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A CRITICAL ANALYSIS OF INFLATION ADJUSTMENT IN THE CALCULATION OF CAPITAL GAINS TAX IN SOUTH AFRICA

Mini dissertation by

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ABSTRACT

A CRITICAL ANALYSIS OF INFLATION ADJUSTMENT IN THE CALCULATION OF CAPITAL GAINS TAX IN SOUTH AFRICA

by

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SUPERVISOR: PROF M CRONJE

DEPARTMENT: TAXATION

DEGREE: MAGISTER COMMERCII

Inflation is a widespread occurrence in the modern world. Even in very stable economies inflation has increased rapidly over the past 20 years. In South Africa rising food, fuel and power costs will ensure that inflation remains high for some time to come. The income tax system cannot afford to ignore the importance of inflation. Capital gains on assets accumulate over the period the asset was held. The inflationary component included in the capital gain will be bigger the longer the asset is held. Capital gains are taxed only when an asset is sold, thus on a realization and not on an accrual basis. Capital gains are taxed as part of normal income in South Africa. If the annual capital gains are allowed to accumulate over years it might push the taxpayer into a higher marginal tax rate because of the use of a progressive income-tax system. A number of countries used indexation to adjust capital gains for inflation. In some countries indexation has been frozen or abolished and in others it is still used extensively today. Before a system of indexation can be introduced in the taxing of capital gains, a number of key factors should be considered. The benefits derived from inflation adjustment should not be out-weighed by the administrative and compliance cost. In the research it is concluded that South African taxpayers enjoy some limited indirect inflation adjustment. If attention is just focused on the asset side, indexation will create a tax benefit for some taxpayers who will finance the purchase of assets with borrowed funds. The liability side cannot be ignored and therefore further research will be needed to determine if the inflationary interest component should also be disallowed as a deduction for taxpayers.

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OPSOMMING

'N KRITIESE ONDERSOEK NA INFLASIE AANPASSING IN DIE BEREKENING VAN KAPITAALWINSBELASTING IN SUID AFRIKA

deur

SANTIE FOURIE

STUDIE LEIER: PROF M CRONJE

DEPARTEMENT: BELASTING

GRAAD: MAGISTER COMMERCII

Inflasie kom wydverspreid in die moderne wêreld voor. Selfs in baie stabiele ekonomieë het inflasie baie gestyg oor die afgelope 20 jaar. In Suid-Afrika sal stygende kos, petrol en elektrisiteitskoste verseker dat inflasie hoog sal bly vir 'n tydperk. Die belastingstelsel kan nie bekostig om die effek van inflasie te ignoreer nie. Kapitaalwins akkumuleer oor die tydperk wat die bate gehou word. Die inflasie komponent wat ingesluit is in die kapitaalwins sal groter wees hoe langer die bate gehou word. Kapitaalwins word slegs belas wanneer die bate verkoop word, d.w.s. met realisasie en nie op 'n toevallingsbasis nie. Kapitaalwins word belas as deel van normale inkomste in Suid Afrika. As die jaarlikse kapitaalwins toegelaat word om oor die jare te akkumuleer mag dit die belastingpligtige in 'n hoër marginale belastingkoers instoot omdat 'n progressiewe inkomste belastingstelsel gebruik word. 'n Aantal lande het indeksering gebruik om kapitaalwins vir inflasie aan te pas. In sommige lande is indeksering gevries of gestop maar ander lande gebruik dit nog steeds op 'n omvangryke basis. Voordat 'n stelsel van indeksering ingestel kan word in kapitaalwinsbelasting moet 'n aantal faktore eers oorweeg word. Die voordele wat verkry word van inflasie aanpassing moet nie oorskadu word deur die administratiewe en nakomingskoste nie. In die navorsing word die gevolgtrekking gemaak dat Suid Afrikaanse belastingpligtiges 'n mate van indirekte inflasie aanpassing geniet. As aandag slegs geskenk word aan die batekant, kan indeksering 'n belastingvoordeel skep vir sommige belastingpligtiges wat bates finansier deur die gebruik van geleende geld. Die laste kant kan nie geïgnoreer word nie en daarom sal verdere navorsing nodig wees om te bepaal of die inflasionêre rente gedeelte nie-aftrekbaar moet wees vir die belastingpligtige.

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Currency	Rand exchange rate on 17 October 2008
American Dollar ($)	$1 = R10.0775
Australian dollar ($)	$1 = R6.96051
Euro (€)	€1 = R13.5663
New Israeli Shekel (NIS)	NIS1 = R1.10174
Pound (£)	£1 = R17.4411
Rupees (Rs)	Rs1 = R0.206168

CHAPTER 1

INTRODUCTION AND PROBLEM STATEMENT

1.1 BACKGROUND

"Do you know that I bought this same tub of margarine for R28 two months ago and now it costs R38. Can you believe it?" In conversations these days many ordinary people express their shock at rising food and energy prices.

In light of the worsening inflation picture, the South African Reserve Bank is battling to keep CPIX within their inflation target of between 3% and 6%. CPIX is defined as "the consumer price index excluding interest rates on mortgage bonds." The year on year increase is calculated with reference to the same month of the previous year. (Statistics South Africa, 2008b.)

CPIX accelerated to 8.6% year on year in December 2007 (University of Stellenbosch, 2008). The increase in inflation coupled with the recent property boom in South Africa from 2000 to 2006, and the good performance of the Johannesburg Stock Exchange, creates the ideal situation for taxing capital gains caused by inflation.

The economic forecast for the year ahead indicates further rising inflation. To add to South Africa's inflationary pressures, Eskom has indicated that it will have to substantially increase the cost of energy, in order to finance expansion projects needed to solve our energy crisis. The oil price has recently hit a new record high. These two factors alone influence every business and household in South Africa. In light of the above, the holder of capital assets has reason to worry that tax will be levied on the inflationary gain and not the real gain, when capital assets are realized.

For the purpose of this study, real gain is defined as the difference between the proceeds and the inflation adjusted base cost of the asset. Inflationary gain is defined as the gain directly attributed to the rise in inflation over a period. (Sadka, 1991:138.)

Research has been conducted internationally on the influence of inflation on taxable capital gains. Previous international research indicates that it is not advisable to have the tax outcome "depend arbitrarily on the rate of inflation" (Mackie III, 2002:322). That indexing capital gains would better the fairness of the tax system in the USA as well as improve the performance of the economy (Dubay, 2006:1). That inflation increases the real rate of taxation (Lochan, 2002:1834).

All the above studies have been done in either the USA or Canada. An extensive search of leading electronic journal databases such as EBSCOHost, Emerald, GoogleScholar, Proquest, SABINET and Science Direct indicates that no previous studies have been conducted on the effect of inflation on capital gains in South Africa.
The study by Lochan (2002:1833-1867) will be partially replicated and extended upon in a South African context.

1.2 CORE RESEARCH QUESTION

The core research question that guided this study is: Should inflation be taken into account in computing taxable capital gains in South Africa?

1.3 RESEARCH OBJECTIVES

The study will be guided by the following specific research objectives:

- is any adjustment for inflation being made when calculating CGT in South Africa;
- the effect of tax on real versus inflationary capital gains;
- what is the current trend worldwide in adjusting CGT for inflation; and
- which key factors need to be considered in deciding whether to adjust CGT for inflation.

1.4 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

The proposed study will make the following contribution to the existing body of knowledge on inflation adjustment of capital gains in South Africa:

Firstly, the income tax legislation in South Africa will be reviewed to determine if any adjustment is currently made for inflation when calculating capital gains tax. Secondly, by reviewing how current practices in various countries take inflation into account in calculating capital gains, the worldwide trend will be identified. Thirdly, the key factors to consider before implementing a system to adjust capital gains for inflation will be identified in order to reach a conclusion if this practice is needed and practical in a South African context.

As far as could be determined by an extensive search of the SABINET database, no previous academic research has been done in South Africa, on the effect of inflation adjustment on capital gains realised.

From a practical perspective all taxpayers are affected by the current rising inflation in South Africa. One of our neighbouring countries, Zimbabwe's official rate of annual inflation hit 66 212% in December 2007. Many people have pondered the question whether South Africa will follow the same path as Zimbabwe.

Many taxpayers hold capital assets such as a second property, shares in companies or bonds as part of their investments or retirement savings. These taxpayers will all be affected by the inflation impact when they realise their capital asset.

Dubay (2006:2) states that inflation is one reason why the taxpayer selling an asset, actually pays a much higher percentage tax on his profit than the statutory tax rate. Furthermore, Rahn (2008:17) states that lowering the cost of capital would stimulate investment and the stock markets. Rahn (2008:17) also points out that the equity of the tax system will be increased by not taxing phantom gains caused by inflation.

1.5 DELIMITATIONS

This study will not include:

- an in dept review of the tax legislation of the various countries referred to in the study. The review will be limited to the areas of capital gains tax and how legislation caters for inflation adjustment;
- a detailed investigation of alternative methods of calculating capital gains tax;
- a detailed investigation as to whether the concept of inflation adjustment should also be introduced to other income earned on capital for example interest; or
- a detailed analysis of the effect of inflation adjustment on equity-financed assets as opposed to debt-financed assets.

1.6 ASSUMPTIONS

This study will:

- review the history and current practice in South Africa to determine if any adjustment for inflation is made when calculating CGT;
- establish what the current worldwide trend is in adjusting CGT for inflation; and
- identify key factors to consider in the adjustment of capital gains for inflation.

1.7 DEFINITION OF KEY TERMS

This study involves a number of key concepts, namely capital gain/loss, effective capital gains tax rate, inflation, consumer price index, CPIX, valuation date value, indexation, taper relief, real and inflationary gain. The way in which these key terms are defined for the purpose of this study is outlined below:

Capital gain/loss: Capital gain or loss is defined as the difference between the **proceeds** and the **base cost** of an **asset** when a **disposal** or deemed disposal occurs during the year of assessment. In order to calculate a capital gain or loss the four

requirements underlined in the definition must be present (Jordaan, Koekemoer, Stiglingh, van Schalkwyk and Wassermann, 2007:606).

Capital gains tax: There is no separate capital gains tax (CGT) in South Africa. CGT is seen as a tax on income, and has therefore been incorporated in the Income Tax Act 58 of 1962 (the Act). The taxable capital gain is included in the taxpayer's taxable income and is subject to normal tax. (Jordaan *et al*., 2007:604.)

Effective capital gains tax rate: As per SARS (2007:29), the effective capital gains tax rate is the statutory rate multiplied by the inclusion rate (see table 2).

Inflation: Britannica Online Encyclopaedia (not dated) defines inflation as follows: "Inflation is thought of as an inordinate rise in the general level of prices". Inflation is also defined as: "a general increase in prices and fall in the purchasing value of money" (AskOxford.com, not dated).

Consumer price index: Consumer price index (CPI) is defined as: "an inflationary indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food and transportation" (Investorwords.com, not dated).

CPIX: CPIX is defined as: "the consumer price index excluding interest rates on mortgage bonds." The year on year increase is calculated with reference to the same month of the previous year. (Statistics South Africa, 2008b.)

Valuation date value: The valuation date value for assets acquired before 1 October 2001 is defined in paragraph 1 of the Eighth Schedule of the Act as the value on 1 October 2001 (Jordaan *et al*., 2007: 616).

Indexation: Indexation is defined as the increase of the base cost of an asset by using an indexation factor based on the CPI (ATO, 2007a:26).

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Taper relief: Taper relief is defined as the relief given according to the period an asset was held before disposal (HMRC, 2007: 6.2). It is also referred to as the tiered rate structure (MacDowell, not dated:148).

Real gain: Real gain is the true increase in the value of an asset and is calculated as the difference between the proceeds received when selling an asset and the inflation adjusted base cost of the asset (Sadka, 1991:138).

Inflationary gain: Inflationary gain is the gain directly attributable to the rise in inflation over a period (Sadka, 1991:138).

Nominal gain: Nominal gain is the difference between the proceeds received when selling an asset and the base cost of the asset (Sadka, 1991:138).

PPI: The Producer price index (PPI) "measure the rate of change in the prices of goods and services bought and sold by producers (IMF,2005:xiii).

The abbreviations used in this research proposal are summarised in Table 1.

Table 1: Abbreviations used in this document

Abbreviation	Meaning
the Act	Income Tax Act 58 of 1962
AFI	Addition for Inflation
ATO	Australian Taxation Office
CGT	Capital gains tax
CII	Cost inflation index
CPI	Consumer price index
CPIX	Consumer price index excluding interest on mortgage bonds
DARDNI	Department of Agriculture and Rural Development
DFI	Deduction for inflation
$	Dollar
GDP	Gross domestic product
€	Euro
HMRC	Her Majesty's Revenue and Customs

Abbreviation	Meaning
IRS	Internal Revenue Service (United States)
ITAIL	Income Tax (Adjustments for Inflation) Law
ITTICL	Income Tax (Taxation under Inflationary Conditions) Law
LTCG	Long term capital gains
NIS	New Israeli Shekel
£	Pound
PPI	Producer price index
PWC	PricewaterhouseCoopers
RBT	Review of business taxation
RPI	Retail price index
Rs	Rupees
SARS	South African Revenue Services
STCG	Short term capital gains
USA	United States of America

1.8 RESEARCH DESIGN AND METHODS

A non-empirical study will be conducted by reviewing existing literature on the research question. Basic or fundamental research will be conducted in this study. This study will have an exploratory purpose by providing a basic understanding of the topic. Non-experimental research will be conducted.

