

**THE IMPACT OF ESTATE PLANNING ON THE EFFECTIVENESS OF
ESTATE DUTY AS A WEALTH TAX IN SOUTH AFRICA**

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ABSTRACT

The thesis examined the current system of the taxation of wealth in South Africa with an emphasis on the taxes that apply upon the death of the taxpayer. The focus of the research was on the problems associated with estate duty, namely the issue of double taxation; the alleged cumbersome administration of the tax and the limited revenue that it brings in; it's questionable efficacy due to extensive estate planning on the part of taxpayers while they are still alive and its lack of uniformity with other wealth taxes.

An interpretative research approach was followed which involved analysing documentary data. The conclusions that were reached were that estate duty as a wealth tax in South Africa has been rendered ineffective due to the inherent problems associated with its application, namely the fact that double taxation exists, not only in the context of capital gains tax, but also in that taxpayers resent being taxed upon death after having paid income tax during their lives. The perceived unfairness that is associated with estate duty has caused the creation of a secondary industry of estate planning, with the aim of minimising estate duty, which industry has resulted in the ineffectiveness of estate duty and its limited revenue. No evidence could be found regarding the Treasury's assertion that estate duty is a cumbersome tax to administer. The final conclusion reached was that the current estate duty regime needs to be overhauled preferably by extending the current system of capital gains tax and abolishing estate duty, with due consideration being given to the consequences associated therewith.

Keywords: Capital gains tax; donations tax; double taxation; estate duty; estate planning; taxation upon death; wealth taxes.

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CHAPTER 1

INTRODUCTION

1.1. Context of the research

While there is no single “wealth tax” in South Africa there are a number of taxes which may be considered to be forms of wealth tax, namely donations tax and capital gains tax (CGT) in terms of the Income Tax Act 58 of 1962, as amended (the Income Tax Act), and estate duty in terms of the Estate Duty Act 45 of 1955, as amended (the Estate Duty Act). Estate duty is payable on death and is levied on the dutiable amount of the estate of a deceased person who died on or after 1 April 1955. The “estate” of a person is defined in the Estate Duty Act as comprising all of the property of that person as at the date of his or her death as well as all property which is deemed to be property of that person. In order to calculate the dutiable amount it is first necessary to establish where the deceased was ordinarily resident at the time of death. If he or she was ordinarily resident in South Africa, all of his or her assets, wherever they may be situated, will form part of the total value of the estate. If he or she was not ordinarily resident in South Africa, only those assets situated in South Africa will form part of the estate.

“Assets” constituting an estate in terms of section 3 of the Estate Duty Act include moveable and immoveable property; fiduciary, usufructuary and similar interests; annuities that accrue to other people on the deceased’s death and certain property that is deemed to be the property of the deceased. Once the total value of the estate has been established there are a number of deductions that can be made in terms of section 4 of the Act in order to arrive at the net value of the estate. These deductions include, but are not limited to, funeral and deathbed expenses, the costs of the administration and liquidation of the estate and property that accrues to the deceased’s surviving spouse. Once all of the relevant deductions have been made a primary abatement is further deductible in terms of section 4A of the Act from the net value. Currently, the abatement amounts to R3.5 million but it can be enhanced by

the portable spousal deduction to a maximum of R7 million. After the abatement has been made the dutiable amount is what remains and estate duty at 20 percent is levied thereon. Once the estate duty liability has been established further relief is available in the form of rebates and/or credits, such as the rebate available in terms of section 16(b), where death duties have been paid in a foreign country.

As the range of allowable deductions is fairly broad and the abatement is substantial, only relatively wealthy people are caught by estate duty. Such people go to elaborate and expensive lengths to minimise their estate duty liability by engaging in shrewd estate planning schemes. It is a well established principle that taxpayers are allowed to minimise their tax liability within the parameters of the law (*IRC v Duke of Westminster* [1936] AC 1) and the minimisation of estate duty liability in particular has become a popular and firmly established form of legal tax avoidance. Such avoidance has not gone unnoticed. In the South African Revenue Services Budget 2010/2011 Tax Proposals (SARS, 2010) it was stated that there were several issues that were going to be researched for possible attention in tax proposals for 2011 and 2012. With regard to estate duty the following was said:

Both estate duty and capital gains tax are payable upon death, which is perceived as giving rise to double taxation. The estate duty raises limited revenue and is cumbersome to administer. Moreover, its efficacy is questionable: many wealthy individuals escape estate duty liability through trusts and other means. Taxes upon death will be reviewed (SARS, 2010: 25).

In the South African Revenue Services Budget 2011/2012 Tax Proposals (SARS, 2011) it was stated that a tax policy research project was underway in terms of which the effectiveness of estate duty was being reviewed, with several options under consideration. However, in the South African Revenue Services Budget 2012/2013 Tax Proposals (SARS, 2012) estate duty was not mentioned at all so it is assumed that research is still ongoing and that the way forward has not yet been established.

The problems associated with estate duty, according to the Budget 2010/2011 Tax Proposals (SARS, 2010), may be summarised as follows:

1. the issue of double taxation;
2. that estate duty raises limited revenue and is cumbersome to administer; and
3. that its efficacy is questionable due to the fact that wealthy individuals can avoid it.

The first problem, being the issue of double taxation, is widely regarded as being the most significant flaw in the current system of taxation upon death. For CGT purposes the occurrence of death is deemed to be a disposal of the deceased's assets at market value (paragraph 11 of Schedule Eight to the Income Tax Act). This means that upon death estate duty is payable on the dutiable value of the deceased's estate, which includes all the deceased's assets, and CGT is payable on any capital gain made on the same assets of the deceased. Müller (2011: 42) points out that this issue was alluded to at the introduction of CGT in 2001 where the then Minister of Finance stated as follows:

A key strength of the proposed capital gains tax is that it is levied when the owner of an asset dies or the asset is donated. To counter any perceived double taxation of these assets, it is proposed to reduce the estate duty and donations tax rates to 20 percent.

While the rate of estate duty was reduced to 20 percent soon after the introduction of CGT in 2001, it is submitted that the fact that there is still a double taxation on death is problematic, the reduction to 20 percent aside. It may be argued that there is another form of double taxation quite aside from the CGT issue in that people will have paid tax during their lifetime on income which they have used to accumulate assets, only for a tax to be levied on the same assets upon their death in the form of estate duty. The issue of double taxation, in its various forms, requires examination.

The second problem is the fact that estate duty brings in limited revenue and is difficult to administer. Estate duty, as compared to other taxes, does not

contribute significantly to the fiscus. The 2012 Tax Statistics (The National Treasury & SARS, 2012) show that in the 2007/2008 tax year R691 million was collected, in the 2008/2009 tax year R757 million was collected, in the 2009/2010 tax year R759 million was collected, in the 2010/2011 tax year R782 million was collected and in the 2011/2012 tax year R1 045 million was collected.

While these amounts represent a seemingly large amount of money, when considered in light of the total amount of tax revenue the percentage of estate duty for the period 2007 to 2010 only represented 0.12 percent (Müller, 2011). The point raised by SARS that the administration of estate duty is cumbersome is of interest particularly when the Katz Commission, as pointed out by Müller (2011: 42), stated as follows in their Third and Fourth Interim Reports:

The administrative systems in the Master's office and the office of the Commissioner of Inland Revenue are geared to an estate duty (Third Interim Report) and the retention of the existing estate duty system would result in a minimum of deflection of resources. The collections systems are well-established (Fourth Interim Report).

In what sense the administration of estate duty is cumbersome is not known as information regarding the cost thereof has not been released by SARS. Perhaps SARS deem it to be cumbersome purely because the revenue that it produces is so minimal. While SARS may not be releasing information regarding the cost of administering estate duty, van Vuren (2010), is of the opinion that estate duty, as a source of revenue for the fiscus, has become completely obsolete. He further states that, at the moment, estate duty is doing more harm than good to the country. His reasoning for this contention, which links up with third problem set out below, is as follows:

Because (at least some) structures were set up purely to avoid estate duty, this has added a level of complexity to estate planning, the relevant legislation as well as the administration of deceased estates that a developing country can well do without. The Estate Duty Act is quite a complex piece of legislation. The entire process ties up very creative

minds that could have been applied to create real new wealth. The real cost to the economy of compliance with this complex legislation is anybody's guess.

The third problem, and the focus of this research, is that the efficacy of estate duty has come into question because wealthy people can avoid it. Those who wish to and who can afford to take steps to minimise their estate duty liability will find that there are many legitimate ways to do so. Jacobs (2012a) states that "estate duty has given rise to the creation of highly complex structures and the existence of a secondary industry resulting in negative spending to avoid the payment of estate duty". Tax planning or avoidance is not illegal. Many books on the subject of estate planning set out clearly the steps to be taken to avoid estate duty (Meyerowitz, 2010 and Stein, 2011). In order to understand how the phenomenon of estate planning by the wealthy has impacted on the efficacy of estate duty it is first necessary to consider why it is that an entire system of estate duty avoidance has been created and perfected. It is submitted that the short answer to this question is that there are inherent flaws in estate duty as a wealth tax which flaws render it unfair and unproductive. It is further submitted that the three problems associated with estate duty, as set out above, are interlinked as the issue of double taxation gives rise to estate planning which in turn gives rise to the limited revenue and seemingly cumbersome administration.

As the Treasury has not yet released its findings regarding the question of the efficacy of estate duty, research needs to be conducted, taking into account the opinions of the various experts in the field of the taxation of deceased estates. Should it be established that estate duty is ineffective alternatives will need to be considered. Submissions made by writers such as Ger (2012) and the South African Institute of Chartered Accountants (2011), both of whom suggest a number of alternatives to estate duty, will be useful in this regard.

It is submitted that this research will contribute to the body of knowledge as a clear and concise analysis of the efficacy of estate duty as a wealth tax with

an emphasis on the impact thereon of estate planning has not been published to date.

1.2. The goals of the research

The specific questions that will be addressed in this research are:

- how the present system of taxation on death, with a focus on estate duty, came about;
- what the problems associated with estate duty are and in particular whether there are more problems than the three identified by the Treasury;
- what the concept of estate planning means, how it has developed and what steps are taken by estate planners to minimise liability for estate duty; and
- how the concept of estate planning with the aim of minimising estate duty liability has impacted on the efficacy of estate duty as a wealth tax.

A question that will need to be addressed once the four questions set out above have been answered will be whether estate duty has been rendered so ineffective that it ought to be abolished and, if so, what alternatives exist.

The goal of the research is therefore to answer the questions set out above and to establish the foundation for the proposal made by the Treasury that the efficacy of estate duty requires consideration.

1.3. Methods, procedures and techniques

An interpretative research approach will be adopted for the present research as it seeks to understand and describe (Babbie & Mouton, 2009). The research methodology to be applied can be described as a *doctrinal* research methodology. This methodology provides a systematic exposition of the rules governing a particular legal category (in the present case the legal rules

relating to income tax and estate duty), analyses the relationships between the rules, explains areas of difficulty and is based purely on documentary data (McKerchar, 2008).

The documentary data to be used for the research consists of the following:

- legislation – the Income Tax Act and the Estate Duty Act;
- relevant case law;
- South African Revenue Service Interpretation Notes, Regulations and Notices, where relevant;
- commentary on the legislation by leading writers in the field; and
- the vast number of articles written on the subject by legal and tax practitioners.

The research is conducted in the form of an extended argument, supported by documentary evidence. The validity and reliability of the research and the conclusions will be ensured by:

- adhering to the rules of legal interpretation, as established by common law;
- placing greater evidential weight on legislation, case law which creates precedent or which is of persuasive value (primary data) and the writings of acknowledged experts in the field;
- discussing opposing viewpoints and concluding, based on a preponderance of credible evidence; and
- the rigour of the arguments.

As all the data is in the public domain, no ethical considerations apply. Interviews will not be conducted, opinions will be considered in their written form.

1.4. Overview

This thesis will begin in chapter 2 with a discussion of the various wealth taxes in South Africa focusing on donations tax and capital gains tax (CGT). In chapter 3 estate duty, which is the most important wealth tax for the purposes of this thesis, will be discussed in detail. In chapter 4 the problems that have been identified, by both the Treasury and other sources, with the current estate duty regime will be analysed. In chapter 5 the most important problem with estate duty for the purposes of this thesis, namely estate planning, will be discussed in detail as will the individual estate planning methods used by taxpayers. In chapter 6 the question whether or not estate duty should be abolished will be addressed. Alternatives to the current estate duty regime will be considered as will the consequences of abolishing estate duty as a wealth tax in South Africa. In the concluding chapter, namely chapter 7, the conclusions reached will be discussed and any unanswered questions will be set out.

CHAPTER 2

WEALTH TAXES IN SOUTH AFRICA

2.1. Introduction

While there is no single “wealth tax” in South Africa there are a number of taxes which may be considered to be forms of wealth tax, namely donations tax and capital gains tax (CGT) in terms of the Income Tax Act 58 of 1962, as amended (the Income Tax Act), and estate duty in terms of the Estate Duty Act 45 of 1955, as amended (the Estate Duty Act). This chapter will involve a discussion of the history of wealth taxes in South Africa followed by a brief analysis of donations tax and CGT. Estate duty will be discussed in detail in chapter 3. An analysis of the wealth taxes in South Africa is necessary in order to understand the context within which estate duty is applied. This will allow for a thorough understanding of how the three taxes, namely donations tax, CGT and estate duty, interact with one another and how such interaction results in the problems associated with estate duty, in particular the issue of double taxation.

2.2. Wealth taxes in South Africa

“The taxation of inherited wealth is one of the oldest fiscal instruments and can be traced back to the ancient civilisations of the Egyptians, Romans and Greeks” (Muller, 2010: 1). This type of taxation has evolved over the years and can still be found in many tax jurisdictions in many diverse forms. Muller (2010) points out that the development of wealth tax on death has involved a clear divergence between transferor-based taxation and recipient-based taxation. The former refers to taxation levied on the deceased estate or donor whereas the latter refers to taxation levied on the heir or donee. Over the years the law commissions in various countries have made proposals which have been far from uniform and some countries have abolished wealth taxes altogether. This has resulted in confusion as to the correct approach that should be followed in relation to wealth taxes and the divergent views thereon

have sparked an international debate as to whether these taxes are conceptually justifiable or not.

Muller (2010) states that wealth transfer tax has become increasingly unpopular around the world. Wealth transfer taxes have been completely abolished in Argentina, Australia, Canada, China, Columbia, Cyprus, the Czech Republic, Estonia, India, Indonesia, Israel, Latvia, Lithuania, Malaysia, Malta, Mexico, Portugal, Russia, the Slovak Republic, Slovenia, Sweden, Switzerland, Thailand and New Zealand. In the United States and United Kingdom there have been calls for the abolishment of wealth taxes although they currently remain in force.

Muller (2010) explains that in South Africa, wealth taxes first appeared in 1864 with the introduction of a recipient-based succession duty in the Cape of Good Hope. Similar taxes were introduced in Natal and the Orange Free State in terms of colonial legislation in 1905. Interestingly, in 1899 the former Zuid-Afrikaanse Republiek introduced a transferor-based form of estate duty. These contradictory provincial laws were repealed in 1922 with the introduction of the Death Duties Act. This Act provided for a parallel system of recipient-based and transferor-based taxation which was modelled on the “dual-duty” approach applicable in England at the time.

Donations tax was introduced in 1955 by way of an amendment to the Income Tax Act and applied to donations made by the taxpayer on or after 23 March 1955. On 1 April 1955 the Estate Duty Act was promulgated and applied to the estates of people who died on or after that date. Muller (2010) states that the new act retained most of the provisions of the old act, namely the Death Duties Act, but those relating to succession duty were not re-enacted. This meant that the new act essentially provided for a transferor-based system of taxation, which system is still in place today. Since the introduction of the Estate Duty Act in 1955 three different commissions have examined the nature and character of the wealth tax system in South Africa, namely the Franzsen Commission (1968 and 1970), the Margo Commission (1986) and the Katz Commission (1994, 1995 and 1997). All three of these Commissions

endorsed the system of wealth tax as well as the transferor-based system of taxation. Interestingly, both the Margo (1986) and Katz Commissions (1995 and 1997) were not in favour of a Capital Gains Tax. Even so, such a tax was introduced in 2001 by way of an amendment to the Income Tax Act.

Donations tax and CGT are discussed in the paragraphs that follow.

2.3. Donations tax

2.3.1. Introduction

As mentioned above donations tax was introduced by way of an amendment to the Income Tax Act in 1955. It applies to donations made on or after the 23rd of March 1955. According to Muller (2010: 90) the introduction of donations tax in 1955 “was aimed at inhibiting the avoidance of income tax and estate duty and was never intended to raise revenue”. Davis *et al* (2012) quote the following statement made by the then Minister of Finance upon the introduction of donations tax in 1955 with regard to the reasons for the introduction of the tax:

A method also employed for avoiding taxation is by distribution of gifts – a practice which has, during recent years, been employed on a large scale. It serves a double purpose. In the first place the donor reduces the assets on which estate duty would be payable at death, and in addition whilst he is still alive, he reduces his income tax, because by means of these donations the assets, and hence also the income derived therefrom, are spread over a great number of taxpayers.

Stiglingh *et al* (2011) state that donations tax fulfils a two-fold function, namely that it imposes a tax on persons who may want to donate their assets in order to avoid normal income tax on the income derived from those assets and/or estate duty when those assets are excluded from their estates.

The donations tax provisions are contained in Part V of the Income Tax Act, namely sections 54 to 64. Section 55(1) contains numerous definitions, important ones being the definitions of a “donation”, a “donee” and “property”.

A “donation” is defined as any gratuitous disposal of property including any gratuitous waiver or renunciation of a right. With regard to the gratuitous nature of a donation, in *Estate Welch’s v CSARS* 66 SATC 303 SCA 2004 the Supreme Court of Appeal held that “a donation will only exist if it was motivated by ‘pure liberality’ or ‘disinterested benevolence’” (Stiglingh *et al*, 2011: 743). Muller (2010) explains that the gratuitous waiver of a usufructuary or fiduciary interest or a debt owing to the donor will amount to a donation in terms of the definition in the Act. Where a person repudiates an inheritance, however, SARS accepts that such repudiation does not amount to a waiver of a right.

A “donee” is defined as:

any beneficiary under a donation and includes, where property has been disposed of under a donation to any trustee to be administered by him for the benefit of any beneficiary, such trustee: provided that any donations tax paid or payable by any trustee in his capacity as such may, notwithstanding anything to the contrary contained in the trust deed concerned, be recovered by him from the assets of the trust.

