

# A Comparative Analysis of the Treatment of Inflation in South African Capital Gains Tax and the Accrual Systems

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## Abstract

Inflation is often defined as a continuous and considerable rise in prices in general. Recently it has become a focal point due to globally elevated levels of inflation. Considering its treatment in the South African legal system, this article unpacks the contrary approaches of the *Matrimonial Property Act 88 of 1984* (MPA) and the *Income Tax Act 58 of 1962* (ITA) regarding inflation. These two Acts are considered as they provide different approaches to inflation, therefore different outcomes. While the MPA makes provision for inflation in determining the growth of each of the estates of spouses married out of community with the accrual system, the ITA does not recognise inflation insofar as it relates to capital gains tax. Comparing the approaches of the MPA and the ITA reveals disparities in the law and justifies the investigation conducted in this article.

Accordingly, this article compares the effect of inflation and capital gains tax and why inflation is not considered when determining the base cost of an asset for capital gains tax purposes. To explain the inconsistency between the MPA and the ITA, this article firstly unpacks the characteristics of the South African matrimonial property regime insofar as it relates to inflation. Thereafter, the article characterises the South African application of the capital gains tax and articulates the shortcomings of existing capital gains tax provisions and the resulting challenges in the application of both Acts.

In comparing the ways in which the MPA and the ITA deal with inflation, a clear distinction becomes evident. This article finds that, while the initial inclusion rate for capital gains tax inflation is largely accommodated, subsequent increases in the inclusion rate have erased this provision. Given these findings, this article suggests that the current South African capital gains tax regime's inclusion rate be further investigated to determine whether a wider set of exclusions could be developed to better accommodate inflation.

## Keywords

Capital gains taxation; marital property regimes; *Zugewinnngemeinschaft*; inflation; capital gains tax inclusion rate; *Matrimonial Property Act 88 of 1984*; *Income Tax Act 58 of 1962*.

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## 1 Introduction

Inflation is simply defined as "a continuous and considerable rise in prices in general".<sup>1</sup> There are several possible causes of it and this definition does not weigh in favour of any specific one. Despite its various possible causes, inflation impacts many aspects of individuals' economic lives. The South African Reserve Bank, for example, acknowledges its impact in calculating Gross Domestic Product (GDP), which measures the growth of the South African economy.<sup>2</sup> By adjusting the GDP the South African Reserve Bank ensures that it does not artificially inflate the purported rate at which the economy grows since inflation may increase the price of a product without increasing its value.<sup>3</sup> To reveal the real economic growth of South Africa, the nominal GDP (calculated at the price of products as they are at the time of calculation)<sup>4</sup> is converted to the real GDP (calculated as if prices remained constant).<sup>5</sup>

When viewed in this light, inflation can be a real concern for citizens, particularly for taxpayers.<sup>6</sup> Mohr *et al*<sup>7</sup> recognise its impact on taxpayers as:

When there is inflation, taxpayers' nominal incomes (e.g. wages and salaries) rise even when their real incomes remain unchanged. Taxes, however, are levied on nominal income and not on real income.

Accordingly, inflation increases the quantum of taxes paid by consumers when salaries increase, but tax brackets remain constant. This principle also stands regarding capital gains tax (CGT) as inflation increases the real price of an asset without increasing its value. This occurrence is defined as "bracket creep" in economics.<sup>8</sup>

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<sup>1</sup> Mohr *et al Economics for South African Students* 382; alternatively, inflation can be defined as "a persistent tendency for prices and money wages to increase" (Black *Dictionary of Economics* 235).

<sup>2</sup> Mohr *et al Economics for South African Students* 235.

<sup>3</sup> Mohr *et al Economics for South African Students* 384.

<sup>4</sup> Mohr *et al Economics for South African Students* 384.

<sup>5</sup> Mohr *et al Economics for South African Students* 384.

<sup>6</sup> Sadka 1991 *SPIMF* 150.

<sup>7</sup> Mohr *et al Economics for South African Students* 384.

<sup>8</sup> Mohr *et al Economics for South African Students* 385.

In comparing the treatment of inflation,<sup>9</sup> this article unpacks the different approaches of the *Matrimonial Property Act*<sup>10</sup> and the *Income Tax Act*.<sup>11</sup> These two Acts are considered as their different approaches have different outcomes.

As will become evident in the paragraphs to follow, the *Matrimonial Property Act* makes provision for inflation in determining the growth of each of the estates of spouses married out of community of property, with the accrual system. Accordingly, a spouse's initial estate must be multiplied by the Consumer Price Index (CPI) to determine an adjusted value.<sup>12</sup> This initial estate value can then be subtracted from the adjusted estate value to determine each of the spouses' net estates.<sup>13</sup> Should the growth of the spouses' estates differ, then the spouse with the smaller estate is entitled to "half of the difference between the accrual of the respective estates of the spouses".<sup>14</sup>

When compared to the *Matrimonial Property Act*, the *Income Tax Act* does not recognise inflation insofar as it relates to CGT. Rather, realised gains are calculated using the base and market values of a taxpayer's assets.<sup>15</sup> In this approach the nominal income of a capital gain consists of an inflationary component and a real income component, leading to the taxation of inflationary growth.<sup>16</sup> Hockley<sup>17</sup> illustrates this challenge from a British CGT background:

Consider the man who in 1968 buys an investment for £10,000 which produces an income of 10 per cent. Let us assume that by 1971 the investment has increased in real value by 10 per cent but that money values have depreciated by 10 per cent. So he sells the asset for £12,100 (in 1971 money) when it is producing £1,210 per annum on which he pays income tax. Under our present law he will pay capital gains tax on a gain of £2,100, although his real gain in 1971 money is only £1,100.

Thus, Hockley<sup>18</sup> considers the fact that in terms of real gains an asset has grown by £2,100, but in nominal terms the growth amounted to only £1,100. When this asset is then sold and becomes subject to CGT, a fictional

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<sup>9</sup> As considered above, for the purposes of this piece, inflation is defined as the "continuous and considerable rise in prices in general" over a period of time (Mohr *et al Economics for South African Students* 382).

<sup>10</sup> *Matrimonial Property Act* 88 of 1984 (the *Matrimonial Property Act*).

<sup>11</sup> *Income Tax Act* 58 of 1962 (the *Income Tax Act*).

<sup>12</sup> Section 4(1)(b)(iii) of the *Matrimonial Property Act*.

<sup>13</sup> Section 4(1)(a) of the *Matrimonial Property Act*.

<sup>14</sup> Section 3(1) of the *Matrimonial Property Act*.

<sup>15</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf>.

<sup>16</sup> Sadka 1991 *SPIMF* 138.

<sup>17</sup> Hockley 1968 *BTR* 8.

<sup>18</sup> Hockley 1968 *BTR* 8.

increase of £1,000 is taxed. Therefore, the additional inflationary gain of £1,000 is included in the CGT calculation as a real gain although it does not add to the increase in the value of the asset.<sup>19</sup>

Comparing the approaches of the *Matrimonial Property Act* and *Income Tax Act* reveals disparities and concretises the intention of this article. In what follows the reasoning for the inclusion of inflation in the accrual system will be explored and the lack of its application in CGT will be evaluated. These two objectives will serve to critique the way CGT is calculated and provide a set of suggestions and observations to review the present position.

