



# **Legal & Policy**

## **Income Tax**

### **Guide on Valuation of Assets for Capital Gains Tax Purposes (Issue 4)**



*South African Revenue Service*

# **Guide on Valuation of Assets for Capital Gains Tax Purposes**

## **Preface**

This guide provides general guidance on valuations. It does not go into the precise technical and legal detail that is often associated with tax, and should not, therefore, be used as a legal reference. It is not an “official publication” as defined in section 1 of the Tax Administration Act 28 of 2011 and accordingly does not create a practice generally prevailing under section 5 of that Act. It is also not a binding general ruling under section 89 of Chapter 7 of the Tax Administration Act. Should an advance tax ruling be required, visit the SARS website for details of the application procedure.

For more information you may –

- visit the SARS website at **[www.sars.gov.za](http://www.sars.gov.za)**;
- visit your nearest SARS branch;
- contact your own tax advisor or tax practitioner;
- contact the SARS National Contact Centre –
  - if calling locally, on 0800 00 7277; or
  - if calling from abroad, on +27 11 602 2093 (only between 8am and 4pm South African time).

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**SOUTH AFRICAN REVENUE SERVICE**

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## Glossary

In this guide unless the context indicates otherwise –

- **“CGT”** means capital gains tax, being the portion of normal tax attributable to the inclusion in taxable income of a taxable capital gain;
- **“Eighth Schedule”** means the Eighth Schedule to the Act;
- **“Estate Duty Act”** means the Estate Duty Act 45 of 1955;
- **“GG”** means *Government Gazette*;
- **“JSE”** means the exchange operated by JSE Ltd which facilitates trade in securities under the style of ‘Johannesburg Stock Exchange’ and is licensed as an exchange under the Financial Markets Act 19 of 2012;
- **“paragraph”** means a paragraph of the Eighth Schedule;
- **“section”** means a section of the Act;
- **“Tax Administration Act”** means the Tax Administration Act 28 of 2011;
- **“the Act”** means the Income Tax Act 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

## 1. Introduction

The rules for determining capital gains and losses for CGT purposes are largely contained in the Eighth Schedule and apply on or after 1 October 2001.

A capital gain or loss on disposal of an asset is determined by subtracting its base cost from the proceeds.

### *Pre-valuation date assets*

The base cost of an asset acquired before valuation date is equal to its valuation date value plus any further allowable expenditure incurred on or after the valuation date under paragraph 20.

The valuation date is generally 1 October 2001 but for certain previously exempt entities it can be a later date. For example, the valuation date of a public benefit organisation approved by the Commissioner under section 30(3) is the first day of its first year of assessment commencing on or after 1 April 2006. The valuation date of a recreational club which applied for approval under section 30A on or before 31 March 2009 is the first day of its first year of assessment ending on or after 1 April 2007.

A recreational club approved under section 10(1)(d)(iv) that failed to apply for approval under section 30A by 31 March 2009 will have a valuation date equal to the first day of its first year of assessment ending after 30 September 2010.

Three methods are potentially available for determining the valuation date value of a pre-valuation date asset, namely –

- $20\% \times (\text{proceeds less allowable expenditure incurred on or after valuation date})$  (generally used when no records have been kept and no valuation was obtained at valuation date);
- market value (see 2); or

- Time-apportionment (This method of calculating the value of the asset takes into account how long the asset has been owned before and after valuation date).

### *Post-valuation date assets*

The base cost of an asset acquired on or after valuation date is generally equal to the qualifying expenditure listed in paragraph 20, which includes amongst other things, the cost of acquiring or improving the asset and specified costs of acquisition and disposal. In some situations, however, a post-valuation date asset will be deemed to be acquired at market value, such as when it is acquired by –

- donation, for consideration not measurable in money, or at a non-arm's length price from a connected person;<sup>1</sup>
- inheritance from a deceased estate on the date of death of the testator;<sup>2</sup> and
- distribution in specie from a company.<sup>3</sup>

In some circumstances a taxpayer is deemed to dispose of an asset for an amount received or accrued equal to market value. Some examples include –

- the disposal of an asset by donation, for a consideration not measurable in money or to a connected person at a non-arm's length price;<sup>4</sup>
- cessation of residence, ceasing to be controlled foreign company or becoming headquarter company;<sup>5</sup>
- commencement of residence or foreign company becoming a controlled foreign company;<sup>6</sup>
- asset ceasing to be part of a person's permanent establishment otherwise than by disposal under paragraph 11;<sup>7</sup>
- conversion of a capital asset to trading stock;<sup>8</sup>
- asset that becomes a personal-use asset;<sup>9</sup> and
- upon the death of a person.<sup>10</sup>

## **2. Market value on valuation date**

Paragraph 29 contains a number of transitional measures which apply to the valuation of assets on 1 October 2001. To the extent that the rules in paragraph 29 do not apply, the rules in paragraph 31 will apply.

