



DSPACE

<https://dspace.org/>

Does capital gains tax add to or detract from the South African tax system?

Maroun, Warren

2010-07-12T06:19:07Z

<http://hdl.handle.net/10539/8286>

Does capital gain tax add to or detract from the fairness of the South African tax system?

Warren Maroun

Does capital gain tax add to or detract from the fairness of the South African tax system?

Contents

Abstract	1
Acknowledgements	2
Chapter 1: Introduction	3
1.1.: Purpose of the research	3
1.2: A brief history of Capital Gains Tax	3
1.3: Research problem	6
1.4: The significance of the study	7
1.5: Delimitations and limitations	9
1.5.1: Delimitations	9
1.5.2: Limitations	10
1.6: Definitions	10
1.7: Assumptions	10
1.8: Methodology	11
1.8.1: Research paradigm	11
1.8.2: Methodological Approach	13
1.8.2.1: Qualitative Research	13
1.8.2.3: Quantitative Research	15
1.8.3: Population and sample	19
1.8.3.1: Population	19
1.8.3.2: Sample	19
1.8.4: Data collection and analysis	21
1.8.5: Validity and reliability	23
1.8.5.1: Internal and face validity	23
1.8.5.2: External validity	25
1.8.5.3: Reliability	25
Chapter 2: The meaning and relevance of fairness	27
2.1: Meaning of tax fairness	27
2.1.1: Revenue versus capital	28
2.1.2: Quid pro quo	29
2.1.3: Taxpayers' abilities to endure taxes	30
2.1.4: In full proportion	32
2.1.5: Conclusion	33
2.2: The need for fairness	34
2.2.1: Democratic alignment	34

2.2.2: Efficiency.....	35
2.2.3: Societal Well-Being.....	35
2.2.4: Conclusion	36
Chapter 3: Taxing the nation's capital	37
3.1: A tax on capital bases	38
3.2: Section 7(A)(4A) of the Act and inflation adjustment.	47
3.3: Conclusion	47
Chapter 4: The cost of services	49
4.1: The lock-in effect.....	50
4.1.1: Does CGT result in the locking in of capital gains?	50
4.1.2: The lock-in effect and state services.....	53
4.2: Anti-avoidance mechanisms	61
4.3: The administrative burden created by CGT	65
4.3.1: General administrative concerns.....	65
4.3.2: Specific amendments to the Eighth Schedule to the Act	72
4.4: Conclusion	76
Chapter 5: Ability to bear the burden	79
5.1: Horizontal and vertical equity.....	79
5.1.1: Vertical Equity.....	80
5.1.2: Horizontal Equity.....	86
5.2: Taxing too much: the 'bunching effect'	88
5.3: Is CGT tantamount to double tax?.....	93
5.4: Lack of inflation and random value adjustment as a specific source of unfairness.....	96
5.4.1: Inflation adjustment	96
5.4.2: Other fair value adjustments	104
5.5: Conclusion	105
Chapter 6: The role played by CGT in social upliftment.	108
6.1: Wealth redistribution: improving the lot of the poor	109
6.1.1: The economic argument.....	109
6.1.2: Political ambition and the upliftment of the poor	114
6.2: Black Economic Empowerment	117
6.3: Public benefit organizations and recreational clubs	121
6.3.1: Public Benefit Organizations	122
6.3.2 Recreational Clubs	124
6.4: Small business and job creation.....	127
6.4.1: A brief discussion of the effect of CGT on business start-ups	128
6.4.2. The perceived fairness of CGT with respect to small business	132
6.5: Savings.....	141
6.6: Conclusion	149
Chapter 7: Correspondence analysis	152
7.1.1: Defining the two-dimensional space.....	152
7.2: Data Analysis	157
7.2.1: Tax Experts	157
7.2.2: General Taxpayers	164
7.2.3: The consolidated view of taxpayers, National Treasury and of SARS	167
7. 3: Conclusion	172

8: Conclusion	174
8.1: The meaning of fairness.....	174
8.2: The perceived fairness of CGT	175
8.2.1: Double tax.....	175
8.2.2: Cost of State provided services.....	177
8.2.4: The ability to bear the tax load	179
8.2.5: Upliftment of the poor.....	182
8.2.6: Final Note	185
Annexures	188
Annexure A: Pilot Study Results	188
A1: Pilot study interpretations	188
A.2: Details of additional explanations given to survey participants	191
Annexure B: Supporting Explanations	193
B1: The relationship between capital, labour and the tax rate.....	193
B1.1: The simple effect of an increase in the CGT rate.....	193
B1.2: The income and substitution effect	196
B.2: The cost of capital and investment decisions	198
B3: The effect of inflation on CGT.....	202
B3.1: Detailed inflation adjusted calculations	202
B3.2: Inflation index table	212
B.4: Home-Made Dividends	214
B5: Examples	215
B5.1: The potential of a small business	215
B5.2: Improper resource allocation.....	215
Annexure C: Administrative information.....	216
C1: Small business tax rates	216
C2: Individual's tax rates	217
C3: Individual sample tax returns: 2007 year of assessment.....	220
C3.1: The IT12S.....	220
C3.2: Extract from the IT 12C	222
Annexure D: Supporting Documentation	223
D.1: Correspondence with Q-Tech (Pty) Ltd.....	223
D.2: Correspondence with Roxo.....	224
D.3: Correspondence with KPMG.....	226
D.4: Correspondence analysis.....	227
D.4.1: Consolidated correspondence results	227
D.4.2: Correspondence results for tax experts	230
D.4.3: Correspondence results for ordinary taxpayers.....	232
D.4.4: Mathematical results:	234
D.4.5: Correspondence with SARS	236
References	239
Books and articles	239
Cases	245
Personal correspondence.....	245
Government Publications.....	246
Statutes.....	247

Bibliography..... 247

Abstract

In attempting to reform the tax system, the State has often relied on the principles of fairness (Vivian, 2006: 79). Indeed, part of the motivation for the introduction of Capital Gains Tax (CGT) was that it could assist with wealth redistribution and bolstering of State revenue to be used to improve the lot of the poor (SARS, 2001). In turn, this would, according to the Congress of South African Trade Unions (COSATU), mark the move to a more progressive tax system that was cognisant of the need for individuals to bear a proportionate share of the tax burden (COSATU, 2001). The principle of fairness and equality of taxes touched upon by the trade union and the South African Revenue Service (SARS) is not a new idea, having been dealt with earlier by economists such as Adam Smith (1776), and Mill (1848). Smith (1776:V.II.II) Stated the so-called first canon of tax dealing with fairness as follows:

‘The subjects of the State ought to contribute to the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to revenue which they respectively enjoyed under the protection of the State. In the observation or neglect of this definition consists, what is called equality or inequality of taxation’

Approximately six years after CGT was first proposed this research seeks to explain what is meant by this classical principle of ‘fairness’ and re-examine the debate on whether or not CGT is aligned with this principle. To place the debate in a more modern context, it also seeks to consider whether key amendments to the Eighth Schedule to the Income Tax Act No.58 of 1962 (the Act) have made favourable ground in remedying perceived obstacles to the ideal of fairness identified when CGT was first proposed.

Acknowledgements

Special thanks needs to be extended to:

Mrs. Magda Turner	For her dedication and patience while supervising this report and its supporting research proposal as well as presenting the proposal to the University of the Witwatersrand's Higher Degree Committee
-------------------	--

Professor Terri Carmichael	For her guidance in writing the research proposal
----------------------------	---

Professor Meave Kolitz , Professor Kurt Sartorius	For assisting in the editing and submission of the research proposal
--	--

and

Mrs. Michelle Aucock

Doctor Anthony Stacey	For graciously agreeing to carry out the statistical manipulations needed for the correspondence analysis and his invaluable insights into the preparation of the research proposal
-----------------------	---

Mrs. Talya Segal	For assisting in the co-ordination of the correspondence analysis
------------------	---

PricewaterhouseCoopers, KPMG, Ernst Young, Deloitte, Grant Thornton, Q-Tech and SARS	For participating in the correspondence analysis
---	--

Chapter 1: Introduction

1.1.: Purpose of the research

The purpose of this research is to examine whether and if so, how Capital Gains Tax (CGT) undermines the perceived fairness of the South African tax system.

1.2: A brief history of Capital Gains Tax

Traditionally, capital gains were not subject to tax primarily due to the definition of 'gross income' contained in s 1 of the Income Tax Act No. 58 of 1962 (the Act) which specifically excluded amounts of a capital nature. SARS, however, had for some time considered a tax on capital gains to be desirable for two reasons. Firstly, the tax would be a useful means of improving the State's revenue. Secondly, it would make tax avoidance achieved by blurring the distinction between income and capital less attractive.

In 1969 the Franzen Commission had proposed a limited form of capital gains tax in Australia on selected assets: at that time immovable properties and marketable securities. In 1986, the Margo Commission examined the feasibility of a tax on capital gains in South Africa. The consensus was that such a form of tax should not be adopted due to the negative ramifications it could have for the South African taxpayer and the economy as a whole in light of the potential of the tax to impair capital formation in the country at a time when such was desperately needed. Accordingly, based on evidence from abroad; evaluation of local literature; and warnings from the likes of the Johannesburg Stock exchange and Chamber of Mines, the Margo Commission recommended not introducing a tax on capital (Margo Commission: 1968).

In 1995, however, the Katz Commission re-investigated the need for a tax on capital gains and went on to recommend that:

'by reason of the lack of capacity on the part of tax administration, there should not be Capital Gains Tax in South Africa at this stage. When the restructuring of the tax administration has been completed in line with the Commissioner's recommendations in its first report, the contents for and against the possible introduction for this tax and its suitability for South Africa shall be revisited' (Katz Commission:1995, 33).

In the 2000 Budget Speech, Mr. Trevor Manuel, the Minister of Finance of the Republic of South Africa (Manuel), indicated that South Africa's tax system had reached a sufficiently refined State to enable SARS to handle the introduction of a tax on capital gains. In addition, it was felt that the introduction of the tax would serve to promote a more efficient and equitable tax system by making numerous tax avoidance schemes less attractive and more readily distributing the tax burden (Budget Speech, 2000 & COSATU, 2001).

As a result, from 1 October 2001, CGT became applicable being levied on certain capital assets disposed of by taxpayers on or after 1 October 2001. According to para 1 of the Eighth Schedule to the Act, an asset is defined widely, including any:

- a) property of whatever nature, whether movable or immovable, corporeal or incorporeal excluding any currency but including coins made mainly from gold or platinum; and
- b) any right or interest of whatever nature to or in such property'.

While the definition of an 'asset' would include most types of property, the Eighth Schedule will exempt certain assets from the scope of CGT. A few examples of assets being exempt are the following:

- Any amount already subject to normal tax is excluded from the definition of proceeds and base cost and thus does not attract CGT (para 20 and para 35 of the Eighth Schedule to the Act).

- Certain amounts derived in connection with gambling and competitions are exempt from CGT (para 60 of the Eighth Schedule to the Act).
- Personal use assets of a natural person or special trust will not attract CGT (para 53 of the Eighth Schedule to the Act).

The disposal or deemed disposal of an asset will attract CGT based upon the residency status of the person disposing of the asset. Residents are subject to tax on the world-wide disposal of capital assets subject to certain exceptions. By comparison, non-residents are subject to CGT on: immovable property situated in the South Africa; rights and interests in such property and assets that are attributable to a permanent establishment that is situated in South Africa.

After determining a person's taxable capital gain, it is included in the person's taxable income by virtue of s 26A of the Act, read with the definition of taxable income in s 1 of the Act. The capital gain is determined by deducting from the proceeds on disposal, determined per para. 35 of the Eighth Schedule to the Act, the base cost of the asset as calculated under para 20 of the Eighth Schedule to the Act. For natural persons and special trusts (as defined in para 1 of the Eighth Schedule to the Act), an annual exclusion is available to reduce both capital gains and losses, leaving the aggregate capital gain. Assessed capital losses from the previous year of assessment may be used to reduce the aggregate capital gain, leaving a net gain. After applying the relevant inclusion rate for a taxpayer, the resulting taxable gain is determined and is subject to tax. An assessed capital loss resulting is carried forward to the next year of assessment where it can be used to reduce aggregate capital gains realised in future years or to increase aggregate losses realised in future years (Paragraphs 3-10 of the Eighth Schedule to the Act).

The application of CGT is, therefore, relatively broad, being levied on the disposal of most assets held by a taxpayer. The nature of capital assets is such that their disposals tend to yield substantial gains and, in turn, substantial tax consequences. This necessitates a sound understanding of CGT.

It should be noted that, in South Africa, there is no separate capital tax. In the interest of conciseness, however, this report will simply refer to the 'CGT effective rate' or 'tax rate'.

1.3: Research problem

The main research problem is to explore whether and if so, how CGT undermines the perceived fairness of the South African Tax System.

In order to better address this problem the characteristics of a fair tax system as advanced by Smith (1776) have been examined and, in turn, several sub-problems have been investigated. These include:

- Using the characteristics of a fair tax system as defined by Smith (1776), an evaluation of the arguments suggesting that CGT undermines or embraces those characteristics. More specifically this analysis has explored:
 - o The concern that CGT is a tax on the capital base of an individual and thus not a tax levied on revenue as recommended by Smith (1776).
 - o Whether and how the lock-in effect (as defined in section 1.6 of this proposal), anti-avoidance potential, and administrative requirements to comply with the Eighth Schedule to the Act impair or support the notion of fairly remunerating government for State services while leaving taxpayers able to bear the tax burden.
 - o The arguments on the possibility that the bunching problem; horizontal and vertical equity; and an absence of direct inflation adjustment in the Eighth Schedule to the Act undermines or promotes taxpayers' abilities to bear a tax load proportionate to their ability to do so.
 - o The debate surrounding whether or not the CGT implications for public benefit organizations; small businesses; and empowerment deals assists in or threatens the upliftment of the poor and previously disadvantaged.
- An exploration of whether and how certain amendments to the Eighth Schedule to the Act have alleviated any perceived lack of fairness inherent in this Schedule, as discussed above per the characteristics advanced by Smith (1776), has also been conducted.

1.4: The significance of the study

CGT was introduced in October 2001. Preempting the implementation of the tax was a debate concerning the merits for the adoption of the tax and in particular whether the levying of a tax on capital gains would promote fairness within the South African tax system (SARS, 2001)

The principle of tax fairness is not a new concept (Vivian, 2006). It could however be desirable to reaffirm this principle by re-examining the arguments suggesting that the Eighth Schedule to the Act either enhanced the principle of fairness inherent in the South African tax system or undermined it. By examining the alignment of some of the amendments to the Eighth Schedule to the Act with the ideal of fairness this research considered if the concerns over a lack of fairness in 2001 still have relevance, and are reflective of current conditions, six years after the introduction of CGT.

In seeking to re-examine the debate surrounding the perceived fairness of CGT and then considering if certain of the amendments to the Eighth Schedule to the Act frustrate or improve the fairness of the South African tax system, the point made by the Nobel laureate, Hayek (1960) should be kept in mind:

'If old truths are to retain their hold on men's minds, they must be restated in the language and concepts of successive generations. What at one time are the most effective expressions gradually become so worn with use that they cease to carry definitive meaning. The underlying ideas may be as valid as ever, but the words, even when they refer to problems that are still with us, no longer convey the same conviction, the arguments do not move in a context familiar to us, and they rarely give us direct answers to the questions we are asking' (Hayek, 1960: 1).

Firstly, part of the exercise of 'restating' the debate in more modern language and 'concepts' required an analysis of one of the original concerns following the introduction of CGT: whether it could promote fairness by remedying the injustice created by the Country's past political system (COSATU, 2001).

The investigation of the debate on whether CGT was undermining economic empowerment is particularly relevant given the South African context where only some thirteen years have passed since South Africa began to normalise its relationships with the rest of the world and adopt democratic principle of fairness and equality. In light of this, there appeared to be a need to remind the tax fraternity of the debate on how aligned CGT is with the Government's policy of economic empowerment and consider what actions have been taken to resolve any hindrances to empowerment deals. This may be particularly poignant given the material empowerment transactions concluded in the last three years such as the share option schemes initiated by Woolworths and Primedia (Primedia, 2006 and Woolworths, 2007).

Secondly, the research re-examined the arguments that CGT results in a locking in of capital; creates a bunching problem; and has impaired the supply of venture capital financing to the detriment of the small business sector. The administrative burden created by the tax was also investigated, as well as the remedial action taken with respect to identified hindrances. In addition, the compounding of these problems due to a lack of inflation adjustment and difficulties in applying horizontal and vertical equity was re-explored. By then considering these arguments from the perspective of whether CGT contradicts the characteristics of a fair tax system advanced by Smith (1776), the research was able to add to the debate on tax fairness by reviewing existing theory from a different perspective.

Finally, in order to add to the richness of the debate on the perceived fairness of CGT, the research analysed the results of a correspondence analysis to be conducted using participants who have studied tax extensively. This analysis was used to further our insight into the key arguments and counter arguments regarding the perceived fairness of CGT based on the definition of fairness advanced by Smith (1776).

1.5: Delimitations and limitations

1.5.1: Delimitations

In order to maintain the focus of the research, the report does not deal with the following aspects of CGT:

- Firstly, no detailed discussion of tax avoidance was undertaken but certain of the CGT anti-avoidance provisions were discussed.
- Secondly, the mechanics of the Eighth Schedule to the Act were only be briefly dealt with for the purpose of providing a backdrop for the research since countless textbooks already deal extensively with this issue.
- Thirdly, the research neither attempted to re-perform the empirical work quoted in existing sources nor corroborate the results. The results are assumed to be correct and further empirical work will be deferred for subsequent research given the apparent lack of South African statistics on the effects of CGT.
- Fourthly the report did not analyse the merits of a source versus resident based system of tax with respect to the fairness of CGT.
- Fifthly, much of the research has a strong economic focus. In order to retain the tax-orientated nature of the report, it was useful to re-present the debate concerning the perceived fairness of CGT by examining the essence of certain economic arguments. In this light, the mathematical technicalities of the relevant economic theories fell outside the scope of the research report.
- Finally, the research adopted the definition of fairness advanced by Smith (1776) and did not attempt to consider the debate surrounding the adequacy of this definition.

1.5.2: Limitations

- Firstly, the foreign legislation dealing with CGT or equivalents thereof were not discussed as it extends beyond the scope of the research.
- Finally, due to the limited number of tax experts available in the Gauteng Province, sample sizes for the correspondence analysis needed to be restricted.

1.6: Definitions

Unless otherwise stated technical terms have the same meaning as contained in s 1 of the Act. Where necessary, a description of a phenomenon under investigation will be provided in the report before the relevant phenomenon is examined in the context of whether it promotes or undermines the perceived fairness of the tax system.

1.7: Assumptions

Two key assumptions underpinned the research:

- Firstly, the definition of 'fairness' that was used as a benchmark in this report was that proposed by Smith (1776). In order to provide focus to the study and limit its extent, the meaning of 'fairness' was not be examined further and the definition advanced by Smith (1776) was thus assumed to be correct in all material respects. This was a material assumption in that the definition applied forms the benchmark against which the implications of CGT are assessed for perceived fairness. It is conceivable that a radically different understanding of the meaning of fairness could produce different insights into the research. Nevertheless, to ensure a tax-orientated research report, the assumption was a necessary one.
- Finally, there was an assumption that any respondents in the correlation analysis provided normal and honest responses.

1.8: Methodology

1.8.1: Research paradigm

Quantitative research is appropriate in circumstances where, for example, one wishes to identify specific factors affecting a given outcome or assessing the utility of a defined action (Creswell, 2003: 172). Creswell (2003) goes on to suggest that the method is a desirable one if the underlying variables can be controlled in order to yield an objective view of a phenomenon. If, however, a concept or phenomenon has not been the subject of extensive research or is characterised by difficulties in defining the variables which effect that phenomenon then a qualitative approach to the research is more desirable. While lacking the mathematical precision of quantitative research, a qualitative approach is, nevertheless, better suited to more exploratory work where we seek to better understand a complex and subjective subject matter (Creswell, 2003: 172-173). While qualitative research may be lacking in terms of mathematical robustness, the methodology reduces the risk of the research overlooking individual perspectives due to excessive reliance on 'remote inferential empirical materials' (Falconer and Mackay, 1999: 288).

Given the strong qualitative element of the research, certain key assumptions regarding qualitative methodologies need to be kept in mind:

- Firstly, the researcher inevitably interacted strongly with that which was being researched. As a result, the tone of the report may be more personal while the report itself is subjective and reflective of a degree of bias.
- Secondly, the report takes cognisance of the multiple perspectives, normal in qualitative research, and attempts to draw attention to each of these.
- Finally, the role of the researcher in the collection and interpretation of data may be more interactive than in quantitative research.

(Creswell: 2003, 4)

In this regard, a primarily qualitative approach to the research in the form of a content analysis was adopted given the need to explore differing individual insights into whether or not CGT is perceived as being unfair.

The need for a predominantly qualitative approach was further supported by the inherent difficulties in defining and measuring the variables which are associated with a fair or unfair tax system due to the existence of diverse perspectives and multiple realities depending on the source of a given opinion. At the same time, a content analysis allowed for the investigation of the contents of numerous bodies of information in order to highlight the emergence of themes and biases (Leedy and Ormrod, 2001). While the quantitative researcher may argue that such an approach may be lacking in terms of reliability and objectivity, this is paradoxically, precisely why a strong qualitative approach is required. Due to the material human element in the research, the relationship between the researcher and the data collected, and high degree of personal interpretation of that data, a qualitative approach which is more flexible than quantitative analysis, was able to better deal with the diversity of the opinions examined, thereby adding to the richness of the debate.

Finally, the objective of this report was not to devise a scale against which the fairness of the CGT may be assessed but rather to explore and discuss a complex factual matrix surrounding the perceived fairness of the tax system in the context of CGT. This invariably necessitated a strong qualitative approach to the research.

In spite of the limitations inherent in quantitative methods, the use of such methods to complement a largely qualitative report may, however, be desirable (Creswell, 2003: 172 and Falconer and Mackay, 1999). By using a qualitative approach relying on a broad spectrum of literary sources, the research report was able to explore generally whether or not CGT promotes the perceived fairness in the South African Tax System. By complementing this with a survey of expert opinions in the form of a correlation analysis, the richness of the report was enhanced by adding the personal views of several tax experts while either corroborating or calling into question the theory which had been advanced on the issue of tax fairness.

Ultimately, a mixed methodological approach was employed in executing this research. Such a methodology contains an appropriate mix of both quantitative and qualitative research reflective of the strategy of the researcher and intention of the research report (Creswell, 2003: 169-173).

Given the high degree of subjectivity and existence of multiple realities with respect to the research problem, the primary method of collecting and analysing data was a qualitative approach in the form of a literature review based on content analysis. Quantitative research in the form of a correspondence analysis was used in a complementary role to add to the debate on tax fairness by highlighting the perceptions of a sample of tax-knowledgeable individuals.

1.8.2: Methodological Approach

1.8.2.1: Qualitative Research

Firstly, a qualitative approach in the form of a literature review was conducted to understand what the basic tax consequences of CGT were in terms of the Eighth Schedule to the Act. This necessitated a detailed review of various paragraphs to the Schedule, complemented with an investigation of the Explanatory Memorandum released by SARS on the implementation and revisions made to the Eighth Schedule to the Act and other Government-issued reports.

Having investigated the provisions of the Eighth Schedule to the Act, an analysis was done on key economic, tax and finance texts. Several economic and finance sources were drawn upon which have made extensive use of analytical work on the effect of CGT. As a result, there was no need to conduct extensive empirical research for the report.

The data analysis required the development of categories or pools in order to classify and interpret the data. The research report required several categories in line with the sub-problems outlined earlier. First, a category for information providing an analysis of the definition of 'fairness' as advanced by Smith (1776) was collated. A second category was then be needed for specific examples of how CGT either undermines or enhances the characteristics of a fair tax system. The sources included in this category included those that investigate the role played by CGT in social upliftment and in supporting BEE transactions. This category also catered for sources exploring, for example, the lock-in effect, the bunching problem or those examining the need for inflation adjustment. Finally, a category was needed for those sources which argue whether or not certain amendments to the Eighth Schedule to the Act, since the introduction of CGT in 2001, have alleviated the perceived lack of fairness inherent in CGT.

By analysing a broad range of sources from both before and after the implementation date for CGT and synthesizing the data contained in those sources, the research report was able to describe what the arguments suggesting that CGT enhanced or detracted from the fairness of the South African tax system were and whether certain amendments to the Eighth Schedule to the Act have taken cognisance of those arguments.

In order to categorise and interpret the various texts, each needed to be scrutinised for content dealing with the principles of tax fairness. Where the sources are lengthy, they were divided into segments and those segments will accordingly be categorised after detailed review. A constant comparative method was then be used to identify interrelationships between the categories and conflicting opinions in order to drive further data collection as needed (Adapted from Blaxter *et al*, 2003).

To support the literature review, extensive use of the library resources of the University of the Witwatersrand was made. CGT requires, as a relatively new form of tax and one that is encountered in several other countries, a need to complement library resources with the key Internet sites - details of which are contained in the references and bibliography section below.

As discussed, the use of a literature review to explore the arguments surrounding the perceived fairness of the CGT is lacking in terms of mathematical elegance and its objectivity. In addition, such an approach can prove time consuming and be tainted by reliability and validity problems (Creswell, 2003: 172-173).

Nevertheless Blaxter *et al* (2003) suggest that such an approach has a number of key advantages which are relevant given the nature of the research report:

- The methodology is better suited to dealing with a complex and subjective subject matter where an emphasis placed on an attempt to 'measure' tax fairness could prove arbitrary.
- The approach is more easily adaptable in response to changing circumstances.
- It facilitates the analysis of a diverse range of literary sources on tax fairness
- Unique situations and differing perceptions are capable of being reflected in the research report.

1.8.2.3: Quantitative Research

Despite the limitations of a quantitative approach in investigating matters where variables may be arbitrary and the differing perceptions of individuals needs to be documented, the use of certain quantitative methodologies may prove useful to support or highlight contradictions in the literature and thus add to the depth of the report (Creswell, 2003: 30-33). Accordingly, having finalized the literature review, a form of correspondence analysis was undertaken in order to add to the richness of the debate. This was used to capture the opinion of a group of participants (details of which are contained below) in order to corroborate or draw attention to key differences of the theories identified in the literature. At the same time, the method chosen was not so limited that the diversity of participants' opinions was over simplified.

. The tableau used to conduct the correspondence analysis is presented below:

Trait		Absence of fairness criteria			
		Based on Smith's (1776) definition of a fair tax system			Based on the South African context
	<i>The references to paragraphs in the Eighth Schedule to the Act are provided in order to give clarity on the traits below.</i>	Gives rise to double tax as CGT is a tax on capital	Does not ensure that all taxpayers contribute fairly for State-provided services.	Undermines ability to support the taxpayer's family	Does not promote the upliftment of the disadvantaged
1	The sale of an equity instrument which is capital in nature is subject to CGT (para 2 of the Eighth Schedule to the Act).				
2	Capital losses are ring-fenced (para 7 to para 9 of the Eighth Schedule to the Act).				
3	On death, a taxpayer suffers a deemed disposal reducing the heir's inheritance (para 40 of the Eighth Schedule to the Act).				
4	CGT discourages capital gain realisations as CGT normally arises only on a disposal of the respective asset.				
5	CGT encourages capital loss realisations as the capital loss is available for set-off against capital gains resulting during the tax year.				

Trait		Absence of fairness criteria			
		Based on Smith's (1776) definition of a fair tax system			Based on the South African context
6	CGT prevents domestic revenue being converted into tax free capital gains.				
7	CGT prevents foreign revenue being converted into tax free capital gains.				
8	CGT requires detailed supporting documentation (part I and II of the Act).				
9	Steps to simplify administrative requirements for CGT have been taken.				
10	CGT taxes the wealthy.				
11	CGT promotes the equal taxing of taxpayers in equal economic positions.				
12	Inclusions under s 26A of the Act are not subject to s 7A(4A) of the Act.				
13	There is no direct inflation adjustment in the Eighth Schedule to the Act.				
14	PBO's are not subject to full CGT exemption.				
15	Recreational clubs are not subject to full CGT exemption.				
16	The CGT effects of s 41 to s 47 of the Act pose difficulties for BEE deals.				
17	CGT acts as a disincentive to business start-ups.				

Trait		Absence of fairness criteria			
		Based on Smith's (1776) definition of a fair tax system			Based on the South African context
18	Small business exemptions (para 57 of the Eighth Schedule to the Act) and deductibility of capital losses from capital gains (para 7 of the Eighth Schedule to the Act) are possible.				
19	The new three year rule (relating to the minimum period shares need to be held in order to constitute a capital disposal) discourages speculative investing.				
20	CGT in general				

The characteristics of a fair tax system as advanced by Smith (1776) served as the 'absence of fairness criteria' against which several key perceived hindrances identified in the literature, and highlighted in the sub-problems addressed previously, were evaluated. The traits, obtained from the literature, represent the characteristics of CGT which the respondents were required to evaluate for a perceived lack of fairness. These form the basis of the chapters to follow.

Ultimately, while a quantitative method is not as well suited to capturing a diverse range of responses, emotions and perceptions, the use of correspondence analysis can nevertheless prove useful for several reasons. Firstly, it has an ability to act as a corroborating source of evidence. Secondly, the methodology is a well established one capable of producing insights with relatively small sample sizes in limited amounts of time (Bendixen, 1996).

Thirdly, the correspondence analysis is relatively easy to understand and interpret (Bendixen, 1996). Finally, the limitations inherent in the use of the method can be overcome with appropriate safeguards, most notably the use of only tax experts to complete the survey, as discussed in the sections to follow.

1.8.3: Population and sample

1.8.3.1: Population

In essence, the population consists of all registered taxpayers who are either tax experts or are in possession of some form of post-matric qualifications.

1.8.3.2: Sample

A purposeful selection technique was applied with the analysis relying on participants who are tax experts. The sample included the tax partners from several audit firms and tax experts in an academic environment. In order to ensure reliability of data a sample size of at least 20 experts was relied upon.

The use of a larger sample size was frustrated due to the small size of the population of tax experts itself. Tax experts will be drawn from the following organizations:

- PricewaterhouseCoopers
- Deloitte
- Ernst & Young
- KPMG
- Grant Thornton
- The University of the Witwatersrand

The above organizations were chosen due to their long-standing reputation as auditing and tax experts. The specific inclusion of these firms depended on access and convenience. The need to ensure that participants are well acquainted with tax-related matters thus negated the use of predominantly random sampling techniques being used on a general population group. Further, due to time and budgetary constraints, tax experts in distant locations were not contacted.

In order to add to the richness and reliability of the data gathered from surveying tax experts, the research also relied on the opinions of a sample of taxpayers, no fewer than fifteen in size, who were not tax experts. These participants did, however, possess adequate knowledge of the Eighth Schedule to the Act in order to ensure that they were able to accurately answer the questions posed. Again, a purposeful sampling technique was applied based on convenience.

As a result of small sample sizes and possible biases predominant in such small groups of people, the quantitative evidence gathered needed to be subject to detailed comparison with the data contained in the literature review rather than form a basis for reaching a conclusion in its own right. At the same time, the opinions of both the tax experts and the general taxpayers was contrast with the views of SARS which were also obtained using the correspondence table detailed in the previous section. While the method of conducting the correspondence analysis does have limitations, by relying on suitably informed participants in the sample the likelihood of questions being fully understood, of receiving prompt and complete responses, and carrying out the analysis within budgetary constraints was greatly improved.

1.8.4: Data collection and analysis

Potential participants were contacted via telephone or electronic mail and invited to participate in the study after being given a brief description of the purpose of the research. If the participants were prepared to cooperate, a formal time was set for the survey to be delivered to them. If requested, any particulars concerning the research were explained.

The correspondence tables were distributed, further explanations furnished on request, and collected upon completion. Respondents were required to mark with an 'X' which of the traits and absence of fairness criteria positively correspond. If they believe that the respective trait is not characterised by a particular lack of fairness criteria, the corresponding box was left blank.

The surveys were coordinated and controlled by the researcher in order to ensure confidentiality and completeness of the surveys collected. In order to ensure that the surveys are well received at each firm, the research relied on the University of the Witwatersrand, School of Accountancy's tax division to encourage the firms and members of staff at the University of the Witwatersrand to cooperate. In a similar light the use of electronic correspondence was limited due to traditionally low levels of response obtained from such means of communication.

After the participants have completed their respective forms the individual results were consolidated into a final contingency tableau which recorded the frequency of responses. Based on these results, the dependency between the rows and columns of the contingency table presented earlier were captured graphically. The various traits would, theoretically, each be plotted on a separate axis creating a multi-dimensional space.

Each of the fairness criteria would then be positioned in this space according to its profile determined by the frequency of responses in the consolidated contingency tableau.

Due to the large number of traits and fairness criteria under review, the difficulty of interpreting a graphical solution was clearly apparent. Accordingly, the plot would be presented only in two dimensions (Adapted from Bendixen, 1996).

In order to define the axes of the two dimensional plot:

'The axes [were] interpreted by way of the contribution that each [trait made] toward the total inertia accounted for by the axis' (Bendixen, 1996: 20).

In this research, there were twenty traits and thus, as a general rule, any trait contributing more than five percent of the responses would:

'represent significance greater than what would be expected in the case of a purely random distribution of Statements' (Bendixen, 1996: 20).

By thus examining the inertia attributable to each of the traits and sign of respective contributions, the axes' poles were defined (Adapted from Bendixen, 1996: 15-21). With the axes defined, the unfairness characteristics could then be positioned in the correct two dimensional spaces based on which of the traits they are most closely associated with. In this simpler presentation, the further a given point was away from the origin and the closer it was to the pole of any axis, the more strongly associated it was with the traits representing the relevant axes. In this way, the graphical representation was able to highlight which of the traits of CGT and unfairness characteristics were associated with each other (Adapted from Bendixen, 1996).

In order to reduce the contingency tableau into a graphical form in two dimensions a statistical program was relied upon to perform the required matrix algebra. While there was a loss of richness of the data due to such, sufficient subtlety was retained by developing a two dimensional plot of the results (Adapted from Bendixen, 1996).

Once the data manipulation was complete, the results of the analysis were ultimately used to identify whether the selected economic and social implications of CGT were associated with a violation of the key characteristics of a fair tax system per the theory advanced by Smith (1776).

In this way, the correspondence analysis was used to support the insights contained in the literature review and content analysis. (The preliminary results of a pilot study conducted during October 2007 are contained in Annexure A).

1.8.5: Validity and reliability

Validity goes to the assurance that 'a measuring procedure represents the intended, and only the intended, concept'. In particular, the external validity of the research needs to be dealt with in order to ensure that the research is applied in only suitable alternative contexts. Internal validity needs to be ensured so as to give reasonable assurance that conceptual and operation measurements reconcile and hence provide assurance regarding the robustness of the research findings. This will need to be complemented with a test of logic in the form of face validity check. In addition, the reliability of the report will also need to be considered in order to ensure that the report is accurate, free from bias, and that descriptions are sufficiently precise (Neuendorf, 2002: 114-115).

The following steps will be taken regarding reliability and validity:

1.8.5.1: Internal and face validity

In order to allow for internal validity of the research, the report ensured that the majority of sources used comprise reputed journals, with emphasis placed on the use of peer reviewed journals. Where journals are not relied upon, the research made use of reports of respected tax practitioners or government issued publications corroborated with other sources to the extent practical. As noted above, qualitative research is characterized by a degree of bias due to the close relationship between the research and data collection and evaluation processes.

Here, the use of multiple sources coupled with an investigation of both the main and counterarguments contained in those sources assisted in limiting this effect thereby improving internal validity. To enhance face validity, the research report was reviewed independently in order to test for clarity and logic of the debate presented.

With respect to the correspondence analysis:

- Only tax experts and those taxpayers suitably informed regarding the basic details of the Eighth Schedule to the Act were surveyed to increase the probability of the analysis being correctly understood.
- The mathematical manipulation of the data was carried out under the supervision of experts from either the Business School of the University of the Witwatersrand or the School of Statistics and Actuarial Science of the University of the Witwatersrand. .
- To improve validity, Leedy and Ormrod (2001) recommend performing a pilot study. Accordingly, a pilot study based on approximately ten participants who are either chartered accountants or tax honours students was conducted. After these participants have completed their respective tables, they were encouraged to comment on the clarity of the survey to ascertain whether the language is concise, clear and unambiguous. They were also questioned to determine whether their understanding of the characteristics and lack of fairness criteria were in line with the essence of the underlying literature and hence, the objectives of the research report.
- As a final safeguard, the table will be reviewed for understandability and accuracy by the University of the Witwatersrand School of Accountancy's tax division thereby improving construct validity. (The results of the pilot study are contained in Annexure A.)
- The analysis was reviewed for clarity and accuracy before being formally conducted.
- The results of the analysis were contrast with the theory advanced by the literature rather than be used as conclusive evidence in its own right. This is necessary given that the results of the analysis may reflect the biases of the relevant participants.
- Given that the results of the correspondence analysis were contrast with the theories identified during the content analysis, the qualitative study became an internal validity check for the quantitative research.

1.8.5.2: External validity

External validity was taken into consideration by ensuring that the conclusions reached were logical and that attention was drawn to amendments, if any, of key definitions contained in the relevant sections of the Act and the Eighth Schedule thereto. By relying on a broad range of literary sources, in order to capture the arguments and counterarguments regarding the perceived fairness of CGT, external validity of the research was improved.

Due to limitations on the sample used to conduct the correlation analysis, however, the external validity of the results may be questionable for the purpose of making inferences about the perceived fairness of CGT from the perspective of the general population. Nevertheless, the use of a sample of tax experts and suitably informed general taxpayers improved the likelihood of the questions being posed being correctly understood and answered, thereby improving validity. In addition, given the subjective nature of the research topic, it was not the intention of the report to make inferences about the perceived fairness of CGT from the perspective of the entire population.

Rather, the purpose of the correlation analysis was merely serve as a complementary tool to the literature review which, by containing diverse sources and opinions, should be applicable in a general sense. In essence, the quest was for improved diversity of opinion rather than statistical coverage in order to add to the depth of the research.

1.8.5.3: Reliability

The reliability of the report will be limited to the matter of fairness from a tax perspective. Given the exclusive use of the definition of fairness advanced by Smith (1776) in order to prepare the report, the research may be inappropriate for use in the context of an alternative definition of fairness being used. Nevertheless, by defining clearly the fairness 'benchmark' being used, the possibility of the research being reproduced based on that benchmark and reaching similar conclusions is improved. The subjective nature of qualitative research and the extensive inputs of the researcher in the data collection and interpretation processes, however, also introduce inherent limitations in the reliability of the report.

The use of a sample of only tax experts to conduct the correlation analysis may have imported bias into the research report. This may prove difficult to resolve as there are only a limited number of tax experts available to survey and the extension of the analysis into the general population may result in an undue threat to validity due to the technical nature of the research report. Accordingly, the correlation analysis was used to complement the literature with significant differences in opinions being fully disclosed. Further, participants were asked to empathize when completing the analysis in an attempt to improve the generic nature of the results obtained.

In order to ensure the accuracy and precision of the correlation analysis, mathematical manipulation of the data was executed under the supervision of experts from either the Business School of the University of the Witwatersrand or School of Statistics and Actuarial Science of the University of the Witwatersrand. Further, the list of characteristics to be evaluated was kept concise to avoid the risk of fatigue or frustration impairing the participant's ability to answer accurately. The use of appropriate tax jargon improved the accuracy of the results obtained due to improved understanding of the survey. The analysis was also kept confidential so as to ensure the sincerity of responses.

Ultimately, by ensuring that the survey was coordinated by the researcher, the use of familiar tax jargon when dealing with the participants, and the use of experts with detailed insights into the tax system, the possibility of producing repeated results in similar trial has been improved. In addition, bias may also have been incorporated due to a disproportionate reliance on certain literary sources. In order to overcome this, the research attempted to highlight any contradictory views to key arguments advanced in the report.

Chapter 2: The meaning and relevance of fairness

2.1: Meaning of tax fairness

The objective of this chapter is to determine an appropriate definition for the meaning of 'fairness' in order to serve as a gauge with which we may assess the perceived fairness of CGT. To this end, the Oxford English Dictionary defines 'fair' as 'just, unbiased [or] equitable' (Concise Oxford English Dictionary, 1995: 484).

This definition is, however, quite broad. In order to deal with the research question more specifically, the report extends on these generic definitions by adopting the meaning of tax fairness suggested by the classical economist, Adam Smith (1776:V.II.II):

'The subjects of the State ought to contribute to the support of the government, as nearly as possible, in proportion to their respective abilities, that is, in proportion to revenue which they respectively enjoyed under the protection of the State. In the observation or neglect of this definition consists, what is called equality or inequality of taxation'

In essence, the definition highlights the following aspects of a fair tax system:

- Firstly, taxpayers ought to pay tax based on their revenues and not on their capital wealth.
- Secondly, taxpayers ought to pay only a fair *quid pro quo* in respect of the services provided to them by the State.
- Thirdly, taxpayers should have an ability to bear the tax burden.
- Finally, the tax system should be based on a proportional rather than a progressive style with respect to tax collections.

Each of these aspects of the definition is investigated in more detail below.

2.1.1: Revenue versus capital

Firstly, the definition makes use of the word 'revenue'. *IAS 18: Revenue* (2005) provides guidance as to the meaning of 'revenue', defining 'revenue' as:

'the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants'
(International Accounting Standards Board, 2005: 993)

The reference to 'revenue' by Smith (1776), however, has a broader meaning than that suggested by Generally Accepted Accounting Practice (GAAP). Rather, 'revenue' is used to define the total economic income of the individual so that 'in theory, all income is included to establish the taxpayer's total income' (Vivian, 2006: 83).

In essence, once income has been subject to tax, any indirect taxes levied after that income was earned and taxed will be a form of double tax and a potential source of unfairness. 'Implicit in Smith's (1776) statement is that tax is levied on income and not capital'. Since capital is the source of the underlying income, a tax on capital could be seen as innately unfair, as it is not only a form of double tax, but also undermines the ability of the taxpayer to earn income in the first place (Vivian, 2006: 83).

In this way, the work of Smith (1776) begs the question as to whether the characteristics of CGT may result in a double tax and one that erodes the capital base of the nation rather than being a tax on economic revenues. The possibility of CGT being a form of double tax in the sense that it: is levied on capital growth that was the source of the underlying post-tax income, is levied without regard to inflationary gains, and is calculated without the application of s 7A (4A) of the Act, may also need to be examined.

2.1.2: Quid pro quo

The second key aspect of Smith's (1776) insight is the reference to 'protection afforded to the individual by the State'. In essence, a fair tax system is one that adopts a *quid pro quo* approach to taxes. The taxes levied on the individual need to be sufficient to cover the cost to the State of protecting that individual whether these are the costs, for example, of the judicial system, healthcare or national defence. This may be better explained with an analogy for the State: a 'great estate of individuals being joint tenants each having an obligation to contribute to the costs of administering the estate in proportion to their interests in the estate'. In this way, only income which is derived 'under the protection of the State' should be subject to tax or alternatively, that earned 'under protection' of a foreign government should be exempt from taxes so that 'only income which has the State as its source is subject to tax by that State' (Vivian, 2006: 84). Since the issue of whether residents ought to be subject to tax abroad or correspondingly, non residents should be subject to tax in South Africa, goes to the debate on a source versus a resident system of tax, which will not be analysed further.

This aspect of Smith's (1776) definition, regarding the protection offered by the State, raises further concerns regarding the perceived fairness of CGT which are addressed in detail in the chapters to follow:

- Does the Eighth Schedule to the Act serve as an anti-avoidance mechanism that prevents taxpayers circumventing the payment of taxes by unduly disguising income as capital? In this way, does CGT help to ensure that taxpayers pay for the services they receive from the State?
- Does the lock-in effect impair the collection of revenue by SARS such that a lower CGT effective rate could result in greater State revenue at lower cost to the individual taxpayer?
- Does the administrative burden imposed on taxpayers imply that the cost of State services is unduly high?

2.1.3: Taxpayers' abilities to endure taxes

Thirdly, tax burdens need to be proportionate to the abilities of the taxpayer to endure them. While certain modern texts have relied on the phrase 'ability to pay', in the original formulation, it was the ability to 'bear' the tax as opposed to merely pay it that was important (Vivian, 2006: 84). The full importance of this aspect of the tax canon may not be properly appreciated without reference to the 'ability to bear' the tax. The meaning of the original phrase 'in proportion to their respective abilities' would not have been lost on the sixteenth century economist. This aspect of the definition makes two points clear. First, it is the 'ability to bear the burden of taxation' that demonstrates fairness, not the fact that the tax assists in the State's inexorable pursuit for more revenue. (Vivian, 2006: 84-85)

The same concept was used by Montesquieu (1748, XIII.1) when he noted that:

'to fix [the State's] revenue in a proper manner, regard should be had both to the necessities of the State and [the necessities] of the subject. Nothing requires more wisdom and prudence than the regulation of that portion of which the subject is deprived [due to tax] and that which he has suffered to retain'

The second key aspect of the phrase: 'in proportion to their respective abilities' is that those who have the capacity to bear a tax should be subject to a greater proportion of the burden of that tax than those who lack the ability to endure the said burden. This gives rise to the belief that before an amount should be taxed, the cost of life's necessities should first be deducted from that amount (Vivian, 2006: 84).

It is by making provision for such allowances that an appropriate balance between the needs of the State and those of the taxpayer may be established, as envisaged by Montesquieu. The principle is firmly rooted in history. Plato writes in *Laws* (347 BC) that 'payment for the common meal should be excluded from the [tax calculation]' Plato, 347BC cited in (Vivian, 2006: 85). Similarly, the philosopher of the Enlightenment, Rousseau wrote that:

'He who only has the bare necessities of life should pay nothing, taxation on him who has a surplus may, if need be, extend to everything beyond necessity' (Rousseau, 1712 cited in Vivian, 2006: 86).

In this way, if a tax is to be fair, then a taxpayer who has no ability to pay for the tax should pay nothing at all. The fact that the violation of this principle is a material source of unfairness is seen on the America Colony's revolt against Imperial Britain which was, in part, due to a lack of the inhabitants of those colonies to bear certain tax burdens (Vivian, 2006: 85-87).

In France, a similar problem was remedied through revolution and the enshrining of the right to a tax system cognisant of the costs of the necessities of life in the Declaration of the Rights of Man in 1789. In England, the need to cater for the necessities of life and hence the 'ability' to bear taxes was recognized - after intense pressure on the State - by allowing for certain deductions needed to pay for the 'common meal' (Vivian, 2006: 85-87).

This fundamental right: leaving sufficient amounts untaxed to allow the taxpayer to afford the basic necessities of life was 'articulated as a general principle' and endorsed by Mills (1848, V.II.3) as essential for ensuring the equality of a tax system:

For a tax system to be fair, it needs to 'leave a certain minimum of income, sufficient to provide for the necessities of life untaxed. Suppose [£50] a year is sufficient to provide the number of persons ordinarily supported by a single income, with the requisites of life and health and with protection against habitual bodily suffering, but not indulgence. This should be made the minimum [and amounts] exceeding it should pay taxes, not upon the whole amount but upon the surplus' (Mill, 1848 cited in Vivian, 2006: 86).

It is important to note that, from the viewpoint of the classical economist, the necessities of life must account for all of the costs based on a taxpayer's obligations. If a taxpayer thus has a duty to support himself and other members of his family, then the relevant support costs must be taken into account when determining the cost of his basic necessities (Vivian, 2006: 86-87). In this way, for a tax to be fair, the taxpayer must be left in a post-tax position that is adequate for the maintenance of himself and his family.

The third aspect Smith's (1776) tax fairness definition, regarding the ability to bear the tax burden, raises a number of concerns regarding the perceived fairness of CGT. Firstly, if taxpayers need to be in a position to maintain themselves and their families after the levying of CGT, the implications of CGT with respect to supporting or undermining empowerment deals becomes important. In a similar light, consideration should also be given to whether CGT has been unduly levied on small businesses and public benefit organizations (PBOs). This may be particularly poignant given the pivotal role such enterprises play in the upliftment of the poor (COSATU, 2001).

Secondly, the perceived success of CGT in entrenching the principles of horizontal and vertical equity may need to be explored in detail. Finally, the question of whether CGT may be resulting in double tax due to a lack of inflation adjustment and the bunching problem may also need to be considered in light of whether such a shortcoming impairs the ability of the taxpayer to bear the tax burden.

2.1.4: In full proportion

The final caveat of the definition that is examined is: 'in proportion to'. This tends to suggest that a proportional rather than a progressive system of tax may be more desirable (Vivian, 2006: 88). Nevertheless, there appears to have been a sluggish response to the use of proportional methods. Part of the explanation may rest in the fact that even after the tax system accommodates for the basic life necessities, the taxpayer is not thriving, merely surviving. As his income grows so he is able to bear an ever larger share of the tax burden until he is finally able to endure the entire effect of the tax. A second reason for the limited progression is to account for indirect taxes. In light of the emergence of exempt income sources, there was an emerging view that everyone should 'make at least some contribution', hence the use of indirect taxes. The emergence of such taxes played a role in frustrating the use of a proportional tax system (Vivian, 2006: 88-89).

Since CGT is merely included in the taxable income of the taxpayer under s 26A of the Act and in turn subject to the progressive tax rates of the Act, however, this aspect of the tax canon will not be discussed further.

2.1.5: Conclusion

In conclusion, the report identifies that while a superficial meaning 'fairness' centres around perceptions of justness and equality, a more robust framework can be developed to address the research question by relying on classical economic theory laid down by Smith (1776) . In summary, Smith (1776) suggests that four key attributes characterise a tax as fair.

- First, while it may be necessary to tax the fruits of the taxpayer's efforts, the seed of that fruit may need to be left untaxed.
- Second, only amounts earned under the protection of the State should be subject to tax. This could imply that a source based system of taxation is superior to the current residence based system in force.
- Third, the taxpayer needs to have an ability to bear the burden imposed by the tax. In this regard, the needs of both the State to generate revenue and the citizen to at least survive must be catered for by the tax system.
- Finally, a progressive system of tax may be less desirable than a proportional one but since CGT was not a separate form of tax, but extension of income tax, this aspect of the tax canon was not examined extensively (Vivian, 2006).

These key principles underpinning a fair tax system, in turn, raise several questions regarding the perceived fairness of GCT which are discussed in more detail in the chapters to follow. These include:

- Firstly, whether or not CGT may be a form of double tax, particularly due to the bunching problem and lack of inflation adjustment which may also be impairing the ability of taxpayers to bear the tax load.

- Secondly, if the lock-in effect, the administrative burden of complying with the Eighth Schedule to the Act, and the role of CGT as an anti-avoidance mechanism support the notion of a taxpayer needing to pay a fair remuneration for State-provided services.
- Thirdly, the debate on whether vertical and horizontal equity and the need to uplift the poor and previously disadvantaged are adequately catered for by the provisions of the Eighth Schedule to the Act.

2.2: The need for fairness

Having defined what is meant by 'fairness', it may be desirable to consider briefly why it is necessary for the tax system to be fair in the first place. Three reasons appear to exist for this: the need to align the tax system with the democratic process; allow for efficient collection of tax revenues; and to guarantee the well-being of society (Post, 2005).

2.2.1: Democratic alignment

'Equality is foundational to democracy, because it follows from the very definition of democracy' and as such, the citizens of any democratic State demand equality in their legislation, including tax legislation (Post, 2005: 7-8). This is clearly the case in the South African context, with the Katz Commission (1994) noting that the country has adopted a Constitution which not only places emphasis on equality, but actually demands it (Katz Commission, 1994: 7). In this light, the tax system, submittedly including CGT, must be subject to the spirit of the Constitution and should thus assist in the entrenchment of fairness and equality in South African society (Katz Commission, 1994: 8). The importance of this principle: that the tax system should be aligned with the fundamental principle of equality is particularly poignant for South Africa where the issue of equality given the legacy of Apartheid is still a topical issue.

2.2.2: Efficiency

The Margo Commission (1986) suggests that, apart from being essential in a democratic society, equity may be instrumental in allowing for the State to make practical use of a new tax. If the proposed tax system is seen as inequitable, it may prove impossible to apply it due to increasing resistance and evasion by taxpayers (Margo Commission, 1986: 37). If the tax system is perceived as being fair, the likelihood of the taxpayer accepting the relevant taxes is improved. This can, in turn, boost the level of collections and State services (Vlassenko, 2001: 389).

