

**AN EVALUATION OF THE USE OF TESTAMENTARY AND  
*INTER VIVOS* TRUSTS AS ESTATE-PLANNING VEHICLES AND  
THE DEVELOPMENT OF HOLISTIC ESTATE-PLANNING  
MODELS INVOLVING THE USE OF THESE TRUSTS**

A thesis submitted in partial fulfillment of the requirements for the degree of

**MASTER OF COMMERCE (TAXATION)**

of

**RHODES UNIVERSITY**

by

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January 2006

## Abstract

Trusts are subject to multiple forms of legislative regulation dealing with taxation and governance. Trusts were widely used by planners as tax-avoidance shelters. Tax legislation was amended to subject trusts, other than special trusts as defined, to the highest income tax rate of forty percent, in terms of section 5(2) of the Income Tax Act, 58 of 1962. The *inter vivos* trust is also subject to a wide range of anti-avoidance measures, including those contained in sub-sections (3) to (8) of section 7 of the Income Tax Act and Part X of the Eighth Schedule to the Act, as well as the general anti-avoidance measures in section 103. These measures impact negatively on the use of trusts for estate-planning purposes. The research objective was to evaluate the use of testamentary and *inter vivos* trusts for estate-planning purposes and to develop a holistic estate-planning model incorporating these planning instruments. Both the testamentary trust and the *inter vivos* trust were evaluated against broad principles of effective estate planning and the taxes and duties applicable to them. The research also reviewed the writings of financial planners on various techniques and models used for estate planning, as well as case studies documented in the literature. The research developed and evaluated holistic estate-planning models incorporating testamentary trusts and *inter vivos* trusts, respectively. By neutralizing the effects of various taxes and duties, it was demonstrated that it is possible to develop an estate plan that satisfies most of the requirements of effective estate planning.

## **CHAPTER ONE: INTRODUCTION**

### **1. Context of the research**

The popularity of especially the *inter vivos* trust has, during the past years, increased significantly, primarily as a result of its perceived advantageous tax implications (Pace and van der Westhuizen, 2002:B1). No sooner had the trust come to fulfill its major vocation of income and estate duty avoidance than it inevitably became a target of anti-avoidance measures (Blue Chip, 2005:74). Huxham and Haupt (2002:527) and Davis et al. (2005:18-3) refer to the recommendations made by the Margo Commission and the Katz Commission, regarding to the use of trusts as anti-avoidance vehicles. Davis et al. (2005:18-6) indicate that the Katz Commission's report contains very few positive recommendations. It rejected the introduction of a general anti-avoidance measure and it rejected specific legislation to remedy the problem of interest-free loans. The Katz Commission proposed only one concrete set of recommendations, namely, a provision to deal with generation-skipping trusts and provisions to deal concomitantly with capital from a trust. The Commission did not see the pressing need to combine donations tax and estate duty into a single statute but left them to the discretion of the South African Revenue Services (referred to hereafter as SARS). With regard to the Margo Commission, Davis et al. (2005) indicate that few of these recommendations were introduced and that the Government had taken the opposite approach by making changes to the rates applicable to estate duty.

A generation-skipping trust is a trust that is primarily used to defer the payment of estate duty and other taxes. This is achieved through the trust deed that specifically provides for the transfer of capital and income from one generation to another in a manner which defers the liability for taxes. The Katz Commission recommended that trusts be subject to tax at periodic intervals on the value of their net assets, however, legislation giving effect to this recommendation has been widely accepted but has not been forthcoming.

Notwithstanding the recommendation of the Katz Commission and the Margo Commission, the Commissioner for SARS has over the years made several changes to a wide variety of taxes applicable to trusts. Trusts are still subject to the following taxes: donations tax, income tax and capital gains tax in terms of the Income Tax Act, no. 58 of 1962 (hereafter referred to as the Income Tax Act), value-added tax in terms of the Value-Added Tax Act, no. 89 of 1991 (hereafter referred

to as the VAT Act), estate duty in terms of the Estate Duty Act, no. 45 of 1955 (hereafter referred to as the Estate Duty Act) and transfer duty in terms of the Transfer Duty Act, no. 40 of 1949 (hereafter referred to as the Transfer Duty Act). These taxes, together with the provisions of the Trust Property Control Act, no. 57 of 1988, provides the basis on which tax planning takes place. In terms of the Commissioner's Practice Note 21, a trust has to be registered for tax purposes. Trusts other than testamentary trusts are also subject to a wide range of anti-avoidance measures as laid down in the Income Tax Act.