## 2 Problem statement and outline of the article

Based on the above, this article addresses the following: which comparatives can be drawn between the effect of inflation and CGT, and why is inflation not provided for when determining the base cost of an asset for CGT purposes?<sup>20</sup>

The ensuing discussion will first consider the approach of the *Matrimonial Property Act* and then the *Income Tax Act* to explain the inconsistency between the *Matrimonial Property Act* and the *Income Tax Act*. Therefore, section 3 investigates the origins and nature of the *Matrimonial Property Act* insofar as it considers inflation.

The fourth section focusses on the *Income Tax Act* and sets out the characteristics of the CGT, its application in South Africa and a few notable alternatives. Given the reasoning behind the South African CGT system, the fifth section provides a calculation of capital gains taxation in South Africa. Through calculation the fifth section highlights the shortcomings of the existing CGT provisions and the challenges posed by the failure to acknowledge inflation therein. Critique and suggestions are then offered on the basis of these findings.

## 3 The accrual system and the *Matrimonial Property Act*

The accrual system was first considered after an investigation by the South African Law Commission (SALC), which had uncovered the "unsatisfactory results" of various aspects of the *Matrimonial Affairs Act 37 of 1953*,<sup>21</sup> including financial exclusion and matrimonial power.<sup>22</sup> Upon the recommendation of the Law Commission in 1975 the Minister approved the

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<sup>19</sup> Hockley 1968 *BTR* 8.

<sup>20</sup> Section 4(1)(b)(iii) of the *Matrimonial Property Act*.

<sup>21</sup> *Matrimonial Affairs Act 37 of 1953*.

<sup>22</sup> Item 1.1 in SALC *Report Pertaining to the Matrimonial Property Law*.

initiation of SALC Project 15, titled the *Review of the Matrimonial Property Law, with Specific Reference to the Matrimonial Affairs Act, the Status of the Married Woman, and the Law of Succession in so far as it Affects the Spouses*.<sup>23</sup> This project culminated in a report of the same name which included a draft Matrimonial Property Bill.<sup>24</sup> The report solidified the need for change and mandated the establishment of a special parliamentary committee to further investigate the SALC's report.<sup>25</sup> Upon recommendation by this special parliamentary committee, the Minister of Justice declared that the Bill be enacted into law on 28 October 1983.<sup>26</sup>

In formulating a recommendation for the then *status quo*, the SALC surveyed the matrimonial property systems of West Germany, the Netherlands, France, Sweden and England.<sup>27</sup> Following deliberations the SALC recommended a system based on the West German *zugewinnngemeinschaft*, which the SALC named the "accrual system" in its draft Matrimonial Property Bill.<sup>28</sup> The *zugewinnngemeinschaft* is the default matrimonial property system of Germany.<sup>29</sup> It is based on legal and financial independence during the marriage and, upon divorce, gains to each estate are pooled and shared equally between spouses.<sup>30</sup> Accordingly, the system allows for the benefits of a "community of accrued gains" but at no stage are the estates of the spouses communal.<sup>31</sup>

The division is achieved by subtracting the "*endvermörger*" (the value of both spouses' separate estates at the time when the divorce action is pending) from the value of each of the spouses' separate estates at the time of their marriage.<sup>32</sup> Unless an asset is proven to be part of an estate prior to the marriage, it forms part of the *endvermörger*.<sup>33</sup> When the total values of each of the German spouses' estates are established, the increases in each of the estates are collectively halved.<sup>34</sup> Consequently, the collective gains of each of the spouses' estates during their marriage are divided and shared

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<sup>23</sup> Item 1.1 in SALC Report Pertaining to the Matrimonial Property Law.

<sup>24</sup> Item 1.1 in SALC Report Pertaining to the Matrimonial Property Law; Sinclair 1983 ICLQ 797.

<sup>25</sup> Sinclair 1983 ICLQ. 797; Van Wyk 1983 Acta Juridica 53.

<sup>26</sup> Van Wyk 1983 Acta Juridica 53.

<sup>27</sup> Item 7-11 in SALC Report Pertaining to the Matrimonial Property Law.

<sup>28</sup> Item 17.4 in SALC Report Pertaining to the Matrimonial Property Law; Sinclair 1983 ICLQ 797, Van Wyk 1983 Acta Juridica 53.

<sup>29</sup> Scherpe 2013 CFLQ 63.

<sup>30</sup> Hahlo 1975 McGill LJ 589; Leyser 1958 Am J Comp L 279.

<sup>31</sup> Scherpe 2013 CFLQ 63; Leyser 1958 Am J Comp L 279.

<sup>32</sup> Scherpe 2013 CFLQ 63; Leyser 1958 Am J Comp L 279.

<sup>33</sup> Scherpe 2013 CFLQ 63; Leyser 1958 Am J Comp L 281.

<sup>34</sup> Scherpe 2013 CFLQ 64.

equally. Should one of the estates have grown more, the spouse with the smaller estate would be entitled to half of the growth of the larger estate.<sup>35</sup>

Following this approach, the *zugewinnngemeinschaft* attempts to promote "equality of the sexes".<sup>36</sup> Nevertheless, the *zugewinnngemeinschaft* could not escape criticism when first introduced.<sup>37</sup> One such criticism was regarding the effect of inflation on the value of the spouses' estates.<sup>38</sup> Hahlo<sup>39</sup> explains that the general understanding in the German legal context at the time was that gains in the value of an estate due to inflation did not qualify as real gains. Similarly, Sherpe<sup>40</sup> and Van Wyk<sup>41</sup> argue that the *zugewinnngemeinschaft* is intended to be a mathematical exercise concerned with the nature of the gain only if it is genuine. Sherpe<sup>42</sup> calls such gains which are not genuine, "*Scheingewinn*" or fictitious gains while Thiele<sup>43</sup> labels such cases "paper gains".

German legislators also identify the concern and highlight that a significant amount of gains in a spouse's estate can be due to inflation, especially in long marriages.<sup>44</sup> Furthermore, when the growth of an estate is calculated upon divorce, the inclusion of inflation may leave a spouse with fewer assets than the spouse had prior to the marriage.<sup>45</sup> Concerning the challenge of inflation, no single solution was clear.<sup>46</sup> To some no solution existed at all; Coester<sup>47</sup> is of the view that a general inflation allocation could never reflect the actual impact of inflation on assets. Hahlo<sup>48</sup> similarly argues that in instances of long marriages it may be "virtually impossible" to ascertain the growth of an estate at all.

Rising to the task, the German Federal Court of Justice resolved the matter by embracing the use of the "*Lebenshaltungskostenindex*",<sup>49</sup> otherwise

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<sup>35</sup> Scherpe 2013 *CFLQ* 64; Leyser 1958 *Am J Comp L* 279.

<sup>36</sup> Leyser 1958 *Am J Comp L* 276; Van Wyk 1983 *Acta Juridica* 53, 65.