“Property” is defined as any right in or to property movable or immovable, corporeal or incorporeal, wheresoever situated.

2.3.2. Deemed donations

Should taxpayers attempt to dispose of assets for an inadequate consideration they will be caught by the provisions of section 58. In terms of section 58 the disposal of property for an inadequate consideration is deemed to be a donation, to the extent that the “adequate consideration” exceeds the actual consideration given.

Davis *et al* (2012) explain that it would *prima facie* appear that the intention of section 58 is to close the obvious loophole, if it could be argued that where some consideration had been given in return for a transfer of property, no “gratuitous disposal” and hence no donation had taken place. In other words, the intention behind section 58 would appear to be to bring within the net of “donation” the disguised donation, the transaction masquerading, for example as a sale, with the purchase price of the asset concerned being set at a ridiculously low price. Had the section not been inserted, avoidance of the donations tax net would have been absurdly easy. It is to be noted that it is not necessary that the consideration be less than market value. “Adequate consideration” is not necessarily synonymous with “market value”. So, for example, a disposition by a father to his child could be for an adequate consideration even though the consideration is less than market value.

2.3.3. Exemptions from donations tax

Section 56 sets out the exemptions from donations tax. There are certain exemptions that are relevant to this discussion due to their connection to CGT and estate duty. Where a donation is exempt from donations tax the problem of double taxation becomes irrelevant, assuming the donation does not incur both CGT and estate duty. Certain of the donations that are exempt from donations tax are also excluded for CGT purposes and in some cases are allowed as deductions for estate duty purposes.

The following donations are exempt from donations tax and CGT:

- donations to or for the benefit of the spouse of the donor under a duly registered antenuptial or post-nuptial contract or under a notarial contract entered into as contemplated in section 21 of the Matrimonial Property Act, 1984 (Act No. 88 of 1984) (section 56(1)(a)); and
- donations to or for the benefit of the spouse of the donor who is not separated from him or her under a judicial order or notarial deed of separation (section 56(1)(b)).

It should be noted that accrual claims in favour of a surviving spouse may be deducted from the gross value of the deceased estate for estate duty purposes in terms of section 4(IA) of the Estate Duty Act. Any bequests or inheritances in favour of a surviving spouse may be similarly deducted in terms of section 4(q) of the Estate Duty Act.

While the following donations may be exempt from donations tax, any growth in the value of the assets donated will be subject to CGT:

- donations made as a *donatio mortis causa* (section 56(1)(c));
- donations in terms of which the donee will not obtain any benefit thereunder until the death of the donor (section 56(1)(d)); and
- a donation which is cancelled within six months from the date upon which it took effect (section 56(1)(e)).

With regard to a *donatio mortis causa* the property that is the subject of the donation will be included in the gross value of the donor's estate for estate duty purposes.

In terms of section 56(1)(l) donations tax is not levied where property is disposed of under and in pursuance of any trust. It should be noted that the original donation to the trust would be subject to donations tax and CGT or, if sold to the trust, the disposal of the asset would be subject to CGT.

Section 56(2)(a) allows for an exemption from donations tax of so much of the sum of the values of all casual gifts made by a donor other than a natural person during any year of assessment as does not exceed R10 000: provided that where the year of assessment exceeds or is less than 12 months, the amount in respect of which the tax shall not be payable in terms of this paragraph shall be an amount which bears to R10 000 the same ratio as that year of assessment bears to twelve months. Section 56(2)(b) further allows for an exemption from donations tax of so much of the sum of the values of all property disposed of under donations by a donor who is a natural person as does not during any year of assessment exceed R100 000. As will be discussed in chapter 5, such small disposals may be used by estate planners

to minimise the value of their estate while they are still alive so as to avoid donations tax during their lifetime and to minimise the payment of estate duty after their death.

2.3.4. Valuation of donated property

Section 62 sets out the methods by which donated property should be valued for donations tax purposes. Section 62(1)(a) deals with fiduciary, usufructuary and like interests while section 62(1)(b) deals with annuities and section 62(1)(c) deals with bare dominium rights of ownership in property. Section 62(1)(d) states that in the case of any other property not dealt with by subsections (a), (b) or (c), the value thereof shall be the fair market value of such property as at the date upon which the donation takes effect: provided that in any case in which, as a result of conditions which in the opinion of the Commissioner were imposed by or at the instance of the donor, the value of any property is reduced in consequence of the donation, the value of such property shall be determined as though the conditions in terms of which the value of the said property is reduced in consequence of the donation, had not been imposed.

With regard to the application of CGT on death (which will be discussed below) in terms of paragraph 40 of the Eighth Schedule, where assets are disposed of to an estate upon death the value of such assets is their market value as at the date of death. Fair market value as at the date of death is also used when calculating the value of assets for estate duty purposes.

It should be noted that the Estate Duty Act contains special valuation rules for unquoted shares, whereas the donations tax provisions do not contain a similar valuation rule. For the purposes of estate duty, usufructuary and other like interests are valued with reference to the life expectancy of the beneficiary (unless the period of enjoyment is fixed), whereas, for donations tax purposes, these interests are generally valued with reference to the life expectancy of the donor (unless the period of enjoyment is fixed) in terms of section 62(1)(a) of the Income Tax Act.

2.3.5. Calculation of the liability

In summary, therefore, Stiglingh *et al* (2011: 742) set out the steps to be used when calculating donations tax.

1. Identify the disposal of property by a resident.
2. Determine whether the disposal constitutes a 'donation' as defined or if it is a deemed donation in terms of section 58.
3. If the disposal is a donation or is deemed a donation, determine whether it is specifically exempt from donations tax.
4. If it is not specifically exempt, determine the value of the donation. If the donee paid any consideration for the property, the consideration paid must be deducted from the value of the donation.
5. Deduct the balance of the general exemption available to the taxpayer from the value of the taxable donation.
6. Multiply this value by 20 percent to determine the donations tax payable.

With regard to point 6 above, section 64 states that donations tax is levied at 20 percent of the value of the property donated. Initially it was levied at a progressive rate but since the 1988 amendment to the Act (the Taxation Laws Amendment Act 87 of 1988) it has been levied at a flat rate (Muller, 2010). The initial flat rate of 15 percent was increased to 25 percent in 1996 and then reduced to 20 percent in 2001. It is only levied when property is donated by a South African resident. A non-resident who donates assets situated in South Africa is not subject to donations tax, but would, in most instances, be subject to CGT and estate duty.

2.3.6. Payment of donations tax

In terms of section 59 the person liable for donations tax shall be the donor, provided that if the donor fails to pay the tax within the period prescribed in subsection (1) of section 60 the donor and the donee shall be jointly and severally liable for the tax.

In the case of a donation to a trust the trustee would be liable as donee for the payment of the tax. Muller (2010) explains that where a donation has been made to a company the public officer of that company would be liable as donee.

It should be noted that where both donations tax and CGT are payable in respect of a donation made, paragraph 22 of the Eighth Schedule to the Income Tax Act provides some relief. In this regard, Muller (2010) explains that in determining a capital gain or loss on the disposal of an asset by virtue of a donation a portion of the donations tax paid is added to the base cost of the asset.

2.3.7. Death and donations tax

Donations made in contemplation of death (*donatio mortis causa*) are exempt from donations tax in terms of section 56(1)(c). However, for estate duty purposes, the assets that are the subject of such a donation are included in the donor's estate on death. In terms of section 56(2)(b), for donations tax purposes, there is an annual exemption of R100 000 that is enjoyed by natural persons. Huxham and Haupt (2011) state that many people utilise this exemption by making annual donations of R100 000 to their family trusts thereby minimising the value of their estate upon death and reducing their estate duty liability.

According to Davis *et al* (2012) a donation is the obvious method of shifting wealth from one person to another, or from one generation to another, and thereby reducing the dutiable amount of one's estate. In this way estate duty could be minimised or avoided altogether. They point out apparent inconsistencies in the application of donations tax and estate duty in that non-residents are not liable for donations tax even in respect of the donation of assets situated in South Africa while such assets would attract estate duty. They would, in many instances, also attract CGT. In addition, interest-free and low-interest loans, which are very common in estate plans, are currently not considered by Revenue to be donations or deemed donations (section 58).

The use of donations as an estate planning method will be discussed in detail in chapter 5.

2.4. Capital Gains Tax (CGT)

2.4.1. Introduction

According to Bornman (2010) South Africa's CGT system is mainly based on the tax systems of Australia and the United Kingdom and has been influenced by the systems in place in the United States of America, Canada and Ireland. Bornman (2010) states that according to the American experience, capital gains accrue mainly to individuals with a higher income and so including capital gains in the taxable income of such individuals contributes to the progressivity of the income tax system.

CGT came into effect in South Africa on 1 October 2001 by virtue of the addition to the Income Tax Act of the Eighth Schedule (in terms of the Taxation Laws Amendment Act 5 of 2001). Before its introduction any capital gain a person made on the disposal of an asset was not taxable. According to Huxham and Haupt (2011) the basic principle behind CGT is that if a capital asset is sold at a profit, the profit is subject to CGT, and if it is sold at a loss, the capital loss can be set off against other capital profits. If there are no other capital profits in the year, the capital loss is carried forward to the next year. CGT is not a separate tax but has been incorporated into the Income Tax Act in terms of section 26A and is regarded as a tax on income.

The Eighth Schedule is a broad and lengthy piece of legislation and so only the important aspects can be discussed here.

2.4.2. Application

The Eighth Schedule applies to the disposal by a South African resident of assets on or after 1 October 2001. With regard to non-residents, only the disposals of certain kinds of assets are taken into account. Davis *et al* (2012)

explain that non-residents are liable for CGT upon gains from the disposal of the assets as set out below:

- (1) Immovable property situated in South Africa held by such a person or any interest or right of whatever nature of that person to or in immovable property. An interest in immovable property situated in the Republic includes any equity shares held by a person in a company or ownership or the right to ownership of a person in any other entity or a vested right of a person in any assets of any trust, if:
 - (a) 80 percent or more of the market value of those equity shares, ownership or right to ownership or vested right, as the case may be, at the time of disposal thereof is attributable directly or indirectly to immovable property held otherwise than as trading stock; and
 - (b) in the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20 percent of the equity share capital of that company or ownership or right to ownership of that other entity.
- (2) Any asset of a permanent establishment of that person through which trade is carried out in South Africa during the relevant year of assessment.

In part 1, paragraph 1 of the Eighth Schedule an “asset” is defined as:

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

A “disposal” is defined as:

an event, act, forbearance or operation of law envisaged in paragraph 11 or an event, act, forbearance or operation of law which is in terms of this Schedule treated as the disposal of an asset, and “dispose” must be construed accordingly.

Part 3 of the Eighth Schedule deals with the disposal and acquisition of assets. Part 3 paragraph 11 deals specifically with disposals. Subparagraph

(1) explains what constitutes a disposal while subparagraph (2) explains what does not constitute a disposal. Only those disposals relevant to this thesis will be discussed.

In terms of subparagraph (1)(a) a disposal includes the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset. The fact that a donation is considered to be a disposal for CGT purposes is of significance as this raises the possibility of double taxation, namely the application of both CGT and donations tax. In terms of subparagraph (1)(d) the vesting of an interest in an asset of a trust in a beneficiary constitutes a disposal. This is of significance as the vesting of interests in trust assets in beneficiaries is a commonly used estate planning method. Similarly, subparagraph (1)(f) which involves the granting, renewal, extension or exercise of an option, is of significance as options may be granted to family members as part of an estate plan.

It should be noted that none of the disposals set out in subparagraph (2) that are excluded from CGT are relevant to this discussion as none of them are disposed of under a donation or form part of the estate of a deceased person.

With regard to whether or not a disposal will incur CGT, Stiglingh *et al* (2011: 781) provide the following guidelines:

In determining whether the disposal of a particular asset will result in a capital gain, and therefore be subject to CGT, it is first necessary to determine whether the disposal is revenue in nature by applying the basic principles of income tax. If it is determined that the disposal is revenue in nature, the gain or loss will then be subject to normal tax, not CGT. The proceeds that are taken into account for normal tax purposes are specifically excluded from proceeds that are used to calculate a capital gain or loss for CGT purposes (par 35(3)(a)). Any expenditure allowed for normal income tax purposes is excluded in a similar way from the base cost that is used to calculate a capital gain or loss for CGT purposes (par 20(3)(a)).

This therefore excludes the possibility that amounts are taken into account for income tax purposes as well as for capital gains tax purposes.

2.4.3. Calculation of the liability

Stein (2011) explains that a person's capital gain for a year of assessment on the disposal of an asset during that year is equal to the amount by which the proceeds received or accrued in respect of the disposal of the asset exceed the base cost thereof. An annual exclusion of R20 000 was allowed to a natural person in the 2012 year of assessment which amount has increased to R30 000 for the 2013 year of assessment. The exclusion is substantially higher if a person dies during the year of assessment. The annual exclusion in the year of death was R200 000 in the 2012 year of assessment and has increased to R300 000 for the 2013 year of assessment. In terms of paragraph 10 a person's taxable capital gain was 25 percent (33,3 percent in the 2013 year of assessment) of the net capital gain for the 2012 year of assessment. This amount is then added to the taxpayer's taxable income for the year of assessment. There is also an exclusion available to natural persons who dispose of their primary residences. This exclusion was R1.5 million in the 2012 year of assessment and has increased to R2 million for the 2013 year of assessment.

The calculation of the CGT liability on the disposal of an asset may best be explained by way of an example. If a taxpayer is paying tax at the maximum marginal rate of 40 percent and he or she sells land in May 2012 for R1 million, which land only cost him or her R200 000 in 2005 then his or her CGT liability will be calculated as follows:

Proceeds of sale.....	R1 million
Base cost.....	<u>R200 000</u>
Capital gain.....	R800 000
Annual exclusion.....	<u>R30 000</u>
Net capital gain.....	R770 000
Taxable capital gain (33.3%).....	R256 410
Tax at 40%.....	R102 564

The above example is calculated on the assumption that no capital loss was brought forward from the previous tax year and that the land sold was not the taxpayer's primary residence.

It is submitted that the exclusions set out above, and the fact that only a portion of the capital gain is subject to normal tax, do serve to mitigate the effect of a potential double tax on the same asset, either when it is donated or on the death of a person.

2.4.4. Donations and CGT

A donation amounts to a disposal for CGT purposes. Muller (2010) states that in determining a capital gain or loss on the disposal of an asset by virtue of a donation a portion of the donations tax paid is added to the base cost of the asset. This is calculated in terms of paragraph 22 of the Eighth Schedule to the Income Tax Act. By way of example, if a person donates fixed property with a market value of R3 million and a base cost of R1 million, and assuming that the exemption of R100 000 for donations tax has been used on other donations, the donations tax payable will be R600 000 but only R400 000 will be added to the base cost for CGT purposes ($[(R3 \text{ million} - R1 \text{ million})/R3 \text{ million} \times R600 \text{ 000}]$). If the base cost is R2,4 million only R120 000 of the donations tax will be added to the base cost.

Davis *et al* (2012) explain that, with regard to donations, it is to be noted that where a person disposed of an asset by means of a donation or for a consideration not measurable in money or to a person who is a connected person in relation to that person for a consideration which does not reflect an arm's length price:

- the person who disposed of that asset must be treated as having disposed of that asset for an amount received or accrued equal to the market value of that asset as at the date of that disposal; and
- the person who acquired that asset must be treated as having acquired that asset at a cost equal to that market value, which cost is the

acquirer's base cost (together with the cost of any improvements to the asset).

This provision is contained in paragraph 38 of the Eighth Schedule to the Income Tax Act.

It should be noted that while donations of cash attract donations tax, they do not attract CGT. An asset consisting of cash forming part of the estate is, however, subject to estate duty.

2.4.5. Death and CGT

According to Stein (2011), as a general rule, deceased persons are treated as having disposed of their assets to their estates upon their death. The assets are deemed to have been disposed of to the estate at their market value as at the date of death of the deceased. The estate is then treated as having acquired the assets for an amount equal to the same market value. This "cost" of acquiring the assets must be treated as an amount of expenditure actually incurred and paid for the purposes of the determination of the base cost of the asset in the hands of the deceased estate in terms of paragraph 20(1)(a). In this way the deceased estate is only subject to CGT on the growth in value of the asset after the date of death.

Davis *et al* (2012) set out four exceptions to the general rule that deceased persons are deemed to have disposed of assets at death:

- (1) assets accruing to the deceased's surviving spouse on the death of the deceased;
- (2) assets bequeathed to a Public Benefit Organisation approved by the Commissioner under section 30 of the Income Tax Act;
- (3) a long-term insurance policy of the deceased which, if the proceeds of the policy had accrued to the deceased, the capital gain or loss determined in respect of that disposal would have been disregarded; and
- (4) an interest in a pension, provident or retirement annuity fund in the Republic or a fund, arrangement or instrument situated outside the

Republic which provides benefits similar to a pension, provident or retirement annuity fund which, if the proceeds thereof had accrued to the deceased, the capital gain or capital loss determined in respect of the disposal of the interest would have been disregarded.

The annual exemptions available to natural persons are increased in the year of death (in the 2012 year of assessment the exemption on death was R200 000 while in the 2013 year of assessment it is R300 000) and the primary residence exemption (R1.5 million in 2012 and R2 million in 2013) is still available upon death. If the deceased's primary residence is bequeathed to the surviving spouse, the whole history of the asset is "rolled over" and only when the survivor disposes of it will the primary residence exclusion be deducted (paragraph 67 of the Eighth Schedule to the Income Tax Act). In this way, the CGT liability is deferred but it should be borne in mind that as a result of this rollover provision, the CGT liability, when the asset is disposed of by the surviving spouse, will be based on the gain from the time the first-dying spouse bought the property.

When a deceased estate disposes of an asset to an heir or legatee or a trustee of a trust, it is deemed to have disposed of it at the deceased estate's base cost and hence there can be no capital gain or loss. Huxham and Haupt (2011) explain that the heir or legatee is deemed to have the same base cost of the asset as the deceased estate plus any other costs which the deceased estate is allowed to add on to the market value. Therefore, no further gain in the value of the asset during the winding-up period is taxed in the hands of the deceased estate.

