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Video Transcription: Introduction to Capital Gains Tax

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Hi, I'm Shaun Parsons, and in this video we are going to review the basics of Capital Gains Tax.

Capital Gains Tax was introduced in South Africa on 1 October 2001. Prior to this date there were no income tax consequences to capital income or expenditure, i.e no amounts were included as income or allowed as deductions, unless those items were brought into taxable income by a special inclusion or a special deduction, or gave rise to capital allowances or the recoupment of those allowances.

However, over time it became obvious that it was quite possible for a taxpayer's wealth to increase as the result of a capital transaction – for example, a taxpayer might sell a capital asset like land at a profit and that such increases in wealth should also be subject to income tax. It was for this reason that capital gains tax was introduced.

A capital gain is essentially a profit on a capital transaction, such as the sale of an asset. The term "capital gains tax" is however somewhat misleading, because it is not a separate tax like VAT or Estate Duty. Rather, it is an addition to the taxpayer's income tax calculation. A portion of the taxpayer's net (or "aggregate") capital gains are included in the calculation of taxable income. The inclusion increases the taxpayer's taxable income and therefore increases the income tax payable.

The rules we use to determine the amount of capital gains or losses are laid out in the Eighth Schedule to the Income Tax Act. It is these rules that we might refer to as "Capital Gains Tax". To have an income tax consequence, there must be a capital gain or a capital loss as determined by the rules of the Eighth Schedule. So when does that happen?

In order for us to recognise either a capital gain or loss, four things must exist. These four things are sometimes referred to as The Four Pillars of CGT, and each is covered in detail by the Eighth Schedule.

The Four Pillars are:

- An asset
- A disposal
- Proceeds
- Base Cost

Let's look at each one of these. An asset includes all property of whatever nature. It is important not to confuse the term "property" as used in the Income Tax Act with the term "property, plant and equipment" as used in financial reporting. The term as used in income tax is much more broad, and includes any asset, whether it is moveable, like a computer, or immovable, like a building, and whether it is tangible, like a car, or intangible, like a trademark. It also includes any right to or interest in such property.

A right is probably the most difficult asset to identify, so let's look at this in more detail. For example, a share option is the right to buy a share. The share option is the property of the holder, it has a value, and the right can be bought and sold. So it will be treated just like any other asset, for example a house or a computer or the actual share.

What is a disposal? A disposal occurs when an asset is sold. However, “disposal” in the Eighth Schedule includes a number of other events, such as a donation, an expropriation, which is where the government takes ownership of an asset, and may or may not compensate the taxpayer, or an exchange for another asset, as well as when an asset is lost or destroyed. When an asset has been disposed of, the capital gain or loss is the difference between the proceeds on disposal and the base cost of the asset. Let’s look at what each of those terms means.

The proceeds are what we received for the sale of the asset. However, some or all of the selling price may have already been included in gross income – for example, where the asset in question is trading stock, or where we have claimed capital allowances, such as section 12C in respect of the asset in the past, and the sale has resulted in a recoupment.

So that the same amount is not taxed twice, we reduce the amount of proceeds by any amount that has already been included in income. The base cost is the sum of the costs that we’ve incurred in respect of the asset. This includes the original purchase price, and can also include subsequent costs such as the cost of installing or moving the asset, and even the cost of selling the asset. The Eighth Schedule is very clear; which costs may be included and would be used as a guide for each calculation.

However, some or all of these costs may already have been allowed as a deduction or an allowance against taxable income. So as not to double count the deductions, we reduce the base cost by all amounts already allowed as a deduction.

Let’s look at an example. Last year a taxpayer purchased a new machine for R100, which he immediately began to use in a process of manufacture. This year he sold the machine for R110. The taxpayer has an asset which he has disposed of. We will therefore need to determine the capital gain or loss that has arisen.

The taxpayer paid R100 for the machine. However, in last year’s return he would have claimed an allowance of 40% of the cost as a capital allowance, and this year he would have claimed another 20%. His base cost is therefore R100, less the R60 he has already claimed in deductions. The taxpayer sold the machine for R110. However, in the course of the sale he has recovered the R60 he had previously claimed in allowances. This is recognised as a recoupment of R60. The proceeds of R50 recognised equal the R110 selling price less the R60 recoupment. The taxpayer’s capital gain is therefore equal to proceeds of R50, being R110 less R60, less a base cost of R40, being R100 less R60. The taxpayer has a capital gain of R10.

Now that we have covered the basics of how to calculate a capital gain or loss, let’s consider which capital gains and losses are subject to income tax in South Africa. For South African tax residents, the Eighth Schedule applies to all of their assets, regardless of where the assets are located. For non-residents, the Eighth Schedule applies only to immovable property located in South Africa, or to the assets of a branch, or “permanent establishment” of that taxpayer located in South Africa.

The Eighth Schedule applies to all assets other than "personal use assets". A personal use asset may be any asset that is used mainly for a purpose other than trade. For example, if you bought a computer to use for your studies and sold it at a profit, you do not need to worry about CGT. Gains or losses on the disposal of personal use assets may be disregarded. However, certain assets can never be considered personal use assets. The most notable of these would be immovable property (even the house you live in) and financial instruments.

Finally, let's look at how to calculate what must be included in the taxpayer's taxable income. Once the gains or losses arising in the year of assessment from the disposal of assets subject to CGT have been determined, the taxpayer adds up all those gains and losses. If the taxpayer is an individual, the total is reduced by R30 000 – we refer to this as the "annual exclusion" allowed to individuals. Companies and other taxpayers do not get an annual exclusion, i.e they may not reduce the total at all.

The sum of all capital gains and losses, less the exclusion if available, is called an "aggregate capital gain" if it is positive, or an "assessed capital loss" if it is negative. If the taxpayer has an aggregate capital gain, this is multiplied by the inclusion rate, either 33,3% for an individual or 66,6% for a company, and this amount – the taxable capital gain – is included in the taxpayer's taxable income.

If the taxpayer has an assessed capital loss, it is not multiplied by the inclusion rate, nor does it reduce the taxpayer's existing taxable income. This year's capital loss can only be offset, i.e subtracted from, aggregate capital gains in future years.

So, in this video we have looked at the basics of Capital Gains Tax or CGT. We have seen that CGT is not a separate tax, but rather a means for determining the amount to be included in taxable income in respect of capital disposals. Although capital transactions have income tax consequences, they differ considerably from those of revenue transactions, and the distinction between capital and revenue remains foundational to income tax in South Africa.

Thanks for watching.