A review of the history and current practice in South Africa will be done to determine if any adjustment is made for inflation in calculating capital gains tax. Relevant legislation, tax guides, text books and articles about South Africa's capital gains tax practices will be reviewed for this purpose and some numeric examples will be used to demonstrate some of the principals. An analysis will be done to demonstrate the effect of tax on real versus inflationary capital gains.

A review of the history and current practices of various countries will be done to analyse the current worldwide trend in adjusting capital gains tax for inflation. Relevant legislation, tax guides, journals and articles about the various countries will be reviewed for this

purpose. Some cross-sectional data will be analysed by comparing capital gains tax rates of different countries at the same point in time.

Key factors that need to be considered before adjusting capital gains tax for inflation will be identified, to analyse if this practice can successfully be implemented in South Africa.

1.9 STRUCTURE OF DISSERTATION

Chapter 1: Introduction and problem statement

Chapter 1 gives an introduction to the background of the study and presents the core research question and research objectives. The importance and benefits of the study as well as the delimitations and assumptions are highlighted. Next, the key terms used in the study are defined after which the research design and methods are described. Chapter 1 ends by giving an outline of the structure of the rest of the dissertation.

Chapter 2: Overview of capital gains tax in South Africa

Chapter 2 gives an overview of the history and reasons for the introduction of CGT in South Africa. After capital gains and losses are defined a brief overview is given of how CGT is calculated in South Africa. Next the effect of inflation on capital gains is examined and an analysis is done on whether South Africa's current system does compensate for inflation.

Chapter 3: The experience of other counties

In chapter 3 a review is done of the history and current practices of various countries in order to analyse the current worldwide trend in adjusting CGT for inflation.

Chapter 4: Identification of key factors to consider in adjusting CGT for inflation

Chapter 4 considers what factors need to be taken into account in considering whether or not a country should adjust its CGT for inflation.

Chapter 5: Conclusion

In chapter 5 the study is brought to a close by reaching a conclusion as to whether inflation adjustment for CGT should be introduced in South Africa.

CHAPTER 2

OVERVIEW OF CAPITAL GAINS TAX IN SOUTH AFRICA

2.1 INTRODUCTION

Capital gains tax (CGT) is a source of much debate worldwide. Countries that have already introduced CGT are academically and politically divided about it (Nedbank, 2000). In January 2001, before the introduction of CGT in South Africa, public hearings were held which created a lot of awareness, interest and debate about the topic. South Africa introduced CGT with effect from 1 October 2001. (SARS, 2007:4.)

The purpose of this chapter is to determine whether South Africa's current system of taxing capital gains compensates for inflation in any way. This chapter will start with an overview of the history and reasons for the introduction of CGT in South Africa. Then it will examine how CGT is calculated in South Africa and what the effect of inflation on capital gains is.

2.2 HISTORY AND REASONS FOR INTRODUCTION

The concept of taxing capital gains was considered from as far back as 1969 when the Franzsen Commission (verwysing?) suggested that capital gains tax should only be implemented on immovable property and marketable securities (SARS, 2007:3).

After the Franzsen Commission various other commissions advocated that CGT should be introduced. Some commissions however advocated that capital gains should not be taxed due to the administration burden it would create and the lack of capacity at SARS to handle it. (SARS, 2007:3.)

In the Budget Speech of 2000, the Minister of Finance announced that CGT would be introduced with effect from 1 April 2001. This date was later extended to 1 October 2001. (SARS, 2007:3.)

Taxable capital gains are determined under the Eighth Schedule to the Act, as it is regarded as a tax on income and is therefore subject to normal tax. Section 26A of the Act links the Act and the Eighth Schedule (Jordaan *et al*., 2007:604).

The decision to incorporate CGT into the Act was taken due to the administrative advantages created by the fact that the current provisions and systems could be used to assess, collect and handle objections and appeals regarding CGT (SARS, 2007:23).

In creating the Eighth Schedule SARS referred to the legislation of other countries such as Australia, the United Kingdom, Canada, the United States of America and Ireland. It was found however that none of the above countries CGT legislation could be used as is, as a model for South Africa. (SARS, 2007:23.)

According to SARS (2007:1), the main reasons for introducing CGT in South Africa were:

- to enable international benchmarking between South Africa and its trading partners;
- to obtain horizontal equity between taxpayers by ensuring that individuals in the same economic circumstances pay the same amount of tax irrespective of whether their income is wages or capital gains;
- to improve the vertical equity of the income tax system to ensure that taxpayers who can afford to pay tax should carry a bigger tax liability. Due to South Africa's uneven wealth distribution it was felt that the introduction of CGT would result in wealthy individuals paying more income tax as they contribute the most to CGT revenue;
- to prevent taxpayers from being creative by re-characterising income as capital;
- to broaden the tax base as more taxpayers will be liable to pay tax which will result in a lowering of overall tax rates; and
- to motivate individuals to rather invest their savings in income producing assets like equipment and machinery, than in assets that render capital gains as a return.

2.3 CALCULTION OF CAPITAL GAINS/LOSSES

2.3.1 Capital gains/losses defined

Jordaan *et al*. (2007:606) defines a capital gain/loss as the difference between the proceeds and the base cost when a disposal or deemed disposal of an asset occurs during the year of assessment. In order to calculate a capital gain or loss, four requirements have to be met. These are also called the four building blocks of CGT as defined in table 2 (Jordaan *et al*., 2007:609).

Table 2: Definitions of the four building blocks of CGT

Building block	Definition	Reference
Asset	Asset is defined as movable or immovable property of any nature, excluding any currency, and including any right or interest of any nature in such property.	Paragraph 1 of the Eighth Schedule of the Act
Disposal	A disposal arises when an asset is created, transferred or obsolete by an event, act, or operation of law. It also includes certain deemed disposals such as the cessation or commencement of residence and the change in the use of an asset.	Paragraph 11 and 12 of the Eighth Schedule of the Act
Base cost	Base cost of an asset is the direct acquisition cost plus the cost of improvement, as well as the cost of disposal of an asset. It includes the cost incurred for the valuation of the asset for CGT purposes.	Paragraph 20 of the Eighth Schedule of the Act
Proceeds	Proceeds is defined as the amount or deemed amount received by or accrued to a person as a result of the	Paragraph 35 of the Eighth Schedule of the Act

Building block	Definition	Reference
	disposal of an asset.	

Source: Adapted from SAIGR (2007: 524-530).

2.3.2 The calculation of capital gains tax in South Africa

Once all the capital gains and losses of a person have been determined, the aggregate capital gain or loss is calculated by deducting the annual exclusion from the sum of a person's capital gains or losses for the year.

The aggregate capital gain or loss is then reduced by the assessed capital loss carried over from the previous year of assessment, if any, to arrive at the net capital gain or assessed capital loss. The net capital gain is then multiplied by the inclusion rate to give the taxable capital gain, or the assessed capital loss which is carried forward to the next year of assessment. A person's taxable capital gain is then included in his taxable income in terms of section 26A and is taxed at normal tax rates. (Jordaan *et al*., 2007:609.)

Table 3 reflects the statutory tax rate as well as the effective tax rates for CGT.

Table 3: Effective CGT rates

Type of taxpayer	Inclusion rate %	Statutory rate %	Effective CGT rate %
Natural persons	25	0 -40	0 -10
Companies	50	29	14.5
Small business corporations	50	0 - 10 – 29	0 - 5 – 14.5

Source: SARS (2007:29).

2.4 INFLATION AND CAPITAL GAINS IN SOUTH AFRICA

2.4.1 Inflation

"Inflation is thought of as an inordinate rise in the general level of prices" (Britannica Online Encyclopaedia: not dated). Inflation is also defined as: "a general increase in prices and fall in the purchasing value of money" (AskOxford.com, not dated). Moderate inflation of between 1 to 3 percent is good for an economy. When inflation rises to above 3 percent it

can negatively influence those people who do not have the ability to increase their income at the same rate as inflation for example pensioners. Runaway inflation is called hyperinflation. (YourDictionary.com, not dated.)

The consumer price index (CPI) is defined as: “an inflationary indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food and transportation” (Invesorwords.com, not dated). CPI is used as a yardstick to measure inflation. The CPI represents the cost of the basket of goods and services of a typical South African household. (Resbank, not dated.)

The annual inflation rate is calculated as the percentage change in CPI of the latest month compared to the CPI of the corresponding month of the previous year (Resbank, not dated).

The South African Reserve bank’s targeted inflation measure is “the consumer price index excluding interest rates on mortgage bonds” (CPIX) (Statistics South Africa, 2008b). The CPIX rate is the monthly “percentage change in the consumer price index excluding interest rates on mortgage bonds”, compared with the same month of the previous year (Statistics South Africa, 2008b).

2.4.2 South Africa’s inflation experience

The average CPI and CPI percentage increases from 2001 to 2007 in South Africa are summarised in table 4 (Statistics South Africa, 2008a). The average CPI % increase for the year, is calculated as the percentage increase between the average CPI index for the current year and the average CPI index for the previous year.

Table 4: Average CPI index and CPI percentage increase for the year

Year	Average CPI Index for the year	Average CPI % increase for the year
2001	105.7	5.7
2002	115.4	9.2
2003	122.1	5.8
2004	123.8	1.4

Year	Average CPI Index for the year	Average CPI % increase for the year
2005	128.0	3.4
2006	134.0	4.7
2007	143.5	7.1

Source: Adapted from Statistics South Africa (2008a).

Capital gains tax was introduced in South Africa in 2001. It can be seen from table 4, that the CPI % increase shows a rising trend from 2005 to 2007 from the low of 2004. CPI breached double digits in March 2008 by reaching 10.6% year on year. This is the first time since 2002 that CPI has risen above 10%. (Statistics South Africa, 2008a.) Economists predict a further rising trend until the fourth quarter of 2008 (Steyn, 2008).

2.4.3 The effect of inflation on capital gains

The effect of inflation on capital gains can be illustrated by the following example in table 5. For the purpose of this example the annual exclusion for individuals is ignored.

The investor realises a nominal capital gain of R2 000 over a ten year period, if the effect of inflation is ignored. The nominal gain is the difference between the original amount paid for the asset or its base cost, and the amount realised when the asset is sold. Tax payable on the nominal gain will be R200. The effective tax rate on the capital gain is 10%. The effective tax rate is calculated by dividing the tax payable of R200 by the nominal capital gain of R2000.

If annual inflation rates of 1,4%, 3,4%, 4,7% and 7,1% are taken into account the inflationary gains are R149, R397, R583 and R986 respectively. Inflationary gain is defined as the gain directly attributable to the rise in inflation over a period.

Real gain is defined as the difference between the proceeds received when selling an asset and the inflation adjusted base cost of the asset. In the example real gains of R1 851, R1603, R1 417 and R1 014 are realised respectively. If tax is calculated on the real gain and not the nominal gain then tax payable declines by R15, R40, R58 and R99 respectively.

Table 5: Effect of adjusting capital gains for inflation

Facts	Annual rate of inflation			
	1.4%	**3.4%**	**4.7%**	**7.1%**
Investment in year 1	R1 000	R1 000	R1 000	R1 000
Proceeds on disposal in year 10	3 000	3 000	3 000	3 000
Nominal capital gain	2 000	2 000	2 000	2 000
Inclusion at rate of 25% for individuals	500	500	500	500
Tax payable at 40%	200	200	200	200
Effective rate of tax on capital gains	10%	10%	10%	10%
Investment adjusted for inflation	1 149	1 397	1 583	1 986
Inflationary gain	149	397	583	986
Real capital gain	1 851	1 603	1 417	1 014
Inclusion at rate of 25% for individuals	463	401	354	254
Tax payable at rate of 40%	185	160	142	101
Difference in tax payable if no adjustment for inflation	15	40	58	99
Real rate of tax on capital gains	10.8%	12.5%	14%	19.7%

Source: Adapted from Lochan (2002:1837).

It can be seen from the above example that the higher the inflation rate the higher the negative impact on the tax payable by the individual. The real rate of tax on capital gains is 10.8 % 12.5 %, 14 % and 19.7 % respectively. This is calculated by dividing the tax payable on the nominal capital gain of R200 by the real capital gain of R1 851, R1 603, R1417 and R1 014 respectively.

This example illustrates that the real rate of tax on capital gains increases due to inflation. The higher the inflation rate the higher the real rate of tax payable.