<sup>37</sup> Thiele 1960 *JZ* 394; Knur *Probleme der Zugewinnngemeinschaft* 5-65; Lorenz 1959 *JZ* 105.

<sup>38</sup> Hahlo 1975 *McGill LJ* 591.

<sup>39</sup> Hahlo 1975 *McGill LJ* 591. This view is also followed by Leyser 1958 *Am J Comp L* 283.

<sup>40</sup> Scherpe 2013 *CFLQ* 65.

<sup>41</sup> Van Wyk 1983 *Acta Juridica* 64.

<sup>42</sup> Scherpe 2013 *CFLQ* 64.

<sup>43</sup> Thiele 1982 *Cal W Int'l LJ* 87-88.

<sup>44</sup> Scherpe 2013 *CFLQ* 64; a concern also recognised by South African courts, as identified by Sinclair 1989 *SALJ* 253.

<sup>45</sup> Scherpe 2013 *CFLQ* 64; a concern also recognised by South African courts, as identified by Sinclair 1989 *SALJ* 253.

<sup>46</sup> Scherpe 2013 *CFLQ* 64.

<sup>47</sup> Coester "Die vermögensrechtlichen Wirkungen" 67.

<sup>48</sup> Hahlo 1975 *McGill LJ* 591.

<sup>49</sup> Coester "Die vermögensrechtlichen Wirkungen" 67.

known as the German national cost of living index as determined annually by the German Federal Statistical Office.<sup>50</sup> The index acknowledges the impact of inflation on an asset by multiplying the index by the nominal value of the asset.<sup>51</sup> This approach provides the spouse with an adjusted initial asset value which more accurately reflects the total growth in each of the spouses' estates.<sup>52</sup> In providing this principle, Mohr *et al*<sup>53</sup> and Bryan and Cecchetti<sup>54</sup> suggest that the CPI is the most common method to measure inflation. Utilising the CPI, inflation is calculated by considering the general increase in the price of a range of goods over a period of one or more than one year.<sup>55</sup>

Acknowledging the benefits of the *zugewinnngemeinschaft*, the SALC included many of its traits in section 4 of the *Matrimonial Property Act*. The SALC further proposed the "accrual system" in its suggested Matrimonial Property Bill.<sup>56</sup> Like the German *zugewinnngemeinschaft*, the accrual system would never join the two estates of spouses but would rather entitle a spouse to half of the growth between the two estates upon divorce.<sup>57</sup> The SALC further proposed a system identical to the *zugewinnngemeinschaft*<sup>58</sup> to calculate the value of an estate whereby the initial value of each spouse's estate is to be subtracted from the end value of the estate.<sup>59</sup> The remaining total would then be considered as the estate's value.<sup>60</sup>

Another parallel between the SALC's recommendation and the *zugewinnngemeinschaft* is the inclusion of a clause dealing with inflation.<sup>61</sup> The SALC held that in order to uphold the principle that spouses share equally in the growth of each other's estates, a clause should be included to ensure that the principle is not counteracted by inflation.<sup>62</sup> Consequently, in the Draft Bill of the SALC Report clause 4(1)(c) allows for the initial value

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<sup>50</sup> Scherpe 2013 *CFLQ* 64.

<sup>51</sup> Scherpe 2013 *CFLQ* 64; Thiele 1982 *Cal W Int'l LJ* 88.

<sup>52</sup> Scherpe 2013 *CFLQ* 64; Thiele 1982 *Cal W Int'l LJ* 88.

<sup>53</sup> Mohr *et al Economics for South African Students* 382.

<sup>54</sup> Bryan and Cecchetti *Consumer Price Index* 3.

<sup>55</sup> Mohr *et al Economics for South African Students* 382.

<sup>56</sup> Sinclair 1983 *ICLQ* 797; Item 17.1 in *SALC Report Pertaining to the Matrimonial Property Law*.

<sup>57</sup> Van Wyk 1983 *Acta Juridica* 64; Sinclair 1983 *ICLQ* 797; Item 17.4 in *SALC Report Pertaining to the Matrimonial Property Law*.

<sup>58</sup> Sinclair 1983 *ICLQ* 797; Item 17.6.1 in *SALC Report Pertaining to the Matrimonial Property Law*.

<sup>59</sup> Sinclair 1983 *ICLQ* 797; Item 17.6.1 in *SALC Report Pertaining to the Matrimonial Property Law*.

<sup>60</sup> Item 17.6.1 in *SALC Report Pertaining to the Matrimonial Property Law*.

<sup>61</sup> Van Wyk 1983 *Acta Juridica* 64, 72; Item 17.6.2 in *SALC Report Pertaining to the Matrimonial Property Law*.

<sup>62</sup> Item 17.6.2 in *SALC Report Pertaining to the Matrimonial Property Law*.

of an estate to be adjusted to reflect the real value of the estate more accurately.<sup>63</sup> The adjustment was made by multiplying the initial value of the estate by the weighted average of the CPI.<sup>64</sup> This clause would ensure that the matrimonial property system provides for the natural "fluctuation in the value of money".<sup>65</sup>

The SALC further believed that such a provision allowed for the fluctuation variance of the items in the estate,<sup>66</sup> arguing that although the value of individual items may be different, all "goods, in the long term change at more or less the same rate".<sup>67</sup> In short, the SALC addressed criticism regarding variable inflation in an estate by arguing that most estates include a fair balance of items which are affected by inflation and those which hold their value or grow in value.<sup>68</sup> However, the SALC was aware that this finding did not imply that balanced inflation exists in all estates and subsequently suggested the addition of clause 4(1)(b), which allowed spouses to specifically exclude assets from the accrual calculation.<sup>69</sup>

The above considerations culminated in sections 3 and 4 of the *Matrimonial Property Act*. Section 3(1) of the *Matrimonial Property Act* establishes a spouse's right to claim "half of the difference between the accrual of the respective estates of the spouses" based on the accrual system.<sup>70</sup> Section 4(1)(a) of the *Matrimonial Property Act* details that the accrual of an estate is the amount by which an estate has grown subsequent to the marriage, supported by section 6(1) of the *Matrimonial Property Act*, which allows a spouse to declare his/her estate's value in the antenuptial contract.<sup>71</sup> Section 4(1)(b)(iii) of the *Matrimonial Property Act* explicitly recognises the impact of inflation:<sup>72</sup>

the net value of that estate at the commencement of his marriage is calculated with due allowance for any difference which may exist in the value of money at the commencement and dissolution of his marriage, and for that purpose the weighted average of the consumer price index as published from time to

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<sup>63</sup> Van Wyk 1983 *Acta Juridica* 72; Item 17.6.2 in SALC *Report Pertaining to the Matrimonial Property Law*.

<sup>64</sup> Van Wyk 1983 *Acta Juridica* 72; Item 17.6.2 in SALC *Report Pertaining to the Matrimonial Property Law*.

<sup>65</sup> Item 17.6.2 in SALC *Report Pertaining to the Matrimonial Property Law*.

<sup>66</sup> Item 17.6.2 in SALC *Report Pertaining to the Matrimonial Property Law*.

<sup>67</sup> Item 17.6.2 in SALC *Report Pertaining to the Matrimonial Property Law*.