This belief is captured succinctly by Grote (2007) who draws the analogy between taxation and the 'plucking [of] a goose' in such a way that 'the largest amount of feathers' are yielded with the least amount of discomfort and resistance from the bird (Grote, 2007, 13).

2.2.3: Societal Well-Being

Finally, equity becomes critical for assuring the well-being of society. The insights of Montesquieu (1748) provide the basis for this assertion. The economist warns that excessive, and thus unjust, taxes could undermine the fabrics of societal order due to their extraordinary oppressive properties (Montesquieu, 1748 cited in Adams, 1995: 3). The French Revolution serves as a classical case study for this. In France, the plight of taxpayers in the wake of unjust taxes is captured by a citizen of France in the weeks before the revolution who noted:

'the country has been ruined, the peasants are reduced to sleeping on straw, their furniture sold to pay taxes; so that to maintain luxury in Paris, millions of innocent persons..., owning but their soles, because no means have been devised to sell these at auction' (Cited in Adams, 1995: 234).

In the context of such hardship, the effect of unduly high taxes, where as much as eighty percent of income could have been paid over to the State, was a sense of desperation. The climate of hopelessness eventually evolved into anger; the quest for justice under the blade of the guillotine; and the unstoppable drift into revolution (Adams, 1992: 231-234).

2.2.4: Conclusion

Smith (1776) provides a framework for what a tax system needs to take into account in order to ensure its perceived fairness. The quest for fairness is not, however, merely a formality but one of critical importance (Adams, 1995 and Post, 2005). In the absence of fairness, the tax system may violate the constitutional rights of taxpayers; impair the efficient collection of revenue by the State; and ultimately undermine the very well-being and order of society.

Chapter 3: Taxing the nation's capital

Implicit in Smith's (1776) definition of a fair tax system is that a tax should be levied only on the income of a taxpayer while leaving his capital base untouched. The reason for this is apparently simple: if capital is the underlying source of income, a tax on capital would not only be unfair, due to its double tax potential, but may also erode the very capital assets used to generate that income. This may ultimately undermine the ability of the taxpayer to earn income in the first place (Vivian, 2006: 83).

The danger of subjecting capital to tax and violating this characteristic of a fair tax system, is more specifically addressed by Ricardo (1817) in his work 'The Principles of Political Economy and Taxation' which states that 'taxes are a portion of the produce of the land and labour of a country' and that these taxes are 'placed at the disposal of the government' and 'are ultimately paid, either from capital, or from the revenue of a country'. More specifically:

'if the consumption by the government, when increased by the levy of additional taxes [is] met either by an increased production or diminished consumption on the part of the people, the tax will fall on revenue, and the national capital will remain unimpaired; but if there [is] no increased production or diminished unproductive consumption on the part of the people, the taxes will necessarily fall on capital, that is to say, they will impair the funds allotted to productive consumption' (Ricardo, 1817: 62-63).

At the heart of the issue of perceived tax fairness may be the need to ensure that every person is at least able to survive or 'keep his station' by maintaining the source of his wealth and thus bear the tax burden. Accordingly, in deciding to introduce a new tax, submittedly including CGT in October 2001, the State needs to be cognisant of the need either for the annual consumption and enjoyment of the population to decrease or for the population to be enabled to increase its capitals and incomes proportionately. A failure to recognize this fundamental need results in the inevitable undermining of the funds used to maintain labour and generate wealth, in turn, leading to economic downturn (Ricardo, 1817: 63).

If the tax on capital results in the context of lower production, a 'death spiral', to use the terminology of the management accountant, may ultimately result. 'With a constantly diminishing annual reproduction, the resources of the people and the State will fall away with increasing rapidity and distress and ruin will follow' (Ricardo, 1817: 106). The problem of the erosion of the capital base may be compounded by the fact that a tax on capital may be a source of double tax. This is especially true if the fruits of the capital asset were already subject to normal tax. The effect of the double tax may be the further frustration of the ability of taxpayers to maintain themselves (Vivian, 2006: 83).

In this way, the work of Smith (1776) and Ricardo (1817) begs the question as to whether the characteristics of CGT may result in an undue burden on taxpayers in the form of a double tax and one that erodes the capital base of the nation rather than being a tax on economic revenues. The fact that CGT is determined without consideration of the effect of inflation or without the application of s 7A(4A) of the Act, may also need to be examined.

3.1: A tax on capital bases

In essence, once income has been subject to tax, any indirect taxes levied after that income was earned and taxed will be a form of double tax and a potential source of unfairness (Vivian, 2006: 83). Ricardo (1817) notes, however, that the mere fact the tax is levied directly on an amount regarded as being of an income or capital nature does not automatically mean that the tax is truly one on capital from an economic perspective. If an individual has R1 000 of income and is required to pay a tax of R100 out of that income, the tax may either be one levied on capital or revenue depending on the predicament of the taxpayer. In the first scenario, if the taxpayer is content with the remaining R900, which in turn is spent, then the tax truly was levied on income. In the second scenario, however, a taxpayer who earns R1 000 and is required to pay R100 in taxes continues to spend R1 000. In this situation, the tax was one levied on capital, even though it was levied *prima facie* on income (Ricardo, 1817: 63).

In this way, if the capital assets that were used to generate the income of R1 000 were valued at say R10 000, then in the first scenario, the value of those assets would be left unaffected. In the second scenario, the effect of the tax is the erosion of the very asset base used to generate the original R1 000 (Ricardo, 1817: 63). This distinction between the tax on revenue and one truly on capital, and the concern that a failure to recognise this distinction could result in double tax, has been applied by numerous, more recent writers, in the wake of the introduction of CGT.

Echoing the theories laid down by the Ricardo (1817), the proponents of CGT have argued that the tax is really one levied on income and that far from undermining the ability of taxpayers to generate wealth and pay other taxes, CGT helps to ensure that all citizens pay a fair share of their wealth in lieu of the benefits that the state has provided. In this way, by ensuring that taxpayers bear a tax burden proportional to their level of wealth, the poor may very well be spared the brunt of the tax load. This stance is clearly seen in the Carter Commission which stated:

‘we have arrived at the conclusion that the present distinction between kinds of gain is inconsistent with what we believe income is for the purpose of determining the individual's capacity to pay real tax...A dollar gained through the sale of a share, bond or piece of real property bestows exactly the same economic power as a dollar gained through employment or operating a business....To tax the gain on the disposal of the property more lightly than other kinds of gains or not at all would be grossly unfair ‘
(Carter Commission,1966:)

Thus, in the opinion of the Carter Commission (1966), CGT was not seen as having an erosive effect on the nation's capital base while giving rise to double tax. Indeed, the Commission was of the opinion that, paradoxically, not having CGT would be the true source of unfairness (Carter Commission, 1966). Manuel (2001) appears to support this view noting that while there are concerns that CGT may be a tax on capital, such fears are unfounded.

Manuel went on record stating that:

'capital gain income falls within the generally accepted definition of income and, as such, should be treated no differently from other income in a comprehensive tax system...The current distinction between ordinary revenue and capital gains is a legacy of English common law precedents [that] has no economic rationale' (Manuel, 2001: 9).

SARS (2000) has shared this point of view, citing the opinion of the Carter Commission (1966) in its own 'Guide to Capital Gains Tax'. SARS thus concludes that the views of the Carter Commission are relevant in the South African context. From a purely economic perspective, an individual who realises a R10 capital profit or one who receives a salary for the same amount have both been enriched by the same amount and ought to be taxed on those gains, as a result, in a similar manner.

Again, the effect of CGT is not to tax the taxpayer's underlying source of income and thus, is not a form of double tax (SARS, 2000).

The viewpoint of SARS (2000) may be supported by a simple example contrasting two shareholders, both of whom hold shares in foreign companies with equal risk profiles. One receives regular dividends from the shares which are subject to tax and the other holds shares in a company which seldom pays out any dividends. In order to raise funds, the second shareholder simply disposes of a given number of shares from time to time thus realizing a capital gain. By simply relying on so-called home made dividends, the second shareholder was able to undo the relevant company's policy of seldom declaring a dividend by selling of some of his shares, in the absence of market imperfections. In spite of the fact that both shareholders are in the same economic position: holding investments of similar value; risk profiles; and returns, the second would be able to avoid tax entirely in the absence of CGT by investing in shares with a low dividend payout ratio (Adapted from Firer *et al*, 2004: 564 & Staszczuk, 2001: 6). In this way, far from undermine the source of income and yield double tax, CGT ensures that taxpayers in equal positions are taxed equally, helping to entrench the principle of fairness in the South African Tax System. (The details of taxing equally footed taxpayers in a similar fashion are discussed in Chapters 5 and 6 while a discussion of home made dividends is presented in Annexure B.)

In this way, the Carter Commission (1966), SARS (2000) and Manuel (2001) appear to adopt the view that CGT does not erode the capital base of taxpayers resulting in double tax. In terms of the principles established by Ricardo, due to the similarities between gains enjoyed through earning a salary or those derived from capital appreciation, those taxpayers who derive a gain of R1 000 and are required to pay R100 in CGT are not left still wanting to spend the original R1 000. Accordingly, CGT may pose no threat to the nation's capital base. Indeed, given the belief that the CGT will assist in alleviating the tax burden born by the poor – as discussed in the chapters to follow – the tax may even ensure the protection of the capital possessed by lower income critics. This may be especially true if we consider the potential for CGT to widen the country's tax base. Such could, in turn, circumvent the need for higher tax rates that may pose an undue burden on poorer South Africans while boosting the State's coffers in order to fund social development projects (Budget Speech, 2000 & Staszczuk, 2001).

Cordes (2000), however, points out a key contradiction in the above arguments. If capital gains are to be seen as 'enriching' a taxpayer in the same way as traditional income sources, then both capital gains and losses should be considered in determining taxable income (Cordes, 2000:1). Nevertheless, capital losses are off-set only against capital gains and can not be taken forward into taxable income under s 26A of the Act read with the definition of taxable income in s 1 of the Act. This directly challenges the views of SARS (2000) and Manuel (2001) who argued that a gain through the sale of shares and one enjoyed by earning a salary placed taxpayers in equal positions necessitating the need for similar tax charges.

Others share Cordes's (2000) sentiment noting that there is a clear distinction that has been drawn between income and capital and that accordingly, a gain through the sale of a share and profit earned by rendering services are equivalent. In *CIR v Visser* (1937 TPD: 276), Judge Maritz J stated that 'if we take the economic meaning of "capital" and "income", then the one excludes the other' (Maritz J, 1937 cited in Jordaan *et al*, 2006: 20). Based on this interpretation, from a financial and economic perspective, capital represents the machinery from which income is generated, negating the view that R100 of capital is equivalent to R100 of income.

In this light, CGT may indeed be a tax on capital as envisaged by Smith (1776) and Ricardo (1817).

Stein (2000) reaches a similar conclusion: that CGT may be taxing the underlying capital source. Echoing Ricardo's (1817) economic framework, he describes capital as 'the seed corn of the nation from which income is earned' and which forms part of the basic foundation of the ability of a taxpayer to generate income. He warns that capital should be preserved and that when 'capital is [reduced a taxpayer's] economic foundation and thus his ability to generate income is diminished'. This argument is used to suggest that, contrary to the view of SARS, CGT is not a tax on economic income but could actually be eroding the tax base and the ability of a taxpayer to provide for himself and his family (Stein, 2000: 102). From this perspective, far from leaving the capital of the nation unimpaired, the effect of CGT may be the undermining of the very source of the nation's wealth and, in turn, the ability of citizens to carry the tax load.

The differentials between the average growth rates of the Organisation for Economic Cooperation and Development (OECD) members with and without CGT in their respective tax legislation may corroborate the opinion of Stein (2000). The statistics are as follows:

	<i>Average growth in real per capita income (1990-1997)</i>
<i>Countries without CGT (Netherlands, New Zealand, Singapore and Switzerland)</i>	2.2%
<i>Countries with indexed based CGT (Australia, Ireland, Luxemburg, Mexico and the United Kingdom)</i>	2.3%
<i>Countries without indexed CGT (remaining members of the OECD with CGT)</i>	1.2%

(Courtesy: PricewaterhouseCoopers, 2000)

The suppressed growth rates exhibited by nations relying on CGT may reflect that, as explained by Ricardo (1817), in the wake of CGT consumption and production may not have been proportionately adjusted in those countries adopting CGT.

In turn, this may have left the capital, and hence growth potential, of the respective countries impaired (Ricardo, 1817). Accordingly, the effect of CGT may be a tax on the very capital base needed to generate income; support economic expansion; and hence, ensure the maintenance of taxpayers.

The fluctuations in the per capita income may, however, be attributable to a plethora of different factors including: population growth; political stability; education levels; or random events. In this light, the exact effect of CGT on 'nation's seed corn' may not be readily determined and accordingly, we can not conclude beyond all reasonable doubt, that CGT is a tax governments levy on capital in spite of the warnings of Smith (1776) and Ricardo (1817).

The taxes levied on the transfer of property from the dead to the living may, however, serve as additional evidence of how CGT may threaten the source of taxpayers' income, and thus, their ability to support themselves. Ricardo (1817) uses the English tax system to make the point:

'If a legacy of £1000 be subject to a tax of £100, the legatee considers...his legacy as only £900 and feels no particular motive to save the £100 duty from his expenditure, and thus the capital of the country is diminished; but if he had really received £1000 and had been required to pay £100 on...wine...[or] servants, he would probably have diminished, or rather not increased his expenditure by that sum, and the capital of the country would have been unimpaired' (Ricardo, 1817)

While the focus of the research is on CGT and not Estate Duty, the provisions of para 40 of the Eighth Schedule to the Act may, nevertheless, highlight a more recent example of the problem with a tax on capital. Upon death, the taxpayer is deemed to have disposed of certain of his assets at an amount equal to market value giving rise to deemed CGT on the difference between that market value – determined on the date of death – and the base cost of the relevant assets per para 20 of the Eighth Schedule to the Act. The heir and recipient of the assets in question may, however, receive fewer assets after some of these assets need to be sold off by the deceased estate in order to settle the CGT charge (Adapted from Jordaan *et al*, 2006: 641-646).

This may, in substance, give rise to same problem identified by Ricardo. The recipient may no longer receive the inherited assets valued at say R1 000, but rather a lower amount due to the indirect tax born by him in the form of CGT. 'Without an inclination to reduce [his] subsequent expenditure', the capital of the country must be impaired. It would only be in a situation where the taxpayer receives the entire inheritance and is required to pay the tax himself that he may have been 'induced to reduce his expenditure', thus preventing the levying of CGT from eroding the nation's capital (Adapted from Ricardo, 1817)

It is submitted that such a scenario could arise, to an extent, when the election of para 41 of the Eighth Schedule to the Act is available. This paragraph allows the heir or legatee to elect that the asset in question be distributed to him and that he bear the CGT burden on the asset to the extent that it exceeds fifty percent of the net value as defined in the Estate Duty Act No.45 of 1955 (the Estate Duty Act).

Unfortunately, however, it does not provide for the full tax to be paid by the recipient of the asset and is only available under limited circumstances. These include where the estate would be forced to sell the asset in order to settle the CGT debt owed to SARS and where the CGT liability is in excess of fifty percent of the net value per the Estate Duty Act. It is submitted that even under this circumstance, where the heir receives all of the inheritance, he is never required to pay the full amount of the CGT over to SARS and thus, to the extent of fifty percent of the CGT liability, may not be induced to reduce his expenditure.

Moore and Silva (1995) have added to the concern that CGT threatens the perceived fairness of tax systems by considering the possibility that CGT is a form of double tax due to its potential to erode the taxpayer's capital base. These concerns are captured by the economists Canto and Hirschorn (1994), cited by Moore and Silva (1995), who explained that:

'A government can choose to tax either the value of the asset or its yield, but it should not tax both. Capital gains are literally the appreciation in the value of the existing asset. The taxes implicit in the assets after tax earnings are already fully reflected in the asset's price or change in price. Any additional tax is strictly double tax' (Canto V and Hirschorn H (1994) cited in Moore *et.al*, 1995: 87).

Stein (2002) corroborates this view that the application of CGT could be tantamount to double tax. He negates the view that CGT represents a fair charge on taxpayers enriched by gains of a capital nature. In his opinion, 'to the extent that the selling price of shares represents accumulated profits, any CGT would amount to a further tax on profits that have already borne income tax'. This is especially true if we accept the value of a share to be the present value of companies' future profits or cash flows (Stein, 2000:102). Thus, any appreciation in the value of those shares is simply a reflection of the growth in future earnings that will be subject to tax in the hand of the company. To this extent, any CGT becomes a form of double tax that directly challenges the ability of taxpayers' to bear the CGT burden (Moore and Silva, 1995: 12).

The problem may be highlighted by considering an investment in equities. An investor who acquires shares in a company may suffer a capital gain on the subsequent disposal of those shares if the sale price exceeds the base cost of the asset.

Using the dividend growth model to explain the appreciation of the share's value, the gain is attributable to a growth in the revenue of the company and, in turn, an expectation of improved dividend payouts to shareholders. Alternatively, the improved share price results from expectations in improved cash flows inherent in those shares, all else equal. Since the future profits of the underlying company will already be subject to tax, the taxing of the gain in the hands of the shareholder becomes tantamount to double tax (Adapted from Firer *et al*, 2004: 229-230 & Staszczuk, 2001: 11). The effect of this double tax: a direct threat to the ability of taxpayers to support themselves and their families (Smith, 1776).

This potential double tax becomes even more problematic for the perceived fairness of the tax system when we consider that it is no longer the elite who hold shares. More recently, increasing emphasis has been placed on empowerment of previously disadvantaged staff in the name of good governance (Jackson and Stent, 2005). In this context, Woolworths (2007) and Primedia (2006) are but a few of the large corporates who have issued shares to lower and middle income employees (Primedia, 2006 and Woolowrths, 2007). If CGT is a form of double tax, then it may be imposing an undue tax burden on the part of the population who are least able to carry it, violating Smith's model of fair tax system.

In spite of the concerns that CGT may be a form of double tax, several key points need to be considered in the defense of CGT. Firstly, it is submitted that the taxing of amounts in the hands of two separate persons, may be fair. The income generated by companies is soundly taxed by virtue of the existence of gross income. The resultant increase in the value of a company's shares because of strong profit growth is an economic advantage enjoyed by the shareholder and not the company. In this light, each respective economic gain is taxed in the hands of the relevant person. Second, certain provisions contained in the Eighth Schedule to the Act may provide relief to the double tax problem. For example, the exclusion of assets from the CGT net in the case of non residents - other than as detailed in para 2 of the Eighth Schedule to the Act - will, to some extent, prevent non-residents being subject to CGT both in South Africa and in the country in which they are resident. The existence of double tax agreements would act as an additional measure to avoid double tax (Jordaan *et al*, 2006: 423). Finally, concessions were introduced in other legislation. For example, a number of amendments have been introduced to the Transfer Duty Act No. 40 of 1949 and the Stamp Duty Act No.77 of 1968 to provide for a transfer of a primary residence from a company or trust to a natural person free of any related duties pending the introduction of CGT (Mewerowitz, 2001: 4).

While several relief measures appear to have been implemented, however, these measures either prevent taxation under more than one piece of legislation or are largely applicable to non-residents. They fail to take cognizance of the fact that a capital gain may embody profits of an underlying company already subject to tax or of the need to provide additional relief for resident taxpayers.

In essence, part of the concern surrounding the levying of CGT is that the tax may be eroding the nation's capital base and subjecting taxpayers to a form of double tax. While the likes of the Cater Commission (1966), SARS (2000) and Manuel (2001) have argued that this is not the case, several counterarguments have been raised in support of the belief that CGT is, to some extent, unfair.

3.2: Section 7(A)(4A) of the Act and inflation adjustment.

The inherent unfairness of CGT as a result of double tax is compounded by the 'bunching effect' discussed in detail in the chapters to follow. It has been said that the 'bunching problem' poses a great injustice to those taxpayers who are unfortunate enough to have accumulated wealth and happen to realise that wealth only in a particular year. This can occur if an artificially high rate of tax is applied in the year of disposal rather than a lower average rate that existed over the asset's life (Moore and Silva, 1995: 30). The Eighth Schedule to the Act fails to make allowance for the application of the rating formula to capital gains potentially challenging the ability of taxpayers to carry the tax burden while still afford the basic necessities of life. In this way, the bunching problem may result in an unduly high rate of tax to the detriment of taxpayers' ability to maintain themselves posing a problem that, in substance, is similar to that posed by the levying of double tax.

At the same time, the lack of adequate inflation adjustments provided for in the Eighth Schedule to the Act may result in a degree of injustice. Until the Act makes express provision for the effects of inflation, largely nominal capital gains will be subject to tax (Meyerowitz *et al*, 2001: b 2). The taxing of what may be tantamount to artificial capital gains goes directly to whether the taxpayer is able to bear the CGT burden, compounding the effect of the bunching problem. (Both the bunching problem and the lack of inflation adjustment are discussed in detail in the chapters to follow.)

3.3: Conclusion

Smith suggests that for a tax system to be fair, one of the key requirements is for the tax to be levied on income and not capital. A failure to do so carries two possible disadvantages. Firstly, the tax may erode the very assets used by a taxpayer to generate income, pay taxes. Secondly, and related closely to the first concern, the effect of taxing capital may be a form of double tax to the extent that the underlying income generated by the capital asset has already been subject to tax. The result: the ability of a taxpayer to bear the tax burden, and thus the fairness of the tax system, comes into question.

These arguments have been applied by critics of CGT who maintain that the tax results in the very two shortcomings identified above. The concerns over the effect of CGT may be supported by three specific examples. First, that countries adopting CGT tended to report lower per capita incomes due to the possible erosion of capital. Second, the deemed disposal resulting in terms of para 40 of the Eighth Schedule to the Act on the death of a taxpayer may leave the heir in receipt of a diminished inheritance without a proportionate reduction in consumption. Finally, since capital gains are the result in improvements in the post tax cash flows of respective companies the CGT charge is a form of double tax.

SARS (2000) and Manuel (2001), however, has rallied to the defence of CGT arguing that the tax is actually one on economic income as opposed to capital. Rather than be a source of unfairness, the tax ensures that the poor are not forced to bear an undue tax burden that would result in the absence of CGT (SARS, 2000 and Manuel, 2001).

In defence of the impairment of capital that may result on the transfer of property from the deceased estate to the heir or legatee, para 41 of the Eighth Schedule to the Act exists limiting the potential for an undue tax on capital, while the results collected by PricewaterhouseCoopers may not so much highlight the shortcomings of CGT as much as the effect of other phenomenon.

The concern that CGT may be impairing the ability of taxpayers to maintain themselves is compounded by the bunching problem and lack of inflation adjustment in the Eighth Schedule to the Act. These two perceived shortcomings may result in an undue tax charge challenging Smith's (1776) notion of a fair tax system. These two concerns are discussed in greater detail in Chapters 5 and 6.

Chapter 4: The cost of services

Smith (1776) suggests that a fair tax system, in part, allows for the taxpayer to fairly remunerate the State for the services he has received whether in the form of internal or external defence, health, education or otherwise. This would imply that there should be a *quid pro quo* for the services that individuals receive from their governments, possibly in the form of taxes. This compensation, however, should represent a fair and reasonable one. (Vivian: 2006, 82-83). To consider whether CGT is in line with this principle, three key issues are considered:

Firstly, the report examines what is meant by the 'lock-in effect', the arguments surrounding whether or not GCT results in the problem, and whether a cut in the CGT rate could actually lead to higher State revenue. In this way, the research will explore whether a lower rate of CGT could actually be equated with better government expenditure; improved State services; and hence whether the current cost of Government services may be too high.

Secondly, the report analyses the administrative burden created by the Eighth Schedule to the Act by considering the requirements that taxpayers must comply with per the Act. The steps taken to simplify compliance are also examined. By evaluating the administrative load that the tax has resulted in, the report considers whether the tax, indirectly, is too costly for taxpayers to comply with.

Finally, a brief analysis has been done on the ability of CGT to act as an anti-avoidance tool, thus preventing some taxpayers enjoying State services while paying less than their counterparts. This goes directly to Smith's (1776) notion of taxpayers paying a fair amount for the services that they have received from the State.

It was not however, the intention of the report to address whether the services offered by the State are adequate in light of the CGT charge. This is due to the politically sensitive nature of the topic.

4.1: The lock-in effect

The levying of CGT may be discouraging both individuals and companies from realising capital assets. This problem is referred to as the 'lock-in effect'. In the opinion of Conda (2006), CGT has created a 'locking in' of capital gains that is ultimately influencing investment decisions and the resultant liquidity and movement of capital. As a result of CGT, assets may not be disposed of at the most efficient times preventing assets from being transferred to the most effective users (Conda, 2006: 2).

In this way, the decision of a taxpayer not to sell an asset to avoid CGT can have adverse effects on the collection of revenue by the State. A taxpayer could simply elect not to sell an asset and effectively avoid tax until death when a deemed disposal results in terms of para 40 of the Eighth Schedule to the Act (Cordes, 2000: 2).

In turn, the lock-in effect may challenge the perceived fairness of CGT. Firstly, the phenomenon frustrates tax collection by the State and hence, the capacity of the State to embark on social investment projects. This may serve to the detriment of the upliftment of the poor and previously disadvantaged. Secondly, the lock-in effect may beg the question as to whether or not a lower CGT rate could allow for more realisations and, hence, improved State revenue. This may translate into the possibility of the State being able to generate higher revenue and offer improved State services by lowering the CGT rate. Accordingly, the issue of whether the current effective CGT rate is adequate in light of State provided services may be relevant. Before this can be explored in more detail we need to first consider whether or not CGT does indeed have a locking in effect.

4.1.1: Does CGT result in the locking in of capital gains?

This hypothesis: that CGT was creating a locking in of capital was tested by considering the effect that the introduction of CGT has had on realisation of sharers held by investors in the United States of America. *Certeris paribus*, most investors may choose to sell securities whose value has declined below the acquisition price as a current tax deduction may be preferable to one that is deferred (Dyl, 1977:166-167).

Correspondingly, an investor whose security has appreciated in value may choose to delay the sale of those securities in order to defer any taxable capital gains. Hence the effect of CGT may be a 'locking in' of capital gains. By considering a random sample of 100 listed stocks and measuring abnormal trade volumes the lock-in effect may, to some extent, be quantified (Dyl, 1977:166-167).

The percentage appreciation or depreciation of share prices in the eleven months preceding the end of the tax year is used as a basic estimate of the extent to which investors may have enjoyed a capital gain or capital loss respectively. Although the measure is not precise, it at least gives some insight into the likelihood of an investor having a capital gain or loss. The movement in stock values over eleven months from month t to T is denoted R_{iT} . If P_{it} is the price of security i in time t , ignoring the effect of dividends, as dividends are exempt for tax purposes, then $R_{iT} = (\sum_{t=1}^{11} P_{it}) - 1$ (Dyl, 1977:166-167).

In order to determine whether trade volumes are abnormal for particular shares, the monthly trading volume of a stock ' i ' (V_{it}) is regressed on the monthly average market volumes (V_m). A linear model was used with a twelve month moving average in order to yield a relative measure of trade volumes. Accordingly, V_{it} is the quotient of the number of shares of stock i traded in month t divided by the average monthly volume of stock i in the months $t-1$ through to $t-12$. V_m is computed in a similar way using the average New York Stock Exchange monthly volumes. The use of a relative measure was expected to eliminate the effect of upward trends, seasonal and cyclical fluctuations, and provide some means of dealing with so called white noise. Using a linear decomposition model, $V_{it} = a_i + b_i V_m + e_{it}$ where ' a ' is a constant; ' b ' represents the slope of the regression line; and ' e ' is a random error term (Dyl, 1977:167-169).

The correlation coefficient between V_{it} and V_m were found to be positive ninety-nine per cent of the time and significant at the five per cent level for eighty-three per cent of the stocks surveyed. Based on the regression equation, the level of abnormal trade volume can be expressed as the actual volume of trade observed for stock i (V_{it}), less the expected volume ($a_i + b_i V_m$). A positive result indicates excessively high trade volumes and a negative solution, abnormally low trade volumes. The results of the above analysis are presented below (Dyl, 1977:167-169).

<i>Classification</i>	<i>Mean R_{it}</i>	<i>Mean difference between actual and expected trade volumes in December</i>
$R_{it} \geq 20\%$	49.2%	-0.125
$20\% > R_{it} \geq 20\%$	0.3%	-0.004
$R_{it} < -20\%$	-31.7%	0.192

(Courtesy Dyl, 1977:170)

The data implies that CGT results in abnormal year end trading volumes. For example, stocks in December showed an abnormally low volume when there were considerable appreciation in values and thus potentially large capital gains. Similarly, shares that experienced depreciation in value showed abnormally higher trade volumes as taxpayers attempted to realise losses and claim possible capital deductions. Further, a t-table analysis at the 0.001 level indicated that the cited December values were significantly different from zero, suggesting that factors other than chance alone explain the data presented above. Further, the correlation coefficient was found to be approximately eighty-six percent further supporting the use of the linear decomposition model (Dyl, 1977:170-172).

Thus, there does appear to be a lock-in effect due to CGT. Since capital gains are only taxed when realised, investors may attempt to defer selling their shares to avoid a higher tax payment in a given year. Correspondingly, a tax minimizing strategy may involve the selling of shares that have declined in value to create capital losses that may be set-off against capital gains for the period. To further test the effect of CGT on share realisations, three bear and bull market years were selected and realisations measured as discussed above. The shares were grouped into distinctive classes as follows:

<i>Price change classes</i>	<i>Classification criteria</i>
A	$R_{it} \geq 20\%$
B	$20\% > R_{it} \geq 0\%$
C	$0 > R_{it} \geq -20\%$
D	$-20\% > R_{it}$

(Courtesy Dyl, 1977:173)

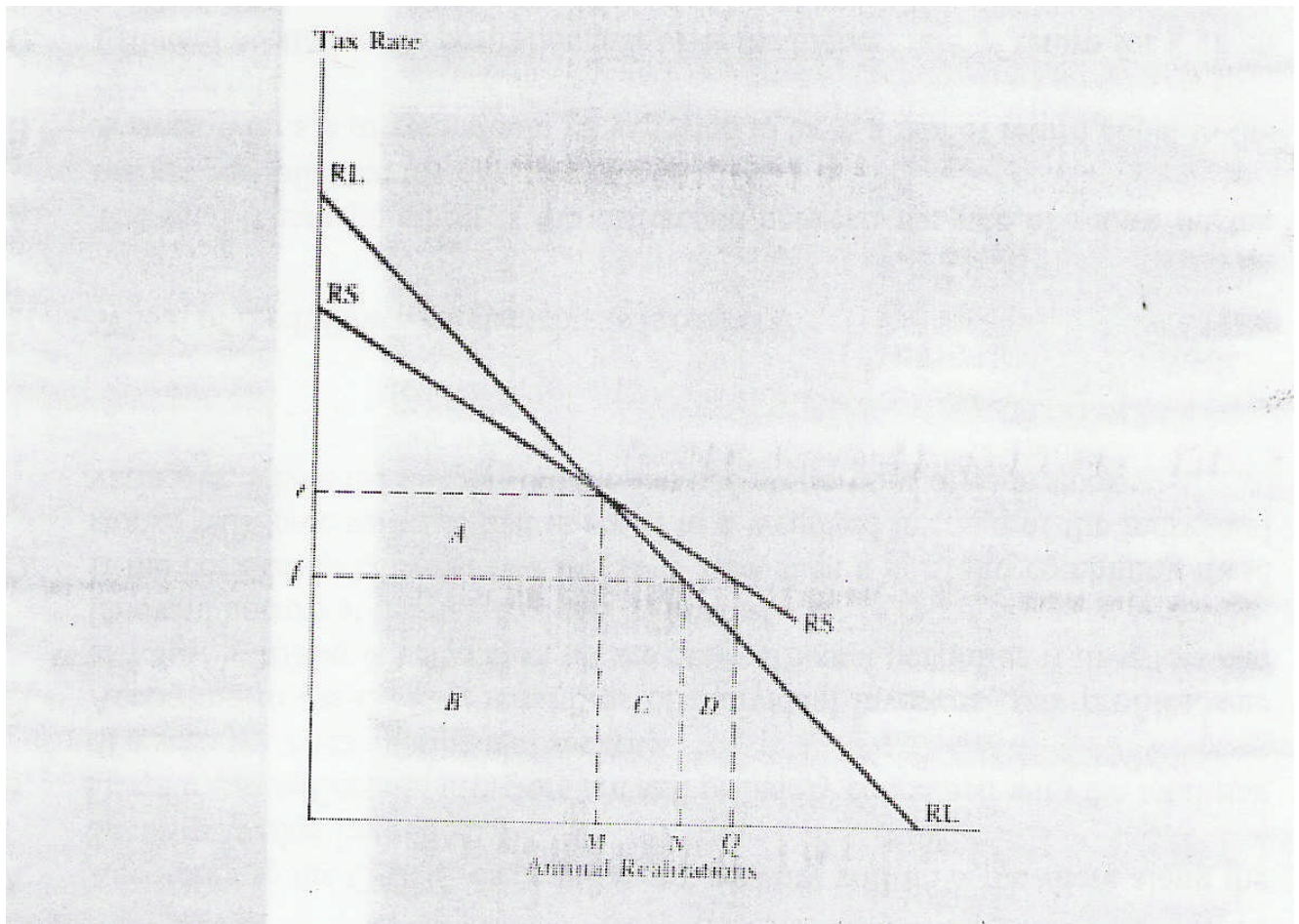
Class A shares are defined as showing significant appreciation in value while class D shares exhibited a significant decline in price. The price classes were chosen arbitrarily. During bull years when prices were rising, those shares showing the highest returns tended to exhibit abnormally low trade volumes. Again, those with reported losses tend to show higher levels of realisations than on average. While bear markets were characterized by less generous returns, the same principle continued to apply. Shares with higher returns tended to be sold in smaller volumes on average than those investments which reported losses (Dyl, 1977:170-172).

4.1.2: The lock-in effect and state services

Based on the work of Dyl (1977) it would appear that a reduction in the effective CGT rates or the removal of the tax would have an 'unlocking effect'. Previously 'locked in' capital would be released for use in 'new investments, stock purchases and business start-ups'. This would result in positive economic benefits as investors shift returns to new activities and assets that yield the highest returns. Paradoxically, a lower effective CGT rate could actually increase the State's revenue allowing for more government expenditure and hence, further economic relief for the poor (Roberts: 2006, 1). This could imply that by lowering the effective CGT rate (or part of the charge for State services), it may be possible to increase State revenue and thus allow for additional services such as improved healthcare or housing to be provided to taxpayers. This may go directly to ensuring that the ability of taxpayers to enjoy the necessities of life is improved in exchange for a lower, more reasonable charge for state services.

In this light, the rate of CGT may be excessively high in relation to the services which citizens receive. A reduction in the CGT rate could result in greater State revenue and, in turn, cheaper government services.

The above argument is supported by Gerald *et al* (1999) who applies several economic principles to demonstrate how the reduction of the effective CGT rates will potentially 'unlock' unrealised gains and boosts the State's revenue. This is shown diagrammatically below:



(Courtesy Gerald *et al*: 1999, 183)

Assuming a flat effective rate for CGT, the schedules RS and RL show how the Rand volume of capital gains realised varies in the long and short run respectively as the effective CGT rate changes. At a tax rate of r , taxpayers realise a gain of RM and pay a total CGT charge represented by the areas marked A and B, where R denotes the currency of the Republic. At a lower tax rate, f , taxpayers realise capital gains of RQ in the short run, and pay a resulting CGT charge shown by the areas B, C and D.

In the long run, the capital gains realised will be N and the CGT is denoted by the areas B and C . The area marked A is thus the 'static loss' suffered by SARS as a result of the lowering of the tax rate. The areas C and D , however, are additional revenues for the State induced by the additional realisations because of the lower tax rates (Gerald *et al*, 1999: 183).

As to whether the areas C and D will exceed A - and hence whether the effect of the reduction in the effective CGT rate will be a growth in State revenue - depends on the elasticity of the realization of gains with respect to the tax rate. (The elasticity measures the responsiveness of revenue from capital disposals to changes in the effective CGT rate.) Several studies have shown that this relationship can be quite elastic (Gerald *et al*, 1999: 184).

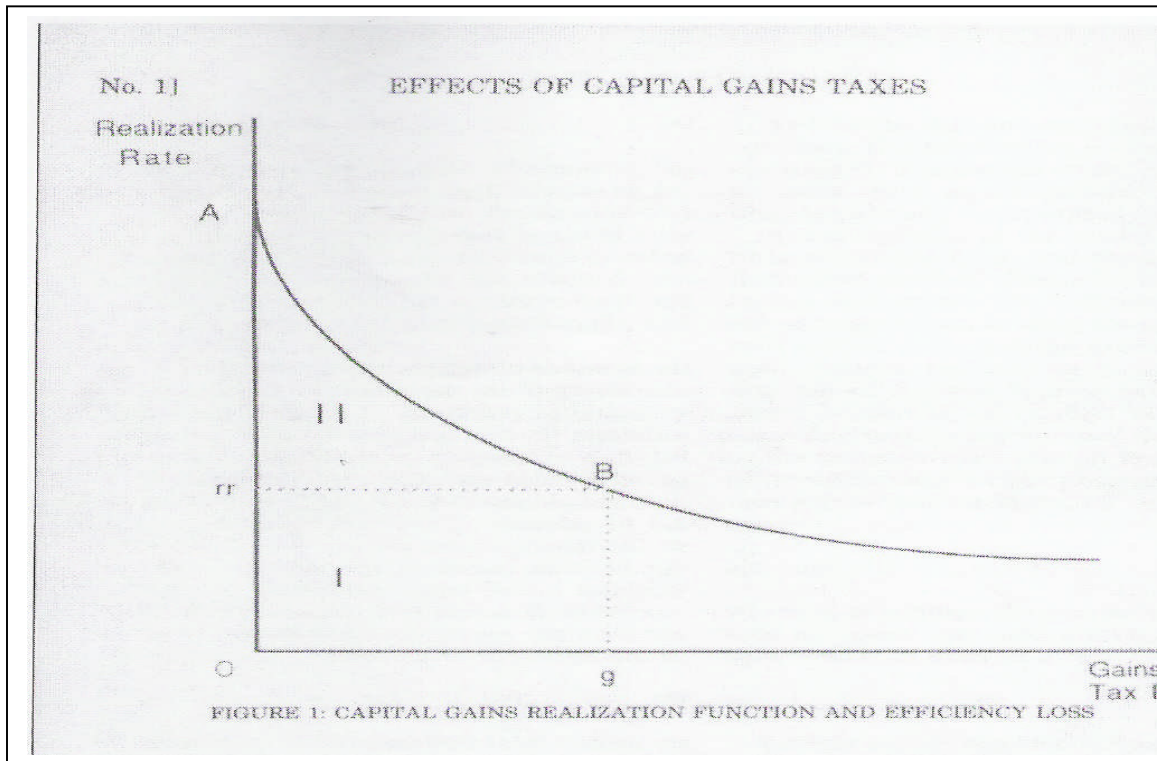
The approach used to determine the elasticity was to perform a multivariable regression analysis on the capital gains realised at different tax rates in a random sample of countries with CGT. Some of the variables tested included wealth levels, age, effective CGT rates and GDP. The studies concluded that in the short run, the elasticity was well above one. This suggests that a decrease in the CGT effective rate could boost State revenue. In the long run, the results were similar but 'more depressed'. That is, in the long run a growth in State revenue would still result from the decrease in the CGT effective rate but to a lesser extent than in the short run. The short term response to a cut in the CGT rates would be larger than the long run effect because of an 'immediate unlocking of capital gains' (Gerald *et al*, 1999: 184). Taxpayers attempt to realise capital gains when the tax rates are artificially low as the post tax returns will clearly be larger. In the long run, the rates stabilise and the benefits of realisation appear less attractive. (Leonard *et al*, 2002: 794-795). This phenomenon is highlighted by the greater gradient for the curve RS than for LR .

That the elasticity of the realization of gains with respect to the tax rate is greater than one appears to be supported by the empirical evidence gathered by Moore and Phil (2001).

By measuring the relationship between the CGT rate and the collection of revenue by the state over a two year period when the CGT rate changed from twenty-eight to twenty per cent, Moore and Phil (2001) discover that the amount of revenue collected by the state from CGT rises by some seventy-five percent. This, in turn, places the State in a better position to improve state offered services and offer future tax cuts in other areas (Moore and Phil, 2001: 5-6).

Thus, it appears that the lock-in effect has negative implications for the State's revenue and hence, limits possible government expenditure. By reducing the effective CGT rate, it would apparently be possible to boost Government's coffers. The added reserves could assist Government in carrying out the threat of the Minister in the Budget Speech (2006): 'hungers beware!' In this way, a lower CGT rate could be associated with improved government revenue translating into more affordable State-offered services.

An alternative analysis corroborates the inverse relationship between the effective CGT rates and the level of realisations. This relationship may give rise to an implicit tax that is paid by the investor but not collected by the State for the benefit of society, thus suggesting an excessive tax charge in spite of the delivery of fewer services. This loss may be highlighted by assuming a functional form of $\ln(rr) = k_0 + k_1g$ ($k_1 > 0$) (or without logarithms as $rr = \exp(k_0 - g/g')$) to explain the relationship between the levels of realisations and the CGT rate. In the equation, 'rr' is the realization rate, 'g' is the CGT effective rate and 'k₀' and 'k₁' are constants (Hendershott *et al*, 1991:23-26). The relationship between the tax and realization rates is as follows:



(Courtesy Hendershott *et al*, 1991:25)

To the extent that the investor is induced to lower realization rates in the wake of a higher CGT charge, the total tax burden is greater than the actual tax paid over to the State. Given the function assumed above, the total tax burden is given by $\int \exp(k_0 - g/g') dg$ between the points 0 and g on the x-axis. This is shown by the area marked I and II. Immediately, it becomes apparent that the effect of an increase in the CGT rate from 0 to g not only results in a direct tax charge of $g(rr)$, as shown by the area marked I, but also in an indirect tax burden denoted by the shaded region II (Hendershott *et al*, 1991:25). While the State may be able to collect the additional tax revenues represented by the area I in exchange for the benefits it has provided to taxpayers, an implicit charge, represented by the shaded region marked II, also arises and may suggest that, for the services received, the tax imposes too high a burden.

The economic analysis above and in Section 4.1.1 ultimately yields two important propositions. Firstly, it may be possible to increase State revenue and thus offer improved services by actually lowering the CGT rate.

Secondly, the CGT charge results not only in a direct tax burden, but an indirect cost that may never yield tangible benefits for society. These two propositions then beg the question as to whether the ideal of a fair *quid pro quo* for state services as advanced by Smith (1776) is indeed being observed.

There may, however, be several shortcomings in the above analysis. These rest in:

- The doubt as to whether CGT does indeed result in a locking in of capital.
- The elasticity of State revenue with respect to the CGT rates.
- The belief that the elimination of CGT could necessitate the need for other tax rate increases.

Firstly, the research conducted by Dyl (1977) may be problematic. While the correlation coefficient suggested that the returns of individual shares were highly correlated with the average market returns, the correlation coefficient does not prove a causal relationship between the two variables. Further, there are a plethora of factors that may prompt an investor to sell his securities other than CGT. These could include: investor sentiment, changing risk appetites, or unforeseen circumstances. Nevertheless, there are no attempts made to quantify the effects of such other than by noting the existence of an error term. There is also no evidence that homoscedasticity, serial correlation or normality of the distributions was tested for. Given the large number of variables that may effect the decision to hold or sell a share, multi-collinearity may also need to be considered before we conclude that CGT has a significant 'lock-in effect' and hence, could give rise to excessive charging for State services (Adapted from Drury, 2005: 1046 and Horngren *et al*, 2004: 380-388).

Further, alternative empirical evidence on the elasticity of revenue given changes in the effective CGT rate suggests that the effect of a lower CGT effective rate may actually reduce State revenue, contrary to the argument presented by Gerald *et al* (1997). While economists agree that by the lowering the effective CGT rate results in more disposals, or an 'unlocking of capital gains', there is uncertainty about the extent of the effect on total revenue (Leonard *et al*, 2002: 795). Studies conducted in the USA generally place the elasticity at below one. This implies that a decrease in the tax rate results in lower tax revenues.

For example: an elasticity of a half means that a ten percent decrease in the tax rate will increase the number of realisations but by only five percent. This results in an absolute decrease in total revenue from CGT (Cordes, 2000: 2). The 'unlocking' of capital gains may also be overstated as the analysis fails to recognize the selling costs associated with the realization. The selling costs may prove to be directly proportional to the accrued gain and thus dampen the market's reaction to the rate cut (Leonard *et al*, 2002: 795). In turn, a decrease in the tax rate may not spur a sufficient realization of capital gains to supplement the State's revenue in the wake of the tax cut.

Secondly, the disagreement on the effect a reduction in the effective CGT rate will have on the level of national revenue appears to rest in the complexities encountered in the way in which elasticity can be measured. Due to the number of assumptions that need to be made and difficulties in performing the calculations, there is no universally accepted elasticity for the number of capital gains realised given changes in the CGT effective rate (Gerald *et al*, 1999: 184-190). In addition, much of the data used to compute the elasticity may be inaccurate or difficult to interpret for several reasons:

- Published tax data by Government may be affected by other changes in the tax legislation thus violating the 'all things equal' principle. This makes it difficult, if not impossible, to determine the effect of changes in the effective CGT rate on Government's income (Gerlad *et al*, 2000: 186).
- Late-filled returns from previous years may be included in statistics for the current year (Gerlad *et al*, 2000: 186).
- Instances of tax evasion may occur and thus the full tax revenue details are simply not presented (Gerlad *et al*, 2000: 186).
- Empirical estimates may need to be dealt with cautiously as they tend to be subject to aggregation biases and are often too sensitive to the sample periods used (Leonard *et al*, 2002: 794-795).

In addition, time series data has generally implied that the realization of capital gains was quite unresponsive to changes in the CGT rate, contrary to evidence collected from tax returns or micro data. (Time series analysis has however, been criticised due to 'traceable aggregation biases' and the fact that the analysis is highly sensitive to changes in the chosen sample period.)

Similarly, micro data may produce overstated estimates of elasticity due to timing problems. This was expressed by Feldstein *et al* (1980) as follows:

'An individual whose tax rate varies substantially from year to year will tend to sell more when his rate is low. To the extent that [the rate is] only temporarily low, our results will overestimate the sensitivity of selling to the tax rate. We have no way of knowing how important this is' (Feldstein *et al*, 1980: 785)

Finally, Brooks (2001) maintains that CGT may be essential to ensure the fairness of the tax system. This rests on the belief that the market will act to direct capital resources to where those assets would yield the highest returns. If capital gains are not taxed, resources will flow into those assets that can be realised with no tax consequences. These assets may not, however, be the assets that benefit society the most. By leaving capital untaxed, the asset markets would provide a means for some to avoid taxes necessitating tax rate increases in order to cover the cost of State services (Brooks, 2001: 2).

These counterarguments directly challenge the view that improved state services could be provided by using a lower CGT rate. In some instances, the lowering of the CGT could either result in lower revenues or result in improper resource allocation to the detriment of the State's coffers. In this light, the levying of CGT may very well be needed to ensure that the State can offer numerous services to its citizens in exchange for a fair remuneration.

Moore and Silva (1995) shares this sentiment, pointing out that the absence of CGT results in undesirable resource allocation. Even if the removal of CGT did result in an 'unlocking' of capital gains, there could be an inclination on the part of investors to simply consume the proceeds; invest them in tax free ventures; or invest abroad. This would serve to impairing the tax base and the ability of the state to offer reasonable level of services. (Moore and Silva, 1995) In this light, CGT may be ensuring a fairer distribution of the tax burden by widening the tax base, and preventing those without extensive capital investments having to pay higher taxes in lieu of State benefits. An equitable distribution of tax burdens and the roles of anti-avoidance mechanisms in this regard are discussed in greater detail below.

4.2: Anti-avoidance mechanisms

CGT was introduced in several countries to serve as a “gatekeeper” tax to prevent people converting taxable income into [exempt] capital gains’, helping to ‘trap’ those who are involved in what is tantamount to tax evasion and thus ensure fairness in the tax system (Cameron, 2001). This sentiment is based on the British Tax System which introduced CGT, in part, for a similar reason. Callaghan, then minister of finance, noted that :

[the absence of CGT] is unfair to the [taxpaying worker as]...there is no doubt that the...immunity from tax of capital gains has given a powerful incentive to the skillful manipulator of which he has taken full advantage to avoid tax by various devices which turn what is really taxable income into tax free capital gains’ (Callaghan, 1965 cited in Staszczuk, 2001: 9).

SARS appears to support this view and has noted that, for South Africa, CGT is a critical element of the income tax system as it ‘protects the integrity of ... the tax base and can materially assist in improving tax morality’ (SARS, 2000). ‘CGT gives the authorities the arsenal to check every capital gain to ensure that it is not actually revenue that should be taxed at a much higher marginal income tax rate’ (Wood, 2001: 113).

In order to further protect the integrity of the CGT system itself and ensure that taxpayers did not unduly avoid paying a fair share of the CGT burden certain anti-avoidance mechanisms were introduced into the Eighth Schedule to the Act. For example, para 39 of the Eighth Schedule to the Act was introduced in 2001 to prevent the artificial inflation of the base cost of assets by transferring them to connected persons while para 97 of the Eighth Schedule to the Act sought to prevent the manipulation of the valuation date value during the transitional period. In 2002, para 86 of the Eighth Schedule to the Act was introduced to further limit the ability to manipulate the base costs of assets (Friedland, 2001: 23). From 2001 to 2006, para 41 of the Eighth Schedule to the Act (which limits losses on re-acquisitions of financial instruments); para 80 of the Eighth Schedule to the Act (to regulate CGT with respect to trusts); and para 63A of the Eighth Schedule to the Act (to limit instances in which PBOs are exempt from CGT) serve as examples of the steps taken to make the avoidance of CGT more difficult.

CGT may be useful, not only for limiting the desirability of converting income to capital, but due to its ability to 'cast the tax net abroad'. By requiring taxpayers to: complete detailed balance sheets disclosing foreign investments (2001); providing for the formal levying of CGT on certain foreign assets under part XIII of the Eighth Schedule to the Act; and allowing SARS to rely on estimates of the value of foreign capital assets under s 78 of the Eighth Schedule to the Act (2002-2003), the ability to avoid tax by moving assets abroad has been made considerably more challenging (Wood, 2001:113 and Jordaan *et al*, 2007: 811-813). Ultimately, the introduction of CGT and the refinement of the Eighth Schedule to the Act by means of various anti-avoidance amendments help to ensure that all taxpayers pay taxes in respect of the State-offered services that they enjoy.

By protecting the tax base, it is also argued that this may lead to the future alleviation of the burden created by other taxes (Wood, 2001:113.) It is submitted that the tax amnesty offered to small business may lay the foundation for further relief by allowing the State to tap into previously untaxed sources of income and capital thus further widening the tax base (Taxgram, 2006 (a)).

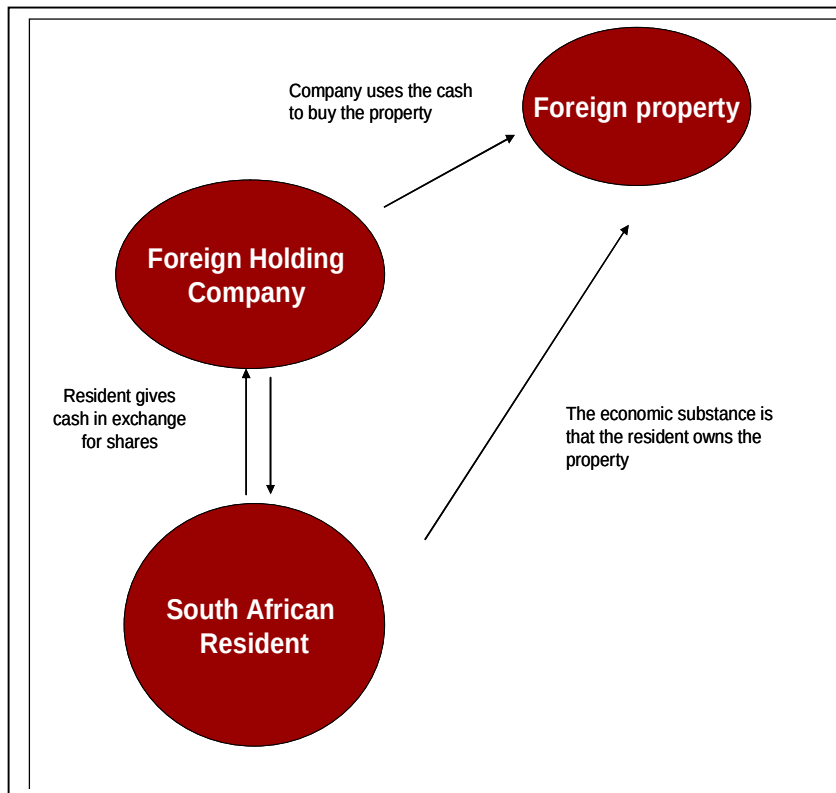
At the same time, the taxing of capital may come to be seen as assisting with wealth redistribution, a key socio-political aim of Government. This could improve the perceived fairness of the tax system. This may be especially true for the majority of South Africans frustrated by the failure to tax gains in the hands of a wealthy minority who nevertheless enjoyed State services (COASTU, 2001).