2.4.4 Determination of the base cost of an asset

The base cost of assets acquired before 1 October 2001 is determined differently from assets acquired on or after 1 October 2001. The base cost of an asset acquired on or after 1 October 2001 is the expenditure incurred to acquire the asset as set out in paragraph 20 of the Eighth Schedule of the Act (Jordaan *et al.,* 2007: 616).

According to paragraph 25, the base cost of an asset acquired before 1 October 2001 is the value on 1 October 2001 (this is also referred to as the valuation date value), plus any paragraph 20 qualifying expenditure incurred on or after the valuation date (Jordaan *et al.,* 2007: 616).

In terms of paragraph 20(1) some of the qualifying expenditure is:

- general acquisition or disposal costs such as the cost price of the asset, transfer cost, transfer duty, installation cost, advertising cost and commission paid to find a buyer or seller; and
- cost of additions or enhancements to the asset provided that the additions are still part of the asset and in a good condition, at the time of its disposal.

The valuation date value is determined according to paragraphs 26, 27 and 28 of the Eighth Schedule of the Act. When an asset is disposed of and the proceeds exceed the qualifying expenditure (historical gain) incurred before, on and after the valuation date, the taxpayer must choose between one of the following amounts as the valuation date value of the asset:

- the market value of the asset on valuation date;
- 20% of the proceeds less allowable expenditure incurred on or after valuation date; or
- the time-apportionment base cost of the asset.

In terms of paragraph 29(4) of the Eighth Schedule a person may only apply market value as the valuation date value where :

- the asset has been valued within three years after 1 October 2001;
- the price of the asset was published in the Gazette, or
- the asset was acquired from a spouse who had adopted the market value in terms of this provision.

Where market value was adopted as the valuation date value and the proceeds from the disposal of the asset do not exceed that market value, the valuation date value must be

substituted with proceeds less paragraph 20 allowable expenditure incurred on/after valuation date. This loss limitation rule in paragraph 26(3) will prevent the creation of phantom losses and replace the loss with a neutral position. This is also referred to as kink test 1. (Jordaan *et al.*, 2007:626.)

Where assets were acquired before 1 October 2001, the increase in the value of the asset which happened before the valuation date is not subject to CGT. Only the appreciation in the value of the asset after the valuation date is subject to CGT. (Jordaan *et al.,* 2007:624.)

This principle can be explained by the following example: A person bought an asset for R100 in 1998 and sold it for R1 900 in 2007. The valuation date value was determined as R900. The capital gain realised is R1800. A portion of the gain of R1800 relates to the pre-valuation date period and is not subject to CGT. This portion is calculated as the valuation date value of R900 less the original cost price of R100. Thus R800 of the R1 800 total capital gain will not be subject to CGT. The R1000 of the gain that relates to the post-valuation date period will be subject to CGT. The only way to determine the pre- and post-valuation date portion of the gain is to determine the valuation date value. (Jordaan *et al.,* 2007:624.)

2.4.5 Rollover relief

Many countries lessen the lock-in effect by granting rollover relief, through which taxpayers may defer the taxing of capital gains for a period of time (Nedbank, 2000).

Paragraphs 65 to 67C of the Eighth Schedule of the Act grants roll-over relief in certain circumstances. The recognition of these gains can be delayed until some future event takes place. Paragraph 65 allows rollover relief when there is an involuntary disposal of an asset due to theft or destruction and compensation is received by the taxpayer which is then used to purchase a replacement asset. Paragraph 66 allows rollover relief where the taxpayer was entitled to claim a capital allowance and the proceeds on the disposal of the asset is reinvested in a replacement asset. Paragraph 67 allows for rollover relief for disposals between spouses. (Jordaan *et al.,* 2007:654.)

Some experts argue that the rollover relief is “an adequate offset for the impact of inflation over the longer term.” However it causes horizontal inequality because it offers the capital gain taxpayer an advantage over the normal income tax payer in that the capital gain taxpayer has the option to defer tax which is not available to the income taxpayer. (Lochan, 2002:1842.)

Taxpayers that delay replacement or that roll their tax liabilities over, can defer their tax payments so that the present value of their tax is effectively reduced. This has the effect of receiving an interest-free loan from SARS. (Nedbank, 2000.)

2.5 CONCLUSION

The option to value an asset on valuation date at its market value effectively gives protection against inflation up to 1 October 2001. However from 1 October 2001 the taxpayer is exposed to the risk of being taxed on the inflationary gain included in capital gains. All assets purchased and all improvements or enhancements made to assets after 1 October 2001 are included in the base cost of the asset as paragraph 20 qualifying expenses, at their cost to the taxpayer on the date of purchase or improvement. No adjustment is made to these costs to take account of the effect of inflation.

South Africa taxes capital gains on the realization basis. Thus the capital gain is only taxed when the asset is sold and not when the gain accrues to the taxpayer. Capital gains accumulate over time when using the realization basis creating a worse inflation problem for CGT than for normal revenue income, which accumulates annually (Nedbank, 2000).

Individuals include 25% of their net capital gains in taxable income (refer to table 2). The included net gains are then taxed at the taxpayers statutory rate as determined by the tax tables (refer table 2). Favourable rates could be justified because income earned in one year is not the same as a gain achieved over many years. Using tax tables based on annual income, such a gain could be placed in an unfairly high tax bracket (Nedbank, 2000). As per Lochan (2002:1834) a number of expert’s are of the opinion that the reason for partial inclusion of capital gains is to compensate for the effect of inflation.

It is thus concluded that there is very little relief in the South African tax system to compensate for the effect of inflation on capital gains.

In the following chapter a review is done of the history and current practices of various countries to analyse the current worldwide trend in adjusting CGT for inflation.

CHAPTER 3

OVERVIEW OF CAPITAL GAINS TAX IN VARIOUS COUNTRIES

3.1 INTRODUCTION

In this chapter a review is done of the history and current practices of various countries to analyse the current worldwide trend in adjusting CGT for inflation.

3.2 THE EXPERIENCE OF OTHER COUNTRIES

Taxpayers in Argentina appealed to the court that their constitutional property rights were being infringed by rising inflation and the devaluation of the Argentine peso in 2002. Taxpayers argued that it was unconstitutional not to take account of the effect of inflation for tax purposes. On 20 June 2005 the Argentine Supreme Court ruled in **Santiago Dugan Trocello S R L c/Poder Ejecutivo Nacional** that, due to a lack of evidence the taxpayer failed to prove that the Argentine Constitution had been violated by restrictions placed on the use of the inflation index for income tax purposes. (PWC, 2005a:1.)

As a result the plaintiff could not to recognize the inflation effects in its income tax return. Even though the plaintiff lost the case it must be pointed out that this Supreme Court ruling challenged the particular legal procedure followed by the taxpayer and not the concept of inflation adjustment. Only time will tell how the Supreme Court will rule in cases where taxpayers follow a different strategy. (PWC, 2005a:1.)

3.2.1 Indexation

Indexation is defined as the increase in the base cost of an asset by using an indexation factor based on CPI (ATO, 2007a:26).

An indexation allowance is an “allowance equal to the amount by which the cost of the asset would have risen monthly if its value had kept pace with inflation” since the asset was purchased, “as measured by the increase in the retail prices index (RPI)” (HMRC, 2007:2.1).

3.2.2 Tapering

Taper relief is defined as the relief given depending on how long an asset has been held before disposal (HMRC, 2007: 6.2). Tapering is also referred to as tiered rate structure (MacDowell, not dated: 148).

3.2.3 Comparison of CGT levied by various countries

Table 6 provides a broad summary of how various countries determine CGT.

Table 6: Comparison of countries

Country	CGT on individuals
Australia	Distinguish between long term (held for twelve months or more) and short term gains. Long term gains are taxed by choosing between the indexation and the discount method. Short term gains are taxed as ordinary income.
Botswana	Gains are taxed at normal income tax rates
Brazil	CGT rate of 15%
Canada	50% of gains are included in ordinary income
Colombia	Gains on assets held two years or more are tax exempt. Gains on assets held less than two years are taxed as normal income.
Germany	Gains on property held less than 10 years and other assets held less than 1 year are taxed at normal tax rates.
India	Distinguish between long term (held for more than three years) and short term gains. Short term gains are taxed as normal income. Indexation is used for long term gains and a CGT rate of 20% applies.
Ireland	CGT rate of 20%
Israel	Inflationary Adjustments Law exempt inflationary gains from tax. Real gains taxed at a rate of 20%.
Mexico	Gains are taxed as normal income
New Zealand	No CGT (except in certain limited circumstances)
Nigeria	CGT rate of 10%
Russia	Gains on assets held for three years are tax exempt, CGT rate of 13% on the sale of shares and securities.
South Africa	25% of gains are included in normal income after annual exclusion is taken into account.
United Kingdom	CGT rate of 18%, annual exemption applies.
United States of America	Distinguish between long term (held for more than twelve months) and short term gains. Long term gains are taxed at a rate of 15% and short term gains are taxed as ordinary income.

Source: Adapted from Deloitte (2008).

A number of countries do not tax capital gains for example Zambia, New Zealand and Namibia (Deloitte, 2008). A number of countries have opted for a fixed CGT rate for example Ireland, Nigeria and Brazil. Some countries distinguish between short term and long term capital gains with different tax rates applicable for example Australia and the United States of America. India and Israel adjust gains for the effect of inflation.

The CGT practices of Australia, United Kingdom, Ireland, the United States of America, Israel and India will be examined in more detail. Australia, United Kingdom and Ireland were selected for further review as they initially used indexation to adjust the base cost of assets for inflation but later frozen this practice. The reasons for freezing the practice will also be examined. The United States of America distinguishes between short and long term gains and currently there is some pressure from opposition parties in the run-up to the election to repeal inflation tax. India and Israel are two countries that adjust capital gains for the effect of inflation. India uses indexation to adjust the base cost of an asset for inflation (Income tax department of India, not dated 2: 6) and Israel has a comprehensive system for adjusting not only capital gains for inflation but also other types of income (Elkins 2007:373).

3.3 AUSTRALIA

Australia introduced capital gains tax in 1985. As in South Africa, CGT is not treated as a separate tax but merely a component of normal income tax. The same tax rate applies to normal income and capital gains. (Review of Business Taxation, 1999a:285.)

CGT is only applicable to assets that were acquired after 1985. This approach may seem easier as no valuation date values have to be determined but it resulted in a lock-in effect. Taxpayers did not want to dispose of their pre-1985 assets because if they reinvested the proceeds, it would be in taxable post-1985 assets. This also made complex anti-avoidance legislation necessary as tax planners devised schemes to transfer value from post-CGT assets to pre-CGT assets. (SARS, 2007:23.)

If capital improvements are made to assets that were purchased before 20 September 1985 and the base cost of the improvement is more than the improvement threshold for

the year, or the base cost is more than 5% of the amount received on disposal of the asset, then this improvement is treated as a separate asset and is subject to CGT when a CGT event takes place for the original asset. In the 2006-07 tax year the improvement threshold was $112 512 per annum. (ATO, 2007a:11.)

Due to indexation, the effective tax rate on capital gains was generally lower than those applicable to ordinary income. If an asset was owned for more than 12 months expenditure forming part of the base cost of an asset could be indexed. The ATO would publish the quarterly CPI to be used for adjusting the base cost of an asset. This resulted in any gain due to inflation not being taxed. However, the indexing of capital gains was frozen at the end of September 1999. (Review of Business Taxation, 1999a:285.)

Reasons cited for the removal of indexation was that it brought Australia in line with other countries, it removed complexity from tax law and it reduced compliance costs for taxpayers (ATO, 2007b).

When removing indexation the calculation of capital gains and losses on depreciating and appreciating assets is done in the same way, resulting in the simplification of the current system and the removal of tax avoidance opportunities. Depreciation is calculated without taking account of inflation and when such an asset is sold for an amount above its book value but below its original cost the full amount of depreciation previously allowed is taxable with no adjustment for inflation. However where an appreciating asset is sold for more than the original cost, the base cost will be adjusted for inflation. (Review of Business Taxation, 1999b:5.)

According to the ATO (2007a:24) there are currently three methods that are used to calculate a capital gain, namely:

- the indexation method;
- the discount method; or
- the other method.

The **indexation method** is only applicable if an asset was acquired before 21 September 1999 and the asset was owned for 12 months or more. Under the indexation method,

each element of the base cost of an asset is increased by an indexation factor. The indexation factor is calculated using the CPI. If the asset was sold on or after 21 September 1999, the elements of the base cost can only be indexed up to 30 September 1999. The indexation factor is worked out by dividing CPI for the quarter ending 30 September 1999 by the CPI for the quarter in which the expenditure was incurred. Capital gains must then be reduced by any capital losses for the income year and any unapplied net capital losses from previous years. The net capital gain will be included in taxable income and will be taxable at the taxpayer's marginal income tax rate. (ATO, 2007a:25.)