Where the deceased was a small business owner, paragraph 57 of the Eighth Schedule will find application. Paragraph 57 deals with the disposal of assets belonging to a small business and defines a 'small business' as a business of which the market value of all its assets, as at the date of the disposal of the asset or interest does not exceed R5 million. As death amounts to a disposal for CGT purposes, this paragraph will apply where the deceased held an active business asset at the time of his or her death. In such a case R900 000

of any gain that is made upon death will be excluded. There are a number of conditions that must be met before this exclusion will apply. The executor of the deceased estate would therefore have to analyse the provisions of paragraph 57 carefully in order to establish whether it is applicable in the circumstances.

According to Davis *et al* (2012) the effect of the deemed disposal on death is that capital gains tax is imposed on the growth in the value of the assets acquired by the deceased during his or her lifetime and this capital gains tax liability, together with the estate duty liability, could impact on the liquidity of the deceased estate. Some relief is provided in such circumstances in terms of paragraph 51 of the Eighth Schedule to the Income Tax Act, namely where the tax relating to the taxable capital gain of the deceased exceeds 50 percent of the net value of the estate, as determined for the purposes of the Estate Duty Act, before taking into account that tax, and the executor of the estate is required to dispose of an asset to pay that tax. In such a case an heir or legatee who would have been entitled to the asset may have the asset distributed to him or her on condition that the portion of the capital gains tax exceeding 50 percent of the net value of the estate is paid by him or her within three years after the date the executor has obtained permission to distribute the assets in the estate.

The tax liability of the deceased up to the date of death, therefore including the capital gains tax payable on the deemed disposal of assets, is deductible in arriving at the net value of the estate, which again does provide some relief.

The impact of the application of both CGT and estate duty may best be illustrated by way of an example. If an asset with a market value of R3 million and a base cost of R1 million was held by the deceased at death and assuming that there are other capital assets that absorb the annual exclusion and the estate duty abatement and that the deceased pays tax at the maximum marginal rate, the tax liability will be R2 million x 33.3 percent x 40 percent which amounts to R266 400. The estate duty will be R600 000 and only R266 400 will be deductible as a debt owing by the deceased at death.

According to Huxham and Haupt (2011) an estate plan that aims to save estate duty will generally save CGT as well. Where an asset is sold to a trust and the amount left standing as a loan owing by the trust, the seller will pay CGT on the disposal of that asset. However, upon the death of the seller there should be no further capital profit to tax as the loan account that is still outstanding and which forms part of the estate will not have grown in value. Upon the death of the seller the market value of the loan account is equal to its base cost so there is no further capital profit to tax, even though the underlying assets may have increased in value.

Huxham and Haupt (2011) refer to the practice prior to the introduction of CGT in 2001 of selling assets to a trust on loan account and thereafter reducing the loan account by R30 000 every year as the first R30 000 of a donation was exempt from donations tax. Reducing the loan account by R30 000 every year had no tax consequences but resulted in reducing the founder's ultimate estate duty liability. However, since the introduction of CGT this practice no longer works as paragraph 12(5) of the Eighth Schedule applies. In terms of paragraph 12(5) a capital gain arises in the hands of the debtor when a debt is reduced or discharged by the creditor. Therefore the amount by which the creditor or founder reduces the loan account owing by the trust is deemed to be a capital gain by the trust. Fifty percent of the gain (66,6 percent from the 2013 year of assessment) will be subject to tax in the trust.

Huxham and Haupt (2011) further warn that a person should not waive loans owed to him in his will as this may lead to capital gains tax being paid by the debtor in terms of paragraph 12(5) when the loan is extinguished. As paragraph 12(5) only applies to the situation where the creditor reduces or discharges the loan it may be argued that death results in an involuntary discharge and therefore paragraph 12(5) shouldn't apply. However, in the recent case of ITC 1793 (67 SATC 256, 2005) the court held that paragraph 12(5) applied when a person bequeathed a loan account to a trust in their will. Counsel for the taxpayer argued that the actions of the deceased by

bequeathing the loan to the trust resulted in a set-off and that paragraph 12(5) did not apply. Bertelsman J responded to this contention as follows:

I am of the view that the argument cannot succeed for two reasons:

- (a) The situation through which set-off could occur was created by an act on the part of the testatrix, namely the discharge of the trust, the debtor. The creditor, the testatrix, disposed of an asset by discharging the trust's debt for no consideration. This created the situation where the claim against the trust was extinguished by operation of law, by way of a set-off between the estate and the beneficiary, the trust.
- (b) It is not the occurrence (or 'act') of set-off which renders the result thereof in the hands of the debtor taxable, but the act which amounted to a discharge of the debt; The drawing up of the last will and testament and its coming into operation at the date of death (Huxham & Haupt, 2011: 730).

Interestingly in ITC 1835 (71 SATC 105, 2008) an *inter vivos* trust was the sole heir of the residue of a testatrix's estate. At the time of her death the trust owed her R539 189 which amount fell into the residue of her estate. The executor could have called up the loan but instead he awarded the loan to the trust as part of the residue and in doing so it was extinguished. The court held that it was not the specific intention of the testatrix to bequeath the loan to the trust and therefore paragraph 12(5) did not apply and so no capital gain arose (Huxham & Haupt, 2011).

The deletion of paragraph 12(5) of the Eighth Schedule has been proposed in the draft Taxation Laws Amendment Bill 2012. In the draft Bill the insertion of paragraph 12A is proposed which states, in terms of subparagraph 12A(2), that the amount of a reduced or cancelled debt is to be deducted from the base cost of an asset where that debt was used to fund the expenditure in respect of that asset. Subparagraph 12A(4) provides that where a debt is cancelled or reduced and the amount thereof is not applied to the expenditure of a particular asset then the amount of the debt cancelled or reduced must be deducted from the debtor's aggregate capital loss for the year of assessment in question. In terms of paragraph 12A(5) this paragraph will not

apply to any debt owed by a person that is an heir or legatee of a deceased estate, to the extent that the debt is owed to that deceased estate and is reduced by the deceased estate. A similar provision, relating to income tax, is proposed in the form of the new section 19. The wording of this section is very similar to that in the proposed paragraph 12A and it provides that the amount of a cancelled or reduced debt is to be deducted from the expenditure incurred in relation to an asset or the aggregate deductions claimed where it does not relate to a particular asset. The proposed section 19 also does not apply to any debt owed by a person that is an heir or legatee of a deceased estate, to the extent that the debt is owed to that deceased estate and is reduced by the deceased estate. Although the amendments to the Act deal with debts cancelled or reduced by the executor of the estate under the prescribed circumstances, this does not address debts waived by the deceased in his or her will.

2.5. Conclusion

As can be seen from the discussion above donations tax and CGT both amount to true wealth taxes in the sense that they are aimed at targeting the wealthy. This is shown by the amounts of the annual exclusions of R100 000 in respect of donations tax and the various exclusions in respect of CGT, being for the 2012 tax year: R20 000 on the capital gain made by a natural person, R200 000 on the capital gain made in the year that a natural person dies and R1.5 million on the sale of a primary residence (increased to R30 000, R300 000 and R2 million respectively for the 2013 tax year).

The overlap between donations tax and CGT is problematic in the sense that a donation is considered to be a disposal for CGT purposes. The fact that deceased persons are considered to have disposed of their assets to their estates for CGT purposes is also the source of much controversy. Chapter 4 will contain a thorough discussion about the fact that both estate duty and CGT are payable upon death and chapter 6 will discuss suggestions by commentators on this problem as to how to remedy the *status quo*. The following chapter (chapter 3) will contain a thorough analysis of estate duty

after which a complete picture will have been formed of the current system of wealth tax in South Africa.

CHAPTER 3

ESTATE DUTY

3.1. Introduction

Frith (2010) explains that estate duty is a tax on accumulated wealth and defines it as a 'levelling the playing fields tax'. He refers to the recent statement by Bill Gates that the state provides the opportunity for education and then employment through the various facets of the economy. In addition the state provides the opportunity to accumulate wealth; salaries and income are taxed and so should be accumulated wealth where nothing is given to charity. Frith concludes that, in essence, this is the only redistribution tax in our country.

This chapter will involve a thorough analysis of estate duty as provided for in the Estate Duty Act. The development of wealth taxes in South Africa was discussed in chapter 2 with a focus on donations tax and CGT. This chapter will focus on the provisions of the Estate Duty Act, particularly how estate duty is calculated. This chapter will provide for the establishment of a complete background regarding the wealth tax system currently in force in South Africa. Following this chapter it will be possible to establish what the problems associated with estate duty currently are in light of its interaction with donations tax and CGT. Before a discussion regarding the calculation of estate duty can begin it is first necessary to outline, in general terms, the basic steps in the administration of a deceased estate.

3.2. Administration of an estate

Based on the researcher's personal experience in deceased estates administration and a thorough reading of Meyerowitz (2010) on the Administration of Estates, the administration process may be summarised as set out hereunder. The administration of a deceased estate is regulated by the Administration of Estates Act 45 of 1970. Upon the death of a person his

or her estate must be reported to the Master of the High Court within the jurisdiction where the deceased was domiciled at the time of death. Should the deceased have died intestate the Master will invite the family members to nominate an executor to take control of and responsibility for the administration of the deceased estate (this person will be known as an “executor dative”). Should the deceased have died testate he or she will have appointed an executor in his or her will (this person will be known as an “executor testamentary”). After appointment the executor will be issued with Letters of Executorship and will immediately commence with the administration of the estate by advertising for creditors and establishing what assets belonged to the deceased at the time of death. The executor will open an estate late bank account and transfer all cash belonging to the deceased into such account. All creditors of the deceased will later be paid out of this account. Once the executor has established what assets belonged to the deceased at the time of death he or she will need to obtain valuations for these assets as at the date of death. Once the executor is aware of the value of all assets and liabilities he or she will proceed to draft the liquidation and distribution account which will be lodged with the Master. This account will set out all of the assets and liabilities of the deceased estate as well as how the assets will be distributed. An estate duty account forms part of this liquidation and distribution account in which the estate’s liability for estate duty will be set out. Upon approval of the account by the Master the executor advertises it and invites interested parties to inspect it and lodge objections within a specific period. Once the period for objections has passed the executor will pay creditors and distribute the assets to the legatees and heirs of the deceased. Once all amounts have been paid and any immovable property transferred, the executor will apply to the Master for release from his or her duty as executor and the estate will be considered to be wound-up.

Should estate duty be abolished, estates will still have to be administered by the Master. It is only the duty to assess the estate duty that the Revenue Services will be relieved of. This suggests that the assertion that estates are cumbersome for the Revenue Services to administer is unfounded.

3.3. Calculation of the estate duty liability

The basic steps to follow when calculating a deceased person's estate duty liability (in terms of the Estate Duty Act) are, firstly, to establish residency, secondly to determine the total value of all property belonging to the deceased at the time of death, thirdly to make the allowable deductions (whereupon the net value of the estate is arrived at), fourthly to deduct the primary abatement, fifthly to calculate the estate duty payable and finally to deduct any relevant rebates and tax credits from the amount of the duty.

The estate duty schedule is set out at the end of the Liquidation and Distribution Account. According to Meyerowitz (2010) it should be worded along the lines of the following example:

	R
Total assets as per liquidation account.....	000
Less liabilities (Section 4 deductions).....	000
Net value of estate.....	<u>000</u>
Less rebate.....	000
Dutiable amount of estate.....	<u>000</u>
Estate Duty.....	<u>000</u>

The steps involved in arriving at the final figure, namely the estate duty payable, will be discussed in detail below.

3.3.1. Residence

When calculating estate duty it is first necessary to establish whether the deceased was ordinarily resident in South Africa at the time of death. The Estate Duty Act does not define the term "ordinarily resident" and case law relating to the term in the context of the Income Tax Act would provide guidance. The term "ordinarily resident" refers to a level of permanence and continuity. The case of *Cohen v CIR* 1946 AD 174 is authority for the contention that a person is ordinarily resident in the country of his or her most fixed or settled residence (Stein, 2011). If the deceased was ordinarily

resident in South Africa then all of his or her assets, wherever they may be situated, will form part of the total value of his or her estate. If he or she was not ordinarily resident in South Africa at the date of death then the following categories of property will be excluded from the estate in terms of section 3(2) of the Act:

- S3(2)(c): any right in immovable property situated outside the Republic;
- S3(2)(d): any right in moveable property situated outside the Republic;
- S3(2)(e): any debt not recoverable or right of action not enforceable in the Courts of the Republic;
- S3(2)(f): any goodwill, licence, patent, design, trademark, copyright or other similar right not registered or enforceable in the Republic or attaching to any trade, business or profession in the Republic;
- S3(2)(g)(i): any stocks or shares held in a body corporate which is not a company; and
 - (ii): any stocks or shares held in a company, provided any transfer whereby any change of ownership in such stocks or shares is recorded is not required to be registered in the Republic;
- S3(2)(h): any rights to any income produced by or proceeds derived from any property referred to in paragraph (e), (f) or (g);
- S3(2)(i): so much of any benefit which is due and payable by, or in consequence of membership or past membership of, any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund as defined in the Income Tax Act, on or as a result of the death of the deceased.

All other property will be included in the estate of a person who was not ordinarily resident in South Africa at the time of death. Typically, such property would include moveable and immovable property situated in South Africa. As the deceased's estate will have been reported in the country where he or she was ordinarily resident at the time of his or her death there is potential for estate duty, or a similar form of tax, to be charged on the same property in both countries. A similar situation will arise where a person who was ordinarily resident in South Africa at the time of his or her death owned property situated

outside South Africa. Sections 16 and 26 of the Act deal with the prevention of, or relief from, double taxation in such cases. Currently South Africa is party to double taxation agreements providing relief from death duties with Lesotho, Sweden, the United Kingdom, the United States of America and Zimbabwe.

Essentially the aim of these agreements is to determine which country has the primary taxing rights where the person is a resident of one country and the assets are situated in the other country. Various forms of relief may be obtained by virtue of Double Taxation Agreements. An agreement may stipulate that certain property is to be excluded from the total value of the estate or that a rebate should be deducted from the estate duty payable or a credit granted. Stein (2011) suggests that persons who live in South Africa but own assets in a foreign country should consider the impact of double taxation and if a double taxation agreement exists between South Africa and the relevant foreign country they should consult the agreement and establish whether any relief will exist upon death.

3.3.2. Property

Section 3(1) of the Act declares that the estate of any person shall consist of all property of that person as at the date of his or her death and of all property which in accordance with the Act is deemed to be property of that person at that date. Section 3(2) states that “property” means any right in or to property, moveable or immoveable, corporeal or incorporeal and includes –

- (a) any fiduciary, usufructuary or other like interest in property (including a right to an annuity charged upon property) held by the deceased immediately prior to his death;
- (b) any right to an annuity (other than a right to an annuity charged upon any property) enjoyed by the deceased immediately prior to his death which accrued to some other person on the death of the deceased.

Fiduciary and usufructuary interests are relevant as they are often used in estate planning schemes (as will be discussed in chapter 5). The fiduciary

interest mentioned in paragraph (a) of section 3(2) as property that constitutes property in the estate refers to an interest by which property is vested in a person, known as the fiduciary, subject to the condition that on the fiduciary's death the property will vest in another person, known as the fideicommissary. A fiduciary cannot dispose of the property but is generally entitled to the fruits thereof, for example, in the form of rental. Should the fideicommissary predecease the fiduciary then the property will vest unconditionally in the fiduciary and he or she may then dispose of it. Fideicommissa are generally created in wills and cater for the situation where the testator or testatrix wants to ensure that a property stays in the family so he or she bequeaths it to his or her son or daughter as fiduciary heir subject to the child of that son or daughter being the fideicommissary.

It should be noted that a fiduciary interest never forms part of the joint estate where parties are married in community of property and one party holds such an interest.

The usufructuary interest mentioned in paragraph (a) of section 3(2) refers to the situation where a property is bequeathed or transferred to a person, known as the bare dominium holder, subject to a usufruct or right of use in favour of another person, known as the usufructuary. The usufructuary may use the property and the fruits thereof but may not dispose of it. A usufruct is usually created where a landowner wants to bequeath property to one of his or her children subject to his or her spouse's right of use for the duration of the said spouse's lifetime. While fideicommissa and usufructs are similar, the main difference between them is that the fiduciary becomes the owner of the property subject to the fideicommissum while the usufructuary never becomes the owner. Ownership at all times vests in the bare dominium holder. As with a fiduciary interest, a usufructuary interest never forms part of the joint estate where parties are married in community of property.

Stein (2011: 21) states that the distinction between a fiduciary interest on the one hand and a usufructuary interest on the other is crucial for one important reason, namely "in certain circumstances a usufructuary or other like interest

ceasing on the death of a surviving spouse is exempt from estate duty, while a fiduciary interest ceasing on the death of a surviving spouse is not.” This point will be discussed in more detail in chapter 5.

The other like interests mentioned in paragraph (a) of section 3(2) refer to interests that are similar to usufructuary interests but that lack one of their essential qualities (Stein, 2011). Meyerowitz (2010) explains that in this regard, “property” will also include a right to income under a trust which ceases upon the death of the deceased. However, where the deceased was a beneficiary of a trust but had no vested right therein then he or she does not hold a limited interest which would form part of the dutiable estate on his or her death. The issues surrounding trusts will be discussed in more detail at a later stage.

Other like interests would also include grazing rights and rights of *habitatio* and *usus*. Stein (2011) explains that essentially for a “like interest” to constitute property it must vest in the holder of the right and must not merely be contingent.

3.3.2.1. Deemed property

Section 3(3) deals with deemed property. Huxham and Haupt (2011) state that deemed property is property which did not exist at the time of the death of the deceased or which did not belong to the deceased. Deemed property consists of:

- S3(3)(a): ‘domestic policies’ of insurance on the life of the deceased;
- S3(3)(b): property donated by the deceased in terms of a donation which was exempt from donations tax under section 56(1)(c) or (d) of the Income Tax Act (such as a *donatio mortis causa*);
- S3(3)(cA): accruals under the Matrimonial Property Act; and
- S3(3)(d): property which the deceased was competent to dispose of for his or her own benefit or for the benefit of his or her estate.

With regard to the insurance policies referred to in section 3(3)(a), subject to certain exclusions, the proceeds of domestic policies on the life of the deceased are included in his or her estate as deemed property.

The accrual claims referred to in section 3(3)(cA) refer to those claims where the deceased spouse's estate was smaller than the survivor's at the date of death. The survivor therefore must pay a certain amount to the deceased estate, which amount is deemed property. In terms of section 3(1) of the Matrimonial Property Act where parties are married out of community of property subject to the accrual system the party whose estate has shown the smaller accrual has a claim against the other party upon the dissolution of the marriage. Death of one of the parties results in dissolution and therefore the claim arises.

