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IN PRACTICE

Will asset sale attract capital gains or income tax?

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Given the difference between the effective rate of tax on capital gains and the highest marginal rate of tax imposed on income, it is important to determine whether the proceeds from the disposal of an asset are subject to capital gains tax or to income tax.

In the Pick n Pay case, the proceeds from the sale of certain shares were found to be capital in nature. The court held that the test for distinguishing between capital and revenue accruals is the inquiry as to whether the taxpayer was engaged in a scheme of profit-making.

The majority of the court reached its decision by first asking whether the taxpayer objectively conducted a business and, second, whether it was the objective of the taxpayer to conduct a business. The court further held that any receipts or accruals bear the imprint of revenue if they are not fortuitous but designedly sought and worked for.

The dominant test to determine whether capital has been productively employed in order to earn profits is the intention of the taxpayer. The test of intention is subjective and involves consideration of all the circumstances surrounding the acquisition of and method of dealing with an asset

When a taxpayer sells an asset and has claimed capital allowances in respect thereof, then, to the extent that the purchase price exceeds the tax value of the asset, the taxpayer may have a recoupment of such allowances, in which case the portion of the proceeds equal to the allowances recouped will be included in the taxpayer's income and subject to income tax.

When the relevant asset is held by a trust and is vested in a beneficiary, then the capital gain is allocated to the beneficiary if such beneficiary is a resident of SA. If such beneficiary is not a resident then, in Sars's view, the capital gain is taxed in the hands of the trust.

In this regard, the vesting of an asset by a trust in the beneficiary is viewed as a disposal for capital gains tax purposes. Though no proceeds are derived from this vesting, the capital gains tax provisions deem the asset to be disposed of at its market value.

Given the high effective capital gains tax rate for a trust (36%), it is generally beneficial for a trust either to vest the relevant asset in a resident beneficiary after which it can be sold by the beneficiary. Alternatively, the trust could sell the asset and vest the capital gain in the beneficiary, in which case it will be taxed at the effective capital gains tax rate for an individual (18%).

There is a specific deeming rule in relation to gains derived from amounts received or accrued in respect of ordinary shares. Any such amounts are deemed to be of a capital nature if the ordinary shares have, at the time of the receipt or accrual, been held for at least three years. Therefore, if a taxpayer holds an ordinary share for a period of at least three years, then generally the proceeds from the disposal of such a share will be deemed to be capital in nature.

A complete exemption from capital gains tax exists where a person disposes of ordinary shares in a foreign company. This is subject to various conditions. For example, the taxpayer must, among others, have held an interest of at least 10% in the ordinary shares and voting rights of the foreign company for at least 18 months prior to the disposal and must dispose of the shares to a nonresident entity.

ALTERNATIVELY, THE TRUST COULD SELL THE ASSET AND VEST THE CAPITAL GAIN IN THE BENEFICIARY

Consideration should therefore be given to the tax consequences arising from the disposal of an asset.

In particular whether the gain is subject to capital gains tax or income tax as well as the complexities arising in circumstances where the asset is held by a trust.

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