In turn, this perceived fairness translates into improved tax morale and hence tax ethics, widening the tax base further and laying the foundations for the tax relief measures announced in the 2004 to 2007 Budget Speeches (Budget Speeches 2004-2007 & Staszczuk: 2001, 6).

Critics, however, have suggested that CGT may not have the profound effect on tax avoidance as purported by SARS. For example, while banks are able to assist SARS in detecting the movement of funds from South Africa abroad, transfers between foreign countries of the billions of Rands already abroad has proven more challenging.

The problem is compounded by the fact that, increasingly, South Africans are becoming 'global citizens domiciled in one country but residing in others'. The tightening of the tax net has also simply resulted in taxpayers finding ever more creative ways for avoiding CGT (Thomas, 2001: 17).

To demonstrate this concern, we consider an individual resident wishing to acquire foreign property interests. If this individual were to directly purchase a property abroad, the sale of the asset would trigger CGT as the tax applies on a world-wide basis in the case of South African residents. In order to avoid this, the taxpayer could simply set up a foreign company in which he owns all of the shares. The company, in turn, acquires the property. This investment plan is presented as follows:



When the investor wishes to realise the asset, he simply needs to persuade the acquirer to take up the shares in the company rather than the property interest directly. The sale of the equity interest will then be subject to the provisions of para 64B of the Eighth Schedule to the Act which states that:

'A person must disregard any capital gain or loss determined in respect of the disposal of any interest in the equity share capital of any foreign company...that person...immediately before that disposal held at least 20 per cent of the equity share capital in that foreign company and held the interest for a period of at least 18 months prior to that disposal unless that person is company and [certain other conditions are met]. '

In this light, since the investor is a natural person and holds 100 per cent of the equity share capital of the company it appears that any capital gain enjoyed by him is fully exempt from CGT.

While the general anti-avoidance provisions of sections 80A to 80L of the Eighth Schedule to the Act may need to be considered, it is conceivable that several reasons for the setting up of such a financial structure could be furnished which dispel any notion of a scheme of tax avoidance (Honiball: 2007, pers. comm., 16 November).

Accordingly, far from ensuring that CGT entrenches the principle of taxpayers pay a fair share for state-provided services, this analysis tends to suggest the opposite. In some situations, the Eighth Schedule to the Act does not act as a disincentive to converting income into capital since by relying on sound, and perfectly legal, tax planning it is possible to avoid both the normal tax consequences had the property been seen as trading stock and the CGT on the disposal of a capital asset.

In summary, in order for a tax system to be fair, it should be such that it requires the paying of a fair quid pro quo for the services the State provides to its citizens. To better understand this principle, the State can be thought of as 'a great estate of individuals being joint tenants each having an obligation to contribute to the costs of administering the estate in proportion to their interest in the estate' (Vivian, 2006: 84).

In this light, the ability of GCT to serve as an anti-avoidance mechanism may very well promote the perceived fairness of the tax system. This is achieved by ensuring that taxpayers are unable to avoid the payment of taxes, even though they enjoy the services made available to them by Government.

4.3: The administrative burden created by CGT

One of the key characteristics of a fair tax system was that it allowed for the taxpayer to remunerate the State for the services it has provided to the taxpayer to a reasonable extent (Vivian: 2006, 84). The introduction of CGT may, however, be creating a significant administrative burden implying that the total cost of State services may not be duly proportionate to the benefits citizens receive. This added cost may also call into question the ability of taxpayers to bear the tax burden as discussed in more detail in Chapter 5 and 6 of this report.

4.3.1: General administrative concerns

The administrative burden may, in part, be demonstrated by s 73B of the Eighth Schedule to the Act which details the required documentation that needs to be kept by a taxpayer for CGT purposes:

(1) A person must retain all records required to determine the taxable capital gains or assessed capital loss of that person for a period of five years from the date on which the return for that year of assessment was received by the Commissioner.

(2) For the purpose of [s 73B of the Act] "records" includes-

- (a) any agreement for the acquisition, disposal or lease of an of an asset together with related correspondence;
- (b) details of any asset transferred into a trust ;
- (c) copies of valuations used in the determination of taxable capital gains or assessed capital losses ;
- (d) invoices or other evidence of payment records such as bank Statements and paid cheques relating to any costs claimed in respect of the acquisition, improvement or disposal of an asset.;

- (e) details supporting the proportionate use of an asset for both private and business purposes;
- (f) details of any continuous absence of more than 6 months from a primary residence as contemplated in the Eighth Schedule.'

The announcement of CGT in the 2000 Budget Speech resulted in many financing houses embarking on a restructuring because of the expected strain that the tax was likely to impose from an administrative perspective (Wood, 2001: 114). For example, the need to value assets acquired before the valuation date could pose a practically challenging task, especially if the asset was acquired in the distant past. As a result, the imposition of CGT is resulting in 'a plague of recording keeping' with s 82 of the Eighth Schedule to the Act frustrating the problem by placing the onus of proof on the taxpayer. As a result, without adequate records, a taxpayer risks not being able to substantiate an asset's base cost, paying more CGT than he ought to (Meyerowitz *et al* (d), 2001: 82).

The Act also does not indicate who should perform the valuations required under the Eighth Schedule to the Act. While a taxpayer may appoint a professional to assist in the valuation, the onus of obtaining and substantiating the valuation will rest with a taxpayer. The fact that a valuation was performed by a qualified valuer will not detract from the Commissioner's right to audit that valuation and request additional information (Meyerowitz *et al* (d), 2001:182) .

Apart from the burden of complying with the above, the fees payable for a valuation may also become onerous. The exact cost of a valuation will inevitably depend on who performs the work and its complexity. According to the Property Valuers Profession Act No. 47 of 2000, each appraiser must be entitled to a reasonable remuneration. This legislation provides for: an *ad valorem fee*; remuneration for time spent on the valuation; and even a form of travel allowance. The result may be the accumulation of a considerable bill that, although deductible as part of the base cost of the asset, must still be paid over by a taxpayer to the valuer upon completion of the valuation (Meyerowitz *et al* (d), 2001:188). This can create a cash flow problem if the payment that must be made to the valuer is not off-set by an inflow of cash from the asset within a short period after the outflow.

In addition, SARS requires detailed documentation on the ownership and all costs related to assets acquired after the valuation date for a period of five years after their disposal. If a taxpayer is not required to submit a return and an asset was disposed of for more than R10 000, then records for five years should also be kept (Bizland, 2006:12).

Further, the introduction of CGT will invariably lead to new ways to achieve tax avoidance. This necessitates the need for more complex rules to prevent means of circumventing the legislation's requirements (Brooks, 2001:2). The result: more complex tax audits and the need to appoint appropriately qualified staff in certain situations to deal with the complexity contained in some of the Eighth Schedule to the Act's paragraphs. Ultimately, the effect is a higher administrative cost for the taxpayer.

In addition, the skills and capital investment that is needed to administer the tax; the costs of ensuring compliance and full disclosure by taxpayers; and the expenses incurred due to more complex assessments may make the cost of administration well in excess of the benefits. In this light, it was submitted that it may prove more advantageous for the taxpayer to use resources devoted to the CGT system to better administer other revenue sources and, in turn, grant relief to taxpayers (Staszczuk, 2001: 8).

A study conducted in the USA highlights the potentially prohibitively high costs of complying with CGT legislation. On average, it was found that small businesses incur nine times the CGT yield to the State in various administrative and opportunity costs. In this way, a small business may need to incur large costs in order to generate limited CGT revenue for the State. These costs may result due to:

- The administrative load imposed by the relevant legislation.
- The lost opportunities from redeploying labour and computer resources from profit generating activities to administrative ones
- Potential fines for non-compliance.

(Q-Tech: 2007, pers. comm., August 15 and Moore and Silva, 1995)

These findings are supported by Blumenthal and Selmrod (1992) who suggest that the compliance costs of tax systems, including with respect to CGT, are generally higher among self employed taxpayers, such as small business owners, who often spend 'significant' amounts of time and money in complying with the administrative requirements supporting CGT calculations (Blumenthal and Selmrod, 1992: 185-202).

The empirical evidence above may be better appreciated by considering a South African example. Q-Tech (Pty) Ltd is a small business concern in the engineering sector. The nature of the firm's business requires it to regularly replace its capital assets. The relationship between the firms CGT liability and the administrative costs is captured in the table below:

Year	CGT Liability	Administration costs	Cost as a percentage of tax liability
2001	R 43,461.23	R 12,341.11	28.40%
2002	R 21,332.98	R 8,652.88	40.56%
2003	R 0.00	R 0.00	0.00%
2004	R 0.00	R 0.00	0.00%
2005	R 32,333.27	R 11,564.21	35.77%
2006	R 7,531.10	R 134.20	1.78%
2007 (to date)	R 8,321.21	R 534.55	6.42%
Cumulative	R 112,979.79	R 33,226.95	29.41%

(Courtesy Q-Tech: 2007, pers. comm., August 15)

The firm's costs related to CGT administration are based on the total time spent determining the CGT and maintaining the relevant documentation in proportion to the total labor time spent on all tax-related matters. This ratio is then multiplied by the total tax administration charge. This administration charge was determined by multiplying the total administration charge by the ratio of number of hours spent on tax-related issues bearing to the total administration labor hours (Q-Tech: 2007, pers. comm., August 15).

The administration load as a percentage of the CGT is an average of twenty-nine percent. These administrative costs also represent 0.8% of the firm's total revenue on average. While not as high as the American estimates, it should be noted that these statistics measure the direct administrative costs alone.

Indirect expenditure including depreciation, lighting and opportunity costs is not included in the above results (Q-Tech: 2007, pers. Comm., Aug 15) (The original correspondence with Q-Tech is contained in Annexure D)

There have, however, been marked efforts on the part of the State to reduce the administrative load of complying with tax legislation (Budget Speech: 2005 & 2006). Several examples of the efforts put in place to deal with administrative complexities include:

- A team of academics, representatives from government and small business owners was appointed to 'review the administrative aspects of businesses' interactions with SARS' and to make recommendations.
- The use of 'community tax helpers' to assist small business owners better understand the application of the Act and the obligations imposed on them by this legislation. Part of this strategy has included the introduction of education programs.
- Dedicated facilities for small businesses will be made available at all SARS offices and call centers.
- Accounting and payroll packages have been introduced to assist business owners in complying with the Act.
- A detailed tax guide has been issued by SARS for small businesses.
- The 'E-Filing' system has been extended to deal with several obligations imposed on taxpayers by the Act.
- SARS has introduced different colored forms and 'has reduced the number of returns that must be filed with respect to different tax instruments'.
- Any taxpayer who is disappointed with the services that he has received at any SARS branch may report the matter to the Service Monitoring Office.
- The finalization of the appeal procedures and the use of the 'alternative dispute resolution procedures' in terms of s 76B – s 76S of the Act has improved the objection and appeal process and made it easier for small business to resolve disputes with SARS.
- Specific registration processes and tax returns have been introduced for public benefit organizations.

(Meyerowitz *et al*, 2005: 23-30, Budget Speech, 2004 and Budget Speech, 2005)

The above relief measures have been complemented by further initiatives with SARS (2007) going on record, noting that: 'policy remains focused on reducing the tax compliance burden for businesses, especially small businesses'. Accordingly, a cost compliance study has been commissioned to support the delivery of a more simplified tax system, particularly for small businesses, expected to be launched in 2008. Several other proposals have been made by SARS (2007) in lieu of the compliance difficulties encountered by many taxpayers (Budget Review, 2007). While not specifically directed at the Eight Schedule to the Act, these measures may indirectly reduce the administered CGT burden as well.

The initiatives include:

- Greater reliance on automated processes, and the refinement of the e-filing system.
- Re-engineering of tax forms to simplify their completion and reduce the time taken to prepare and submit the necessary information.
- Greater reliance on third party documentation in order to speed up processing times.
- The adoption of World Custom Organization Framework of Standards in order to allow for more efficient processes.
- Simplified registration processes (Budget Review: 2007).

Most recently has been the introduction of simplified tax returns for both individuals and companies for the 2007 year of assessment. These returns are simpler to complete than those previously used by SARS and require less time to complete as a result. (Specimens of the new tax returns for individuals are contained in Annexure C). Unfortunately, while the returns are simpler complete and need no longer be accompanied by the same extensive collection of supportive documentation on submission, taxpayers are required to maintain detailed records in order to comply with possible tax audits (SARS:2007).

It is submitted that while the above actions have not been specifically aimed at the provisions of the Eighth Schedule to the Act, they will, nevertheless, reduce the administration burden created in complying with this part of the Act. Further, It is submitted that the promulgation of the advanced tax rulings (s 76B – s 76S of the Act) will complement the relief measures discussed above by providing for greater clarity at reasonable cost to business owners on various tax matters, including the application of the Eighth Schedule to the Act's provisions. The advanced rulings will allow for taxpayers to formally request a ruling from SARS with respect to the interpretation, relevance and application of tax laws for particular transactions, barring certain exceptions.

Subject to full disclosure being made to the Commissioner with regards to the details of the transaction, the rulings will generally be binding for both the Commissioner and the taxpayer promoting greater certainty in the tax system at an estimated application cost of R10 000 and recovery fee based on the complexity of the transaction (Taxgram, 2006 (b)): 6-7) .

The simplification of the administrative requirements; refinement of the appeal process; and the introduction of advanced tax rulings may also go to improving the perceived justice inherent in the tax system. According to Vlassenko (2001) by ensuring the integrity of the appeal process; streamlining administrative processes; and making tax appeals 'user friendly' and economical, the tax system can be aligned with a sense of justice thereby improving its perceived fairness (Vlassenko, 2001: 391). While Vlassenko's (2001) work is based on the property tax system of the UK, it is submitted that the essence of the research may also be relevant for CGT.

Despite the view that CGT could add to the State's coffers, and that numerous relief measures have been out in place to address the administrative burden of CGT, proponents of the abolition of CGT continue to argue that it imposes too high an administrative cost for both the tax gather and payer. Accordingly, it has been argued that a better growth in revenue can be achieved by eliminating CGT (Conda, 2000: 6). In this regard, the Katz Commission (1997) argued that, at the time of implementing CGT, SARS lacked the administrative capacity to deal with the tax. It was accordingly suggested that the introduction of CGT should be delayed.

The conclusion was supported by arguing that CGT may produce a 'low potential yield' making it uneconomical (Stein, 2000: 100). In the Budget Speech (2000), however, Manuel felt that SARS had 'enhanced its administrative capacity' and that CGT would probably provide a considerable contribution to the country's tax base. He went on to note that the tax would bring the Republic's tax system in line with several other countries and reduce the opportunities for tax arbitrage (Moosa, 2000: 88). Unfortunately, the exact contribution made by CGT to the State's revenue is not disclosed by Government making it impractical to perform a cost benefit analysis needed to resolve the debate.

4.3.2: Specific amendments to the Eighth Schedule to the Act

Apart from measures directly aimed at the administrative relief when dealing with SARS, amendments to the Eighth Schedule to the Act have also been enacted to combat the administrative burden created by CGT. For example, para 12 of the Eighth Schedule to the Act was amended in order to avoid undesirable consequences in the case of a liquidation or deregistration of companies. Para 12(5) of the Eighth Schedule to the Act was originally introduced in order to ensure that where a debtor is released from a debt which he owes the creditor that a capital gain, equal to the difference between the face value of the debt released from and the consideration given, is potentially subject to tax. This paragraph, however, had an unfortunate consequence: dormant companies were unable to deregister or liquidate as a capital gain would arise if creditors were to reduce or discharge the debts owed by these companies. Accordingly, the paragraph was amended. Where the debtor is a company and the discharge is granted by a connected person to the debtor:

'in the course of or anticipation of liquidation, winding up or deregistration of that company and the amount of the reduction does not exceed the creditor's allowable expenditure in respect of the debt at the time of the reduction or discharge',

an exemption from the provisions of para 12(5) of the Eighth Schedule to the Act is then granted.

This ensures that a deemed disposal does not result allowing for the simple deregistration or liquidation of the relevant company, an act previously frustrated by para 12(5) of the Eighth Schedule to the Act (Budget Review, 2005).

The provisions of para 12(5) of the Eighth Schedule to the Act are, however, not perfect and may still impose hardships for taxpayers. On death, taxpayers suffer a deemed disposal of most of their assets giving rise to a CGT charge in the hands of the estate (para 40) of the Eighth Schedule to the Act. This deemed disposal is made subject to para 12 (5) of the Eighth Schedule to the Act. Thus, if a testator moves to relieve a debtor from a debt owing to the estate, para 12(5) of the Eighth Schedule to the Act could come into play and result in a CGT charge in the hands of the legatee.

It would appear that by simply choosing to bequest a sum to the debtor, that the effects of para 12(5) of the Eighth Schedule to the Act, and accordingly the added CGT burden, could be circumvented (Meyerowitz *et al*, 2005: 81-82).

Nevertheless, in substance, the release of a debtor and the bequest of an amount to him may be construed as the same, or at least, similar economic event. What is more, the avoidance of this paragraph by bequeathing an amount to a debtor rather than remitting the debt may be impractical due to the nature of the estate's assets. This difference between substance and form may prove to be a 'trap for testators who wish to acquit debtors', particularly those who happen to be the children or spouse of the deceased and were helped to set up businesses or buy homes (Meyerowitz *et al*, 2005: 81-82). This may cast doubt onto the notion of CGT leaving taxpayers able to bear the tax load and still afford the basic necessities of life.

More recently, the provisions of para 29 of the Eighth Schedule to the Act were amended in order to promote fairness in the tax system in light of the costly valuation exercise necessary in respect of pre-valuation date assets. If a taxpayer had successfully valued an asset before the effective date, he would be entitled to use that value as the valuation date value in the determination of the capital gain or loss on the disposal of the asset. If he failed to correctly value the asset, provided that detailed records of actual expenditure had been maintained, he could elect the time apportioned base cost method to determine the CGT charge (Croome, 2007:4-5).

In the absence of either detailed cost schedules or an appropriate valuation, he must instead resort to the default twenty percent rule to establish the valuation date value. Under this method, the taxpayer is subject to CGT on eighty percent of the proceeds of an asset falling within the scope of para 26 of the Eighth Schedule to the Act (Croome, 2007:4-5).

The market value of the asset could be used in the CGT calculation as the valuation date value only if the asset in question was valued on or before 30 September 2004. Difficulties were encountered as the Act did not specify how the valuation was to be performed but merely required the valuation to be recorded on a prescribed form. In addition, the Act required proof of the valuation to be submitted in the first tax return submitted on or after 30 September 2004 for certain assets namely:

- those with market value in excess of R10 million;
- intangible, other than financial instruments, in excess of R1 million market value; and
- shares in unlisted companies if the market value of all of the shares exceeded R10 million.

Many taxpayers, however, failed to comply with these requirements. The valuations were either not submitted to SARS or were submitted after the 30 September 2004. By failing to fully comply with the requirements of para 29 of the Eighth Schedule to the Act, a taxpayer automatically excludes the use of market value to determine the valuation date value and must instead rely on either the time apportioned base cost or the twenty percent rule. Unfortunately, the market value method often presents itself as the most desirable way for the taxpayer to determine the valuation date value. The shortcoming was frustrated by the fact that the Act made no provision for the Commissioner to condone a late submission of information (Croome, 2007:4-5).

The Revenue Laws Amendment Act No. 20 of 2006, however, catered for this potential source of unfairness by adding to para 29 of the Eighth Schedule to the Act the following text:

‘Or, if it was not submitted with that return, within such period as the Commissioner may allow if proof is submitted that the valuation was performed within the period prescribed.’

The amendment allows for taxpayers ‘to regularize their affairs when CGT valuations were submitted with tax returns other than the first tax returns submitted on or after 30 September 2004 (or even when the CGT valuations were not submitted at all)’. Unfortunately, the deadline for the performance of the valuation was not altered (Croome, 2007:4-5). Thus, while the Commissioner has the power to overlook the late submission of the required CGT valuations, he may not condone the failure to perform the valuation before the 30 September 2004 limiting the benefit of this amendment for the taxpayer (Croome, 2007:4-5).

Nevertheless, the amendment may assist in providing an indirect source of relief when calculating the amount of distributions made by companies to be taxed as a dividend and subject to secondary tax on companies (STC). A company which declares a liquidation dividend as envisaged by para a of the definition of a ‘dividend’ contained in s 1, may find that the entire post 1 October 2001 dividend could effectively be subject to STC (Croome, 2007:4-5).

This will be the case if the market value of the asset on the valuation date had not been determined or submitted timeously. A company that is unable to prove which part of the gains arose pre and post valuation date and would thus be unable to escape unfavorable CGT and STC consequences (Croome, 2007:4-5). This is especially true given that s 82 of the Act places the onus of proving that an amount is not subject to tax on a taxpayer (Mitchell, 2006: 20-21). The benefit, however, will be of limited relevance given that the Act has been amended. With respect to liquidation dividends on or after 1 January 2009, the definition of a dividend per s 1 of the Act includes all gains, as opposed to merely the post 1 October 2001 ones, as dividends and thus potentially subject to STC (Budget Speech 2008 & Budget Review 2008).

Ultimately, in light of the amendments made to the Eighth Schedule to the Act it would appear that SARS has begun to take the necessary steps to address the lack of perceived fairness emanating from the administrative burden created by CGT. Nevertheless, flaws in these relief efforts have been identified making a resolution of the potential lack of fairness problematic.

4.4: Conclusion

The tax fairness definition advanced by Smith (1776) requires that a tax system ensure that taxpayers pay a fair *quid pro quo* for the services which they receive from the state. In addition, this remuneration of the state should be in proportion to a taxpayer's ability to bear the tax burden. In order to explain this characteristic of a fair tax system, it was useful to think of the State as an estate and the taxpayers as the tenants who are required to pay towards the costs of administering the estate based on the extent to which they have an interest in that estate (Vivian, 2006: 84).

In this context, the research considered whether or not the 'locking in' of capital gains prevented efficient resource allocation and the definitionization of the State's revenue. This, in turn, begged the question as to possibility of a lower CGT effective rate being able to boost State revenue and allow for taxpayers to enjoy the same extent of State-offered services.

One point of view was that, based on empirical evidence, such is indeed possible calling into question the cost of state services and hence the perceived fairness of CGT. Critics of the tax accordingly point out that by cutting the tax rate, the number of capital gain realisations would increase and more than offset the fall in the CGT rate. In this light, CGT may not represent a fair remuneration for State services.

Supports of the tax maintain that tax may be imperative for efficient resource allocation and that its removal would weaken Government's fiscal position. This counter argument is fortified by the uncertainty surrounding the elasticity of capital realisations with respect to the effective CGT rate. It may thus be the case that a cut in the tax rate will not translate into higher revenues and better state-sponsored services.

In this regard, the removal of CGT may simply necessitate the need to raise other tax rates in order to cover the cost of State services, thus implying that CGT is presently a key part of a fair *quid pro quo* given for those services.

The argument surrounding the ability of GCT to ensure that taxpayers pay a fair share for the benefits they receive from the State was then extended to the issue of anti-avoidance. It was argued that by preventing taxpayers from converting revenue to tax free capital gains, a loophole allowing taxpayers to avoid paying for State services was eliminated. This benefit would be fortified by the refining of disclosure requirements regarding foreign assets and capital gains. At the same time, CGT may help to widen the tax base creating the opportunities for further relief measures with respect to other taxes. In this way, CGT not only ensures that taxpayers pay for the services they receive from the State, but may be helping to reduce the tax burden of other taxes.

Critics of the tax, however, noted a key shortcoming: that CGT was still not a full proof anti-avoidance mechanism. Despite the apparent benefits CGT may simply encourage taxpayers to find ever more creative ways to avoid paying taxes. At the same time, the levying of CGT on the large reserves of wealth already outside of the country has proven challenging begging the question of how successful CGT is in ensuring that taxpayers pay a fair price for the services they enjoy from the State.

The final aspect considered regarding whether taxpayers were paying a fair share for government-provided benefits was the debate surrounding the administrative load created by CGT. From one perspective, the administrative requirements of complying with the Act are too onerous and pose an indirect cost on the taxpayers which thus violates Smith's (1776) tax fair definition.

SARS has, however, rallied to the defense of the tax arguing that it has attempted to take the necessary steps to deal with the apparent administrative burden. Numerous relief measures have been introduced not only for CGT directly, but indirectly via other tax systems. For example, the refinement of the individual tax return is one of the more recent announcements from the Minister of Finance addressing the administrative burden created by the tax system in general.

Further, in spite of the fact that critics argue that CGT imposes costs well in excess of its burden, the Eighth Schedule to the Act has been operative for some six years now. This suggests that the tax does indeed generate sufficient revenues to cover its costs and assist in the State's goal of social upliftment.

Still, it has been pointed out that several relief measures in the Eighth Schedule to the Act remain limited. In addition, the State has not disclosed the revenue it generates from CGT making the performance of a cost benefit analysis impractical.

In essence Smith (1776) notes that one of the features of a fair tax system is its ability to ensure that taxpayers bear a proportionate burden of the tax system in order to provide a *quid pro quo* for the services offered by the State. The arguments and counterarguments surrounding Smith's (1776) definition both appear to have logical merit. Unfortunately, conclusive evidence to resolve this part of the CGT-fairness-debate does not appear to be available.

Chapter 5: Ability to bear the burden

One of the characteristics of a fair tax system is that the tax imposed should not be such that it leaves taxpayers unable to bear the tax burden and in proportion to taxpayers' ability to do so. This is seen clearly in the work of the classical economist Smith (1776) who notes: 'the subjects of the State ought to contribute...in accordance to their respective abilities' (Smith: 1776 cited in Vivian: 2006, 83). In this way, there appears to be a need for equality of sacrifice such that a taxpayer feels that his inconvenience suffered due to tax is equivalent to that which is experienced by other taxpayers in equal standing (Grove: 1974, 32). The importance of the need for taxpayers to be able to carry a tax burden is highlighted by the turmoil of the French Revolution where part of the reason for the bloody removal of the monarchy was an intolerable eighty percent tax burden that proletariat were unable to endure (Adams, 1992: 231-324). In this light, this chapter of the research considers whether taxpayers are able to bear the CGT burden by considering:

- The interaction of CGT with the principles of horizontal and vertical equity.
- The bunching problem and failure to apply s 7(A)(4A) of the Act to capital gains.
- Whether CGT results in double tax.
- The effects of a lack of inflation adjustment on the tax liability and hence, the taxpayer's burden.

5.1: Horizontal and vertical equity

To have a fair and just society, redistribution of income is necessary and is mainly achieved by the tax system. In this light, taxes become 'the adjustment levers to fine-tune the economic machine that grinds out goods and services' (Gwratney and Stroup, 1986: 801-802 cited by Coetzee, 1998: 2). This conviction rests on one of Smith's (1776) key traits of a fair tax system: the ability of taxpayers to bear the tax burden in proportion to their ability to do so. In this spirit, the fact that CGT may be promoting horizontal and vertical equity could suggest that it enhances the fairness of the South African Tax System.

This was the view adopted by the Katz Commission (1997). One of its key arguments in support of the belief that the introduction of CGT was fair was the ability of the tax to promote vertical and horizontal equity. Horizontal equity hinges on the belief that it is fair to expect that taxpayers with equal economic standing bear the same tax burden. Vertical equity dictates that the wealthy bear a larger share of the tax load in order to prevent the poor bearing the brunt of a tax. The failure to implement CGT would possibly undermine these principles by leaving large amounts of capital untaxed in the hands of a wealthy minority (Katz Commission, 1997: 46).

5.1.1: Vertical Equity

The Institute for Fiscal Studies in England noted that for a tax system to be fair, 'it must be capable of use for vertical distribution between the rich and poor' (Meade, 1978: 12). Stiglitz (1976) shared this sentiment noting that dissimilar taxpayers should not be taxed in a similar way: an individual who earns only R400 per month can not be expected to pay the same taxes as one earning ten times that. Such differences may necessitate a collection of tax from the richest in order to spare the poor an undue tax burden and thus, secure the fairness of the tax system (Stiglitz, 1976: 26). It is submitted that the same could apply with respect to CGT. A taxpayer earning only a salary should not be expected to bear a tax burden equivalent to a taxpayer earning both income and capital. In this way, the use of CGT could be aligned with the goal of lessening perceived unfairness with respect to the tax loads born by different taxpayers.

This view is consistent with that of Musgrave (1968) captured in his analysis of tax equity advanced by the Carter Commission (1967). Noting the importance of a tax system being cognizant of the ability of taxpayers to bear the tax load, it was felt that a tax on income should be based on not only returns generated from the use of assets, but rather on the total 'accretion' enjoyed by the taxpayer. This 'accretion' would need to include the sum of all increases in wealth during a tax year (Musgrave, 1968:160),

'whether it be earned or unearned, regular or irregular, expected or unexpected, cash or imputed, realized or accrued, factor income or transfer, and so forth' (Musgrave, 1968:160)

In this light, if the tax system is to be fair and ensure that taxpayers are able to bear the tax load in accordance with their respective proportionate ability to do so, capital gains need to be taxed. This tax on capital may even need to be on an accrual basis in order to give full effect to ensuring the fairness of the tax system. A failure to apply this tax on capital may very well result in a distortion of the tax loads born by the rich and poor. With large quantities of capital held by high wealth earners, CGT is necessary to ensure that the rich bear a larger portion of the tax charge in order to spare the poor an unduly high tax load (Musgrave, 1968:160).

The belief that the failure to tax capital gains promotes unfairness due to its ability to leave the wealthy untaxed and the poor bearing the majority of the tax burden is also accepted by COSATU (2001). The union was of the opinion that the distribution of wealth in the country was unacceptably skewed in favour of a white elite, while the majority of 'Africans' shared in a highly disproportionate share of the country's capital. Accordingly, CGT was welcomed as a tax that would assist to reduce wealth inequalities in the wake of Apartheid by forcing a wealthy white minority to pay a portion of their capital gains over to the State. The State could, in turn, use these tax revenues to ease the tax burden of the disadvantaged (COSATU, 2001). (The ability of CGT to entrench fairness in the tax system by easing the tax load for the poor through wealth redistribution is discussed in more detail in Chapter 6.) In this way, COSATU (2001) appears to champion the introduction of CGT due to its potential to entrench one of Smith's (1776) characteristics of a fair tax system: that taxpayers are to bear a tax load in proportion to their ability to do so.

Supporting both the view COSATU (2001) is the fact that the International Monetary Fund (IMF) 'strongly endorsed' the introduction of CGT citing the high degree of inequality in the wake of the legacy of Apartheid that made remedial action 'particularly urgent'. The introduction of CGT, according to the IMF, would prove instrumental in ensuring that taxpayers paid a fair share of taxes in proportion to their abilities to do so (Ensor (e), 2001: 11).

The fact that CGT is fair due its ability to promote vertical equity is not, however, universally accepted. In spite of the apparent benefit of vertical equity, there are a number of potential shortcomings. Perhaps most notably is the question: to what extent should the rich be called upon to subsidise the poor (Voster, 2000)? The answer is a subjective one that may make the finding of an optimal solution unlikely. A further challenge to the alleged fairness of vertical equity is the fact that it may act as a penalty to the active and economically efficient and even discourage them from behaving in such a manner. This, in turn, could undermine the tax base, threatening the well being of lower income earners that vertical equity, paradoxically, was implemented to protect. At the same time, mandatory charity may serve to the detriment of the spirit of philanthropy that is so crucial for a healthy society (Coetzee: 1998, 5).

These concerns could apply *mutatis mutandis* to CGT. While the tax may act as a means for transferring wealth from the capital owing elite to the poorer South Africans, the tax may act as a disincentive to capital owners to expand their capital base, thus impairing the collection of revenue by the State for subsequent social investment. The tax also begs the question as to whether it is fair to spare the poor of a tax burden, while penalizing the other taxpayers for their hard work and innovation, a concern addressed by Voster (2000).

Voster (2000) also negates the belief that CGT fairly promotes the ideal of vertical equity arguing that '[equity] is a ruse to introduce progression in the tax system'. While the accumulation of wealth may be fortuitous or hereditary, it is often as a result of the application of skill and hard work. In this context, CGT's ability to redistribute wealth and achieve vertical equity becomes tantamount to the State attempting to 'to turn the strong into the weak; the healthy into the sick and the wise into the stupid to make them equal' (Voster, 2000: 125).

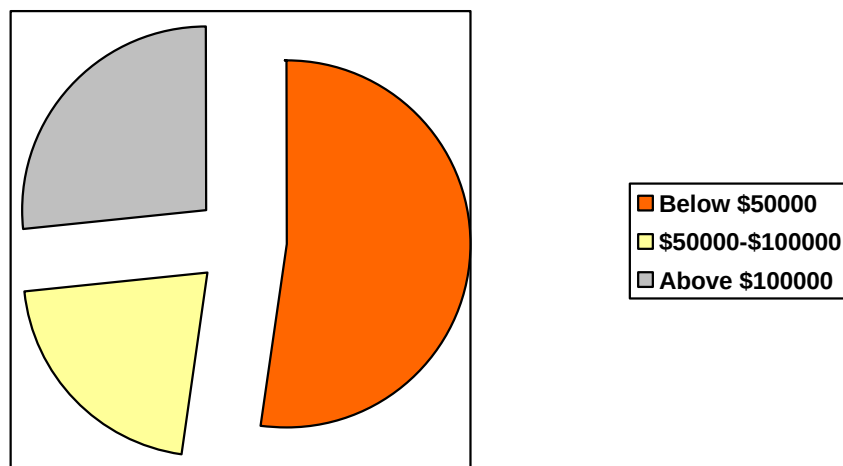
Thus, Voster (2000) is concerned that the effect of CGT may be manifestly unfair in that, rather than improve the economic lot of the population, it may merely result in impoverishing those with capital for the sake of achieving vertical equity. In this way, while possibly alleviating the tax burden felt by the poor, CGT may also undermine the ability of the wealthy to bear their tax burden.

In essence, far from shelter the poor from additional taxes that would be needed in the absence of CGT, CGT may tax those who aspire to wealth rather than those who already have it. Not only does this undermine the desire to ensure that taxpayers bear a proportional share of the tax burden, but also results in preventing people being able to afford the basic necessities of life and then improve on them. This worry is made more poignant when we consider the interrelationship between capital preservation in the hands of the wealthy and the level of wages enjoyed by lower income workers, as discussed in more detail in Chapter 6.

From a different perspective, the lock-in effect may also pose a challenge to the principle of vertical equity. In spite of the desire to ensure that the wealthy are able to bear a larger portion of the CGT burden in line with the principle of the ability of the taxpayer to shoulder the tax load advanced by Smith (1776), this may seldom be achieved. Often the wealthy are able to postpone the realisations of their gains being able to rely on other sources of funds to finance their lifestyle. In years when losses are realised, due to the strategy to cap losses on declining equity values in a bear market, previously unrealised gains can be synthesized into cash and be sheltered from the tax due to capital losses arising in the same year. This ability to defer realisations may offer the opportunity for tax arbitrage. Paradoxically, it is the lower income worker who is forced to sell off an inheritance in order to provide for his family as he simply lacks the financial prowess to defer the gain in the same way as a wealthy stockholder (Voster: 2000, Moore and Phil, 2001 and Moore and Silva, 1995).

Here, the lock-in effect may directly call into question whether CGT is indeed aligned with Smith's (1776) definition of a fair tax system. Ultimately, it is the poorer taxpayer who is unable to defer the CGT and who thus bears a larger tax charge in spite of a lesser ability to do so. This problem may be highlighted by the statistical findings presented below:

Percentage of Canadian CGT paid by income groups on the basis of total income minus capital gains



(Courtesy Statistics Canada, 1992, cited in Staszczuk, 2001: 21)

The data challenges the belief that that effect of CGT has been the enforcing of the principles of vertical equity. Contrary to the view of Smith (1776): that taxpayers bear a proportionate tax burden, Staszczuk suggests that, given the essential similarities between CGT in South Africa and Canada, the data shows that the majority of the CGT burden was born by lower income earners rather than a wealthy elite (Staszczuk, 2001: 21). It is submitted that the essence of Staszczuk's work could apply equally in a South African context.

In this light, it would appear that a reduction on the CGT rate could reduce the tax load of both the poor and the rich. There may be several reasons for this. Firstly, with poorer taxpayers enjoying capital gains as opposed to merely an elite few, a reduced tax rate could offer immediate and direct relief (Moore and Phil, 2001: 25). This may be equally relevant in South Africa where previously disadvantaged citizens are being empowered through the use of broad based share incentive schemes (Woolworths, 2007 and Primedia, 2006).

Second, a cut in the CGT rate could boost investment levels and offer a stimulus to the formation of new business. The result: improved employment opportunities that may prove invaluable for the upliftment of communities. (This issue is discussed in more detail in Chapter 6.) Third, the reduction of the CGT rate could act to alleviate the lock-in effect and bunching problem. This could assist in reducing the tax burden shouldered by taxpayers by, not only lowering the tax rate and increasing disposable income, but improving the State's revenue leading to improved social spending and job creation (Moore and Phil, 2001: 24-28).

Nevertheless, the above analysis captures a Canadian and American socio economic problem that may not be truly reflective of the South African condition. Most notably, the USA does not appear to have an annual exclusion at the time the above arguments were presented (Moore and Phil, 2001: 5). It is submitted that this exclusion of currently R16 000 would largely exempt the poorer South African from CGT with reductions in the CGT rate accordingly serving the rich to the detriment of vertical equity. Further, the USA and Canada, as developed markets, tend to be characterised by higher levels of capital than South Africa (Firer, *et al*, 2004). This may challenge the view that the poor taxpayers in South Africa may also enjoy sizable capital gains making a reduction on the CGT rate necessary in order to shelter the poor from an undue tax burden. In addition, despite the criticism surrounding the application of vertical equity, there are several examples of how the Eighth Schedule to the Act has been amended in order to avoid the poor and middle income earners from bearing the brunt of the CGT burden. These include:

- Firstly, taxpayers have enjoyed a progressive increase in the primary residence exclusion from the initial one to one and a half million Rand. This was felt to be particularly useful for lower income earners, many of whom could continue to enjoy full exemptions from CGT on the sale of their homes while luxury homes would still attract some CGT (Ensor (b), 2001: 12 and Budget Speech, 2006).
- The annual exclusion available to reduce the sum of capital gains and losses was increased from R15 000 to R 16 000 (Budget Speech, 2008). It is submitted that this could be potentially helpful for lower income earners who may be able to enjoy a full exemption from CGT while wealthier taxpayers, generating more sizable capital gains, still bear a CGT load.

- The annual exclusion on death has also been subject to several increases, again aimed mainly at the lower income earning taxpayers (Ensor (b), 2001: 12 and Budget Speech 2006).

5.1.2: Horizontal Equity

Apart from the use of vertical equity, horizontal equity may also prove instrumental for the entrenching of fairness in the tax system, particularly with regards to CGT. Horizontal equity 'demands that equals be treated equally' and that 'taxpayers in similar circumstances should bear essentially equal tax burdens' (Coetzee, 1998, 2).

The minister of finance in the United Kingdom, James Callaghan, appears to have relied on this viewpoint when he addressed the members of parliament noting that:

'The failure to tax capital gains is widely regarded...as the greatest blot on our existing system of direct taxation. There is little dispute nowadays that capital gains confer much of the same kind of benefit on the recipient as taxed earnings more hardily won. Yet earnings pay tax in full while capital gains go free. This is unfair to the wage earner. It has in the past been one of the barriers to the progress of an effective incomes policy' (Callaghan, 1965, cited in Staszczuk, 2001, 9)

Manuel (2001) shared a similar sentiment when he stated for the record that:

'Tax policy and tax reform are informed by...equity...The horizontal equity principle indicates that taxpayers should bear similar tax burdens, whether their income is received in the form of wages or capital gains. The absence of a tax on capital gains unfairly burdens those taxpayers who earn primarily wages and salaries' (Manuel, 2001: 9).

In this light, from an economic perspective, it may be argued that an individual who realises R10 capital profit or one who receives a salary for the same amount have both been enriched by the same amount and ought to be taxed on those gains as a result.

The Carter Commission's (1966) recommendations stated: 'a Dollar gained through the sale of a share... bestows exactly the same economic power as a Dollar gained through employment'. By leaving capital untaxed, a taxpayer relying more on investments to generate wealth than a basic salary would bear no tax burden, even though he is in the same position as a taxpayer who generated the same amount of wealth, albeit in the form of income rather than a capital gain.

In this way, despite equal abilities to bear the tax burden, the taxpayer invested more heavily in capital bears a disproportionately low tax burden while his counterpart bears an unduly high tax load (Carter Commission. 1966 cited in SARS, 2000: 4).

The sentiment of the Carter Commission (1966) is fully endorsed by Musgrave (1968) in his analysis of the Carter Commission's (1966) recommendations. He reiterates that if a tax system is to be seen as aligned with the notion of Smith (1776): that taxpayers are able to bear the tax load proportionately to their ability to do so, that CGT is indeed necessary. If economic income is viewed as an 'index of ability to pay', then total accretion of wealth during a tax year, even if such is in the form of capital gains, would need to be taxed. Again, a man earning a salary or rent and one enjoying a capital gain of the same value will need to bear equal tax loads if the ideal of horizontal equity, and hence tax fairness, is to be entrenched in tax systems (Musgrave, 1968: 162).

Horizontal equity may, however, prove more of a theoretic ideal than a practical solution to entrenching fairness in the tax system. The exact quantification of ability of households to pay taxes, and hence for the identification of equal taxpayers, may prove too difficult for horizontal equity to be a feasible means of ensuring that our tax systems are fair. The use of preferential treatment for different types of taxpayers may also entrench horizontal inequalities. For example, the use of grants, allowances or exemptions for special classes of taxpayers (such as married men, certain manufactures or farmers) occasionally resulted in abuse as others attempted to unjustly rely on the preferential treatment to avoid paying their fair share of taxes (Coetzee: 1998, 10-12). A similar principle may be relevant when considering horizontal equity in the context of CGT.

Here, the use of special exemptions for PBO's, discussed in detail in Chapter 6, was seen as a potential source of unfairness because of the undue competitive advantage it afforded to the PBO over other, similar organizations. In this way, the use of the exemptions from CGT by PBOs may actually have undermined equity (Budget Review, 2006 and South African Council of Churches, 2006).

Ultimately, for a tax system to be fair as suggested by Smith (1776) it should remain mindful of the need to ensure that taxpayers are able to bear the tax load in proportion to their ability to do so. By ensuring that the ideals of vertical and horizontal equity are incorporated better into the South African Tax System, CGT may be promoting tax fairness. Nevertheless, numerous shortcomings regarding the alignment of CGT with the spirit of equity have been identified by critics of CGT.

5.2: Taxing too much: the 'bunching effect'

A further criticism of CGT is that it hinders fairness by creating a so-called 'bunching problem'. An asset may be held for extended periods during which unrealised capital gains or losses could occur, yet the full capital gain or loss is taken into account only when the asset is finally sold. The result can be the taxing of a larger gain or the granting of an excessive deduction against other capital gains as a result of progressively higher marginal tax rates. The phenomenon is succinctly explained by Minarik (1981):

'The bunching problem arises when a taxpayer realises a long-term gain relative to his average income. Such a taxpayer bears a far higher liability on that gain upon realization than he would under accrual taxation or [some method of proration]' (Minarik, 1981: 77).

The correct method to account for these capital gains and losses would thus appear to be using an average tax rate that has existed over the full period of possession of the capital asset (Katz Commission, 1997: 39).

Unfortunately, the provisions of s 7A(4A) and s 5(1)(10) of the Act make no provision for the application of the rating formula to taxable capital gains. Currently, s 5(1)(10) of the Act applies only to:

'special remuneration, or where the provisions of section 7A (4A) or [certain paragraphs] of the First Schedule...are applicable'

while s 7A(4A) of the Act only applies where:

'the taxable income...includes any amount ...received or accrued to [a taxpayer] as an employee or the holder of any office by way of a bonus, gratuity or compensation upon or because of termination of his services or because of the impending termination of services...'

A failure to address the bunching problem may directly challenge the notion of CGT as a fair form of tax. Such a problem could be perceived as an 'injustice' as it results in capital gains being taxed arbitrarily in the year of sale even though such gains were accrued over the life of the relevant asset (Moore and Phil, 2001: 27).

The apparent shortcomings of s 5(1)(10) or s (7A)(4A) of the Act could thus introduce possible unfairness into the CGT provisions as taxpayers may be charged an unduly high rate of tax. This may directly contradict the work of Smith (1776): that a fair tax system ought to charge taxpayers a fair amount for the services received from the State. At the same time, the artificially high rate of tax may challenge the ability of taxpayers who suffer capital gains to bear the tax load.

Such a problem may be particularly relevant in the case of trusts. Due to the high rates of tax imposed on trusts, assets held by trusts and disposed of will attract CGT at the highest effective rates. In order to prevent this, it would be necessary to vest the asset in the hands of the beneficiaries. Such an action, however, would result in a CGT charge under para 80 of the Eighth Schedule to the Act. The other alternative would be to vest the asset in the hands of the beneficiary from the outset in order to circumvent the high effective tax charge on the trust. Such an action, however, can result in a large CGT burden in the hands of the beneficiary when he subsequently disposes of the asset.

The disposal of the asset, whether by alienation or donation, could also trigger a CGT charge in the hands of the original owner of the relevant asset. The levying of CGT coupled with the absence of the rating formula may cause the suffering of an artificially high tax burden by either the recipient, original owner or both of these taxpayers. In this way, the taxpayer is caught on the proverbial horns of a dilemma: to be taxed at forty percent by using a trust or subject the beneficiary to an artificially high rate of tax due to the bunching problem.

The decision may ultimately undermine the ability of either the beneficiary or the original owner to bear the tax burden, violating the tax fair definition advanced by Smith (1776) (Adapted from Jordaan *et al*, 2006: 639-645 and Temkin, 2001: 4). In spite of this, however, the provisions of s 7A(4A) of the Act and para 80 of the Eighth Schedule to the Act remain largely unchanged, resulting in continued frustration for taxpayers.

In addition, the need to circumvent the trust in order to avoid an excessive CGT burden may result in another problem: the erosion of security. Jordaan *at al* (2006) suggests that part of the reason for the formation of trusts is to ensure that beneficiaries - often too immature to manage the assets personally - will be adequately provided for after the death or old age of the parents. The circumvention of a trust in order to avoid prohibitively high tax charges may simply result in the vesting of assets in the hands of beneficiaries ill equipped for the task (Adapted from Jordaan *et al*, 2007: 725-728). Such may directly challenge the ability of taxpayers to provide for their families and improve their quality of life, by relying on sound estate planning tools.

The 'bunching problem', also colloquially referred to as 'bracket creep', is particularly relevant for the elderly. Logically, those entering retirement will be more likely than younger taxpayers to realise any capital gains. Often, such taxpayers realise share investments or sell of their businesses in order increase their liquidity in order to provide for the cost of living during retirement. In addition, these assets have often generated sizable returns over the majority of the life of the taxpayer which may have already been subject to tax. The effect of a high CGT rate is thus to impose a tax burden on the elderly; on those who may be least able to afford it (Goodman *et al*, 1990: 82, Moore and Phil, 2001: 27 and Staszczuk, 2001: 12).

A similar problem may be encountered when a taxpayer dies. On the death of a taxpayer his accumulated wealth will, in part, be deemed to have been realised under para 40 of the Eighth Schedule to the Act. Paragraph 40 of the Eighth Schedule to the Act calculates the gain as the difference between certain of his assets' market value on death and their respective base cost determined under para 20 of the Eighth Schedule to the Act. The resultant capital gain without the benefit of the rating formula may ultimately result in the deceased reporting an artificially high taxable income forcing the estate to pay tax at the definitionum marginal rates.

In addition, a potential cash flow problem may arise. Often the assets of the deceased are not sold off, but rather passed on to surviving heirs. Unless the deceased had sufficient liquidity at death, the estate may be forced to sell certain assets simply to pay the tax debt, depriving the heir of his inheritance (Jordaan *et al*, 2007: 725-729 and Staszczuk, 2001: 12).

The negative effect of CGT due to the bunching problem may be compounded by the Estate Duty Act No.45 of 1955. With the bunching problem yielding an undue tax burden for the taxpayer, the effect of estate duty may result in bankruptcy. Not only may the estate need to carry the high CGT load, but may also be levied with estate duty at a flat rate of twenty percent (Stein G, 2001: 1). In spite of this potential shortcoming the provisions of para 40 of the Eighth Schedule to the Act remain largely unchanged with the result that CGT arising on death continues to be a frustration for sound estate planning (Adapted from Jordaan *et al*, 2007: 640-645).

To overcome the 'bunching problem' may require the taxation of capital gains on an accrual basis (Katz Commission, 1997: 40). The 'Framework' notes that the accrual basis of accounting 'provides a type of information ...that is most useful to users' (IASB, 2005: 40). It is submitted that this could apply to the taxing of capital gains and losses, with the accrual basis producing a conceptually superior way of taxing such gains and losses than the use of a cash basis currently in force.

The above statement: that an accrual basis of tax may be needed in order to entrench fairness in the tax system is supported by the work of Musgrave (1968). He argues that for a tax system to be fair, it needs to tax the total accretion in wealth of a taxpayer, even if such is in the form of capital gains. In this context,

'gains in value which have not been realized do not differ from gains that have been realized and reinvested in the same asset. The importance of realization was understandable in the early stages of accounting when the Byzantine merchant would scan the horizon for the return of the ship before he could count on his proceeds, but is irrelevant to the equity issue and misleading as well for modern accounting '(Musgrave, 1968: 162)

Thus, an accrual basis of taxing capital gains presents a more robust method of tax collection. Such also fortifies the importance of taxing increases in wealth enjoyed by taxpayers and not merely converted into cash if the notion of taxing taxpayers in accordance with their ability to bear the tax load is to be upheld (Musgrave, 1968).

This accrual method could, however, necessitate taxpayers having to prematurely sell an asset simply to pay the resulting CGT on unrealised gains, imposing an undue burden on the holders of capital assets (Katz Commission, 1997: 40). Further, the application of an accrual basis may be too administratively impractical, paradoxically introducing greater inefficient use of resources than the inefficiency inherent in the current method of taxing the gains in the first place (SARS, 2000).

As an alternative to the accrual approach, other relief mechanisms have been put in place in order to indirectly remedy the bunching problem. These include:

- The annual exclusion of R15 000, which has subsequently been increased to R16 000 At the same time the annual exclusion on death has been raised from the original R50 000 to R60 000 (Budget Speech, 2008).
- The exemption from CGT of certain long term assurance policies and lump sums from pension, provident and retirement annuity funds could also indicate attempts of the State to overcome the ' bunching problem' and introduce greater fairness to the CGT system.

- A deduction is available for estate duty purposes for the amount of normal taxes owing to SARS. To further address the potential estate duty tax problem, the general abatement of R3, 5 million is also available (Budget Speech, 2007).
- It has also been argued that the use of the annual exclusion and partial inclusion rate are themselves, able to reduce the taxable gain and hence, indirectly, compensate taxpayers for lack of an accrual basis of taxing gains (Moore and Phil, 2001: 27).
- Perhaps most notable has been the steady improvement in the tax rates applicable to individuals per the tax tables over the last few years, details of which are contained in Annexure C

In essence, for a tax system to be fair it needs to ensure that taxpayers pay a fair *quid pro quo* for state services and are thus left in a position to bear the tax load while still being able to afford the necessities of life (Vivian, 2006: 83-85). The bunching problem may violate these principles by subjecting taxpayers to an artificially high tax rate upon the disposal or deemed disposal of capital assets. While an accrual basis of taxing capital gains may be conceptually superior, such is also more administratively onerous and could result in acute cash flow problems for taxpayers. Nevertheless, several relief measures do appear to be in place to attempt to remedy the problem.