Section 3(5) states that for purposes of paragraph (d) of subsection (3) –

- (a) the term “property” shall be deemed to include the profits of any property;
- (b) a person shall be deemed to have been competent to dispose of any property –
 - (i) if he had such power as would have enabled him, if he were *sui juris*, to appropriate or dispose of such property as he saw fit whether exercisable by will, power of appointment or in any other manner;
 - (ii) if under any deed of donation, settlement, trust or other disposition made by him he retained the power to revoke or vary the provisions thereof relating to such property;
- (c) the power to appropriate, dispose, revoke or vary contemplated in paragraph (b) shall be deemed to exist if the deceased could have obtained such power directly or indirectly by the exercise, either with or without notice, of power exercisable by him or with his consent;
- (d) the expression “property of which the deceased was immediately prior to his death competent to dispose” shall not include the share of a spouse of a deceased in any property

held in community of property between the deceased and such spouse immediately prior to his death.

Where the deceased was married in community of property his or her half share of the joint estate must be ascertained and included in the estate for estate duty purposes. In addition, any property that did not form part of the joint estate must be taken into account. An example of such property would be items inherited by the deceased in terms of a will in which it was stated that the inheritance was to be free from any community. Stein (2011) cautions that the domicile of the husband at the time that the marriage was entered into must be taken into account. If he was domiciled in South Africa and no ante-nuptial contract was entered into then the marriage will automatically be in community of property. If he was domiciled in a foreign country, then whatever the automatic regime is in that country, it will apply.

According to Stein (2011), it should be noted that rights that cease upon the death of the deceased do not form part of the estate unless they constitute fiduciary, usufructuary or similar interests. In order for property to constitute property of the deceased for estate duty purposes it must actually have belonged to or vested in the deceased at the time of his death. Meyerowitz (2010) explains that if the deceased had no proprietary right in the property at the time of his or her death but subsequent to his or her death it became his or her property it will not be included. An example would be rental paid after the date of death in respect of property owned by the deceased.

3.3.2.2. Donations

Where a donation was made by the deceased prior to his or her death and such donation was exempt from donations tax the property donated is deemed to be property in the estate in terms of section 3(3)(b). Any growth on the value of the donated property will also be subject to CGT. Reference is made to donations which are exempt from donations tax under section 56(1)(c) or (d) of the Income Tax Act. Subsection (c) refers to *donatio mortis*

causa while subsection (d) refers to donations under which the benefit only passes to the donee upon the death of the donor.

3.3.2.3. Valuation of property

Section 5 of the Estate Duty Act sets out the methods by which property must be valued. In terms of section 5(1)(a) where property is sold by way of a *bona fide* purchase and sale in the course of the liquidation of the estate the price realised by such sale will be the value thereof. This may differ from the value on which CGT was determined. Section 5(1)(b) sets out complicated steps that must be followed when calculating the value of limited interests such as fiduciary and usufructuary interests while section 5(1)(f) deals with the value of the bare dominium of property subject to such limited interests. As mentioned in chapter 2, fiduciary and usufructuary interests are valued with reference to the life expectancy of the beneficiary thereof. This differs from the donations tax approach which is based on the life expectancy of the donor. Sections 5(1)(c) and (d) deal with the valuation of annuities. Where property is not sold it must be valued at fair market value as at the date of death in terms of section 5(1)(g).

3.3.3. Deductions

Once the total value of the estate has been established there are a number of deductions that can be made in terms of section 4 of the Act in order to arrive at the net value of the estate. These deductions are as follows:

- (a) Funeral, tombstone and death-bed expenses: Such expenses include payments to medical practitioners, nursing homes and pharmacies as well as the cost of burial or cremation.
- (b) Debts due within the Republic: Such debts must be due to persons ordinarily resident within the Republic. This does not include any debt which constitutes a claim by such a person to property donated by the deceased in terms of a donation which was exempt from donations tax under section 56(1)(c) or (d) of the Income Tax Act. The tax liability of

the deceased for the period up to the date of death also falls within the ambit of this provision.

- (c) Administration charges: These are the general costs of the winding up of the estate, other than expenses incurred in the management and control of any income accruing to the estate after the date of death. An example of such administration charges would be the Master's fees.
- (d) Expenditure necessary to comply with the Act: This includes all expenditure incurred in carrying out the requirements of the Master or the Commissioner in pursuance of the provisions of the Estate Duty Act.
- (e) Certain foreign assets held by the deceased: The property must be situated outside the Republic as at the date of death and:
 - (i) must have been acquired by the deceased before he or she became ordinarily resident in the Republic for the first time; or
 - (ii) if he or she acquired it after he or she became ordinarily resident in the Republic for the first time,
 - (aa) he or she must have acquired it by donation from a non-resident (not a company), or
 - (bb) he or she must have inherited it from a non-resident; or
 - (iii) he or she must have acquired it out of the proceeds from the disposal of the property mentioned above or out of any income from such property (Huxham & Haupt, 2011).
- (f) Debts due outside the Republic: This includes debts due by the deceased to persons ordinarily resident outside the Republic which have been discharged from property included in the estate to the extent that the amount of such debts is proved to the satisfaction of the Commissioner to exceed the value of the assets of the deceased outside the Republic and not included in the value of the estate. Huxham and Haupt (2011) explain that such debts of the deceased must first be paid from foreign assets which are not property and then only the excess is deducted under this paragraph.
- (g) Any fiduciary, usufructuary or other like interest in property (including a right to an annuity charged upon property):

- (i) Fiduciary or usufructuary interests: If the deceased held such interest by virtue of a donation made to him or her, and, on his or her death, the right reverts to the original donor, then the value of the limited interest (usufruct, fideicommissum or annuity) is deducted from the value of the estate.
 - (ii) Annuity charged against property: Where the deceased held such an interest by virtue of a donation and the right reverts to the donor the amount is allowed as a deduction (Huxham & Haupt, 2011).
- (h) Charitable and other bequests: This includes amounts accruing to any Public Benefit Organisation which is exempt from tax in terms of section 10(1)(cN) or (cA)(i) of the Income Tax Act, the State or any Municipality.
- (i) Improvements made to property: This includes the amount by which the value of any property included in the estate has been enhanced by any improvement made to the property concerned at the expense of the person to whom such property accrues on the death of the deceased and during the lifetime of the deceased and with his or her consent.
- (j) Improvements made to property subject to a right of use: The amount by which the value of any fiduciary, usufructuary or other like interest which ceased upon the death of the deceased has been enhanced by any improvements made to the property concerned –
 - (i) at the expense of the person to whom the benefit arising by reason of the cessation of such interest upon the death of the deceased, accrues; and
 - (ii) during the lifetime of the deceased and with his or her consent.
- (IA) Claim by surviving spouse in respect of an accrual under the Matrimonial Property Act: This refers to claims in terms of section 3 of the Matrimonial Property Act by the surviving spouse of the deceased.
- (m) Usufructuary or like interest, or a right to an annuity charged upon property in terms of section 3(2)(1) created by a predeceased spouse of the deceased: A deduction will be allowed where the property over which the deceased enjoyed such a right formed part of the predeceased spouse's estate and no deduction in respect of the value

of such interest was allowable in the determination of the net value of the estate of the predeceased spouse under the provisions of paragraph (q).

- (o) Books, pictures, statuary or other objects of art: The value of such items may be deducted if the items have been lent under a notarial deed to the State or any local authority within the Republic or to any institution referred to in subparagraph (ii) of paragraph (h) for a period of not less than thirty years and the deceased died during such period.
- (p) Value of deemed property taken into account in valuation of shares: This includes so much of the value of any property deemed to be property of the deceased by virtue of the provisions of section 3(3) as has not been deducted under any of the other provisions of this section and as the Commissioner is satisfied has been taken into account under the provisions of section 5(1)(f)*bis* in the determination of the value of any company shares or a member's interest in a close corporation included as property in the estate.
- (q) Property left to surviving spouse: This includes so much of the value of any property included in the estate which has not been allowed as a deduction under any other provision of section 4, as accrues to the surviving spouse of the deceased: Provided that-
 - (i) the deduction allowable under the provisions of this paragraph shall be reduced by so much of any amount as the surviving spouse is required in terms of the will of the deceased to dispose of to any other person or trust;
 - (ii) no deduction shall be allowed under the provisions of this paragraph in respect of any property which accrues to a trust established by the deceased for the benefit of the surviving spouse, if the trustee of such trust has a discretion to allocate such property or any income therefrom to any person other than the surviving spouse.

Once the deductions set out above have been deducted from the gross value of the estate the net value of the estate will have been arrived at. From the net value of the estate the primary abatement may be deducted (discussed below).

3.3.4. Primary abatement

A primary abatement of R3,5 million is currently deductible from the net value of the estate in terms of section 4A of the Act. With effect from 1 January 2010 so much of the rebate amount that has not been used as a section 4A rebate is rolled over to the estate of the surviving spouse. The effect of this is that the surviving spouse may have a rebate of up to R7 000 000 in certain circumstances.

Section 4A of the Estate Duty Act reads as follows:

- (1) Subject to subsections (2) and (3), the dutiable amount of the estate of any person shall be determined by deducting from the net-value of that estate, as determined in accordance with section 4, an amount of R3,5 million.
- (2) Where a person was the spouse at the time of death of one or more previously deceased persons, the dutiable amount of the estate of that person shall be determined by deducting from the net value of that estate, as determined in accordance with section 4, an amount equal to the amount specified in subsection (1) –
 - (a) multiplied by two; and
 - (b) reduced by the amount deducted from the net value of the estate of any one of the previously deceased persons in accordance with this section.
- (3) Where a person was one of the spouses at the time of death of a previously deceased person, the dutiable amount of the estate of that person shall be determined by deducting from the net value of that estate, as determined in accordance with section 4, an amount equal to the sum of –
 - (a) the amount specified in subsection (1); and
 - (b) the amount specified in subsection (1) divided by the number of spouses, reduced by an amount which is determined by dividing the amount deducted, in accordance with this section, from the net value of the estate of the previously deceased person by the number of spouses of that previously deceased person.
- (4) The amount contemplated in subsection (2)(b) or (3)(b) shall not exceed the amount specified in subsection (1).

- (5) Subsections (2) and (3) shall not apply unless the executor of the estate of that person submits, at the time and in the manner and form prescribed by the Commissioner, to the Commissioner a copy of a return submitted to the Commissioner in terms of section 7 in respect of the estate of the previously deceased person.
- (6) Where a person and his or her spouse die simultaneously, the person of whom the net value of the estate, determined in accordance with section 4, is the smaller must be deemed for the purposes of this section to have died immediately prior to his or her spouse.

Surtees (2009) explains that if a deceased had more than one surviving spouse, the rebate would be apportioned amongst the surviving spouses. Bornman (2010) submits that there are differing opinions as to how to interpret the legislation if a deceased spouse has been a surviving spouse more than once. The uncertainty revolves around which unused abatement the executor will be entitled to use when determining the estate duty liability of the deceased. However, it can be assumed that the words “any of the previously deceased persons” means that any unused rebate of the previously deceased spouses can be used for the abatement for the last dying spouse. The executor would therefore select the largest available unused rebate.

The rebate may only be claimed if the executor submits the estate duty return of the first dying spouse in terms of section 4A(5) of the Estate Duty Act. Huxham and Haupt (2011) submit that this is the main problem with claiming this larger abatement as a copy of the return may be unobtainable at the time of the death of the later-dying spouse.

Bornman (2010) explains that according to section 4A(6) of the Estate Duty Act, where a person and his or her spouse die simultaneously, the person of whom the net value of the estate, determined in accordance with section 4, is the smallest must be deemed for the purposes of this section to have died immediately prior to his or her spouse.

Huxham and Haupt (2011) suggest that as the total section 4A abatement can never exceed R7 million there is still scope to use a trust to increase the overall estate duty saving where a person has more than one spouse.

3.3.5. Rate of estate duty

Once the abatement discussed above has been deducted from the net value of the estate the figure that remains is the dutiable amount of the estate.

The First Schedule to the Act sets out the rate at which estate duty is to be calculated on the dutiable amount of the estate. Currently it is at 20 percent which percentage was decreased from 25 percent by section 4 of Act 5 of 2001 in respect of the estate of any person who dies on or after 1 October 2001.

The First Schedule further sets out the application of the “quick succession rebate”. This rebate is applied where estate duty was levied on property that fell into the estate of the first-dying person who died no more than ten years prior to the second-dying person. Where the same property, upon which estate duty was levied, falls into the estate of the second-dying person and estate duty is levied thereon again, the value of such property may be reduced by a percentage according to the following scale:

If the deceased dies within two years of the death of the first-dying person.....	100%
If the deceased dies more than two years, but not more than four years after the death of the first-dying person.....	80%
If the deceased dies more than four years, but not more than six years after the death of the first-dying person.....	60%
If the deceased dies more than six years, but not more than eight years after the death of the first-dying person.....	40%
If the deceased dies more than eight years, but not more than ten years after the death of the first-dying person.....	20%

This rebate is subject to a maximum reduction equal to so much of the duty previously payable upon the death of the first-dying person as is attributable to the value of that moveable or immoveable property or, as the case may be, to an amount equal to the value determined by reference to the value of that moveable or immoveable property, and as is proved to the satisfaction of the Commissioner to have been borne by the deceased. The reasoning behind this rebate is that it would be unfair for estate duty to be paid on particular property, whether moveable or immoveable, only for it to be paid again on the same property within a few years of the death of the first-dying person.

3.3.6. Rebates and credits

Once the amount of estate duty payable has been established in accordance with the provisions of the First Schedule certain rebates and credits may be deducted from or applied to the amount of estate duty payable.

3.3.6.1. Foreign death duties

In terms of section 16(c) where the deceased was ordinarily resident in South Africa at the time of death and his or her executor had to pay death duties in a foreign country in respect of property situated there and owned by the deceased at the time of death, a rebate will be allowed for the amount of death duties paid. However, the amount of the rebate may not exceed the estate duty imposed on the particular property in South Africa. Stein (2011) states that the deduction is therefore limited to the lesser of the foreign death duties paid on the property and the South African estate duty attributable to the property. It should be noted that relief in terms of this rebate will not be available where relief has already been provided in terms of a double taxation agreement.

3.3.6.2. Double taxation agreement credits

Stein (2011) explains that double taxation agreements providing relief from death duties currently exist between South Africa and the United Kingdom,

the United States of America, Sweden, Lesotho and Zimbabwe. These agreements do not set out the method by which the duty attributable to the property concerned should be calculated and therefore the Commissioner has developed a particular formula. Essentially the credit available will be the lesser amount of the South African estate duty liability and the foreign death duties attributable to the property concerned.

3.3.6.3. Transfer duty

In terms of section 16(a) a rebate is available for transfer duty paid in respect of the acquisition from the deceased or his or her estate of any property included in the estate by a person who is liable for the estate duty attributable to the property.

Stein (2011) submits that this rebate is unlikely to be available under the current law as it was more appropriate under an earlier version of the law when property donated by a deceased was deemed to be property in his or her estate upon his or her death. A deduction of transfer duty paid was then allowed when transfer duty was paid by a donee on the donation of immovable property by the deceased. The property was acquired from the deceased and was included in his or her estate as a donation made by him or her, while the donee would pay the transfer duty and would be liable for estate duty attributable to the donation. Now that donations made by the deceased during his lifetime are no longer deemed property this situation cannot arise. Stein (2011) further cautions that the deduction will not be available where a person has bought immovable property from a deceased prior to his or her death and the transfer of the property had not been passed as of the date of death. The reasoning behind this is that while the buyer would pay the transfer duty and the property would constitute property in the estate, the transfer duty would not have been paid by the person liable for estate duty attributable to the property as transfer would not have been effected as at the date of death.

3.3.7. Assessment of and liability for estate duty

The executor of a deceased estate will arrive at the dutiable amount after calculating the net value of the estate and deducting the primary abatement therefrom. He or she may calculate the estate duty liability on that amount in anticipation of the assessment received from SARS. The executor therefore must submit a return to SARS disclosing the amount claimed to represent the dutiable amount of the estate together with full particulars regarding –

- (a) the property of the deceased as at the date of his death;
 - (b) property which, in terms of section 3(3) of the Act is deemed to be property of the deceased as at that date;
 - (c) any deduction claimed in terms of section 4 of the Act.
- (Meyerowitz, 2010: 30-4).

If the Commissioner is not satisfied with the information contained in the return or if he has further questions he will request a copy of the liquidation and distribution account.

In terms of section 12 of the Act, as a general rule the estate is liable for estate duty and therefore the duty is payable by the executor of the estate, namely the holder of Letters of Executorship issued in that person's favour by the Master of the High Court. Stein (2011) sets out several instances in which a person other than the executor is liable for estate duty, namely a donee under a death-bed donation, the person entitled to recover the amount due under a dutiable insurance policy, the person to whom benefits accrue from a fund on the death of the deceased and the person benefiting from the cessation of a limited interest enjoyed by the deceased.

3.4. Conclusion

The discussion of estate duty in this chapter completes the discussion of how the present system of taxation on death came about and what the applicable taxes are.

It is clear from the discussion in this chapter that the administration of an estate, and the calculation of the estate duty liability in particular, is a complicated matter. Establishing what property was owned by the deceased at the time of death may be difficult where the deceased has not kept careful records of all of his or her investments as well as documentary evidence of any limited interests. The provisions of the Act dealing with deemed property need to be carefully scrutinised by the executor so that it can be established whether their application is necessary. The executor must also take care to ensure that all of the available deductions are claimed and that any available rebates or credits are claimed.

The discussion in this chapter has resulted in clarity regarding the need for estate planning to be engaged in so as to lessen the burden placed on the executor when he or she is attempting to meet the requirements of the Administration of Estates Act 45 of 1970 and the Estate Duty Act. The reasons why estate planning measures are used, other than for the reason set out above, and what these measures are will be discussed in detail in chapter 5. In the following chapter (chapter 4) the problems associated with estate duty as a wealth tax in South Africa will be identified and discussed.

CHAPTER 4

THE PROBLEMS ASSOCIATED WITH ESTATE DUTY

4.1. Introduction

Having discussed the history of wealth taxes in South Africa in chapter 2 and briefly outlined the application of donations tax and CGT and having analysed the Estate Duty Act in chapter 3, it is now possible to consider the problems that are associated with estate duty as a wealth tax in South Africa.