<sup>1</sup> Paragraph 20(1)(h)(vi) (acquisition from non-resident) and paragraph 38.

<sup>2</sup> Paragraph 20(1)(h)(v) (acquisition from non-resident deceased estate) and section 25(3)(b).

<sup>3</sup> Paragraph 75.

<sup>4</sup> Paragraph 38.

<sup>5</sup> Section 9H.

<sup>6</sup> Paragraph 12(2)(a).

<sup>7</sup> Paragraph 12(2)(b).

<sup>8</sup> Paragraph 12(2)(c).

<sup>9</sup> Paragraph 12(2)(e).

<sup>10</sup> Section 9H.

## 2.1 Time limit for performing valuations

All valuations as at 1 October 2001 were required to be carried out by 30 September 2004.<sup>11</sup> Under paragraph 29(4), a public benefit organisation or recreational club may not adopt or determine the market value of an asset unless it has valued the asset within two years from the valuation date.

Failure to comply with the time periods for performing valuations means that the market-value method cannot be used to determine the valuation date value of the asset.

The asset must have been valued according to the factors prevailing on valuation date such as its condition at the time and prevailing economic conditions.

The requirement to value assets by 30 September 2004 does not apply to those assets whose prices as at 1 October 2001 were published in the *Government Gazette* such as shares listed on the JSE and participatory interests in collective investment schemes. Similarly, public benefit organisations and recreational clubs are not subject to a time limit for valuing financial instruments listed on a recognised exchange or participatory interests in collective investment schemes in securities or property.

## 2.2 Who may perform valuations?

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

## 2.3 Methods to be adopted in valuing specified assets

The table below sets out the methods to be used for valuing assets on valuation date.

**Table 1 – Market values on 1 October 2001**

| Paragraph 29 | Type of asset                                                                             | Market value                                                                                                                                                                       |
|--------------|-------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| (1)(a)(i)    | Financial instruments listed on a recognised exchange in South Africa                     | Prices supplied in GG 23037 of 25 January 2002 and on SARS website under Types of Tax/Capital Gains Tax/Market values. Price based on five business days preceding 1 October 2001. |
| (1)(a)(ii)   | Foreign financial instruments listed on a recognised exchange outside South Africa        | The ruling price on that recognised exchange on the last business day before 1 October 2001.                                                                                       |
| (1)(b)(i)    | Participation rights and "property shares" in South African collective investment schemes | Average "sell" price for the last five trading days before 1 October 2001. Prices supplied in the <i>Government Gazette</i> .                                                      |
| (1)(b)(ii)   | Participation rights in foreign collective investment schemes                             | Same as for South African collective investment schemes, except based on last trading day before 1 October 2001. If no price quoted, the price which could                         |

<sup>11</sup> This deadline was originally 30 September 2003 but was extended to 30 September 2004 by the Minister of Finance in GG 26026 of 20 February 2004.

| Paragraph 29 | Type of asset                                          | Market value                                                                                                                                         |
|--------------|--------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------|
|              |                                                        | have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market on 1 October 2001 |
| (1)(c)       | Any other asset                                        | The market value determined under paragraph 31.                                                                                                      |
| (2) and (3)  | Controlling interest in listed company (see Example 1) | Control premium/discount determined on disposal and applied to listed price at 1 October 2001 (see conditions below).                                |

#### *Conditions for valuing controlling interest under paragraph 29(2)*

A holder of shares will be able to value a controlling interest in the manner described in paragraph 29(2) if –

- The company is listed on a recognised exchange;
- The entire controlling interest is disposed of to a person who is not a connected person in relation to the seller and the acquirer acquires the entire controlling interest; and
- The controlling interest comprises more than 35% of the company's equity shares.<sup>12</sup>

## **2.4 Submission and retention requirements**

The requirements for submission of the prescribed valuation forms (CGT 2L if completed after 30 September 2004 or CGT2 / Annexure if completed before that date) and related particulars are set out in paragraph 29(5) and (6).