5.3: Is CGT tantamount to double tax?

Adding to the concern that CGT is innately unfair is the fact that the Eighth Schedule to the Act may result in the levying of double tax. This argument was discussed in detail in Chapter 3 and is re-examined briefly here.

Conda (2006) uses an investment in equity to demonstrate how income will be taxed at the corporate level notwithstanding CGT. Increases in income will be subject to tax at the corporate rate in the hands of the respective company. This increase in profits will, in turn, be a key factor in increasing the price of the shares which are held by individuals and who are taxed on the disposal of those shares as a result of a capital gain (Conda:2006:5-6).

In this way, an amount which was already subject to tax may very well be re-taxed, albeit in the form of CGT, thus violating Smith's (1776) tax fairness definition. Once income is already taxed, any additional tax is a double tax that may challenge the notion of fairly remunerating the State for its services and being able to bear the tax load.

Similar to the argument presented by Conda, Stein (2000) also felt that the application of CGT could be tantamount to double tax. He negates the view that CGT serves only as a fair anti-avoidance tool to prevent a taxpayer 'transforming' profits into a tax-free capital status', as discussed in Chapter 4. In his opinion, 'to the extent that the selling price of shares represents accumulated profits, any CGT would amount to a further tax on profits that have already borne income tax' (Stein, 2000:102).

The argument is supported by Moore and Silva (1995) who notes that, theoretically, the value of a share is in essence the present value of the future proceeds the company in question expects to earn. Thus, any appreciation in the value of those shares is simply a reflection of the growth in future earnings that will be subject to tax in the hand of the company. To this extent, any CGT becomes a form of double tax that directly challenges the ability of taxpayers' to bear the CGT burden (Moore and Silva, 1995: 12).

The inherent unfairness of CGT as a result of double tax is compounded by the 'bunching problem' discussed above. It has been said that the 'bunching problem' poses a great injustice to those taxpayers who are unfortunate enough to have accumulated wealth and happen to realise that wealth only in a particular year. The reason: the artificially high rate of tax applied in the year of disposal rather than the use of a lower average rate that existed over the asset's life. The problem is made more apparent given the existing burden CGT poses due to its double tax potential (Moore and Silva, 1995: 30).

While it could be argued that CGT may be a form of double tax, it is submitted that the taxing of amounts in the hands of two separate persons, may be fair. The income generated by companies is soundly taxed by virtue of the existence of gross income. The resultant increase in the value of a company's shares because of strong profit growth is an economic advantage enjoyed by the shareholder and not the company. In this light, each respective economic gain is taxed in the hands of the relevant person.

Further, concessions were also introduced to prevent double tax. For example, a number of amendments were introduced to the Transfer Duty Act No. 40 of 1949 and the Stamp Duty Act No.77 of 1968 to provide for a transfer of a primary residence from a company or trust to a natural person free of any related duties pending the introduction of CGT (Mewerowitz, 2001: 4). The exclusion of assets from the CGT net in the case of non residents, other than as detailed in para 2 of the Eighth Schedule to the Act, will also reduce the possibility of non-residents being subject to CGT both in South Africa and in the country in which they are resident. The existence of double tax agreements would act as an additional measure to avoid double tax, presumably also with respect to CGT (Adapted from Jordaan *et al*: 2006, 423).

In essence, critics have suggested that since the price of a share is often a reflection of the cash flows that the underlying company is expected to generate, that CGT is a form of double tax. This is due to the fact that the cash flows are already subject to tax at the flat rate of twenty-eight percent in the hands of the relevant company. The concern is very much in line with the work of Vivian (2006): that once income is taxed directly, all other taxes are paid out of post-tax income and inevitable become a form of double tax (Vivian: 2006, 83). To this extent, the tax fair definition as advanced by Smith (1776) is violated calling into question the ability of taxpayers to bear the tax burden. While several relief measures appear to have been implemented, these measures either prevent taxation under more than one piece of legislation or are largely applicable to non-residents. They fail to take cognisance of the fact that a capital gain may embody profits of an underlying company already subject to tax or of the need to provide additional relief for resident taxpayers

5.4: Lack of inflation and random value adjustment as a specific source of unfairness

5.4.1: Inflation adjustment

Although the taxing of capital gains may achieve a form of equity, the lack of adequate inflation adjustments provided for in the Eighth Schedule to the Act may result in a degree of injustice. Until the Act makes express provision for the effects of inflation, largely nominal capital gains will be subject to tax (Meyerowitz *et al* (b), 2001: 2). The taxing of what may be tantamount to artificial capital gains may go directly to the question of whether the taxpayer is able to bear the CGT burden, as required by Smith's (1776) tax fairness definition.

Accordingly, the lack of inflation adjustment is cited by as a key reason for the need to reduce the effective CGT rate or to, alternatively, provide for inflation indexing to ensure the fairness of the tax system (Cordes, 2000: 3).

The problem is compounded by the limited ability of taxpayers to add the cost of financing the acquisition of assets to their base costs. Under the current wording of para 20 of the Eighth Schedule to the Act , which remains largely unamended, only financing costs on assets used wholly and exclusively for business purposes can be added to the base cost in full. For listed shares on recognized exchanges and collective investment schemes in securities, only a third of the financing costs are deductible. In periods of high inflation, when interest rates are on an upward trend, the cost of acquiring the assets may often prove pervasively high, yet this expense is often prohibited from being taken into account when determining capital gains (Staszczuk, 2001:10). The current provisions of the Eighth Schedule to the Act may, thus, amount to an unfair tax treatment since it is not the inflation adjusted and hence 'true' gain on which a taxpayer is taxed.

Then Federal Reserve Board Governor, Angell determined in 1999 that the effect of inflation at even reasonable levels could result in taxpayers being taxed on so called 'phantom' or artificial capital gains.

Alan Greenspan, chairman of the Board of Governors of the Federal Reserve shared a similar concern noting that:

‘...it is wrong to tax apart of the gain in assets attributable to a decline in the purchasing power of the currency, which is attributable to poor governmental economic policy. So, for government to tax people's assets which rise as a consequence of inferior actions on the part of government strikes me as most inappropriate’ (Greenspan (2000), cited in Grubel:2000, 34).

In spite of these views, however, a review of the average real capital taxes on the NASDAQ, Dow Jones, FTSE 100 and Standard and Poor's Composite Index from 1972 to 1992, revealed that ‘in many cases, investors paid CGT on investments that actually lost money in real terms. This was particularly true of the lower to middle income earners and the aged who were worse affected by the taxing of ‘phantom’ capital gains (Moore and Silva, 1995: 32). In turn, this may translate into an undue tax burden on those who are less able to bear it than their more wealthy counterparts.

It is submitted that the possibility of incurring excessive CGT liabilities simply due to high inflation may provide further impetus to the locking in of capital to shelter the rich from the tax burden, while the poor are forced to carry the added tax load as discussed above. This overstated tax liability goes directly to Smith's (1776) principles of tax fairness, particularly the issues of vertical equity and the taxpayer's ability to bear the tax burden if the effect of CGT is such that he is no longer able to adequately maintain himself and his family. (In order to apply these findings to a South African context, a simplified example of this phenomenon is provided in Annexure B.)

An inability to maintain oneself due the lack of inflation adjustment was a worry also noted by Musgrave (1968). If a tax system is to be mindful of an ability to pay the underlying tax and still being able to thereafter afford the necessities of life, some means of indexing capital gains may be needed:

‘[An] equitable concept of income must be in real terms and, ideally, all income would be adjusted accordingly. Thus, inflationary gains in equity prices would not be taxed, real gains of debtors would be taxed and real losses of creditors would be allowed for.

The question is whether, short of this total solution, a case can be made for allowing price level adjustment of at least capital gains. The [Carter Commission concludes] no, but [one could] wonder – especially if assets are held over a long period so that even a slow price rise may result in substantial pseudo-gains' (Musgrave: 1968, 163).

Accordingly, Angell (1993) concluded in his report to the Federal Reserve Board that:

'If we are to reduce the damaging effects we know are caused by all capital taxation, it makes sense to eliminate the most damaging tax on capital – the tax on phantom gains. The tax on real gains is a middle of the road bad tax. But the tax on nominal capital gains without regard to whether the gain is real or only the effect of inflation is truly the worst tax' (Angell 1993, cited in Moore and Silva: 1995, 32.)

That the lack of inflation adjustment creates an undue burden on taxpayers to the detriment of the perceived fairness of the tax system is also dealt with by Vlassenko (2001). In the UK, France and Sweden, the question of whether or not property taxes were based on frequently reassessed property values rather than historic costs was felt to be a deciding factor in whether or not the relevant tax systems were fair (Vlassenko, 2001: 391). This lesson may be equally applicable to CGT in South Africa.

Fortunately, a number of provisions exist in the Eighth Schedule to the Act which may alleviate the problem. It is submitted that the annual allowances for natural persons and for special trusts will reduce the gains subject to tax and thus make some provision for the effects of inflation. The primary residence exclusion – previously R1 million and increased to R1.5 Million in 2006 – could achieve a similar result. The inclusion of only twenty five percent of the net gain in taxable income for natural persons and special trusts; zero percent for untaxed policyholder funds; and fifty percent in any other case (para 10 of the Eighth Schedule to the Act) may be another example of the indirect way in which the Eighth Schedule to the Act accounts for the effects of inflation.

In the Budget Speech (2008), Manuel announced that the proposed amendments to the Act would include the increase of the annual allowances from R15 000 to R16 000 and that the primary residence exclusion would be raised by fifty percent (Budget Speech, 2006).

It is submitted that these amendments would keep the allowances in the Eighth Schedule to the Act current and go some way towards addressing the problem associated with inflation.

SARS was, at the time of the introduction of CGT, also of the opinion that direct methods for inflation adjustment were unnecessary. This argument was based on the fact that most OECD countries made no provision for inflation adjustment in CGT calculations, except under circumstances where high inflation rates have persisted (Ensor, 2000: 1). It is submitted that due to the relatively stable inflation rates – within the Reserve Bank's stated target – this position may be defensible.

The argument that the annual exclusion; use of partial inclusion rates for net capital gains when calculating taxable capital gains; and the fact that the inflation rate has remained reasonable over the last few years may be supported by considering a practical example.

We use an investor who has acquired 3 240 Sasol shares on 15 July 2002 for the average ruling price of R92.57 each and with transaction costs of 0.7 per cent of the deal consideration. He holds these shares as a capital investment until 15 August 2007 when they are sold for R275.44 and transaction costs of 0.45 per cent of the proceeds are incurred. Under these assumptions, the base cost per share would be approximately R116.89 if the effects of inflation are taken into account. Excluding inflation adjustment, the base cost would be R93. 57 per share. The differences in the capital gains with and without inflation adjustment is shown below (Roxo, pers. comm., 2007, October 24)

<i>Capital gain per share</i>		
	Nominal gain	Inflation adjusted gain in year of disposal
<i>Proceeds</i>	275.44	275.44
<i>Base cost</i>	94.46	116.98
<i>Capital gain</i>	180.98	158.46

It initially appears that the effect of inflation is an undue burden on taxpayers as per the arguments presented above as the capital gain is unduly inflated by approximately fourteen per cent per share.

By allowing for an annual exclusion and only including a portion of the net gain in taxable income under s 26A of the Act, however, the Eighth Schedule to the Act may indirectly compensate for the effect of inflation. This is demonstrated using the following comparison:

<i>For a natural person</i>	<i>Nominal results</i>	<i>Real results</i>
<i>Taxable gain</i>	143 469	513 410
<i>Incremental tax assuming an effective forty percent rate</i>	57 388	205 364
<i>Excess of real over nominal tax effect</i>		147 976
<i>For a company</i>	<i>Nominal results</i>	<i>Real results</i>
<i>Taxable gain</i>	293 188	513 410
<i>Incremental tax assuming an effective twenty-nine percent rate given that the disposal is assumed to occur in the 2008 year of assessment</i>	85 024	148 900
<i>Excess of real over nominal tax effect</i>		63 876

It appears that if inflation is not accounted for, the investor enjoys the annual exclusion and either a fifty or twenty five per cent inclusion rate, he pays the least amount of CGT. On the other hand, if inflation indexing was used but the annual exclusion and reduced inclusion rates are not applied, the investor is left in a less desirable position.

To better appreciate this, we may need to consider the sensitivity of this result to the inflation rate. To do so, we calculate the level of inflation at which the indexing alternative produces a result that is the most desirable for taxpayers:

	<i>For a natural person</i>	<i>For a company</i>
Proceeds	892 426	892 426
Nominal taxable gain	160 820	327 890
Selling costs	4 016	4 016
Net proceeds	727 590	560 520
Total acquisition cost	232 629	232 629
Quotient	3.13	2.41
Index at acquisition	106.1	106.1
Index at disposal	332.1	255.6
Percentage inflation over holding period	213%	140%
Effective annual inflation	22%	16%

It would appear that only under instances of high inflation approaching approximately nineteen percent per annum on average that inflation indexing would be beneficial for taxpayers. This would tend to add weight to the conviction of SARS: that indirectly, the Eighth Schedule to the Act more than compensates for the effects of inflation negating the belief that the absence of inflation indexing imposes a threat to the perceived fairness of the tax system. (A detailed explanation of the above calculations is presented in Annexure B).

(It should be noted that the example is based on the rates applicable to the 2008 year of assessment since the disposal occurs during this period. Nevertheless, the methodology and conclusion reached would apply equally to disposals occurring during the 2009 year of assessment given that the fundamental principles under which taxable capital gains are calculated have not changes.)

The findings of Krever (2001) may further support for the use of annual exclusions and the partial inclusion rates rather than a direct method of inflation indexing, albeit from a different perspective. He argues that the effects of inflation are not only limited to CGT but effect every aspect of life from borrowing costs to salaries and wages (Krever, 2001).

In this light, inflation, due to its broad effect on all aspects of life, may not pose an undue burden for taxpayers in so far as CGT alone is concerned. Krever (2001) goes on to note that:

'It is conceivable to index the South African income tax system for inflation. Other countries have indexed their tax systems and shown it is a feasible, if horribly administratively complex possibility. However, indexing only one part of the tax system would be the worst of all worlds - economically inefficient and distorting and administratively complex and costly' (Krever, 2001)

Thus, Krever (2001) may imply that by attempting to inflation index capital gains, the administrative load and complexity may pose more of a burden on taxpayers than the inflation itself. Such could also produce distortions in the tax system in general as the effect of inflation regarding other taxes is currently not directly catered for. Not only may indexation challenge the taxpayer's ability to bear the tax burden, it may also challenge the notion of fairly remunerating the state for services one receives from it, per Smith's (1776) definition. To this end, Krever (2001) notes that:

'one effect of indexing capital gains will be to exacerbate tax avoidance arrangements. Many persons deriving capital gains have some debt. It would be a completely unjustifiable rule that allowed taxpayers to deduct the full nominal cost of interest payments to derive gains while taxing only the nominal inflation-adjusted gains. It would be the ultimate whipsaw against the revenue authority. However, it would be impossible to prevent this system if taxpayers ensure their investments generate a small current income such as rent while most of the gain could be characterised as capital gain' (Krever, 2001).

These arguments are similar to those advanced by Musgrave (1968) years earlier when he noted that the inflation adjustment of capital gains did not represent a comprehensive solution to an inflation-posed problem (Musgrave, 1968: 163).

In this light, by inflation adjusting capital gains while not making provision for such in other areas of the tax system, two aspects of Smith's (1776) definition may be violated. Firstly, the administrative load (as discussed in Chapter 5) maybe frustrated calling into question the ability of taxpayers to bear the tax load. Secondly, indexation indexing could create tax avoidance opportunities allowing taxpayers to avoid paying or services they receive from the state.

The use of the annual exclusion, partial inclusion rates and other specific exemptions from CGT may not, however, be the optimal solution either. By granting such exemptions and exclusion, the effective rate of tax is effectively lowered, and may reflect a 'bias' against the public sector and its funding needs. This may be especially true if we consider that such exclusions may well be arbitrary (Musgrave, 1968). A further threat to the interests of the public sector may also come in the form of tax avoidance. The availability of exemptions and exclusions may act as an irresistible temptation to the taxpayer who decides to unduly convert income into capital in order to enjoy the relevant relief measures, whether fairly deserved or not (Vlassenko, 2001: 390-395). Such concerns formed, in part, the basis for the decision to refine the CGT exemption enjoyed by recreational clubs and public benefit organizations as discussed in Chapter 6 of this report.

In this light, while the annual exclusion, partial inclusion rate, and other specific CGT exemptions pose an interesting dilemma. On one hand, they ensure that taxpayers are better able to bear the tax burden by ensuring that they are not taxed on pseudo-gains. From a different perspective, these relief measures may be arbitrary; they may over-compensate for the effect of inflation; or provide a tax avoidance opportunity. This may serve to the detriment of the public sector, undermining social expenditure and development. In turn, the notion of fairly remunerating the Sate for services it provides to its citizens may be violated.

5.4.2: Other fair value adjustments

Similar to the problem of taxing artificial gains due to the effects of inflation is the concern that investors – particularly those holding financial instruments - may be subject to an undue CGT burden due to materially pervasive fluctuations in the value of those instruments. This is particularly the case with respect to shares that were acquired on or around 11 September 2001.

In this light, a specific example of the intention of the Legislature to ensure economic fairness, while still introducing CGT, may be the adjustments made for the valuation of assets in the immediate aftermath of terrorist attacks on the USA in September 2001. These events had a profound negative effect on world markets with a depression in share prices creating the opportunity for a potential CGT windfall for SARS. The fluctuation of share prices would have profound effects for the valuation of shares as on 1 October 2001 and on the gains on subsequent disposal of those shares given the artificially low valuation date value (Meyewrowitz *et al* (c), 2001: 168).

As at September 2001, SARS was prepared to ‘carefully monitor the market trends over the weeks to come in order to determine whether appropriate corrective measures could be introduced to ensure ...a realistic and appropriate [valuation date value]’ (Meyewrowitz *et al* (c), 2001:168). The Act has subsequently been amended to cope with the effects of the September 2001 terrorist attacks. Paragraph 29(2A) of the Eighth Schedule to the Act reads as follows:

Where –

- A financial instrument listed on an exchange in the Republic was not traded during the last five business days preceding the valuation date;
- A financial instrument listed on an exchange in the Republic is suspended for any period during September 2001 ;or
- The market value of a financial instrument...exceeds the average of the ruling price of that financial instrument , determined for the first 14 business days of the month of September 2001, by five per cent or more,

The Commissioner must , after consultation [with the relevant bodies], determine the market value of the financial instrument having regard to the value of the financial instrument, circumstances surrounding that financial instrument or the reasons for the increase in the value of that financial instrument.

In addition, SARS subsequently published a list of market values of all assets traded on the JSE Securities Exchange. This was done, in part, to establish a fair method of determine the valuation date value of assets falling within the scope of the Eighth Schedule to the Act (Meyewrowitz *et al* (c), 2001:168).

Ultimately, despite the concern that the simplified method of calculating capital gains could introduce unfairness into the Eighth Schedule to the Act due to a failure to adequately adjust for the effect of inflation and random affects on share values, relief measures are in place. This includes the introduction of para 29 (2A) of the Eighth Schedule to the Act, the annual exclusion, and the use of an inclusion rate for net gains less than one hundred per cent for the purpose of s 26A of the Act. These measures, while compensating for the ability of taxpayers to bear the tax load, may also threaten the notion of remunerating the State fairly for the services it provides taxpayers. The reasons: relief measures could prove overcompensating providing lucrative tax avoidance opportunities.

5.5: Conclusion

For a tax system to be fair, it needs to be mindful of the need for taxpayers to be able to support themselves and their families. In this light, taxpayers should only have to pay a fair *quid pro quo* for the services received from the State and should not be subject to any form of double tax (Vivian, 2006: 83-86).

Part of the reason for the levying of CGT was to ensure that the principles of horizontal and vertical equity are adhered to. In this light, given the argument that people generating wealth from income or capital are both enriched to equal extents, the failure to tax capital gains would leave those with equal abilities to bear a tax burden paying unequal taxes. Concern was also raised that, given South Africa's past, the absence of CGT would leave a white elite, in possession of most of the nation's capital, untaxed on a large amount of their accumulated wealth. In contrast, the poor, and those least able to bear the tax load, would have to carry the brunt of the tax burden.

Despite the apparent benefits of CGT with respect to horizontal and vertical equity, doubt has been raised on how fair it is to penalize those who generated wealth due to innovation and hard work in the name of vertical equity. This may be particularly worrying given that the preservation of capital may be closely interrelated with the wage rate of lower income workers and hence, the ability of such people to maintain themselves. This concern was supported by statistical evidence gathered from Canada that may imply that CGT may not be born primarily by the rich, but rather the poor.

The difficulties experienced when quantifying the wealth and ability of taxpayers to bear a tax burden may also be frustrating the success of CGT in preserving horizontal equity. While Smith (1776) suggests that a fair tax system should call for taxpayers in equal positions to bear equal tax loads, this may not always be practical to achieve. In addition, the move to introduce certain exemptions and deductions in order to achieve horizontal equity may have actually created opportunities for unintended taxpayers to avoid taxes. In this way, the ideals of horizontal equity are, paradoxically, undermined. This may, in turn, challenge the notion that CGT does not impact on the ability of taxpayers to bear the tax load in proportion to their respective abilities to do so.

Concerns over the equity of CGT are complemented by the failure to apply the provisions of s 5(1)(10) of the Act to capital gains or, alternatively, some accrual method of taxing such gains. If a taxpayer thus suffers a capital gain for the period, the sliding tax scales used for individuals could result in that taxpayer being subject to tax - not only on his taxable capital gains but total taxable income - at an artificially high tax rate.

This may directly challenge the notions of paying only a fair tax for State services and ensuring that taxpayers are able to bear the CGT load.

The so-called bunching problem may pose a particular challenge for estate planning. A taxpayer wishing to provide for his children in old age, for example, is faced with an almost impossible dilemma. While a trust affords security to the underlying assets to be enjoyed by the beneficiaries, the trust is also subjected to the highest effective rate of tax. In order to circumvent this, the taxpayer has no other alternative but to vest the asset in the hands of the beneficiary, only to have the bunching problem impair the beneficiary's ability to bear the tax burden.

Unfortunately, while an accrual system of tax may be conceptually desirable it not only poses an administratively impractical solution, but could result in the premature alienation of property in order to pay the CGT on unrealised capital gains. Instead, the State appears to have implemented several relief mechanisms ranging from improved exemptions and deductions to lower tax rates which could assist in compensating for the bunching problem.

The final part of this chapter on the ability of taxpayers to bear the tax load explores the arguments surrounding a lack of inflation adjustment in the Eighth Schedule to the Act. While the increases in the allowances and exemptions, discussed above, were well received, the lack of inflation adjustment could result in taxpayers being taxed on nominal and hence artificial gains. In many ways, this could frustrate the lock-in effect and worries concerning double tax, as discussed in previous chapters, challenging the ability of taxpayers to support themselves.

In defense of CGT, the effect of the annual exclusion and the inclusion rate of less than one hundred percent could more than compensate for the lack of inflation adjustment. At the same time, the use of some method of indexing capital gains may prove too complex and administratively onerous to provide practical relief.

Ultimately, it may be the case that some aspects of the Eighth Schedule to the Act may not have adverse effects on the perceived fairness of the South African Tax System. The counterargument is that due to the inability to entrench the ideals of equity in the Act; the failure to resolve the bunching problem; and the lack of direct inflation adjustment violate certain characteristics of a fair tax system as advanced by Smith (1776).

Chapter 6: The role played by CGT in social upliftment.

For a tax system to be fair, it should comply with the characteristics laid down by the classical economist, Smith (1776) whose model of a fair tax system is reproduced here for convenience:

'The subjects of the State ought to contribute to the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to revenue which they respectively enjoyed under the protection of the State. In the observation or neglect of this definition consists, what is called equality or inequality of taxation' (Smith 1776, cited in Vivian, 2006: 83).

This chapter extends the meaning of fairness laid down by Smith (1776) by considering whether CGT assists with the upliftment of the country's poor. The chapter focuses on a critical evaluation of the debate on whether or not the introduction of CGT has assisted in wealth redistribution for the benefit of the previously disadvantaged or has merely worsened the lot of the poor. In a similar light, the chapter then considers whether CGT may impair empowerment deals particularly by examining difficulties encountered when attempting to establish sustainable transformation programmes.

To add to the debate on the perceived fairness of CGT, the chapter then includes an investigation of the key arguments on the perceived effect of CGT on public benefit organisations and recreational clubs. This is complemented by an examination of the arguments and counterarguments concerning the effects CGT has had on small businesses, particularly given the changes in the venture capital market that is relied on in order to finance a material number of new firms. In addition, the chapter examines the arguments suggesting that CGT threatens savings levels and, in turn, undermines the ability of taxpayers to provide for unforeseen circumstances.

The effect of CGT on wealth redistribution; charity organisations; job creation in new businesses; and black economic empowerment will help to clarify whether CGT is impairing the nation's capital; the ability of taxpayers to contribute to the State for the services they receive from it; and the ability of taxpayers to support themselves.

6.1: Wealth redistribution: improving the lot of the poor

6.1.1: The economic argument

Tax policies can have a critical role to play in social upliftment. A suitable point of departure in analyzing this Statement is provided for by the economist Montesquieu (1784) who noted:

‘To fix [the State’s] revenues in a proper manner, regard should be had both of the necessities of the State and those of the subject. Nothing requires more prudence than the regulation of that portion of which the subject is deprived...and that which he suffered to retain.’ (Montesquieu, 1784)

In this light, COSATU (2001) has approved of the introduction of CGT. Labour was of the opinion that the tax would assist in taxing the accumulated gains in the hands of the ‘already wealthy’ that would otherwise have gone untaxed. This would go some way toward eliminating the disproportionate burden of the tax that was born by the poor (COSATU, 2001). In this way, by requiring the wealthy to shoulder a larger portion of the total tax burden, CGT would assist in entrenching fairness in the tax system by ensuring that taxpayers contribute ‘in proportion to their respective abilities’, per the principles laid down by Smith (1776).

According to COSATU (2001), ‘Africans pay the highest percentage of their income in both direct and indirect tax...with whites paying the lowest percentage’. This alleged inequality provides justification for the introduction of CGT. The wealthy ‘by definition have capital at their disposal while the working class depends on labour power for earning income.’ In the absence of CGT, it would be ‘unjustifiable and prejudicial’ for the proletariat to be taxed in full on their wages while capital gains are untaxed (COSATU, 2001).

The argument appears to be in line with that presented by the Carter Commission (1966): income earned through capital affords the same economic potential as that from any other source.

Given the disproportionate share of capital held by the wealthy, the exemption of capital gains thus 'entrenched the principle of inequality' by creating a tax structure 'bias in favour of the wealthy'; in favour of those who needed the least protection from the State against tax burdens (COSATU, 2001).

The union noted that the distinction between income and capital was also often used as a means of avoiding tax obligations and that the introduction of CGT would eliminate this loophole in the Act. This would 'overcome the perverse incentive...of the wealthy to [deliberately] convert income into capital'. The introduction of CGT would accordingly result in resources no longer being 'wasted on tax consultants to minimize tax... [and instead] being available for productive public use'. In turn, this would improve the 'perceived fairness of the tax system', crucial for the morale of the 'wage earners'. In addition, by eliminating loopholes in the Act and widening the tax base, the result would be a growth of State revenue, 'sorely needed for investment in social and economic infrastructure and the meeting of service backlogs' (COSATU, 2001).

Given high levels of inequality identified by COSATU (2001) in the tax system, the introduction marked a move towards progressive tax structures that would assist in wealth redistribution and the upliftment of the poor. Ultimately, the union was of the opinion that CGT would be beneficial for social upliftment and for ensuring that the poor, previously disadvantaged sector of the population would be better able to bear the tax burden. In addition, by levying the tax primarily on the wealthy, wealth redistribution appeared, from COSATU's (2001) perspective to be in line with Smith's (1776) notion of taxpayers bearing a tax burden in proportion to their ability to do so.

This sentiment was shared by First National Bank (FNB) following the 2006 Budget Speech in which Manuel (2006) proposed to provide for improved CGT relief by raising the primary residence exclusion from R1 to R1.5 million. The chief executive of FNB Homeloans, Mr. Grondel, felt that the CGT relief was in line with Government's intention of more evenly distributing wealth by allowing lower and middle income earners to obtain access to better housing. This was especially true for young, first time homeowners. (Grondel, 2007 cited in Property 21, 2007).

Chas Everitt's managing director, Mr. Everitte, shared a similar sentiment noting that the CGT and transfer duty relief proposed in the budget would serve to benefit South Africans across all income brackets. Mr. Rogers, the managing director of property group Homenet, noted that the CGT relief marked a commitment of fairness by adjusting the primary residence exclusion in the wake of rapidly growing property prices translating into 'good news for the average seller' (Grondel, 2007 and Rogers, 2007 cited in Property 24, 2007).

While there were concerns that it would be the middle and upper income earners who would benefit from the improved exemption, Mr. Smith, managing director of international property group Cluttons, noted that:

'by further raising the transfer duty threshold, easing [CGT] and promoting international investment by increasing the offshore individual allowance to R2 million, [Manuel has promoted] continued prosperity for the South African property market and economy and allowed South Africans to play a more active part investing as global citizens' (Smith, 2007 cited in Property 24, 2007).

It is submitted that while the poorest South Africans who own low cost housing are unlikely to benefit directly from the improved exemption, the stimulation that the exemption offers for the property market may foster improved growth in the sector leading to better market values for all homeowners and new job opportunities. At the same time many young and middle class property investors would be left in a position to better bear the CGT liability after the relief measures discussed above.

COSATU's (2001) argument that the wealthy need to be taxed to redistribute capital and that the improved primary residence exemption benefit only the upper classes may, however, be flawed. Capital formation is important in generating higher levels of income. Empirical research undertaken in the USA identified the increase in real capital growth as a driving factor in improved standards of living and a six fold growth in real wages earned by American workers, particularly those in lower paying employment (Moore and Silva, 1995: 5-6).

Thus, the argument that the absence of CGT assisted only the wealthy ignores the link between capital and wage levels. The greater the amount of capital each worker has at his disposal, the greater is his marginal productivity. This means that 'the competitive real wage rises as workers become more valuable to [their employers]' (Moore and Silva, 1995: 5-6). In this regard, it would appear that relief measures introduced to shelter the wealthy from CGT, contrary to the views of COSATU (2001), are not a violation of characteristics of Smith's (1776) fair tax system. Paradoxically, due to the relationship between capital and wages, protection of capital in the hands of the rich may yield important benefits helping the poor better bear the tax burden.

The findings are supported by the relationship between the rate at which capital was taxed and the number of jobs available in the USA's economy which revealed an inverse correlation. In the USA, as the effective CGT rate grew, so the number of jobs available in the economy decreased. The converse was also found to be true. A decrease in the effective CGT rates resulted in an increase in the level of employment (Moore and Silva, 1995: 20-21). In the apparent absence of clear domestic empirical evidence it is submitted that the same principles would be relevant for South Africa.

This inverse relationship is best explained by a chain of events when the effective CGT rate is raised or alternatively, when CGT is first introduced:

- The higher tax rate lowers the expected after-tax return for the holder of certain capital investments.
- The lower rate of return on capital will result in firms relying on less capital inputs.
- In the short run, there is a substitution away from capital and towards labour in order to produce a given level of output.
- Capital has become more expensive and as a result the costs of production must rise.
- The marginal rate of productivity of labour must fall given the reduction in capital in the context of growing capital costs.

- The higher costs and lower levels of productivity may cause production to fall.
- Wages – which are a function of productivity – must fall.
- The lower levels of production and rising costs results in job losses.

(Moore and Silva, 1995: 21-22) (A diagrammatic explanation of this chain of events is contained in Annexure B.)

In essence, the view of COSTAU (2001) was that the imposition of CGT would result in a redistribution of wealth by imposing a capital tax burden primarily on the wealthy. This wealth redistribution would transfer reserves to the needy and uplift the poor, thus aiding in entrenching in two key aspects of Smith's (1776) notion of a fair tax system in the South African tax system. Firstly, the poor would be better able to bear the tax load and hence, maintain themselves. Secondly, and related closely to the first point, the rich would finally bear a more sizable tax load, better reflective of their proportional ability. The postulation is, however, rejected by Moore and Silva (1995). While there are ground to claim that the reduction or removal of CGT would provide a gain primarily to the wealthy, evidence exists suggesting that all income earners would benefit to some extent by lowering the CGT rates (Moore et.al, 1995: 28). There are three key reasons for this:

- Firstly, economic growth spurred by the elimination of CGT, as discussed above, would benefit all taxpayers, not only the wealthy. The basic principle is that, a reduction in the effective CGT rate produces more investments and jobs stimulating the economy as a whole. Logically, this will result in the entire population benefiting (Moore and Silva, 1995: 28).
- Secondly, not only the wealthy have generated capital gains. Increasingly, low to middle income earners are also enjoying capital gains (Conda, 2006:1). It is submitted, that this may be the case in South Africa where a growing number of companies are introducing share incentive schemes for the purpose of empowering their previously disadvantaged staff. The Phuthuma Nati Scheme implemented by Primedia (2006) and the broad based empowerment scheme launched by Woolworths (2007) serve as key examples (Primedia, 2006 and Woolworths, 2007).

- As discussed in Chapter 5, the 'bunching problem' can result in an otherwise low income earner being subjected to a large tax burden in a year in which he realises a particular asset. This is as a result of an artificially high taxable income created by non-recurring capital gains (Moore and Silva, 1995: 28).

The work of Moore and Silva (1995), thus, suggests that capital represents the tools of the modern worker used to carry out his tasks and ensure his level of productivity. It is for this reasons that the preservation of capital, even in the hands of the wealthy, is critical to ensure the sound functioning of the economy and hence, the overall well being of society, including its poor (Moore and Silva, 1995: 10). This is precisely the same conclusion reached by the renowned economist Ricardo (1817), who warns:

'if the consumption of the government, when increased by the levy of additional taxes, be met either by an increased production or by a diminished consumption on the part of the people, the tax will fall upon revenue and the national capital will remain unimpaired; but if there be no increased production or diminished unproductive consumption on the part of the people, the taxes will necessarily fall on capital...[resulting ultimately] in the resources of the people and the State [falling] away with increased rapidity, and distress and ruin will follow' (Ricardo, 1817: 62-63).

The argument is restated in more modern terminology by Stein (2000): with capital representing the 'seed corn of the nation' - not only of the rich but indeed the entire country - CGT may actually be impairing the upliftment of South Africa's poor (Stein, 2000: 12).

6.1.2: Political ambition and the upliftment of the poor

We should also consider whether the introduction of CGT was fuelled by motives other than social upliftment. Vorster (2000) argues that 'CGT... is plunder of the same nature as was carried on by conquerors of antiquity' and that the notion of wealth redistribution is merely 'a passionate slogan which enables the State to pillage the rich, the capable and the hardworking' usually for the purpose of 'massing wealth to buy votes' (Voster, 2000: 124).

In this light, far from being a tool designed to entrench fairness in the South African Tax System, CGT may have become an instrument of political expediency in the quest for more votes.

In order to retain these votes, the State must take steps to realise its electoral promises, part of which amount to redistribution of wealth from a white minority (fifteen percent of the population) to an impoverished black majority representing some eighty-five percent of the population. In this regard, the use of CGT is not so much in the name of equality, but a move on the part of Government to retain its power. In this light, the use of GCT may not be totally for improving the fairness of the tax system, but a tool of political necessity (Voster, 2000: 124).

Voster (2000) deals with the equity argument more directly in order to dispute the notion that, in the quest for horizontal equity, CGT marks a move towards a more fair tax system. To do so, she refers to one of the characteristics of a fair tax system referred to by Smith (1776): the ability of the taxpayer to bear the respective tax burden. Voster (2000) challenges this ideal by begging the question: 'whether it is fair and reasonable to expect a person to do something against his will because he has the ability to do so' (Voster, 2000: 125).

Rather, one may choose to interpret the 'ability to pay' not so much as characterizing a fair tax system, but one that is innately unfair:

[While the ability to pay ideal] claims to represent the concept of fairness for justifying discrimination between those who are not equal so as to preserve [equity it is] in fact a ruse to introduce progression into the effective rate structure. How will this rule be applied to a labourer who is strong enough to carry twice as much weight as his fellow workers?
Why should this principle apply to the distribution of wealth only'
(Voster, 2000: 125)?

By applying CGT in order to redistribute wealth while making no provision for addressing other differences between citizens, the government adopts the simplified view that wealth is hereditary (Voster, 2000: 125).

Such a view fails to take cognizance of the 'innate ability, wise planning and sustained effort' exhibited by those who are able to accumulate wealth. In this light, far from entrenching the principle of fairness, CGT becomes a political tool, the use of which 'wickedly' threatens to punish hard work (Voster, 2000: 125).

What is worse, notes Voster (2000), is that this lesson has already been learned in our quite distant past. The long repealed Glen Grey Act of 1894 serves as the example with its decree that no black man was entitled to own more than one piece of land (an indirect form of CGT) to ensure equity between workers. In response to such intention, the words of Pamla (appointed spokesman for black commercial farmers) are relevant:

'This shuts out all improvement and industry of some individuals who may work and buy [land]... surely Mr. Rhodes can't expect that all natives will be equal. He himself is richer than others; even trees differ in height' (Pamla, 1894 cited in Voster, 2000: 125).

In this light, if citizens believe that the aim of CGT is indeed to redistribute wealth in the name of remedying the injustice of the past, as suggested by COSATU (2001), then there may be disappointment. 'Available evidence shows that redistribution often does not help the people it is intended to...[and] that the poor are not helped by the destruction of the rich' (Voster, 2000: 125). The concern may be particularly relevant given the fact that the upper income earners already pay a sizeable amount of their income in the form of taxes (PricewaterhouseCoopers, 2000: 6).

In this way, Voster (2000) suggests that CGT can not mark a move towards ensuring greater fairness in the South African Tax System. Her concerns are based on two beliefs. Firstly, the need for CGT may be driven by political ambition on the part of the African National Congress (ANC), rather than the philanthropic intention of improving the lot of the poor. Secondly, the nature of the tax is that it tends to impose additional hardship on those whose only offence was *bona fide* commitment and drive to succeed. By levying additional tax on success, the State may, as suggested by Moore and Silva (1995), not only undermine the rich, but also the poor who rely on the rich for their livelihood.

6.2: Black Economic Empowerment

There may be several impediments to Black Economic Empowerment (BEE) deals in the Act. While the provisions of s 41 to s 47 of the Act can offer some relief by means of the various 'roll over' provisions, numerous difficulties continue to be encountered (Arendse, 2004: 8-9). This is particularly the case with respect to CGT. In light of the need for a tax system to allow the taxpayer to still be able to enjoy some of the necessities of life, these hindrances may call the fairness of CGT into question.

For example, s 45 of the Act has provisions relevant to CGT arising in the case of an inter-group transfer of capital assets. Section 45 of the Act will ensure that the transferor enjoys a nil inclusion in taxable capital gain with the transferee company bearing the CGT burden when it disposes of the asset to a non-group member. Compliance with the requirements of these sections is, however, 'no easy matter'. To meet the requirements of the section one must often create 'costly structures only to avoid the additional tax costs that would otherwise arise' (Arendse, 2004: 8-9).

Several, more specific issues include:

- The definition of a 'group of companies' in s 1 of the Act, needed for the 'numerous tax relief measures' necessitated a seventy-five percent holding. This was, unfortunately, not in line with many BEE charters that required only a twenty-five percent holding (Arendse, 2004: 8).
- As a result, the usefulness of the CGT roll over provisions of certain sections of the Act such s 45 and s 43 of the Act was limited. Fortunately, the definition of a 'group of companies' was amended from 8 November 2005 to require only a seventy percent holding, in line with the BEE charters, addressing this fundamental problem (Budget Speech, 2005).
- The reorganization provisions of Part III of the Act contain numerous anti-avoidance provisions. For example, an eighteen month holding period for transferred assets is needed to avoid CGT and other tax-relief measures under these sections being forfeited.

Unfortunately, this increases the risk of BEE structures failing, especially if assets need to be sold in order to finance the transactions (Arendse, 2004: 8).

- The connected person provisions in s 1 of the Act are particularly onerous. Paragraph 38 of the Eighth Schedule to the Act provides that a disposal to a connected person may be deemed to be at market value. In addition, para 39 of the Eighth Schedule to the Act will requires capital losses arising on transactions with connected persons to be disregarded and be available for set off only against capital gains with respect to the same connected person. Again, this could impose a crippling CGT burden on BEE deals (Arendse, 2004: 8).
- The Act limits the deductibility of finance costs. Some relief is available in that a third of these costs may be included in the base cost of an asset under para 20 of the Eighth Schedule to the Act in certain circumstances. 'This is, however, a small consideration' and unlikely to yield much relief (Arendse, 2004: 9).
- Where a BEE partner receives shares in exchange for services, there appears to be no explicit way of establishing the base cost of those shares, costing the BEE partner a future deduction for CGT purposes. In addition, s 24B of the Eighth Schedule to the Act caters only for the acquisition of assets and not services, compounding the problem (Arendse, 2004: 9).

The above limitations may have a frustrating effect on the conclusion of empowerment deals. They may also undermine the success of many BEE deals already in place and thus impair the upliftment of the previously disadvantaged. This may, in turn, go directly to the notion of whether CGT undermines the ability of taxpayers to maintain themselves and their families.

SARS (2001) has, however, pointed out that the reform process is an evolutionary one. At the time of the introduction of CGT in 2001, no provisions existed that recognized the group of companies as an economic unit (Harrison, 2001: 4). Such omissions could translate into shortcomings for the perceived fairness of the CGT system, particularly as the absence of provisions dealing with groups, restructurings, and share swaps could result in double tax (Ensor (a), 2001: 1).

In addition, a further problem due to the absence of sound restructuring rules could be the taxing of unrealised gains, creating cash flow problems and forcing taxpayers to sell off assets in order to pay the CGT liability. This could ultimately result in the inhibiting of corporate restructuring rules, particularly to the detriment of BEE deals (Ensor (d), 2001: 3). Many of the provisions contained in Part III of the Act – including the relevant CGT provisions – were however, introduced for the relief of the taxpayers in the period 2002 to 2006 as part of SARS's 'evolutionary' improvement of the CGT provisions.

SARS (2007) has also appeared to take note of the inherent limitations in the current version of Part III of the Act and, accordingly, several amendments to Part III of the Act have been proposed in order to ensure that BEE restructurings do not face an undue tax burden. These are detailed in Annexure C to Chapter 4 of the Budget Review (2007). The suggested relief measures include:

- Despite the fact that the roll over provisions of sections 41-47 of the Act have been amended to cater for ongoing transactions, the anti-avoidance provisions for companies containing mainly financial assets and liabilities frustrates the ability of these entities to rely on the relief offered by these sections. This would, submittedly, extend to those relief measures applicable for CGT purposes.
- Accordingly, it has been proposed that this anti-avoidance rule be removed from the Act or at least made simpler to apply given that the required calculations are burdensome and currently add little to the mitigation of tax avoidance.
- While s 45 of the Act provides for both normal tax and CGT relief for companies forming part of the same group, the roll over relief is effectively eliminated when the companies unbundle. Due to the large tax burden that may be imposed by these provisions, particularly for BEE deals, it has been suggested that the de-grouping charge should only be applicable if the break-up occurs within six years of the original inter-group transfer. (This recommendation has been taken into Account being announced in the 2008 Budget Speech and becoming effective on or after 1 January 2009.)
- Further relief may be granted by the elimination of anomalies such as the alleged double tax that exists on transferred mining capital assets.

- A material proportion of BEE deals often centre around a share cross-issue in terms of which the operating company issues ordinary shares to the BEE company while the empowerment partner reciprocates with an issue of preference shares to the operating company. If the ordinary shares reach a predetermined value, they are often required to be sold, thus allowing the BEE company to redeem the preference shares. The Act may need to be amended to ensure that the ultimate dual disposessions do not give rise to artificial gains and losses and thus, unreasonable CGT effects.
- Many BEE deals rely on a two step process. Shares are first repurchased from the public, often pursuant to a forced sale facilitated by s 311 of the Companies Act No. 61 of 1973, and then issued to BEE partners. Many of those forced to sell shares often repurchase identical shares from non-BEE participants. There is concern that it may be unjust to levy tax - including CGT- on those forced to sell their shares and, in turn, use the proceeds to restore their original shareholdings. In the event of a timely repurchase of shares that in substance returns the shareholder to his original economic position, it may be necessary to grant a CGT and normal tax exemption.

(Budget Review, 2007: 202-203, Budget Review 2008 & Meyerowitz *et al*, 2007: 24-26)

To summarise: part of the criticism of CGT hinged on the fact that it often acted as a stumbling block to many empowerment deals, impairing the ability of taxpayers to improve themselves and support their families. This would violate the characteristics of a fair tax system as advanced by Smith (1776), particularly problematic given the emphasis on the need to remedy the injustice of the past. Despite the on-going difficulties, however, several relief measures have been proposed in order to remedy the tax shortcomings, including those related to CGT, with respect to empowerment deals. In doing so, such BEE transactions may be made more sustainable, and the ability of taxpayers to bear the tax load and support their families could, accordingly, be improved.

6.3: Public benefit organizations and recreational clubs

Smith (1776) suggests that, in order for a tax to be fair, it needs to be able to leave taxpayers able to bear the tax load. This aspect of the definition makes the following point clear: it is the 'ability to bear the burden of taxation' that demonstrates fairness, not the fact that the tax assists in the State's inexorable pursuit for more revenue (Vivian, 2006: 84-85). This gives rise to the belief that before an amount should be taxed, the cost of life's necessities should first be deducted from that amount (Vivian, 2006: 84-85). By making provision for such allowances an appropriate balance between the needs of the State and those of the taxpayer may be established. The principle is firmly rooted in history. It is Mills (1848, V.II.3) who notes that:

'For a tax system to be fair, it needs to 'leave a certain minimum of income, sufficient to provide for the necessities of life untaxed. Suppose [£50] a year is sufficient to provide the number of persons ordinarily supported by a single income, with the requisites of life and health and with protection against habitual bodily suffering, but not indulgence. This should be made the minimum [and amounts] exceeding it should pay taxes, not upon the whole amount but upon the surplus' (Mill, 1848 cited in Vivian, 2006: 86).

This minimum should reflect the relevant direct and indirect support costs necessary for providing the basic necessities of life (Vivian, 2006: 86-87). In this way, for a tax to be fair, the taxpayer must be left in a post-tax position that is adequate for the maintenance of himself and his family.

The need for taxpayers to be able to bear the tax load then begs the question as to whether the subjecting of public benefit organisations and recreational clubs violates this aspect of Smith's (1776) definition. This may be particularly poignant given the role that such organizations play in the upliftment and support of their respective local communities. In this light, the imposing of a CGT burden on such organisations may affect their ability to provide essential services, indirectly violating the ideal of taking the costs needed to support the necessities of life into consideration when levying CGT.

6.3.1: Public Benefit Organizations

The concern that CGT may be operating to the detriment of philanthropic efforts, and hence the upliftment of the of the poor, was raised by the South African Council of Churches (SACC) which noted that CGT may be imposing an undue burden on public benefit organizations (PBO's) (SCC, 2006). Manuel (2006), however, appears to defend the position by noting that the trading and realization of capital gains by tax exempt bodies poses a potential threat to the sound functioning of the economy. The fiscus is concerned that tax exempt bodies may become a source of real competition to taxpaying entities carrying on similar activities, particularly small businesses. This undermines fair competition and may erode the tax base to the detriment of a large portion of the population (Budget Review, 2006).

This sentiment appears to be accepted by Vlassenko (2001) who warns about the importance of resisting 'inevitable political pressure' to provide exemptions for specific classes of taxpayers. The reason: with a passage of time, these specific exemptions tend to accumulate and can provide tax avoidance opportunities that 'obscures the connection between the tax base and the tax liability' (Vlassenko, 2001: 390)

Further, Manuel (2003) was satisfied that the certain amendments to the Eighth Schedule to the Act had at least provided some relief with respect to the CGT burden of PBO's, particularly the insertion of para 63 into the Eighth Schedule to the Act (Budget Review, 2003). The provisions of the paragraph are as follows:

A person must disregard any capital gain or capital loss in respect of the disposal of an asset where any amount constituting gross income of whatever nature would be exempt from tax in terms of section 10 were to be received by or accrued to that person.

These concessions have been extended following the promulgation of para 63A of the Eighth Schedule to the Act which allows for more generous exemptions from CGT by PBOs (Explanatory Memorandum to the Revenue Laws Amendment Bill, 2006). The paragraph allows for:

'A public benefit organization approved by the Commissioner in terms of s 30(3) [to] disregard any capital gain or loss determined in respect of the disposal of an asset if-

- a) That public benefit organization did not use that asset on or after the valuation date in carrying on any business undertaking or trading activity; or
- b) Substantially the whole of the use of that asset by that public benefit organization on or after the valuation date was directed at-
 - i. a purpose other than carrying on a business undertaking or trading activity; or
 - ii. carrying on a business undertaking or trading activity contemplated in section 10(1)(cN)(ii)(aa), (bb) or (cc).

While the SACC was satisfied that assets not used wholly for public benefit activities could not be exempt from CGT, there was doubt as to how assets used for dual purposes were to be accounted for:

'if CGT will be assessed on *all* assets not directly deployed in connection with public benefit activities, this would mean that PBOs would effectively be penalized for investing surplus funds in securities or any financial instrument. This would be a particular problem for PBOs engaged in the provision of funds and resources to other PBOs. Presumably their activities will be supported by a significant endowment which is likely to be invested in shares and other assets.

Taxing the returns on this investment will undermine their capacity to finance public benefit activities and tend to frustrate the very objectives that the PBO tax regime was established to promote' (SACC, 2006).

A further concern was raised over the potential CGT consequences associated with so-called 'real' or non-financial assets that have a hybrid purpose. As an example, the SACC pointed out that a building may be used, in part, for the work of PBOs but also let to others during periods when excess capacity existed. The income generated from the letting activities is more closely related to cost recovery in the course of servicing the community than a scheme of profit making. Thus the profits – relating to public benefit activities and being sufficiently low – are tax free. The letting of the facility at lower than normal rates, however, could conceivably result in a high level of demand for that facility and the asset in question. Paradoxically, the philanthropy of the owning charity proves to work to its detriment (SACC, 2006). Since the building is likely let out at below market rates, it may very well be used by tenants more than the PBO resulting in a full CGT charge upon the disposal of that asset (SACC, 2006).

Accordingly, on the sale of the asset, the PBO is unable to rely on the CGT exemptions available and is subject to CGT on the full capital gain. 'In effect, [the PBO] is being penalized for being a good steward of this resource, ensuring that it is fully utilized and making it available at sub-market rates to community groups'. A similar problem could occur when an asset that would have qualified for the exemption is offered for sale but the nature of the market is such that the asset can only be sold after a period of time during which it is rented out to generate revenue (SACC, 2006).

It thus appears that the CGT regime promotes inefficiency on the part of PBO's. In the above example, had the PBO in question left the building – or relevant parts - vacant, it would have been able to enjoy a considerably lower tax burden yet to the detriment of the local community who are deprived of the subsidized use of the asset (SACC, 2006). The result: CGT may frustrate the ability of PBO's to assist the impoverished communities that they were designed to aid. In doing so, the tax may directly threaten the notion explained by Vivian (2006): that a fair tax system needs to take cognizance of the costs of providing basic necessities in order to ensure that taxpayers are able to maintain themselves and their families (Vivian, 2006:86-87).

6.3.2 Recreational Clubs

A similar debate may centre on the decision to subject recreational clubs (clubs) to tax. As a general rule, clubs were able to enjoy an exemption from income tax in terms of s 10(1)(d)(iv)(aa) of the Act and para 64 of the Eighth Schedule to the Act. For years of assessment commencing on or after 1 April 2007, these principles will be changed:

'the complete exemption enjoyed by recreational clubs is iniquitous. Recreational clubs are treated more leniently than Public Benefit Organizations (PBOs). Previously, the income tax system provided complete exemption for PBOs, even if those activities included a small level of trading. Since 1 April 2006, a system of partial taxation was implemented. As a result, sizeable trading activities no longer put at risk PBO exempt status.