In terms of the definition offered by The Hague Convention on the Law Applicable to Trusts and their Regulation (10 January 1986), the term 'trust' refers to the legal relationship created *inter vivos* (during one's lifetime) or on death by a person (the settlor) who places assets under the control of another (the trustee) for the benefit of a beneficiary or for a specified purpose (Scholtz, 2005:39). It therefore follows that there are two types of trusts, namely, the *inter vivos* trust and the testamentary trust. A trust is an *inter vivos* trust if it is established during the settlor's lifetime; it is a *mortis causa* (or a testamentary) trust if it is established on 'account of death'. The *mortis causa* trust is referred to as the testamentary trust (which includes a special trust) for the purpose of this thesis.

A special trust is defined in section 1 of the Income Tax Act, as a trust created solely for the benefit of a person who suffers from mental illness (as defined) or any serious physical disability where such illness or disability incapacitates such person earning sufficient income for the maintenance of such person or from managing his or her own financial affairs. The definition of a special trust was, with effect from 1 March 2002, extended to include a trust created in terms of the will of a deceased person, solely for the benefit of beneficiaries who are relatives (as defined) in relation to that deceased person and who are alive on the date of death of deceased person (including any beneficiary who has been conceived but not yet born on that date), where the youngest of those beneficiaries on the last day of the year of assessment of that trust is under the age of twenty one years. Estate planning opportunities involving the use of special trusts are dealt with in chapter four.

The following table shows the tax rates applicable to trusts other than a special trust for the period 2001 to 2005. (For the sake of convenience, reference to trusts for the purpose of this table will imply trusts other than special trusts).

<b>Tax</b>	<b>Prior to 1 October 2001</b>	<b>2002</b>	<b>2005</b>
Income tax in terms of section 5(2) of the Income Tax Act.	32% on taxable income up to R100 000 and 42% on taxable income in excess of R100 000	32% on taxable income up to R100 000 and 42% on taxable income in excess of R100 000	40%
Value-added tax in terms of section 7 of the Value-Added Tax Act.	14%	14%	14%
Donations tax in terms of section 64 of the Income Tax Act.	25%	20%	20%
Capital gains tax in terms of paragraph 10 of the Eighth Schedule to the Income Tax Act.	Not applicable	Inclusion rate of 50% (effective rate depends on the taxable income)	Inclusion rate of 50%, maximum effective rate 20%
Estate duty in terms of the First Schedule to the Estate Duty Act.	25%	20%	20%
Transfer duty in terms of section 2(a) of the Transfer Duty Act.	10%	10%	10%

It is also necessary to compare the above tax rates with that of a company and a natural person.

Companies:

Companies pay income tax at a rate of twenty-nine percent in terms of section 5(2) of the Income Tax Act, as well as Secondary Tax on Companies (STC) at a rate of 12,5 percent on net dividends (dividends distributed, less dividends received) in terms of section 64B(2) of the Income Tax Act. The inclusion rate of a capital gain is the same as that of a trust. However, the effective rate of taxation in respect of a capital gain is 14,5 percent (29% x 50%), which is much lower than that of a trust.

Natural persons:

In terms of section 5(2) of the Income Tax Act, income tax is levied at a maximum marginal rate of forty percent on taxable income in excess of R300 000 (in 2005 year of assessment), while taxable income below that amount is taxed on a sliding scale. With regard to capital gains tax, the inclusion rate of a capital gain is twenty-five percent in terms of paragraph 10 of the Eighth Schedule to the

Income Tax Act. In effect, this means that a capital gain will be subject to income tax at a maximum effective rate of ten percent, which again is much lower than that of a trust.

As can be seen from the above, a trust pays the highest rate of income tax. Clearly this has a severe negative effect on the use of trusts as estate planning vehicles. Other provisions in the Income Tax Act, which impact directly on *inter vivos trusts* are the tax avoidance measures in sections 7(3) to 7(8). These provisions relate to donations, settlements and other dispositions and, where the circumstances addressed in the sub-sections apply, deem the income flowing from the asset donated to, *inter alia*, a trust to have accrued to the donor.

Noting the changes made to the tax rates applying to trusts, financial planners and authors of articles on taxation started developing new tax and estate planning models and have published various case studies. Some of these models have discounted the use of trusts as sound tax planning vehicles while others have not.

In a case study published by David Clegg (Star: 2001), the dual effect of capital gains tax and estate duty was illustrated. This study does not illustrate the overall effects of all the taxes applicable to trusts nor does it offer alternate tax planning strategies. In a case study published by Deidre Pieterse (De Rebus, 2002:30), the focus fell on capital gains tax. This study also fails to offer alternate planning strategies. In a model developed by Davis et al. (2005) to illustrate how a company or a close corporation could be integrated into an estate plan, the focus fell on control of trust property. This model does not integrate the effect of all applicable taxes nor is an attempt made to optimize planning techniques for each of the planner's assets. Although the model provides for the application of bequests to the surviving spouse as an estate-planning instrument, the model lacks a holistic dimension.