#### *High value assets [paragraph 29(5)]*

For specified assets the valuation forms were required to be lodged with the first return of income submitted after 30 September 2004, irrespective of whether the relevant assets had been disposed of. These categories of assets are set out in the table below.

**Table 2 – Submission requirements for high value assets**

| Type of asset                                        | Applies                                      | Where market value exceeds |
|------------------------------------------------------|----------------------------------------------|----------------------------|
| Intangible assets (such as goodwill and trade marks) | Per asset                                    | R1 million                 |
| Unlisted shares                                      | All shares held by the person in the company | R10 million                |
| All other assets                                     | Per asset                                    | R10 million                |

See Example 2.

<sup>12</sup> Paragraph 29(3).

### *Other assets [paragraph 29(6)]*

It is no longer required that the valuation form be submitted with the return of income reflecting the disposal of the asset concerned. Instead, proof of the valuation must be retained and submitted only when called upon by SARS to do so.

### *Retention requirements*

The periods for which the valuation forms and any related valuation documentation must be retained are set out in section 29 of the Tax Administration Act.

A person who has submitted a return of income reflecting a capital gain or loss must retain records, books of account or documents supporting the determination of that capital gain or loss for a period of five years from the date of submission of the return.

A person who is required to submit a return but has not done so will have to retain the relevant records for at least five years after the date on which the return is eventually submitted.

A person who is not required to submit a return under the criteria set out in the annual notice to furnish returns, for example, because the sum of capital gains or sum of capital losses during the year of assessment does not exceed R40 000,<sup>13</sup> must retain the records pertaining to any capital gain or loss for at least five years from the end of the year of assessment in which the asset was disposed of.

## **2.5 Loss limitation rules**

Paragraphs 26 and 27 contain rules to limit losses when the market-value method is used to determine the valuation date value of an asset. These rules are designed to prevent the creation of phantom losses arising from inflated valuations, but apply equally when the valuation is realistic and the market value exceeds the proceeds. For more information on this topic see the *Comprehensive Guide to Capital Gains Tax* in Chapter 8.

## **2.6 Burden of proof**

Under section 102(1)(e) of the Tax Administration Act, the taxpayer bears the burden of proving that a valuation is correct.

The fact that a valuation was done by a qualified valuer will not prevent the Commissioner from auditing the valuation. The Commissioner may, if dissatisfied with a valuation –

- request further information or documents relating to the valuation;<sup>14</sup> or
- adjust the valuation.<sup>15</sup> The Commissioner's right to adjust the valuation is subject to objection and appeal.<sup>16</sup>

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<sup>13</sup> See the annual notice to furnish returns. The notice for the 2018 year of assessment was published in GG 41704 of 15 June 2018.

<sup>14</sup> Paragraph 29(7)(a).

<sup>15</sup> Paragraph 29(7)(b).

<sup>16</sup> Section 3(4)(h).

The following are examples of the detail which the Commissioner may require:

*Residential property*

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

*Farming property*

- The detail requested in the Land Bank questionnaire used for valuing immovable property on which *bona fide* farming operations are carried on is a useful aid when farm land is valued using the market-value method.
- As from 1 February 2006, Land Bank valuations no longer apply and the market value must be the fair market value as per paragraph (b) of the definition of "fair market value" in section 1(1) of the Estate Duty Act, namely, the price that could be obtained between a willing buyer and willing seller dealing at arm's length in an open market, less 30%.

*Mineral rights*

- Valuer's valuation, including basis of valuation and calculations
- The description of the mineral right and its registered number at the Deeds Office
- Type of mineral
- Location and extent of mineral right
- Exploitation of mineral right as at 1 October 2001
- Original cost of mineral right
- Quantification of reserves still to be mined
- Remaining life of mine
- If exploitation has not commenced, details and results of prospecting undertaken as at 1 October 2001
- Department of Minerals and Energy valuation
- Any other information which may be relevant

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

### Unlisted shares

- Valuer's valuation, including basis of valuation and calculations

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

Possible valuation methods include the following:

- Dividend-based valuations may be used for minority holdings when the company has a history of paying dividends.
- Earnings-based minority holding valuations may be used in cases of influential minority holdings (concentrating on net earnings per share and price earnings ratios).
- Earnings-based whole company valuations for majority holdings (concentrating on maintainable pre-tax profits, a capitalisation factor and a discount which takes cognisance of the size of the shareholding).
- Proof of shareholding
- Full description of the business carried on by the company
- The company's annual financial statements for the last three years before the valuation date
- If there are different classes of shares, documentation proving the rights of each class, in particular those concerning voting, dividends and distributions on liquidation of the company
- Any other information which may be relevant

### 3. Market value of assets otherwise than on valuation date

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

- pre-valuation date assets not covered by the transitional valuation rules in 2;
- other occasions, such as –
  - cessation and commencement of residence;
  - death or donation;
  - connected person transactions at a non-arm's length price; and
  - assets acquired or disposed of by distribution *in specie*.

**Table 3 – Market values otherwise than on valuation date**

| Paragraph 31 | Type of asset                                        | Market value                                                                                                                        |
|--------------|------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------|
| (1)(a)       | Financial instrument listed on a recognised exchange | The ruling price at close of business on last business day before disposal                                                          |
| (1)(b)       | Long-term insurance policy                           | Greater of – <ul style="list-style-type: none"><li>• surrender value; and</li><li>• insurer's market value (assume policy</li></ul> |

| Paragraph 31         | Type of asset                                                                                                                                            | Market value                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|----------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                      |                                                                                                                                                          | runs to maturity)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| (1)(c)(i)            | Participation right in a portfolio of a collective investment scheme in securities or property                                                           | Management company's repurchase price                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
| (1)(c)(ii)           | Participation right in a foreign collective investment scheme which is comparable to a collective investment scheme in participation bonds or securities | Management company's repurchase price or, if not available, selling price based on willing buyer, willing seller acting at arm's length in open market                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| (1)(d) read with (2) | Fiduciary, usufructuary and other like interests (see Example 3)                                                                                         | Present value of future benefits discounted at 12% a year over life expectancy of person entitled to asset or lesser period of enjoyment. Commissioner may approve less than 12% if justified                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| (1)(e)               | Property subject to fiduciary, usufructuary or other like interest                                                                                       | Market value of full ownership, less value of fiduciary, usufructuary or other like interest as determined above                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
| (1)(f) read with (4) | Immovable property on which a <i>bona fide</i> farming undertaking is carried on                                                                         | <ul style="list-style-type: none"> <li>• Market value less 30%;<sup>17</sup> or</li> <li>• Price based on willing buyer, willing seller at arm's length in open market</li> </ul> <p>On disposal by death, donation or non-arm's length transaction, "market value less 30%" may be used only if it is used in determining the base cost of the disposer on –</p> <ul style="list-style-type: none"> <li>• Valuation date; or, if applicable</li> <li>• Date acquired by inheritance, donation or non-arm's length transaction at Land Bank value or market value less 30%.</li> </ul> <p><b>Note:</b> As from 1 February 2006 the market value must be the fair market value as per paragraph (b) of the definition of "fair market value" in section 1(1) of the Estate Duty Act, namely, the price that could be obtained between a willing buyer and willing seller dealing at arm's length in an open market, less 30%.</p> |

<sup>17</sup> As determined under paragraph (b) of the definition of "fair market value" in section 1(1) of the Estate Duty Act.

| Paragraph 31 | Type of asset   | Market value                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
|--------------|-----------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| (1)(g)       | Any other asset | The price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| (3)          | Unlisted shares | <p>The price which could have been obtained upon a sale of the share between a willing buyer and a willing seller dealing at arm's length in an open market subject to the following:</p> <ul style="list-style-type: none"> <li>• no regard shall be had to any provision – <ul style="list-style-type: none"> <li>➤ restricting the transferability of the shares, and it shall be assumed that those shares were freely transferable; or</li> <li>➤ whereby or whereunder the value of the shares is to be determined;</li> </ul> </li> <li>• if upon the winding-up of the company that person would have been entitled to share in the assets of the company to an extent that is not in proportion to that person's holding of shares, the value of the shares held by that holder of shares must not be less than the amount to which that holder of shares would have been so entitled if the company had been in the course of winding-up and the said amount had been determined as at valuation date.</li> </ul> <p>The valuation must reflect the extent to which a potential buyer of the shares can control or influence the company. There are many degrees of control, usually determined by the voting power of a particular block of shares, running from full control (including power to liquidate the company) to a small or non-existent influence over the company's affairs of a minority shareholding. It follows that, unless there are exceptional circumstances, if the degree of control is less than complete, the value of the shares will be less than a <i>pro rata</i> proportion of the overall value of the company.</p> |