However, the quid-pro-quo of this change left certain trading activities of PBOs subject to partial taxation. This partial taxation led to the review of the income tax status of clubs, which currently can claim complete exemption – even for sizeable trading activities.’ (Explanatory Memorandum to the Revenue Laws Amended Bill, 2006: 37-38)

SARS (2006) has argued that the new provisions promote fairness as it aligns the tax treatment of clubs with PBO's while not affording clubs an unfair competitive advantage over other taxpayers. The motivation for this is similar to that relevant for PBO's: that while full exemption may yield worthwhile benefits in the fight against poverty, such could threaten the growth of competing taxpayers to the detriment of the economy and upliftment of the poor (Explanatory Memorandum to the Revenue Laws Amended Bill, 2006: 37-39).

In order to avoid posing an undue tax load on clubs, however, SARS has offered some relief to clubs which will now be subject to both normal tax and CGT. This comes - in part - in the form of para 65B which has been inserted into the Eighth Schedule to the Act in 2007 and provides that:

‘a recreational club approved in terms of section 30A may elect that this paragraph applies in respect of the disposal of an asset the whole of which was used mainly for the purpose of providing social and recreational facilities and amenities for members of that club’.

The election, however, may only be made if certain requirements are met as detailed in s 65(B)(1). These include:

- a) proceeds accrue to that club in respect of [the disposal of the relevant asset;
- b) the proceeds are equal to or exceed the base cost of that asset
 - an amount at least equal to the receipts and accruals from that disposal has been or will be expended to acquire one or more replacement assets all of which will be used mainly for such purpose;
 - the contracts for the acquisition of the replacement asset or assets have all been or will be concluded within 12 months after the date of disposal of that asset; and

- the replacement asset will be brought into use within three years of the disposal of that asset

Provided that the commissioner may extend the period within which such contract must be concluded or the asset brought into use by no more than six months if all reasonable steps are taken to conclude those contracts or bring those assets into use; and

- (d) That asset is not deemed to have been disposed of and to have been reacquired by that club.

When the club has elected for para 65B of the Eighth Schedule to the Act to apply, it is effectively entitled to disregard the capital gain arising on a particular asset. That capital gain must be prorated among the replacement asset and treated as a capital gain upon the disposal of those replacement assets. If the club fails to conclude the contract or bring the replacement asset(s) into use within the prescribed period, then the gain originally deferred is treated as a capital gain on the date the prescribed period ends. In addition, interest at the prescribed rate is levied from the date of disposal to the date the prescribed period ends and is treated as a further capital gain (Mitchell K, 2006: 137).

The decision to subject clubs to CGT on certain disposals, in spite of the relief offered by para 65B of the Eighth Schedule to the Act, has been met with criticism.

Given the poor performance of South African sport at the professional level, there is a clear need to develop sporting skills in South African clubs. As CGT will inevitably translate into an additional claim on the clubs' resources, the CGT burden may make it progressively more difficult for clubs to achieve excellence. This may, in turn, have negative ramifications for the upliftment of local communities many of whom are dependent on sport clubs for the positive role they play in the raising of the country's youth (Crosby, 2006).

The situation is made worse by the fact that the exemptions offered for both normal tax and CGT are not automatically available. Clubs will first need to submit an application to SARS before normal tax relief may be obtained.

Such relief will only be granted if several conditions, detailed in s 10(1)(cO) of the Act, are satisfied according to s 30A(2) of the Act since the para 65B of the Eighth Schedule to the Act exemption is only available if s 30A has been complied with. In particular, the requirement that clubs offer annual or seasonal membership before they qualify for CGT relief may prove problematic for numerous clubs offering more short-term memberships. Clubs will also need to submit their constitutions to SARS after the necessary amendments to comply with this section in order to prove that its requirements were met, thus posing an administrative burden (Crosby, 2006).

In essence, the arguments surrounding the subjecting of clubs to CGT are similar to those voiced regarding PBO's. One perspective is that, the amended CGT treatment could bolster State revenue needed for social investment and prevent clubs competing with taxpaying organisations that play a pivotal role in employing the masses (Budget Review, 2006). The alternative view is that the CGT treatment of clubs may impair their ability to actively engage with and improve the lives of local communities (Crosby, 2006).

6.4: Small business and job creation

In order for the tax system to be fair, the taxpayer needs to be able to bear the tax burden while still being able to afford the basic necessities of life. In this respect, Montesquieu (1748:XIII.1) suggested, over two centuries ago that:

‘To fix [taxes] in a proper manner, regard should be had both of the necessities of the State and those of the subject. Nothing requires more wisdom and prudence than the regulation of that portion of which the subject is deprived [by tax] and that which he [is permitted] to retain’ (Montesquieu, 1748, cited in Vivian, 2006: 84).

Given this point of departure, it is submitted that for CGT to be fair, it needs to be such that it does not act as an impediment to the entrepreneur in the development of his business. Without an observance of this, the ability of the taxpayer to bear the CGT - and other tax - burden is directly challenged due to a failure to take cognisance of a key necessity of the taxpayer: the right to earn an income from his chosen trade.

The significance of this potential shortcoming is made apparent when we consider that most of a country's economic activity and employment opportunities in developing sectors are from small business (Holtz-Eakin, 2000). It has been said of small businesses and their entrepreneurs that:

'They create [invaluable] new jobs. They provide competition to existing businesses. They help to improve product quality; help to reduce prices; add new goods and services never before thought of; advance new technologies; and [maintain a nation's] competitive stance' (Holtz-Eakin, 2000: 283-284).

In this context, it might be desirable to offer tax relief to small businesses. This may be especially true given that, 'it is the sector where, internationally, it's been shown, more jobs are created ' (Whitfield, 2006).

6.4.1: A brief discussion of the effect of CGT on business start-ups

Empirical evidence has shown an inverse relationship between the level of CGT and the availability of equity funding for new businesses. When the CGT rate was reduced from forty-nine to twenty per cent, venture capital funding available increased by 700 percent in the USA (Conda, 2006: 5-6).

This inverse relationship is also believed to exist by Moore S (2001) and is captured diagrammatically as follows:



(Courtesy Moore and Phil, 2001: 14)

The correlation between the amount of venture capital financing available and the effective CGT rate may be explained using a simplified economic model. We assume that some fraction of the population (L) will pursue a career path to earn a salary at relatively low risk.

Alternatively, a proportion of individuals (E) elect to start up a new enterprise and earn an income by selling so called 'innovative goods'. Accordingly, $1 = L + E$. The salary earner (L) contributes his time and skill, rendering the required services to his employer. The entrepreneur (E) will contribute his idea to a business investment together with certain personal services while the venture capitalist often assists with financing and managerial expertise given the limited resources of the entrepreneur (Keuschnigg *et al*, 2002: 1-6 & 21-26).

Since the new firms are inherently risky, however, some of them will inevitably fail. Denoting the probability of a successful venture being created and operated as P , the supply of innovative goods is $P \times E$. Similarly, if successful firms have a value of V and unsuccessful ones a value of zero, then a successful start up will yield a capital gain of PV . If the start up costs are denoted as I the capital gain on the investment is $PV - I$. If some of the start up costs were subsidized by the State, then the gain would be $PV - (1-z)(I)$ where z is the subsidy rate (Keuschnigg *et al*, 2002: 1-6 &21-26).

The immediate effect of CGT is that it may make the venture capitalist less inclined to assist the emerging firm as some of the gains are taxed and the net gain enjoyed by the venture capitalists are thus smaller. Accordingly, the added costs of additional support would be unlikely to exceed the diminishing marginal benefit. Instead, the reduced return on the investment may encourage venture capitalists to cut the amount of support they provide the start-up in order to reduce their costs and hence, still enjoy similar pre-CGT returns (Keuschnigg *et al*, 2002: 1-6 &21-26).

In the context of less managerial support the entrepreneur must provide more effort and must accordingly be compensated for it. Accordingly, he demands a larger share of the equity of the new firm. Unfortunately, many of these entrepreneurs lack the contacts and expertise of the venture capitalist, reducing probability (P) of success and hence the value of the investment (Keuschnigg *et al*, 2002: 1-6 &21-26).

This may lead to a further round of reduced managerial support and hence a further reduction in the venture capitalist's equity share. With the growing prospect of losses, venture capitalists will finance fewer start-ups resulting in a supply contraction that must raise the price of innovative goods to restore the equilibrium. The increased price must, in turn, impair demand for innovative goods which ultimately results in a contraction in the size of the entrepreneurial market (Keuschnigg *et al*, 2002: 1-6 &21-26).

The exact extent of the contraction will depend on demand and supply elasticity. Since it is unlikely that both supply and demand are perfectly inelastic, the effect of CGT will, to some extent, have negative implications for the entrepreneurial market (Keuschnigg *et al*, 2002: 1-6 &21-26).

This change in mindset of venture capitalists resulting in a reduction in the number of new start-ups financed by them can also be explained using the finance theories. These theories concern the evaluation of investment decisions based on their respective net present value (NPV).

The NPV of a project needs to be positive for it to be accepted since only a positive NPV project creates value. This NPV is a function of both the cash flows of the project and the discount rate used to present value those cash flows, with this discount rate being sensitive to tax rates, including the effective CGT rate (Firer *et al*, 2004: 260-270 and 293 and Moore and Silva, 1995: 9-11). These postulations are supported by Lally and Zijl (2003) who note the possible need to develop refined finance models in order to take cognizance of the effect of CGT on the required rate of return, or discount rate, of new investments. Indeed, empirical evidence collected by Moore and Silva adds additional weight to the work of Lally and Zijl (2003) and Firer *et al* (2004), highlighting that a positive correlation between the effective CGT rate and weighted average cost of capital (the discount rate) appears to exist. (A supporting explanation of these works is contained in Annexure B)

Based on the theory of NPV, it could thus be argued that by applying CGT to small businesses, the required rate of return on these ventures will increase (Moore and Silva, 1995). This increase in the discount rate will translate into a lower NPV for the proposed investment, increasing the risk of the investment actually destroying, rather than creating, value (Firer *et al*, 2004). Accordingly, the likelihood of an investor providing finance for an emerging business is reduced.

This contraction in the supply of venture capital financing may give rise to a welfare problem. At an effective CGT rate of r , the tax revenues raised by the State will be $r(PV - I)$ which has the potential to boost Government's coffers and allow for additional social investment. This redistribution of tax revenues indirectly to households may offset the negative effect felt due to the reduction in the entrepreneurial market. Unfortunately, there is still the possibility that the increase in disposable income does not offset the increased price of and reduced demand for innovative goods resulting in a welfare loss (Keuschnigg *et al*, 2002: 21-26).

In essence, the consumer, faced with higher input costs due to CGT, substituted away from capital goods and towards those unaffected by the tax. In a comparable way, the market responds to CGT by substituting away from start up companies in favor of other wealth sources, in this case, the more risk adverse employment sector. The exact loss to society by failing to encourage innovation, growth and the development of new technologies may, however, prove too severe to quantify.

By not taxing capital gains, it may thus be possible to stimulate the level of domestic investments being made in capital assets, particularly new businesses. The converse is also true: the effect of CGT may, as suggested by Keuschnigg *et al* (2002), act as a key disincentive to venture capitalists when deciding whether or not to invest in emerging firms (Meyerowitz *et al*, 2001: a 3). The stimulation of such investments could possibly provide additional employment opportunities going directly to ensuring that taxpayers are able to support themselves and their families.

Keuschnigg (2002), however, also presents a positive view on the effect of CGT. While an excessively high rate may be undesirable, at the same time, the rate should not be zero. At a moderate rate of CGT, the effect of the tax may not be excessively pervasive and, as discussed, might be outweighed by the added benefit of improved State spending. In addition, many companies are entitled to set off capital losses against their gains, further minimizing the effect of CGT. By then providing some limitation on the deductibility capital losses, (as the Eighth Schedule does by ring fencing excess capital losses in excess of the sum of all capital gains) the State can indirectly penalize the venture capitalist who suffers too many investment failures because of a lack of managerial and financial support (Keuschnigg *et al*, 2002: 21-26).

6.4.2. The perceived fairness of CGT with respect to small business

Small businesses have become the proverbial cornerstone in the country's economic growth potential, providing a critical source of new jobs in a country plagued by high unemployment (Stein, 2001: 20.) Accordingly, the then South African Chamber of Business (SACOB) (2001) lashed out at Government following the introduction of CGT.

They argued that the tax would have adverse implications on entrepreneurship and job creation. Citing France, Germany and Italy as an example, SACOB (2001) recommended that an exemption be provided to small businesses to ensure that future economic growth and employment opportunities remained healthy (Meyerowitz *et al*, 2001: a 3). In doing so, the State would presumably be able to, not only tackle the problem of unemployment, but indirectly address a critical requirement identified by Smith (1776) with respect to a tax system: the need for taxpayers to be left in a post tax position that allows for them to maintain themselves and their families.

Moore and Silva (1995) and Poterba (1989) corroborated the belief that a CGT exemption or reduction in the effective CGT rate could spur the growth of new small businesses, particularly in capital intensive industries. Again, this was felt to be of 'vital importance' given the large number of jobs that these types of business offer an economy and the contribution such would invariably make towards social upliftment and improving the quality of life for the poor (Moore and Silva, 1995: 16 and Poterba, 1989).

Supporting this motion is the fact that many foreign states with a similar CGT structure to South Africa have now been called upon to revise their CGT system since the tax is regarded as a major disincentive to investors. As result, the UK and Australia both revised their CGT regimes in 2000. In Canada, there was also intense lobbying for a reduction in CGT rates in order to stimulate the level of investments in domestic markets. 'The consensus in these countries is that [CGT] inhibits investment, risk taking and economic expansion' and, in turn poses a direct threat to social upliftment initiatives (Eedes, 2000: 12).

These concerns appear to have been shared by American tax experts and economists as well. Noting the importance that small businesses play in the creation of innovative goods; the supply of new jobs; and the upliftment of the poor, it was felt that a reduction in the CGT rate could boost the growth of the small business sector for the benefit of the entire nation.

This theory appears to be supported by empirical evidence gathered in the USA on the relationship between:

- the number of initial public offerings;
- the supply of venture capital; and
- the number of new business start-up from 1969 to 2001.

In all three of the above areas, an inverse relationship existed with respect to the CGT rate. Such relationships were felt to be compelling evidence for further reductions in the CGT rate especially since the enterprises concerned tend to be engaged in emerging sectors where the potential to create employment opportunities is high (Moore and Phil, 2001: 12-15).

CGT may, however, not only affect investments in new enterprises made by residents. In a similar way, the removal of CGT could stimulate direct foreign investments in South Africa. Foreign investors will - as a general rule - also be interested in taking those investments whose internal rate of return is sufficiently high, as discussed in Annexure B (Firer *et al*, 2004: 249-252). By reducing the level of the effective CGT rate, it may be possible to reduce the cost of capital for investments in South Africa and stimulate the flow of capital into the South Africa as domestic markets provide more attractive investments to non-residents, all other things equal. This may lead to a further round of improved investor confidence and a boost to job creation.

This argument appears to be corroborated by empirical evidence from the USA. This data demonstrates that, in the USA, the effect of a high effective rate of CGT has resulted in a reduction of foreign capital flowing into the USA's economy (Moore and Silva, 1995: 13). A similar concern was raised in Australia and the UK: that CGT is undermining the attractiveness of local markets to foreign investors and hence, the ability of those markets to foster prosperity and improvements in the quality of life (Taxation Review Committee, 1995: 597).

While the reduction of capital inflows in the USA and Australia has been due, in part, to higher income tax rates, higher CGT rates may also be the source of the problem. The considerably higher level of CGT in the USA by comparison to its key major trading partners such as the UK and Japan served as 'a barrier to growth and global US leadership'.

Accordingly, the competitive edge enjoyed by a country by choosing not to impose CGT was cited as a key reason for countries such as Belgium and the Netherlands being able to attract greater levels of foreign capital investments and, in turn, offer ever improving standards of living (Moore et. al.:1995, 12-13).

Skeptics of CGT have accordingly argued that the introduction of CGT acts as a disincentive to shrewd investors. With potentially large capital gains in the context of the accelerated growth potential of small enterprises, there is a very real possibility that such investments will attract a large CGT burden. This can be seen in the inverse relationship between the number of registered start-up companies and initial public offerings with respect to the CGT rates. The number of stock offerings in the USA fell by close to 100 percent in the same period that the effective CGT rate in the USA rose from twenty-seven-and-a-half to forty-nine percent (Moore and Silva, 1995: 16). Given the large number of start-ups financed by venture capital in South Africa, the lessons learned in the USA may invaluable (Firer *et al*, 2004).

The 'drying up of venture capital' financing has been particularly severe for capital intensive industries. Unfortunately, many of these industries are emerging ones in information technology, aerospace and pharmaceuticals which also seek to expand countries' economic and scientific frontiers (Moore and Silva, 1995:17). Again, these industries not only offer immediate job opportunities, but innovative solutions to social, economic and political concerns, sorely needed if the quality of life of ordinary taxpayers is to be improved.

South Africa may be no exception. In the Budget Review (2006) Manuel clearly highlighted the importance of these new frontiers when he noted:

[Government's aim] is the raising of South Africa's rate of economic growth and sustaining a more rapid pace requires greater knowledge creation and new business development in competitive markets. [Thus], the 2006 Budget recognizes the contribution of science and technology to sustained growth ...and [the need] to bolster partnerships between businesses and research institutions' (Budget Review, 2006).

It is submitted that, although the empirical research on the effect of CGT on venture capital availability was conducted in the USA, its essence is still relevant in South Africa. Venture capital has proven to be an important source of financing in the South Africa for the purpose of new business formation, as seen by the fact that the demand for venture capital outstrips its supply (Firer *et al*, 2004: 496). Since venture capitalists have traditionally relied on capital growth in investments rather than dividend streams to generate returns, the effect of CGT would be notable (Cordes, 2000: 1).

In this way, the critics of CGT suggest that CGT may act as a disincentive to new, innovative firms that not only offer new goods and services, but much needed employment opportunities in a country plagued by high unemployment (SACOB, 2001). The indirect effect: citizens are left in a post-tax position unable to pursue their right to earn an income from their chosen trade in order to support themselves and their families. The reason for this stems from the relationship between risks and rewards, as discussed in section 6.3.1. Small start-up firms, despite higher levels of risk, also tend to offer the prospect for much larger payoffs than an investment in established enterprises (Moore and Silva, 1995: 16). The result: an investment in small business offers potentially large growth and employment opportunities should the business succeed. Unfortunately, this growth and upliftment potential also makes small business vulnerable to the effects of CGT (Conda, 2006: 5-6). (An example of the potential of small businesses to contribute to the upliftment of the poor is given in Annexure B.)

SARS (2001) has, however, rallied to the defense of CGT. It has argued that South Africa will not experience the same negative effects as the USA from the application of CGT to small businesses due to a lower effective CGT rate and different economic circumstances.

According to SARS (2001), CGT should not affect the ability of small business and middle class families to accumulate wealth since this is often achieved through the rendering of personal services. These income sources will fall within the scope of the gross income definition - as they always have - and are thus not subject to CGT in any event (Meyerowitz *et al* 2001: b 3). The additional revenue which SARS (2001) felt would be collected from the introduction of CGT could also result in an increase in the funds available to the State, providing room in subsequent legislation for future tax relief (Budget Speech, 2001).

In response to concerns over the effect of GCT on the level of new foreign investment, proponents of the tax have been quick to point out that such fears may be overemphasized. Non-resident investors are either not subject to CGT in South Africa or, if they are, are entitled to relief in terms of a double tax agreement or their respective countries' equivalent of s 6 *quat* of the Act (Meyerowitz (b): 2001:3).

Further, it has been pointed out that much of the empirical evidence available which highlights the undesirable effects CGT has on investment levels, particularly with respect to small businesses, has been obtained in the context of different economic and social backdrops to that experienced by South Africa. This evidence may, therefore, provide little insight into the effect of CGT on the South African economy (Meyerowitz: 2001 b, 3).

In addition, the provisions of the Eighth Schedule to the Act were amended to specifically grant relief to small business. Paragraph 57 of the Eighth Schedule to the Act's provisions dealing with the disposal of small business assets were introduced initially for the first R500 000 of qualifying gains (Meyerowitz *et al*, 2000: 24). In the Budget Speech (2006), the minister announced a further increase from R500 000 to R750 000 (Budget Speech, 2006). The roll forward relief offered by para 65 and para 66 of the Eighth Schedule to the Act; the corresponding amendments to s 8(4)(e) of the Act; and the special allowances afforded by s 12E of the Act were also expected to be particularly useful for smaller concerns in improving their cash flow positions (Meyerowitz *et al*, 2004: 24).

It may also be argued that while CGT may be imposing an added hardship for small businesses, several measures have been introduced outside of the Eighth Schedule to the Act which may compensate for this. Certain of these measures include:

- The lowering of the effective rate at which small businesses' taxable income is taxed – details of which are contained in Annexure C - and the accelerated capital allowances afforded by s 12E of the Act (Budget Review, 2004:94-95, Mazansky, 2001: 125 and Taxgram, 2004: 7-8).
- The increase in the mandatory VAT registration threshold from R150 000 to R300 000 together with the introduction of the cash basis of accounting for VAT (Budget Review, 2004: 94-95 and Taxgram, 2004: 7-8). This is complemented by the proposed threshold increase to R1 million per the 2008 Budget (Budget Speech and Review, 2008).
- Making available the Service Monitoring Office for taxpayers to report poor service by tax officials and the streamlining of the reporting and dispute resolution process (Budget Review, 2004: 94-95 and Taxgram, 2004: 7-8).
- The deductions available for research and development have been improved with s 11D of the Act now offering a 150 per cent deduction for certain expenditure incurred in connection with research and development (Budget Speech, 2006).
- Section 11A of the Act was also introduced to grant a deduction for pre-trade expenditure. This would be particularly useful for start-ups which often incur material pre-trade expenditure in preparation for the commencement of business activity (Jordaan *et al*, 2006: 176).

In this way, the effect of CGT on small businesses are hopefully dampened either through the use of exemptions upon the disposal of interest in such enterprises, or measures which seek to reduce other tax-related costs and thus, indirectly, address the CGT burden. Nevertheless, concerns linger. For example, in situations where small businesses are able to entice an investor to advance desperately needed funds in exchange for an ownership interest, the gains discussed above under s 12E of the Act are often no longer available if the financier were to hold interests in other companies or is itself a juristic person. Further, s 12E of the Act is only available if the shareholders of the small business corporation are all natural persons.

In addition, these shareholders are only allowed to have certain limited interests in other companies. What is more, even when small companies are able to qualify for small business benefits, they often fail to use them due to a lack of sound tax knowledge (Taxgram, 2006: 10).

From a different perspective, others have suggested that the success or limitations of the relief measures discussed above should not be considered from the perspective of the firm itself, but rather its investors.

This perception is based on the belief that while the arguments of tax fairness may be relevant for natural persons, they are not readily applicable in the case of juristic ones given that it is not truly the firm that pays taxes, but rather its owners. In this light, the company merely acts as a conduit which is not truly affected by an inability to bear taxes (Holtz-Eakin, 2000: 7 and Musgrave, 1968: 163).

Hence, it is the individuals who constitute the firm, as opposed to the firm itself, who benefit or suffer from tax policy. In this context, the application of the notion of fairness to the firm may lead to inconsistencies in the treatment of individuals. This problem is highlighted by the use of reduced CGT rates for small businesses in the USA. The result of the policy has, contrary to its objectives, been the same as a reduction on the individual CGT rates for certain classes of taxpayers. Capital gains 'accrue to the savers'. In essence, these savers are 'the suppliers of capital to the economy'. Further, these 'suppliers usually occupy a particular stratum of the income distribution', most notably the upper income parts. The result of the reduced CGT for small businesses has thus been a form of tax relief to a primarily capital rich, wealthy elite part of the American population (Holtz-Eakin, 2000: 7).

This is due to the fact that the reduced CGT rates has simply translated into improved post-tax returns that are available for distribution to the owners of the firm's equities. Thus, if fairness demands that capital gains be taxed, then capital gains of small businesses should also be taxed if the principles of horizontal and vertical equity are not to be undermined (Holtz-Eakin, 2000: 7).

In this way, contrary to the concerns raised above, by levying CGT on small businesses, the tax system may be fully compliant with a key part of Smith's (1776) tax fairness definition: that taxpayers must contribute proportionately to their ability to do so.

In conclusion, a number of measures have been introduced to assist small business in lieu of the 'important role in stimulating [the economy] they play' (SARS, 2006: 25). Indirectly, Government's drive to 'improve education, control the spread of AIDS and enhance investment in information technology via amendments to [various tax legislation]' will ultimately serve to stimulate **all** businesses.

These measures have been complemented with more specific efforts including the introduction and improvement of para 65 of the Eighth Schedule to the Act and the use of accelerated capital allowances for small businesses (Budget Speech, 2006, 2005 and 2004).

Given the country's high unemployment rates and the need for the State to champion BEE, assistance given to small businesses via relief measures in the Eighth Schedule to the Act will be of crucial importance in ensuring that sufficient opportunities exist for taxpayers to find employment; care for their families and bear tax burdens. Nevertheless, despite the State's move to ease the CGT burden of small business, 'in light of the importance of these entities...the [CGT] relief is not enough' (Mazansky, 2001: 125). Many of the relief provisions discussed either did not deal with CGT directly or offered only limited exemption from CGT. A further concern is that even where provisions did exist to ease the CGT burden on small businesses, the complexity of those provisions, coupled with a lack of education, often limited their usefulness. The lack of understanding regarding relief measures may, in turn, call into question how fair the South African tax system may be (Vlassenko, 2001:391).

In this light, the effect of CGT – with respect to its impact on small businesses – may be an undermining of the perceived fairness of the tax system. What is more, if small business owners are to subject to CGT, the bunching problem and lack of inflation adjustment, as discussed in Chapter 5 may aggravate the perceived lack of fairness identified in the Eighth Schedule to the Act.

6.5: Savings

While CGT may have a negative effect on the development of small businesses, the tax may nevertheless assist in encouraging better spending habits; promoting better savings levels; lower liquidity risk for individuals; and thus help to improve the capacity for taxpayers to provide for their families in unforeseen circumstances. In this way, far from impairing the ability of taxpayers to bear the tax burdened and be able to afford the necessities of life, CGT may paradoxically be helping those taxpayers with a low marginal propensity to save to become more prudent in their spending habits.

At the same time, by setting a clear line of demarcation between income and capital, the CGT provisions may assist in ensuring equity among taxpayers regarding the sale of capital assets while acting as an anti-avoidance tool that ensures that all taxpayers pay their fair share for the services they receive from the State.

COSATU (2001) has supported this view, arguing that CGT can help to promote national savings by 'locking taxpayers into investments and increasing the costs of realizing consumption from appreciated assets'. Further, the levying of the tax would discourage the making of speculative investments that served only to 'destabilize' the markets and do little to create more jobs (COSATU, 2001). A similar sentiment was expressed in the Budget Speech (2007) in which Manuel proposed that a refinement of the CGT rules with respect to the sale of shares may be needed.

'In order to provide equitable treatment and certainty for both taxpayers and SARS, all shares disposed of after three years will trigger a [CGT] event' (Budget Speech, 2007).

This move was triggered due to the 'facts and circumstances test' traditionally used to distinguish income from capital 'being problematic' as it often 'results in some large institutions receiving [CGT] treatment on the sale of shares', while numerous other taxpayers 'paying ordinary income tax'.

This additional certainty, while acting as an anti-avoidance mechanism, would also serve to promote equity in the tax system by standardizing the circumstances under which CGT will become applicable for all tax payers. In doing so, taxpayers in equal economic positions are treated equally by the tax system (Budget Speech, 2007).

The new provisions, in addition, make it more difficult to conceal profit making schemes as capital realisations thereby ensuring that taxpayers pay a fair share for the services received from the State (Budget Speech, 2007). This improved certainty also translates into speculative, and hence short-term, investments and dealings serving as a tax inefficient method of wealth creation.

‘If individuals take a strategic, rather than a speculative, approach to equity investment they ensure favorable tax treatment’ (Botha, 2007: 1).

This may, in turn, promote healthier savings and investment behavior. Investors will be prompted to reconsider whether the speculative, often high risk ventures offer a suitable return not only in the context of the investment’s beta, but also in light of sound tax planning. A reassessment may well highlight the benefits of more long-term, stable methods of wealth creation (Botha, 2007:1).

In this way, CGT may be encouraging taxpayers to become more prudent. The drive to improve national savings; penalize speculative and destabilizing investment; and ensure equal treatment of taxpayers may promote savings levels and thus place them in a better position to afford basic necessities. Improved levels of savings could also offer enhanced income levels, providing adding impetus to the drive to uplift the poor (Moore and Silva, 1995)

Botha (2007) goes on to note that:

‘The new [three year CGT rule also] confirms the long-standing attack by the fiscus on the inveterate "trader" though a formalized preference for the saver-investor’ (Botha, 2007: 1).

In this regard, the 'three year rule' should not be seen in isolation, but part of a broader, State sponsored plan to boost national savings. Government's mammoth investments in infrastructure in the wake of the 2010 Soccer World Cup has been supplemented by large investments by the private sector in capital assets, thus creating a current account deficit. In order to stabilize the deficit and free up State funds for additional social projects, Government appears to be using CGT - together with other incentives - to foster savings by South Africans and hence the growth of domestic capital (Botha, 2007: 1-2).

This reserve of local funds could potentially assist in the financing of new initiatives and promotion of economic development, crucial for the upliftment of the poor (Botha, 2007: 1-2). It is submitted that the 'three year CGT rule' may also be complementing the State's drive to ensure better retirement savings.

The Budget Speech (2006) already announced the elimination of tax on retirement funds while in his Budget Speech (2007), Manuel announced the proposed increase in the Estate Duty rebate from R2.5 to R3.5 million together with an increase in the annual exclusion for CGT purposes. These actions may promote better retirement planning and reduce the number of citizens dependent on the State in old age, releasing large reserves of capital for additional Government spending (Budget Speech, 2007).

This seems to re-iterate the belief of COSTAU (2001): that CGT may act as a means of discouraging 'short-termist' investment strategies and bolster an individual's marginal propensity to save. Again, rather than undermine the taxpayer's ability to carry tax burdens, by promoting more stable long-term saving habits, CGT may have a critical role to play in ensuring that taxpayers have sufficient reserves not only for taxes, but unforeseen circumstances. This forms a key part of a fair tax system as advanced by Smith (1776): that such a system needs to take cognizance of and support the taxpayer in providing for life's necessities (Vivian, 2006: 85-87).

The sentiment of COSATU is echoed by Manuel (2001) who notes that apparent inverse relationship between savings levels and the introduction of CGT is not supported by empirical evidence. This argument is based on the fact that in 1979, national savings levels fell considerably in spite of the absence of CGT.

In addition, the absence of CGT in the past does not appear to have negatively influenced national savings levels (Manuel, 2001: 9). Subsequent analysis reached a similar conclusion: CGT has not impaired the levels of savings over time in any material way (Moore and Silva, 1995 & Budget Speech, 2002 & 2004). In this respect, therefore, it may be that CGT in so far as promoting savings is concerned, does not undermine the fairness of the tax system.

Gerlad *et al* (1999) reaches a similar conclusion. Strictly, a decrease in the effective CGT rate could assist in making savings more attractive (Gerald *et al*, 1999: 185). At the very least, the introduction of CGT may not have materially altered the post-tax returns for many investors. This is especially true for individuals whose total lifetime wealth is comprised only marginally of capital gains (Gerald *et al*, 1999: 185).

Hence, while the application of CGT may not aid in improving the level of savings in South Africa - contrary to the belief of COSATU (2001) - it does not impair investment levels. CGT may, therefore, be irrelevant – or at least non-pervasive - given the marginal role it plays in enhancing the economy. This would lend support to the view that the tax is not unfair in so far as its ability to impair efforts to uplift the poor.

Critics of CGT have suggested the exact opposite: that CGT may actually undermine the incentive to save and hence, the ability of citizens to finance their tax and other obligations. Addressing Congress during a tax reduction and reform debate, Kennedy (1963) said the following of CGT:

‘The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital ...the ease or difficulty experienced by new ventures in obtaining capital, and therefore the strength and potential [of the economy]’
(Kennedy, 1963 cited in Staszczuk, 2001: 7).

Due to the fact that CGT is effectively based on the accumulation of wealth over a long term period there may be an incentive not to hold investments in assets such as equities or properties in order to avoid CGT. Further, the tax may cause investors to behave irrationally, consuming surplus funds in the instant rather than invest them in order to avoid the tax that inevitably arises on the realization of large capital gains.

In this way, by impairing the incentive to save, the tax may directly undermine the ability of the taxpayer not only to pay other future tax liabilities, but support himself and his family in old age (Grubel, 2000). This sentiment is shared by Stuart (2001) who notes that the disincentive that CGT poses to savings may have two key negative ramifications: a reduction in financing for new businesses and reduced funds for random expenditure (Stuart, 2001: 15). In turn, these concerns beg the question as to whether CGT is actually undermining the incentive to save; to provide for one's self in old age; and hence to ensure that one is able to bear the tax burden. The opinion of Stuart also raises the possibility of CGT detracting from the desirability of new business ventures to the detriment of lower unemployment levels, as discussed in section 6.4.

In a similar light, concern has been raised about the effect of CGT on retirement savings, such as pension and provident funds. The maturing of those funds could be construed as a disposal giving rise to CGT and aggravating the erosion of a person's savings for old age (Ensor (c), 2001: 4). Several steps have, however, been taken to address this concern, most notably, the exemption provided for such retirement savings under para 55 of the Eighth Schedule to the Act which effectively exempts gains made on long term assurance policies from CGT.

Stein (2006), however, continues to support the belief that, in many respects, capital is not adequately sheltered from the effects of CGT, particularly retirement savings. While para 55 of the Eighth Schedule to the Act allows for gains and losses on qualifying policies, to be disregarded, the provisions of the paragraph continue to be lacking despite being in existence for well over three years (Stein, 2006: 126).

The effect of this shortcoming may be three fold. Firstly, the limitations of the CGT exemption could undermine the desirability of saving and hence, the ability of taxpayers to finance the necessities of life, a key component of a fair tax system as explained by Vivian (2006). Secondly, the absence of an effective exemption could result in large CGT charges for taxpayers who elected to save, particularly for old age, challenging the ability of taxpayers to bear the tax load. Finally part of Smith's (1776) definition demands that only revenue, and not capital, should be subject to tax. The failure to afford protection to long term assurance amounts upon realizations may violate this requirement for a fair tax system.

In this context, the details of para 55 of the Eighth Schedule to the Act are as follows:

A person must disregard any capital gain or capital loss determined in respect of a disposal that resulted in the receipt by or the accrual to that person of an amount –

- a) in respect of a policy, where that person –
 - i. is the original beneficial owner or one of the official beneficial owners of the policy;
 - ii. is the spouse, nominee, dependent ... or deceased estate of the original beneficial owner of the relevant policy and no amount was paid or is payable or will become payable, whether directly or indirectly, in respect of any cession of that policy from the beneficial owner of that policy to that spouse, nominee or dependent; or
 - iii. is the former spouse of the original beneficial owner and that policy was ceded to that spouse in consequence of a divorce order or, ... an agreement of division of assets which has been made by an order of court
- b) in respect of any policy, where that person is or was an employee or director whose life was insured in terms of that policy and any premiums paid by that person's employer were deducted in terms of section 11(w);
- c) in respect of a policy that was taken out to insure against the death, disability or severe illness of that person by any other person who was a partner of that person or held any share or similar interest in a company in which that person held any share or similar interest ... and no premium on the policy was paid or borne by that person while that other person was the beneficial owner of the owner; or
- d) in respect of a policy originally taken out on the life of a person, where that policy is provided to that person or dependent by or in consequence of that person's membership of a pension fund, provident fund or retirement annuity fund.

The first instance in which the exemption is available is where the policy pays out to the original beneficial owner or one of the original beneficial owners of that policy. SARS, however, noted that the exclusion would not be available when the policy was taken out with a foreign long-term insurance provider, limiting the benefits available to taxpayers (Stein, 2006: 126).

The second type of long-term insurance policy qualifying for the para 55 of the Eighth Schedule to the Act exclusions is one which pays out to the spouse, nominee, dependent or deceased Estate of the taxpayer otherwise than by virtue of cession of the policy.

Again, problems may be encountered. It may also be possible for the original beneficial owner to cede the policy to a beneficiary who derives the benefit upon the maturity of the policy. This payment, however, would be exempt only if:

‘no amount was paid or payable for the cession of the policy to the dependent... If even a cent was paid [for the cession of [the policy] the gain or loss can not be disregarded’ (Stein, 2006: 126).

A third instance in which difficulties may be encountered is when policies are ceded in consequence of divorce. If the original beneficial owner cedes a policy to his spouse and subsequently, they get divorced, the amounts received by the now former spouse after the divorce are no longer CGT free as the para 55 of the Eighth Schedule to the Act exclusion applies only to a cession to the former spouse and fails to cater a cession to a spouse followed by a subsequent parting (Stein, 2006: 126-127).

These difficulties ultimately limit the scope, and hence usefulness of the exemption (Stein, 2006). In turn, the ability of para 55 of the Eighth Schedule to the Act to protect capital amounts from tax; avoid large CGT charges in years when policies pay out; and encourage taxpayers to provide for their old age is called into doubt. .

The next instance in which para 55 of the Eighth Schedule to the Act attempts to grant relief is with respect to key man or third party policies. Again, a potential shortcoming may arise. If a company takes out a policy on the life of the employee with the employee as the beneficiary, then the policy is no longer a conforming one as the s 11(w) of the Act allowance would not have been available to the company. Accordingly, unless the policy is taken out with the company itself as the beneficiary and is ceded to the employee, the para 55 of the Eighth Schedule to the Act exemption will be unavailable leaving the employee or his Estate with a potentially large CGT burden (Stein, 2006: 126-127).

This may directly challenge the notion advanced by Smith (1776): that taxpayers need to be able to bear the tax load and ought to pay only a fair amount of tax, proportionate to their ability to do so. This may be particularly relevant for lower to middle income employees who may be least able to sustain the large CGT charge.

In conclusion, as was noted by Smith (1776), a tax system needs to be cognisant of the need of the taxpayer to maintain himself and be able to afford the necessities of life. In this regard, arguments exist suggesting that CGT may not have a negative implication for the levels of savings. Indeed, the tax may actually aid in encouraging more long term, conservative investment planning that can only contribute to the financial stability of the taxpayer. Rather than undermine the taxpayer's ability to bear the tax burden, CGT may be encouraging improved liquidity in order to finance tax and the cost of necessities, as well as encouraging savings for old age. At the same time, the exemption available under para 55 of the Eighth Schedule to the Act goes some way to protecting potential capital amounts from the effect of CGT, in line with the views of Smith (1776): that revenue, not capital, ought to be taxed.

In addition, by promoting savings, and hence the funds available for the financing of new enterprises and State expenditure, the tax may even assist in the development of the nation's capital rather than erosion of its capital base. This may be particularly important given the concerns about the effect of CGT on small business start-ups, discussed in Section 6.4.

Others have, however, argued that CGT has negative effects on the levels of savings and that by lowering savings levels, the availability of capital for new business start-ups is threatened; job security becomes problematic; and the ability of taxpayers to maintain themselves is undermined. In addition, a reduction in savings levels can make it more difficult for taxpayers to meet unforeseen expenses, and hence have sufficient funds for key life necessities. A final concern was that, while para 55 of the Eighth Schedule to the Act offered some protection against taxing capital, the paragraph contained several shortcomings limiting its effectiveness.

6.6: Conclusion

In order for a tax system to be fair, it needs to meet certain requirements. Certain of these include, firstly, the need for the tax to be in proportion to taxpayer's ability to bear the tax load. Secondly, and related to the first point, the tax must allow for the affordability of the basic necessities of life. Finally, the tax must not be a tax on the capital asset used to generate an underlying source of income (Vivian, 2006: 83-88).

In this context, one side of the argument regarding the perceived fairness of CGT is that the introduction of the tax improved the tax system by requiring a white minority in possession of the majority of the nation's wealth to pay a proportionately higher share of the tax burden. This would appear to be consistent with Smith's (1776) notion of 'in proportion to their respective abilities'. In turn, this would spare the black proletariat from having to carry an undue tax burden in given the impoverished condition Apartheid subjected them to, in line with ideal of being able to bear the tax load.

This argument is refuted, however, by Moore and Silva (1995) and Voster (2000) who maintain that CGT may not be assisting in the upliftment of the poor and ensuring that less wealthy taxpayers are not subject to a disproportionately high tax burden. This conviction is based on the positive correlation between capital levels and labourers' wages and the adverse effects that CGT may have on capital growth. In this light the words of Voster are relevant: 'the poor are not helped by the destruction of the rich' (Voster, 2000: 125).

The apparent unfairness of the tax is further highlighted when considering its effects on BEE deals, PBO's and recreational clubs. Part of the requirements for a fair tax system is that the system does not impose an undue burden on the taxpayer such that he is unable to enjoy the basic necessities of life. Given the role that PBO's and many recreational clubs play in supporting their local communities, the limiting effect of CGT on these bodies may impair their ability to provide often impoverished people with access to basic comestibles. At the same time, CGT provisions frequently provided numerous obstacles for empowerment deals undermining the chances for successful transformation and the upliftment of the previously disadvantaged.

SARS (2001, 2006 ad 2007) has, however, rallied to the defense of CGT noting that the limited exemptions from CGT offered to clubs struck a delicate balance between ensuring that these bodies were not subject to an undue tax burden while at the same time, promoting fairness by not affording these bodies a clear tax advantage over other organizations offering similar services but forced to pay tax. As far as the concerns surrounding BEE deals are concerned, numerous amendments have been made to the Act including the introduction of Part III of the Act and the proposed streamlining of this part's key sections to ensure better applicability.

The final aspect of this chapter concerned the effect of CGT on savings levels and small businesses. Skeptics have forwarded the motion that, by eroding the supply of venture capital financing, the number of new successful start-ups is reduced. This calls into question if CGT attacks the very ability of taxpayers to earn incomes and hence carry, not only the CGT burden, but the total direct and indirect tax load. This may be particularly poignant given South Africa's high unemployment rate.

The counterargument is that empirical evidence exists to suggest that a zero CGT rate may not be the most elegant economic solution while numerous relief measures, such as the exemptions afforded by para 57 of the Eighth Schedule to the Act, have been introduced into the Act. Unfortunately, while, empirical evidence exists to show that investments in small businesses were not adversely affected by CGT, there is also empirical evidence to support the counter argument: that the tax does have negative consequences for capital investment in emerging sectors. The result is that while the argument that CGT does not act as a disincentive to small business start-ups is a reasonable one, there appears to be no irrefutable evidence to support this claim.

Related to the ability of taxpayers to support themselves was then the question surrounding the perceived fairness of CGT given its effects on savings levels. Proponents of CGT have argued that the tax encourages savings and, in turn, the need to provide for one's essential living expenses, particularly in old age.

By providing exemptions under para 55 of the Eighth Schedule to the Act, the fiscus also seeks to ensure that taxpayers' capital bases are preserved. In addition, by promoting savings, and hence the funds available for the financing of new enterprises and State expenditure, the tax may even assist in the development of the nation's capital rather than erosion of its capital base.

Nevertheless, critics point out that the application para 55 of the Eighth Schedule to the Act may be fraught with difficulties and that empirical evidence has, to some extent, suggested that there is an inverse relationship between the CGT rate and level of savings, refuting the apparent benefits identified previously. They maintain that CGT has negative effects on the levels of savings and that by lowering savings levels, the availability of capital for new business start-ups is threatened; job security becomes problematic; and the ability of taxpayers to maintain themselves are undermined. In addition, a reduction in savings levels can make it more difficult for taxpayers to meet unforeseen expenses, and hence have sufficient funds for key life necessities.

Ultimately, the question of whether or not CGT is promoting the upliftment of the poor while complying with Smith's (1776) definition of tax fairness, as discussed in Chapter 2, is a complex one. As such, the reaching of a definitive conclusion is unlikely.

Chapter 7: Correspondence analysis

7.1.1: Defining the two-dimensional space

In order to add to the richness of the debate surrounding the received fairness of the South African Tax System, a correspondence analysis was undertaken based on a purposeful sample of both tax experts and general taxpayers. This analysis was then contrast with the opinions of SARS in order to capture the views of both taxpayers and SARS. Before the results of the analysis can be interpreted, however, it is necessary to consider how the analysis was conducted.

After the participants had completed their respective forms the individual results were consolidated into a final contingency tableau which recorded the frequency of responses. (The details of the analysis are contained in Annexure D.) This consolidated tableau was then reduced into graphical form. Ideally, we would need to have a separate axis for each of the nineteen traits detailed in the survey thus creating a nineteen-dimensional space. Each of the fairness criteria would then be positioned in this space according to its profile determined by the frequency of responses in the consolidated contingency tableau. While this would achieve definitionum accuracy it clearly poses difficulties in terms of the understandability of the graph. Using matrix algebra a computer program (NCSS) is able to reduce the nineteen dimensional space into a two dimensional one by aggregating those traits that the participants regarded as being closely related (Adapted from Bendixen, 1886).

More specifically, in order to define the axes of the two dimensional plot,

‘The axes [were] interpreted by way of the contribution that each [trait made] toward the total inertia accounted for by the axis’ (Bendixen, 1996: 20).

Since the research contained nineteen traits, as a simple rule of thumb, any trait contributing more than five percent of the responses would be attributable to a level of significance in the eyes of participants that is not merely representative of a ‘purely random distribution of statements’ (Adapted from Bendixen, 1996: 20).

By thus examining the inertia attributable to each of the traits and sign of respective contributions, the axes' poles can be defined (Adapted from Bendixen, 1996: 15-21). In this way, several traits can be used to characterise each of the four poles contained in the graphical analysis. While this aggregation may detract from the accuracy and richness of the data, the interpretation of the results becomes far more feasible. At the same time, the use of a two dimensional space allowed for the retention of ninety percent of the data's richness.

By inspecting the Plot Details Section contained in Annexure D, the following traits, based on their inertias, define the respective axes:

<i>Axis 1</i>		<i>Axis 2</i>	
Positive x-axis		Positive y-axis	
No.	Description	No.	Description
1	The sale of an equity instrument which is capital in nature is subject to CGT (para 2 of the Eighth Schedule to the Act).	14	PBO's are not subject to full CGT exemption.
3	On death, a taxpayer suffers a deemed disposal reducing the heir's inheritance (para 40 of the Eighth Schedule to the Act).	15	Recreational clubs are not subject to full CGT exemption.
9	Steps to simplify administrative requirements for CGT have been taken.	16	The CGT effects of s 41 to s 47 of the Act pose difficulties for BEE deals.
Negative x-axis		Negative y-axis	
No.	Description	No.	Description
6	CGT prevents domestic revenue being converted into tax free capital gains.	4	CGT discourages capital gain realisations as CGT normally arises only on a disposal of the respective asset.
7	CGT prevents foreign revenue being converted into tax free capital gains.	5	CGT encourages capital loss realisations as the capital loss is then available for set-off against capital gains resulting during the tax year.
12	Inclusions under s 26A of the Eighth Schedule to the Act are not subject to s 7A (4A) of the Act.	2	Capital losses are ring- fenced (para 7 to para 9 of the Eighth Schedule to the Act).
17	CGT acts as a disincentive to business start-ups.		

(The numbers refer to the trait numbers as detailed in the correspondence table in Chapter 1).

The statistical program determines which of the traits are located on the x and y axes as well as the sign of those traits based on the perceptions of participants. In this way, we are able to determine which of the traits characterise the four poles of the graphical representation. (Those traits which define each of the four poles are highlighted in Annexure D). For example: the program uses advanced statistics and algebra to determine that, based on the responses from participants, trait number one is located on the first or x-axis. Since the inertia of the trait is large relative to the other traits on the axis, it is probably relevant for characterising this axis.

At the same time, it has a positive value suggesting that it is located on the positive side of the x-axis. Each of the remaining traits is then dealt with in a similar fashion. In this way, by considering the axis of each of the traits whose inertias are larger than average and the sign of the inertias we are able to define the axes of the graph (Adapted from Bendixen, 1996 and Stacey, 2007, pers. comm., 28 November).

At this point, it is important to note that the sign of the respective traits' inertia merely determines their positioning relative to each other and is not, in itself conclusive. That is to say that a positive inertia does not necessarily imply a positive response. Similarly, a negative inertia is not synonymous with a response in the negative. The sign of the inertias and the axes on which they fall merely highlights which of the traits the respondents regarded as similar or closely related to each other and which were quite distinct. Those traits which did not have large inertias are not separately considered in order to improve the understandability of the data. As mentioned, such simplifications only resulted in a loss of ten percent of the data's richness (Adapted from Stacey, 2007, pers. comm., 28 November).

Based on the above we could label the axis of the two dimensional plot as follows:

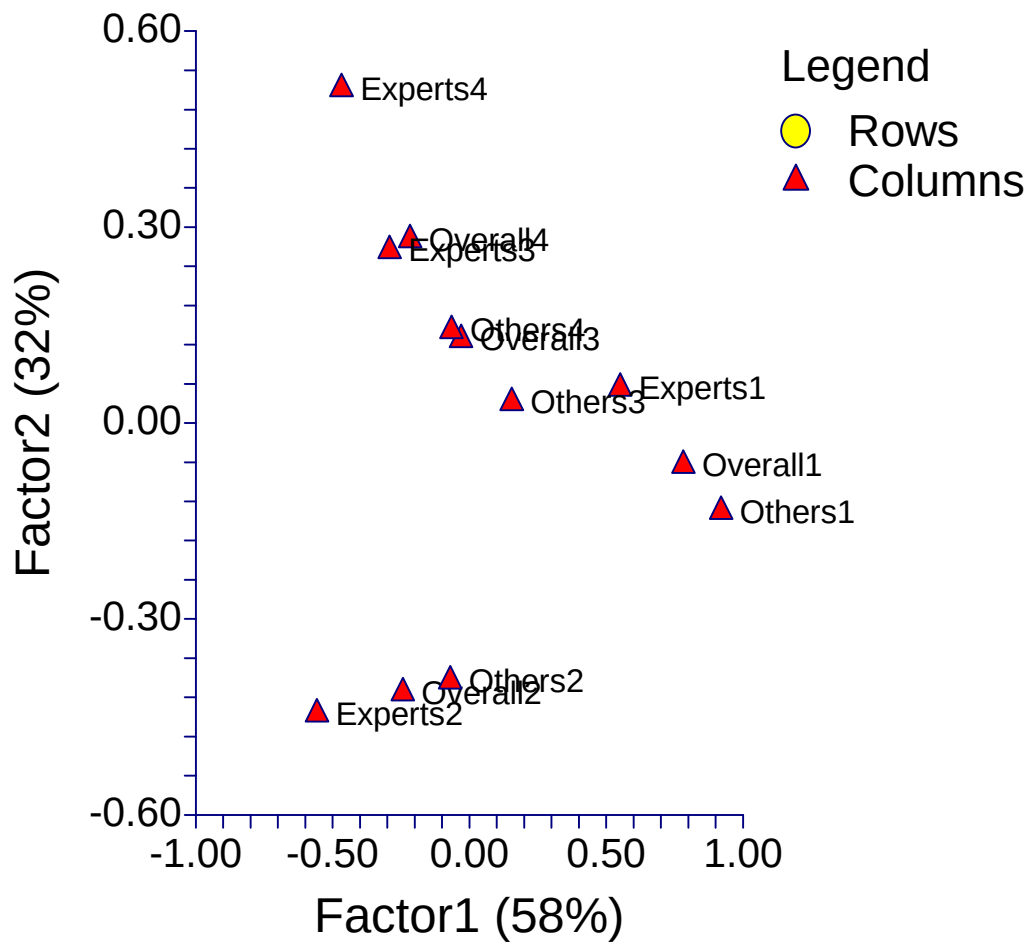
<i>Axis</i>	<i>Label</i>
<i>Positive x-axis (axis 1)</i>	Double tax and administrative load
<i>Negative x-axis (axis 1)</i>	Anti-avoidance; the bunching problem and small business impediments
<i>Positive y-axis (axis 2)</i>	The lock-in effect
<i>Negative y-axis (axis 2)</i>	Social upliftment and philanthropy

(Adapted from Stacey, 2007, pers. comm., 28 November)

With the axes defined, the unfairness characteristics can then be positioned in the correct two dimensional spaces based on which of the traits they are most closely associated with. In this simpler presentation, the further a given point was away from the origin and the closer it was to the pole of any axis, the more strongly associated it was with the traits representing the relevant axes. In this way, the graphical representation was able to highlight which of the traits of CGT and unfairness characteristics were associated with each other (Adapted from Bendixen, 1996).