Professor Goldswain's case study (UNISA: 2002) provides an elaborate plan to save estate duty and addresses some of the shortcomings found in the model developed by Davis et al. The major shortcoming of Professor Goldswain's model is that the focus falls chiefly on the saving of estate duty. Although Professor Goldswain highlights the need to be cognizant of the various taxes applicable to trusts, he makes no reference to the manner in which this should be done.

The writer of this thesis is of the opinion that a categorization of the planner's assets into growth assets and non-growth assets, the marital status of the planner, the age of the beneficiaries, projecting the planner's balance sheet as at a predetermined future date and the use of techniques to optimize the planner's tax position are just some of the factors which would impact on the development of a holistic tax planning strategy.

Architects of estate planning models have warned planners to be mindful of the possible implementation of the recommendations made by the Katz Commission, but have not made any attempt to provide the mechanisms to do so. In this regard the need for research is vital. The writer of this thesis believes that in-depth research needs to be done to develop a holistic tax and estate-planning model that will address the shortcomings found in case studies and models mentioned above.

Many individuals make use of trusts for estate planning, including members of the farming community. Often these trust deeds are not regularly reviewed to take account of legislative changes. A holistic tax and estate-planning model will assist in the effective evaluation and amendment of the provisions of existing trust deeds.

## **2. Goals of the study**

A detailed and systematic examination of various textbooks, articles, models, relevant legislation, case studies and case law will be undertaken for the purpose of:

(a) answering the following questions:

1. Will trusts continue to serve as effective tax planning vehicles?
2. What are the appropriate planning techniques with regard to the use of trusts? and

(b) developing a holistic tax planning model.

The ultimate purpose of this study is to serve as a guide to the relevant provisions of various statutes as well as tax and estate planning techniques for attorneys, accountants, financial advisers and the community at large who have to deal with tax and estate planning.

### 3. Limitations of the study

The scope of this study was confined to the various taxes applicable to resident testamentary trusts and resident *inter vivos* trusts. The taxes referred to include: income tax, donations tax and capital gains tax in terms of the Income Tax Act, value-added tax in terms of the Value-Added Tax Act, estate duty in terms of the Estate Duty Act, and transfer duty in terms of the Transfer Duty Act. The scope of this study was limited to the application of the various taxes to tax and estate planning. The legal interpretation of all Revenue Statutes falls outside the scope of this study. This study was further confined to beneficiaries and founders of trusts, who are natural persons resident within the Republic of South Africa.

### 4. Research methods and design

This study was intended to develop and validate a tax-planning model and to provide answers to the research questions. To meet with the objective of the research, the research was designed as follows. Owing to the fact that this thesis required a detailed study of various relevant Acts, commentary by various authors on the legislation, as well as models and case studies presented by planners, the approach to the research was qualitative and was based on documentary data. The research process entailed a detailed and systematic critical analysis of data for the purpose of identifying and verifying information, identifying themes and analyzing planning models. Bearing in mind that the information presented in data other than legislation could be biased with regard to the viewpoint of writers on trusts, the data was categorized and analysed against the framework of relevant legislation.

This research entailed the use of triangulation, that is comparing multiple data sources in search of common themes, and therefore the validity of the research was strengthened. As all the data were in the public domain, no ethical considerations arose.

### 5. Conclusion

An individual has to continuously amend his or her estate plan because of amendments that are made to tax legislation every year, as well as changes in the financial position and the marital status of the individual. Not being mindful of these changes, a planner could find himself or herself in a

predicament. In this regard, each estate planner should, at the least, have a basic estate plan flexible enough to incorporate such changes. This study therefore aimed at providing tax and estate planners with a holistic tax planning model, as well as equipping taxpayers with the necessary knowledge essential for sound estate planning.

## 6. Outline of the study

This chapter has briefly outlined the context of the research, stated the research goals and the methods and techniques to be used to achieve the research goals.

Chapter two outlines that part of the research that focused on identifying the principles of estate planning as well as the nature and definition of trusts in terms of legislation that governs trusts.

Chapter three outlines the various taxes applicable to trusts. An evaluation of these taxes entailed an investigation of the tax consequences facing each party to a trust at each stage in the 'life cycle' of a testamentary trust as well as an *inter vivos* trust. This chapter is divided into two sections, namely, sections A and B. The taxation of the testamentary trust is dealt with in section A and the taxation of the *inter vivos* trust in section B.

