CAPITAL GAINS TAX

(EIGHTH SCHEDULE TO THE INCOME TAX ACT)

VALUATION OF ASSETS

(I) INTRODUCTION

Taxpayers will need to determine the base cost of their assets in order to determine the gain or loss on disposal of the assets. One of the following methods may be used:

(a) 20% of the proceeds, reduced by any post-valuation date expenditure, upon realisation of the asset can be deemed to be the base cost.

(b) Market Value of the asset *(this topic is expanded upon below)*.

(c) Time apportionment basis.

In addition, it will be necessary to determine the market value of assets under a variety of other circumstances, which include death, donation, immigration, emigration and connected person transactions.

(II) MARKET VALUE ON VALUATION DATE (1 OCTOBER 2001)

The **transitional** measures which deal with the requirements regarding the valuation of assets on valuation date are contained in paragraph 29 of the Eighth Schedule to the Income Tax Act.

The following requirements apply when determining the market value of an asset on 1 October 2001:

- **Time limit for performing valuations**

  All valuations must be carried out by 30 September 2003. Failure to do so will mean that this method cannot be used. It is emphasised that, whenever the valuation is carried out prior to 30 September 2003, the asset must be valued according to its condition, prevailing economic conditions, etc. pertaining as at 1 October 2001.

- **Who may perform valuations?**

  The Act does not prescribe who may perform valuations. This is the responsibility of the taxpayer and the onus of substantiating a valuation rests with the taxpayer. The taxpayer may, however, appoint a professional person to assist with the valuation.

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- **<u>Methods to be adopted in valuing certain assets</u>**

In general the Act does not specify the methods to be used in performing valuations, though there are some exceptions, as summarised in the table below:

MARKET VALUE ON 1 OCTOBER 2001	
General rule	Market value = price based on willing buyer, willing seller at arm's length in an open market *
Financial instruments listed on a recognised exchange in the Republic	Prices will be supplied in *Government Gazette*. Price based on 5 trading days preceding 1 October 2001
Foreign financial instruments listed on a recognised exchange elsewhere	The ruling price on that recognised exchange on the last trading day before 1 October 2001
Units in S.A. unit trusts and property unit trusts	Average "sell" price for the last five trading days before 1 October 2001. Prices will be supplied in *Government Gazette*
Units in foreign unit trusts	Same as for S.A. unit trusts, except based on last trading day before 1 October 2001
Controlling interest in listed company *(see example 1)*	Control premium/discount determined on disposal and applied to listed price at 1 October 2001**
S.A. second-hand endowment policies	Greater of: • Surrender value • Insurer's market value (assume policy runs to maturity)
Farm land	Land Bank value or market value based on general rule

* The open market value of an asset is the best price at which an interest in the asset would have been sold unconditionally for a cash consideration on the date of valuation assuming:

(a) a willing seller (under no duress at all)

(b) that, prior to the date of valuation, there had been a reasonable period (having regard to the nature of the asset and the state of the market) for the proper marketing of the interest and for the sale to be concluded;

(c) that no account is taken of any additional bid by a prospective purchaser with a special interest;

(d) a sale either:

(i) of the asset as a whole for use in its working place; or

(ii) of the asset as a whole for removal from the premises of the seller at the expense of the purchaser; or

(iii) of individual items for removal from the premises of the seller at the expense of the purchaser; and

(e) that both parties to the transaction had acted knowledgeably, prudently and without compulsion.

** Conditions:
- Company must be a listed company
- Buyer must not be a connected person of the seller
- Seller must dispose of **entire** controlling interest in the company
- "Controlling interest" = more than 50% of equity share capital

- **Submission requirements**

Copies of valuations must generally be lodged together with the relevant return of income (IT14) for the year in which the asset was disposed of. However, certain valuations must be lodged with the first return of income submitted after 30 September 2003, irrespective of whether the relevant assets have been disposed of or not. These categories of assets are set out in the table below:

TYPE OF ASSET	APPLIES	WHERE MARKET VALUE EXCEEDS
Intangible assets	Per asset	R 1 million
Unlisted shares	All shares held by the shareholder in the company	R10 million
All other assets	Per asset	R10 million

(see example 2)

- **Loss limitation rules**

Certain rules are in place to limit losses when the market value method is used. These rules are designed to prevent the creation of phantom losses arising from inflated valuations, but apply equally when the valuation is realistic but where the market value exceeds the proceeds.