This methodology is applied *mutatis mutandis* to the results from the general taxpayers and those respondents who were tax experts. By then plotting the results on the graph, we are able to see the opinions of both groups of participants as well as the consolidated results. Having completed this manipulation exercise, the correspondence analysis appears as follows:

Correspondence Plot



(Courtesy Stacey, 2007, pers. comm., 28 November)

The symbols contained in the graph have the following meanings:

Symbol	Meaning
$\Delta 1$	Gives rise to double tax as CGT is a tax on capital
$\Delta 2$	Does not ensure that all taxpayers contribute fairly for State-provided services.
$\Delta 3$	Undermines ability to support the taxpayer's family
$\Delta 4$	Does not promote the upliftment of the disadvantaged
<i>In the interest of brevity, the opinion of experts, general taxpayers and consolidated results will be demoted E. O_t and O_v respectively</i>	

Once the data manipulation was complete, the results of the analysis can be used to identify whether the selected economic and social implications of CGT were associated with a violation of the key characteristics of a fair tax system per the theory advanced by Smith (1776). In this way, the correspondence analysis can be used to support the insights contained in the literature review's content analysis.

(In order to ensure the reliability of the results as discussed in Chapter 2, a pilot study was conducted to test the feasibility of the methodology. The preliminary results of a pilot study conducted during October 2007 are contained in Annexure A.)

7.2: Data Analysis

Having discussed the manipulation of the required data, it is now possible to analyse the results of the correspondence analysis. In doing so, the research will consider, firstly, the opinion of tax experts and contrast this briefly with arguments and counterarguments contained in the literature review in Chapters 3 to 6. Secondly, to add to the richness of the debate the insights of general taxpayers will be considered and compared to those of the tax experts. Finally, the view of SARS and National Treasury will be used to juxtapose with beliefs of both the tax experts and general taxpayers. In this way, the research will be able to add to the debate on the perceived fairness of the tax system.

7.2.1: Tax Experts

The position of E4 and E3 in close proximity to each other may imply that these unfairness characteristics are associated with similar traits. In this light, the data yields several important insights:

Firstly, given that E4 and E3 have positive y-values that are quite far from zero, this may suggest that the lock-in effect (trait four and five) may be serving to the detriment of the upliftment of poor and disadvantaged. The result may be the impaired ability to support one's family thus violating the notion of leaving the taxpayer in a position able to bear the tax load.

The location of E2, however, suggests that the lock-in effect tax was not directly associated with an unacceptably high charge for state services as discussed in Chapter 4, implying that at least one of Smith's definitions were not violated. Nevertheless, the results may highlight that one of the effects of CGT, with respect to the locking in of capital gains, is to frustrate the collection of revenues on the part of the state limiting the level of social investment and other direct relief measures that the state may offer to the poor. This may lend support to the arguments advanced by the likes of Roberts (2006) in Chapters 4 and 6. In this way, even though the tax experts did not feel that the lock-in effect directly resulted in an undue cost for state services, the phenomenon nevertheless could be undermine the ability of taxpayers to support themselves and the efforts of the state to uplift the poor.

Secondly, the fact the ordinates of E3 and E4 are both strongly negative implies a reasonable correlation between E3 and E4 and trait twelve. In this light, the failure to apply the rating formula when determining the taxable income attributable to taxable capital gains may violate the framework for a fair tax system as advanced by Smith (1776).

SARS (2001 and 2006) was of the belief that an accrual basis of taxing capital gains could create cash flow difficulties and that the use of the rating formula was unnecessary due to the numerous indirect relief measures in place. The correspondence analysis, however, highlights a sentiment on the part of tax experts more in line with that of Moore and Phil (2001) and Temkin (2001).

Far from being unnecessary, the failure to remedy directly the bunching problem challenges the ability of taxpayers to bear the tax load and to an even greater extent, the upliftment of the poor.

The bunching problem was also associated with an undue charge for state services seen by the fact that E2 has a negative x-value. Again, this may lend weight to the work of Goodman *et al* (1990), Staszczuk (2001), and Moore and Phil (2001). By failing to apply an average rate of tax as envisaged by s 7(A)(4A) or some other method of proration, taxpayers may be taxed at an unduly high rate of tax calling into question whether they have the ability to bear the tax load.

With taxpayers left unable to bear the tax burden, the respondents appeared to feel that such could ultimately threaten the upliftment of the poor and previously disadvantaged as well as the ability of taxpayers to support their families as seen by the similar x-values of points E2, E3 and E4. In doing so, the tax may violate Smith's (1776) tax fairness definition.

Thirdly, the position of E2, E3, and E4 also calls into question the arguments advanced by Callaghan (1965), SARS (2000), Cameron (2001) and Wood (2001): that CGT acts as an anti-avoidance tool which ensures that all taxpayers pay their fair share allowing for further tax relief measures to be implemented due to the widening of the tax base.

In this light, that the x-value of E2's coordinate is negative implies that respondents felt that CGT's anti-avoidance potential (trait six and seven) was associated quite strongly with a failure to ensure that taxpayers pay their fair share. Contrary to the view of Cameron (2001): that the CGT could serve as a 'gatekeeper tax' to prevent the avoidance or evasion of tax, it appears that respondents were of the opinion that the tax was not an efficient anti-avoidance tool and thus did little to ensure that all taxpayers paid their fair share, as suggested by the likes of Thomson (2001) and Honiball (2007).

The strong association between traits six and seven and the failure to uplift the poor (E4) while preserving the ability of taxpayers to support their families (E3) lends further weight to the view of Thomson (2001) and Honiball (2007). Rather than ensure that taxpayers pay a fair *quid pro quo*, the tax may simply create an impetus to find ever more creative ways of tax avoidance. By allowing for tax evasion and avoidance to continue, CGT may ultimately be doing little to improve the lot of the poor and affordability of life's necessities. Again, the conclusion appears to be that respondents believed that this aspect of CGT violated the tax fairness definition proposed by Smith (1776)

Fourthly, a further threat to the ideals of tax fairness comes in the form of the disincentive that CGT may result in *vis-à-vis* business start-ups. In apparent support of the views of Moore and Silva (1995) and SACOB (2001), South African tax experts were of the apparent opinion that CGT's negative implications for new business ventures contradicted the ideal of social upliftment. This is seen by the fact that E4 has a negative x-value that is not close to zero.

At the same time, the x-value of E3 is of a similar magnitude to E4 implying that the disincentive to entrepreneurship raised concerns about whether or not CGT could be threatening the ability of taxpayers to provide for themselves. To some extent, the effect of GCT on small businesses, also called into question whether the tax imposed an indirect cost on taxpayers that frustrated the notion of paying only a fair share for state provided services. This is seen by the reasonably strong relationship between trait seventeen and E2. Thus, in so far as the effects of CGT on small businesses were concerned, respondents appear to have identified a relationship between a possible undue indirect cost being imposed on taxpayers and an undermining of social upliftment schemes. To a slightly lesser extent, given the larger x-value of E3, the ability of those taxpayers to support themselves was also called into question

Fifthly, the position of E2 raises doubt about the fairness of CGT with respect to its effects on PBO's, recreational clubs and BEE deals. Based on the location of E2 relative to traits fourteen, fifteen and sixteen, it appears as though tax experts were of the opinion that taxpayers did not always pay a fair share fair share for State services.

This is in apparent support of the view of the SACOC (2006) which felt that by not allowing PBO's to enjoy full exemption from CGT that such could impose an undue tax burden on these organisations. Similarly, tax experts appear to agree with the views of Arendse (2004): that CGT imposed several costly impediments to BEE deals that could call into question whether taxpayers were indeed paying a reasonable amount for state services in the form of CGT.

Interestingly while participants identified CGT's effect on PBO's, clubs and transformation deals as violating the ideal of paying only a fair share, this was not seen as a direct threat to the upliftment of the poor. This appears in contrast to the views of the SACOC (2006), Arendse (2004) all of whom suggest that CGT may pose an undue tax load on critical social initiatives to the detriment of the poverty stricken. There may be several reasons for this:

- While the tax is seen as violating these taxpayers' right to pay only a fair *quid pro quo*, it may not be so pervasive as to directly affect the social support offered to the poor by these structures or upliftment schemes. This may be particularly true given the numerous benefits such organisations are granted outside of the tax legislation as suggested by SARS (2001 and 2006). Thus, the results may imply that the respondents agreed with the views of SARS (2001 and 2006): that the levying of CGT on clubs and PBO's ensured those bodies were not allowed to unfairly compete with tax paying organisations. Similarly, the position of E2 could suggest that the relief measures introduced for BEE deals under Part III of the Act and those proposed in the Budget Speech (2006 and 2007), were adequate in protecting the drive to enhance the position of the previously disadvantaged from an undue tax load. Such could possibly lend support to the view that CGT is not unfair in this regard as implied by Ensor (2001) and SARS (2001 and 2006). Thus, CGT may not be undermining the ability of the poor to support themselves and their family but merely pose limited difficulties for individual PBO's, clubs or empowerment structures.
- On the other hand the lack of correlation between E4 and E3 and traits fourteen, fifteen and sixteen could be the result of sampling error arising due to the limited size of the tax expert sample.
- In a similar light, the result may be indicative of biases. Again, this could emerge due to the use of only twenty-two tax experts all of whom are members of the tax fraternity and who rely on CGT, in part, for a living.

The final plot that needs to be considered is E1. While the ring fencing of capital losses was not associated with double tax as advanced by Conda (2000), given the distance between trait two and E1, such was nevertheless perceived to contribute to the difficulties which CGT imposed on the ability of taxpayers to bear the tax load and improve their economic position. Further, due to E1's position almost on the x-axis and quite strongly on the positive side, it appear that the sample of experts believed that subjecting the disposal of shares to CGT and the deemed disposal arising on death were nevertheless possible sources of double tax. This view negates the belief of SARS (2000): that CGT is not truly a tax on the underlying capital base of the nation and rather lends support to the exact counterargument advanced by the likes of Conda (2000) and Cordes (2001).

In terms of the principles established by Ricardo (1817), due to the dissimilarities between gains enjoyed through earning a salary or those derived from capital appreciation, those taxpayers who derive a gain of R1 000 and are required to pay R100 in CGT may be left still wanting to spend the original R1 000 as far as the sample of tax experts were concerned. Accordingly, CGT may pose a real threat to the nation's capital base.

The strong association between point E3 and the administrative load created by the tax is also relevant. Rather than see the tax as directly associated with unduly costly state services, respondents did appear to associate the CGT administrative load with a form of double tax. This view may lend weight to the arguments of Meyerowitz (2001), Croome (2007) and Q-Tech (2007): while relief measures have been put in place, these are possibly inadequate and thus do not fully shelter taxpayers from an undue tax load.

On the other hand, the fact that trait nine was not associated with an undue charge for state services (E2), as advanced in the literature, could suggest that respondents did not see that administrative load as an undue charge on taxpayers. It is submitted, however, that this is merely an issue of interpretation. While respondents did not directly associate trait nine with E2, they nevertheless identified it with a double tax and thus a tax on capital implying that CGT does indeed pose an additional unfair charge on taxpayers. In this light, the words of Vivian (2006) are relevant: once an amount has been subject to tax, any indirect taxes levied after that income was earned and taxed will be a form of double tax and a potential source of unfairness. In this context, the administrative charge may indirectly challenge the notion of paying only a fair amount for public goods and services.

In addition, while the respondents appeared to believe that CGT was a source of unfairness due its double tax potential, the points E3 and E4, with fairly strong negative x-values, were not seen as closely correlated with the double tax phenomenon. There may be several reasons for this:

- While CGT may be a form of double tax, the views of COSATU (2001) may hold weight. Since the tax is primarily one levied on the wealthy, it does not significantly impair the ability of taxpayers to support themselves. Similarly, since the poor and disadvantaged may not be the holders of extensive estates and equity investments, the subjecting of such to CGT may not materially threaten the upliftment of the disadvantaged.
- While some respondents may have felt the exact opposite: that points E2, E3 and E4 were strongly associated with traits one, three and nine, the majority of respondents did not feel the same. Alternatively, they believed that while such relationship was valid, the ability to support one's family and the upliftment of the poor was more strongly related with issues such as the bunching problem and impediments to BEE deals.

In essence, the respondents highlight three key points. Firstly, there are possible sources of unfairness inherent in the tax system. Secondly, while a particular phenomenon may be seen as fair in one light, it may still prove to ultimately violate Smith's tax fairness definition. For example: the bunching problem was not seen as a tax on capital and a form of double tax (E1 has a positive x-value) but is associated with points E2, E3 and E4. The phenomenon may thus challenge the ideal of paying only a fair amount of tax; being able to afford the necessities of life; the upliftment of the poor; and ultimately, the ability of taxpayers to bear the tax load.

Finally the analysis revealed that the unfairness characteristics can not be viewed in isolation. This is clearly seen in the close proximity of the points E3 and E4 and the fact that E3 and E2 have similar x-values. Even point E1 with a y-value close to zero is not on the origin implying that it is a factor to be considered when attempting to conclude on the perceived fairness of the tax system.

The perceptions of the respondents are summarised as follows:

Unfairness characteristic					
Trait No.	Trait description				
		Gives rise to double tax as CGT is a tax on capital	Does not ensure that all taxpayers contribute fairly for State-provided services.	Undermines ability to support the taxpayer's family	Does not promote the upliftment of the disadvantaged
1	The sale of an equity instrument which is capital in nature is subject to CGT (para 2 of the Eighth Schedule to the Act).	Possible			
2	Capital losses are ring-fenced (para 7 to para 9 of the Eighth Schedule to the Act).			Possible	Possible
3	On death, a taxpayer suffers a deemed disposal reducing the heir's inheritance (para 40 of the Eighth Schedule to the Act).	Possible			
4	CGT discourages capital gain realisations as CGT normally arises only on a disposal of the respective asset.			Possible	Possible
5	CGT encourages capital loss realisations as the capital loss is then available for set-off against capital gains resulting during the tax year.			Possible	Possible
6	CGT prevents domestic revenue being converted into tax free capital gains.		Possible	Possible	Possible
7	CGT prevents foreign revenue being converted into tax free capital gains.		Possible	Possible	Possible
9	Steps to simplify administrative requirements for CGT have been taken.	Possible			
12	Inclusions under s 26A of the Act are not subject to s 7A(4A) of the Act.		Possible	Possible	Possible
14	PBO's are not subject to full CGT exemption.		Possible		
15	Recreational clubs are not subject to full CGT exemption.		Possible		
16	The CGT effects of s 41 to s 47 of the Act pose difficulties for BEE deals.		Possible		
17	CGT acts as a disincentive to business start-ups.		Possible	Possible	Possible

7.2.2: General Taxpayers

In order to add to the insights obtained from the tax experts, the correspondence analysis was extended to those taxpayers who were not tax experts but did have a sufficient understanding of the general provisions of the Eighth Schedule to the Act. The results are as follows:

Firstly, the position of O₄ and O₃ suggests that general taxpayers, as with the experts, did feel that there was some relationship between the upliftment of the poor and the ability of taxpayers to support themselves and:

- The lock-in effect (trait six and seven).
- The anti-avoidance potential of CGT (trait four and five).
- The inapplicability of the rating formula or accrual basis of taxing capital gains (trait twelve).
- The disincentive to entrepreneurship caused by CGT (trait seventeen).

This is seen in by the fact that the points O₄ and O₃ do not lie on the origin. As with the tax experts, the general respondents were also of the opinion that the upliftment of the poor and the ability to support one's family were related, with O₄ and O₃ respectively being located in the same quadrant.

While the general taxpayer thus interpreted the above traits as threatening the efforts to uplift the poor and the need for taxpayers to be able to afford the necessities of life, the correspondence between these traits and the unfairness characteristics were not as obvious as in the case of tax experts. This is seen in the closer proximity of O₄ and O₃ to the origin than in the case of E₄ and E₃. Thus, while the results may support the views on the tax experts and certain literary work as detailed in Section 7.2.1, the results are not entirely conclusive.

This may be due to the fact that the sample size was quite small and based mainly on those taxpayers with some form of post-matric qualification in order to ensure that the survey would be understood and correctly answered. Unfortunately, this could import bias in to the results such that the sample of general taxpayers may have been unable to empathise with the need to enrich the poor. There is also a possibility that given the personal financial position of the general respondents that the respondents did not feel that the CGT rate was so pervasive as to threaten their ability to afford the necessities of life and hence support themselves. A second explanation for the lower apparent correlation could be due to the technical nature of these traits and the difficulty on the part of respondents who are not tax experts to fully appreciate the specifics of matters such as the lock-in effect or the rating formula.

Secondly, point O₂ is positioned in a similar region as E2 again implying that general taxpayers -as with the expert respondents- did feel that, in some respects, CGT imposed an undue charge on taxpayers that prevented them paying their fair share. This was particularly true vis-à-vis the absence of an absolute exemption from CGT for PBO's and recreational clubs and the threat CGT imposes on empowerment deals. SARS (2001, 2006 and 2007) was of the opinion that relief measures for BEE deals in Part III of the Act were adequate and that the subjecting of PBO's and recreational clubs prevented these bodies competing unduly with non-exempt organisations. Echoing the sentiment of the tax experts it may well be that this argument rejected by general taxpayers given the negative y-value of point O₂ that is not close to zero.

Unlike the experts however, the general taxpayer did not appear to identify trait six, seven, twelve and seventeen with a violation of the notion that taxpayers should pay only a fair share for state services. The apparent indifference of taxpayers in this regard, it is submitted, is not so much in contradiction to the literature and the view of tax experts as it is reflective of difficulties in appreciating the complexity of the respective traits.

Thirdly, on the matter of whether or not CGT is a form of double tax, the general and expert respondents appear to be in agreeance. The fact that O₁ has a positive x-value implies that it is strongly associated with traits one, three and nine. Thus, it appear that general taxpayers are of the opinion that the deemed disposal on death and subjecting of equity instruments to CGT on disposal may give rise to a tax on capital and hence, double tax.

At the same time, they perceive material administrative load to exist and the relief measures introduced to be inadequate to address the indirect tax charge that this results in. Again the effect is double tax. In this regard, the general taxpayer felt even more strongly that CGT was double tax than the tax experts did.

As with the tax experts, while the general respondents appeared to believe that CGT was a source of unfairness due its double tax potential the points O₃ and O₄, were not seen as closely correlated with the double tax phenomenon.

The reasons for such advanced in Section 7.2.1 may apply *mutatis mutandis* to the results from the general tax payers. This result may also be reflective of the following:

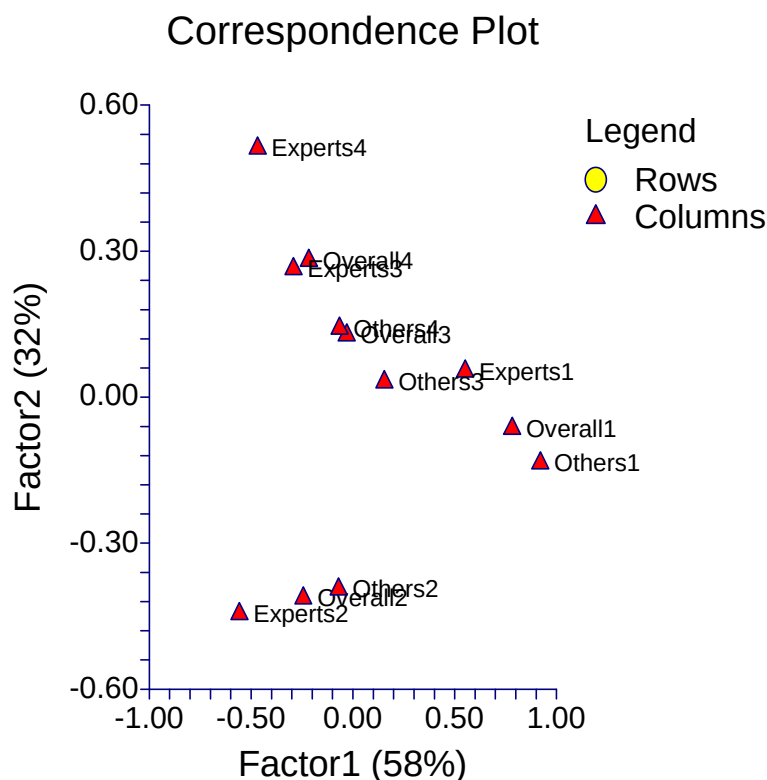
- Sampling error and biases inherent in the general respondent sample. Given that many of the taxpayers in this sample tended to be financially independent may, in particular, have impaired their ability to identify with the need to uplift the poor and provide for the basic necessities of life.
- Again, it needs to be stressed while every effort was made to select respondents who could accurately answer the tax survey, these respondents are not tax experts and as such may not have fully appreciated the interrelationships between the traits and unfairness characteristics.

Finally, the correspondence analysis on general taxpayers yields similar insights into the perceived fairness of CGT. In particular, there are characteristics of CGT which are regarded as sources of unfairness while the unfairness criteria themselves can not be considered in isolation. Nevertheless, the reliability of the results is not absolute especially in light of the limitations on the sample's size and diversity and the limited knowledge of participants regarding CGT.

7.2.3: The consolidated view of taxpayers, National Treasury and of SARS

Having completed an analysis of the insights of the general taxpayers and the tax exerts regarding the perceived fairness of CGT the final part of the correspondence analysis deals with the determination of the consolidated view of these two groups in order to gain some idea of the perceived fairness of CGT on the part of taxpayers as a whole.

The correspondence analysis is reproduced here for convenience:



(Courtesy Stacey, 2007, pers. comm., 28 November).

Axis	Label
Positive x-axis (axis 1)	Double tax and administrative load
Negative x-axis (axis 1)	Anti-avoidance; the bunching problem and small business impediments
Positive y-axis (axis 2)	The lock-in effect
Negative y-axis (axis 2)	Social upliftment and philanthropy

(Adapted from Stacey, 2007, pers. comm., 28 November)

Since the results obtained from the tax experts and the general taxpayers were largely consistent, the consolidated results reflect the same general insights as those discussed above:

- In general, taxpayers regarded CGT as giving rise to double tax and an undue administrative load. While not strongly associated with violation of paying more than one's fair share, taxpayers nevertheless regarded CGT as imposing an additional indirect charge on them which is ultimately unjust.

While tax experts shared the view of general taxpayers, the latter tended to feel more strongly about the issue than the former. The consolidated results reflect the average of the two perceptions

The fact that the CGT's double tax potential was not correlated with a violation of the need to uplift the poor and for taxpayers to be able to maintain themselves may, however, be indicative of the fact that the tax is not totally unfair. The result could also be the product of statistical errors.

- On average, taxpayers were of the opinion that the bunching problem, posed a threat to the perceived fairness of the tax system by challenging the upliftment of the poor and, to a lesser extent, the ability of taxpayers to maintain a reasonable standard of life.

The existence of small business impediments, the lock-in effect and the inability of the tax to serve as an efficient anti-avoidance tool were also sources of unfairness. In particular, such phenomenon violates two of Smith's (1776) tax fairness criteria. Firstly, they may undermine the ability of taxpayers to support themselves. Secondly, the question of the upliftment of the poor, related closely to the first point, may be called into question.

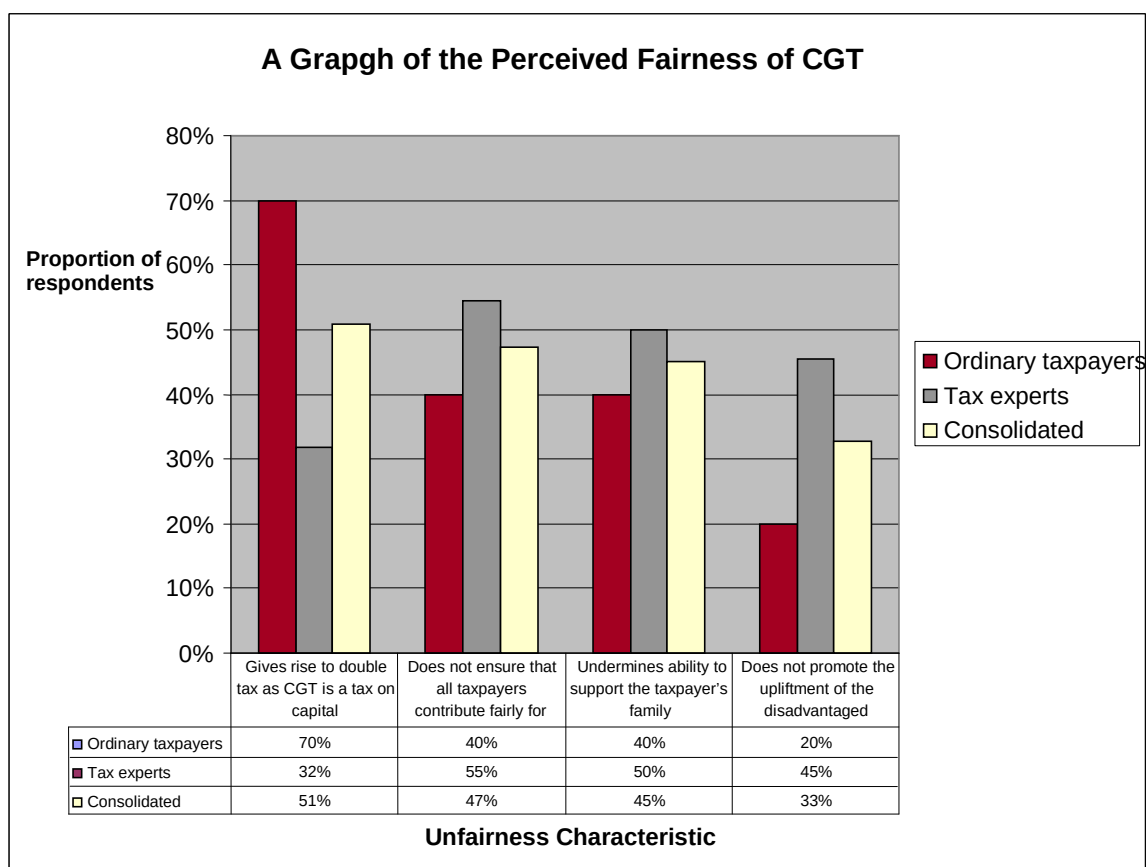
In this instance, it was the tax experts who felt most strongly about the unfairness of CGT, particularly with respect to traits six, seven, twelve and seventeen. This may imply that general taxpayers did not regard such traits as source of unfairness given the x-value of O_3 and O_4 quite close to zero.

As discussed in Section 7.2.2, however, this may be largely due to general taxpayers being unable to appreciate the technical nature of the relevant traits under investigation. Again, the consolidated results reflect an average of the two perceptions.

- Finally the tax experts were of the opinion that poor anti-avoidance potential, the bunching problem, small business impediments, and threats to social upliftment could be a source of unfairness. In particular, such could undermine the notion of taxpayers paying only a fair share for state services.

The sentiment appears to be shared by general taxpayers but with less conviction. While this may imply a perceived fairness on the part of general taxpayers, the result may again be attributable to the technical nature of these aspects of CGT.

The results of the analysis may be summarised as follows:



(The results upon which this chart is based are contained in Annexure D)

In spite of the apparent unfairness inherent in the Eighth Schedule to the Act SARS, however, has rallied to the defence of CGT. Based on a sample of ten representatives from SARS who co-ordinated their responses it appears that SARS does not identify the same extensive sources of unfairness inherent in the Eighth Schedule to the Act as taxpayers did. (Details of this correspondence are contained in Annexure D.)

Firstly, regarding the taxiing of equity instruments and the deemed disposal resulting on death the respondents felt that such would pose a possible threat to the upliftment of the poor.

This may add weight to the sentiment expressed in Chapters 3 and 6: that as ever more previously disadvantaged employees enjoy greater equity interests in their respective employers and growing wealth that CGT could impair the rate of transformation. At the same time, the tax on death could result in a burden placed not only on the deceased estate but the surviving heirs of the deceased as touched on Chapter 3. The sentiment appears to be shared by taxpayers given the large positive x-value of the point O_v1 and hence its correlation with traits one and three.

Secondly, SARS was of the opinion that the lock-in effect did pose problems for the ideal of ensuring that taxpayers paid a fair quid pro quo for state services. The view appears to be in line with that of Moore and Silva (1995) and Roberts (2007): that the lock-in effect often allows wealthier taxpayers to avoid CGT while lower to middle income earners are less able to defer to realising of gains. At the same time such frustrates the ability of the state to offer improved public goods and services while lowering the tax rate and hence cost of those comestibles.

The respondents did not, however, believe that the effect of such would be so pervasive as to threaten the upliftment of the poor or the ability of poorer taxpayers to maintain themselves and their families as was believed to be the case by taxpayers. This also appears to contradict the close relationship which taxpayers felt existed between the ability to support one's family and the improvement of the economic lot of the disadvantaged.

Finally was the concern regarding recreational clubs, PBO's and the disincentive to business start-ups regarding CGT. Here SARS, as with the taxpayers, felt that CGT burden on such organisations could be a source of unfairness. SARS, however, appears to have adopted a more conservative approach. Rather than suggest that the tax imposes an undue charge on taxpayers in general SARS was more concerned that CGT would adversely effect the upliftment of the previously disadvantaged. This may imply that the perceived unfairness may not be as generic as believed by taxpayers.

In addition to these concerns, taxpayers appear to have identified the bunching problem, the inefficiency of CGT as an anti-avoidance tool, the administrative load of the tax, and its potential to impede transformation deals as possible violations of Smith's (1776) tax fairness definition. These traits were not, however, raised by SARS as matters of concern implying that, from the perspective of the tax gatherer, the relief measures introduced directly or indirectly in response to these phenomenon are adequate to ensure that the tax system is fair.

7. 3: Conclusion

The correspondence analysis based on the views of taxpayers revealed that there are potential sources of unfairness inherent in the Eighth Schedule to the Act. These can include the possibility that that by taxing the disposal of equity instruments; the transfer of certain assets to the surviving heirs of the deceased; and requiring detailed supporting documentation that CGT may be imposing a form of double tax. In doing so, the Eighth Schedule to the Act may violate Smith's (1776) tax fairness definition as detailed in Chapter 2.

To an extent, SARS appears to accept the view but rejects the notion that the administrative load is so pervasive as to give rise to an indirect form of double tax. The tax gatherer also appeared more concerned that taxing equity instruments and the transfer of certain assets under para 40 of the Eighth Schedule to the Act would have more of a negative effect on the upliftment of the poor than pervasive ramifications for taxpayers in general.

The second aspect of Smith's (1776) definition examined by the analysis was whether or not CGT undermined the ability of taxpayers to support their families. The bunching problem; poor anti-avoidance potential; and threat to business start-ups were felt by expert taxpayers to possibly violate this criteria. In doing so, these traits challenged the upliftment of the previously disadvantaged. The sentiment was not as strongly shared by ordinary taxpayers possibly due to a lack of technical prowess. SARS, however, appears to have rejected the notion in its entirety, not identifying these traits at all with the unfairness characteristics.

Further, the correspondence analysis revealed that taxpayers regarded the lock-in effect as a source of unfairness. This was, in part, also due to the potential of the phenomenon to undermine the ability of taxpayers to support themselves and hinder the improvement of the lot of the poor. While SARS appears to accept that there may be traces of unfairness inherent in the lock-in effect, the tax gather felt that this was rather due to the impact such had on allowing for the deferral of gain realisations and hence the notion of contributing fairly for state provided services.

In this light, the final part of Smith's (1776) definition that was examined was whether or not CGT ensures that taxpayers pay a fair *quid pro quo* for public goods. Accordingly, taxpayers were most concerned that by taxing PBO's and recreational clubs this aspect of the definition was violated. A similar fear appears to exist regarding the impediments to BEE deals which CGT may give rise to. To an extent, the opinion is corroborated by the tax gather. SARS has, however, identified the taxing of PBO's and recreational clubs as a source of unfairness based more on the belief that it may hinder the ability of PBO's to carry out their acts of philanthropy. Even then, the effect of CGT was felt to be only moderately relevant. This may be due to the ability of the tax to boost state coffers and hence social investment. A second reason for this may be due to the tax removing an unfair competitive advantage that these PBO's and recreational clubs would otherwise have enjoyed over taxpaying entities.

The concerns of the general body of taxpayers regarding CGT and BEE, however, appear to be rejected by SARS. The correspondence analysis reveals that SARS did not associate trait sixteen with any of the four unfairness characteristics used in the correspondence analysis. As discussed, this may be indicative of the conviction that the relief measures introduced into the Act are adequate for ensuring the success of transformation.

Ultimately, the analysis adds to the debate surrounding the perceived fairness of CGT. Unfortunately, inherent limitations impair the reliability of the data. These include:

- The fact that sample sizes are small and not sufficiently diverse to capture the opinion of the entire population of taxpayers.

- The analysis is based on the opinions of respondents rather than on documented fact.
- The nature of the questions posed is such that the results may not be easily quantified in order to measure the probability of either the taxpayer or tax gatherer being correct.

These inherent limitations inevitably result in the reaching of a definitive conclusion with any reasonable level of assurance being highly improbable.

8: Conclusion

8.1: The meaning of fairness

Firstly, the report needed to determine an appropriate definition for the meaning of 'fairness' in order to serve as a gauge with which we may assess the perceived fairness of CGT. To this end, the *Oxford English Dictionary* defined 'fair' as 'just, unbiased [or] equitable' (Concise Oxford English Dictionary: 1995, 484). This definition was, however, found to be quite broad. In order to deal with the research question more specifically, the report extended on this generic definition by adopting the meaning of tax fairness suggested by the classical economist, Smith (1776:V.II.II):

'The subjects of the state ought to contribute to the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to revenue which they respectively enjoyed under the protection of the state. In the observation or neglect of this definition consists, what is called equality or inequality of taxation'

The reference to 'revenue' by Smith (1776), suggests that **all** income or increases in wealth should be considered when determining the taxpayer's total income. In essence, once income has been subject to tax, any indirect taxes levied after that income was earned and taxed will be a form of double tax and a potential source of unfairness. Further, Smith (1776) suggests that tax should be levied on income and not capital as the fruit of the capital would already have been taxed (Vivian:2006, 83 emphasis added).

The second aspect of the definition is: 'protection afforded to the individual by the [State]'. In essence, a fair tax system is one that adopts a *quid pro quo* approach to taxes. The taxes levied on the individual need to be sufficient to cover the cost to the State of protecting that individual while leaving the taxpayer able to bear the tax load. In this light, we have the third part of the definition: 'in proportion to their respective abilities'. This aspect of the definition makes two points clear. First, it is the 'ability to bear the burden of taxation' that demonstrates fairness, not the fact that the tax assists in the State's inexorable pursuit for more revenue.

Second, those who have the capacity to bear a tax should be subject to a greater proportion of the burden of that tax than those who lack the ability to endure the said burden. This gives rise to the belief that before an amount should be taxed, the cost of life's necessities should first be deducted from that amount (Vivian: 2006, 83-85).

8.2: The perceived fairness of CGT

While the work of Smith (1776) clearly predates the introduction of CGT, the essence of his work may still be applicable in exploring the debate surrounding the perceived fairness of CGT. In this way, based on the Smith's (1776) definition, the research considered:

- If CGT is a form of double tax since it may be a tax on underlying capital bases.
- If the tax facilitates the paying of a reasonable *quid pro quo* for the services the state provides to its citizens.
- If this 'contribution' is in line with the ability of taxpayers to bear the tax burden.

8.2.1: Double tax

Critics of CGT maintain that CGT results in two key shortcomings. Firstly, the tax may erode the very assets used by a taxpayer to generate income and pay taxes.

Secondly, and related closely to the first concern, the effect of taxing capital may be a form of double tax to the extent that the underlying income generated by the capital asset has already been subject to tax. The result: the ability of a taxpayer to bear the tax burden, and thus the fairness of the tax system, comes into question. These concerns are brought to the fore by three key issues:

Firstly, empirical evidence appears to suggest that countries adopting CGT tend to report lower per capita incomes, presumably due to the erosion of the underlying capital base. This erosion may translate into a lessened capacity to bear the tax burden. Secondly, the deemed disposal resulting in terms of para 40 of the Eighth Schedule to the Act on the death of a taxpayer may leave the heir in receipt of a diminished inheritance without a proportionate reduction in consumption possibly adding to the plight of taxpayers. Finally, is the concern that CGT may directly result in a form of double tax. This is based on the premise that capital gains are the result in improvements in the post tax cash flows of respective companies with the CGT charge, in substance, being a tax on an amount that has already been subject to normal tax. These concerns appear, in part, to be corroborated by the correspondence analysis on taxpayers which revealed a reasonable correlation between the taxing of equity interest and application of para 40 of the Eighth Schedule to the Act and the imposition of a double tax.

In defence of the fairness of CGT is the fact that the lower per capita statistics may be indicative of a multiple of other variables including statistical error, changes in population growth rates or market sentiment, and other random fluctuations. Of further comfort is the fact that the impairment of capital that may result on the transfer of property from the deceased estate to the heir or legatee is partially remedied by virtue of para 41 of the Eighth Schedule to the Act.

Finally, in support of the tax, was the view that a person earning R10 of capital and R10 from a salary were enriched to the same extent and ought to be taxed equally. In this light, the tax is actually one on economic income as opposed to capital. Rather than be a source of unfairness, the tax ensures that the poor are not forced to bear an undue tax burden that would result in the absence of CGT. In addition, since the substance of the increase in wealth from earning a salary or capital gains is virtually the same, CGT is not a tax on the nation's underlying capital base.

This argument appears to be supported by the respondents from SARS who did not attribute the taxing of equity instruments or the application of para 40 of the Eighth Schedule to the Act to the levying of double tax. Concerns were, however, raised by the SARS respondents regarding the relationship between CGT and the ability of taxpayers to bear the tax load, as discussed below.

..

8.2.2: Cost of State provided services

Smith (1776) suggests that for a tax system to be fair, it needs to allow for taxpayers to pay a reasonable *quid pro quo* for the services which government renders to its citizens. In this context, the locking in of capital gains may be relevant. Empirical evidence and economic theory tend to suggest that by reducing the CGT rate, it would be possible to encourage the realization of capital gains. In this way, a lower tax rate would translate into higher State revenue and improved State services ultimately stimulating social upliftment and development initiatives. If this is indeed possible: that a lower CGT rate could yield improved State Services, then the research poses the question as to whether the cost of current service levels is unduly high. The argument maybe supported by two key aspects of the correspondence analysis on the body of taxpayers:

- Firstly, the levying of CGT on PBO's and recreational clubs was seen as imposing an undue tax charge on these entities to the detriment of their acts of philanthropy. In this way, the indirect cost of CGT could prove prohibitively high.
- Secondly, the identification of double tax and a threat to the taxpayer's ability to bear the tax load may indirectly beg the question as to whether the charge for State services in the form of CGT may be disproportionately high.

The research supporting the above propositions was not, however, conclusive. A material degree of uncertainty surrounding the exact elasticity of the level of realisations with respect to the tax rate makes the reaching of a definitive conclusion difficult. The problem is compounded by the apparent lack of South African statistics allowing for proponents of the tax to argue that the above proposition is based on foreign socio economic conditions that may not hold locally.

Thus, supporters of the tax maintain that CGT may be imperative for efficient resource allocation and that its removal would weaken Government's fiscal position. Contrary to the view above, it may be the case that a cut in the tax rate will not translate into higher revenues and better State-sponsored services. In this regard, the removal of CGT may simply necessitate the need to raise other tax rates in order to cover the cost of State services, thus implying that CGT is presently a key part of a fair *quid pro quo* given for those services.

These counterarguments appear to be corroborated by the results obtained from the correspondence analysis. Apart from the relationship between PBO's, clubs and BEE deals, participants did not otherwise identify a directly apparent correlation between the lock-in effect and the cost of State services. In this context, CGT may not be unfair.

Fortifying the view that CGT is a sound mechanism for entrenching the principles of fairness in the South African tax system is the ability of the tax to serve as an anti-avoidance mechanism. By eliminating a key means of circumventing the payment of tax on income and refining the documentary evidence required to be kept by taxpayers, CGT helps to ensure that all taxpayers pay a fair share for the public goods and services which they enjoy. At the same time, CGT may help to widen the tax base creating the opportunities for further relief measures with respect to other taxes. In this way, CGT not only ensures that taxpayers pay for the services they receive from the State, but may be helping to reduce the tax burden of other taxes.

The subjectivity of this evidence regarding the fairness of CGT was, however, highlighted when critics noted that the tax was not a perfect anti-avoidance tool. Paradoxically, the Eighth Schedule to the Act may have simply added to the complexity of the Act thereby creating the impetus for the development of ever more elaborate tax avoidance strategies. Such an outlook appears to have characterised the opinion of taxpayers who participated in the correspondence analysis. It should be noted, however, that SARS respondents, while accepting the limitations of CGT, still regarded it as a useful anti-avoidance tool that helped secure the fairness of the tax system.

The alleged failure of CGT in so far as compliance with Smith's (1776) definition was concerned was further demonstrated by the administrative load created by CGT. From one perspective, the administrative requirements of complying with the Act are too onerous and pose an indirect cost on the taxpayers. This is seen not only in the literature but also in the results of the correspondence analysis where taxpayers identified the administrative load as an additional indirect tax and thus a form of double tax.

SARS has, however, rallied to the defense of the tax arguing that it has attempted to take the necessary steps to deal with the apparent administrative burden. Numerous relief measures have been introduced not only for CGT directly, but indirectly via other tax systems. Further, in spite of the fact that critics argue that CGT imposes costs well in excess of its burden, the Eighth Schedule to the Act has been operative for some six years now. This suggests that the tax does indeed generate sufficient revenues to cover its costs and assist in the State's goal of social upliftment.

8.2.4: The ability to bear the tax load

For a tax system to be fair, it needs to be mindful of the need for taxpayers to be able to support themselves and their families. In this light, taxpayers should only have to pay a fair *quid pro quo* for the services received from the state and should not be subject to any form of double tax.

Part of the reason for the levying of CGT was to ensure that the principles of horizontal and vertical equity are adhered to in order to comply with the above ideal. This was felt to be particularly poignant given South Africa's past where the absence of CGT would leave a white elite, in possession of most of the nation's capital, untaxed on a large amount of their accumulated wealth. In contrast, the poor - and those least able to bear the tax load - would have to carry the brunt of the tax burden.

Critics of CGT have, however, condemned the notion of vertical and horizontal equity as romantic idealism. In particular, equity has been portrayed not so much as an agent of fairness, but as a means of penalising those who generated wealth due to innovation and hard work.

This may be particularly worrying given that the preservation of capital may be closely interrelated with the wage rate of lower income workers and hence, the ability of such people to maintain themselves. The fact that empowerment deals and transformation in the work place have begun to enrich the disadvantaged with capital assets may further add to the concern that CGT impairs the ability of taxpayers to not only maintain themselves, but improve their social and economic standing.

In support of this view is the fact that respondents from SARS as well as general and expert taxpayers did identify the taxing of equity instruments and application of para 40 of the Eighth Schedule to the Act as potential hindrances to transformation and the improvement of the lot of the poor.

In addition, ensuring that taxpayers in equal positions bear equal tax loads may prove more theoretical than practically achievable. In some instances, the introduction of certain exemptions and deductions in order to achieve horizontal equity may have paradoxically, created opportunities for tax avoidance directly challenging the belief of paying one's fair share. This may, in turn, undermine the notion that CGT does not impact on the ability of taxpayers to bear the tax load in proportion to their respective abilities to do so, a sentiment again captured by the correspondence analysis on taxpayers.

The failure to apply the rating formula and to take remedial action against the bunching problem may compound the apparent lack of fairness in the tax system. If a taxpayer suffers a capital gain for the period, the sliding tax scales used for individuals could result in that taxpayer being subject to tax - not only on his taxable capital gains but total taxable income - at an artificially high tax rate.

This may be particularly problematic for a taxpayer wishing to provide for his children in old age. Such a taxpayer is faced with an almost impossible dilemma. While a trust affords security to the underlying assets to be enjoyed by the beneficiaries, the trust is also subjected to the highest effective rate of tax.

In order to circumvent this, the taxpayer has no other alternative but to vet the asset in the hands of the beneficiary, only to have the bunching problem impair the beneficiary's ability to bear the tax burden. The end result: a direct challenge to the notions of paying only a fair tax for State services and ensuring that taxpayers are able to bear the CGT load.

The above argument appears to be fortified by the results of the correspondence analysis. While SARS respondents saw no relationship between the bunching problem and lock-in effect and the unfairness characteristics used in the analysis, this was not the opinion of the taxpayers. In particular, a sample of the country's tax experts were of the opinion that these phenomenon were, to some extent, associated with an inability to maintain one's standard of life and efforts to uplift the poor.

Unfortunately, while an accrual system of tax may be conceptually desirable it not only poses an administratively impractical solution, but could result in the premature alienation of property in order to pay the CGT on unrealised capital gains. Instead, the State appears to have implemented several relief mechanisms ranging from improved exemptions and deductions to lower tax rates which could assist in compensating for the bunching problem.

Apart from the issue of equity and the bunching problem concern has also been raised about the absence of direct inflation adjustment in the Eighth Schedule to the Act. While the increases in certain allowances and exemptions were well received, the lack of inflation adjustment could result in taxpayers being taxed on nominal and hence artificial gains. In many ways, this could frustrate the lock-in effect and worries concerning double tax challenging the ability of taxpayers to support themselves.

In defense of CGT, the effect of the annual exclusion and the inclusion rate of less than one hundred percent could more than compensate for the lack of inflation adjustment. At the same time, the use of some method of indexing capital gains may prove too complex and administratively onerous to provide practical relief.

Unfortunately, the use of such relief measures may also overcompensate for the effects of inflation and create an incentive to deliberately transform income into capital in order to avoid tax. Such may serve to the detriment of the collection of revenue by the State and the fight against poverty.

8.2.5: Upliftment of the poor

Certain requirements need to be met if a tax system is to be seen as fair. These include:

- Firstly, the relevant tax must be in proportion to taxpayer's ability to bear the tax load.
- Secondly, and related to the first point, the tax must allow for the affordability of the basic necessities of life.
- Finally, the tax must not be a tax on a capital asset used to generate an underlying source of income.

In this context, one side of the argument regarding the perceived fairness of CGT is that the introduction of the tax improved the tax system by requiring a white minority in possession of the majority of the nation's wealth to pay a proportionately higher share of the tax burden. This would appear to be consistent with Smith's (1776) notion of 'in proportion to their respective abilities'. In turn, this would spare the black proletariat from having to carry an undue tax burden in light of the impoverished condition Apartheid relegated them to.

This argument is refuted, however, by some who maintain that CGT may not be assisting in the upliftment of the poor and ensuring that less wealthy taxpayers are not subject to a disproportionately high tax burden. This conviction is based on the positive correlation between capital levels and labourers' wages and the adverse effects that CGT may have on capital growth. In this light the words of Voster are relevant: 'the poor are not helped by the destruction of the rich' (Voster, 2000: 125).

The apparent unfairness of the tax is further highlighted when considering its effects on BEE deals, PBO's and recreational clubs. Part of the requirements for a fair tax system is that the system does not impose an undue burden on the taxpayer such that he is unable to enjoy the basic necessities of life.

Given the role that PBO's and many recreational clubs play in supporting their local communities, the limiting effect of CGT on these bodies may impair their ability to provide often impoverished people with access to basic necessities. At the same time, CGT provisions frequently provided numerous obstacles for empowerment deals undermining the chances for successful transformation and the upliftment of the previously disadvantaged.

These concerns are brought to the fore by the correspondence analysis contained in Chapter 7. Based on the analysis, it appears that taxpayers associated the taxing of PBO's, recreational clubs and BEE deals as imposing an undue burden on taxpayers in the form of an excessively high tax charge. The results of the analysis were, however, not conclusive. SARS respondents did not agree fully with the taxpayers who participated in the survey. In addition, the taxpaying respondents did not directly associate the subjecting of such organizations or schemes to CGT definitively with a threat to the upliftment of the poor.

Accordingly, SARS (2001, 2006 and 2007) has rallied to the defense of CGT noting that the limited exemptions from CGT offered to recreational clubs struck a delicate balance between ensuring that these bodies were not subject to an undue tax burden while at the same time, promoting fairness by not affording these bodies a clear tax advantage over other organizations offering similar services but forced to pay CGT. As far as the concerns surrounding BEE deals are concerned, numerous amendments have been made to the Act including the introduction of Part III of the Act and the proposed streamlining of this part's key sections to ensure better applicability.

The final aspect of this chapter concerned the effect of CGT on savings levels and small businesses. Skeptics have forwarded the motion that, by eroding the supply of venture capital financing, the number of new successful start-ups is reduced. This calls into question if CGT attacks the very ability of taxpayers to earn incomes and hence carry, not only the CGT burden, but the total direct and indirect tax load. This may be particularly poignant given South Africa's high unemployment rate.

The counterargument is that empirical evidence exists to suggest that a zero CGT rate may not be the most elegant economic solution while numerous relief measures, such as the exemptions afforded by para 57 of the Eighth Schedule to the Act, have been introduced into the Act. Unfortunately, while, empirical evidence exists to show that investments in small businesses were not adversely affected by CGT, there is also empirical evidence to support the counter argument: that the tax does have negative consequences for capital investment in emerging sectors. The result is that while the argument that CGT does not act as a disincentive to small business start-ups is a reasonable one, there appears to be no irrefutable evidence to support this claim.

Related to the ability of taxpayers to support themselves was then the question surrounding the perceived fairness of CGT given its effects on savings levels. Proponents of CGT have argued that the tax encourages savings and, in turn, the need to provide for one's essential living expenses, particularly in old age. By providing exemptions under para 55 of the Eighth Schedule to the Act, the fiscus also seeks to ensure that taxpayers' capital bases are preserved. In addition, by promoting savings, and hence the funds available for the financing of new enterprises and State expenditure, the tax may even assist in the development of the nation's capital rather than erosion of its capital base.

Nevertheless, critics point out that the application para 55 of the Eighth Schedule to the Act may be fraught with difficulties and that empirical evidence has, to some extent, suggested that there is an inverse relationship between the CGT rate and level of savings, refuting the apparent benefits identified previously. They maintain that CGT has negative effects on the levels of savings and that by lowering savings levels, the availability of capital for new business start-ups is threatened; job security becomes problematic; and the ability of taxpayers to maintain themselves are undermined.

In addition, a reduction in savings levels can make it more difficult for taxpayers to meet unforeseen expenses, and hence have sufficient funds for key life necessities.

Ultimately, the question of whether or not CGT is promoting the upliftment of the poor while complying with Smith's (1776) definition of tax fairness is a complex one. As such, the reaching of a definitive conclusion is unlikely.

8.2.6: Final Note

The nature of the research question: whether or not CGT is aligned with the principles of tax fairness as advanced by Smith (1776) is a subjective one. On one hand, supporters of the tax argue that far from being a form of double tax, it is fair to tax all increases in wealth whether from earning a salary; generating rent; or enjoying capital gains. Such would go to ensuring that the State's revenue was boosted allowing for additional social investment, critical if the country is to address its high unemployment rate. At the same time, the tax on capital could act as a key anti-avoidance mechanism by removing the existence of a tax free growth in wealth while compelling wealthier taxpayers, in possession of the majority of the nation's capital, to pay additional taxes. Ultimately, the result is that the rich bear a larger tax burden, sparing the poor an undue tax load, consistent with part of Smith's (1776) definition: in proportion to their respective abilities.

Opponents of the tax appear to suggest the exact opposite. They reject the belief that the taxing of capital is fair arguing that it gives rise to a possible double tax, frustrating the ability of taxpayers to maintain themselves and their families. This shortcoming is then compounded by high administrative costs; a lock-in and bunching problem; and a disincentive to business start-ups. In such a context, the very capacity of taxpayers to be in a post tax position that allows for the enjoyment of the necessities of life is impaired.

In many instances, the arguments in favour of CGT are simply met by equally compelling counterarguments. For example, the use of the annual exclusion and partial inclusion rates to calculate taxable capital gains was shown to more than compensate for the lack of inflation adjustment and the possibility of taxpayers being taxed on artificial gains.