Chapter four chapter sets out the results of the research that focused on identifying the stages that are involved in developing a holistic estate-planning model for a testamentary trust and an *inter vivos* trust. Because the research distinguishes between the testamentary trust and the *inter vivos* trust, the outcome of the evaluation is outlined in two sections, namely, sections A and B.

In chapter five conclusions are drawn from the study and recommendations are made. These recommendations are aimed at simplifying the estate planning process. Chapter five also contains constructive suggestions and cautionary remarks that are directed towards estate and tax planners.

## **CHAPTER TWO: ESTATE PLANNING AND THE NATURE OF TRUSTS**

### **1. Introduction**

Estate planning is a complex process that requires the expertise of qualified planners and advisers. Abrie et al. (2000:6) highlight the need for sound planning by stating that few things are as tragic as poor planning. The estate owner takes the trouble to do the planning, but due to poor advice, incorrect assumptions or inflexible plans that cannot be adapted to changed circumstances, the plan turns out to be less than satisfactory.

The planner or his adviser should display a high level of skill in effecting estate planning and such skill should be complemented by a thorough knowledge of relevant legislation and the principles of estate planning. In this regard, this chapter outlines the essentials of estate planning and provides the conceptual framework relating to trusts.

### **2. Estate planning**

#### **2.1 Definition**

Meyerowitz (1965:1) has described estate planning in the following terms: “The arrangement, management and securement and disposition of a person’s estate so that he, his family and other beneficiaries may enjoy and continue to enjoy the maximum from his estate and his assets during his lifetime and after his death, no matter when death may occur.” Expounding on this definition, Davis et al. (2005:1-3) refer to the following points that deserve special attention:

- It is implicit within the definition that planning take place timeously and in an orderly fashion;
- No mention is made in the definition of the saving of estate duty: on the contrary, stress is laid upon the “arrangement, management and securement and disposition” of the estate. As noted, estate planning is not concerned solely or even mainly with the minimization of estate duty, but has a wider concept. The planning process must therefore always take cognisance of the fact that estate duty, and the basis upon which it is levied, are but one part of the changing environment against which estate planning is performed.

As noted in the above commentary by Davis, estate planning is a far wider concept and as such, should meet with the objectives stated below.

## **2.2 Objectives and advantages of estate planning**

The objectives and advantages of estate planning are summarized by Goldswain (2003:2):

(a) Flexibility

Flexibility in an estate plan enables the planner to make provision for changes not only in the legal or tax environment, but also for personal and family circumstances. Unduly rigid estate plans can cause unnecessary hardship for the dependants of the planner whilst too much flexibility can lead to hardship for the planner (if he is still alive). Therefore a balance is needed and this is achieved by building certain safeguards into the plan.

(b) The minimization of estate duty

This can only be achieved by having a good knowledge of the Estate Duty Act. A good estate plan also avoids the problem of the same property being subjected to estate duty a second time in the hands of the beneficiaries.

(c) The minimization of income tax

In view of certain of the deeming provisions of section 7 of the Income Tax Act, an estate plan does not normally lead to immediate income tax benefits while the planner is still alive. However, significant savings can be achieved for later generations.

(d) The minimization of other taxes

This objective would include a consideration of the effect of new taxes such as Capital Gains Tax (CGT).

(e) The provision of liquidity

It is important that there is sufficient liquidity after the death of a planner so that liabilities can be met without having to dispose of assets at, possibly, an inappropriate time.

(f) The provision of capital and income for dependants

The capital generated during a taxpayer's lifetime should be sufficient to produce income for dependants particularly where a regular income flow such as a salary or pension ceases on death. The avoidance of estate duties goes some way towards alleviating the problem.

(g) The provision of retirement capital and income

Care must be taken that a planner on retirement is not cut off from the flow of income generated from the growth assets included in the plan. He must still be able to live in relative comfort.

(h) Capital appreciation and income generation

This goes hand-in-hand with liquidity and the provision of retirement capital and income. Commercial considerations should not be dismissed especially in view of the fact that many estate plans legally separate the planner and his growth assets.

(i) Protection against insolvency and inflation

Protection against insolvency is more a by-product of estate planning than an objective. Protection against the effects of inflation should not be dismissed in view of the fact that estate planning involves long-term considerations.

(j) The facilitation of the administration of the estate

The administration of the estate after the death of the planner is most important especially where the beneficiaries of the deceased are unable to take control of the assets, either temporarily or permanently, for example, children and minors. Simplicity and flexibility are most important factors if the administration of the estate is to run smoothly after the death of the planner and the original advisors.