As mentioned in chapter 2, as far back as 1986 the Margo Commission was informed by Government that estate duty was “terminally ill”. The Commission investigated the efficacy of estate duty and recommended that both estate duty and donations tax be replaced with a capital transfer tax, which recommendation was accepted by Government (Muller, 2010). According to Muller (2010) in the 1993 Budget Review the view of the Margo Commission was endorsed as it was reported that the Taxation Advisory Committee had recommended that the possibility of combining estate duty and donations tax should be investigated with the aim of providing for a more effective wealth transfer tax system. Despite this recommendation and the Margo Commission’s report, which was endorsed by the Katz Commission (1995), nothing has materialised to date.

Interestingly the criticisms levelled at estate duty as a wealth tax at the time that the Margo and Katz Commissions were heard did not address the most pertinent issue being double taxation. This was because CGT had not been introduced at that stage. It is submitted that the flaws in the wealth transfer system were significant as far back as 1986 and are even more significant now. It seems that the Treasury is now taking the call for the abolishment of estate duty seriously judging by the statements made in recent tax proposals. As mentioned in chapter 1, in the South African Revenue Services Budget 2010/2011 Tax Proposals (SARS, 2010) it was stated that there were several issues which were going to be researched for possible attention in tax

proposals for 2011 and 2012. With regard to estate duty the following was said:

Both estate duty and capital gains tax are payable upon death, which is perceived as giving rise to double taxation. The estate duty raises limited revenue and is cumbersome to administer. Moreover, its efficacy is questionable: many wealthy individuals escape estate duty liability through trusts and other means. Taxes upon death will be reviewed (SARS, 2010: 25).

In the South African Revenue Services Budget 2011/2012 Tax Proposals (SARS, 2011) it was stated that a tax policy research project was underway in terms of which the effectiveness of estate duty was being reviewed, with several options under consideration. However, in the South African Revenue Services Budget 2012/2013 Tax Proposals (SARS, 2012) estate duty was not mentioned at all so it is assumed that research is still ongoing and that the way forward has not yet been established.

The problems with estate duty as identified by SARS may be summarised as follows:

1. the issue of double taxation;
2. the fact that it raises limited revenue and is difficult to administer; and
3. that its efficacy is questionable due to the fact that many wealthy individuals escape estate duty liability through trusts and other means (this will be referred to as the “estate planning” problem).

It is unclear whether SARS based its identification of these problems on the international view of death duties. With regard to the international view, SAICA (2011) states as follows:

As debated and recorded at the International Fiscal Association congress held in Rome in 2010 on death as a taxable event with 43 countries participating, arguments favouring the repeal of death taxes were based on the following considerations:

- limited revenue;
- the cost of administration;

- the cost of collection;
- the difficulty in dealing with avoidance schemes;
- recourse to artificiality and costly ownership structures to avoid; and
- the undesirable effects of double taxation since the estate was accumulated from income that was subject to tax or comprised of assets which were subject to wealth taxes during the deceased's lifetime.

These problems overlap with those identified by SARS in that limited revenue, the cost of administration and the cost of collection all fall under SARS' second problem, being limited revenue and cumbersome administration. The difficulty in dealing with avoidance schemes and recourse to artificiality may be said to fall under SARS' third problem, being estate planning. The undesirable effects of double taxation match SARS' first problem. A problem that has not been specifically mentioned by SARS but which may have spurred on the need for change is that, according to SAICA (2011), it has been noted internationally that South Africa is the only country that levies CGT and estate duty on death and that this is not a positive signal for attracting investment into South Africa. As this problem is linked to double taxation it may be said to form part of the first problem identified by SARS.

Before the abolishment or overhauling of the current system of estate duty as a wealth tax in South Africa, which will be discussed in chapter 6, can be considered it is first necessary to discuss in some detail the three problems associated with estate duty as identified by SARS. A fourth problem, not identified specifically by SARS but alluded to by the various Commissions and elaborated on by Muller (2010) is that there is a lack of uniformity between the various wealth taxes in South Africa. After a general discussion of the problems associated with estate duty the most important problem for the purposes of this thesis, namely estate planning, will be discussed in detail in chapter 5.

4.2. Double taxation

The first problem raised by the Treasury, being the issue of double taxation, is widely regarded as being the most significant flaw in the current system of taxation upon death. SAICA (2011) states that there has never been a conscious decision by government, or the past commissions, to have two taxes applying on death. As set out in chapter 2, for CGT purposes the occurrence of death is deemed to be a disposal of the deceased's assets at market value (par. 11 of Schedule Eight to the Income Tax Act). This means that upon death estate duty is payable on the dutiable value of the deceased's estate, which includes all the deceased's assets, and CGT is payable on any capital gain made on the same assets of the deceased. Müller (2011: 42) points out that this issue was alluded to at the introduction of CGT in 2001 where the then Minister of Finance stated as follows:

A key strength of the proposed capital gains tax is that it is levied when the owner of an asset dies or the asset is donated. To counter any perceived double taxation of these assets, it is proposed to reduce the estate duty and donations tax rates to 20 per cent.

While the rate of estate duty was reduced to 20 percent soon after the introduction of CGT in 2001, it is submitted that the fact that there is still a double taxation on death is problematic, the reduction to 20 percent aside. It may be argued, as it was at the International Fiscal Association congress mentioned above, that there is another form of double taxation quite aside from the CGT issue in that people will have paid tax during their lifetime on income which they have used to accumulate assets, only for a tax to be levied on the same assets upon their death in the form of estate duty.

Ger (2012) explains that estate duty gives rise to double taxation in the following three ways.

1. Assets owned by a deceased person in an offshore jurisdiction could be subject to both estate duty locally as well as whatever death duty is imposed in that foreign country. Estate duty is generally not covered by the treaties South Africa has concluded with several countries that

prevent double taxation because these agreements usually restrict themselves to income taxes. At present there are only four specific agreements that South Africa has entered into with other countries.

2. The assets that form part of the dutiable estate comprise income or assets that were already subject to income tax during the lifetime of the deceased.
3. Estate duty overlaps in many ways with CGT. In terms of current legislation, both estate duty and CGT are levied on death. Since 1 October 2001 the assets an individual owns on death (with some exceptions such as life insurance policies) are deemed to have been disposed of at their market value and CGT may be imposed on the 'gain' that is made on this deemed disposal. Although CGT is imposed on the appreciation in value of the assets, whereas estate duty taxes the transfer of wealth, and although the CGT liability as a debt owing by the deceased would decrease the dutiable amount of the estate, there is still arguably double taxation on some portion of the same assets. Of significance is the fact that South Africa is the only country in the world that levies both estate duty and CGT on death.

Donations tax must also be taken into account as the making of a donation is a disposal and an event which triggers CGT in addition to donations tax which also leads to a double tax.

4.3. Limited revenue and cumbersome administration

The second problem raised by SARS is the fact that estate duty brings in limited revenue and is difficult to administer. Estate duty, as compared to other taxes, does not contribute significantly to the fiscus. The 2012 Tax Statistics (The National Treasury & SARS, 2012) show that in the 2007/2008 tax year R691 million was collected, in the 2008/2009 tax year R757 million was collected, in the 2009/2010 tax year R759 million was collected, in the 2010/2011 tax year R782 million was collected and in the 2011/2012 tax year R1045 million was collected.

While these amounts represent a seemingly large amount of money, when considered in light of the total amount of tax revenue, the percentage of estate duty for the period 2007 to 2010 only represented 0.12 percent (Müller, 2011). It should be noted that the increase in the amount collected from the 2010/2011 tax year to the 2011/2012 tax year is significant. The reasons for this sharp increase are presently unknown.

The point raised by SARS that the administration of estate duty is cumbersome is of interest particularly in light of the comments made by the Katz Commission in their Fourth Report (1997: 12). In this report the Commission dealt with the question of introducing an inheritance tax to be paid by an heir instead of estate duty which is paid from the deceased estate. With regard to the question of the administration of such a tax the Commission said the following:

In evaluating the relative merits of the inheritance tax and the estate duty, the following further factors arise:

- (a) the capacity of the tax administration to collect each of these taxes; and the fact the estate duty has been in place over many years, is well documented in the existing reference sources and has been the subject matter of numerous judicial decisions, and that administrative systems in the Master's office and the office of the Commissioner for Inland Revenue are geared to an estate duty;
- (b) the retention of the existing estate duty system would result in a minimum of deflection of resources. The collection systems are well-established, there is a body of decided case law which means that we are relatively rich in precedent, which results in greater certainty and hence a greater ability to plan one's affairs; and
- (c) resources available to the South African Revenue Service can be used more effectively elsewhere.

In what sense the administration of estate duty is financially cumbersome is not known as information regarding the cost thereof has not been released by the Treasury. Perhaps SARS deem it to be cumbersome purely because the

revenue that it produces is so minimal. While SARS may not be releasing information regarding the cost of administering estate duty, van Vuren (2010), is of the opinion that estate duty, as a source of revenue for the fiscus, has become completely obsolete. He further states that, at the moment, estate duty is doing more harm than good to the country. His reasoning for this contention, which links up with third problem set out below, is as follows:

Because (at least some) structures were set up purely to avoid estate duty, this has added a level of complexity to estate planning, the relevant legislation as well as the administration of deceased estates that a developing country can well do without. The Estate Duty Act is quite a complex piece of legislation. The entire process ties up very creative minds that could have been applied to create real new wealth. The real cost to the economy of compliance with this complex legislation is anybody's guess (Van Vuren, 2010).

SAICA (2011) states that an apparent argument for the retention of estate duty is that it is well established, understood and to date, has not given rise to any major issues. They are of the opinion that this can never be an argument for retaining a tax. They further state that should estate duty be abolished, which will be discussed in more detail in chapter 6 of this thesis, it will not disrupt SARS' administration in that few persons, being SARS employees, are currently assigned to estate duty. In addition, it appears that the Master's Office itself is doing much of the work for SARS. According to Meyerowitz (2010) the Commissioner for Inland Revenue has the power to delegate the administration of the Estate Duty Act and has in fact delegated a large number of his powers to the several Masters and Assistant Masters, and all officers holding administrative rank in their offices.

4.4. Estate planning

The third problem raised by the Treasury and the focus of this discussion is the impact of estate planning on the efficacy of estate duty.

Stiglingh *et al* (2011: 925) set out the following reasons for a person to engage in estate planning:

1. Fiscal reasons: the planner may want to minimise the potential liability for estate duty, income tax and CGT after his or her death.
2. Personal and family reasons: the planner may, for example, want to provide for his or her spouse and children after his or her death.
3. Commercial reasons: the planner may, for example, be the sole owner of a business and may want to provide for the continued running of the business after his or her death.

The reasons for estate planning, as set out above, will be discussed in more detail in chapter 5 followed by an analysis of the various methods utilised by estate planners.

4.5. Lack of uniformity

As stated above, while SARS has not specifically mentioned the lack of uniformity between the wealth taxes in South Africa as a reason for looking into the abolishment of estate duty, this problem was raised by the various Commissions and elaborated on by Muller (2010). Muller (2010: 433) lists the following discrepancies in the current South African wealth transfer tax system:

- estate duty is levied under the Estate Duty Act whereas donations tax is levied under the Income Tax Act;
- estate duty is levied on a (limited) worldwide as well as a *situs* basis, whereas donations tax is only levied on a (limited) worldwide basis;
- estate duty is levied with reference to a person “ordinarily resident” in the Republic, whereas donations tax is levied on a “resident”;
- the double taxation agreements concluded for the purposes of wealth transfer taxation, with the exception of the agreement entered into with the United Kingdom, apply only to transfers on death;
- unilateral relief is available under the estate duty provisions, but similar relief is not contained under the donations tax provisions;

- the Estate Duty Act contains special valuation rules for unquoted shares, whereas the donations tax provisions do not contain a similar valuation rule;
- for the purposes of estate duty, usufructuary and other like interests are valued with reference to the life expectancy of the beneficiary (unless the period of enjoyment is fixed), whereas, for donations tax purposes, these interests are generally valued with reference to the life expectancy of the donor (unless the period of enjoyment is fixed);
- some exemptions are, it is submitted, unjustifiably offered under the donations tax provisions, without corresponding relief being provided for under the Estate Duty Act; and
- the general anti-avoidance rule contained in the Income Tax Act also applies to donations tax whereas the Estate Duty Act does not contain a similar provision.

A further inconsistency not referred to by Muller (2010) is that section 56(1)(g) exempts any right in property situated outside the Republic that was acquired by the donor (i) before the donor became a resident of the Republic for the first time (own emphasis), or (ii) by inheritance from or donation by a person not ordinarily resident in the Republic at the date of death or donation. The Estate Duty Act (in section 4(e)) provides for a deduction of the value of any right in or to property situated outside the Republic acquired by the deceased (i) before he or she became ordinarily resident in the Republic for the first time, but the deductions for donations by or inheritances from persons not ordinarily resident in the Republic (section 4(e)(ii)) are limited to those acquired “after he or she became ordinarily resident in the Republic for the first time”. Therefore inherited or donated foreign property is treated differently in the Income Tax Act and the Estate Duty Act.

Muller (2010) suggests that, based on the inconsistencies set out above, it is not surprising that the Margo and Katz Commissions identified the lack of integration between the two different tax regimes as an area in need of tax reform and proposed the introduction of an integrated regime known as a “capital transfer tax”. It appears to be inconceivable that such glaring contradictions have not been remedied to date. The fact that CGT has been

levied for over ten years without the issue of double taxation being remedied is also inconceivable.

4.6. Conclusion

From the above discussion it is apparent that the first and third problems identified by SARS have merit. The first problem, being the issue of double taxation, needs to be solved as it is a cause for great concern that South Africa is the only country in the world in which estate duty and CGT are levied on death. CGT aside, the fact that taxpayers resent having to pay taxes all of their lives and then again on death is problematic as it gives rise to tax avoidance. It is submitted that the third problem, being estate planning with the aim of minimising the payment of estate duty, has arisen primarily because of the double taxation problem. An element of the second problem, being the limited revenue brought in by estate duty, has merit as is evidenced by the figures provided by the Treasury. However, the element of the second problem relating to the cumbersome administration of estate duty has not been shown to have any merit as no evidence exists regarding the cost of the administration of the tax. In this chapter a fourth problem, not mentioned by SARS, was identified being the lack of uniformity in the application of the various wealth taxes. It is submitted that this lack of uniformity is problematic as uniformity in the rules relating to the application of the taxes and the valuations of the assets, disposals or donations in question is necessary.

With regard to estate planning, while there are reasons for entering into estate planning schemes other than the minimisation of estate duty liability, it is submitted that the minimisation of liability is the main reason. The other reasons, as set out by Stiglingh *et al* (2011) will be dealt with briefly in chapter 5 as will an analysis of the methods used by estate planners to decrease the estate duty liability. Thereafter, in chapter 6, the question whether estate duty should be abolished will be addressed and alternatives to the tax will be considered.

CHAPTER 5

ESTATE PLANNING

5.1. Introduction

Jones (2006) states as follows:

Estate planning, whilst important in the context of ensuring that your beneficiaries are appropriately taken care of after your death, has historically been more focused on one target – the reduction of estate duty as far as is humanly possible. Many people take the view that SARS took enough money during their lifetime, and they'll be darned if the taxman will get any more once they have gone. This led to a number of convoluted and rather costly schemes aimed at reducing SARS' slice to the minimum.

It is submitted that Jones is correct in his assertion that the primary target of estate planning is estate duty but the other reasons for entering into an estate plan need to be considered briefly for the purposes of completeness. Thereafter it will be possible to consider how the concept of estate planning, with the aim of minimising estate duty liability, has impacted on the efficacy of estate duty as a wealth tax and what can or should be done about this problem.

5.2. Objectives of estate planning

According to Roeleveld (2010) "tax should never be the only consideration in any tax planning exercise, and the needs of all parties affected should be taken into account. Life expectancy tables are certainly not helpful in determining how long you will actually live, despite many valuations being made on this basis."

As mentioned in chapter 4, Stiglingh *et al* (2011: 925) set out the following reasons for a person to engage in estate planning:

1. Fiscal reasons: the planner may want to minimise the potential liability for estate duty, income tax and CGT after his or her death.
2. Personal and family reasons: the planner may, for example, want to provide for his or her spouse and children after his or her death.
3. Commercial reasons: the planner may, for example, be the sole owner of a business and may want to provide for the continued running of the business after his or her death.

5.2.1. Fiscal reasons

It is a well-established principle that taxpayers are allowed to minimise their tax liability within the parameters of the law (*IRC v Duke of Westminster* [1936] AC 1) and the minimisation of estate duty liability in particular has become a popular and firmly established form of legal tax avoidance. "Taxpayers incur no legal penalties and, strictly speaking, no moral censure, if, having considered the lines drawn by the legislature for the imposition of taxes, they make it their business to walk outside them" (*Levene v IRC* [1928] AC 217, 13 TC 486).

Cornelissen and Frith (2009) state that the purpose of a proper estate plan is, amongst other things, to reduce or minimise estate duty and any potential capital gains tax liability. They explain that South Africa has no forced "heirship" rules, and the basic philosophy that taxpayers are perfectly entitled to arrange their affairs so as to pay the least amount of tax has repeatedly been confirmed by the courts. As so eloquently put by Lord President Clyde in *Ayreshire Pullman Motor Services and DM Ritchie v Commissioner for Inland Revenue* 14 TC 754:

No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow – and quite rightly – to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be

astute to prevent, as far as he honestly can, the depletion of his means by the Revenue.

The efficacy of estate duty has come into question because wealthy people can avoid it. Those who wish to and who can afford to take steps to minimise their estate duty liability will find that there are many legitimate ways to do so. Jacobs (2012a) states that “estate duty has given rise to the creation of highly complex structures and the existence of a secondary industry resulting in negative spending to avoid the payment of estate duty”. Tax planning or avoidance is not illegal. Many books on the subject of estate planning set out clearly the steps to be taken to avoid estate duty (Meyerowitz, 2010 and Stein, 2011). Huxham and Haupt (2011) go as far as to state that estate duty used to be called a voluntary tax, because planning to avoid it was relatively easy. Over the years this has become more difficult, especially with the introduction of the tax on capital gains. According to van Vuren (2010) the only way for a person to avoid CGT legally is to keep all their wealth in cash investments, as cash is exempt from CGT. He states that even if a person never sells an asset, it will attract CGT upon death (provided it is not bequeathed to a surviving spouse). However, keeping all investments in cash is not realistic as this will result in a loss of wealth over time. He goes on to explain that because of structures such as trusts, some of which were set up purely to avoid estate duty, assets may stay in such structures for generations without CGT ever being triggered. Had it been possible to transfer these assets freely without estate duty, fewer of these structures would have been created. This in turn would probably have led to more regular transfer of these assets, which would have caused more CGT events, with a resulting increase in income from CGT for the fiscus.