The **discount method** should be used if a CGT event happens to an asset after 21 September 1999 and the asset was owned for 12 months or more and the taxpayer chooses not to use the indexation method. To calculate the period the asset was held before disposal one excludes both the day of purchase and the day of the CGT event. The taxpayer can choose to use either the indexation method or the discount method whichever gives the most favourable result. Capital gains must first be reduced by any capital losses for the income year and any unapplied net capital losses from previous years before the discount percentage can be applied. A discount percentage of 50% is applicable for individuals and trusts. Companies do not qualify for a CGT discount. The discount cannot be applied if the indexation or other method is used. (ATO, 2007a:25.)

The **other method** must be used if the asset has been purchased and sold within 12 months. The indexation and discount methods cannot be used in this instance. The capital gains are calculated by deducting the base cost from the proceeds. The capital gain so calculated is included in the taxpayer's income and taxed at his marginal tax rate. (ATO, 2007a:24.)

The different calculations will be illustrated by an example in table 7. A property was bought for $150 000 in June 1991. Improvements were made to the property in June 1993 of $25 000. The property was sold in December 2007 for $750 000 and agents commission of $5 000 was paid on the sale. CPI for the quarter ending 30 September 1999 was 123.4 and CPI for the quarters ending June 1991 and June 1993 was 106.0 and 109.3 respectively (ATO, 2008).

Table 7: Calculation of CGT in Australia

Facts	Indexation method	Discount method
Purchase price	$174 623	$150 000
Improvements	28 225	25 000
Agents commission	5 000	5 000
Base cost	207 848	180 000
Proceeds	750 000	750 000
Base cost	207 848	180 000
Capital gain	542 152	570 000
CGT discount		285 000
Net capital gain		285 000

Source: Adapted from ATO (2007a:28).

The purchase price is adjusted for inflation by using the indexation factor for the quarter ended September 1999 (date indexation was frozen) and dividing that by the indexation factor for the quarter ended June 1991 ($150 000 x 123.4/106). The improvements are adjusted for inflation on the same basis ($25 000 x 123.4/109.3) and added to the indexed purchase price, as this asset was acquired after 1985 and improvements to it is therefore not treated as a separate CGT asset. The agent's commission was paid on the sale of the property in 2007, so no indexation can be applied as it is after September 1999. (ATO, 2007a:28.)

As the discount method provides the better result, the amount of $285 000 will be included on the tax return as taxable capital gains and will be taxed at the taxpayer's normal income tax rate.

If this was a short term capital gain, where the asset was acquired and sold within 12 months, the capital gain will be calculated the same way as the discount method, but no discount will apply so that the amount of $570 000 will be included in the taxpayers tax return as a taxable capital gain (ATO, 2007a:28).

Australia distinguishes between short term and long term gains, and the tax on the long term gains is more favourable using the discount method.

In table 8, using the same facts as in table 7, it is presumed that indexation was not frozen in September 1999 and indexing is applied up to the date of sale. The CPI for the quarter ending 31 December 2007 was 160.1 (ATO, 2008).

Table 8: Calculation as if indexation was not frozen

Facts	Indexation method	Discount method
Purchase price	$226 557	$150 000
Improvements	36 619	25 000
Agents commission	5 000	5 000
Base cost	268 176	180 000
Proceeds	750 000	750 000
Base cost	268 176	180 000
Capital gain	481 824	570 000
CGT discount		285 000
Net capital gain		285 000

Source: Adapted from ATO (2007a:28).

The purchase price is adjusted for inflation by using the indexation factor for the quarter ended December 2007 and dividing that by the indexation factor for the quarter ended June 1991 ($150 000 x 160.1/106). The improvements are adjusted for inflation on the same basis ($25 000 x 160.1/109.3) and added to the original purchase price. The agent's commission is not adjusted for inflation as it was paid at the date of the sale. The capital gain using the indexation method is much lower than the capital gain calculated using the discount method. However the net capital gain after applying the discount of 50% will give the taxpayer the better result (ATO, 2007a:28).

In the Review of Business Taxation (1999a:292), it was stated that the elimination of indexation was seen as an acceptable trade-off for other reductions in the burden of CGT. It was argued that the lowering in the rate of capital gains would encourage savings and investment and economic growth as well as reduce the lock-in effect created by the

realization basis of CGT. Therefore the CGT rate was reduced by introducing the CGT discount of 50%.

3.4 UNITED KINGDOM

CGT was first introduced in the United Kingdom in 1965 and was levied on capital gains realised on the disposal of assets by individuals, personal representatives and trustees. Capital gains realised by companies are subject to corporation tax. (HMRC, not dated2.)

In **Secretan v Hart, 45TC701** (HMRC, not dated1), the taxpayer claimed that CGT is a tax on inflationary capital gains. The fall in the value of the pound must be taken into account on assessment; therefore any amount paid by the taxpayer should be reassessed. The court ruled that legislation applicable at that time did not provide for this kind of deduction. (HMRC, not dated1.)

High inflation was experienced during the 1970's. This together with the above court case increased pressure on the Government to introduce measures to combat tax on inflationary gains. Therefore in 1982 government introduced an indexation allowance. This allowance was calculated as the difference between the cost incurred when purchasing the asset and the same costs indexed by the RPI. Initially, indexation was only allowed from 12 months after the date of any expenditure incurred or March 1982, whichever was the later. (HMRC, not dated2.)

These restrictions on indexation were removed in 1985. From 1985, indexation could be applied on the market value of any earlier costs (HMRC, not dated2). In 1988 the revaluation of an asset to its market value at 31 March 1982 was allowed. The rules of rebasing and the kink test apply to the disposal of assets that were held at 31 March 1982 (HMRC, 2008:7).

Rebasing means that assets that were held before 31 March 1982 are treated as if they had been purchased at their market value on that date. The kink test allows for the gain or loss based on the market value on 31 March 1982 to be compared with the gain or loss

based on the actual cost before 31 March 1982. The lower of the two gains is taxable or the lower of the two losses is deductable. (HMRC, 2008:7.)

This meant that on any asset disposed of, which was already held on 31 March 1982, the chargeable gain will only be calculated on the increase in market value after that date. From 1988, capital gains were taxed at normal income tax rates. (HMRC, not dated2.)

Indexation could only reduce or extinguish a capital gain from 30 November 1993. The creation or increase of a capital loss was not allowed. Indexation was frozen at 5 April 1998. (HMRC, not dated2.)

Tapering was introduced where depending on the length of time an asset was held after 5 April 1998, the chargeable gains would be tapered. There is a distinction made between business assets and non-business assets. The taper relief for business assets is more favourable. Tapering is applied to the net capital gain after the deduction of any losses carried forward from earlier tax years. Losses are allocated to gains on the basis that will produce the lowest tax charge. (HMRC, not dated2.)

The taper relief for non-business assets have not changed since 6 April 1998 but the rates for business assets disposed of between 6 April 1998 and 6 April 2002 and thereafter are different (HMRC,2007:6.2).

If an asset has been disposed of on or after 6 April 2002, the amount subject to CGT is shown in table 9.

Table 9: Taper relief on assets disposed of after 6 April 2002

Business assets		Non-Business assets	
Number of whole years in the qualifying holding period	**Gain remaining chargeable (%)**	**Number of whole years in the qualifying holding period**	**Gain remaining chargeable (%)**
Less than 1	100	Less than 1	100
1	50	1	100

Business assets		Non-Business assets	
Number of whole years in the qualifying holding period	**Gain remaining chargeable (%)**	**Number of whole years in the qualifying holding period**	**Gain remaining chargeable (%)**
2 or more	25	2	100
		3	95
		4	90
		5	85
		6	80
		7	75
		8	70
		9	65
		10 or more	60

Source: HMRC (2007:6.2).

In 2000 the CGT rates were changed to 10%, 20% and 40% respectively for individuals, depending on the level of income liable to income tax (HMRC, 2008:17).

In the pre-budget report of 2007 it was announced that CGT was going to be reformed to simplify the rules in determining capital gains. The CGT rules were found to be complicated due to a number of historic changes. These historic changes were the rebasing of expenditure to 31 March 1982 (subject to the kink test), the introduction and the subsequent freezing of the indexation allowance in April 1998 and the introduction of taper relief, the rules regarding identification and matching of assets disposed of with assets acquired to replace them. (HMRC, 2008:11.)

The changes announced will take effect for disposals on or after 6 April 2008, and entail:

- the introduction of a single CGT rate of 18%;
- the abolishment of taper relief, indexation allowances (currently frozen at April 1998) and halving relief;
- the making of rebasing of cost to 31 March 1982 mandatory for assets held at that date; and

- the simplification of rules for matching certain assets disposed of with assets purchased (HMRC, 2008:1).

The changes do not apply to companies as they still pay corporation tax in respect of capital gains (HMRC, 2008:1).

The example below in table 10 will attempt to illustrate why the calculation of CGT became so complicated in the UK before the announced April 2008 changes. In the example a taxpayer sells a building site in March 2003 for £50 000 which he bought for £2000 in 1981.

Table 10: CGT calculation with indexation and taper relief

Facts	Pounds
Proceeds on sale	£50 000
Less: Cost (or market value at March 1982)	2 000
Less: Indexation allowance to April 1998 (£2 000 x 1.047)	2 094
Capital gain before taper	45 906
Business asset taper (held more than 2 years thus 75% taper- see table 9)	34 429
Tapered chargeable gains	11 477
Less: Annual exempt amount	7 700
Amount chargeable to CGT	3 777
Tax payable (presume individual tax rate of 40%)	1 510

Source: DARDNI (2006).

The capital gain is calculated as the proceeds less the purchase price of the asset or asset value as at March 1982. Here is the first difficulty. The rebasing rules ensure that only the increase in value after 31 March 1982 is taken into account in calculating the chargeable gain for assets held since before 31 March 1982, but the taxpayer has to choose to disregard the actual acquisition cost. If the taxpayer did not make that choice then the calculation of the gain/loss must be made using both the market value at that date and the original purchase price, and if both computations show a gain then the smaller of the gains is the chargeable gain. If both computations show a loss then the smaller of the losses is the allowable loss. (HMRC, 2007:3.18.) From April 2008 the rebasing of all assets held before 31 March 1982 is compulsory (HMRC, 2008:1).

The second difficulty is that the indexation allowance must then be applied only up to April 1998. The indexation allowance effectively eliminates the inflationary element of any gain up to April 1998 by multiplying the greater of the acquisition cost of the asset or the market value of the asset at 31 March 1982, with an indexation factor. (HMRC, notdated2.)

The indexation allowance was substituted with taper relief. Taper relief is based on the length of ownership as well as the classification as a business or a non-business asset. Based on these two factors the gross gain is reduced by a taper percentage. The classification of business and non-business assets became very difficult. In some instances a business asset could meet the non-business asset criteria and be subjected to a less favourable non-business asset taper rate. The taper relief was also a way that was used to try and avoid tax by classifying an asset as a business asset when it was actually a non-business asset. (DARDNI, 2006.)

After the tapered taxable gain was determined the annual exemption was deducted from the gain. Relief and allowable losses were deducted before the application of the taper but the annual exemption was only deducted after the taper has been calculated. (DARDNI, 2006.)

It can be seen from the above example that the UK CGT calculation became very complicated because of many different measures that were introduced and then frozen or changed with an effective date.

3.5 IRELAND

Ireland introduced the taxation of capital gains on 6 April 1974, at a preferential tax rate of 26 % (Lochan, 2002:1857). The tax was raised on realized rather than accrued gains from the sale of a capital asset. The period of high inflation in the 1970's resulted in high CGT on assets held for long periods. In response to protest over this unfair tax, an inflation-adjustment tool was introduced in 1978. (MacDowell, not dated:147.)

The inflation adjustment is made by multiplying the allowable expenditure by a factor. The factor is called the "multiplier". The multiplier reflects the changes in the All Items

Consumer Price Index during the period since the asset was acquired. To determine the multiplier to be used, reference will be made to the year of assessment in which the expenditure was incurred and the year of assessment in which the disposal is made. Every year the Revenue Commissioner issues a table of multipliers to be used for this purpose. (Ireland Revenue, 2005:11.)
Assets acquired before 6 April 1974 are re-valued at their market value on that date. The allowable expenditure and the indexation relief is calculated based on the market value. (Ireland Revenue, 2005:10.)

The Finance Act of 1978 also introduced a tiered rate structure based on how long an asset was held. The CGT rate was increased to 30% for all short term gains. A short-term gain was realised on the disposal of assets held for less than three years. If an asset was held between three and six years before disposal, the CGT rate decreased to 25.5%. For every additional three years an asset was held the rate reduced further by three to 4.5% until at 21 years the gain was tax-free. (MacDowell, not dated: 148.)

It is argued by MacDowell (not dated:148) that taxpayers that realised gains on assets held for longer time periods were over compensated for inflation as they also received the inflation indexing adjustment.

An increase in revenue from CGT occurred from 1978 due to the introduction of inflation indexing and the tiered rate structure based on length of ownership. Although the tax liability was reduced by the introduction of these relief measures it also encouraged realizations and reporting, resulting in the higher revenues from CGT. (MacDowell, not dated:152.)