- **<u>The onus is on the taxpayer to substantiate a valuation</u>**

  The fact that a valuation was done by a qualified valuer will not prevent the Commissioner from auditing such a valuation. Where the Commissioner is not satisfied with a valuation, he may

  - request further information or documents relating to the valuation; or

  - adjust the valuation.

  His right to adjust the valuation is subject to objection and appeal.

  The following are **<u>examples</u>** of the detail which the Commissioner may require:

  * <u>Residential property</u>

  Valuer's valuation, including basis of valuation and calculations
  Physical address
  Size of property
  Details of improvements to property
  Plans of the property as at 1 October 2001
  Details of recent property sales in the same area
  Current municipal valuation of the property
  Any other information which may be relevant

  * <u>Farming property</u>

  If the Land Bank's valuation is not used, it would do taxpayers well to note the detail requested in the Land Bank questionnaire used for valuing immovable property on which *bona fide* farming operations are carried on (for Estate Duty purposes).

  * <u>Mineral rights</u>

  Valuer's valuation, including basis of valuation and calculations.
  The description of the mineral right and its registered number at the Deeds Office.
  Type of mineral
  Location and extent of mineral right
  Exploitation of mineral right as at 1 October 2001

- Original cost of mineral right
- Quantification of reserves still to be mined
- Remaining life of mine

If exploitation has not commenced, details and results of prospecting undertaken as at 1 October 2001
Department of Minerals and Energy valuation
Any other information which may be relevant

NOTE: A mineral right is a capital expense to a mining company but a revenue expense to a prospecting or exploration company. Only companies involved in mining activities, or who intend to themselves mine any areas covered by mineral rights which they possess, are required to value their mineral rights for capital gains tax purposes.

* Unlisted shares

Valuer's valuation, including basis of valuation and calculations

The method used will depend on the degree of control which the particular block of shares may exercise over the affairs of the company, which may vary from full control to a small or non-existent influence.

Possible valuation methods are, but not limited to, the following:

(1) Dividend based valuations may be used in cases of minority shareholders and the company has a history of paying dividends.
(2) Earnings based minority holding valuations may be used in cases of influential minority holdings (concentrating on net earnings per share and price earnings ratios).
(3) Earnings based whole company valuations in cases of majority shareholders (concentrating on maintainable pre-tax profits, a capitalisation factor and a discount which takes cognisance of the size of the shareholding).

Proof of shareholding
Full description of the business carried on by the company
The company's annual financial statements for the last three years prior to the valuation date.
If there are different classes of shares, documentation proving the rights of each class, in particular those concerning voting, dividends and distributions on liquidation of the company.
Any other information which may be relevant.

(III) MARKET VALUE OF ASSETS IN VARIETY OF CIRCUMSTANCES

The **permanent** market valuation rules, as opposed to the **transitional** market valuation rules on valuation date, are contained in paragraph 31 of the Eighth Schedule and are summarised in the table below. These rules apply to:

- valuation date (1 October 2001) assets not covered by the transitional valuation rules in section (**11**) above.
- other occasions, such as:
  - immigration and emigration
  - death or donation
  - connected person transactions at a non-arm's length price

TYPE OF ASSET	MARKET VALUE
Financial instrument listed on a recognised exchange	The ruling price at close of business on last trading day before disposal
Long-term insurance policy	Greater of: • Surrender value • Insurer's market value (assume policy runs to maturity)
Units in unit trusts and property unit trusts	Management company's repurchase price
Units in foreign unit trusts	Management company's repurchase price or, if not available, selling price based on willing buyer, willing seller acting at arm's length in open market
Fiduciary, usufructuary and other like interests *(see example 3)*	Present value of future benefits discounted at 12% p.a. over life expectancy of person entitled to asset or lesser period of enjoyment. Commissioner may approve less than 12% where justified.
Property subject to fiduciary, usufructuary or other like interest	Market value of full ownership, less value of fiduciary, usufructuary or other like interest as determined above
Immovable farming property	• Land Bank value (defined in Estate Duty Act); or • Price based on willing buyer, willing seller at arm's length in open market On disposal by death, donation or non-arm's length transaction, the Land Bank value may only be used if it is used in determining the base cost of the disposer on – • Valuation date, or, where applicable, • date acquired by inheritance, donation or non-arm's length transaction at Land Bank value.
Any other asset	Price based on willing buyer, willing seller at arm's length in open market (see notes on page 2)