<sup>68</sup> Item 17.6.2 in SALC *Report Pertaining to the Matrimonial Property Law*.

<sup>69</sup> Item 17.6.3 in SALC *Report Pertaining to the Matrimonial Property Law*.

<sup>70</sup> De Jong and Pintens 2005 *TSAR* 557.

<sup>71</sup> De Jong and Pintens 2005 *TSAR* 557.

<sup>72</sup> De Jong and Pintens 2005 *TSAR* 557.

time in the Gazette serves as prima facie proof of any change in the value of money.<sup>73</sup>

Note that this clause does make provision for inflation; the CPI serves only as *prima facie* proof of the rate of inflation. Spouses can also institute a measure other than the CPI – e.g., market value – in their antenuptial contract.<sup>74</sup>

Considering the above, one finds that the principle that spouses share equally in the growth of each other's estates reflects in both the Draft Bill and the *Matrimonial Property Act*.<sup>75</sup> By the same token, the clauses regarding the accrual system in the Draft Bill of the SALC report and the *Matrimonial Property Act* include inflation.<sup>76</sup> Given the fact that the principles of the *zugewinnngemeinschaft* accounted for inflation, the resulting South African legislation based on this principle followed suit.<sup>77</sup> The *Income Tax Act*, on the other hand, does not account for inflation when determining the total value of assets (in the context of CGT). This will be discussed in the following section, whereafter the positions of the two Acts are juxtaposed.

## 4 Capital Gains Tax

### 4.1 The principles of the Capital Gains Tax

Evans<sup>78</sup> explains that various forms of CGT have existed since the inception of the tax in Norway in 1911. Of 161 countries surveyed, 112 had a CGT system in place in 2002, including South Africa.<sup>79</sup> Of the countries that form part of the Organisation for Economic Co-operation and Development (OECD), only two do not make provision for CGT, specifically New Zealand and the Netherlands.<sup>80</sup> The South African CGT position is explained in this section. Thereafter, a consideration of foreign CGT systems is provided. The comparative develops from the "nearly universal"<sup>81</sup> practice of CGT, with a few notable exceptions. The provisions of New Zealand, the Netherlands and other jurisdictions which account for inflation are discussed and compared to the South African CGT system.

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<sup>73</sup> Section 4(1)(b)(iii) of the *Matrimonial Property Act*.

<sup>74</sup> De Jong and Pintens 2005 *TSAR* 557.

<sup>75</sup> Leyser 1958 *Am J Comp L* 276; Van Wyk 1983 *Acta Juridica* 53, 65.

<sup>76</sup> Section 4(1)(C) of the Draft Bill (Item 17.6.2 in *SALC Report Pertaining to the Matrimonial Property Law*) and s 4(1)(a)(iii) of the *Matrimonial Property Act*.

<sup>77</sup> Item 17.6.1 in *SALC Report Pertaining to the Matrimonial Property Law*.

<sup>78</sup> Evans 2002 *Journal of Australian Taxation* 116.

<sup>79</sup> Evans 2002 *Journal of Australian Taxation* 117.

<sup>80</sup> Jacomb 2014 *Auckland U L Rev* 125; Evans 2002 *Journal of Australian Taxation* 116.

<sup>81</sup> *Tanzi Taxation, Inflation and Interest Rates* 4.

Firstly, Barker<sup>82</sup> provides a general definition which will serve as the point of departure for this inquiry into CGT:

capital gains are non-recurring gains from the disposition of properties that do not form part of the normal stream of income from employment, business or investment. Are capital gains income? The answer is that our views on this question have changed over time.

For South Africa, the *Commissioner for Inland Revenue v Visser*<sup>83</sup> case established the distinction of whether capital gains were income.<sup>84</sup> The *Visser* case followed the principle established in the United States of America's Supreme Court case, *Eisner v Macomber*,<sup>85</sup> which introduced the distinction between income and capital.

In referencing one of Adam Smith's<sup>86</sup> foundations of a fair tax – "the fruits of the taxpayer's efforts may be taxed but not the seed of those fruits" – it was held in *Visser*<sup>87</sup> that, as a tree produces fruit, capital produces income.<sup>88</sup> Recognising the appropriateness of Smith's fruit and tree analogy, *Visser*<sup>89</sup> is notably cautious in recognising that fruit in one case may be capital in another.<sup>90</sup> An art collection, for example, amounts to a capital asset for a home owner while the same collection is an income asset for an art gallery when the pieces of art are disposed of in the production of income.<sup>91</sup> This distinction may vary based on the specific facts of each case and not all cases are as simple as that of *Visser*.<sup>92</sup> For that reason the development of a single universal test to distinguish assets in this manner seems futile.<sup>93</sup> Instead multiple indicators to determine whether a receipt is income or capital in nature have been developed.<sup>94</sup> This includes a number of

<sup>82</sup> Barker 2005 *Penn St L Rev* 720.

<sup>83</sup> *Commissioner for Inland Revenue v Visser* 1937 8 SATC 271 (the *Visser* case).

<sup>84</sup> An in-depth evaluation of the distinction between capital and revenue is beyond the scope of this article. For the current South African position see SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 11-30.

<sup>85</sup> *Eisner v Macomber* 1920 252 US 189.

<sup>86</sup> As quoted by Maroun, Turner and Sartorius 2011 *SAJEMS* 436.

<sup>87</sup> *Visser* case 271.

<sup>88</sup> *Visser* case 276. See also SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 18.

<sup>89</sup> *Visser* case 271.

<sup>90</sup> *Visser* case 276.

<sup>91</sup> *Visser* case 276.

<sup>92</sup> *Visser* case 271.

<sup>93</sup> SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 13.

<sup>94</sup> SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 13-30; Coetzee *et al Student's Approach to Income Tax* 57.

subjective tests and objective factors to be considered and applied insofar as the individual matters relate to the specific case.<sup>95</sup>

For the purposes of this article, the test used in *Visser* is sufficient to illustrate this comparison at the heart of CGT, failing which, the lack of a CGT leads to:

many distortions in the economy, by encouraging taxpayers to convert otherwise taxable income into tax-free capital gains.<sup>96</sup>

Accordingly, CGT acts as a "backstop" to ensure that income cannot be misrepresented as capital gains and therefore not taxed.<sup>97</sup> While this countermeasure does assist in ensuring adequate taxation, it is not without critique.<sup>98</sup> When considering the distinction between income and capital gains, Jacomb<sup>99</sup> argues that the CGT is an administrative burden that does not increase the tax base of a country meaningfully. However, Jacomb<sup>100</sup> acknowledges that having no CGT fails to ensure horizontal equity in the tax base.<sup>101</sup> Thereby, two taxpayers who each receive the same revenue could pay divergent tax rates due to the fact that one receives revenue of a capital nature while the other receives revenue of an income nature.<sup>102</sup> Burman and White<sup>103</sup> also reach this conclusion when examining the New Zealand tax system – which does not accommodate CGT.