In 1994, a single rate of 40% was introduced and the previous tiered system which distinguished between short and long term gains fell away. In 1997 the CGT rate was further reduced to 20 %. On the disposal of certain foreign life policies and units in offshore funds a CGT rate of 40% still applies. (MacDowell, not dated: 149.)

Indexation relief was abolished with effect 31 December 2002 when inflation was at a very low level. The government felt that because inflation had been very low during most of the

1990's at under 3% per annum, the relief provided was not as significant as before except for assets that were acquired a number of years ago. It was argued that this would be the appropriate time to abolish indexation relief as it would not attract such severe criticism as could be expected during a period of higher inflation. (Government of Ireland, 2001.)

If an asset is disposed on or after 1 January 2003, indexation relief will only apply for the period up to 31 December 2002 if the asset was held for at least 12 months. A monetary loss or gain cannot be created by the inflation adjustment. If a loss is changed into a monetary gain, or a gain into a monetary loss, the disposal of the asset is treated as being neutral, no gain or loss. (Ireland Revenue, 2005:11.) The actual capital gain or loss is computed by using the original cost without any allowance for inflation (Ireland Revenue, 2005:42).

A separate return from normal income tax has to be completed for all capital gains and losses and the CGT year runs from 1 January to 31 December (Ireland Revenue, 2005:5).

In Table 11 an example will illustrate the calculation of CGT in Ireland. A house that was held as an investment was sold for €100 000 in August 2003. The house was bought for €5 600 in 1973. The market value of the house at 6 April 1974 was €6 000. Improvements was made to the property in March 1980 for €4 000. As per the table of inflation/indexation multipliers published by the Irish Revenue office, the multiplier for expenditure incurred was 7.528 for the year ended 31 December 2004 and 3.742 for the year ended 31 December 1980 (Ireland Revenue, 2005:37).

Table 11: Calculation of CGT in Ireland

Facts	Euro
Proceeds	€100 000
Less: Value on 6 April 1974 adjusted for inflation (6000 x 7.528)	45 168
Less: Improvements adjusted for inflation (4000 x 3.742)	14 968
Capital gain	39 864
Less: Personal exemption	1 270

Facts	Euro
Chargeable gain	38 594
Tax due @ 20%	7 719

Source: Adapted from Ireland Revenue (2005:29).

It can be seen from the above example that calculating the chargeable gain was easy enough as the tiered rate structure fell away in 1994 and was replaced by a single tax rate.

3.6 UNITED STATES OF AMERICA

The United States introduced capital gains tax as early as 1942. Fifty percent of the capital gain was excluded from normal tax. In 1986 the exclusion was removed and the statutory rate for capital gains was capped at 28 percent. Indexing for capital gains taxation is not applied in the United States. They do distinguish between long term and short term capital gains. (Lochan,2002: 1857.)

The gain is calculated as the difference between the sales price and the cost or other basis of the asset. The cost includes the cost of the property, any improvements made to it, any purchase commission paid less depreciation or other depletion. (IRS, 2007b:7.)

Long term capital gains are realised where assets that were held for more than one year, are sold. Short term capital gains are realised where the asset was held for one year or less. The totals for short and long-term capital gains and losses are calculated separately. All the short term capital gains and losses are combined and the total is the net short-term capital gain or loss. The same is done to calculate the net long-term capital gain or loss. (IRS, 2007b:2.)

All the gains or losses are combined to give either a net gain or a net loss. If the outcome is a net capital gain the amount will be taxable at a rate generally lower than the tax rate on ordinary income. The highest tax rate on a net capital gain is generally 15% but exceptions do apply for a gain from small business stock and a gain from selling collectibles which is taxed at a maximum rate of 28%. The USA uses a stepped rate or income brackets to determine the CGT rate. The CGT rate is linked to the annual taxable

income of the taxpayer, for example a taxpayer earning between $61 401 and $ 128 100 per annum's CGT rate will be 15%. (IRS, 2007a:34.)

If the outcome is a net capital loss the difference is deductable from normal income subject to an annual limit of $3 000 per taxpayer. The remainder of the loss can be carried forward to the next tax year. The original character of a long term or short term loss is retained if it is carried forward to a new year. Short-term losses carried forward from the previous year are added to short-term losses occurring in that year and long-term losses carried forward will be added to long-term losses occurring in that year. (IRS, 2007a:34.)

With the presidential elections in America coming closer the debate around capital gains tax is heating up. Bills have been introduced in Congress to index capital gains for inflation.

Bill number H.R 6057 has been introduced in the House of Representatives to index capital gains for inflation. This bill proposes that taxpayers adjust the price of an asset held for a period of longer than three years using the Gross Domestic Product Implicit Price Deflator, as published by the Bureau of Economic Affairs. (Dubay,2006: 3.)

This bill sponsored by representatives Mike Pence and Eric Cantor, would revoke inflation tax by adjusting the tax basis of an asset for inflation thereby creating a situation where only real gains and not inflation is taxed. It is argued that bill H.R 6057 should become law as it comes down to basic fairness, sound politics and policy. (Kerpen, 2006.)

The American Conservative Union (2006), the nation's oldest and largest conservative lobbying organization, announced its strong support for HR 6057. This bill would ensure that only real gains and not inflationary gains are taxed by the Treasury Department.

Subsequently two bills, H.R 1261 and S.892, were introduced on 1 March 2007 in the House of Representatives also sponsored by representative Mike Pence. These bills propose the amendment of the Internal Revenue Code of 1986 to accommodate indexing of certain assets for purposes of determining a gain or loss. (GovTrack.us, 2007.)

Rahn (2008:17) states that Rudy Giuliani's tax-reform proposals include indexing capital gains taxes for inflation. All the Republican candidates have called for low or lower taxes on capital gains, while the Democrats favour higher capital-gains taxes. He argues that

inflation indexing of capital gains should be part of every candidate's economic stimulus package regardless of party affiliation. (Rahn, 2008: 17.)

Although the United Kingdom has abolished indexation of capital gains, and Australia and Ireland has frozen the use of indexation there is a strong drive in the USA to introduce some measures to combat the effect of inflation when calculating capital gains tax.

3.7 INDIA

India introduced CGT in 1946 but abolished it again in 1948. It was reintroduced with effect from 1 April 1957. Indexation of capital gains was introduced with effect from 1 April 1981. (Income tax department of India, not dated 1.)

A gain realised on an asset held for 36 months or less is called a short-term capital gain (STCG) and an asset held longer than 36 months will give rise to a long-term capital gain (LTCG). The period is calculated by counting from the date of acquisition to the date of sale. (Income tax department of India, not dated2.)

It is important to classify a gain correctly as either a STCG or LTCG as the calculation of the taxable gain is different and different tax rates apply. Capital gains are calculated as the difference between the consideration received and the actual cost of the asset or its market value on 1 April 1981, if the asset was acquired before 1 April 1981. The cost of any improvements to the asset and any expenses incurred on the transfer of the asset can also be deducted. (Income tax department of India, not dated3.)

A STCG is calculated as the consideration received less the cost of acquisition and improvements to the asset less the exemption provided for by sections 54B,D, and G. If the asset was obtained without payment, the fair market value of the asset must be determined on the date the asset was obtained. STCG are included in normal income and taxed at the rate applicable to the individual. (Income tax department of India, not dated3.)

A LTCG is calculated as the consideration received less the indexed cost of acquisition and improvements to the assets less the exemption allowed for in sections 54, 54B and

54C. Where a residential house is sold and the proceeds are re-invested in a new house, the amounts spent on the new house are allowed as a deduction from the LTCG as per section 54. (Income tax department of India, not dated3.)

The indexed cost of acquisition/ improvement is calculated by multiplying the cost of acquisition by the factor created by dividing the cost inflation index (CII) of the year of transfer with the CII of the year of acquisition/improvement or 1 April 1981 whichever is the later (Income tax department of India, not dated 3). LTCG so calculated is taxed at 20%. The CII is issued by the Income Tax department on a yearly basis for the period starting on 1 April and ending on 31 March of the next year. (Income tax department of India, not dated 2.)

Capital losses made can be offset against capital gains made on the transfer of assets. Any capital loss remaining cannot be set off against other sources of income but will be carried forward to the next year of assessment for set off against capital losses in the new year. Short term losses can offset capital gains on both long and short-term assets but long term losses can only offset long-term gains. A loss can be carried forward for a maximum of eight years from the year in which it originated. (Delloite, 2008.)

The concepts above will be illustrated by an example in table 12. A property was bought for Rs250 000 in June 1990. Improvements of Rs25 000 were made to the property in June 1993. The property was sold in December 2008 for Rs750 000. CII for the year ending 31 March 1990 was 172 and CII for the years ending March 1993 and March 2008 were 223 and 551 respectively (Income tax department of India, not dated 4). If the same property was bought, improvements made and sold within 12 months it would result in a STCG. We presume this individual has a marginal tax rate of 35%.

Table 12: Calculation of LTCG and STCG

Facts	LTCG	STCG
Consideration	Rs750 000	Rs750 000
Indexed cost/cost of acquisition	800 872	250 000
Indexed cost/cost of improvement	61 771	25 000

Facts	LTCG	STCG
Actual cost	862 643	275 000
Capital gain/(loss)	(112 643)	475 000
Tax rate	20%	35%
Tax payable	nil	166 250

The indexed cost of acquisition was calculated as Rs750 000 x 551/172 and the indexed cost of improvements was calculated as Rs25 000 x 551/223. The LTCG will be carried forward to the next year of assessment as it can not be offset against STCG or other income. There is no restriction that indexation cannot create a capital loss. If we look at the above example based on actual CII figures as published by the Income tax department, it can be seen that the increase in CII from 1990 to 2008 was 220% ((551-172)/172) (Income tax department of India, not dated 4).

South Africa's CGT calculation will be similar to the STCG calculation except that the asset would have been revalued on 1 October 2001 and the inclusion rate for capital gains is 25% and not 100% (SARS, 2007:29). This example illustrates the severe impact inflation can have when realising an asset. The original purchase price of Rs250 000 grew to Rs800 872 when indexed for inflation.

India's inflation rate increased to a 13 year high, reaching 11.42% in June 2008 after remaining between 3% and 4% from 2000 to 2007. This forced the central bank to raise interest rates to 8.5% as rising fuel and commodity prices stoke inflation. (Freshplaza, 2008.)

3.8 ISRAEL

Notable indexation developed in Israel even before the start of rising inflation. However the gradual increase of inflation was countered by gradual expansions to the degree of indexation. (Roy, 2003:9.)

The history of CPI started in Israel in 1942 during the Second World War when the government froze all prices, wages and rent. However despite government policy, prices

continued to rise and a method had to be found to remunerate employees without raising their real wages. That was the start of indexation in Israel, where salaries were linked to CPI to prevent the loss of buying power but also to prevent salaries increasing faster than inflation. (Rosenberg, 2001.)

Over the years more and more future transactions were indexed. Banks for instance, would guarantee savings account deposits according to their real value reflected by the rise in the index between the date of deposit and date of withdrawal. So successful was the linkage system, that when inflation started to rise in Israel, citizens hardly noticed, because their real income was protected by this index-linked mechanism. (Rosenberg, 2001.)

Neutralizing the effects of inflation has been part of the Israeli capital gains tax system since its introduction. In those days the nominal gain was taxed but the tax was reduced by a fixed percentage based on the number of years the asset was held. In 1975 the method was changed so as to adjust the base cost of the asset for inflation. (Elkins, 2007: 373.)

Israel had a period of very high inflation from 1979 to the mid 1980's, when inflation varied between 101% and 740% a year. The high rates of inflation posed a threat to the running of the economy as well as the integrity of the tax system. The Israeli tax system had to adapt to find new methods of distinguishing between real gains and nominal gains. Therefore the government appointed a tax reform commission to investigate the current system and to recommend reforms. (Elkins, 2007: 365.)

The Israeli government introduced new legislation in 1982 to deal comprehensively with the effects of inflation on the calculation of taxable income. The Income Tax (Taxation under Inflationary Conditions) Law (ITTICL) was introduced in 1982 as a temporary measure to be applied for the years 1982 – 1984 only. ITTICL was replaced by the Income Tax (Adjustments for Inflation) Law (ITAIL) in 1985 to be applied for 1985 only. (Elkins 2007:365.)

Although ITAIL was introduced as a temporary measure during a period of very high inflation, it is still in effect today over 23 years later, even though Israel's inflation rate is currently in the region of 3% per annum (Elkins 2007:365).

ITAIL incorporated existing tax law, Income Tax Ordinance 5721-1961, which already adjusted capital gains for inflation by indexing the base cost of an asset, and added the adjustment of other income and expenses by using a comprehensive method (Elkins 2007:365).

The Israeli government uses a combination of the comprehensive and piecemeal methods to adjust income for inflation and to protect capital assets against the effect of inflation. The comprehensive approach of simply allowing for a phantom deduction for equity is technically simple but creates timing problems. The piecemeal approach would alleviate the timing problem of matching inflationary interest deductions with inflationary gains but this is technically problematic if one has to look at each transaction individually. Therefore the Israeli government rather opted for a combination of the two methods which combines the simplicity of the comprehensive method with the accuracy of the piecemeal method. (Elkins 2007:373.)