5.2.2. Personal and family reasons

Estate planning does not only aim to avoid estate duty. Huxham and Haupt (2011) emphasise the importance of liquidity when entering into an estate plan. There are various amounts that need to be paid in cash by the executor such as the Master’s fees, fees for advertising the liquidation and distribution

account, and so on. They suggest that where estate planners realise that there will not be sufficient liquidity they will need to formulate a plan in terms of which liquidity will be raised. Where the person for whom the plan is being formulated is likely to die in the near future the planner can provide for liquidity by way of a life insurance policy. When the person whose life is insured is already elderly the premiums for such a policy will be substantial if the person is insurable at all. They therefore suggest that a term policy would be preferable or a diminishing term policy. They further warn that a policy taken out for liquidity reasons will in itself increase the liquidity requirements because section 3(3)(a) deems the proceeds of insurance policies on the life of the deceased to be property in the estate. A further way in which liquidity may be provided for is by way of a bequest price. This is where an asset is bequeathed to an heir subject to such heir paying a bequest price to the estate.

As well as liquidity, planners need to ensure that they do not divest themselves of assets to such an extent that they become destitute. On this point Davis *et al* (2012) state as follows:

As estate duty is payable based upon the value of a deceased's estate at date of death, the most obvious way of reducing a person's (planner's) estate may seem to be to divest the planner of assets during his lifetime. Whilst much estate planning does involve a divestiture of assets prior to death, there are important issues to bear in mind in doing this – the most obvious is that if the planner disposes of assets too readily and then proceeds to live longer than expected, he may be destitute in his later years.

Estate planning is essential when the persons engaging in it have minor children for whom they want to provide after their death. Where such a person owns immovable property, placing such property in a trust, as will be discussed below, for the benefit of such children is logical. There are instances, although they are in the minority, where the primary objective of a planner is to provide for his children and the minimisation of estate duty on death is only a secondary consideration.

5.2.3. Business reasons

Where planners are running their own business it is imperative that they make provision for what should happen to the business after their death. Schoeman (2012) explains that the reality is that whether it is planned or unplanned, complex or simple, succession planning – or the lack of it – inevitably has profound implications for smaller businesses. Without it, for example, the business a person spent their whole life building could end up being sold for under its true value. Worse still, it could end up failing and becoming a black hole of debt consuming the founder's personal assets. This is not always the case in corporate enterprises, where sheer size and operating principles shield principals from the harsh realities facing small business operators.

She states that a sound understanding of the concept of succession planning is of vital importance to any entrepreneur, regardless of how big their business is. It involves much more than simply setting up a will or an estate planning structure. Whether their business is large or small business owners will have to put plans in place for the continuation or dissolution of their business after their death. Such persons should consult an estate planner who specialises in business succession planning when establishing such an estate plan.

An estate planner who is also a business owner should also consider the provisions of paragraph 57 of the Eighth Schedule as discussed in chapter 2.

5.3. Estate planning methods

Estate planning is a complex field which should only be engaged in by an expert. Over the years many methods have been used to effectively plan for the consequences that arise upon the death of an individual. The most commonly used methods will be discussed below.

5.3.1. Wills

Yochum (2009) states as follows:

Many South Africans neglect to put in place a will that is up to date and valid to protect their loved ones' interests after they die. The tragic result is that their dying wishes are not carried out, meaning that a lifetime of labour fails to benefit family and friends, according to its original purpose.

The most important estate planning tool is a will. It is therefore essential that individuals get a competent person, ideally an expert in estate planning, to draft their will for them. Such a person must be informed of all of the individual's financial assets and liabilities and the needs of their family or business. The will should be reviewed regularly and the relevant legislation should be strictly adhered to, namely the Wills Act 7 of 1953. Jacobs (2012b) states that

when you are planning your will, you must, as a basic step, be aware of which assets do or do not fall into your estate, and also which assets can or cannot be regulated through your will. To deal adequately with your assets and harmonise the benefits with your overall scheme of inheritance, you need to bear in mind that estate planning is wider than merely having a will. It often requires the collaboration of a number of professionals, such as financial planners, brokers, and drafters of wills.

Frith (2009) is of the opinion that an expert with the correct experience and understanding can draft a will which complies with the testator or testatrix's intentions with regard to what and to whom bequests are made, including what will be left to the surviving spouse or charity. He states that such a will should never allow for more money than is necessary being paid to SARS. In his opinion an expertly drafted will need never be changed unless the testator wishes to change a beneficiary and in fact, the idea of having to update your will other than to change a beneficiary is a further absurdity of the past.

While there is merit in Frith's assertion that a cleverly drafted will should not need to be revised, the average person may struggle, logistically and

financially, to find an expert who is capable of drafting a fool-proof will which adequately makes provision for every eventuality.

5.3.2. Donations

Donations tax was discussed in some detail in chapter 2. Stiglingh *et al* (2011) explain that if a planner donates assets to his or her children during his or her lifetime (*inter vivos* donations), these assets will fall outside his or her estate on death and there will consequently be a reduction in the estate duty payable. An annual exemption from donations tax of R100 000 exists, but donations in excess of this amount are subject to donations tax. It should be noted that the donation of assets to the planner's children will merely shift the potential liability for estate duty to them if they already have substantial estates of their own, or will have substantial estates after the donation by the planner. In addition, the donation of an asset is treated as a disposal at market value for CGT purposes, so the donor will be liable for this tax on any capital gain made on the donations of assets to his or her children.

By way of example, if a taxpayer who pays tax at the maximum marginal rate of 40 percent owns a rental property that is bringing in a substantial amount of rental every year, he or she may decide to donate it to an adult child who would be inheriting the property upon the taxpayer's death. Where the rental income is, for example, R200 000 a year the taxpayer would be paying R80 000 a year in income tax thereon. Should the taxpayer decide to donate the property, which has a market value of R2 million at the date of donation, he or she would pay R400 000 in donations tax (assuming the R100 000 exemption was applied elsewhere) and the child to whom it was donated would take over the payment of income tax on the rental received. If the child is paying income tax at a marginal rate of 30 percent then, according to Huxham and Haupt (2011), SARS would be losing normal tax of R20 000 per year but would have gained donations tax. In such a case the donor will be ensuring that less estate duty is paid upon his or her eventual death, but the estate duty problem is being shifted to his or her child. The donor will also be subject to CGT on the asset donated. Assuming that the base cost of the property was R1

million, it will be increased by R200 000 (par. 22, Schedule Eight) and CGT will amount to (assuming a 2012 year of assessment and that the annual exclusion of R20 000 is available) $(R800\ 000 - R20\ 000) \times 25\% \times 40\% = R78\ 000$.

Huxham and Haupt (2011) suggest that a husband and wife could each donate R100 000 per annum to a family trust thereby avoiding donations tax liability as the annual donations tax exemption amounts to R100 000 (section 56(2)(b) of the Income Tax Act). It should be noted though that if the donation is made by way of the donors waiving R100 000 per annum of their loan claim against the trust, there is a capital gains tax effect (par 12(5) of the Eighth Schedule). Stofberg (2008) states as follows with regard to the R100 000 exemption:

Donations not exceeding this exemption are often utilised by an estate planner (the donor) and his spouse to fund investments held by an *inter vivos* trust. The trustees will invest in an investment policy such as an endowment policy or a sinking fund policy.

According to Davis *et al* (2012) donations can save significant estate duty where the assets being donated are growth assets which are likely to appreciate rapidly in value in the future. It may for instance be better to pay the donations tax in respect of such an asset now and donate the asset, rather than pay significantly more estate duty in the future. They state further that section 56(1)(c) of the Income Tax Act exempts from donations tax a *donatio mortis causa* and section 56(1)(d) exempts a donation in terms of which the donee will not obtain any benefit thereunder until the death of the donor. While donations tax may be avoided by utilising the provisions of section 56(1)(c) and (d) it is not possible to avoid estate duty as the value of the property donated will be included as an asset in the calculation of the gross value of the estate. In addition, CGT will be calculated at the date of death on the assets that are donated in terms of a *donatio mortis causa* or a donation in terms of which the donee will not obtain any benefit thereunder until the death of the donor.

Whether planners choose to make *inter vivos* or *mortis causa* donations they will not be able to avoid estate duty, donations tax and CGT. The planner therefore has to choose the lesser evil as avoidance of tax altogether is an impossibility.

5.3.3. Bequests to a spouse

According to Huxham and Haupt (2011) the easiest form of estate plan seems to be to reduce the estate of the first-dying spouse by using the provisions of section 4(q) of the Estate Duty Act. As discussed in chapter 3, section 4(q) permits a deduction from the gross value of an estate of property which accrues to the surviving spouse of the deceased.

Before 1 January 2010 it would not have been wise to bequeath the entire estate to one's spouse as the estate duty liability would merely have been shifted to that spouse. Since the introduction of the portable abatement, however, such a move will result in a considerable saving. Huxham and Haupt (2011) suggest that the best simple plan would be the following:

- the first-dying spouse leaves R3,5 million in assets to the family trust and the balance of the estate to the surviving spouse;
- generally, the assets left to the trust will be those with the smallest capital gains tax exposure (for example, the shares most recently purchased);
- the assets left to the surviving spouse are not subject to CGT on the death of the first-dying spouse, therefore it does not matter which assets are left to the surviving spouse;
- if the primary residence is left to the surviving spouse, the CGT exclusion in respect of the primary residence is not used because the CGT cost is "rolled over" to the surviving spouse; and
- any property which is inherited is not subject to transfer duty when transferred to the heir.

With regard to bequests to a spouse and CGT it should be noted that a deceased estate will not be liable for CGT on assets that are transferred to the surviving spouse. However, Stiglingh *et al* (2011) state that these assets are treated as having been acquired by the surviving spouse at a cost equal to their base cost to the deceased, so that the potential liability for CGT on the ultimate disposal of the assets is effectively shifted or 'rolled-over' from the deceased to the surviving spouse. On this point, Huxham and Haupt (2011) state that donating or leaving assets to a surviving spouse merely shifts the estate duty problem from one spouse to the other. They suggest that the advantage in transferring assets to the surviving spouse lies not in reducing the estate duty liability but in deferring it.

5.3.4. Bequests to Public Benefit Organisations

Frith (2009) states that by making proper use of the provisions contained in section 4 of the Estate Duty Act, and section 4(h) in particular, a testator may save estate duty. In terms of section 4(h) the value of any property included in the estate which has not been allowed as a deduction under any other provision of section 4 and which accrues to or accrued by way of bequest to –

- any Public Benefit Organisation (as defined in section 30 of the Income Tax Act) which is exempt from tax in terms of section 10(1)(cN) of the Income Tax Act;
- any institution, board or body, which is exempt from tax in terms of section 10(1)(cA) of the Income Tax Act, which has as its sole or principal object the carrying on of any public benefit activity (as defined in section 30 of the Income Tax Act); or
- the state or any 'municipality' as defined in section 1 of the Income Tax Act,

may be deducted from the gross value of the estate.

Cornelissen and Frith (2009) state that with regard to bequests in terms of section 4(h),

it is important to note that the deduction applies to both monetary accruals and those accruals that may be put into money terms. For

example, where a usufruct or annuity or fiduciary interest, which the deceased enjoyed at the time of his/her death, accrues to a qualifying institution that accrual will rank as a deduction when determining the net value of the estate. Similarly, where the proceeds from an insurance policy, which would otherwise have been included in the property of the deceased's estate, were bequeathed to a qualifying institution that amount will be deductible.

While bequests to a Public Benefit Organisation may reduce the estate duty liability they will of course minimise the amount available for distribution to the deceased's spouse or children. The utilisation of the section 4(h) deduction will therefore only be attractive in particular circumstances.

5.3.5. Insurance policies

With regard to insurance policies, Surtees (2009) explains that there has always been at least one good reason to nominate beneficiaries for the proceeds of life policies rather than allow the proceeds to accrue to the deceased estate of the insured person. Although such proceeds form part of the deceased estate and are therefore subject to estate duty, the executor is not entitled to remuneration on them, and this translates into a saving of 3.5 percent of the proceeds for the estate. He explains further that since the judgment in *Shroobree NO v Love* 2005 (1) SA 309 (SCA) there is another, more compelling reason to nominate beneficiaries, namely when the insured person is insolvent on death. In the *Shroobree* case the Supreme Court of Appeal resolved a conflict between two High Court decisions. In one of those decisions the court found that, where a person dies insolvent, the proceeds of a policy form part of the estate and must therefore be used to pay creditors, to the evident prejudice of the nominated beneficiaries. In the other decision another division of the High Court found that the proceeds bypassed the estate and accrued directly to the nominated beneficiary. In the *Shroobree* case the Supreme Court of Appeal found that, when a person takes out a life policy and nominates a beneficiary, the contract is a stipulation *alteri*, a contract for the benefit of a third person. On the death of the insured, the

beneficiary, on accepting the terms of the contract, has an enforceable right against the insurer and the estate does not enter the picture at all. Therefore any person whose estate is to any degree vulnerable to market risk should seriously consider nominating beneficiaries for any life policies. The proceeds will still be subject to estate duty, but there is a saving of 3.5 percent in executor's remuneration and, most importantly, protection of the beneficiaries from the predations of creditors.

Based on the above insurance policies may be a useful estate planning tool where the planner wants to ensure that his or her beneficiaries receive an amount of cash which is not only available after the settlement of debts owing to creditors of his or her estate.

5.3.6. Trusts

Labuschagne (2008) states that

Trusts were not designed for beneficiaries to evade the payment of tax but were created to care for the well-being of beneficiaries and minors who may have been incapable of managing this aspect themselves. However, trusts have evolved, through the intervention of estate and financial planners, as conduits for passing income down to beneficiaries. In these beneficiaries' hands, the receipts would be taxed at lower tax rates while, at the same time, pegging the settlor's exposure to estate duty as his estate continues to grow over the years, or as a haven to safeguard vulnerable assets from one's creditors in insolvency.

For income tax purposes a 'person' includes a trust. In terms of section 25B of the Income Tax Act trust income is taxed either in the trust or in the hands of the beneficiaries. Section 25B is, however, subject to section 7 which will be discussed below. Income accrues to the beneficiary of a trust where such beneficiary has a vested right in and to such income. Where such a vested right exists the income will be taxed in the beneficiary's hands. Muller (2010) explains that where beneficiaries do not have such a vested right the income accrues to the trust and tax thereon is payable by the trustees. However,

where a donation is made to a trust the trustees are regarded as the donees and not the beneficiaries.

There are various kinds of trusts, including *inter vivos* trusts and testamentary trusts. An *inter vivos* trust is created during the lifetime of the donor and is regulated by a trust deed. The donor transfers property to the trustees of the trust who then manage it for the benefit of the beneficiaries, one of whom may be the donor. The donation of property to a trust is popular for estate planning purposes because once the donor transfers it to the trust it cannot form part of the donor's dutiable estate for estate duty purposes upon death. Stein (2011) suggests that because of the impact of donations tax *inter vivos* trusts are now usually created by a small donation after which the donor transfers his or her growth assets at fair market value in exchange for an interest-free loan account. The result of this is that the value of the transferred asset is frozen at a sum equivalent to the value of the loan. Any increase in the value of the assets will fall outside the donor's estate since they no longer belong to him or her. Estate duty will only be payable on the outstanding amount of the loan account which amount will be much less than the value of the growth assets as at the date of the planner's (donor's) death. However, the decision of the Supreme Court of Appeal in the case of *CSARS v Woulidge* 2002 (1) SA 68 (SCA) has resulted in the necessity for a cautious approach to be taken to the practice of selling assets to trusts in exchange for interest-free loans. The *Woulidge* judgment will be discussed under the heading "interest-free loans" below.

A testamentary trust is created in terms of the will of a person and only comes into effect upon death. The will itself acts as the trust deed which regulates the trust. The executor of the deceased estate is responsible for transferring the property bequeathed to the trust.

Stiglingh *et al* (2011) state that assets may be left to a trust of which the surviving spouse will be the income beneficiary during his or her lifetime. On his or her death the trust will be dissolved and the assets transferred to the children of the planner. If the surviving spouse has a vested right to the

income of the trust, the section 4(q) deduction will be available for the value of the bequest to the trust. The surviving spouse must have a vested right to the income of the trust: if the trust is discretionary and if other beneficiaries may benefit from the income, the Commissioner does not regard the spouse as having a vested right to the income of the trust and will not allow the section 4(q) deduction for the value of the bequest to the trust

Huxham and Haupt (2011: 721) suggest that a good estate plan involving a trust must have certain features.

- (a) It should enable the owner of the assets to divest himself of the assets for estate duty purposes while, at the same time, enabling him to retain some element of control.
- (b) It should not create a vested right in the property in the hands of individual beneficiaries as this will merely result in the estate duty problem being transferred from one person (usually the parent) to one or more other persons (usually the children).
- (c) It should not give rise to donations tax as this will result in an immediate cash flow problem.

Huxham and Haupt (2011) also warn that the founder of a trust must not retain so much control over the trust that he or she is able to control the assets. The reason for this is that section 3(3)(d) of the Estate Duty Act provides that if the deceased was competent to dispose of property for his or her own benefit or the benefit of his or her estate such property will amount to deemed property in his or her estate. Huxham and Haupt (2011: 725) give the following examples of where this situation can arise:

- the founder retains the right to dismiss trustees and appoint new trustees in their place;
- the founder has a controlling vote; and
- the founder is the only trustee.

Huxham and Haupt (2011: 726) therefore suggest that one of the following should be done:

- the founder should be made only one of three trustees so that he or she can be out-voted;

- the founder should not be a capital beneficiary so that even if he or she does retain control he or she cannot benefit;
- the founder's veto rights should be limited; and
- the trust deed can stipulate that no person can apply the assets of the trust for the benefit of himself or his estate, and neither can the trust deed be amended to give anyone that power.