In response, however, CGT critics note that such relief measures may be over-compensatory challenging the notion of paying a fair *quid pro quo* for State services. These measures may also create an impetus for anti-avoidance schemes frustrating concerns about the fairness of CGT.

Similarly, while amendments to the Act have been made to address CGT difficulties experienced when structuring BEE deals, worries remain that the amendments remain ineffective. This may act to the detriment of the upliftment of the poor and previously disadvantaged.

In order to add to the debate the research complemented the content analysis detailed above with a correspondence analysis based on the interpretations of tax experts, representatives from SARS and ordinary taxpayers. While the analysis yielded additional insights into what some South Africans thought about the fairness of CGT, the results were inconclusive for several reasons:

- The data may reflect the biases of the parties questioned or desire on their part to provide a response that is socially acceptable rather than genuine reflection of opinions.
- Due to time constraints and the limited number of tax representatives from SARS and various professional bodies, sample sizes had to be limited thus impairing the usefulness of the data for drawing inferences for the entire population.
- Perhaps most notably, ordinary taxpayers may have lacked the technical prowess to fully assess the questions posed to them and provide an answer based upon detailed and complete knowledge of the relevant facts.

Further compounding the problem was the apparent lack of sound statistics, particularly in the form of macroeconomic information from a South African context. This is frustrated by non-disclosure of the exact revenues and costs generated and incurred respectively because of CGT on the part of Treasury.

Accordingly, future research may be needed in several areas. This could include:

- The examination of alternative definitions of tax fairness and which may be most appropriate in a South African context.
- To add to the debate on the perceived fairness of CGT in South Africa, empirical evidence of whether or not and if so, to what extent CGT results in a locking in of capital gains. Similarly the quantification of the relationships between CGT and the number of new business start-ups in a South African context may be desirable.
- The use of alternative quantitative tools to corroborate or dispel the information generated from the correspondence analysis. Ideally, such methods should rely on larger, more diverse samples in order to remedy the limitations identified in Chapters 1 and 7.
- To better understand the shortcomings of CGT in so far as tax fairness is concerned, it may be insightful to conduct a similar analysis to that used in this report in other jurisdictions levying CGT

Ultimately, the subjective nature of the research question makes the reaching of a definitive solution and the quantification of the lack of fairness inherent in the Eighth Schedule to the Act impossible. The research has however been able to achieve two key objectives. Firstly, it has re-examined some of the key concerns regarding fairness of CGT raised at the time CGT was first proposed. Secondly, it has examined certain amendments to the Act that have either remedied or aggravated some of those original concerns. In this way, the report adds to our knowledge on whether or not taxpayers and the tax gatherer regard CGT as innately unfair.

Annexures

Annexure A: Pilot Study Results

A1: Pilot study interpretations

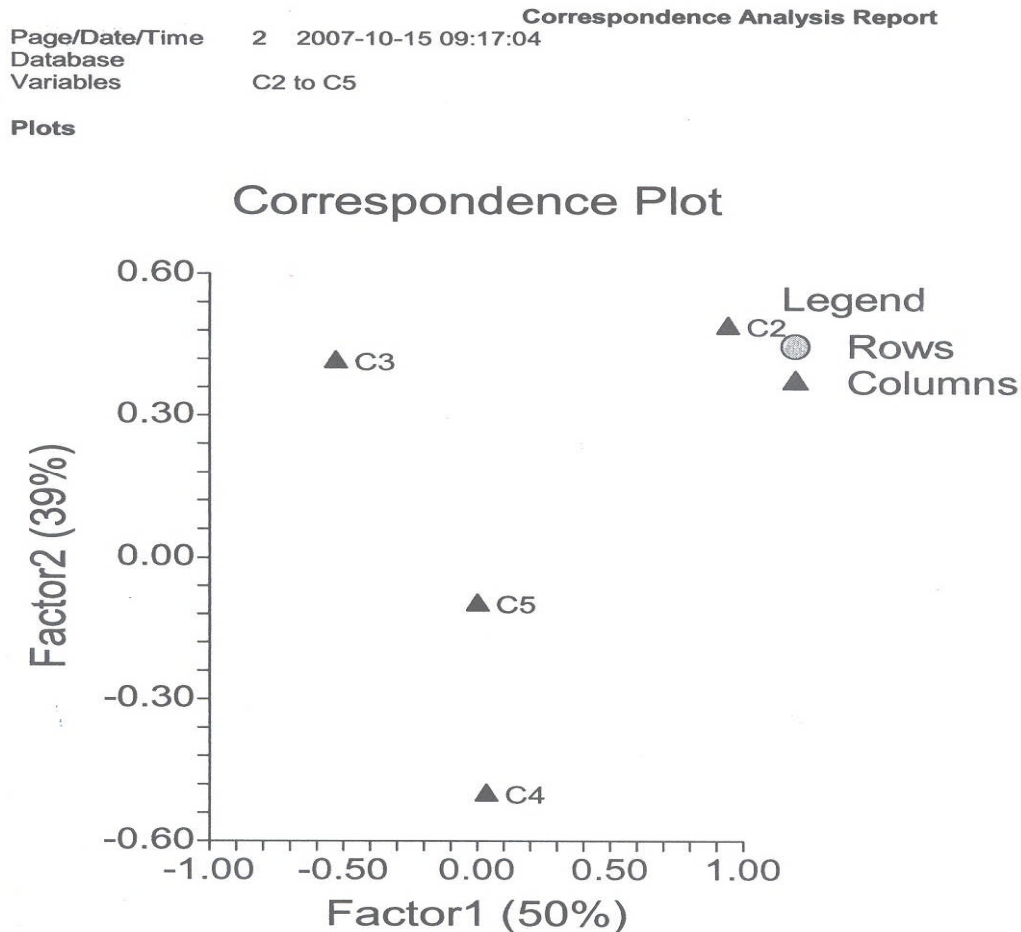
A pilot study based on twenty participants who are either chartered accountants or tax honours students was conducted. After these participants completed their respective tables, they were encouraged to comment on the clarity of the survey to ascertain whether the language was concise, clear and unambiguous. They were also questioned to determine whether their understanding of the characteristics and lack of fairness criteria were in line with the essence of the underlying literature and hence, the objectives of the research report. In this regard, no material problems regarding the tableau were brought to the researcher's attention. Where difficulty in understanding the traits were identified, additional explanations were furnished. Details of these explanations are contained in Annexure A2 and will be made known to recipients who participate in the formal survey. To this end, the explanations will be attached to the table when distributed to participants in the formal study. As a final safeguard, the tableau and explanation of certain traits was reviewed for understandability and accuracy by the University of the Witwatersrand, School of Accountancy's tax division. No material modifications were recommended.

The statistical analysis suggests that even though the data was presented in only two dimensions, the richness of the results was not materially impaired with approximately eighty-nine percent of the data's detail being retained.

Further, based on the relative inertias of the various traits the poles of the axis used to define the region are possibly as follows:

- The positive *y-axis*: characteristics one, nine and ten.
- The negative *y-axis*: characteristics eleven, twelve, seventeen and eighteen
- The positive *x-axis*: characteristics two and three
- The negative *x-axis*: characteristics four and five.

A graphical representation of the correspondence analysis based on the pilot study is presented below:



Based on the diagram above, it appears that a significant number of respondents associated the taxing of equity instruments, the deemed disposal resulting on death, and the taxing of the wealthy as being associated with double tax (C2). At the same time, the identification of possible double tax inherent in these CGT traits was also associated strongly with a belief that such meant that taxpayers were no longer paying a fair *quid pro quo* for State services.

In a similar fashion, the pilot study reveals a preliminary belief that the bunching problem and the disincentive to small business start-ups that CGT may result in potentially undermined a taxpayer's ability to support his family (C3).

The fact that CGT:

- offered the potential benefit of horizontal equity; and
- that mechanisms to provide relief to small business owners had been put in place

may also not be seen as materially improving the lot of taxpayers. This is supported by the significant association between the 'inability to support ones family' unfairness characteristic and these two traits. Preliminary analysis also suggests that respondents believed that the lock-in effect and administrative load created by CGT undermined the belief that taxes should represent no more than a fair payment for state Services (C3).

In conclusion, the results of the correspondence analysis largely appear to be consistent with some of the key arguments contained in the literature on the perceived fairness of CGT. While the respondents appeared to believe that the various traits of CGT corresponded with one or more unfairness criteria, one of these criteria, the inability to promote the upliftment of the disadvantaged (C4), did not, however, appear to be highly correlated with any of the CGT traits. This is seen in the fact that this characteristic exhibits a close proximity to the origin. This may highlight a genuine perception of the tax fraternity, but could also be indicative of inconsistency due to a small sample size.

A.2: Details of additional explanations given to survey participants

Trait no.	Description	Additional explanation
1	Sale of an equity instrument which is capital in nature is subject to CGT (para 2 of the Eighth Schedule to the Act).	The trait deals only with equity instruments as it specifically seeks to test the arguments presented in the literature on such assets.
2	Capital losses are ring- fenced (para 7 to para 9 of the Eighth Schedule to the Act).	No queries raised
3	On death, a taxpayer suffers a deemed disposal reducing the heir's inheritance (para 40 of the Eighth Schedule to the Act).	This statement deals with the concern that if the deceased is subject to CGT, the heir's inheritance is reduced potentially resulting in him having to consume his assets rather than merely the fruits of those assets.
4	CGT discourages capital gain realizations as CGT normally arises only on a deemed disposal.	No queries were raised
5	CGT encourages capital loss realizations as the capital loss is then available for set-off against capital gains resulting during the tax year.	No queries were raised
6	CGT prevents domestic revenue being converted into tax free capital gains.	The introduction of CGT was, in part, to ensure that taxpayers were not able to transform income into capital in order to avoid tax. The trait thus deals with the introduction of CGT in 2001.
7	CGT prevents foreign revenue being converted into tax free capital gains	This trait is similar to the previous.

Trait no.	Description	Additional explanation
8	CGT requires detailed supporting documentation (part I and II of the Act).	This statement deals with whether participants feel that the indirect cost of CGT in the form of its administrative load are excessive and thus, unfair.
9	Steps to simplify administrative requirements for CGT have been taken.	This statement deals with whether participants feel that the steps taken to reduce the indirect cost of CGT in the form of its administrative load are adequate. In other words, do participants feel that certain amendments dealing with record keeping has remedied any unfairness identified in the previous trait?
10	CGT taxes the wealthy.	No queries were raised
11	CGT promotes the equal taxing of taxpayers in equal economic positions	No queries were raised
12	Inclusions under s 26A of the Act are not subject to s 7A(4A) of the Act.	In essence, two alternatives are possible. In essence we could tax capital gains as they are earned or at least subject them to the rating formula (in the case of individuals) to prevent taxpayers being subject to a higher than usual rate of tax. The second alternative does not enjoy these benefits but does avoid a cash flow problem for taxpayers.
13	There is no direct inflation adjustment in the Eighth Schedule to the Act.	No queries were raised
14	PBO's are not subject to full CGT exemption.	By not exempting PBOs in full from CGT, the state undermines their ability to support the poor. The counterargument is that by fully exempting them, PBOs may be given an unfair competitive advantage over other, non-exempt businesses.
15	Recreational clubs are subject to certain CGT exemptions.	This trait seeks to explore whether or not respondents feel it fair that recreational clubs are entitled to certain CGT relief, including the deferral of CGT on the disposal of replacement assets. By granting this relief, recreational clubs, such as soccer leagues, could provide better services to their patrons and local community. On the other hand, such may grant them an unfair competitive advantage over entities that do not enjoy CGT relief.
16	The CGT effects of s 41 to s 47 of the Act pose difficulties for BEE deals.	An example: while s 45 offers some CGT relief, compliance with its requirement can prove challenging. The state has, however, proposed a number of amendments to remedy these shortcomings.
17	CGT acts as a disincentive to business start-ups.	The literature argues that if suppliers of capital know that the sale of new ventures may result in CGT, they become less inclined to finance these new businesses. Indirectly, this may impair the ability of taxpayers to find employment and support their families.

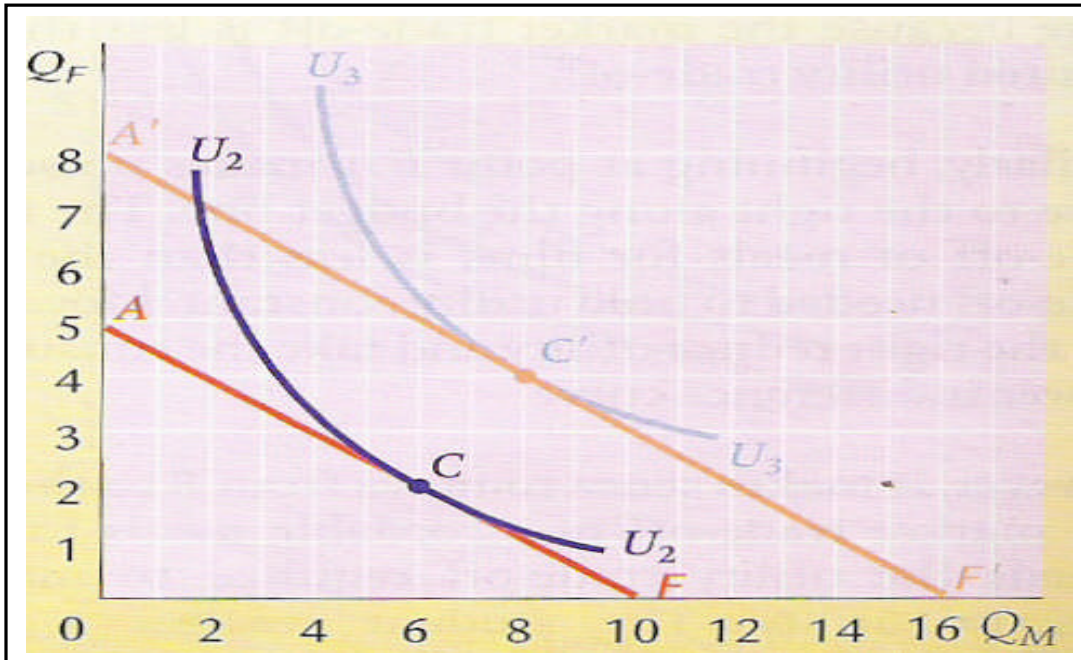
Trait no.	Description	Additional explanation
18	Small business exemptions (para 57 of the Eighth Schedule to the Act) and deductibility of capital losses from capital gains (para 7 of the Eighth Schedule to the Act) are possible	This tests whether respondents feel that the remedial action to address the problem above is adequate i.e. whether or not the amendments are fair.
19	The new three year rule (relating to the minimum period shares need to be held in order to constitute a capital disposal) discourages speculative investing.	The literature argues that by discouraging speculative investment taxpayers are guided towards more prudent saving habits creating a more liquid economy and improving the ability of taxpayers to finance necessary expenditure. The counterargument is that taxpayers will decide on their own risk appetite and that the proposed amendment to the Act will not achieve its desired result.

Annexure B: Supporting Explanations

B1: The relationship between capital, labour and the tax rate

B1.1: The simple effect of an increase in the CGT rate.

In order to analyse the effect that CGT will have on the demand for capital inputs, we assume that the consumer will rely on the disposal of existing capital assets in order to finance new ones. The effect of the introduction of CGT is thus a decrease in the post tax proceeds from the disposal of existing capital assets and, in turn, a decrease in the funds available for the acquisition of a new capital asset. Alternatively, we can think of CGT in terms of its effect on the cost of a new capital asset. Namely, that in order to acquire a new capital asset, more pre-tax proceeds will be required. This captures the basic effect of CGT: that less money will be available to purchase new capital goods. The effect is shown diagrammatically below:



(Courtesy Begg, 2003:62.)

We make a number of assumptions in order to simplify the diagram above and calculations:

- The supplier requires only two capital inputs to operate. This avoids the need for multidimensional calculus.
- The effective rate of CGT is fourteen and a half per cent and applies equally to both capital inputs.
- The entity has set a net present cost for capital assets which is the definitionum cost it is prepared to incur over the life of its capital assets; that is that there exists some form of budgetary constraint.
- The capital assets all have the same useful lives.
- There are no capital losses or asessed losses to be carried forward to the next year of assessment.

The slope of the net present cost line depends only on the prices of the two inputs relative to each other. Since CGT is applied to both, the relative price remains the same but the effect of CGT will mean a higher net cost since, on sale of capital assets, an amount of tax will be levied on the gains.

Had no CGT been applied, the entity would avoid the tax payment at the end of the assets' useful lives. Accordingly the net present cost of the decision to buy the capital assets for any discount rate - all else equal- would be lower.

Thus, if we start the analysis with no CGT, the net present cost curve is given by AF. The effect of the higher costs imposed by the introduction of CGT means that, for a given capital budget, less capital investment could now occur. The net cost line (the budget line) shifts downwards to AF. As discussed, since we assume that both inputs attract CGT, the slope of the cost curves remains the same.

To determine the optimal quantities of the two capital inputs, we need to apply an indifference curve map. The optimal combination of the two inputs will be given by the points where the indifference curves are tangent to the cost function.

The indifference curves are defined as 'showing the bundles [of the two inputs] which yield the same [profits]'. (Begg, 2003:8.) In this example, the indifference curve U_3 would represent a profit level that is higher than that represented by U_2 . Alternatively, we can also think of U_3 as representing the amount of capital good M that must be given up to acquire one more unit of capital good F or *visa versa*. U_3 is therefore better than U_2 as it requires a rate of substitution of the one good for the other that yields a higher level of utility (a measure of satisfaction or profit). Using the indifference curves U_3 and U_2 , the optimal combinations are given by C' and C respectively.

The analysis reveals that the firm's investment in capital assets will fall, with lower quantities of both inputs being used at C than at C'. This would also suggest a decrease in the level of production and profits, seen in the movement from U_3 to U_2 .

(The above analysis was adapted from: Begg, 2003:58-64.)

B1.2: The income and substitution effect

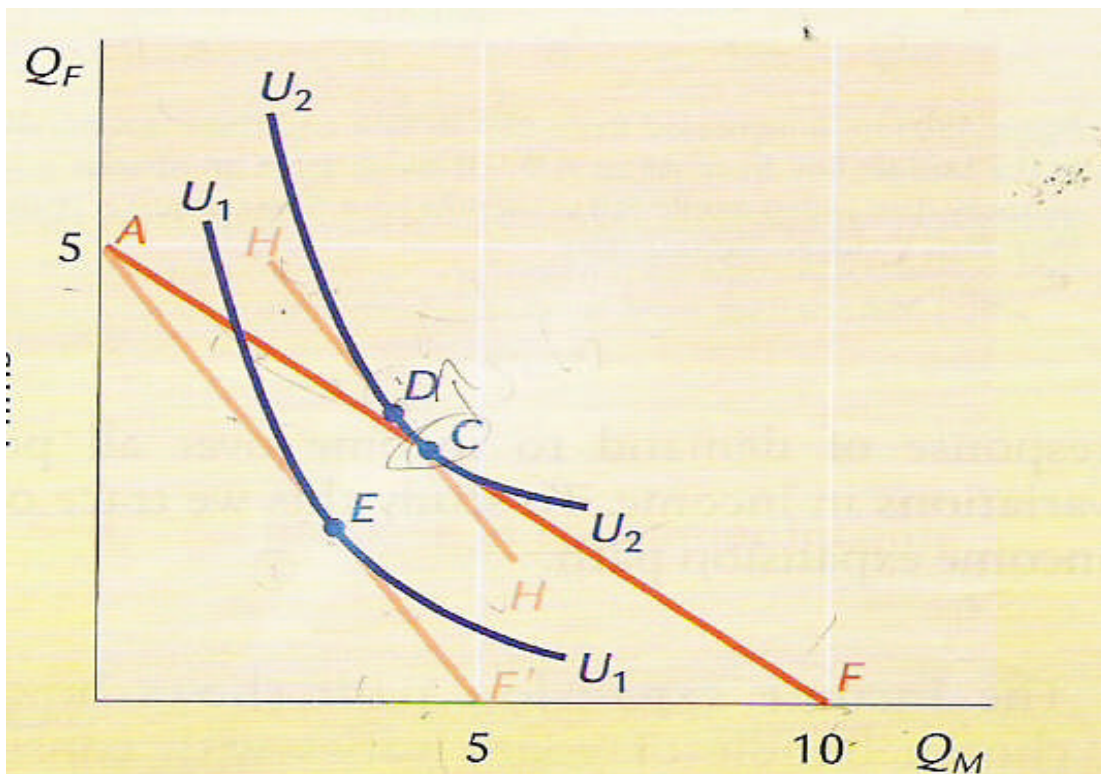
The effects of CGT may be more complex if we consider the relationship between capital and non-capital (labour) inputs to production. For this analysis, we represent capital inputs as M and labour inputs as F . At the original level of costs, the investor - or consumer of the inputs - is faced with the budget line AF and chooses the combination of capital and labour represented by the point C . This is determined by applying a map of indifference curves similar to the approach followed in the previous example.

The increase in costs as a result of the introduction of CGT rotates the budget line inwards to its new position AF' . Unlike the previous scenario, the budget line no longer remains parallel to the original budget line because CGT only imposes an added cost on the capital goods, leaving the cost of labour (a non-capital good) unchanged. Thus, relative to the capital goods, the labour has become cheaper and thus the budget line has rotated inwards to reflect this. The consumer now chooses the combination capital and labour inputs denoted by the point E given the set of indifference curves that he faces.

The introduction of CGT has thus resulted in a decrease in both of the inputs used by the consumer as shown from the change in the optimal combination of capital and labour from points C to E . This effect can, however, be better understood by decomposing the movement from C to E into the income and substitution effect of CGT.

To determine the substitution effect we superimpose a budget line (HH) parallel to the new line AF' . Since HH is parallel to the new budget line, this suggests that HH reflects the new prices of capital and labour in the context of CGT. By ensuring that HH is tangential to the original indifference curve, we can determine how the consumer would respond to the higher cost of capital relative to labour if the consumer were still able to afford the original level of inputs. The substitution effect - being the effect of a change in the quantity of labour and capital consumed as a result of the change in the relative prices of the two commodities alone - can now be seen. The effect is an increase in the quantity of labour and decrease in the quantity of capital inputs needed to achieve the same output and profit level; hence for the curve HH to still be tangential to U_2 .

If we wish to isolate the income effect, we must analyse the movement from points D to E. By considering the parallel shift from HH to AF', we are able to isolate the effect that CGT has as a result of the added cost it imposes on the consumer. Alternatively, we could think of the effect that CGT has as a result of the decrease in post-tax income. The effect is a decrease of both labour and capital inputs required. The effects are captured diagrammatically below.



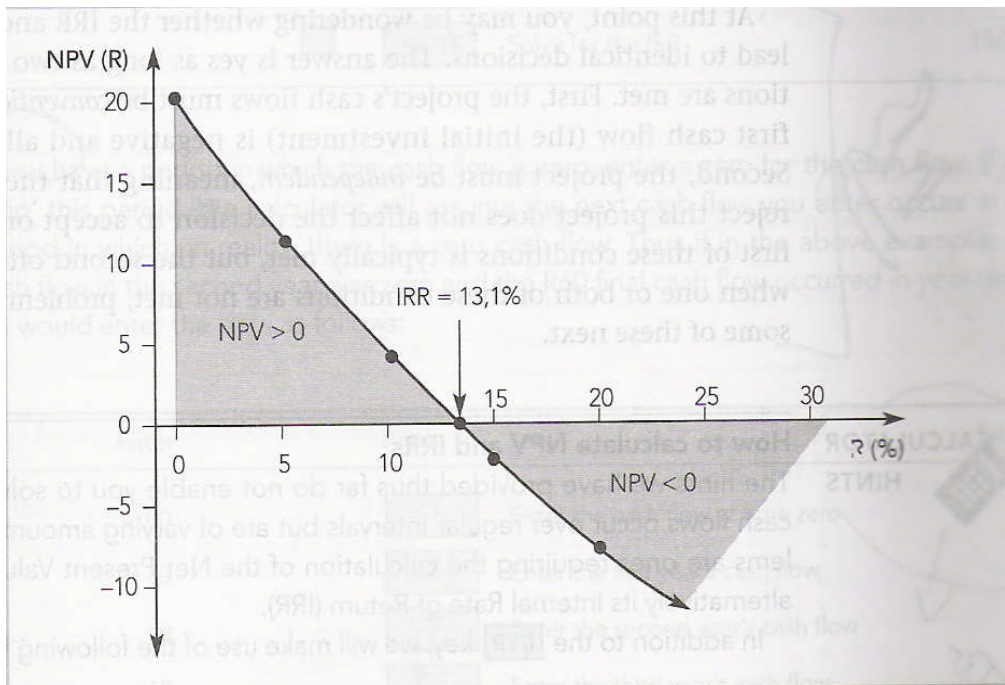
(Courtesy Begg, 2003:64.)

(The analysis of the income and substitution effects was adapted from Begg, 2003:64-66.)

In this way, the analysis reveals that an increase in the CGT rate results not only in a reduction of capital inputs used, but also the quality of labour. This reduction in the demand for labour must translate into an excess supply (unemployment) and a potential fall in the wage rate to restore equilibrium to the labour market. Ultimately, some taxpayers will be left less able to provide for themselves and their families.

B.2: The cost of capital and investment decisions

The economic rationale behind the internal rate of return (IRR) and required rate of return is explained by Fama *et al* (2004) in 'The Fundamentals of Corporate Finance'. The IRR is simply the discount rate that causes the net present value (NPV) of a project to be zero. An investment is accordingly accepted if the IRR exceeds the required rate of return as this would suggest that the NPV of the project is positive and thus creates wealth (Fama *et al*, 2004: 261-269). For convenience, the relationship between the IRR and required return is shown below:



(Courtesy Fama *et al*, 2004, 293)

The IRR in this example is approximately thirteen percent. Thus any required rate of return for a project that is lower than thirteen percent means that the project should be accepted as it yields a positive NPV. Similarly, a required return greater than thirteen percent results in a negative NPV and hence an investment that destroys value.

The required rate of return may be equated with the weighted average cost of capital (WACC). The WACC is determined using the following simplified equation:

$$WACC = (E/V)(R_E) + (P/V)(R_P)(1+t_c) + (D/V)(R_D)(1-t) \dots \dots \text{Formula B2.1}$$

(Firer *et al*, 2004: 473-474)

The introduction of CGT and the fact that its effective rate is not the same as the normal tax rate applicable to taxpayers has, however, necessitated a refinement of the capital asset pricing model used to determine R_E :

'Estimates of the cost of equity based on [the unrefined model, when] compared with estimates based on the version of the CAPM typically applied in Australia, which differs only in assuming equality of the tax rates on capital gains and ordinary income [produced differences]. The differences between the estimates can be material. In particular, with a high dividend yield, allowance for differential taxation can result in an increase of two to three percentage points in the estimated cost of equity' (Lally and Zijl, 2003: 187)

In light of this research a revised, albeit simplified approach, to calculate the required rate of return could be to adjust the return on equity for the effect of CGT. Thus:

$$WACC = (E/V)(R_E)(1+t_c) + (P/V)(R_P)(1+t_c) + (D/V)(R_D)(1-t) \dots \dots \text{Formula B2.2}$$

(Adapted from Lally and Zijl, 2003 and Swartz, 2007, pers. comm., 12 Aug)

Each of the symbols has the following meaning:

<i>Symbol</i>	<i>Explanation</i>
E	The market value of ordinary equity
P	The market value of preference shares
D	The market value of debt
V	The market value of the firm
R_E	The market return on ordinary equity
R_P	The market return on preference shares
R_D	The market return on debt
T	The normal tax rate
t_c	The tax attributable to capital gains (CGT)

Contrasting formula B2.1 and B2.2 highlights that the introduction of CGT or the raising of the effective CGT rate will thus result in an increase in the WACC. The conceptual underpinning is that in the presence of CGT investors realise that some of their returns will be of a capital nature and no longer exempt from tax. To be left in the same economic position as before the tax, and hence have command over the same resources, they demand a higher return on the investment (Swartz, 2007, pers. Comm: 12 Aug). This postulation is supported by empirical evidence collected by Moore and Silva (1995) detailed below:

Capital Gains Taxes Rates and Required Rate of Return on Various Investments

Type of Investment	Required Rate of Return under Zero Capital Gains	Required Rate of Return under 28% Capital Gains
	Tax	Tax
Corporate equity with 3% growth of corporate assets	12.7%	15.1%
Assets yielding no taxable income with 3% annual increase in asset price ^a	7.0	8.7
Owner-occupied housing	10.0	10.6
Producers' durable equipment	14.5	15.5
Rental structures	14.0	15.5

Source: Kopcke R: 'No Gain, No Pain: Some Consequences of Taxing Capital Gains,' *New England Economic Review*, March-April 1989, pp. 39-55. Note: All examples assume investors' required rate of return is 10 percent and that the assets are held for five years ^a. Examples include works of art and natural resources.

(Courtesy Moore and Silva: 1995)

The formula used to derive the WACC is thus corroborated by Moore and Silva (1993). He notes that the introduction of CGT had a profound effect on the total cost of new financing in both the USA and UK where up to a half of the increase in the cost of financing could be attributable to CGT (Moore and Silva, 1995: 9-11).

As explained, a project is accepted if the WACC is exceeded by the IRR of the investment. The introduction of CGT, as shown in the table above, will result in an increase in the required return (WACC) demanded by investors and thus a reduced probability that the IRR will exceed the WACC. The higher the cost of capital (as shown on the x-axis), the more likely it is that the net present value (NPV) of the project is negative, reflecting the growing excess of the cost of capital over the IRR. Alternatively, for a higher cost of capital, a larger IRR will be required in order for an investment to appear desirable. This results in a decline in the level of investments and hence capital formation that further leads to a decline in economic activity (Moore *et al*, 1995: 9-13).

This concern is supported by empirical evidence gathered in the USA which highlights the consequence of the higher cost of capital: that the effect CGT may ultimately be an impairment of investment levels and economic growth. Data gathered over the last decade suggests that the introduction and subsequent increase in the CGT rates 'caused and observable slowdown in the rate of growth in the USA'. In a study conducted for the Means Committee (1995) on the possible effects of a decrease of the effective CGT rates in the USA by half, the following was highlighted:

Economic Effects of GOP Capital Gains Tax Cut	
Effect	Percentage Change
Growth rate of GDP	0.7
Capital spending- Total	2.1
Capital spending- Equipment	1.6
Capital spending- Structures	3.6
Capital spending- Cost of capital	-3.7
Source: Allen Sinai, Testimony before the House Ways and Means Committee, January 24, 1995. Cited in Moore and Silva, 1995	
(Courtesy Moore and Silva, 1995: 55)	

The empirical results imply that the level of investments, and hence the growth rate of the economy, is 'indeed sensitive to changes in the rate at which capital is taxed'. In this context, a reduction of the effective CGT rate will stimulate the level of growth in the economy (Moore and Silva, 1995: 12).

B3: The effect of inflation on CGT

B3.1: Detailed inflation adjusted calculations

An investor acquires one share for R100 in January 2006. The Reserve Bank has sought to keep inflation in a three to six percent band. Assuming that the inflation for 2006 averaged five percent and the investor sells the share in January 2007 for R150, what will the capital gain be?

	<i>Nominal gains</i>	<i>Inflation adjusted gains in year of disposal</i>
Proceeds	150	150
Base cost	100	105
Capital gain	50	45

Thus, an investor is taxed on the nominal gain and is effectively overtaxed on R5 per share. The situation is more pervasive if the shares are held for a longer duration. If we apply the above principles but assume the shares will be held for fifteen years during which time CGT applies and the inflation rate is five percent:

	<i>Nominal gain</i>	<i>Inflation adjusted gains in year of disposal</i>
Proceeds	150	150
Base cost	100	208
Capital gain	50	(58)

In this scenario, an investor suffers a real capital loss yet will be taxed on the nominal gain made on the disposal. He is overtaxed on R108 per share.

(Example adapted from Cordes, 2000: 2).

This example may be extended by considering a more practical scenario involving an investor with a capital investment in Sasol shares, a petro-chemical company listed on the JSE Securities Exchange. The example assumes that:

- The shares were acquired on 15 July 2002.
- That on that date, R300 000 was invested in SASOL shares.
- The shares are sold on 16 July 2007. Thus the rates applicable to the 2008 year of assessment (as opposed to the 2009 year of assessment) will be used.
- The shares are bought and sold using the online dealing services offered by BOE.

To calculate the capital gain, we would need to subtract the base cost of the shares from the proceeds derived on the sale of those shares (para 3 of the Eighth Schedule to the Act). The base cost will include the acquisition price of the share as well as the costs directly attributable to their acquisition and disposal, in this instance, the BOE transaction costs (para 20 of the Eighth Schedule to the Act).

In order to calculate the inflation adjusted gain, we use the following formula:

$$G = R_s(1-C_s) - R_a(1+C_a) \dots\dots\dots (Formula B3.1.1)$$

If we express R_a as $P \times Q_s / Q_a$ then

$$G = R_s(1-C_s) - (P \times Q_s / Q_a)(1+C_a) \dots\dots\dots (Formula B3.1.2)$$

(Roxo: 2007, pers. comm., 24 October).

Paragraph 20 of the Eighth Schedule to the Act, however, requires the transaction costs both on acquisition and disposal to be added to the base cost. The above formula simplifies the calculation by accounting for the transaction costs on sale as reducing the proceeds on disposal rather than increasing the base cost. A slight manipulation of Formula B3.1.2 brings it in line with the definition of a share's base cost per para 20 of the Eighth Schedule to the Act:

$$G = R_s - [(P \times Q_s / Q_a)(1+C_a) + (R_s \times C_s)] \dots\dots (Formula B3.1.3)$$

(Adapted from Roxo, 2007, pers. Comm., 24 October)

Each symbol has the following meaning:

<i>Symbol</i>	<i>Explanation</i>
G	The real capital gain
R_s	The real value of the shares on 16 July 2007
C_s	The transaction costs on sale of the shares in 2002 prices
R_a	The real value of the shares bought on 15 July 2002 expressed in terms of 2007 prices
C_a	Transaction costs on acquisition in 2002 prices
P	Price of shares on 15 July 2002 in 2002 prices
Q_s	Value of the CPI Index on 16 July 2007
Q_a	Value of the CPI Index on 15 July 2002

(Roxo: 2007, pers. comm., 24 October)

According to BOE (<https://boepersonal.nedsecure.co.za/Services/Costs.aspx>), transaction costs are as follows:

Online deal consideration	Online Brokerage Rate	Deal Consideration	Fee paying brokerage rate	Non fee paying brokerage rate
	Min charge of R70 per deal			
Up to R300,000	0.7%	Up to R25,000	1.00%	1.5%
R300,000 to R750,000	0.5%	R25,000 to R35,000	0.75%	0.95%
R750,000 to R1,000,000	0.45%	R35,000 to R50,000	0.70%	0.95%
R1,000,000 and above	0.35%	R50,000 to R75,000	0.70%	0.85%
		R75,000 to R150,000	0.65%	0.75%
		R150,000 to R200,000	0.60%	0.70%
		R200,000 to R250,000	0.55%	0.60%
		R250,000 to R750,000	0.45%	0.50%

Online deal consideration	Online Brokerage Rate	Deal Consideration	Fee paying brokerage rate	Non fee paying brokerage rate
		R750,000 to R1,000,000	0.40%	0.45%
		R1,000,000 and above	0.35%	0.40%
		Minimum charge per deal	R100	

(Courtesy BOE, 2007 (adapted))

To calculate the real capital gain per Sasol share we use Formula B3.1.3:

Assuming the investor spent R300 000 on 15 July 2002 when the price per Sasol share was R92.57 (www.boe.co.za), he would have acquired 3 240 shares. Assuming further that the transaction was executed using internet dealing services offered by BOE, the transaction costs would have been based on 0.7 per cent of the deal consideration.

When the shares are sold on 15 July 2007, the ruling price was R275.44 (www.boe.co.za) yielding a total consideration received on the sale of the shares of R892 426. Again, assuming that the transaction was executed using the internet dealing services offered by BOE, the transaction costs would be approximately 0.45 per cent of the deal consideration. The inflation indices used are contained in Annexure B3.2 below. Inputting this information into Formula B3.1.2, the following capital gain is realised per share:

$$\begin{aligned}
 G &= 275.44 - [92.57(1+0.007) (144.4/116.3) + (275.44 \times 0.0045)] \\
 &= 275.44 - 116.98 \\
 &= 158.46 \text{ capital gain per share}
 \end{aligned}$$

Contrasting the above result with the nominal capital gain per share yields the following:

Capital gain per share		
	Nominal gain	Inflation adjusted gain in year of disposal
Proceeds	275.44	275.44
Base cost	94.46	116.98
Capital gain	180.98	158.46

Thus, if the investor sold the original 3 240 shares, he would pay an additional R22.52 capital gain per share or an additional R72 965. This represents a premium of approximately fourteen per cent over the real capital gain, lending support to the view that the lack of inflation adjustment could impose an unduly high tax burden on taxpayers.

To gain further insight into this argument, we apply the above results to determine the taxable capital gain under s 26A of the Act for the investor with 3 240 shares, the calculation is as follows:

For an natural person	Nominal results	Real results
Total capital gain	586 375	513 410
Annual exclusion	(12 500)	(12 500)
Aggregate gain	573 875	500 910
Assed losses brought forward	0	0
Net gain	573 875	500 910
Taxable gain (25%)	143 469	125 228
Incremental tax at an assumed effective rate of forty percent	57 388	50 091

<i>For a company</i>	<i>Nominal results</i>	<i>Real results</i>
<i>Total capital gain</i>	586 375	513 410
<i>Annual exclusion</i>	0	0
<i>Aggregate gain</i>	586 375	513 410
<i>Assed losses brought forward</i>	0	0
<i>Net gain</i>	586 375	513 410
<i>Taxable gain (50%)</i>	293 188	256 705
<i>Incremental tax at an assumed effective rate of twenty-nine percent</i>	85 024	74 444

It appears that a lack of inflation adjustment has resulted in an excessive tax burden imposed on the investor. A natural person would be over taxed by some R7 297 due to inflation, or by a approximately fifteen per cent premium on the real tax. Similarly, a company may be overtaxed by approximately R10 580 or an excess of roughly fourteen per cent over the real tax. Again, it appears that the lack of inflation adjustment places an undue burden on taxpayers.

If, however, we consider the effect of the annual exclusion, and the fact that only part of the aggregate gain was included in taxable income, then it appears that the Eighth Schedule to the Act does compensate for inflation. This can be seen by comparing the taxable capital gain with no inflation adjustment to the real capital gain assuming that this substitutes for the real taxable gain. The results are as follows:

<i>For a natural person</i>	<i>Nominal results</i>	<i>Real results</i>
<i>Taxable gain</i>	143 469	513 410
<i>Incremental tax assuming an effective forty percent rate</i>	57 388	205 364
<i>Excess of real over nominal tax effect</i>		147 976

<i>For a company</i>	<i>Nominal results</i>	<i>Real results</i>
<i>Taxable gain</i>	293 188	513 410
<i>Incremental tax assuming an effective twenty-eight percent rate</i>	85 024	148 900
<i>Excess of real over nominal tax effect</i>		61 662

Based on the analysis above, it would appear that inflation indexing would not present the best alternative for taxpayers. Far better is to ignore the direct effect of inflation and compensate for this indirectly by relying on an annual exclusion and partial inclusion rate. This would appear to challenge the view that CGT presents an undue burden for taxpayers due to a lack of express inflation adjustment.

Again, we compare the nominal taxable gain with the real capital gain and assume that the shares were bought on 1 October 2001 when the inflation index is 106.1 and that the market value (R71.30) on the valuation date is used as the valuation date value to definitionise the effect of inflation, the following capital gains result:

<i>For a natural person</i>	<i>Nominal Result</i>	<i>Real Result</i>
<i>Proceeds</i>	892 426	892 426
<i>Base cost</i>	236 645	320 620
<i>Capital gain</i>	655 781	571 806
<i>Annual exclusion</i>	(12 500)	
<i>Net gain</i>	643 281	
<i>Taxable capital gain</i>	160 820	571 806

<i>For a company</i>	<i>Nominal Result</i>	<i>Real Result</i>
Proceeds	892 426	892 426
Base cost	236 645	320 620
Capital gain	655 781	571 806
Annual exclusion		
Net gain	655 781	
Taxable capital gain	327 890	571 806

In this scenario, the effect of the annual exclusion and the partial inclusion rate are still more than adequate to compensate for the lack of inflation adjustment. Indeed the taxable nominal gains is some forty three per cent lower than the real taxable capital gain assuming that inflation indexing is used to substitute for the absence of an annual exclusion and partial inclusion rate. This may be true, even if the share was acquired at or before the valuation date when the growing length of time between the acquisition date and the realisation date would make the effect of inflation more pervasive.

(Adapted from Roxo, 2007, pers. comm., 24 October)

In the above scenario, the inflation index was 106.1 on the acquisition date and 144.4 on the date of disposal yielding roughly a thirty six percent change on the inflation index over the period from 1 October 2001 to 15 July 2007. One may ask what the change in the inflation index would need to be for the real adjusted capital gain to be less than the nominal taxable gain. To this end the formula used to calculate the real gain was:

$$G = R_s - [(P \times Q_s / Q_c)(1 + C_a) + (R_s \times C_s)] \dots \dots (Formula B3.1.3)$$

In order to solve for Q_s / Q_c :

$$G - R_s = - [(P \times Q_s / Q_c)(1 + C_a) + (R_s \times C_s)] \text{ and thus}$$

$$\frac{[R_s - G - (R_s \times C_s)]}{(P \times (1 + C_a))} = Q_s / Q_c \dots \dots \dots (Formula B3.1.4)$$

	<i>For a natural person</i>	<i>For a company</i>
<i>Proceeds</i>	892 426	892 426
<i>Nominal taxable gain</i>	160 820	327 890
<i>Selling costs</i>	4 016	4 016
<i>Net proceeds</i>	727 590	560 520
<i>Total acquisition cost</i>	232 629	232 629
<i>Quotient</i>	3.13	2.41
<i>Index at acquisition</i>	106.1	106.1
<i>Index at disposal</i>	332.1	255.6
<i>Percentage inflation over holding period</i>	213%	140%
<i>Effective annual inflation</i>	22%	16%

Only when the inflation over the holding period begins to exceed 208 per cent (in the case of individuals) or 138 per cent (for juristic persons) would a method of inflation indexing capital gains be desirable. IAS 29 regards defines a hyperinflationary economy as one suffering an inflation rate approaching or exceeding one hundred per cent (IASB, 2005: 1258). Based on the above analysis, it would seem that South Africa would need to experience hyperinflation over the holding period of the Sasol shares before the absence of direct inflation adjustment in the Eighth Schedule to the Act could become problematic.

In this context, it now appears that the application of the annual exclusion coupled with only a partial inclusion of the net gain in the taxpayer's taxable income more than compensates for the effects of inflation. Using real gains rather than nominal ones adjusted by the annual exclusion and partial inclusion rate results in a taxpayer, who is a natural person, paying approximately R300 000 more. Analogously, a company would pay approximately R60 000 more. The above example may thus undermines the belief that the lack of inflation adjustment results in taxpayers being taxed on an artificial gain and hence, that the Eighth Schedule to the Act challenges taxpayers' abilities to bear the tax burden.

(It should be noted that while the rates applicable to the 2008 year of assessment were applied, the same conclusions would be reached for the 2009 year of assessment. This is due to the fact that while the tax rates have been lowered and the annual exclusion has been increased, the fundamental principles used to compute the inclusion under s 26A of the Act have not changed.)

B3.2: Inflation index table

ANNUAL INFLATION ON A MONTHLY BASIS

Metropolitan areas - All Items Base year: 2000 = 100

Year	Index	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Ave.
1978	%	+11,1	+11,1	+9,6	+9,3	+9,3	+9,3	+11,8	+11,7	+13,0	+12,8	+12,8	+11,4	+10,5
1979	%	+11,3	+12,5	+13,8	+12,2	+12,2	+13,4	+14,1	+14,0	+13,8	+13,6	+13,6	+14,8	+13,1
1980	%	+13,5	+13,3	+13,2	+13,0	+14,1	+15,1	+12,4	+11,2	+13,1	+14,0	+15,0	+15,8	+13,7
1981	%	+15,8	+16,7	+15,5	+15,4	+15,2	+14,0	+14,7	+16,5	+16,1	+14,9	+14,8	+13,7	+15,7
1982	%	+13,7	+13,4	+16,0	+16,7	+16,5	+16,4	+14,4	+14,2	+13,1	+13,7	+14,4	+13,5	+14,4
1983	%	+14,3	+14,8	+13,0	+12,9	+12,8	+12,0	+12,6	+12,4	+11,6	+10,7	+10,6	+10,6	+12,6
1984	%	+10,5	+9,7	+10,3	+10,8	+11,3	+11,9	+11,8	+11,7	+11,6	+12,7	+12,6	+13,2	+11,2
1985	%	+13,7	+16,5	+15,1	+16,0	+15,8	+16,9	+16,1	+15,9	+16,9	+16,7	+17,0	+18,5	+16,2
1986	%	+20,9	+17,7	+19,2	+18,2	+17,1	+16,8	+18,7	+19,0	+19,6	+19,4	+19,1	+18,3	+18,8
1987	%	+16,0	+16,7	+16,9	+16,7	+17,5	+17,3	+15,7	+16,3	+15,6	+15,4	+15,3	+14,7	+16,2
1988	%	+14,2	+13,2	+13,4	+12,9	+13,1	+12,3	+12,9	+12,3	+12,2	+12,4	+12,3	+12,5	+12,9

		Index	34,7	35,0	35,6	36,1	36,6	37,0	37,4	37,9	38,2	38,5	39,0	39,5	37,1
	1989		%		+13,4	+13,6	+13,7	+14,2	+14,7	+15,6	+15,4	+15,5	+15,1	+14,6	+15,0
+14,5															

		Index	40,0	40,3	40,9	41,3	41,7	42,0	42,3	43,0	43,7	44,0	44,9	45,2	42,4
	1990		%		+15,3	+15,1	+14,9	+14,4	+13,9	+13,5	+13,1	+13,5	+14,4	+14,3	+15,1
+14,3															

		Index	45,7	46,3	46,7	47,4	48,1	48,4	49,0	49,7	50,4	51,3	51,8	52,6	49,0
	1991		%		+14,3	+14,9	+14,2	+14,8	+15,3	+15,2	+15,8	+15,6	+15,3	+16,6	+15,4
+15,6															

		Index	53,1	53,6	54,0	54,7	55,1	55,7	56,2	56,8	57,2	57,3	57,6	57,6	55,7
	1992		%		+16,2	+15,8	+15,6	+15,4	+14,6	+15,1	+14,7	+14,3	+13,5	+11,7	+11,2
+9,5															
+13,7															

		Index	58,2	58,4	59,2	60,8	61,0	61,3	61,8	62,1	62,3	62,8	62,9	63,1	61,2
	1993		%		+9,6	+9,0	+9,6	+11,2	+10,7	+10,1	+10,0	+9,3	+8,9	+9,6	+9,2
+9,5															
+9,9															

		Index	64,0	64,2	64,6	65,0	65,4	65,8	66,8	67,8	68,6	68,9	69,1	69,3	66,6
	1994		%		+10,0	+9,9	+9,1	+6,9	+7,2	+7,3	+8,1	+9,2	+10,1	+9,7	+9,9
+9,8															
+8,8															

		Index	70,2	70,5	71,3	72,2	72,5	72,4	72,8	73,0	73,1	73,3	73,5	74,1	72,4
	1995		%		+9,7	+9,8	+10,4	+11,1	+10,9	+10,0	+9,0	+7,7	+6,6	+6,4	+6,4
+6,9															
+8,7															

		Index	75,0	75,1	75,7	76,2	76,7	77,4	78,0	78,4	79,2	79,9	80,2	81,0	77,7
	1996		%		+6,8	+6,5	+6,2	+5,5	+5,8	+6,9	+7,1	+7,4	+8,3	+9,0	+9,1
+9,3															
+7,3															

		Index	82,0	82,5	83,0	83,7	84,0	84,2	85,1	85,2	85,6	86,0	85,7	86,0	84,4
	1997		%		+9,3	+9,9	+9,6	+9,8	+9,5	+8,8	+9,1	+8,7	+8,1	+7,6	+6,9
+6,2															
+8,6															

		Index	86,7	86,9	87,5	87,9	88,3	88,6	90,7	91,7	93,3	93,7	93,7	93,7	90,2
	1998		%		+5,7	+5,3	+5,4	+5,0	+5,1	+5,2	+6,6	+7,6	+9,0	+9,0	+9,3
+9,0															
+6,9															

		Index	94,4	94,4	94,4	94,6	94,5	95,0	95,1	94,7	95,1	95,3	95,5	95,8	94,9
	1999		%		+8,9	+8,6	+7,9	+7,6	+7,0	+7,2	+4,9	+3,3	+1,9	+1,7	+1,9
+2,2															
+5,2															

		Index	96,9	96,6	97,6	98,9	99,3	99,9	100,8	101,2	101,7	102,0	102,2	102,5	100,0
	2000		%		+2,6	+2,3	+3,4	+4,5	+5,1	+5,2	+6,0	+6,9	+6,9	+7,0	+7,0
+7,0															
+5,4															

		Index	103,8	104,1	104,8	105,3	105,7	106,2	106,1	105,9	106,2	106,1	106,6	107,2	105,7
	2001		%		+7,1	+7,8	+7,4	+6,5	+6,4	+6,3	+5,3	+4,6	+4,4	+4,0	+4,3
+4,6															
+5,7															

		Index	109,0	110,2	111,3	113,1	113,9	114,7	116,3	116,9	118,1	119,9	120,3	120,5	115,4
	2002		%		+5,0	+5,9	+6,2	+7,4	+7,8	+8,0	+9,6	+10,4	+11,2	+13,0	+12,9
+12,4															
+9,2															

		Index	121,6	121,5	122,7	123,1	122,8	122,4	122,4	122,9	122,5	121,7	120,8	120,9	122,1
	2003		%		+11,6	+10,3	+10,2	+8,8	+7,8	+6,7	+5,2	+5,1	+3,7	+1,5	+0,4
+0,3															
+5,8															

		Index	121,8	122,4	123,2	123,4	123,5	123,9	124,3	124,1	124,1	124,6	125,3	125,0	123,8
	2004		%		+0,2	+0,7	+0,4	+0,2	+0,6	+1,2	+1,6	+1,0	+1,3	+2,4	+3,7
+3,4															
+1,4															

		Index	125,4	125,6	126,9	127,6	127,6	127,4	128,5	129,0	129,5	129,6	129,5	129,5	128,0
	2005		%		+3,0	+2,6	+3,0	+3,4	+3,3	+2,8	+3,4	+3,9	+4,4	+4,0	+3,4
+3,6															
+3,4															

Index	130,4	130,5	131,2	131,8	132,6	133,6	134,9	136,0	136,3	136,6	136,5	137,0	134,0
2006	%	+4,0	+3,9	+3,4	+3,3	+3,9	+4,9	+5,0	+5,4	+5,3	+5,4	+5,8	+4,7

Index	138,2	138,0	139,2	141,0	141,8	143,0	144,4	145,1	..	..	..	..	..
2007	%	+6,0	+5,7	+6,1	+7,0	+6,9	+7,0	+7,0	+6,7	..	..	..	..

Courtesy <http://www.statssa.gov.za/keyindicators/CPI/CPIHistory.pdf>

B.4: Home-Made Dividends

Firer *et al* (2006). suggest that ‘individual investors can undo a company's dividend policy by reinvesting dividends or selling shares’ and that, accordingly, in the absence of market imperfections - such as taxes – the dividend policy of the firm is irrelevant. An investor who prefers a dividend of R100 on date x and date y each; a company paying a dividend of R110 and R89 on each of those respective dates; and a weighted average cost of capital of ten percent per annum is used to illustrate the point (Firer et.al.:2006, 564).

On date x, the shareholder receives R10 more dividends than he desires and can accordingly simply re-invest those excess dividends in additional shares in the company in question. The excess dividends invested would be worth R11, using the assumed cost of capital, at the end of date y, one year later. When he receives the dividend of R89 on date y, the shareholder can sell of the additional shares he acquired at date x, now worth R11, and receive the desired cash inflow of R100. Thus, by simply reinvesting the excess funds received in the first year and selling off the additional shares acquired year one in the second year, the investor is able to ‘undo’ the company’s dividend policy and create the desired cash flows in the absence of market imperfections (Firer et.al.:2006, 564).

