001). The base cost prices were published in the *Government Gazette*, the *ACI* website as well as the *SARS* website. Sanlam Collective Investments also keep a file on the base cost prices of our funds on the "Vinnige Fanie" file. The base cost for investments done after 01.10.2001, is simply the weighted average price paid for the units.



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**Base Cost** Two other methods of valuation are available, but not used by the collective investment schemes industry. The investor must consult a tax adviser for these alternatives. These alternatives are:

- the time apportionment method
- and the market value method

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**Weighted Average Cost method** The collective investment schemes industry makes use of the weighted average cost method for the calculation of the base cost. SARS requires the industry to supply the investor and SARS with a base cost calculation using this method, as well as the weighted average value.

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**Disposal** A disposal generally triggers a *CGT* event. As a general rule, an asset is acquired or disposed of whenever there is a change in ownership of the asset. Most common events that will trigger a *CGT* event will be things such as the sale of units, fund switches, transfer of units, death and the divorce of a couple married in community of property as assets jointly owned are sold to divide the proceeds between two parties. Events that will not trigger a *CGT* event include the transfer of units from a management company to a linked company and vice versa. Units donated to a spouse will not be regarded as a *CGT* event.

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**Proceeds** This is the actual or deemed amount received on disposal of the investment. A capital gain or loss is the difference between the base cost and the proceeds.



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**Capital gain**      It is the profit you make when you sell something that you own.

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**Capital loss**      When you sell something for less than it cost you.

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**What is the Annual exclusion?**      Each year the first R10 000 you realise on the sale of assets will be exempt from tax for CGT purposes. This is referred to as the annual exclusion and it also applies to losses. In other words, if you make a gain of less than R10 000, it will be excluded for CGT purposes.

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**What is the Inclusion rate?**      When you calculate the tax you owe, as an individual, you only need to include 25 percent of the net gain. However, when you are completing your tax return, you must declare the full amount of the gain or loss you have made, as the annual exclusion and the inclusion rate will be calculated by SARS. It is because of this inclusion rate, that the effective rate of CGT is in fact lower than your income tax rate. For example, if your marginal tax rate is 40 percent and you add only a quarter of any capital gain to your taxable income where it will be taxed at 40 percent, the effective rate of the CGT you pay is 10 percent. CGT is worked out in the same manner for companies and trusts, but the applied CGT rate varies. The inclusion rate for special trusts is also 25%, while for other trusts and companies it is 50%.



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**Example:**  
**Calculation of**  
**CGT**

Here is a simple example to illustrate the concept of CGT.

A private individual invests R100 000 in fund A and R50 000 in fund B and disposes of the investment a year later. Assume investment A has a value of R160 000 and that fund B has made a loss of R5 000. The gain is R55 000. On this R55 000 an amount of R 10 000 is exempt from CGT, leaving a net gain of R45 000. In this instance 25% of R45 000 amounts to R11 250 and CGT is calculated on this amount at the investor's marginal tax rate of 42%. The result is a R4 725 tax liability, effectively 10,5% of R45 000.

Another client in the same example with a 32% marginal income tax rate would pay R3 600, effectively 8% instead of 10,5%.

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**RSA funds and**  
**CGT**

SARS requires collective investment schemes managers to calculate the weighted average value for all local funds. No calculations are, however, done for the offshore funds and the investor will have to maintain his own records in order to do this.

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**Offshore**  
**Funds and CGT**

- If you have invested in an offshore collective investment using your R750 000 offshore allowance, the value of those units on October 1, 2001 is the last published price at which a unit sold before that date. You will need a letter from the Manager confirming the price at the end of trading on Friday, September 28, 2001.
- All capital gain or loss calculations are done in rands. You need to use the ruling exchange rate on the day of purchase or sale, even though you may not be transferring the assets back to South Africa.
- Many offshore collective investments do not declare a dividend or interest but use the money that comes into the fund to issue you with further units. These extra units will be regarded as a capital gain and will be subject to CGT when you sell the units.



## ACTIVITY SHEET 14



1. When was capital gains tax implemented and how did it affect the collective investment schemes industry?

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2. Which of the three proposed methods do the collective investment schemes industry use?

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3. Explain what the base cost is, and how was it calculated on 01.10.2001.

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## ACTIVITY SHEET 14



4. Describe the difference between the annual exclusion rate and the inclusion rate.

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Link the phrases below with the following terms:

**Inclusion rate**

**Weighted average**

**Base cost price**

**Inception date of CGT**

**CGT events**

**Annual exclusion amount**

- Standard method used in CIS industry for base cost evaluation.
- 25% of capital gain
- R10 000.00
- Repurchases; switches out; and transfer of units where beneficial ownership changes.
- The simple average of the repurchase price calculated for the last 5 working days the inception of CGT.
- 1 October 2001



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## CRITICAL CROSS FIELD AND DEVELOPMENTAL OUTCOMES

1. **Identify and solve problems** - in which learner must use knowledge learnt on CGT to explain the capital gains tax statement.
2. **Communicate effectively using mathematical and language skills in modes of written presentations** - learners can explain concepts and calculations (in class and assessments ie. gain or loss) in a clear and understandable manner.