## 4. Examples

### Example 1 – Valuation of controlling interest in listed shares

#### Facts:

Sweet Pea Ltd holds 51% of the issued shares of Pea Ltd, a company listed on the JSE since 1990 when Sweet Pea Ltd acquired its holding. Sweet Pea Ltd disposed of its entire holding in Pea Ltd to OH (Pty) Ltd for cash.

|                                                                                 |                |
|---------------------------------------------------------------------------------|----------------|
| Date of sale                                                                    | 1 October 2018 |
| Total number of Pea Ltd shares held by Sweet Pea Ltd                            | 3 000 000      |
| Last buying price for each Pea Ltd share on 30 September 2018 (per JSE)         | R1,95          |
| Last selling price for each Pea Ltd share on 30 September 2018 (per JSE)        | R2,05          |
| Price for each share under sale agreement                                       | R2,20          |
| Price for each Pea Ltd share as at valuation date per <i>Government Gazette</i> | R1,50          |

#### Result:

#### Step 1 – Calculate market value on valuation date

|                                                 |            |
|-------------------------------------------------|------------|
| Valuation date market value (3 000 000 × R1.50) | R4 500 000 |
|-------------------------------------------------|------------|

#### Step 2 – Calculate control premium or discount

|                                               |       |
|-----------------------------------------------|-------|
| Average last price quoted (R1,95 + R2,05) / 2 | R2,00 |
| Control premium (R2,20 – R2,00) / R2,20       | 10%   |

The control premium is determined by deducting the price per share per the sale agreement from the average last price quoted on the JSE and dividing the result by the selling price per the sale agreement.

#### Step 3 – Determine base cost

|                                                 |                  |
|-------------------------------------------------|------------------|
|                                                 | R                |
| Valuation date market value (3 000 000 × R1.50) | 4 500 000        |
| Control premium (R4 500 000 × 10%)              | <u>450 000</u>   |
| Base cost                                       | <u>4 950 000</u> |

#### Step 4 – Determine capital gain

|                              |                    |
|------------------------------|--------------------|
|                              | R                  |
| Proceeds (3 000 000 × R2,20) | 6 600 000          |
| Less: Base cost              | <u>(4 950 000)</u> |
| Capital gain                 | <u>1 650 000</u>   |

### Example 2 – Submission requirements for valuations

#### Facts:

Andrew owns 10 shares in Enne (Pty) Ltd, a company with a 31 August financial year-end. His accountant valued his shares on 31 August 2003 at R1, 5 million each as at 1 October 2001. The accountant's valuation of the assets in the company was as follows:

|                       |            |
|-----------------------|------------|
|                       | R          |
| Fixtures and fittings | 10 000 000 |
| Goodwill              | 2 500 000  |
| Trade marks           | 1 700 000  |
| Liquor licence        | 800 000    |

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

Enne (Pty) Ltd submitted its return for the year ending 31 August 2003 on 31 August 2004 and obtained an extension to submit its return for the year ending 31 August 2004 by 31 August 2005. Andrew submitted his return for the year ending 28 February 2004 on 28 February 2005.

Andrew and Enne wish to adopt the market value basis for all their assets.

*Result:*

Andrew and Enne (Pty) Ltd will be permitted to use the market value basis for the following assets if proof of valuation was submitted to SARS with the return of income specified:

| <b>Asset</b>             | <b>Reason</b>    | <b>Proof to be submitted with return for year ending:</b> |
|--------------------------|------------------|-----------------------------------------------------------|
| <i>Andrew</i>            |                  |                                                           |
| Shares in Enne (Pty) Ltd | MV > R10 million | 28 February 2004                                          |
| <i>Enne (Pty) Ltd</i>    |                  |                                                           |
| Goodwill                 | MV > R1 million  | 31 August 2004                                            |
| Trade marks              | MV > R1 million  | 31 August 2004                                            |

Note: The furniture and fittings do not fall within paragraph 29(5) because their individual values do not exceed R10 million. The prescribed valuation form for the fixtures and fittings is no longer required to be submitted with the return of income reflecting their disposal but must be retained for five years from the date of submission of that return.