Inflationary profits made on assets owned up to and including 31 December 1993 were taxed at 10 percent. After the introduction of ITAIL the government was under pressure to cancel the 10 percent tax. Therefore any asset sold after 1993 the inflationary gain made up to 1993 is still taxed at a rate of 10% and any inflationary gain made after 1993 is exempt from tax. (Elkins, 2007:375.)

Previously the real capital gain was taxed using the taxpayer's ordinary income tax rate (State of Israel: 1999). From 1 January 2003 real gains are taxable at a flat rate of 20 percent (PWC, 2005b:2).

ITAIL distinguishes between fixed assets and non-fixed assets. Fixed assets are capital assets excluding assets that produce interest which are protected against inflation through piecemeal legislation. All other assets on the balance sheet, for instance stock and cash, will be non-fixed assets. (Elkins, 2007:376.)

When buying fixed assets either equity or debt can be used to finance the purchase. As per ITAIL debt is attributed to non-fixed assets and equity is attributed to fixed assets as far as possible. (Elkins, 2007:377.)

A taxpayer will be entitled to a deduction for inflation (DFI) where equity exceeds fixed assets. To determine the deduction, the amount by which equity exceeds fixed assets will be multiplied by the rate of inflation. Where fixed assets exceed equity an addition for inflation (AFI) will be added to taxable income, calculated as the difference multiplied by the rate of inflation. (Elkins, 2007:377.)

To illustrate the concept of AFI and DFI above, see table 13 for an example of the calculation of AFI or DFI:

Table 13: Calculating AFI and DFI

Balance sheet			
Assets	**NIS**	**Liabilities and equity**	**NIS**
Non-fixed assets	NIS900	Debt	NIS1300
Fixed assets	1100	Equity	700
	2000		2000
Rate of inflation for the year	5%		

Source: Elkins (2007:377).

In the example fixed assets exceed equity with NIS400 (NIS1100 – NIS700). The taxpayer will report an AFI of NIS20 (NIS400 multiplied by the rate of inflation for the year of 5%). If the figures are turned around and equity is NIS1100 and fixed assets are NIS700 then the taxpayer would have been entitled to a DFI of NIS20.

A balance sheet gives a snapshot of assets, liabilities and equity at a certain date. Over time though there might be changes to such assets, liabilities and equity. ITAIL therefore distinguishes between positive and negative changes on the balance sheet. Positive changes are the increase of equity or the sale of fixed assets. Negative changes are the purchase of fixed assets or the reduction in equity. The value of the changes is multiplied by the rate of inflation from the month in which it occurred until the end of the year and is either added or deducted from DFI or AFI. (Elkins, 2007:379.)

The final formula for neutralizing the effects of inflation would therefore be:
[(Equity – Fixed assets) x (Annual Inflation)]+- [(Changes x (Inflation from Month of Each Change)] (Elkins, 2007:379).

The above approach is applicable to taxpayers that keep a double-entry bookkeeping system. For taxpayers who do not use a double-entry accounting system the piecemeal approach is used as explained in Chapter 3 of ITAIL. (Elkins, 2007: 379.)

Israel's economic history of hyperinflation in the 1980's forced the country to find a way to only tax the real increase in wealth without obligating the taxpayer to undertake the impossible task of distinguishing between real and inflationary income on individual items (Elkins, 2007:381). Elkins states that the Israeli experience proves that it is possible and easy enough to calculate real increase in wealth (Elkins, 2007:365).

3.9 CONCLUSION

In South Africa as in the rest of the world, inflation is currently rising. South Africa's inflation rate (CPI) increased from 1.4% in 2004 to 7.1% in 2007 (refer to table 4 in chapter 2) and reached double digits in March this year. Many people have wondered if South Africa will follow in the footsteps of neighbouring Zimbabwe and descend into hyperinflation. The higher the inflation rate the bigger the impact on capital gains realised.

Capital gains tax is actually two different taxes. Firstly, it is "a tax on real increases in asset values" and secondly it is "a tax on nominal, inflationary increases in asset values". "Inflation tax, levied on the phantom gains in asset values due to inflation is one of the most unfair and economically destructive taxes the federal government levies". (Kerpen, 2006.) With the American presidential elections coming closer and with continued rising inflation in the USA, there is a new drive to abolish taxing the inflationary portion of capital gains and several bills have been introduced in the House of Representatives in this regard.

As was seen in the United Kingdom, a court case and the additional pressure of rising inflation pressured the government into giving taxpayers relief from inflation when calculating capital gains.

The current trend in first world countries is to move away from indexation. First world countries like Australia, Ireland and the United Kingdom all previously used indexation to adjust CGT for inflation. These countries experienced very low inflation before and in the period that indexation was abolished, for example Australia had an inflation rate of 2.2% in 1999 when indexation was frozen. In Ireland the government felt that because inflation had been very low during most of the 1990's at under 3% per annum, it would be the appropriate time to abolish the relief because the move would not attract negative criticism at such low inflation levels. The United Kingdom froze indexation in 1998 when the inflation rate had been stable for a period of time at low levels.

Some of the main reasons cited by first world countries for moving away from indexation were simplification and removing of complexity from the tax system. It must be noted that the United Kingdom's tax calculation was so complicated due to a number of historic changes such as introducing relief measures and then freezing them and then making a certain rule applicable only up to a certain date. The calculations done for indexation by Ireland and Australia were easy and understandable.

After a period of runaway inflation in the 1980's, the Israeli government was forced to introduce legislation to protect the taxpayer from tax on nominal gains as opposed to real gains. Although this was introduced as a temporary measure it is still in effect today over 23 years later, even though Israel's inflation rate is currently in the region of 3% per annum. Israel opted for a comprehensive inflation adjustment method which has proven to be simple and understandable to taxpayers..

India and South Africa are both considered to be developing economies as per the International Monetary Fund. Both countries are classified as big emerging market economies because good economic potential has been exhibited and sustained economic growth has been maintained over a number of years. (Wikipedia,2008a.)

Both South Africa and India's inflation rates accelerated during this year to reach double digits. India implemented the indexing of capital gains in 1981 and is still applying indexing today. The manner in which India has introduced indexation without subsequent adjustments keeps the calculation simple and understandable. Of all the countries examined, South Africa is the most comparable with India. If indexation was implemented and applied in India without problems, could it not be possible in South Africa as well.

In the following chapter the key factors to consider in indexing capital gains will be identified.

CHAPTER 4

IDENTIFICATION OF KEY FACTORS TO CONSIDER IN ADJUSTING CGT FOR INFLATION

4.1 INTRODUCTION

Inflation is a widespread occurrence in the modern world. Even in very stable economies inflation has increased rapidly over the past 20 years. The income tax structure cannot afford to ignore the importance of inflation. To reduce the effects of bracket creep where a taxpayer is subject to higher tax rates due to an increase in nominal income, tax brackets, credits and exemptions are regularly updated to account for the decrease in the value of money due to inflation. (Elkins, 2007: 363.) As mentioned above there are measures in place to protect income from the effect of inflation. Why should capital gains then be treated differently?

In chapter 4 the key factors for consideration in the decision as to whether a country should adjust its CGT for inflation or not, are identified.

4.2 KEY FACTORS

The following key factors identified needs to be considered before taking any decision to adjust capital gains tax for inflation:

- the effect of inflation adjustment on the revenue office;
- the effect of inflation adjustment on the taxpayer;
- the use of CPI;
- the tax rate for capital gains;
- the treatment of assets and liabilities;
- the effect on the economy;
- the period the asset was held;
- alternatives to indexation as an inflation adjustment measure; and
- the timing of introduction.

These key factors will now be discussed in more detail.

4.2.1 The effect of inflation adjustment on the revenue office

When considering inflation adjustment of CGT it is necessary to determine if it will place an **increased administration** burden on the revenue office. It is suggested by some that indexing capital gains will not cause a bigger administration burden as only one multiplication calculation has to be added to each transaction. It should also be easy enough for the Revenue office to publish the index to be used on a monthly, quarterly or yearly basis. (Lochan, 2002: 1851.)

Others argue that indexing has the potential to greatly increase the **complexity** of the tax process (Chamberlain, 2006). If various acquisitions of the same assets are made for example shares are bought over a long period of time at different dates, the taxpayer will have to keep separate records for every acquisition**.** If and when these shares are sold they will have to be indexed using the rate applicable on the various purchase dates. This can complicate calculations. (Lochan,2002: 1852-1853.)

In an empirical investigation done on the possibility that there is a relationship between the inflation rate and **tax evasion**, it was found that because inflation wears away the real value of nominal disposable income, it can provide an incentive for taxpayers to evade tax. In this study it was argued that inflation is a non legislated tax increase which increases government revenues. The study concluded that tax evasion can be positively linked to the inflation rate. This being the case, **tax compliance costs** for the revenue authorities might also increase because compliance efforts will have to be increased in periods of higher inflation. The tax system might also not be seen as **fair** if inflationary gains are taxed, which can motivate taxpayers to evade tax. (Crane and Nourzad, 1986:217-222.)

It is argued by Mackie III (2002:23) “that indexing may lead to arbitrage and **tax shelter** problems due to the fact that only some elements of the capital income tax system are indexed” (own emphasis).

In Ireland it was found that with the introduction of inflation indexing and differential taxing of short-term and long-term gains in 1978, it appeared that the tax liabilities were reduced

on the one hand but it encouraged realizations and reporting on the other hand, so that **revenues actually increased**. It was found that within a reasonable range, the lowering of capital gains tax rates increased government revenues from that tax. It was however unclear to what extent this result was due to increased realizations or increased compliance. The greater the realization due to lower tax rates the greater the unlocking of capital to **reinvest** in other assets. This has the additional effect of increasing the efficiency of the use of capital by re-investing the money in higher yielding investments which in turn leads to higher revenues and greater prosperity. (MacDowell, not dated: 157.)

According to Rahn (2008:17) the adjusting of capital gains for inflation will definitely increase revenues in the short run because of the "unlocking" effect and probably also in the long run due to the higher levels of investment it would create. This sentiment is shared by others who argue that indexing may remove the tendency to hold on to assets therefore leading to shorter holding periods of indexed assets and the earlier payment of taxes. This might however only lead to future revenue being taxed in the present, unless the conduct of taxpayers leads to reinvestment in assets giving a higher return. (Lochan, 2002:1849.)

In periods of high inflation the income collected by the revenue office is also negatively affected. If indexing is allowed for taxpayers the revenue office can also argue that due to **collection lags** tax payments must also be indexed. This involves adjusting the tax liability with CPI to determine the tax due on payment date. This measure becomes very important when the inflation rate exceeds 100% per annum. Even in cases where monthly payments are made, the loss in tax revenues can be substantial. In such a situation the frequency with which CPI is calculated and published becomes very important. (De Jantscher, Coelho & Fernandez, 1992: 255.)

4.2.2 The effect of inflation adjustment on the taxpayer

There are some that argue against the indexation of capital gains because it would be too complex thus adding to the taxpayers **compliance burden**. The taxpayer's **compliance cost** will also increase because the taxpayer will have to consult with an accountant or other tax specialist in order to decipher and apply the tax rules correctly in transactions and the required records will have to be kept. (Lochan, 2002:1851.)

If we look at Australia where indexing was used but later frozen, two of the reasons cited by the ATO for the removal of indexation were that it would remove complexity from tax law and reduce compliance costs for taxpayers (ATO, 2007b).

In calculating accounting profits no adjustment is made for indexation and capital gains form part of normal business profits. In removing indexation the tax and accounting values will move closer. (Review of Business Taxation, 1999b:4.) If accounting and tax values of assets are the same it will reduce the taxpayers compliance cost as two separate calculations will not be necessary.

On the other hand, some argue that in the age of computerised software the calculation of the indexed capital gains should not be more complex than any other tax calculation (Rahn, 2008:17).

The calculation of indexed capital gains would be a simple multiplication exercise whereby the taxpayer would use the ratio of CPI or some other index for that year, to determine the inflation adjusted value of the asset when it is sold (Dubay, 2006:3). It is argued that it would be just an additional exemption based on the inflation figures published yearly by the revenue authorities (Dubay, 2006:6). It is an extremely simple process that would be readily understood by taxpayers (MacDowell, not dated:155).

4.2.3 The use of CPI

CPI or some similar index is commonly used to adjust capital gains for inflation. Concerns have been raised with using the **CPI** as it is not the most inclusive measure of inflation. Some economists prefer to use a more inclusive measure like the Gross Domestic Product (GDP) deflator to reflect changes in the value of money. (MacDowell, not dated:155.)

GDP can be defined as a measure of the “total domestic economic activity. GDP is equivalent to the value added to the economy by its activity.” (HM Treasury,2006.)