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<sup>95</sup> Coetzee *et al Student's Approach to Income Tax* 57-66; SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 13-19. The most important test used to determine the distinction between capital and revenue receipts is intention (*Commissioner for Inland Revenue v Stott* 1928 3 SATC 253 254; Rabenowitz *et al South African Financial Planning Handbook* 694) but other factors like the length of the holding period, the realisation of an asset to the best advantage of the owner, the sale of surplus land, the realisation period etc. can also influence the nature of the revenue. Other tests which are used include the "filling a hole" test, the "once and for all" test, the "for keeps" test and the "enduring benefit" test (SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 17-25).

<sup>96</sup> SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 1.

<sup>97</sup> Evans 2002 *Journal of Australian Taxation* 118.

<sup>98</sup> Burman and White 2003 *NZJTL* 356.

<sup>99</sup> Jacomb 2014 *Auckland U L Rev* 125.

<sup>100</sup> Jacomb 2014 *Auckland U L Rev* 125.

<sup>101</sup> Which is a factor that is also emphasised by the SARS (SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 1-2).

<sup>102</sup> Jacomb 2014 *Auckland U L Rev* 125; Evans 2002 *Journal of Australian Taxation* 126; SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 1.

<sup>103</sup> Burman and White 2003 *NZJTL* 357, 363.

Barker<sup>104</sup> is of the opinion that the introduction of CGT to the South African context also assists in producing "more equity in the income tax by broadening the tax base". Barker<sup>105</sup> further argues that CGT "promotes redistribution by taxing more effectively high-income individuals". This is specifically important in the context of the high levels of inequality in South African where "the biggest share of CGT revenues can be attributed to the wealthiest of individuals".<sup>106</sup> This practice, in turn, promotes equity for the South African tax system<sup>107</sup> as groups which are able to bear the tax burden are taxed in accordance with their ability.<sup>108</sup> The South African interpretation of these principles is discussed in the following subsection, followed by an international perspective.

## **4.2 The application of the capital gains tax in South Africa and other jurisdictions**

### **4.2.1 South Africa**

The inclusion of the CGT in South African tax law was first announced by the Minister of Finance during the National Budget Review on 24 February 2000,<sup>109</sup> with the specific conditions forming the Eighth Schedule of the *Income Tax Act*.<sup>110</sup> This was authorised by the inclusion of section 26A of the *Income Tax Act* stipulating that a taxpayer's taxable income included "the taxable capital gain of that person for that year of assessment". This provision was formalised in the South African tax regime on 1 October 2001<sup>111</sup> and only gains made after 1 October 2001 are taxed.<sup>112</sup>

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<sup>104</sup> Barker 2005 *Penn St L Rev* 720.

<sup>105</sup> Barker 2005 *Penn St L Rev* 720.

<sup>106</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 10-11.

<sup>107</sup> Barker 2005 *Penn St L Rev* 720; Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 10.

<sup>108</sup> Maroun, Turner and Sartorius 2011 *SAJEMS* 438.

<sup>109</sup> Cassidy 2004 *SA Merc LJ* 164. On 23 February 2000 the SARS also published an introductory guide to the proposed CGT and invited commentary thereon from stakeholders until 31 March 2000 (SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 1).

<sup>110</sup> Coetzee *et al Student's Approach to Income Tax* 485; for the detailed reasoning behind the inclusion of the tax see the National Treasury briefing of 24 January 2001 (Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf>).

<sup>111</sup> Coetzee *et al Student's Approach to Income Tax* 485; Rabenowitz *et al South African Financial Planning Handbook* 691.

<sup>112</sup> Rabenowitz *et al South African Financial Planning Handbook* 691; Cassidy 2004 *SA Merc LJ* 167; Rabenowitz *et al South African Financial Planning Handbook* 691.

CGT is calculated by adding all the capital gains and losses for the year and subtracting any capital losses brought forward.<sup>113</sup> Should a gain exist which is above the annual exclusion threshold of R40 000 and no other exemptions apply,<sup>114</sup> then it would be included at a rate of 40% for natural persons.<sup>115</sup>

To determine whether each disposal of an asset that is of a capital nature constitutes a capital gain (which is taxable) or loss (which is not taxed), an individual calculation is made.<sup>116</sup> Notably, inflation is excluded from these calculations.<sup>117</sup> A capital gain exists when the proceeds or the amount received by the taxpayer on the disposal of an asset<sup>118</sup> "exceed(s) the base cost of an asset".<sup>119</sup> Conversely, should the proceeds of the disposal not exceed the base cost of the asset, a capital loss exists and is not taxed.<sup>120</sup>

During the months prior to the implementation of the CGT system in South Africa, a briefing was held by the National Treasury's Tax Policy Chief Directorate to specifically deal with the impact of inflation on the CGT.<sup>121</sup> While the report stated that an ideal tax system would not include inflationary gains, it acknowledged that all income types have "some inflationary element" for which the existing tax system provided no compromise.<sup>122</sup> The report also acknowledged that sales in capital assets could include "a significant inflationary element" but argued that inflation

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<sup>113</sup> Coetzee *et al Student's Approach to Income Tax* 489; SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 33-35.

<sup>114</sup> Paragraph 5 of the Eighth Schedule of the *Income Tax Act*. Also see SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 35.

<sup>115</sup> Paragraph 10 of the Eighth Schedule of the *Income Tax Act*. Also see SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 7.

<sup>116</sup> Capital gains and capital losses are defined in paras 3 and para 4 of the Eighth Schedule of the *Income Tax Act*. For an example hereof please see SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 34.

<sup>117</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 22-26.

<sup>118</sup> Coetzee *et al Student's Approach to Income Tax* 490; SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 33; Rabenowitz *et al South African Financial Planning Handbook* 705.

<sup>119</sup> Paragraph 3 of the Eighth Schedule of the *Income Tax Act*.

<sup>120</sup> Paragraph 4 of the Eighth Schedule of the *Income Tax Act*.

<sup>121</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf>.

<sup>122</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 13.

was generally provided for by the moderate inclusion rate of the suggested legislation.<sup>123</sup> The National Treasury reasoned that the determination of the inclusion rates was informed in part by "partially adjusting for inflation".<sup>124</sup> The validity of this argument in later years will be tested in the example below as the inclusion rate has increased from the initial 25%<sup>125</sup> to 40%.<sup>126</sup>

Locally, only one instance exists where the South African CGT system acknowledges inflation, and it relates specifically to foreign inflation. The *Income Tax Act* acknowledges the impact of inflation on CGT when referring to controlled foreign companies,<sup>127</sup> and the tax treatment of controlled foreign companies (CFC) is in itself a contentious matter.<sup>128</sup> It is generally applied to prevent tax avoidance and ensure that the income of a CFC with domestic shareholders is taxed on a current basis.<sup>129</sup> In defining the net income of a controlled foreign company<sup>130</sup> – which includes CGT – section 9D(2A)(l)(i)(bb) of the *Income Tax Act* determines that if a CFC acquired an asset, and the foreign currency experienced an official inflation rate increase of 100% or higher in the tax year applicable, and the country subsequently abandoned its currency for a new currency, the asset would be assumed to have been acquired in the new currency rather than the abandoned currency. In comparison, other jurisdictions approach CGT in different manners. The following sub-section unpacks related examples of alternative approaches to CGT and the South African response thereto.