B5: Examples

B5.1: The potential of a small business

Blockbusters Entertainment Corporation started off as a small private venture. It raised some \$32 million in 1986 and 1987 by a share issue to finance further expansion. The same initial shares at current prices would now be worth over \$640 million. This is tantamount to a 1900 percent growth rate for a small business turned into a multinational (Adapted from Moore *et al.*: 1995,16).

B5.2: Improper resource allocation

The Margo Commission (1986) highlighted a growing trend in the number of elaborate homes being acquired in certain European and Asian countries. Part of the explanation for this trend was the intention of taxpayers to channel resources into primary residences to avoid CGT due to various exemptions available. This has concerned the State as these are largely unproductive investments, not yielding the same benefits in terms of returns, job creation and tax revenues as other investments such as new business start-ups (Margo Commission: 1986: 223).

Annexure C: Administrative information

C1: Small business tax rates

The tax rates that are applicable to small business are as follows:

Taxable income brackets	Tax rates
For years ending between 1 April 2006 and 31 March 2007	
0-40 000	0%
40 000 – 350 000	10%
Over 350 000	29%
For years ending between 1 April 2005 and 31 March 2006	
0-35 000	0%
35 000-250 000	10%
Over 250 000	29%
For years ending between 1 April 2004 and 31 March 2005	
0-150 000	15%
Over 150 000	30%
For years ending between 1 April 2003 and 31 March 2004	
0-150 000	15%
Over 150 000	30%
For years ending between 1 April 2002 and 31 March 2003	
0-150 000	15%
Over 150 000	30%
For years ending between 1 April 2001 and 31 March 2002	
0-150 000	15%
Over 150 000	30%
For years ending between 1 April 2001 and 31 March 2002	
0-100 000	10%
Over 100 000	30%

(Meyerowitz et. al.: Vols. 49-54 No.7 July 2001-2006: 33)

The above table reveals a progressive improvement in the tax burden required to be born by small business. The 2008 Budget Speech has highlighted additional relief measures with proposed rates for 'very small businesses', regarded as those with a turnover not exceeding R1 million per annum, as follows:

Proposed presumptive tax for very small businesses for the 2009 tax year	
0 - R100 000	0%
R100 001 - R300 000	2% of each R1 above R100 000
R300 001 - R500 000	R4 000 + 4% of the amount above R300 000
R500 001 - R750 000	R12 000 + 5.5% of the amount above R500 000
R750 001 - R1 000 000	R25 750 + 7.5% of the amount above R750 000

(Budget Speech, 2008)

C2: Individual's tax rates

The tax rates applicable to persons other than companies are as follows

Taxable income	Rates	Rates
Year of assessment ending 28 February 2009		
0 – 122 500	0 + 18% of each R1	
122 001 – 195 000	21 960 + 25% of the amount over	122 500
195 001 – 270 000	40 210 + 30% of the amount over	195 000
270 000 - 380 000	62 710 + 35% of the amount over	270 000
380 000 - 490 000	101 210 + 38% of the amount over	380 000
Over 490 000	143 010 + 40% of the amount over	490 000
Year of assessment ending 28 February 2008		
0 - 112 500	0 + 18% of each R1	
112 500 - 180 000	20 250 + 25% of the amount over	112 00
180 000 - 250 000	37 125 + 30% of the amount over	180 00
250 000 - 350 000	58 125 + 35% of the amount over	250 00
350 000 - 450 000	93 125 + 38% of the amount over	350 00
Over 450 000	131 125 + 40% of the amount over	450 00

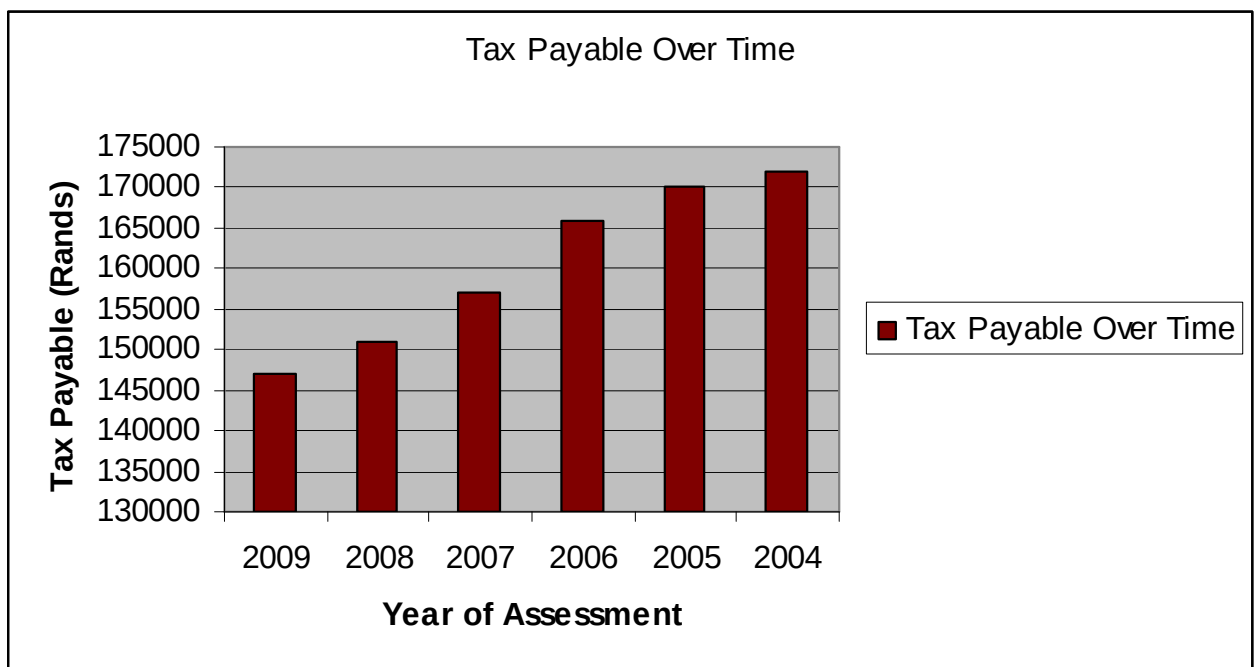
Taxable income	Rates	Rates
Year of assessment ending 28 February 2007		
0- 100 000	0 + 18% of each R1	
100 000 - 160 000	18 000 + 25% of the amount over	100 000
260 000 - 220 000	33 000 + 30% of the amount over	260 000
220 000 - 300 000	51 000 + 35% of the amount over	220 000
300 000 - 400 000	79 000 + 38% of the amount over	300 000
Over 400 000	117 000 + 40% of the amount over	400 000
Year of assessment ending 28 February 2006		
Taxable income		
0 - 80 000	0 + 18% of each R1	
80 000 - 130 000	14 400 + 25% of the amount over	80 000
130 000 - 180 000	26 900 + 30% of the amount over	130 000
180 000 - 230 000	41 900 + 35% of the amount over	180 000
230 000 - 300 000	59 400 + 38% of the amount over	230 000
Over 300 000	86 000 + 40% of the amount over	300 000
Year of assessment ending 28 February 2005		
0 - 74 000	0 + 18% of each R1	
74 000 - 115 000	13 320 + 25% of the amount over	74 000
115 000 - 155 000	23 570 + 30% of the amount over	115 000
155 000 - 195 000	35 570 + 35% of the amount over	155 000
195 000 - 270 000	49 570 + 38% of the amount over	195 000
Over 270 000	78 070 + 40% of the amount over	270 000
Year of assessment ending 28 February 2004		
0 - 70 000	0 + 18% of each R1	
70 000 - 110 000	12 600 + 25% of the amount over	70 000
110 000 - 140 000	22 600 + 30% of the amount over	110 000
140 000 - 180 000	31 600 + 35% of the amount over	140 000
180 000 - 255 000	45 600 + 38% of the amount over	180 000
255 000	74 100 + 40% of the amount over	255 000

(Jordann et.al.: 2004 -2007)

As an example on the effect of changes in the relevant tax tables for individuals, consider a taxpayer who earned R 500 000 in each year of assessment from 2004 to 2009:

Taxable income	Year of assessment ending 28 February	Normal tax payable	Effective rate of tax
500 000	2009	147 010	29.4%
500 000	2008	151 125	30.2%
500 000	2007	157 000	31.4%
500 000	2006	166 000	33.2%
500 000	2005	170 070	34.01%
500 000	2004	172 100	34.42%

The above table is displayed graphically below:



The above chart makes it apparent that individual taxpayers have been enjoying progressive tax relief due to the widening of the taxable income brackets since 2004.

C3: Individual sample tax returns: 2007 year of assessment

C3.1: The IT12S

IT 12S: Page 1

SARS PERSONAL INCOME TAX RETURN (Income Tax Act, No. 58 of 1962, as amended)		IT12S 2007 Year of Assessment
TAX REFERENCE No. 2007		
If you have additional income and/or deductions to declare for which space is not provided on this return please contact your nearest SARS branch or call 0869 12 1218 to obtain the IT12C return.		
SIGNATURE		ID No.
Date		Passport No.
Please consult the SARS Brochure prior to completing this tax return.		Date of Birth
PERSONAL DETAILS		
Surname	Initials	Home Tel No.
Married	Cell No.	Fax No.
If yes	Out of country of property	Blue Tel No.
In community of property		
Email		
ADDRESS DETAILS		
Postal Address	Postal Code	
Residential Address	Postal Code	
Work Address	Postal Code	
BANK ACCOUNT DETAILS		
Account No.	Branch No.	
Clisque	Savings / Transmission	
Name of Account Holder		
PREFERRED MEANS OF CONTACT		
Rate your preference as to how you would like to be contacted (Scale of 1 to 5)		
Email	SMS	Post
0	0	0
Fax	0	0
Through Tax Practitioner 0		
TAX PRACTITIONER DETAILS		
Did a tax practitioner complete this form?		
Tax Practitioner Registration No. PR -		
Tax Practitioner's Tel No.		

C3.2: Extract from the IT 12C

IT 12C: Page for capital gain declarations

Gross foreign income (excluding CGT)

Foreign interest

Foreign dividends

Taxable foreign income - Rands only

Business / Trading

Farming

Other

CFC

Foreign tax credits i.t.o.:

Foreign interest

Foreign dividends

Other foreign income

Do you elect to be taxed on net foreign dividends?

4 2 1 8

4 2 1 6

4 2 2 2

4 2 2 3

0 1 9 2

0 1 9 3

4 2 2 8

4 2 2 9

4 2 3 0

4 1 1 3

4 1 1 2

4 1 1 1

Y

CAPITAL GAIN / LOSS

Local

Profit

Loss

Foreign

Profit

Loss

Foreign tax credit in respect of foreign capital gain

Other RECEIPTS AND ACCRUALS - Rands only

Royalties / Other

Did you participate in any farming operation?

Other QUALIFYING DEDUCTIONS - Rands only

Expenses claimed against foreign taxable subsistence allowance

Travel expenses (no allowance - commission income)

DIRECTORS / MEMBERS OF CC

Are you a director of a company / member of a close corporation?

4 2 5 0

4 2 5 1

4 2 5 2

4 2 5 3

4 1 1 4

Y

4 0 1 9

4 0 1 5

X

STATEMENT OF ASSETS AND LIABILITIES

Fixed property

All improvements to property

Shares in private companies

Members interest in close corporations

Loan accounts

Financial instruments listed (e.g. shares, units in unit trusts, etc.)

Net capital of business, profession or farming

Equipment, machinery, implements

Motor vehicles, caravans, boats

Debtors

Stock

Livestock - elected value(s)

Cash in bank and other similar institutions

Cash on hand

Furniture

Personal effects, e.g. jewellery, paintings and fire-arms

Other assets

Total assets local

Bonds

Loan accounts

Creditors

Bank overdraft

Other liabilities

Total liabilities local

TOTAL ASSETS FOREIGN

TOTAL LIABILITIES FOREIGN

LOCAL ASSETS

LOCAL LIABILITIES

FOREIGN

INFORMATION - DEDUCTIONS & ALLOWANCES

Have you submitted the Research & Development (Sec. 11D) information required to the Dept. of Science and Technology?

In respect of how many learnerships did you claim an allowance i.t.o. Sec. 12 H:

Learnerships registered

Learnerships completed

Total cost i.t.o. UDZ (Sec. 13quat) buildings brought into use during this year of assessment:

R

Y

4 4 9 8

4 4 9 9

4 4 8 0

ADDITIONAL DECLARATIONS

How many IRP5 / IT3(a) certificates did you receive?

How many vehicles did you make use of to calculate your claim against your travel allowance?

0 1

0

MA MAROUN

0724050836 P 2007



Page 222 of 252

Annexure D: Supporting Documentation

D.1: Correspondence with Q-Tech (Pty) Ltd.

From: maroun@mweb.co.za [mailto:maroun@mweb.co.za]
Sent: Thursday, November 15, 2007 2:08 PM
To: Warren Maroun
Subject: FW: test

----- Original Message -----

From: Qtech
Sent: Tuesday, November 13, 2007 15:33
To: Mark Maroun maroun@mweb.co.za;
Subject: tax costs

Dear Warren

As per your discussion with us, here are the details of the costs we think we have to incur because of GCT

<i>Year</i>	<i>CGT Liability</i>	<i>Administration costs</i>
2001	R 43,461.23	R 12,341.11
2002	R 21,332.98	R 8,652.88
2003	R 0.00	R 0.00
2004	R 0.00	R 0.00
2005	R 32,333.27	R 11,564.21
6006	R 7,531.10	R 134.20
2007 (to date)	R 8,321.21	R 534.55
Cumulative	R 112,979.79	R 33,226.95

These are from our internal management systems. We use ABC costing in order to calculate these numbers.

Basically we know the total labor hours spent doing various activities including tax admin work. This is because tax compliance is an important part of our business since we rely heavily on government contracts. We then divided the total labor costs by the number of labor hours and times the answer by the admin labor hours. Our accounting program does this automatically for us.

We hope that this will be helpful for your thesis.

Regards

Q-Tech Management team

D.2: Correspondence with Roxo

Ryan Roxo is a BsC (Actuarial Science) graduate from the University of the Witwatersrand and is currently employed by MCI Consultants in Johannesburg. .

From: Ryan Dias-Roxo [mailto:r.roxo@mci.co.za]

Sent: Tuesday, October 23, 2007 11:35 AM

To: Warren Maroun

Subject: CPI Calculation

Hi Warren,

Here is the calculation you asked for. I am not sure how you want to present the data but you can edit it however you need to. I have attached the inflation tables I used to do the calculation

Let:

$P(\text{date})$ = Price of a share on the date: *date*

$Q(\text{date})$ = Value of the CPI Index on the date: *date*

$C(\text{value of trade})$ = Percentage of the transaction that will be charged as transaction costs (based on value of trade (in cents))

$R(\text{date})$ = Real Value of the share on the valuation date, for a share bought on date: *date* (including an adjustment for inflation)

G = Gain on one share having sold the share at a given date (including transaction costs for sale and purchase, and inflation)

Therefore,

$$\begin{aligned} R(\text{date}) &= \text{Price of the share on a given day adjusted for inflation} \\ &= \frac{P(\text{date bought}) \times Q(\text{valuation date})}{Q(\text{date bought})} \end{aligned}$$

$$\begin{aligned} G &= R(\text{date sold the share}) \times (1-C) - R(\text{date bought the share}) \times (1+C) \\ &= \frac{P(\text{date sold the share}) \times Q(\text{valuation date}) \times (1-C)}{Q(\text{date sold the share})} - \end{aligned}$$

$$\frac{P(\text{date bought the share}) \times Q(\text{valuation date}) \times (1+C)}{Q(\text{date bought the share})}$$

Example:

Suppose we look at a Sasol (SOL) share.

Assuming we bought the share on 15 July 2002 and sold the share on 16 July 2007.

Assuming we bought R 300 000 worth of shares.

Transaction Costs:

According to BoE Stockbrokers the transaction costs would be as follows:

Online Deal Consideration	Online Brokerage Rate (Minimum charge per deal R70)	Deal Consideration	Fee Paying Brokerage Rate	Non Fee Paying Brokerage Rate
Up to R300,000	0.7%	Up to R25,000	1.00%	1.5%
R300,000 to R750,000	0.5%	R25,000 to R35,000	0.75%	0.95%
R750,000 to R1,000,000	0.45%	R35,000 to R50,000	0.70%	0.95%
R1,000,000 and above	0.35%	R50,000 to R75,000	0.70%	0.85%
		R75,000 to R150,000	0.65%	0.75%
		R150,000 to R200,000	0.60%	0.70%
		R200,000 to R250,000	0.55%	0.60%
		R250,000 to R750,000	0.45%	0.50%
		R750,000 to R1,000,000	0.40%	0.45%
		R1,000,000 and above	0.35%	0.40%
		Minimum charge per deal	R100	R150

(Adapted from <https://boepersonal.nedsecure.co.za/Services/Costs.aspx>)

We will be trading online, and therefore will use the online brokerage rate.

Share Prices:

SOL closing share prices on:

P (15 July 2002) = 9257 cents

P (16 July 2007) = 27544 cents

Therefore,

$$\begin{aligned} N &= \text{Number of shares bought} \\ &= 300\,000 / 9257 \\ &= 3240 \text{ shares} \end{aligned}$$

Source: www.boe.co.za

Inflation figures:

See attachment

Therefore,

Q (15 July 2002) = 116.3

Q (16 July 2007) = 144.4

Source: <http://www.statssa.gov.za/keyindicators/CPI/CPIHistory.pdf>

Calculation of Gain (on one share):

$$\begin{aligned} G &= R (16 \text{ July } 2007) \times (1-C) - R (15 \text{ July } 2002) \times (1+C) \\ &= P (16 \text{ July } 2007) \times (1-C) - \frac{P (15 \text{ July } 2002) \times Q (16 \text{ July } 2007) \times (1+C)}{Q (16 \text{ July } 2007)} \\ &= 27544 \times (1-0.0045) - \frac{9257 \times 144.4 \times (1+0.007)}{116.3} \\ &= 27420.05 - 11574.01 \\ &= 15846.04 \text{ (subject to rounding error)} \end{aligned}$$

Therefore,

$$\begin{aligned} \text{Gain on entire transaction} &= N \times G (15 \text{ August } 2007) \\ &= 3240 \times 15842.04/100 \\ &= R 513\,412 \end{aligned}$$

D.3: Correspondence with KPMG

Mr. Michael Honiball is a CA(SA) and Director of International Tax and Transfer Pricing at KPMG, Johannesburg Office

From: Honiball, Michael [Michael.Honiball@kpmg.co.za]

Sent: Friday, November 16, 2007 6:29 PM

To: Warren Maroun

Subject: RE: Tax survey

Hello Warren,

Great to hear from you again! Have you decided yet whether you want to join KPMG's tax department? You won't regret it!

I am happy to set out the details of the plan, no need to credit me for it at all!

It is quite simple: instead of purchasing a foreign property directly in the name of a South African tax resident individual, which would result in a South African CGT liability on disposal based on the world-wide (residence) basis of taxation, he or she can simply set up an offshore company and hold all the shares in such company. The company can then purchase the immovable property.

On disposal, the individual can persuade the purchaser to buy all the shares in the company, as opposed to the immovable property itself. If the sale was to a non-resident purchaser, it will be exempt from CGT under Para 64B of the Eighth Schedule, provided of course that all the other requirements of that paragraph are met. Obviously, the provisions of the GAAR (Section 80A-L) must also be considered, but normally there are many good non-tax reasons for using a company in these circumstances so the GAAR should not apply.

I am happy to meet with you to discuss this in more detail, should you so require, I am available this week-end, or I could review your draft thesis before you submit it, when is the deadline?

Regards, Michael.

Michael Honiball
Director, International Tax
Global Transfer Pricing Services

KPMG Services (Proprietary) Limited
85 Empire Road
Parktown
South Africa
2193

D.4: Correspondence analysis

D.4.1: Consolidated correspondence results

	Trait	Absence of fairness criteria			
		Based on Smith's (1776) definition of a fair tax system			Based on the South African context
		Gives rise to double tax as CGT is a tax on capital	Does not ensure that all taxpayers contribute fairly for State-provided services.	Undermines ability to support the taxpayer's family	Does not promote the upliftment of the disadvantaged
1	The sale of an equity instrument which is capital in nature is subject to CGT (para 2 of the Eighth Schedule to the Act).	27	5	26	13
2	Capital losses are ring- fenced (para 7 to para 9 of the Eighth Schedule to the Act).	5	13	7	8
3	On death, a taxpayer suffers a deemed disposal reducing the heir's inheritance (para 40 of the Eighth Schedule to the Act).	31	21	32	14

	Trait	Absence of fairness criteria			
4	CGT discourages capital gain realisations as CGT normally arises only on a disposal of the respective asset.	2	20	12	9
5	CGT encourages capital loss realisations as the capital loss is then available for set-off against capital gains resulting during the tax year.	2	17	9	9
6	CGT prevents domestic revenue being converted into tax free capital gains	0	11	13	6
7	CGT prevents foreign revenue being converted into tax free capital gains	0	12	12	5
8	CGT requires detailed supporting documentation (part I and II of the Act)	21	24	21	14
9	Steps to simplify administrative requirements for CGT have been taken.	17	9	14	10
10	CGT taxes the wealthy.	1	7	12	4
11	CGT promotes the equal taxing of taxpayers in equal economic positions.	4	6	11	11
12	Inclusions under s 26A of the Act are not subject to s 7A(4A) of the Act.	2	15	10	11
13	There is no direct inflation adjustment in the Eighth Schedule to the Act.	6	11	3	10
14	PBO's are not subject to full CGT exemption.	4	7	14	21
15	Recreational clubs are not subject to full CGT exemption.	1	5	15	16

	Trait	Absence of fairness criteria			
16	The CGT effects of s 41 to s 47 of the Act pose difficulties for BEE deals.	6	2	21	21
17	CGT acts as a disincentive to business start-ups.	2	18	28	27
18	Small business exemptions (para 57 of the Eighth Schedule to the Act) and deductibility of capital losses from capital gains (para 7 of the Eighth Schedule to the Act) are possible.	1	6	10	10
19	The new three year rule (relating to the minimum period shares need to be held in order to constitute a capital disposal) discourages speculative investing. CGT in general	12	13	19	10
20		21	20	19	14

(The above is based on a sample of twenty two tax experts and twenty ordinary taxpayers.)

D.4.2: Correspondence results for tax experts

	Trait	Absence of fairness criteria			
		Based on Smith's (1776) definition of a fair tax system			Based on the South African context
		Gives rise to double tax as CGT is a tax on capital	Does not ensure that all taxpayers contribute fairly for State-provided services.	Undermines ability to support the taxpayer's family	Does not promote the upliftment of the disadvantaged
1	The sale of an equity instrument which is capital in nature is subject to CGT (para 2 of the Eighth Schedule to the Act).	12	1	10	4
2	Capital losses are ring- fenced (para 7 to para 9 of the Eighth Schedule to the Act).	4	6	3	4
3	On death, a taxpayer suffers a deemed disposal reducing the heir's inheritance (para 40 of the Eighth Schedule to the Act).	12	2	13	1
4	CGT discourages capital gain realisations as CGT normally arises only on a disposal of the respective asset.	2	8	4	5
5	CGT encourages capital loss realisations as the capital loss is then available for set-off against capital gains resulting during the tax year.	2	7	3	6
6	CGT prevents domestic revenue being converted into tax free capital gains.	0	5	8	2
7	CGT prevents foreign revenue being converted into tax free capital gains.	0	7	12	3

	Trait	Absence of fairness criteria			
8	CGT requires detailed supporting documentation (part I and II of the Act).	3	6	1	2
9	Steps to simplify administrative requirements for CGT have been taken.	1	1	1	1
10	CGT taxes the wealthy.	1	1	1	0
11	CGT promotes the equal taxing of taxpayers in equal economic positions.	1	3	3	3
12	Inclusions under s 26A of the Act are not subject to s 7A(4A) of the Act.	1	9	9	2
13	There is no direct inflation adjustment in the Eighth Schedule to the Act.	4	6	2	4
14	PBO's are not subject to full CGT exemption.	1	5	10	12
15	Recreational clubs are not subject to full CGT exemption.	1	4	8	8
16	The CGT effects of s 41 to s 47 of the Act pose difficulties for BEE deals.	6	0	14	14
17	CGT acts as a disincentive to business start-ups.	0	5	10	9
18	Small business exemptions (para 57 of the Eighth Schedule to the Act) and deductibility of capital losses from capital gains (para 7 of the Eighth Schedule to the Act) are possible.	1	1	5	5

	Trait	Absence of fairness criteria			
19	The new three year rule (relating to the minimum period shares need to be held in order to constitute a capital disposal) discourages speculative investing.	2	2	3	1
20	CGT in general	7	12	11	10

(The above is based on a sample of twenty two tax experts)

D.4.3: Correspondence results for ordinary taxpayers

	Trait	Absence of fairness criteria			
		Based on Smith's (1776) definition of a fair tax system			Based on the South African context
		Gives rise to double tax as CGT is a tax on capital	Does not ensure that all taxpayers contribute fairly for State-provided services.	Undermines ability to support the taxpayer's family	Does not promote the upliftment of the disadvantaged
1	The sale of an equity instrument which is capital in nature is subject to CGT (para 2 of the Eighth Schedule to the Act).	15	4	16	9
2	Capital losses are ring- fenced (para 7 to para 9 of the Eighth Schedule to the Act).	1	7	4	4
3	On death, a taxpayer suffers a deemed disposal reducing the heir's inheritance (para 40 of the Eighth Schedule to the Act).	19	19	19	13
4	CGT discourages capital gain realisations as CGT normally arises only on a disposal of the respective asset.	0	12	8	4

	Trait	Absence of fairness criteria			
5	CGT encourages capital loss realisations as the capital loss is then available for set-off against capital gains resulting during the tax year.	0	10	6	3
6	CGT prevents domestic revenue being converted into tax free capital gains.	0	6	5	4
7	CGT prevents foreign revenue being converted into tax free capital gains.	0	5	0	2
8	CGT requires detailed supporting documentation (part I and II of the Act).	18	18	20	12
9	Steps to simplify administrative requirements for CGT have been taken.	16	8	13	9
10	CGT taxes the wealthy.	0	6	11	4
11	CGT promotes the equal taxing of taxpayers in equal economic positions.	3	3	8	8
12	Inclusions under s 26A of the Act are not subject to s 7A(4A) of the Act.	1	6	1	9
13	There is no direct inflation adjustment in the Eighth Schedule to the Act.	2	5	1	6
14	PBO's are not subject to full CGT exemption.	3	2	4	9
15	Recreational clubs are not subject to full CGT exemption.	0	1	7	8
16	The CGT effects of s 41 to s 47 of the Act pose difficulties for BEE deals.	0	2	7	7

	Trait	Absence of fairness criteria			
17	CGT acts as a disincentive to business start-ups.	2	13	18	18
18	Small business exemptions (para 57 of the Eighth Schedule to the Act) and deductibility of capital losses from capital gains (para 7 of the Eighth Schedule to the Act) are possible.	0	5	5	5
19	The new three year rule (relating to the minimum period shares need to be held in order to constitute a capital disposal) discourages speculative investing	10	11	16	9
20	CGT in general	14	8	8	4

(The above is based on a sample of twenty ordinary taxpayers)

D.4.4: Mathematical results:

Dr. Anthony Stacey is a BSc (Elec Eng) graduate from the University of Cape Town. He holds an MBA and PhD from the University of the Witwatersrand.

From: Anthony Stacey [Anthony.Staceyl@wits.ac.za]

Sent: Wednesday, 28 November, 2007 12:05 PM

To: Warren Maroun

Subject: RE: Tax survey

The correspondence tables above yield the following statistical results when analysed.

Correspondence Analysis Report

Page/Date/Time 1 2007-11-28 12:24:16

Database

Variables Overall1 to Overall4

Eigenvalue Section

Factor No.	Eigenvalue	Individual Percent	Cumulative Percent	Bar Chart
1	0.126952	58.42	58.42	
2	0.069191	31.84	90.25	
3	0.021184	9.75	100.00	
Total	0.217327			

Plot Detail Section for Rows

Name	Quality	Mass	Inertia	Axis1			Axis2		
				Factor	COR	CTR	Factor	COR	CTR
1 Row 1	0.989	0.080	0.165	0.643	0.926	0.262	0.168	0.063	0.033
2 Row 2	0.790	0.037	0.021	-0.103	0.085	0.003	-0.295	0.704	0.047
3 Row 3	0.980	0.111	0.103	0.433	0.926	0.163	-0.104	0.054	0.017
4 Row 4	1.000	0.049	0.063	-0.367	0.478	0.052	-0.383	0.521	0.103
5 Row 5	0.973	0.042	0.052	-0.365	0.496	0.044	-0.358	0.477	0.077
6 Row 6	0.723	0.034	0.041	-0.410	0.635	0.045	-0.153	0.088	0.011
7 Row 7	0.780	0.033	0.048	-0.423	0.560	0.046	-0.265	0.220	0.033
8 Row 8	0.977	0.090	0.046	0.242	0.530	0.042	-0.222	0.447	0.065
9 Row 9	0.979	0.057	0.061	0.477	0.978	0.101	-0.018	0.001	0.000
10 Row 10	0.298	0.027	0.028	-0.252	0.288	0.014	-0.048	0.011	0.001
11 Row 11	0.966	0.036	0.009	-0.093	0.160	0.002	0.208	0.806	0.023
12 Row 12	0.946	0.043	0.034	-0.353	0.722	0.042	-0.197	0.224	0.024
13 Row 13	0.206	0.034	0.038	-0.023	0.002	0.000	-0.221	0.204	0.024
14 Row 14	0.824	0.052	0.054	-0.217	0.208	0.019	0.374	0.616	0.105
15 Row 15	1.000	0.042	0.058	-0.331	0.363	0.036	0.438	0.637	0.116
16 Row 16	1.000	0.057	0.082	-0.056	0.010	0.001	0.559	0.990	0.255
17 Row 17	0.998	0.085	0.063	-0.357	0.793	0.085	0.181	0.205	0.040
18 Row 18	1.000	0.031	0.022	-0.328	0.697	0.026	0.216	0.303	0.021
19 Row 19	0.814	0.061	0.013	0.180	0.721	0.016	-0.065	0.094	0.004

\

Plot Detail Section for Columns

Name	Quality	Mass	Inertia	Axis1			Axis2		
				Factor	COR	CTR	Factor	COR	CTR
1 Overall1	0.991	0.163	0.465	0.782	0.984	0.784	-0.065	0.007	0.010
2 Overall2	0.996	0.251	0.267	-0.244	0.257	0.117	-0.413	0.738	0.619
3 Overall3	0.309	0.327	0.084	-0.031	0.017	0.002	0.128	0.292	0.077
4 Overall4	0.814	0.259	0.184	-0.217	0.305	0.096	0.280	0.509	0.294
1 Experts1	0.399	0.000	0.000	0.551	0.396	0.000	0.053	0.004	0.000
2 Experts2	0.724	0.000	0.000	-0.557	0.442	0.000	-0.446	0.282	0.000
3 Experts3	0.327	0.000	0.000	-0.292	0.180	0.000	0.264	0.147	0.000
4 Experts4	0.654	0.000	0.000	-0.468	0.298	0.000	0.511	0.356	0.000
5 Others1	0.841	0.000	0.000	0.920	0.823	0.000	-0.136	0.018	0.000
6 Others2	0.763	0.000	0.000	-0.070	0.023	0.000	-0.395	0.739	0.000
7 Others3	0.117	0.000	0.000	0.155	0.113	0.000	0.031	0.005	0.000
8 Others4	0.263	0.000	0.000	-0.066	0.047	0.000	0.141	0.216	0.000

Correspondence Analysis Report

Page/Date/Time 2 2007-11-28 12:24:16
 Database
 Variables Overall1 to Overall4

Plots

D.4.5: Correspondence with SARS

The SARS offices in the Johannesburg areas were visited in order to circulate the correspondence analysis. Ten representatives from SARS agreed to participate and coordinated their results independently. The results are as follows:

	Trait	Absence of fairness criteria			
		Based on Smith's (1776) definition of a fair tax system			Based on the South African context
		Gives rise to double tax as CGT is a tax on capital	Does not ensure that all taxpayers contribute fairly for State-provided services.	Undermines ability to support the taxpayer's family	Does not promote the upliftment of the disadvantaged
1	The sale of an equity instrument which is capital in nature is subject to CGT (para of the Eighth Schedule to the Act 2).				YES
2	Capital losses are ring- fenced (para 7 to para 9 of the Eighth Schedule to the Act).				
3	On death, a taxpayer suffers a deemed disposal reducing the heir's inheritance (para 40 of the Eighth Schedule to the Act).				YES
4	CGT discourages capital gain realisations as CGT normally arises only on a disposal of the respective asset.		YES		

	Trait	Absence of fairness criteria			
5	CGT encourages capital loss realisations as the capital loss is then available for set-off against capital gains resulting during the tax year.		YES		
6	CGT prevents domestic revenue being converted into tax free capital gains.				
7	CGT prevents foreign revenue being converted into tax free capital gains.				
8	CGT requires detailed supporting documentation (part I and II of the Act).				
9	Steps to simplify administrative requirements for CGT have been taken.				
10	CGT taxes the wealthy.				
11	CGT promotes the equal taxing of taxpayers in equal economic positions.				
12	Inclusions under s 26A of the Act are not subject to s 7A(4A) of the Act.				
13	There is no direct inflation adjustment in the Eighth Schedule to the Act.				
14	PBO's are not subject to full CGT exemption.				YES - MODERATELY
15	Recreational clubs are not subject to full CGT exemption.				YES - MODERATELY
16	The CGT effects of s 41 to s 47 of the Act pose difficulties for BEE deals.				

	Trait	Absence of fairness criteria			
17	CGT acts as a disincentive to business start-ups.				YES
18	Small business exemptions (para 57 of the Eighth Schedule to the Act) and deductibility of capital losses from capital gains (para 7 of the Eighth Schedule to the Act) are possible.				
19	The new three year rule (relating to the minimum period shares need to be held in order to constitute a capital disposal) discourages speculative investing				
20	CGT in general				

(The above result are based on the self-coordinated opinions of ten SARS officials.)

References

Books and articles

- Adams C (1999) *For Good and Evil*, 2nd Edition, Madison Books, Maryland
- Angell W (1993), Statement before the Republican members of the Joint Economic Committee, June 22, 1993 cited in Moore and Silva (1995)
- Arendse J (2004) 'Solutions to the tax conundrum', *Accountancy SA*, October
- Arendse J (2004) 'BEE and tax: should there be a common ground ?', *Accountancy SA*, October
- Auten G and Cordes P (1991) 'Policy Watch: Cutting Capital Gains Taxes', *Journal of Economic Perspective*, Vol.5, No.1, Winter
- Begg D, Fischer S and Dornbush R (2003), *Economics*, 7th Edition, McGrawhill Company, London
- Blumenthal M and Selmrod J (1992), 'The compliance cost of the US individual income tax system: a second look after tax reform', *National Tax Journal*, Vol. 54, No.2, June
- Bizland (2006), supported by: The South African Revenue Services, accessed on 30 March 2006 at <<http://www.bizland.co.za/cgt.htm.records> >
- Botha A (2007) 'Taxman increases rewards for thinking long-term', *Business Report*, 15 March, accessed on 27 May 2007 at <<http://www.busrep.co.za/index.php?fArticleId=3754462&fSectionId=642&fSetId=662>>
- Brooks P (2001) 'Capital gains tax', *Taxgram*, May
- Callaghan J (1965) *Budget Speech* (United Kingdom) cited in Stasxczuk (2001)
- Cameron B (2001) 'Capital gains tax', *Personal Finance*, October, accessed on 15 March 2006 at: <<http://www.persfin.co.za/html/persfin/cgt/page1.php>>
- Canto V and Hirschorn (1994) , 'In Search of a Free Lunch', Laffer and Canto Associates, San Diego (cited in Moore and Silva (1995))

- Coetzee K (1998) 'Problems with equity in taxation with special emphasis on the South African situation'. In: KH Kleynhans ed. *South African Accounting Association Biennial Conference*, 9 July 1998, Johannesburg. Johannesburg: South African Accounting Association
- *The Concise Oxford English Dictionary* (1995), Ninth Edition, Clarendon Press, Oxford
- Conda C (2006) *The Best Cap-Gains Tax Rate is Zero*, accessed on 10 March 2006 at
<http://www.freedomworks.org/informed/issues_template.php?issue_id=2524>
- Cordes J (2000) *Capital Gains Tax*, accessed on 10 February 2006 at:
<<http://www.econlib.org/library/ENC/CapitalGainsTax.html>>
- Commercial Organization of South African Trade Unions (COSATU) (2001) *Capital gains tax: presentation to the portfolio committee on finance*, January, accessed on 10 March 2006 at
<<http://www.cosatu.org.za/docs/1999/progtax.htm>>
- Croome B (2007), 'Timing of CGT valuations – submissions to SARS', *Tax Planning*, Vol 21, No. 1, March
- Drury C (2005) *Management and Cost Accounting*, 6th Edition, Thomson Learning, London
- Dyl E (1977) 'Capital Gains Tax and Year End Stock Market Behaviour', *The Journal of Finance*, Vol. 32, No. 1, March 1977
- Ededes J (2000) 'Capital Gains Tax', *Financial Mail*, 15 April
- Endershott P, Toder E and Won Y (1991) 'Effects of capital gains taxes on revenue and economic efficiency', *National Tax Journal*, Vol. XLIV, No. 1, Winter
- Ensor L (2000) 'Capital gains tax will not offer inflation relief', *Business Day*, 9 August
- Ensor L (2001a) 'No concessions yet for restructurings', *Business Day*, February 12
- Ensor L (2001b) 'More tax concessions for the middle class', *Business Day*, March 15
- Ensor L (2001c) 'Changes to capital gains draft offer some relief', *Business Day*, February 9
- Ensor L (2001d), 'Call to exclude share-based deals from capital gains tax', *Business Day*, February 10

- Ensor L (2001e) 'IMF welcomes gains tax', *Business Day*, January 11
- Feldstein M, Selmrod J and Yitzhaki S (1980) 'The Effects of Taxation on the Selling of Corporate Stocks and Realization of Capital Gains': *The Quarterly Journal of Economics*, Vol. 94, No. 4, June
- Firer C, Ross S, Westerfield R and Jordan B (2004), *Fundamentals of Corporate Finance*, Third Edition, The McGraw-Hill Companies, Johannesburg
- Frank H (2003) *Microeconomics and Behaviour*, 5th Edition, The McGraw-Hill Companies, New York
- Friedland R (2001) 'The noose is tightening, don't try to be too clever', *Financial Mail*, August 11
- Gerald E, Cordes A and Cordes J (2000) 'Cutting Capital Gains Tax', *Journal of Economic Perspective*, Vol. 5, No. 1 accessed on 17 July 2006 at
[<http://www.jstor.org/view/08953309/di960533/96p0014i/0?searchUrl=http%3a//www.jstor.org/search/BasicResults%3fhp%3d25%26si%3d1%26Query%3dcapital%2bgains%2btax%26xc%3don&frame=noframe&currentResult=08953309%2bdi960533%2b96p0014i%2b0%2cFF1F&userID=928d0fdf@wits.ac.za/01cc99332620fa10f04066c80&dpi=3&config=jstor>](http://www.jstor.org/view/08953309/di960533/96p0014i/0?searchUrl=http%3a//www.jstor.org/search/BasicResults%3fhp%3d25%26si%3d1%26Query%3dcapital%2bgains%2btax%26xc%3don&frame=noframe&currentResult=08953309%2bdi960533%2b96p0014i%2b0%2cFF1F&userID=928d0fdf@wits.ac.za/01cc99332620fa10f04066c80&dpi=3&config=jstor)
- Goodman J, Robbins A, Gary Robbins G (1990) *Elderly taxpayers and the capital gains tax debate*, 3rd Edition, The National Centre for Policy Analysis, Texas
- Groves, H and Curran J (1974) *Tax Philosophers*, 1974 Edition, University of Wisconsin Press, Wisconsin.
- Holtz-Eakin D (2000) 'Small Business Economics', *Dordrecht*, Vol.15, No. 1, December
- Horngren C, Foster G, Datar S and Uliana E (2004) *Cost Accounting in South Africa*, 1st Edition, Prentice Hall, New Jersey printed by Creda Communications, Johannesburg
- Grubel G (2000) *Unlocking Canadian Capital*, 2nd Edition, Fraser Institute, Vancouver
- Harrison P (2001) 'Do we need a new tax ?', *Business Day*, February 12
- International Accounting Standards Board (IASB) (2005) *The Framework*, 2005 Edition, The International Accounting Standards Board Publications Department, London

- Jackson and Stent (2005), 'Auditing Notes for South African Students', 5th Edition, Audit Education, Durban.
- Krever R (2001) 'A Capital Gains Tax for South Africa', *Presentation to the Portfolio Committee on Finance and the Select Committee on Finance* accessed on 6 November 2007 at < <http://www.ftomasek.com/RickKreverDraft.html>>
- Lally M and T van Zijl (2003) 'Capital Gains Tax and the Capital Asset Pricing Model', *Journal of Accounting and Finance*, Vol. 1 No. 43
- Leonard E, Randolph B and Randolph W (2002) 'Measuring Permanent Responses to Capital-Gains Tax: Changes in Panel Data', *American Economic Review*, Vol. 84 No. 4, accessed on 1 June 2007, at < <http://www.jstor.org/cgi-bin/jstor/printage/00028282/di976326/97p0149b/0.pdf?backcontent=page&dowhat=Acrobat&config=jstor&userID=928d0fdf@wits.ac.za/01cc00332800501bd0bec&0.pdf>>
- Manuel T (2001) 'Why capital gains should be taxed', *Financial Mail*, February 9
- Mazansky E (2001) 'Big and Small', *Tax Planning*, Vol 15, No 1, March
- Meade J (1978) 'The structure and reform of direct taxation', *The Institute for Fiscal Studies*, George Allan and Unwin, London.
- Meyerowitz D, Emsile T and Davis D (2001a) 'Capital Gains Tax', *The Taxpayer*, Vol. 50, No. 4, April
- Meyerowitz D, Emsile T and Davis D (2001b) 'Capital Gains', *The Taxpayer*, Vol. 50, No. 5, May
- Meyerowitz D, Emsile T and Davis D (2001c) 'Capital Gains Tax Implications Arising from Recent Events in New York', *The Taxpayer*, Vol. 50 No. 9, September
- Meyerowitz D, Emsile T and Davis D (2001d) 'Capital Gains Tax (Eighth Schedule to the Income Tax Act) – Valuation of Assets', *The Taxpayer*, Vol. 50, No. 10, October
- Meyerowitz D, Emsile T and Davis D (2004), 'The Revenue Laws Amendment Act', *The Taxpayer*, Vol. 53, No. 1, January
- Meyerowitz D, Emsile T and Davis D (2005a) 'The 2005 Budget', *The Taxpayer*, Vol. 54. No. 2, February

- Meyerowitz D, Emsile T and Davis D (2005b) 'Capital Gains Tax in Respect of Bequest Releasing Debtor from Debt Owed to the Deceased', *The Taxpayer*, Vol. 54, No. 5, May
- Meyerowitz D, Emsile T and Davis D (2007) 'The 2007 budget', *The Taxpayer*, Vol. 56, No.2, February
- Mill J (1848) *Principles of Political Economy Books IV and V*, Penguin Classics, 1985, reprint
- Minarik J (1981), *Capital Gains Tax*, 5th Edition, Brookings Institution, Washington
- Mitchell L (2006), 'Companies do die', *Tax Planning*, Vol. 20, No.3, June
- Mitchell K (2006), 'Off side- recreational clubs', *Tax Planning*, Vol. 20, No.6, December
- Montasquieu B (1784), *The Spirit of the Laws*, G. Bell & Sons, Ltd., London (1914), accessed on 11 November 2006, at:
<<http://www.constitution.org/cm/sol.htm>>
- Moore S and Silva J (1995) 'The ABC's of capital gains tax', *Cato Institute: Policy Analysis*, No. 242, October accessed on 9 July 2007 at :
< https://cato.org/pub_display.php?pub_id=1101&print=Y&full=1 >
- Moore S and Kerpen P (2001) 'A Capital Gains Tax Cut: The Key to Economic Recovery' *Institute for Policy Innovation*, Report Number 164, accessed on 12 October 2007, accessed at
<<http://www.ipi.org/ipi/IPIPublications.nsf/PublicationLookupFullText/EC18ED9B8007A06486256AE2002BA80D>>
- Musgrave R (1968) 'The Carter Commission Report', *The Canadian Journal of Economics*, Vol.1 No. 1, February accessed on 10 November 2007 at
<<http://limks.jstor.org/sici?sici=0008-4085%28196802%291%3A1%3C159%3ATCCR%3E2.0.CO%3B2-U> >
- Poterba J (1989) 'Venture Capital and Capital Gains Tax' accessed on 1 November 2007 at <http://nber15.nber.org/papers/w2832.pdf?new_window=1>
- PricewaterhouseCoopers (2000), *CGT- no pain, no gain*, 5th Edition, PricewaterhouseCoopers, Johannesburg,
- Primedia Ltd. (2006) 'Annual Report', Primedia Ltd., Johannesburg, accessed on 1 November 2007 at
<http://www.primedia.co.za/investor_relations/06_annual_rep/pdf/ar2006.pdf>

- Property 24 (2007) *Industry Budget Roundup*, accessed on 1 June 2007 at <http://www.property24.com/property24/hub/Finance_Full.asp?articleid=2951>
- Roberts S (2006) 'Capital Gains Tax - Advantages & Disadvantages Of Capital Gains Tax Cut', *Idia Finance and Investment Guide*, July, accessed on 11 November 2006, at :
http://finance.indiamart.com/taxation/advantages_disadvantages_capitalgains.html
- Ricardo D (1817), *The principles of political economy and taxation*', John Murry, London (1984) accessed on 1 July 207 at
<<http://www.econlib.org/LIBRARY/Ricardo/ricP.html>>
Smith A (1776) *An Inquiry into the Nature and Causes of the Wealth of Nations*
- South African Council of Churches (2006) *Submission to the Portfolio Committee on Finance*, accessed on 31 May 2007 at <<http://www.sacc-ct.org.za/rlab2006.html>>
- South African Revenue Services (2000) *Guide to Capital Gains Tax*, accessed on 11 November 2006 at:
<http://www.treasury.gov.za/documents/budget/2000/cgt/cgt.pdf>
- Staszczuk O (2001), 'Capital Gains Tax: the Pros and Cons', *The Free Market Foundation*, Monograph No. 28
- Stein M (2000) 'Capital Gain Tax', *Income Tax Reporter*, Vol. 39, No. 3
- Steyn G (2001) 'SARS stands firm on capital gains tax', *Business Day*, 11 May
- Stiglitz J (1976) *Simple formulae for optimal income taxation and the measurement of inequality*, 1st Edition, Institute for Mathematical Studies in Social Sciences – Stanford University, California
- Stuart J (2001) 'Reconsider the capital gains tax', *Business Day*, August 11
- Temkin S (2001) 'Capital gains tax may be hard on trusts', *Business Day*, September 12
- Thomas S (2001) 'No place left to hide', *Financial Mail*, August 9
- Vivian R (2006) 'Equality and personal income tax – the classical economist and the Katz Commission', *South African Journal of Economics* Vol. 74, No.1, March

- Vlassenko I (2001) 'Evaluation of the efficiency, and fairness of the British, French and Swedish property tax system', *Property Management*, Vol.15 No. 5 accessed on 13 November 2007 at <<http://0-www.emeraldinsight.com.innopac.wits.ac.za/Insight/viewPDF.jsp?Filename=html/Output/Published/EmeraldFullTextArticle/Pdf/1130190502.pdf>>
- Voster D (2000) 'Capital gains tax – a discredited tax', *Tax planning*, Vol. 14, No. 6, October
- Whitfield B (2007), 'Trevor Manuel Interviewed', *Business iAfrica.com*, accessed on 6 November 2007 at <http://business.iafrica.com/budget_2006_2007/budget_news/900980.htm>
- Wood S (2001) 'Brace for the blade', *The Financial Mail*, August
- Woolworths Holdings Ltd. (2007) *Annual Report 2007*, Cape Town, Woolworths Holdings Limited
- Taxgram (2004), 'Small business receive support from SARS', *Taxgram*, No. 3, April
- Taxgram (2006a), 'Small business tax amnesty – latest', *Taxgram*, No. 7, August
- Taxgram:(2006b), 'Advanced tax ruling system implemented', *Tagram*, No. 10 December

Cases

- *Visser v CIR* 1937 TPD 77, 8 SATC 271

Personal correspondence

- Honiball M (Michael.Honiball@kpmg.co.za), 16 November 2007, RE: *tax avoidance*, emailed to W Maroun (Warren.Maroun@wits.ac.za)
- Q-tech Ltd (Q-tech@mweb.co.za), 15 August 2007, RE: *the administration costs of complying with the Eighth Schedule to the Act*, e-mailed to W Maroun (Warren.Maroun@wits.ac.za)

- Roxo R (r.roxo@mci.co.za) , 23 October 2007, *RE: the effects of inflation on capital gains*, e-mailed to W Maroun (warren.maroun@wits.ac.za) (Mr. R Roxo is an BSc (Actuarial Science) graduate from the University of the Witwatersrand currently employed at MCI, a financial advisory and consultancy firm in Johannesburg)
- Swartz G (Gary.Swartz@wits.ac.za), 7 August 2007, *RE: CGT and the cost of capital*, e-mailed to W Maroun (Warren.Maroun@wits.ac.za) (Mr. G Swartz is CA(SA) and a senior lecturer at the University of the Witwatersrand – School of Accountancy, Division of Managerial Accountancy and Finance.)
- Stacey A (Anthony.Stacey@wits.ac.za), 28 November 2007, *RE Correspondence analysis – results*, emailed to W Maroun (Warren.Maroun@wits.ac.za) (Dr A Stacey is a BSc (Electrical Engineering) graduate for the University of Cape Town with an MBA and PhD from the University of the Witwatersrand. He currently lectures at the University of the Witwatersrand's Business School)

Government Publications

- Budget Review (2004) accessed on 11 November 2006, at :
<http://www.treasury.gov.za>
- Budget Review (2005) accessed on 11 November 2006, at :
<http://www.treasury.gov.za>
- Budget Review (2006) accessed on 11 November 2006 at :
<<http://www.treasury.gov.za>>
- Budget Review (2007) accessed on 12 November 2007 at:
<<http://www.treasury.gov.za>>
- Budget Review (2008) accessed on 12 November 2007 at:
<<http://www.treasury.gov.za>>
- Budget Speech (2005) accessed on 11 November 2006 at :
<<http://www.treasury.gov.za>>
- Budget Speech (2006) accessed on 11 November 2006 at :
<<http://www.treasury.gov.za>>

- Budget Speech (2007) accessed on 1 June 2007 at :
<<http://www.treasury.gov.za>>
- Budget Speech (2008) accessed on 1 June 2007 at :
<<http://www.treasury.gov.za>>
- Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa (The Katz Commission) (1995), Government Printer, Pretoria
- Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa (The Margo Commission) (1986), Government Printer, Pretoria
- Taxation Review Committee - (Accessed at
<http://www.setis.library.usyd.edu.au/ozlit/> on 11 November 2006.)

Statutes

South Africa:

- Income Tax Act No. 58 of 1962 (as amended), contained in *SA/CA Legislation Handbook 2006/2007*, LexisNexis Butterworths, Durban, 2006
- Estate Duty Act No. 45 of 1955 (as amended), contained in *SA/CA Legislation Handbook 2006/2007*, LexisNexis Butterworths, Durban, 2006

Bibliography

- Andrew K (2001) 'Lets get our priorities straight', *Financial Mail*, February 8
- Browning E, William J (1984) 'The trade-off between equality and efficiency', *Journal of Political Economy*, Vol.92, No.2, June
- Kay J and King M (1978) *The British Tax System*, Oxford University Press, Oxford
- Rosen H (1992) *Public Finance*, 3rd Edition, R.R. Donnelley and Sons Company, New York
- Shlaes A (2007) 'Like vineyards, US taxation has its good and bad years', *Business Report*, April 12, accessed on 20 May 2007, at
<<http://www.busrep.co.za/index.php?fSectionId=642&fArticleId=3777996>>