When it comes to disposing of assets to a trust the founder may choose to either sell them to the trust or donate them. A donation will result in donations tax at the time of making the donation but no estate duty will result upon the founder's death as he or she will have totally divested himself or herself of the assets during his or her lifetime. Huxham and Haupt (2011) suggest that a donation would, in normal circumstances, not be wise as it will result in an outflow of cash in the form of donations tax. However, they suggest that where the donor is old and there is a risk at the time of making the donation that the rate of estate duty may increase above 20 percent it may be preferable to donate the assets. If such a route is chosen the donor (founder) must be warned that section 7 of the Income Tax Act will be invoked which section deals with income arising from a donation and in terms of which income is taxed in the hands of the donor. The donor should also be aware that if the trust sells the asset the donor will be taxed on a part of the capital gain in terms of paragraph 70 of the Eighth Schedule to the Income Tax Act. Huxham and Haupt (2011) submit that this is not "bad news" as the donor will be taxed at a lower rate than the trust.

It should be noted that section 7 of the Act is essentially an anti-avoidance provision which provides for the taxation, in the hands of the donor, of any income which has resulted from a donation or similar disposition. In terms of section 25B trust income is taxed in the hands of the trust or the beneficiaries subject to section 7. Subsections (3) to (10) apply to trusts and subsection (3) in particular provides an example of what section 7 is trying to prevent. In terms of subsection (3) income is deemed to be received by a parent of a minor child where that parent made a disposition that has resulted in income accruing to that minor child. Section 7(3) therefore provides for the situation

where a taxpayer tries to “hide” income-producing assets in a trust of which his or her child is a beneficiary.

There are a number of paragraphs in the Eighth Schedule which should also be borne in mind by an estate planner who plans on utilising a trust. Parts five and seven of the Eighth Schedule contain provisions in terms of which trust income is taxable in the hands of the donor or beneficiary and not the trust. It is not possible to discuss these provisions in detail in this thesis but it should be noted that in terms of paragraph 80 where a trust distributes an asset to a beneficiary any gain made by the trust will be taxed in the hands of the beneficiary. An example of the attribution rules in the Eighth Schedule is paragraph 70, which provides that where a taxpayer makes a conditional disposition to a trust in terms of which any capital gain shall not vest in the beneficiaries of the trust and the trust makes a gain as a result, the gain is taxable in the hands of the taxpayer who made the disposition and not the trust.

Should the founder choose to sell assets to the trust instead of donating them then CGT becomes an issue. The trust may create a loan account in the founder’s favour which loan may or may not carry interest. If interest is included then the founder’s estate will increase as the interest on the outstanding loan account adds up. This means that the goal of freezing the asset is not reached. The interest that accrues to the founder will be taxable as well. The sale must also be for full market value failing which donations tax will arise where the disposition is for an inadequate consideration. Huxham and Haupt (2011) suggest that the best approach is for the asset to be sold to the trust, for a loan account to be created in the founder’s favour and for there to be no interest attached to the loan. Section 7 of the Income Tax Act will apply where the loan is interest-free as will paragraph 70 of the Eighth Schedule. Huxham and Haupt (2011) submit that an individual needs to choose between paying estate duty or income tax as it is rarely possible to save both. They submit that saving estate duty is the usual choice as the anti-avoidance provisions often cannot be side-stepped. Upon the death of the founder the balance of the loan account will be included in the estate.

Huxham and Haupt (2011) are of the opinion that selling an asset is more desirable than donating it.

Huxham and Haupt (2011) raise an important point regarding a plan that involves the freezing of the value of growth assets. They state that where the plan is aimed at freezing a person's estate and preventing any further growth in his or her hands, it should not have the same effect on the growth potential of the assets. If growth assets are put into a non-vesting trust, the benefit of the increase in value of the assets and the income on the assets would accrue to the trust and not to the founder thereof. The founder's estate is further reduced by the tax on the income that is taxed in his or her hands in terms of section 7(5), with the growth of the assets in the trust not being hindered by the tax on the income.

Cohen (2011) explains that the advantages and disadvantages of using a trust as an estate planning tool are not only tax related. She states that the estate duty saving achieved by transferring growth assets to a trust should never be considered apart from the other tax and non-tax advantages and disadvantages of trusts. The most significant non-tax benefits include the fact that the trust's assets (net of the settlor's loan claim) are protected from creditors of the settlor, the trustees and the beneficiaries, as well as the administrative procedures (freezing of accounts, and so on) and costs, such as executor's fees, incurred at death. A discretionary trust in particular allows for flexibility in a way that no other legal entity can. The trustees of a discretionary trust can decide what and how much to distribute to beneficiaries, depending on changes in both the legislative environment and in the beneficiaries' circumstances. Trust assets can be vested in a beneficiary or applied for his or her benefit, without actually being distributed to him or her. In addition, whereas the details of one's deceased estate appear in the liquidation and distribution account which is filed at the Master's Office, a trust's financial affairs are never made publicly available.

5.3.7. Companies

A similar effect to that outlined above can be achieved by transferring assets to a company of which the planner's spouse and children are the shareholders. Any increase in the value of the assets transferred to the company will be for the benefit of the shareholders and will not increase the net value of the estate of the planner. The use of a company does, however, merely shift the liability for estate duty from the planner to his or her spouse and children, who will have the value of the shares included as property in their own estates. Stiglingh *et al* (2011) suggest that an alternative course would be to transfer the assets to a company whose shares are held by a family trust. It is important not to defeat the objective of reducing the estate duty on the planner's estate by falling foul of the provisions of section 3(3)(d) of the Estate Duty Act. Section 3(3)(d) states that property which the deceased was immediately prior to his or her death competent to dispose for his or her own benefit or the benefit of his or her estate will amount to deemed property.

Huxham and Haupt (2011: 726) suggest that one of the ways in which to avoid the application of section 3(3) is to set up a plan along the lines suggested below.

1. The founder forms the trust and donates a nominal amount to it.
2. The trust promotes the formation of the company and subscribes for 450 ordinary shares amounting to 100% of the ordinary share capital.
3. The founder will then subscribe for 500 non-participating preference shares (100%) which each carry a vote. The preference shares must, however, not carry sufficient votes to enable the founder to pass a special resolution but must just be sufficient to give him control of the assets (the founder must therefore hold less than 75% of the votes so as to avoid any potential section 3(3)(d) problem).
4. The assets will be transferred into the company from the founder by way of either a sale or donation.

They submit that this plan will ensure that the trust is the holder of the entire equity share capital and all growth in assets will, therefore, accrue to the trust and not to the founder.

Huxham and Haupt (2011) explain further that the founder has 500 voting preference shares which enable him to block any decision by the ordinary shareholders who only have 450 votes. This ensures that the founder can protect his assets against any reckless actions by the trustees. As the preference shares are not equity shares they will not increase in value. Section 3(3)(d) is not applicable in this scenario as the founder is not able to dispose of the assets for his own benefit. With 500 votes he is able to force the company to dispose of the assets but the benefits which result will accrue to the ordinary shareholders and not the preference shareholders. This protects the beneficiaries as they will be given no vested rights in the assets and therefore will not incur estate duty. Huxham and Haupt (2011) caution that it is important when creating such an estate plan not to do anything which is artificial or lacking in commercial substance as this could invoke the anti-avoidance provisions contained in the Income Tax Act.

5.3.8. Interest-free loans

The sale or donation of assets to trusts, which are the usual recipients of property, in exchange for interest free loans was discussed in subparagraph 5.3.6. above. Muller (2010) discusses various estate freezing techniques and in particular considers the sale of assets to heirs or trusts in exchange for interest-free loans, payable on demand. On the death of the planner the loan is often extinguished due to prescription and the creditor's failure to claim performance.

Currently disposing of an asset in exchange for an interest-free loan does not amount to a donation for donations tax purposes although many commentators on the subject suggest that an interest-free fixed period loan may be considered to be a disposition for inadequate consideration in terms of section 58(1) of the Income Tax Act (Muller, 2010). The Margo Commission

recommended that the lack of interest charged should be regarded as a taxable capital transfer. This recommendation was not acted upon and when the Katz Commission revisited the issue in 1997 it came to the conclusion that due to the fact that effective action against interest-free and low-interest loans has been relatively rare in foreign jurisdictions the complexities involved outweighed the advantages (Muller, 2010). In the *CSARS v Woulidge* 2002 (1) SA 68 (SCA) case the founder set up two trusts for his two children. He later sold shares in companies to the trusts in exchange for loans upon which no interest was charged. The question before the court was whether or not the sale of the shares constituted a disposal for the purposes of section 7(3) of the Income Tax Act. Section 7(3) states that income shall be deemed to have been received by the parent of any minor child or stepchild, if by reason of any donation, settlement or other disposition made by that parent of that child it has been received by or has accrued to or in favour of that child or has been expended for the maintenance, education or benefit of that child; or it has been accumulated for the benefit of that child.

Huxham and Haupt (2011) summarise the important aspects of the judgment as follows:

- where a disposition contains both appreciable elements of gratuitousness and of proper consideration an apportionment may be made between the two elements for the purposes of determining the income deemed to have accrued to or received by the parent under section 7(3);
- the sale of the shares for full value did not constitute a disposition;
- however, as long as the capital remained unpaid the failure to charge interest amounted to a continuing donation or disposition. Usually, an interest-free loan is not a donation of the interest but in this case Mr Woulidge had the contractual right to charge interest but chose not to do so. His decision not to charge interest therefore amounted to a donation to the trust. Whether or not the decision not to charge interest is a donation, it is still a gratuitous disposition which gives rise to the application of section 7 of the Income Tax Act;

- the interest that should have been charged on the loan account would be regarded as that portion of the income deemed to be that of the parent within the meaning of section 7(3); and
- in this case, the non-charging of interest constituted an appreciable degree of gratuitousness.

Huxham and Haupt (2011) explain that based on the *Woulidge* judgment, an interest-free loan would be a gratuitous disposition and would result in the application of section 7(3), (4), (5), (6), (7) or (8) of the Income Tax Act, depending on the circumstances. The gratuitous disposition would not amount to a donation so no donations tax would be payable but if it was agreed that interest would be paid and the lender later waives his or her right to such interest, the waiver amounts to a donation.

5.3.9. Fideicommissa and usufructs

It is common for immoveable property to be bequeathed to a testamentary trust or the testator or testatrix's children subject to a usufruct in favour of the surviving spouse. A fideicommissum may also be created where the fiduciary is the surviving spouse and the ultimate fideicommissary is a trust or one or more of the testator or testatrix's children. A usufruct is useful because immoveable property can be transferred directly to the trust or heirs with a condition in the deed of transfer dealing with the usufruct. The condition will lapse upon the death of the usufructuary without the need for any further transfer or endorsement of the deed of transfer. When a usufruct or fideicommissum is created and the rights are bequeathed to the surviving spouse the value of the usufruct or value of fiduciary rights is a deduction from the estate of the first-dying in terms of section 4(q). Huxham and Haupt (2011: 719) suggest that the problem with this arrangement is that the usufruct or fiduciary rights form part of the estate of the surviving spouse and grow in value as the value of the underlying asset grows. They state that

various plans have tried to address this problem by providing that the usufruct goes to a third person for a limited period (usually a year) and thereafter to the family trust as the bare dominium holder. As the usufruct

will only last a year after the date of death of the second-dying spouse, the argument is that it has very little value in the estate of the second-dying spouse. The Legislature has indicated that it will introduce legislation to prevent this type of avoidance and SARS has indicated that it is possible that it may challenge this type of avoidance, even under current legislation.

With regard to the issue of tax avoidance, Desmond (2009) states that the proposed anti-avoidance provisions referred to by Huxham and Haupt, relate to an often used estate planning measure that is regarded as an abuse of the legislation. This measure involves a spouse leaving a usufruct over his or her assets, to his or her surviving spouse on the basis that, on the surviving spouse's death, the usufruct is to be transferred to another person often a trust, for one year. The underlying property is then transferred, after the one year period has passed, to the ultimate heirs. The intervening one year usufruct serves to reduce the value, for estate duty purposes, that must be included in the second-dying spouse's estate. He explains that the perceived loophole is proposed to be closed by providing that all usufructs be valued over the expected lives of the beneficiaries. Desmond is of the opinion that this approach is likely to be widely regarded as broader than is necessary to close the perceived loophole, especially where the usufruct was originally for a limited period only.

According to Stein (2011) the conferring of a fiduciary, usufructuary or other like interest, whether made under a will or an *inter vivos* trust may create a liability for estate duty upon the subsequent death of the beneficiary when his or her interest ceases. He states further that where a person waives his or her usufructuary right or a right to income during his or her lifetime in favour of the succeeding beneficiary he or she frees his or her estate from liability for estate duty but he or she does run the risk of incurring donations tax on the basis that the waiver may amount to a donation without consideration. In such a case Stein suggests that the holder of the interest will have to compare the potential amount of donations tax payable with the potential amount of estate duty payable. Stein (2011: 35) states the following:

A person who disposes of an asset but retains the usufruct may create serious estate duty problems for his or her estate, since, upon his or her death, the usufruct ceasing must be valued and included in his or her dutiable estate. The capitalised amount may be almost the same as the fair market value of the asset at the date of death.

With regard to the donation of usufructuary interests, Stein (2011) suggests that an elderly person who enjoys a limited interest such as a usufruct over an income-producing asset that is passed to a relatively young person on his or her death should consider donating the usufruct to the ultimate beneficiary before his or her death. He explains that the basis of valuation of the donation of a usufruct is more favourable than the basis of valuation of a usufruct ceasing on death for estate duty purposes. This is because the estate duty valuation is based on the life expectancy of the person succeeding to the right, while the value for donations tax purposes is based on the (shorter) life expectancy of the donor. He suggests that alternatively, to retain some form of financial security, the elderly holder of the usufruct may sell the remaining right to the ultimate beneficiary on loan account for its value for donations tax purposes. There would then be no donation for donations tax purposes, only the balance owing on the loan account at the date of death would constitute property in his or her estate, and he or she would still have some financial security in the form of the asset, that is, the loan account.

5.4. Planning versus evasion

Section 80A of the Income Tax Act states that an avoidance arrangement is an impermissible avoidance arrangement if (a) in the context of business, it's sole or main purpose was to obtain a tax benefit; (b) in a context other than business, it was entered into or carried out by means or in a manner which would not normally be employed for a bona fide purpose, other than obtaining a tax benefit; (c) in any context it has created rights or obligations not normally created between persons dealing at arm's length; or would result directly or indirectly in the misuse or abuse of the provisions of the Act or the anti-avoidance provisions.

Section 80L of the Act defines a tax benefit as any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by the Income Tax Act or by any other Act administered by the Commissioner. Also section 80G deals with the presumption of purpose and states that an avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit unless and until the party obtaining a tax benefit proves that reasonably considered, in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.

Labuschagne (2008) states that

our courts have not been fooled by those camouflage experts out there that dress up “schemes/arrangements” to look like one thing but mean another and will not hesitate to look at both the substance and form of a transaction to ascertain the parties true intention – also referred to as the simulation and label principle.

According to Muller (2010) the Katz Commission did not favour the introduction of a general anti-avoidance measure for the purposes of estate duty. The reasons advanced were:

- (a) at the time when a transaction is challenged, the founder would have died (which would make the entire issue of evidence difficult);
- (b) there would be much uncertainty (which would undermine sensible estate planning); and
- (c) it would result in a wasteful proliferation of litigation.

Muller (2010) states that the Commission instead supported the introduction of some additional specific anti-avoidance measures such as can be found in the United Kingdom system. However, none of these additional measures have since been introduced despite the fact that in the 2008 Draft Revenue Laws Amendment Act (Act 60 of 2008) it was proposed to introduce a general anti-avoidance rule similar to that contained in the Transfer Duty Act (Act 40 of 1949).

While, as stated above, there is no anti-avoidance provision in the Estate Duty Act Stiglingh *et al* (2010: 932) warn that

when drawing up an estate plan, the anti-avoidance provisions of section 7, paragraphs 68-72 of the Eighth Schedule and the general anti-avoidance rules of the Income Tax Act must be borne in mind. If the plan contains features that may trigger the application of these provisions, an opportunity to achieve savings in income tax or CGT may be lost.

5.5. Conclusion

Having established why people enter into estate planning schemes and what methods they use to implement such schemes it appears clear that the lengths that planners go to are extreme and the methods that they utilise are very complicated. As there is no specific anti-avoidance legislation in place that deals with estate duty, liability for the tax is, at present, relatively easy to plan your way out of. The conclusion that can be reached at this stage is that the impact of estate planning on the efficacy of estate duty as a wealth tax in South Africa is nothing short of significant. It has taken many years for the current sophisticated system of legal tax avoidance in the context of estate planning to be established. Should estate duty not be abolished or amended substantially then this tax avoidance industry will only become more highly-evolved. Possibilities regarding the alternatives to estate duty will be discussed in chapter 6.

CHAPTER 6

ALTERNATIVES TO ESTATE DUTY

6.1. Introduction

Having established that the problems associated with estate duty are significant and that these problems have resulted in an advanced secondary industry of estate planning with the aim of minimising estate duty liability, the conclusion that can be reached at this stage is that estate planning has had a major impact on the effectiveness of estate duty as a wealth tax in South Africa.

In this chapter alternatives to the current estate duty regime will be considered as will the consequences of abolishing estate duty as a wealth tax in South Africa.