#### 4.2.2 Alternatives and the South African response

As stated above, all OECD countries including South Africa employ some form of CGT with the exception of New Zealand.<sup>131</sup> A number of OECD countries also allow for disregarding CGT after a specified period has passed.<sup>132</sup> In New Zealand specifically, the OECD has recommended the introduction of a CGT twice, but a number of factors including New

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<sup>123</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 13-15.

<sup>124</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 26.

<sup>125</sup> SARS 2000 <http://www.treasury.gov.za/documents/national%20budget/2000/cgt/cgt.pdf> 1.

<sup>126</sup> SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 37.

<sup>127</sup> Section 9D of the *Income Tax Act*.

<sup>128</sup> See for example Oguttu 2009 *CILSA* 73; Gutuza 2014 *CILSA* 189.

<sup>129</sup> Oguttu 2009 *CILSA* 73.

<sup>130</sup> Typically, a controlled foreign company exists where South African residents own more than half of the total participation rights of a foreign company (s 9D of the *Income Tax Act*).

<sup>131</sup> Jacomb 2014 *Auckland U L Rev* 125; Evans 2002 *Journal of Australian Taxation* 116.

<sup>132</sup> Harding *Taxation of Dividend* 33.

Zealand's "economic environment, global tax policy developments, the political will and sustainability"<sup>133</sup> have prevented its government from passing a Bill including CGT.<sup>134</sup>

New Zealand has included a set of 25 assets and trades categorised as revenue and not as capital in an attempt to achieve a system with the same function as a CGT.<sup>135</sup> Nevertheless, some argue that this inclusion does not adequately address concerns in the system.<sup>136</sup> In 2001 a Tax Review Committee was established by the New Zealand Government in part to suggest a solution to these concerns.<sup>137</sup> Surprisingly, the Committee did not suggest the implementation of a CGT and held firm that the inclusion of a CGT would not increase the fairness or benefit the administration of the tax system.<sup>138</sup> As an alternative, the Committee proposed the "Risk Free Return Method" (RFRM),<sup>139</sup> which the Committee believed could decrease the amount of "distortions generated by the absence of a comprehensive capital gains tax".<sup>140</sup>

In short, the RFRM would tax "designated investment vehicles and residential housing" by determining the asset's value at the start of each year multiplied by the "statutory risk-free rate of return" which naturally accounts for inflation.<sup>141</sup> Thereby:

if an asset is worth \$100,000 at the beginning of the year and the risk-free rate equals 4 percent, the risk-free return is \$4,000. That amount would be included in the income of the taxpayer and taxed at the taxpayer's marginal tax rate.<sup>142</sup>

The RFRM model consequently proposes that the specific types of capital gains mentioned be taxed at the rate of return on the government bonds' increase beyond inflation.<sup>143</sup> Hereby the RFRM attempts to account for New Zealand's general rate of inflation when determining the tax payable for the gains in the value of an asset. Although this may seem an effective alternative, it remains untested as the RFRM or any other CGT model has

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<sup>133</sup> Buckle 2010 *NZEP* 135.

<sup>134</sup> Jacomb 2014 *Auckland U L Rev* 141.

<sup>135</sup> Burman and White 2003 *NZJTL* 356-357, 363.

<sup>136</sup> Burman and White 2003 *NZJTL* 357; Tiong 2010 *Auckland U L Rev* 295; Buckle 2010 *NZEP* 131.

<sup>137</sup> McLeod *et al Tax Review 2001* 29.

<sup>138</sup> McLeod *et al Tax Review 2001* 8.

<sup>139</sup> McLeod *et al Tax Review 2001* 8.

<sup>140</sup> McLeod *et al Tax Review 2001* 27.

<sup>141</sup> McLeod *et al Tax Review 2001* 27. In this instance the risk-free rate of return refers to the rate of return on New Zealand government bonds minus inflation (McLeod *et al Tax Review 2001* 27).

<sup>142</sup> Burman and White 2003 *NZJTL* 371.

<sup>143</sup> McLeod *et al Tax Review 2001* 27.

not received the necessary support to be enacted into law in New Zealand.<sup>144</sup>

Another alternative approach to CGT is that of the Netherlands, where a system similar to the proposed RFRM has been in operation since 2001.<sup>145</sup> The Dutch system taxes capital income "on the basis of the expected (*ex-ante*) investment return" correlating with the risk-free rate of return,<sup>146</sup> meaning that an asset's CGT is determined by an anticipated return rather than an actual return.<sup>147</sup>

Like the Netherlands and New Zealand, four other OECD countries also acknowledge inflation in determining CGT.<sup>148</sup> Portugal, Chile and Mexico account for inflation in the realisation of an asset by either multiplying the initial cost of the asset by the inflation rate<sup>149</sup> or by correlating the realisation amount of the asset with the initial cost of the asset.<sup>150</sup> To account for inflation the initial or sale value of an asset is adjusted to include or exclude inflation, a much simpler approach than that of the Netherlands.<sup>151</sup>

Considering the unconventional methods followed by the countries above, the South African National Treasury advanced three arguments to exclude inflation from the South African interpretation of CGT.<sup>152</sup> Firstly, the taxation of CGT "on a real basis while other income and expenses are taxed on a nominal basis", it is argued, would lead to "inefficiency" in the determination of the value "as well as inequity" by distorting investment values.<sup>153</sup> The National Treasury suggests that the tax system would be iniquitous as a consequence, as wealthy individuals would benefit the most from the

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<sup>144</sup> Jacomb 2014 *Auckland U L Rev* 141.

<sup>145</sup> Cnossen and Bovenberg 2001 *International Tax and Public Finance* 471.

<sup>146</sup> Cnossen and Bovenberg 2001 *International Tax and Public Finance* 474.

<sup>147</sup> Harding *Taxation of Dividend* 24.

<sup>148</sup> Harding *Taxation of Dividend* 24.

<sup>149</sup> The South African Reserve Bank is tasked with ensuring that the South African inflation rate remains between 3 and 6 per cent, which it influences by adjusting the repurchase rate (Mohr *et al Economics for South African Students* 269).

<sup>150</sup> Harding *Taxation of Dividend* 24, 32-33.

<sup>151</sup> A comparison of the effective CGT rates as influenced by the recognition of inflation therein is beyond the scope of this piece. For a detailed international comparative from a South African perspective see Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 5-9; In 4.3 below a comparison of the impact of the systems mentioned is made by way of an example.

<sup>152</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 22-26.

<sup>153</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 27. Please see the following part for a discussion on the difference between real and nominal rates.

introduction of inflation in CGT while inflation is not exclusive to them.<sup>154</sup> Finally, the Treasury maintains that the introduction would also lead to significant administrative complexity as evidenced by the example of the Netherlands.<sup>155</sup> In considering these drawbacks and the international trend away from inflation indexation,<sup>156</sup> the National Treasury concludes that only in cases of sustained and significant inflation would inflationary adjustments be necessary.<sup>157</sup>

It becomes clear that plausible alternatives from the international perspective were considered prior to the suggested South African CGT regime's implementation.<sup>158</sup> This section discusses how – although this mechanism is not exempt from critique<sup>159</sup> - CGT contributes to the equity of a tax system by primarily functioning as a "backstop".<sup>160</sup> In the following section the impacts of inflation on CGT are illustrated by way of an example, leading to critique and a set of considerations for the South African CGT regime.