TYPE OF ASSET	MARKET VALUE
Unlisted shares	Price based on willing buyer, willing seller at arm's length in open market. The valuation must reflect the extent to which a potential buyer of the shares can or cannot control or influence the company. There are many degrees of control, usually determined by the voting power of a particular block of shares, running from full control (including power to liquidate the company) to a small or non-existent influence over the company's affairs of a minority shareholding. If follows that, unless there are exceptional circumstances, if the degree of control is less than complete, the value of the shares will be less than a pro-rata proportion of the overall value of the company.

EXAMPLE 1

Sweet Pea Ltd. holds 51% of the issued share capital of Pea Ltd., a company listed on the JSE for the past 6 years. Sweet Pea Ltd. decides to dispose of its entire interest in Pea Ltd. to Oh (Pty.) Ltd.

Date of sale	1 October 2002
Total number of Pea Ltd. shares held by Sweet Pea Ltd.	3 000 000
Last buying price per Pea Ltd. share on 30 September 2002 (per JSE)	R1.95
Last selling price per Pea Ltd. share on 30 September 2002 (per JSE)	R2.05
Price per share in terms of sale agreement	R2.20
Average price per Pea Ltd. share per paragraph 29(1)*(a)*(i)	R1.50

STEP 1: CALCULATE MARKET VALUE ON VALUATION DATE

Valuation date market value (3 000 000 x R1.50) 4 500 000

STEP 2: CALCULATE CONTROL PREMIUM OR DISCOUNT

Average last price quoted = (1.95 + 2.05)/2
= R2.00

$$\text{Base cost adjustment} = \frac{\text{Price per sale agreement} - \text{Last price quoted}}{\text{Last price quoted}}$$

$$= \frac{(2.20 - 2.00)}{2.00}$$

$$= 10\%$$

STEP 3: DETERMINE BASE COST

Control premium R4 500 000 x 10%	450 000
Base cost	R4 950 000

STEP 4: DETERMINE CAPITAL GAIN

Proceeds 3 000 000 x R2.20	6 600 000
Base cost	4 950 000
Capital gain	R1 650 000

EXAMPLE 2

Andrew owns 10 shares in Enne (Pty.) Ltd., a company with a 31 August financial year-end. His accountant carried out a valuation of his shares on 31 August 2002 and valued them at R1.5 million each as at 1 October 2001. The accountant's valuation of the assets in the company was the following:

Fixtures and fittings	R10 000 000
Goodwill	R2 500 000
Trademarks	R1 700 000
Liquor licence	R800 000

The fixtures and fittings are made up of numerous small items, each valued at less than R200 000.

Enne (Pty.) Ltd. submitted its return for the year ending 31 August 2002 on 31 August 2003 and obtained an extension to submit its 2003 return by 31 August 2004.
Andrew submitted his return for the year ending 28 February 2003 on 28 February 2004.

Assuming that Andrew and Enne (Pty.) Ltd. wish to adopt the market value basis for all their assets, proof of valuation must be submitted to SARS in respect of the following assets:

Asset	Reason	Proof to be submitted with return for year ending:
Andrew		
Shares in Enne (Pty.) Ltd.	MV > R10 million	28 February 2003

Enne (Pty.) Ltd.

• Goodwill	MV > R1 million	31 August 2003
• Trademarks	MV > R1 million	31 August 2003

Note:
The valuation of the assets not specified above need only be submitted with the tax return covering the tax year in which they are disposed of

EXAMPLE 3

Tim owns a farm with a Land Bank value of R800 000. He donates a usufruct over the farm to Kevin for the rest of Kevin's natural life. Kevin is 30 years old.

What is the value of the usufruct?

Solution

Annual value: R800 000 x 12% = R96 000

According to life expectancy tables for males, Kevin's life expectancy is 38,48 years.
Present value of R1 capitalised at 12% p.a. for 38,48 years = R8,22694

Value of usufruct – R96 000 x 8,22694 = R789 786