6.2. Replacing estate duty with an inheritance tax

Ger (2012) suggests that an alternative to estate duty may be a new inheritance tax in terms of which the beneficiaries are taxed. However, he states that this may be problematic as it could lead to a complex new tax regime that does not solve the double taxation problem. Muller (2010) seems to favour the idea of a recipient-based tax which in effect would be a tax paid by the beneficiaries of an estate. She states that the administration process that is undertaken upon the death of a person appears to determine whether the taxation system should be transferor or recipient-based. What she means by this is that where an executor collects a deceased person's assets and pays creditors, as is the case in South Africa, the system of taxation is generally transferor-based. However, in countries where the heirs inherit the debts of the deceased the system of taxation is generally recipient-based. While a discussion of the respective merits of transferor versus recipient-based systems of taxation cannot be undertaken in the present thesis it is worth noting that some form of inheritance or beneficiary tax may be

considered by SARS due to the fact that such a tax exists in numerous other jurisdictions such as The Netherlands and Ireland (Muller, 2010). Muller (2010) explains that while transferor-based taxation was supported by the Franzsen (1970), Margo (1986) and Katz Commissions (1995), none of these Commissions had actually considered recipient-based taxation properly. She suggests that this wasn't necessary because at the time that these Commissions were heard the issue of double taxation that arises now due to CGT had not yet become an issue. She highlights a number of problem areas that exist by virtue of the transferor-based system of taxation. These problem areas may be summarised as follows:

- the demarcation of the world-wide basis of taxation under both the estate duty and donations tax regimes;
- the fact that life policy benefits payable to the deceased estate constitute property of the estate for estate duty purposes and that policies payable to a specified beneficiary amount to deemed property for estate duty purposes. In the first instance estate duty is paid by the estate while in the second instance it is paid by the recipient of the proceeds of the policy. Muller's problem with this is that it shows a lack of horizontal equity as some benefits are treated as recipient-based and others as transferor-based. The exemptions available where policy benefits are recoverable by the surviving spouse or children, in terms of certain nuptial contracts, under buy-sell arrangements and key-man policies have been utilised in sophisticated tax planning schemes. In the 2008 budget speech the Minister of Finance proposed to exempt a certain amount of life insurance benefits from estate duty but soon after announcing this proposal it was withdrawn on the basis that the Treasury's Chief Director of Tax Policy raised the concern that taxpayers would make their savings in one vehicle and then get it into their estate tax-free which would raise a serious avoidance problem; and
- the fact that upon the donation of a limited interest such as a usufructuary, fiduciary or similar interest such interest is valued, for donations tax purposes, on the basis of the life expectancy of the donor

(i.e. transferor based taxation) whereas for estate duty purposes the calculation is based on the life expectancy of the beneficiary (i.e. recipient-based taxation).

SAICA (2011) does not support the introduction of an inheritance tax. They state that South Africa does not need any new complicated taxes and therefore any arguments for introducing an inheritance tax model cannot be supported.

6.3. Extension of CGT and abolishment of estate duty

Ger (2012) suggests that the best alternative may be to broaden the existing CGT regime and to abolish estate duty altogether. His reasoning behind this suggestion is that CGT is a globally understood and accepted tax which is easy to collect and administer as it is merged with income tax. He further suggests that a broadening of the CGT regime would prevent the situation where tax is levied in two countries as there are numerous double taxation agreements in place. He further adds that from the perspective of the fiscus, the yield from CGT may exceed that of estate duty as capital gains increase over time.

SAICA (2011) is in favour of the extension of CGT and abolishment of estate duty. They give a number of reasons why CGT is a superior tax to estate duty.

1. It is internationally understood and accepted.
2. It has a reasonably wide tax base.
3. It covers all events treated as disposals, for example becoming a non-resident for tax purposes, transferring assets and donating assets. Also included are donations, sales or any transfer of assets into trusts.
4. Collections from CGT will increase as time advances from 1 October 2001.
5. CGT has been collected from 2001 and although this cannot be measured, as it is aggregated into taxable income, this is a tax which is relatively easy to collect and has contributed to the National Budget since 2001. It would be better to retain this source of income which is

globally acceptable rather than eliminating CGT on death and retaining estate duty.

6. CGT does not allow a deduction for debts and mortgages as is the case with estate duty.
7. It is an equitable tax as the greater the value of the assets the more CGT will be payable.
8. It is relatively easy to administer as it is merged with income tax. No additional administration is required. In any event there are very few SARS personnel currently allocated to the administration of estate duty.
9. An extensive excellent comprehensive guide to CGT is available from SARS.
10. It is a modern tax compared to an archaic tax like estate duty which has not kept pace with significantly changed domestic legislation.
11. Probably the most important advantage of CGT is that it is included or covered by most Double Tax Treaties on income and capital (DTA's). This means that none of the nearly seventy DTA's need to be renegotiated, unlike Death Model Treaties which are not common in all countries around the world. These Death Model Treaties are hugely inadequate, predating the OECD Death Model and written when South Africa levied tax on a source basis of taxation.
12. The physical presence and ordinarily resident tests cover CGT. This is not the case with estate duty which refers to persons ordinarily resident and this is mirrored in the Death Model Treaties. Assets of non-residents who only become physically present in SA do not fall into the estate duty net, but any capital gains made in respect of these assets are subject to CGT as they fall under the definition of residency in the Income Tax Act.
13. CGT makes provision for indirect interests in immovable property especially in regard to non-residents. The Estate Duty Act and the Death Model Treaties all do not adequately deal with this situation. This is important as shares held at death in a foreign company holding SA immovable property will not be included in the SA tax net for estate

duty purposes; however CGT has legislation to deal with this situation, namely paragraph 2(b) of the Eighth Schedule to the Act.

14. All the anti-avoidance rules in the Act are applicable to CGT.

Jacobs (2012a) states that most commentators are in agreement that if estate duty were to be abolished one such consideration would be that it would be replaced and the obvious choice has been possible changes to CGT. In his opinion, such a dispensation could counter both ideological and fiscal arguments for the retention of estate duty. The regime would have to be extended in respect of one or more aspects, namely the extension of the group of assets that fall into the CGT net, the increase of the inclusion rate, and/or the increase of the tax payable to align the actual effective rate of the tax to donations tax and estate duty which is currently at 20 percent. He states that CGT is relevant to estate planning, firstly because CGT becomes payable on all those assets which are included assets for CGT purposes during one's life on the basis that it becomes automatically payable on death in terms of a so-called deeming provision.

6.4. Retention of estate duty and abolishment of CGT on death

SAICA (2011) provides an alternative suggestion to the abolishment of estate duty and the extension of CGT, being the retention of estate duty and abolishment of CGT on death. They state that this system is not uncommon and that many countries that levy CGT do not treat dying as an event triggering CGT. SAICA (2011) raises a few concerns with this suggestion. Firstly, they state that in order to avoid double taxation donations will also need to be exempt from CGT. They suggest that CGT will have to be amended in that the market value used for donations tax must still be the base cost for the donee for a subsequent disposal. Secondly, with regard to the base cost for beneficiaries and heirs, they state as follows:

Under the current regime heirs or beneficiaries will acquire assets at market value in terms of paragraph 40 of the Eighth Schedule. This means they take on the stepped up value as CGT has been paid up to that amount (as well as estate duty on full market value). It is submitted

that this paragraph will have to be reworded allowing the heir to deem the market value for estate duty purposes to be the base cost. To ensure equity it could be broader in that all inheritances or gifts received have a base cost of market value on the date of the accrual (SAICA, 2011).

With regard to estate duty, SAICA (2011) suggests that, should it be retained, there are various sections that will have to be amended. They further suggest that the rate of estate duty cannot be increased as it is already above the 15 percent level for a capital transfer tax. They also suggest that personal use assets be ignored for estate duty purposes perhaps up to a general exclusion value of R50 000.

With regard to this suggestion SAICA (2011) makes the following general points:

- in view of the fact that estate duty is a low yielding tax, the Act will have to be scrutinised in order to make the administration as simple and cost effective as possible. For the same reason the Estate Duty Act has been tried and tested and is fairly simple to administer, this might be a point in favour of retaining estate duty and abolishing CGT on death. The retention of CGT on death and abolishment of estate duty would necessitate more legislation changes than the other way around;
- it seems as if most overseas countries are used to CGT and death taxes being two separate taxes. From a viewpoint of attracting investments it might be worthwhile to remain with the system that is known to most overseas investors, even though the replacement of estate duty with CGT on death might have the same effect from a fiscal point of view;
- section 5 of the Estate Duty Act should be amended, more specifically regarding the valuation of limited interests on death. Present legislation creates loopholes where limited interests for a limited period can be used in order to avoid estate duty. This can be rectified by way of a simple amendment; and

- in order to accommodate the taxpayer, consideration can be given to exempt the proceeds of life insurance policies on the life of the deceased up to a certain amount or even up to the amount of estate duty payable in the estate. This will also assist taxpayers in providing liquidity in order to pay estate duty.

6.5. Consequences of the abolishment of estate duty

Based on the discussion above, it appears that the favoured approach is the extension of CGT and the abolishment of estate duty. It is therefore necessary to consider the consequences of the abolishment of estate duty. Frith (2008) states that currently a family with net assets up to R7 000 000 can avoid estate duty. In our country many people would say that family wealth of R2 000 000 is a large amount and if asked, would agree with the levying of estate duty. It would take more than a brave Minister of Finance to get rid of estate duty. According to Jacobs (2012a) the abolishment of estate duty remains a sticky point, more so however for ideological reasons than fiscal reasons.

Bornman (2010: 78) lists a number of arguments against the abolishment of estate duty.

1. Even though the revenue contribution of estate tax is not viable, a modest source of revenue is not to be “thrown away” only on the basis that it does not raise a significant amount of revenue: there must exist other convincing reasons for abolition. It is argued that a tax that appears to be working, even if it raises minute revenue from wealthier people who do not care to have proper estate planning tools in place, is just what is needed in the society.
2. Estate tax raises a fair distribution of [the] tax burden by raising revenue from wealthy people. Death and taxes are inevitable and so is the transfer of property. For as long as it only affects wealthy people it does not interfere with the welfare of the descendants of the deceased.
3. It is essential to keep estate tax as it is a tax on capital and there is no reason to abolish estate tax. The correct allocation of a tax burden

requires that the wealthy be taxed and a repeal of a tax that applies only to the wealthy is intrinsically reprehensible and, in the end, ends up shifting more of the tax burden to the less wealthy.

4. The marital deduction offers protection to the surviving spouse.
5. Estate tax is a delayed tax and only payable on death. It allows persons to increase their savings for their own consumption as the tax is not levied until death.
6. If estate tax is abolished it will be regarded as a giveaway and as favouring the wealthy.

Ger (2012) also mentions some implications of abolishing estate duty, namely that adjustments would have to be made to the CGT regime to ensure a similar stream of revenue as provided for by estate duty. For example, life insurance, which is currently subject to estate duty but not CGT on death, would have to be included in a broadened CGT regime. In addition, if estate duty is abolished, it would be necessary to consider doing away with donations tax for the same reasons as those cited above. He states that donations tax is in many ways a sister tax to estate duty as it too levies a duty on the transfer of wealth, the difference being that the transfers it targets occur before death. The problem, however, is it too intrudes on the territory of CGT, resulting in double taxation. On the basis that the making of a donation is also treated as a disposal for CGT purposes, that triggers both CGT and donations tax.

With regard to the administration of deceased estates, as discussed in chapter 3, if estate duty is repealed, the administration of estates will still have to be carried out by the executors of the estates and the Master's office. As before, SARS will have to assess the deceased up to the date of death and the only duty that SARS will no longer perform is the assessment of the estate duty liability.

6.6. Conclusion

The three suggested alternatives to estate duty made by the various commentators may be summarised as being firstly, the introduction of a new recipient-based inheritance tax, secondly the extension of CGT and the abolishment of estate duty and thirdly the retention of estate duty and the abolishment of CGT on death. SAICA (2011) and Ger (2012) favour the second option, namely the extension of CGT and the abolishment of estate duty.

It is submitted that the second suggestion should be accepted as introducing a new inheritance tax will be complicated and will delay the resolution of the current problems as new legislation will need to be drafted and eventually passed. The retention of estate duty and abolishment of CGT on death, being the third option, is more favourable than the introduction of a new inheritance tax but it is submitted that the changes that would need to be made to the current Estate Duty Act are so extensive as to render the exercise impractical. It is submitted that a cause for concern should estate duty be abolished is that, as pointed out by Ger (2012), donations tax may then have to be abolished as well. This will mean that CGT will be the only real wealth tax left in South Africa and its provisions would have to be extended accordingly. Whether or not having the sole wealth tax provisions contained in the Income Tax Act would be an advantage or a disadvantage is debateable.

Which way the Treasury will choose to go to address the question of estate duty is unknown at this stage. The Treasury needs to place an emphasis on foreign investment and should therefore make its decision according to which option will encourage the most foreign investment. While the favoured option is currently the extension of CGT and the abolishment of estate duty it may be found that the retention of estate duty and abolition of CGT on death may be the better option based on SAICA's submission that most foreign countries are used to the idea of CGT and death taxes being separate.

In the concluding chapter the conclusions reached throughout this thesis will be set out.

CHAPTER 7

CONCLUSION

It is submitted that it has been established in this thesis that estate planning, in its various forms, has had a profound effect on the effectiveness of estate duty as a wealth tax in South Africa.

In chapter 2 the history of the three wealth taxes, namely donations tax, CGT and estate duty, were outlined. Of significance was the fact that there has been much debate over the years, particularly by the various Commissions of Enquiry, regarding the wealth tax system and that many suggestions made to improve the system have not been implemented. Donations tax, which was analysed in chapter 2, appears to be a relatively useful tax when considered on its own. However, the problem of double taxation that arises in some instances with CGT and estate duty is problematic. The fact that there are discrepancies between the donations tax provisions in the Income Tax Act and the estate duty provisions in the Estate Duty Act is also a cause for concern. CGT, which was also analysed in detail in chapter 2, was shown to be a complicated but comprehensive tax. The issue of double taxation aside, CGT is globally understood and is a good source of revenue for the fiscus.

Estate duty was analysed in chapter 3 and it was shown that the Estate Duty Act is an overly complicated piece of legislation which can only be effectively interpreted by knowledgeable professionals. Of importance is that there is no anti-avoidance provision in the Estate Duty Act and that the Act itself provides many opportunities for avoidance by way of the deductions allowed in section 4.

In chapter 4 the problems associated with estate duty were set out. These problems were firstly, the double taxation problem, secondly the limited revenue and cumbersome administration problem, thirdly, the estate planning problem and fourthly, the lack of uniformity between estate duty and the other wealth taxes currently in force. It should be noted that problems one to three

were identified by SARS but the fourth problem was identified by Muller (2010).

With regard to the double taxation problem, this problem was identified as being of major significance particularly in the context of CGT. Due to the fact that death is considered to be an event for CGT purposes double taxation arises. The CGT issue aside, double taxation also arises in that people pay tax all of their lives only to have their estates taxed after death. Probably the biggest implication of the double taxation problem is that as South Africa is the only country in the world to levy both CGT and estate duty on death, foreign investment is negatively affected.

With regard to the second problem, namely the limited revenue and cumbersome administration, the conclusion reached was that the revenue brought in by estate duty is indeed limited as was evidenced by the statistics provided by The National Treasury and SARS (2012), the increase between the 2010/2011 and 2011/2012 tax years aside. It is submitted that this limited revenue is caused by the fact that taxpayers engage in estate planning schemes in order to avoid the payment of the tax as it is inherently flawed due to the double taxation problem. The submission by SARS that estate duty is cumbersome to administer was not shown to have any merit and in fact the opposite appears to be true. The systems in place in both the Master's office and SARS are well established and very few SARS employees need to be tasked with the collection of estate duty.

The third problem, being estate planning, was discussed briefly in chapter 4 and then analysed in detail in chapter 5. The fourth problem, being the lack of uniformity in the application of the various taxes, was shown to be of significance as the lack of integration between the taxes results in double taxation and the contradictions in the various valuation methods and application of exemptions allows for avoidance and opens the entire system up to criticism.

With regard to estate planning, in chapter 5 it was established that taxpayers utilise estate plans for three reasons namely fiscal reasons, personal and family reasons and commercial reasons. It was established that the vast majority of taxpayers enter into estate plans for fiscal reasons namely the minimisation of their potential liability for estate duty at death. Various estate planning methods were discussed namely wills, donations, bequests to a spouse, bequests to Public Benefit Organisations, insurance policies, trusts, companies, interest-free loans and fideicommissa and usufructs. These methods were shown to be complicated and in the case of trusts and interest-free loans, potentially open to attack under the anti-avoidance provisions in the Income Tax Act. It was established that estate planners should engage a professional who is familiar with the advantages and disadvantages of the various methods and knowledgeable enough to utilise the method that would best suit the aims of the individual or family concerned. It was further established that estate planning with the aim of minimising or avoiding liability for tax should not cross the line and become tax evasion. Chapter 5 concluded with the finding that estate planning, in its various complicated forms, has indeed had a major impact on the effectiveness of estate duty as a wealth tax in South Africa. Based on that finding alternatives to estate duty were considered in chapter 6.

In chapter 6 it was established that there are three viable options available to SARS as replacements to the current system of taxation upon death. The first option is the introduction of a new recipient-based inheritance tax. This option was found to be the least likely to be implemented due to the fact that it will be impractical for new legislation to be drawn up and having a new complicated system of taxation on death will compound the problem currently faced. The second option is the extension of CGT and the abolishment of estate duty which is submitted to be the best option currently available. The third option was the retention of estate duty and the abolishment of CGT on death which is submitted to be viable should it be found that estate duty cannot be abolished for ideological or practical reasons. SAICA (2011) made the important comment that the third option may be the most likely to please

foreign investors as it mirrors the systems in place in a number of foreign countries.

As the second option, namely the extension of CGT and abolishment of estate duty, is favoured by various writers on the topic (SAICA, 2011 and Ger, 2012) the consequences thereof were considered. Ger (2012) suggests that if this option is chosen it will have to be established whether or not donations tax should be abolished as well as it is considered to be a sister tax to estate duty. Essentially this would mean that only one wealth tax exists in South Africa. As CGT is globally understood and the Eighth Schedule is a comprehensive and well-drafted piece of legislation the extension thereof to cover taxation on death should not be too difficult. The abolishment of estate duty, however, may be difficult for ideological reasons as the public may mistakenly believe that the wealthy are being favoured and there may be resistance to the abolishment of such an old and seemingly well-established piece of legislation.

It is submitted that the goals of the research were met in that firstly, the way in which the present system of taxation on death, with a focus on estate duty, came about was established. Secondly, the problems associated with estate duty, as identified by SARS, were analysed and an additional problem, namely lack of uniformity (as identified by Muller (2010)) was discussed. Thirdly, the concept of estate planning was discussed with emphasis on what estate planning means, how it has developed and what steps are taken by estate planners to minimise estate duty. Fourthly, it was established that estate planning with the aim of minimising estate duty liability has negatively impacted on the effectiveness of estate duty as a wealth tax in that there are numerous effective methods in place which are utilised regularly by estate planners to achieve that aim. On the basis of the four goals set out above the final question of whether estate duty has been rendered so ineffective that it ought to be abolished was answered in the affirmative. The alternatives to estate duty were discussed with the final conclusion being that the best approach would be for SARS to extend the current system of CGT and to abolish estate duty.

The question that remains unanswered is which way SARS will choose to go in remedying the problematic *status quo*. It is submitted that this question will only be answered once the research undertaken by the Treasury on this topic is released and a decision is made. How long it will take for the current system of taxation on death to be rectified is unknown.

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