GDP deflator can be defined as a measure of inflation over a period of time across all sectors of the economy. The change in prices for a wide range of goods and services are

taken into account for example consumer goods such as bread, investments in inventory, housing and computers, imports and exports of goods and services. (HM Treasury,2006.)
The implicit GDP deflator measures the ratio of nominal GDP to real GDP. The formula for the calculation of the GDP deflator is (Wikipedia,2008b):

"GDP deflator = $\frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$"

Unlike CPI, the GDP deflator is not calculated using a fixed basket of goods and services. A fixed basket of goods might not be a true reflection of consumer spending and investment patterns as new expenditure patterns and the introduction of new goods and services might be excluded from the basket. Changing expenditure patterns will automatically be reflected in the GDP deflator as GDP takes into account all goods and services that were produced domestically, weighted by the market value of the total consumption of each good. Often the variance between the deflator and CPI is minimal. (Wikipedia,2008b.)

The use of CPI might also be the incorrect option for South Africa where the average basket used to calculate CPI excludes items that will be in the capital owner's trolley. The PPI tracks the value of capital goods and might be a better index to use. Another option is to use a specially designed index. (Nedbank, 2000.)

The PPI "measure the rate of change in the prices of goods and services bought and sold by producers. An output PPI measures the rate of change in the prices of products sold [by a producer and] an input PPI measures the rate of change in the prices …of goods and services purchased by the producer." PPI is also calculated using the basket of goods approach. The prices of the same products are observed over a period of time. (IMF,2005:xiii.)

When using an index for adjusting capital gains, the other concern is how readily available the index is that is to be used (Lochan, 2002: 1848). In South Africa the CPI and PPI figures are published monthly by Statistics South Africa and are available from their website under key indicators. The GDP deflator is however not as readily available as CPI or PPI.

The GDP figures are published by Statistics South Africa on a quarterly basis, but the GDP deflator figures are not published.

4.2.4 The tax rate for capital gains

In most countries capital gains are taxed at a lower statutory rate than normal income. Preferential rates are normally to compensate for the lack of inflation relief. Also a portion of the gains per annum is normally excluded, for example in South Africa the first R16 000 is excluded. This is normally done for administration purposes so that small gains do not create an extra administration burden. (Nedbank,2000.)

If capital gains are indexed for inflation, consideration will have to be given to what **tax rate** to use. Should a preferential rate still apply or should the capital gains attract tax at the normal statutory rate. In South Africa capital gains are included in normal income at an inclusion rate of 25% which creates an effective tax rate of 10% if the taxpayer falls in the maximum bracket of 40% tax. If indexation is considered in South Africa then the inclusion rate of 25% will have to be re-examined.

One of government's main reasons for the introduction of CGT was that it will minimise the motivation for taxpayers to avoid tax by representing revenue as capital gains. Treating capital gains and other income differently can cause investment choices to be guided by false tax incentives. Taxing capital gains at a lower rate than other income undermines many of the tax's objectives. For a South African taxpayer it is still attractive to classify normal income as a capital gain, due to the effective CGT rate being only 10% versus the normal income tax rate of 40%. (Nedbank,2000.) Some experts feel that it is preferable to have the statutory rate match the effective rate without the confusion caused by inflation in the tax base (Dubay, 2006:4).

4.2.5 The treatment of assets and liabilities

Some experts believe that in order to cut out the effect of inflation on the real tax liability in practice, only three steps are needed:

- "exempt inflationary capital gains from tax;
- disallow tax deductibility of inflationary interest charges; and

- allow replacement cost depreciation or in other words indexation of historic cost depreciation" (Sadka,1991:139).

Some argue that inflationary capital gains are offset by the inflationary interest deduction but this could be untrue where the asset was bought using equity rather than debt and secondly capital gains are only taxed on realization whereas interest is deductible on an accrual basis (Sadka, 1991:139).

Sadka (1991:139) argues that the above three step approach will be sufficient when the inflation rate is below 15% but when the inflation rate breaches 100% it will not be able to deal with the effects of inflation in the business sector, as other factors that mainly effect operating income come into play. Production happens over a period of time where the product is sold at the end at inflated prices while the costs such as labour and materials are incurred during the process, thus the nominal income will overstate the real income when the product is sold (Sadka,1991:140).

The ATO cited that the removal of indexation would have the result that all income producing business assets, whether they are appreciating or depreciating, would be treated the same. This will remove tax **avoidance** opportunities where taxpayers characterise an asset as a CGT asset to benefit from indexation. The calculation of depreciation is based on the nominal value of the asset without any inflation adjustment. If the asset is sold for an amount above its depreciated value but below its original cost the full difference is recouped with no allowance for inflation. If the asset is sold for more than its original cost then the excess over the original cost is reduced by indexation based on the original cost and capital gains tax applied. The ATO felt that such an arrangement is both complex and not balanced. The removal of indexation would result in the same tax treatment for depreciating and appreciating assets. (Review of Business Taxation, 1999b:4.) It is concluded that the ATO removed indexation rather than to change to replacement cost depreciation.

Lochan (2002:1854) on the other hand states that when depreciating assets, for example a building, is sold for more than its book value, the original cost should be adjusted for

inflation in calculating the capital gain as the recoupment of depreciation previously allowed will have the effect that the full inflationary gain is taxed.

Partial indexing, as apposed to indexing of the entire tax code, can cause some assets to become tax preferred compared to those that aren't indexed, potentially creating large economic misrepresentations (Chamberlain, 2006). To index the entire tax code can also prove very difficult as the gain or loss on all property transactions will have to be adjusted and the inflationary portion of both interest income and deductions will have to be determined (Elkins, 2007:370). If all the measures only relate to the asset side and the liability side is overlooked, businesses will increase their borrowings to buy assets to benefit from this (Sadka, 1991:141).

Interest income creates a real increase in wealth only to the extent by which it exceeds the rate of inflation. That portion of interest which merely compensates for the devaluation of the currency in which the loan is to be repaid is not real income. Where the interest income is inadequate to offset the effect of inflation, a deduction should be allowed for the decrease in value of cash and interest-earning assets. (Elkins, 2007: 369-370.)

With **interest expense**, the portion that merely compensates for the wearing away in the value of the currency is not real interest either. Only the real interest is an actual expense and only the real expense and not the inflationary portion should be permitted as a deduction. Where the interest paid is inadequate to offset the effect of inflation the variance between the real value of the borrowed amount and the real value of the amount repaid, including the interest should be taxed in the hands of the borrower. (Elkins, 2007: 369-370.)

When buying fixed assets either equity or debt can be used to finance the purchase. When inflation starts to rise, those businesses who have invested huge amounts in fixed assets financed by **debt** usually gain because capital gains are taxed on realization whereas interest charges are deducted on the accrual basis. Those businesses that used **equity** capital to finance their production process usually lose. (Sadka,1991:141.)

Some argue that the indexing of capital gains cannot be done in isolation because debt financing of assets will create a tax benefit for those who had access to borrowed funds (Wall street journal:2008).

To overcome the above mentioned difficulties the Israeli government uses a combination of a comprehensive and a piecemeal approach to adjust income for inflation and to protect capital assets against the effect of inflation (refer to chapter 3.8). The comprehensive approach allows for a phantom deduction for equity and the piecemeal approach calculates inflationary and real gains for each transaction. As per ITAIL, debt is attributed to non-fixed assets and equity is attributed to fixed assets as far as possible. The taxpayer is entitled to a deduction for inflation (DFI) where equity exceeds fixed assets. Where fixed assets exceed equity an addition for inflation (AFI) will be added to taxable income. (Elkins, 2007:377.)

4.2.6 The effect on the economy

According to Kerpen (2006) “one reason for the poor stock market performance of the 1960’s and 1970’s [in America was due to] inflation tax which imposed a major tax penalty on investors who generally did no better than break even in real terms.”

It is argued by Rahn (2006:17) that inflation indexing should be part of the economic “stimulus package” of any country. Dubay (2006:1) argues that indexing capital gains will improve the performance of the economy as investors would be able to predict their future tax liabilities better. Lochan (2002:1853) states that because indexing would protect investors against inflation they are more likely to invest in capital assets and this will stimulate entrepreneurship, risk taking and the more effective use of capital.

Some experts argue that indexation creates short term benefits in countries experiencing moderate to high inflation because it **stimulates savings** by safeguarding it from inflationary depletion. However, in the long run indexation is not so beneficial. Partial relief of the pain of inflation through indexation might speed it up even further and can lead to **hyperinflation**. Indexation might be seen as a “willingness to accommodate inflation rather than taking serious steps to fight it.” (Roy, 2003:8.)

In Israel most future transactions were linked to inflation indexing, from salaries and insurance policies to the property market. This left Israeli's unaffected by the steady increase in inflation in the 1970's, because their real income was protected by this index-linked mechanism. When inflation spiralled out of control in the 1980's it was found that the linkage method was fuelling further increases in prices and was taking its toll on economic activity. Daily linkage adjustments were taking up valuable time and resources. This situation led to the Economic Stabilization Policy in 1985 when a total price freeze was introduced on all goods and services. (Rosenberg, 2001.)

The Israeli government also introduced new legislation in 1982 (ITTICL) and 1985 (ITAIL) to deal comprehensively with the effects of inflation on the calculation of taxable income. Although ITAIL was introduced as a temporary measure during a period very high inflation, it is still in effect today over 23 years later, even though Israel's inflation rate is currently in the region of 3% per annum. (Elkins 2007:365.)

Consideration should also be given to what will be done in periods of deflation. Deflation is defined as a general decrease in prices or a decrease in money supply. Deflation is the opposite of inflation but is not such a common occurrence as inflation. (Wikipedia, 2008c.) If during periods of inflation the base cost of assets is adjusted higher to reflect its real value, then in periods of deflation the base cost of assets will have to be adjusted lower to reflect its real value. Taxpayers might not be happy with such a downward adjustment. (Lochan, 2002:1856.)

4.2.7 The period the asset was held

Long-term gains should be treated more favourably than short-term gains because of the use of a progressive income-tax structure. If capital gains are taxed yearly by using the accrual basis, a lower tax rate will apply because the taxpayer will fall into a lower tax bracket. If the annual capital gains are allowed to accumulate over years it might push the taxpayer into a higher marginal tax rate in the year the gains are realized. (MacDowell, not dated:148.) In South Africa capital gains are taxed, not at a flat rate, but as part of normal income. Gains are therefore subject to increasing marginal rates the higher the income, so this argument is very relevant in South Africa.

One argument often used to rationalize the higher taxation of short-term gains is that it is a deterrent for speculation which suggests that speculation is unwanted both economically and socially. However many economists believe that speculation plays an important role in the optimal allocation of resources in the economy. The elimination of speculation through taxation will reduce the performance of the economy as well as lower income and harm wealth creation. (MacDowell, not dated:159.)

There are a number of countries that do distinguish between long and short term capital gains for instance Australia, America and India. Here short term capital gains are taxed more severely then long term gains (refer to chapter 3.3, 3.6 and 3.7).

4.2.8 Alternatives to indexation as an inflation adjustment measure

Capital gains are normally taxed upon realization rather than on an **accrual basis**, so that the inflationary component of the capital gains is taxed only when the asset is sold (Sadka, 1991:138). When using a realization basis it is sometimes difficult to determine whether a realization took place or not and some very difficult rules have to be built into the tax system to curb avoidance. Under an accrual basis these complex rules to determine the date of realization will not be necessary. (Lochan, 2002:1851.)

Various countries including Canada, New Zealand and the USA have done previous investigations regarding using the accrual method for taxing capital gains. The USA identified the following three factors that would make implementation virtually impossible:

- "the administrative burden of annual reporting;
- the difficulty and cost of determining asset values annually; and
- the potential hardship of obtaining funds to pay taxes on accrued but unrealized gains" (Lochan, 2002:1846).

The accrual basis would increase the administrative burden for the taxpayers due to the regular valuation of assets (Lochan, 2002:1851). The value of some assets might also be very difficult to determine, for instance art works or shares in unlisted private companies. The cost to the taxpayer will be high if various assets have to be valued where there are no known values available unlike the case of shares in publicly quoted companies. (MacDowell, not dated:155.) Suggestions made to cut costs for the taxpayer is to require

valuations on a periodic and not an annual basis, for example every five years (Lochan, 2002:1846).

Valuations are already required in a number of situations in South Africa where the disposal has not yet taken place. In paragraph 12(1) to 12(5) of the Eighth Schedule of the Act, certain events are deemed as disposals for CGT and it will trigger a capital gain or loss for example where a person ceases to be a resident in terms of paragraph 12(2)(a) or a person becomes a resident in terms of paragraph 12(4).

The biggest problem is however the one of liquidity. The taxpayer will have to pay tax on amounts that have not been realized yet, and this can cause severe hardship for some taxpayers. One suggestion on how to accommodate this problem is to introduce an interest accrual on deemed taxes that will only be payable upon the disposal of the asset. This will however create even more complexity in the system. (Lochan, 2002: 1847.)