## 5 Capital Gains Tax and inflation

Paragraph 3 showed that the South African matrimonial property system introduced the accrual system to further equality between spouses,<sup>161</sup> by calculating and distributing the growth in the estates of the spouses equally.<sup>162</sup> This process also accounted for the impact of inflation in the calculation of the growth of an estate.<sup>163</sup> The reasoning behind this inclusion was founded in the German *zugewinnngemeinschaft* on which the accrual system was largely based.<sup>164</sup> When compared with the South African CGT

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<sup>154</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 24.

<sup>155</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 24.

<sup>156</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 33.

<sup>157</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 27. Sustained and significant inflation is characterised by the National Treasury as beyond 20% for a period of more than one year (Tax Policy Chief Directorate of the National Treasury *Capital Gains Tax* 29).

<sup>158</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 4-10; SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 55.

<sup>159</sup> Maroun, Turner and Sartorius 2011 *SAJEMS* 436.

<sup>160</sup> Evans 2002 *Journal of Australian Taxation* 118; Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 2.

<sup>161</sup> Leyser 1958 *Am J Comp L* 276; Van Wyk 1983 *Acta Juridica* 53, 65.

<sup>162</sup> Section 3(1) of the *Matrimonial Property Act*; De Jong 2012 *Stell LR* 225.

<sup>163</sup> Section 4(1)(b)(iii) of the *Matrimonial Property Act*.

<sup>164</sup> Item 17.6.2 in *SALC Report Pertaining to the Matrimonial Property Law*.

regime, it is found that the system does not account for inflation whereas some foreign jurisdictions do, recognising the possible impact thereof on taxation.<sup>165</sup> Below, CGT is applied to an example to illustrate the impact of inflation and gauge the validity of the South African National Treasury's response to the challenges raised. Thereafter, concluding recommendations are made in the final section of this article.

Consider the following to illustrate<sup>166</sup> the nature of the CGT regime. Assume that an individual purchases a townhouse in Potchefstroom for R500 000,00 on 2 October 2009.<sup>167</sup> Shortly thereafter, that same individual buys a family home also for R500 000,00. As time passes, the value of both properties increases, in part due to inflation. Should the individual later sell the family home for R2 600 000 and the townhouse for R1 800 000, the capital gains would amount to R2 100 000 and R1 300 000 respectively for these two transactions.<sup>168</sup> These amounts would be subject to CGT as depicted in Table 1 below.

**Table 1**

Family house		Townhouse	
Proceeds	R2,6m	Proceeds	R1,8m
Base cost	R0,5m	Base cost	R0,5m
Gain	R2,1m	Gain	R1,3m

<sup>165</sup> Harding *Taxation of Dividend* 24, 32-33. Accruals are also excluded from CGT (SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 187).

<sup>166</sup> This is a refashioned example from the SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 440. In the example, two properties are purchased for R500 000 and sold for R2,6m and R1,8m respectively.

<sup>167</sup> In the example of SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 440 the above figures were used to represent the impact of a primary residence exclusion for an individual with two houses. For the current purpose, the example adequately represents the impact of the inclusion rate on inflation, as will be discussed further below.

<sup>168</sup> This is a significantly simplified example. The sale of a house can be subject to several additions in its base cost and some exclusions see SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 437 in this regard.

Primary residence exclusion	R2,0m	Primary residence exclusion	R0
Balance for both transactions subject to CGT			R1,4m
Minus the annual exclusion			R40 000
Aggregate capital gain			R1,36m
Taxable capital gain (40% of aggregate capital gain)			R544 000
Tax payable (in accordance with the 2020/21 tax brackets)			R141 033

Should the individual have no other income during the period, the taxable capital gains income would amount to R544 000,00 and R141 033,00 would be payable to the South African Revenue Service.<sup>169</sup> It is clear in this case that the full gain including inflation is taxed for the townhouse, while not for the family house. For the duration of the ownership (from 2009 to 2021) the annual national house price inflation rates are detailed in Table 2 in percentages.<sup>170</sup>

**Table 2**

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
2.6	4.1	2.7	4.1	5.1	5.5	5.6	4.6	4.1	2.5	3.0	4.6

Considering the accumulated inflation in the national housing market, an inflationary effect to the value of each of the properties purchased is implied. In this example the inflationary effect on the house price totals to the amount of R 803 865,79 for each house. This quantum is calculated by multiplying the purchase price of each house with the annual inflation rates for 2009 to 2020. Thus, although the market price increases, when inflation is added to the base cost, as undertaken in Portugal, Chile, and Mexico,<sup>171</sup> the total

<sup>169</sup> SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 38.

<sup>170</sup> Lightstone 2021 <https://lightstoneproperty.co.za/adminNews/news.aspx?cid=3>.

<sup>171</sup> Harding *Taxation of Dividend* 24, 32-33.

inflationary effect amounts to R 803 865,80 for each house. The impact of this approach is detailed in table 3 below.

**Table 3**

Family house		Townhouse	
Proceeds	R2,6m	Proceeds	R1,8m
Base cost	R0,803m	Base cost	R0,803m
Gain	R1,796m	Gain	R0,996m
Primary residence exclusion	R2,0m	Primary residence exclusion	R0
Balance subject to CGT			R996 134,20
Minus the annual exclusion			R40 000
Aggregate capital gain			R956 134,20
Taxable capital gain (40% of aggregate capital gain)			R382 453,68
Tax payable (in accordance with the 2020/21 tax brackets)			R86 008,64

From Table 3 it is clear that, for the family home, this comparison has no significant impact as the primary residence exclusion allows for growth of up to R2 million to be deducted from the base cost, effectively neutralising the CGT of the family home and the impact of inflation.<sup>172</sup> Markedly, the primary residence exclusion was created in part to combat the inflationary effect and the tables above indicate that the exclusion functions effectively for this purpose.<sup>173</sup>

However, this does not hold true for the townhouse. In this example, R 303 865,79 of the increase is a fictional gain created by inflation and is not considered in the calculation. Should the approach of Portugal, Chile, and Mexico<sup>174</sup> be followed in this context, the total CGT would be reduced to R86 008,64.

<sup>172</sup> SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 437.

<sup>173</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 26.

<sup>174</sup> Harding *Taxation of Dividend* 24, 32-33.

The South African, Portuguese, Chilean, and Mexican approaches could be taxed at the same effective rate to remove the impact of the tax brackets on the outcome. Dividing the tax payable by the taxable capital gain of the South African example yields an effective tax rate of 25,9% for this example. To compare the findings, this flat rate could be utilised in the other example: with the flat rate of 25,9% the tax payable for the Portuguese, Chilean and Mexican approach would amount to R99 055.