### **Example 3 – Valuation of usufruct**

*Facts:*

The market value of Tim's farm less 30% is R800 000. He donated a usufruct over the farm to Kevin for the rest of Kevin's natural life. Kevin is 30 years old.

*Result:*

The value of the usufruct is determined as follows:

- Annual value:  $R800\,000 \times 12\% = R96\,000$
- According to the life expectancy tables for males, Kevin's life expectancy is 38,48 years.
- Present value of R1 capitalised at 12% a year for 38,48 years = R8,22694

*Value of usufruct:*

$R96\,000 \times 8,22694 = R789\,786$

## 5. Case law

Some recent tax cases involving valuations are summarised below.

In *C: SARS v Stepney Investments (Pty) Ltd*<sup>18</sup> the taxpayer company had disposed of a 4,37% interest in a company in two tranches during the 2002 and 2003 years of assessment. The taxpayer had used the market-value method to determine the valuation date value of the shares. Since the proceeds on disposal of the shares were less than the market value established by the taxpayer, a capital loss had arisen which was eliminated by paragraph 26(3). All shares in the company had been valued by the taxpayer using the “discounted cash flow” basis with the market value of its holding being determined by multiplying the total value by the percentage holding. The Commissioner adjusted the market value of the shares disposed of under paragraph 29(7)(b) to nil. The memorandum of incorporation of the company in which the shares were held described its main object as developing, owning, operating and conducting the business of casinos, hotels and related leisure ancillary activities. The company was awarded a casino licence on 21 October 2000 by the KZN Gambling Board which gave it an exclusive right to operate a casino for 15 years in the Richards Bay area. After the licence was awarded, a religious group objected to the proposed location of the casino and the company obtained an alternative temporary venue in Empangeni for which it was granted a temporary licence on 4 October 2001. The objection brought by the religious group did not succeed after valuation date. The Commissioner valued the shares on the net asset value basis, arguing that the shares had a value of nil. The Commissioner’s valuation took into account the various uncertainties that existed on valuation date. Having lost in the tax court the Commissioner took the matter on appeal to the Supreme Court of Appeal (SCA). In the SCA the Commissioner conceded that the net asset value method was inappropriate but challenged the taxpayer’s valuation as being defective on a number of grounds. It then fell to the SCA to evaluate the conflicting opinions of the experts called by SARS and the taxpayer. On the question of relying on the evidence of experts the court cited the following dictum of Wessels JA in *Coopers (SA) (Pty) Ltd v Deutsche Gesellschaft Für Schädlingsbekämpfung MBH*:<sup>19</sup>

“As I see it, an expert’s opinion represents his reasoned conclusion based on certain facts [or] on data, which are either common cause, or established by his own evidence or that of some other competent witness. Except possibly where it is not controverted, an expert’s bald statement of his opinion is not of any real assistance. Proper evaluation of the opinion can only be undertaken if the process of reasoning which led to the conclusion, including the premises from which the reasoning proceeds, are disclosed by the expert.”

The court also cited Addleson J in *Menday v Protea Assurance Co Ltd* thus:<sup>20</sup>

“It is not the mere opinion of the witness which is decisive but his ability to satisfy the Court that, because of his special skill, training or experience, the reasons for the opinion which he expresses are acceptable . . . the Court, while exercising due caution, must be guided by the views of an expert when it is satisfied of his qualification to speak with authority and with the reasons given for his opinion.”

Next, the court proceeded to examine the various assumptions underpinning the valuation:

- The future forecast free cash flows – The valuation was performed in 2004 but the taxpayer had relied on estimates submitted to the Gambling Board around 2001 despite being aware that the earlier estimates were substantially overstated. The valuer also disregarded a letter dated 20 March 2003 submitted to the Gambling

<sup>18</sup> 2016 (2) SA 608 (SCA), 78 SATC 86.

<sup>19</sup> 1976 (3) SA 352 (A) at 371 F–H.

<sup>20</sup> 1976 (1) SA 565 (E) at 569B–E.

Board which painted a bleak picture of the company's profitability. The court rejected the taxpayer's argument that to take into account subsequent events would have amounted to valuing the shares with hindsight. It noted that a valuer cannot just blindly accept figures presented to him or her and has a duty to assess their reasonableness and correctness. The valuer was duty bound to evaluate the soundness of management's projections and it was wrong not to take the later information into account.