The accrual method will also imply the use of unrealized losses to offset capital gains. Capital losses can be carried forward indefinitely to be used against future capital gains. (Lochan, 2002: 1850).

In the partial inclusion method which is currently used in South Africa there are too many implied factors in the specified inclusion rate. It is not possible to determine what portion of the exclusion is due to inflation and what portion due to other factors. The partial inclusion rate will only be correct in the extraordinary event that the portion of the capital gain that is excluded from tax is equal to the rate of inflation. A system of partial inclusion also unfairly treats all capital gains the same, irrespective of how long the asset was held before it was realized. (Lochan, 2002:1852.)

4.2.9 Timing of introduction

When the inflation rate is low, taxpayers are happy to ignore the erosion in the value of their money and to accept nominal income as being equal to their real income. Thus they do not mind paying tax on the nominal income. However as the erosion in the value of money accelerates due to high inflation, taxpayers will naturally focus on the difference between their nominal and real income. (Elkins, 2007:365.)

Nedbank (2000) suggest that indexation should only be considered when inflation exceeds 20%. Other experts however feel that it should rather be introduced during a period of lower inflation to minimise the effect on revenue loss for the government (Dubay, 2006:6).

It should be noted that the introduction of indexation in Israel happened at least two decades before the start of their high inflationary period during the 1970's (Roy,2003:2). Taxing capital gains at a lower rate than normal income is often justified as a substitute for indexation but a preferential rate undermines many of the tax's objectives (Nedbank, 2000).

The manner in which inflation adjustment is introduced by government should also be considered. It should not be done in a piecemeal way. As can be seen from chapter 3.4 and 3.8, most governments only gave relieve to taxpayers after the public objected to the harmful affects of inflation and only much later did the Revenue office close the loopholes which left the system open to abuse. Relief should not only be given on the asset side while ignoring the liability side. It became clear in Israel that inflationary capital gains cannot be excluded from business income while taxpayers are allowed to deduct the total inflationary portion of the interest incurred by them, from their ordinary income. As a result businesses will increase their borrowings to invest in assets to increase their interest deduction. The partial adjustment measures were replaced by ITTICL in 1982 and later by ITAIL in 1985. (Sadka, 1991:141.)

4.3 CONCLUSION

There are a number of key factors to consider before a decision can be made as to whether capital gains should be indexed to adjust for inflation. The principal of using an index to adjust the nominal value to its real value seems very simple on the surface but if it is analysed further there are a number of issues that can complicate the decision.

The effect on the revenue office and the taxpayer must be considered. If the benefits derived from inflation adjustment are out-weighed by the administrative burden and compliance cost it might not be the best option for South Africa.

CPI is used worldwide as a measure for inflation adjustment. It should be considered if it is the best index to use or if another measure like PPI or the GDP deflator should be used.

Currently in South Africa an inclusion rate of 25% is applied to capital gains for individuals and an inclusion rate of 50% for companies. Indexing capital gains in addition to the current partial inclusion method will reduce government revenue (Lochan, 2002:1853). Indexing will however provide a more exact method to adjust for inflation than the current partial inclusion method.

Consideration will have to be given as to whether partial indexing will lead to some assets becoming tax preferred compared to those that aren't indexed. If capital gains are indexed it should be considered whether an adjustment will also need to be made to interest and debt. A system of partial inclusion also unfairly treats all capital gains the same, irrespective of how long the asset was held before it was realized. (Lochan, 2002:1852.)

It should be considered if a distinction between short term and long term capital gains should be made and if different tax rates should apply to them.

The timing of the introduction of such a measure also needs to be considered. South Africa's inflation rate reached double digits recently and could be classified as moderate inflation, between 5 and 40% (Roy, 2003:4). Some experts feel that indexation should only be introduced when the inflation rate accelerates to above 20% while others feel that the introduction of indexation should be in a period of low inflation to minimise the effect when it is introduced.

The effect on the economy must also be considered. Will indexation not create a situation where taxpayers accept inflation because the effect on them is minimal rather than to put pressure on government to keep inflation within a reasonable level. If indexation is only introduced as a measure to adjust capital gains and not over the whole spectrum of the economy as was done in Israel, the risk of people not feeling the effect of inflation on their day-to-day life should be minimal. People are still exposed to rising fuel and food prices on a daily basis. In South Africa the average household income between 1995 and 2005 was R2 870 (Burger & Yu, 2006:3). The majority of average household spending goes towards

food and transport cost. Recently trade unions held country wide demonstrations over rising inflation (Mail & Guardian, 2008). So it seems that in South Africa the pressure will remain on government to curb inflation.

Lastly it should also be considered if the accrual method can be an alternative for calculating capital gains. Academics argue that this is the most correct method that should be used but the cost and complexity of annual valuations must be compared to the benefit derived from taxing gains as they accrue versus taxing gains only on realization. A number of countries have already investigated the accrual method and have decided to stay on the realization method due to complexity and liquidity issues.

All factors need to be considered before a conclusion can be reached as to whether indexation must be applied to adjust CGT for inflation. If a government decides to introduce such a measure it must not be done in a piecemeal way because that will leave loopholes in the system that can create abuse. A complete analysis must be done to determine the effect on the country's economy and taxpayers.

In chapter 5 a final conclusion will be reached based on the analyses and discussions done in the previous chapters.

CHAPTER 5

CONCLUSION

5.1 INTRODUCTION

CGT incorporates two different taxes. Firstly it is a tax on the real increase in value of an asset and secondly it is a tax on the inflationary increase in the asset value (Kerpen, 2006). Income tax brackets and annual exemptions are adjusted annually to compensate for the increase in the cost of living but no adjustment is made to CGT to compensate for the effect of inflation (Chamberlain, 2006).

In chapter 5 a conclusion will be reached on whether inflation adjustment for CGT should be introduced in South Africa.

5.2 OVERVIEW

An introduction to the study and the core research question and research objectives were given in chapter 1. Chapter 2 focused on the history and reasons for the introduction of CGT in South Africa as well as the calculation of CGT. In chapter 3 a review was done of the history and current practices of various countries. In chapter 4 key factors for consideration as to whether to adjust CGT for inflation were identified.

In these chapters the objectives of the study were achieved in that:

- a conclusion was reached that South African taxpayers receive minimal indirect adjustment for inflation when calculating CGT (chapter 2);
- the effect of tax on real versus inflationary capital gains were analysed and the results indicated that the higher the inflation rate the bigger the negative impact on the taxpayer (chapter 2);
- the current worldwide trend in adjusting CGT for inflation was analysed and it was found that some first world countries moved away from indexing while other countries are still successfully applying indexing years after implementation (chapter 3); and

- the key factors for consideration in deciding whether to adjust CGT for inflation were identified as:
  - the effect it will have on the taxpayer, the revenue office and the economy;
  - should CPI or another index be used;
  - the treatment of assets and liabilities and the period the asset was held;
  - whether there are other alternatives to indexation as a measure to adjust for inflation; and
  - the tax rate to apply as well as the timing of introducing such a measure (chapter 4).

5.3 RESULT

In South Africa taxpayers don't receive any direct inflation adjustment for CGT. Some features of the South African tax system do give minimal indirect relief against taxation of inflationary gains.

All assets purchased before 1 October 2001, were valued on 1 October 2001. Thus the increase in the value of the asset before the valuation date is not subject to CGT. CGT is only applied, to the appreciation in value after the valuation date. (Jordaan *et al.,* 2007:624.)

In South Africa individuals include 25% of their net capital gains in taxable income which is then taxed at the taxpayer's normal statutory rate. Some experts are of the opinion that the reason for partial inclusion of capital gains is to compensate for the effect of inflation (Lochan, 2002:1834).

However there are too many implied factors in the specified inclusion rate. It is not possible to determine what portion of the exclusion is due to inflation and what portion due to other factors. The partial inclusion rate will only be correct in the extraordinary event that the portion of the capital gain that is excluded from tax is equal to the rate of inflation. A system of partial inclusion also unfairly treats all capital gains the same, irrespective of how long the asset has been held before being realized. The same exclusion applies if an asset was

held for 1 year or 10 years. (Lochan, 2002:1838,1852.) Some experts feel that the inclusion rate could be adjusted annually, to keep pace with inflation as is the case with tax brackets and exemptions (Lochan, 2002:1838).

Rollovers also give some relief for inflation in that the payment of tax is effectively deferred until some future event takes place, normally when a replacement asset is sold. The longer the tax is deferred the bigger the benefit to the taxpayer. (Lochan, 2002:1842.)

The current trend in first world countries is to move away from indexation. Australia froze indexing in 1999, Ireland in 2002 and most recently the United Kingdom abolished it in April of this year (it was previously frozen in 1998). All these countries experienced very low inflation for a number of years before freezing indexing. The main reasons cited by these countries for freezing indexing were to simplify and remove complexity from the tax system.

As was seen in Israel runaway inflation and the increased public outcry against the impact thereof can force governments to introduce measures to curb its effect. The Israeli government opted for a combination of the comprehensive and piecemeal methods to adjust income for inflation and to protect capital assets against the effect thereof. This method has proven to be simple and understandable to taxpayers, so that is still in effect today, 23 years after its initial implementation.

India implemented the indexing of capital gains 27 years ago. Indexing is only applied on the asset side without adjustment for the liability side. The manner in which India introduced indexation without subsequent adjustments keeps the calculation easy and logical.

Consideration must be given to a number of key factors before a decision can be made to index capital gains for inflation. Complexity will be reduced if the legislation is introduced properly and not on a piecemeal basis, so that the impact on the taxpayer and the revenue office will be kept to a minimum. The impact on the revenue collected should be minimal if the partial inclusion rate is abolished or adjusted at the same time as the introduction of indexation.

A decision will have to be made on what index to use for purposes of adjusting for inflation. Most experts recommend using the GDP deflator rather than CPI to adjust capital gains for inflation. However CPI is published monthly by Statistics South Africa whereas the GDP figures are only published quarterly. From the GDP figures the GDP deflator can be calculated. With South Africa's inflation rate currently in double digits it would be sufficient to adjust for inflation using quarterly figures.

One of government's main reasons for the introduction of CGT was that it would minimise avoidance by discouraging taxpayers from representing revenue as capital gains. Taxing capital gains at a lower rate than other income, undermines many of the tax's objectives because it is still advantageous for a South African taxpayer to classify normal income as a capital gain, due to the effective CGT rate being only 10% where the taxpayer is on the maximum marginal rate, versus the normal income tax rate of 40%. (Nedbank, 2000.)

Long-term gains should be treated more favourably than short-term gains because of the use of a progressive income-tax structure. If the annual capital gains are allowed to accumulate over years it might push the taxpayer into a higher marginal tax rate in the year the gains are realized. (MacDowell, not dated:148.) By distinguishing between short and long term gains, 100% of short term gains and only the real long term gains will be added to taxable income. The real long term gain is calculated by adjusting the base cost of the asset for inflation. The same effective tax rate will then apply to both revenue and capital which will decrease the motivation for taxpayers to classify income as capital.

The use of an alternative calculation method such as the accrual basis will be too problematic. It would add a huge administrative burden and cost to the taxpayer due to yearly valuations of assets and it will cause hardship where tax must be paid before the realization of the asset. (Lochan, 2002:1846.)

There are different opinions as to when it is the best time to introduce indexation. Nedbank (2000) suggest that indexation should only be considered when inflation exceeds 20%. In August 2008 CPI reached 13.3% year on year. Israel showed that a system of indexation becomes a necessity during periods of very high inflation. Both Israel and India showed that the system can also work throughout periods of low to medium inflation. The argument

that indexation will create a situation where taxpayers will accept inflation because the effect on them is minimal will not hold in South Africa as most households spend the majority of their income on food and energy cost, where prices is still rising monthly. As was recently seen, trade unions organised protest marches countrywide to put pressure on government to fight inflation.

The biggest problem with the introduction of inflation adjustment of capital gains could be that if it is only introduced on the asset side and not on the liability side as well, it would create a tax benefit for those who have access to borrowed funds.

Some experts recommend a three step approach to eliminate the effect of inflation on the real tax liability. Over and above the exemption of the inflationary capital gains from tax, depreciation must also be indexed and the inflationary interest should be disallowed as a deduction. (Sadka,1991:139.) This is the reason why the Israeli government uses a combination of a comprehensive and a piecemeal approach to adjust income for inflation and to protect capital assets against the effect of inflation.

5.4 CONCLUSION

It is concluded that South African taxpayers do enjoy some indirect inflation adjustment on capital gains. There is no doubt that using indexing would give a more precise adjustment for inflation than the partial inclusion method. However indexing will inevitably create a tax benefit for some taxpayers who have access to borrowed funds to buy assets, if attention is not also given to the liability side. This study only focused on the inflation adjustment of capital gains, thus the asset side. Before a government can decide whether to implement an inflation adjustment system, the benefits enjoyed by taxpayers who bought assets with borrowed funds (also called the liability side) will need to be fully investigated. Thus more research on the liability side will be needed before a system of indexation can be introduced in South Africa.

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