Another consideration is the increase in the inclusion rate. Should the inclusion rate have remained at the initial 25%, the total taxable capital gains would be only R340 000,00 in comparison with R544 000,00 for the current South African system.<sup>175</sup> When applying the 25% inclusion rate amount to an effective tax rate of 25,9%, the tax payable would amount to R88 060,00.

In comparing the calculations based on the 25,9% effective tax rate, there are some noteworthy findings. Firstly, it is noteworthy that the 25% inclusion rate provides very similar outcomes for the South African approach and the approach of Portugal, Chile and Mexico. Utilising the 25% inclusion rate yields a total tax payable of R88 060,00 for the South African example and R99 055,00 for the approach of Portugal, Chile and Mexico. This comparison substantiates the argument of the National Treasury's Tax Policy Chief Directorate that a moderate inclusion rate can balance the effect of inflation.<sup>176</sup>

Yet when comparing the 25% inclusion rate to the current inclusion rate, the tax payable increases from R88 060,00 to R141 033. This difference amounts to an increase of 60,16% in tax payable. While viable at lower rates, this example suggests that at an inclusion rate of 40% the argument of the South African National Treasury is invalid. This article considers several recommendations in the following, final section to address this matter.

## 6 Recommendations and conclusion

In comparing the ways in which the *Matrimonial Property Act* and the *Income Tax Act* deal with inflation, a clear distinction becomes evident. In the accrual system, the increase in the value of an estate is determined by the initial value of the estate prior to the marriage in comparison with the CPI adjusted value of the estate upon the dissolution of the marriage.<sup>177</sup> The

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<sup>175</sup> SARS 2000 <http://www.treasury.gov.za/documents/national%20budget/2000/cgt/cgt.pdf> 1.

<sup>176</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 13-15.

<sup>177</sup> Section 4(1)(b)(iii) of the *Matrimonial Property Act*.

CGT system, on the other hand, determines a capital gain by deducting the amount received on the sale of an asset from the base cost of the asset without accounting for inflation.<sup>178</sup>

This comparison has revealed that the concerns raised by the German Federal Court of Justice regarding the adjustment of the *zugewinnngemeinschaft* were considered in the establishment of the South African CGT regime. This is evidenced by the initial 25% inclusion rate and the comparative findings of section 5. Nonetheless, this does not imply that the concerns raised by the Court are not applicable in instances where no CGT exclusions exist. In the *zugewinnngemeinschaft*<sup>179</sup> and the South African accrual system,<sup>180</sup> fictional gains are accommodated by including the CPI in calculating the growth of spouses' estates. This position is also true for the CGT regimes of the Netherlands, Portugal, Mexico and Chile,<sup>181</sup> whose CGT regimes all account for inflation in their CGT calculations.

Fundamentally these CGT regimes address the concerns of the German Federal Court of Justice and allow for the taxation of real capital gains but not of *scheingewinn*. In contrast, when applying a 40% inclusion rate the South African CGT regime does not recognise the impact of *scheingewinn*. Accordingly, the South African CGT regime currently requires that taxpayers be taxed on fictional gains to the value of their assets upon disposal, should no exemption apply. This has not always been the case. Based on the initial 25% inclusion rate proposed, inflation is largely accommodated; however, subsequent increases in the inclusion rate have effectively nullified this provision.

In the *zugewinnngemeinschaft* this concern was identified and addressed by including the "*Lebenshaltungskostenindex*" in the calculation of a spouse's estate.<sup>182</sup> In South Africa the recognition of inflation in the CGT system was rejected by the National Treasury.<sup>183</sup> In short, the National Treasury held that regardless of the nature of the income, inflationary effects are experienced across all assets. Providing for the effect of inflation would lead to unfairness as well as additional administrative encumbrances to make an exception for CGT.<sup>184</sup> However, this does not detract from the fact that –

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<sup>178</sup> Paragraph 3 of the Eighth Schedule of the *Income Tax Act*.

<sup>179</sup> Scherpe 2013 *CFLQ* 64.

<sup>180</sup> Section 4(1)(b)(iii) of the *Matrimonial Property Act*.

<sup>181</sup> Harding *Taxation of Dividend* 24, 32-33.

<sup>182</sup> Coester "Die vermögensrechtlichen Wirkungen" 67.

<sup>183</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 24-27.

<sup>184</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 27.

especially for assets held for lengthy periods – "a significant inflationary element" can be present.<sup>185</sup>

At first this concern was accommodated partially through exemptions and a moderate inclusion rate,<sup>186</sup> but the subsequent increases in the inclusion rate have weakened this argument as illustrated in the example above.<sup>187</sup> Instances where no exemptions apply essentially lead the CGT system to be contrary to Smith's<sup>188</sup> widely accepted fair tax system, which requires that "the fruits of the taxpayer's efforts may be taxed but not the seed of those fruits."

Given the inequalities in the treatment of inflation in the accrual system and the CGT regime, this article therefore suggests that the current CGT regime be further investigated and the inclusion rate revisited. For example, a wider set of CGT exclusions might be developed to better accommodate inflation for particularly susceptible assets. Contributions could potentially minimise instances where taxpayers need to account to and recompense the government for fictional gains in their CGT. This proposed approach would limit ordinary taxpayers from recompensing government for fictional gains, "Scheingewinn"<sup>189</sup> or "paper gains".<sup>190</sup>

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<sup>186</sup> Tax Policy Chief Directorate, National Treasury 2001 <http://www.ftomasek.com/NationalTreasury.pdf> 13-15.

<sup>187</sup> See 4.3 above; SARS 2018 <https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf> 38.

<sup>188</sup> As quoted by Maroun, Turner and Sartorius 2011 *SAJEMS* 436.

<sup>189</sup> Scherpe 2013 *CFLQ* 64.

<sup>190</sup> Thiele 1982 *Cal W Int'l LJ* 87-88.

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### List of Abbreviations

Am J Comp L	American Journal of Comparative Law
Auckland U L Rev	Auckland University Law Review
BTR	British Tax Review
Cal W Int'l LJ	California Western International Law Journal
CFC	controlled foreign company
CFLQ	Child and Family Law Quarterly
CGT	Capital gains tax

CILSA	Comparative and International Law Journal of Southern Africa
CPI	Consumer Price Index
GDP	Gross Domestic Product
ICLQ	International and Comparative Law Quarterly
ITA	Income Tax Act 58 of 1962
JZ	JuristenZeitung
McGill LJ	McGill Law Journal
MPA	Matrimonial Property Act 88 of 1984
NZEP	New Zealand Economic Papers
NZJTLP	New Zealand Journal of Taxation Law and Policy
OECD	Organisation for Economic Co-operation and Development
Penn St L Rev	Penn State Law Review
RFRM	Risk Free Return Method
SAJEMS	South African Journal of Economic and Management Sciences
SA Merc LJ	South African Mercantile Law Journal
SALC	South African Law Commission
SALJ	South African Law Journal
SATC	South African Tax Court
SARS	South African Revenue Service
SPIMF	Staff Papers of the International Monetary Fund
Stell LR	Stellenbosch Law Review
TSAR	Tydskrif vir die Suid-Afrikaanse Reg
U Chi L Rev	University of Chicago Law Review