- Starting date for valuation – The valuer used 1 March 2002 instead of 1 October 2001 which had an adverse impact on the valuation.
- Tax estimates – Incorrect figures had been used by the valuer.
- Projected capital expenditure – The projected capital expenditure was significantly understated.
- Terminal value – The terminal value had been based on discounting into perpetuity while the licence had a lifespan of 15 years. The risk of non-renewal or the costs of submitting a renewal application should have been taken into account.
- Discount factor – The discount rate used of 20,86% was used in valuing all the entities in the group and did not take into account the specific circumstances of the casino in question which was a start-up and not an established business.

In the result the court found that the valuation was fatally flawed in respect of the matters listed above. It noted that a court is entitled to reject a valuation if it is not satisfied with the investigations underpinning it and cited the following words of Denning LJ in *Dean v Prince*:<sup>21</sup>

"For instance, if the expert added up his figures wrongly, or took something into account which he ought not to have taken into account, or conversely, or interpreted the agreement wrongly, or proceeded on some erroneous principle – in all these cases, the court will interfere."

The court upheld SARS's appeal and referred the matter back to SARS for further investigation and assessment.

In Tax Board Case 0110<sup>22</sup> the appellant had disposed of a residence for proceeds of R3,2 million in 2003. The valuation date value of the residence had been determined at R4 million on the market-value basis by a professional valuer using the comparable sales method in which three comparable sales were selected. The valuation of R4 million was actually done for mortgage bond purposes at the instance of a bank and therefore carried out conservatively. A larger property was sold in the same road by public auction for only R2,3 million a month after valuation date but was in poor condition and disposed of under a forced sale. It was therefore not accepted by the chairman as a comparable property for valuation purposes. The chairman noted that for non-expert criticism to be accepted as evidence above the testimony of experts is not easy. In summing up the evidence he noted that –

"[w]e are left with a valuation done by an impartial valuator with many years' experience who valued the property conservatively. No evidence was produced to counter either his valuation or his methodology. The evidence produced by cross-examination, which was the only actual evidence adduced by the respondent, did not assist the respondent in any way".

In the result the chairman found in favour of the appellant.

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<sup>21</sup> 1954 (1) All ER 749 at 758.

<sup>22</sup> Durban Tax Board, 23 August 2007, unreported.

In *C: SARS v Executors Estate Late Sidney Ellerin*<sup>23</sup> the court had to consider the valuation of preference shares held by the deceased on the date of death under paragraph 40(1).<sup>24</sup>

The deceased held 112 000 7% redeemable non-cumulative preference shares of R1 each on date of death in Sidney Ellerin Trust (Pty) Ltd. The company's share capital also included 600 ordinary shares held by a number of trusts. Each of the preference and ordinary shares carried one vote with the result that the deceased held 99,5% of the voting rights in the company ( $112\,000 / 112\,600 \times 100$ ).

In the deceased's return of income up to date of death the proceeds on the deemed disposal of the shares were shown as R112 000, being their par value, which was the same as their redemption value. By contrast, SARS had assessed the deceased on proceeds of R563 million on the basis that the deceased could have converted the preference shares to ordinary shares. The preference shares should thus have been valued as if they were ordinary shares. The issue before the court was whether the right to convert the preference shares to ordinary shares should be taken into account when valuing the preference shares. The crux of the matter was whether the consent of the ordinary shareholders was required before the preference shares could be converted to ordinary shares. The articles of association of the company provided that any variation in the rights of shares of a particular class required the consent of 75% of the shareholders in that class. The respondent argued that the conversion of the preference shares to ordinary shares would result in the variation of the rights in the ordinary shares because it would result in a drastic decrease in their value, and hence the consent of 75% of the ordinary shareholders would have been required. The court noted that English law supported the view that a variation of rights occurs when the rights which attach to shares are varied and not when they become commercially less valuable. The court cited various authorities which confirmed that this principle applied equally in South Africa. In the result the court held that the deceased could have converted the preference shares to ordinary shares without the consent of the ordinary shareholders. The appeal was accordingly upheld, with the court finding that the shares should have been valued at R563 million.

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<sup>23</sup> [2018] JOL 40193 (SCA), 80 SATC 389.

<sup>24</sup> Paragraph 40(1) provided for a deemed disposal of the deceased's assets at market value on the date of death. For persons dying on or after 1 March 2016 this deemed disposal is now contained in section 9H.