(k) Business continuity provisions

A business owned by a trust can continue indefinitely. The imposition of a trust into the estate planning structure can prevent a spouse or child from taking control of the business yet allow the business to continue under professional management until such time as the trustees think that the spouse or child is capable of running the business. Allied to this is

the fragmentation of control that can ensue when an interest of this nature is left to a number of heirs.

Although it may not be possible in certain cases to meet with all the objectives mentioned above, advisors and consultants should aim at achieving most of the objectives. There are instances where advisors have for their own opportunistic reasons, marketed the need to achieve a specific objective while dismissing the importance of other objectives. For example, an assurance advisor will recommend the use of an assurance on the grounds of maintaining a liquid estate while totally ignoring tax implications. In this regard, assurance planning and even tax planning are not independent processes. Tax planning, assurance planning and retirement planning are inextricably interwoven into the fabric of estate planning.

### **2.3 Tax planning within the context of estate planning**

The most important, single rule in tax planning according to Kruger and Scholtz (2003:01) is that one must not lightly allow tax considerations to distort a sound commercial bargain. These authors further suggest that victory in achieving an optimum tax position with regard to a particular tax should not be hailed as conclusive. An attempt to neutralize the effects of all relevant taxes concerned ought to be the objective. Tax planning should aim at neutralizing the effects of various taxes without discounting the economic or commercial objectives of the plan. Tax planning should not deprive the planner from enjoying his hard-earned assets.

Davis et al. (2005:1-3), commenting on the definition of estate planning, state that the person whose estate is being planned must not, through an estate plan, be cut off from the enjoyment of the assets he has built up during his lifetime. Rigorous tax planning should not create liquidity problems for the planner. It is therefore imperative not to view tax planning in isolation, but to recognize tax planning as an integral part of the estate planning process. Abrie et al. (2000:126) indicate that in practice, estate, financial and tax planning go hand in hand.

The question a financial planner needs to ask is: Which estate planning vehicle best meets with the overall objectives of an estate plan? In this regard, the trust, and in particular the discretionary *inter vivos* trust, has in many ways become the hallmark of most modern estate plans. Davis et al. (2005:

14-3) warn that this should not be taken to mean that trusts are indispensable in estate planning, or that every estate plan should be built on this foundation. In view of this statement, an evaluation of the use of trusts as estate planning vehicles would be the obvious yet necessary function of the advisor. A diagnostic evaluation should remedy shortcomings by offering alternative strategies to the use of trusts. An evaluation of the use of trusts should commence by exploring the conceptual background surrounding trusts.

### **3. Trusts**

#### **3.1 Definition**

It is important to distinguish a trust in the broad sense of the word from a trust in the narrow sense of the word. Abrie et al. (2000:26) state that the importance of the distinction lies in the fact that the legal rules, which are applicable to the trust in the narrow sense of the word, are not applicable to the trust in the broad sense of the word. The Trust Property Control Act, no. 57 of 1988 (referred to as the Trust property Control Act), for example, only applies to trusts in the narrow sense.

##### The trust in the broad sense

Honore' and Cameron (1992:2) indicate that a trust in this context is a trust which is created through any legal arrangement by which one person is to administer property, whether as an office bearer or not, for another or for some impersonal object. The principle characteristic of a trust in this sense is the fact that there is a separation between the control of the trust property and the benefits that flow from such control. For example, a father controls the property of a minor for the benefit of the minor, and may not apply the property for his own (the trustee's) benefit.

##### The trust in the narrow sense

Honore' and Cameron (1992:3) state that in the strict or narrow sense a trust exists when the creator of the trust, who is called the founder, has handed over or is bound to hand over to another the control of property which, or the proceeds of which, is to be administered or disposed of by the other (the trustee or administrator) for the benefit of some person other than the trustee as beneficiary, or for some impersonal object. The scope of this thesis is limited to trusts in the narrow sense.

### **3.2 The law applying to trusts**

Trusts are governed largely by common law. The Trust Property Control Act, no 57 of 1988 (referred to hereafter as the Trust Property Control Act), came into effect on 1 March 1989, replacing the Trust Monies Protection Act, Act no 34 of 1934 and followed an extensive study of the law of trusts by the South African Law Commission in 1987. The Trust Property Control Act aims mainly to establish firmer control over trustees and their stewardship of the trust, by the Master of the High Court.

### **3.3 The trust as a person**

Resulting from two very important cases, namely, *Joubert and Others v Van Rensburg and Others*, 2001 (1) SA 753 WLD, and *Mkangeli v Joubert*, 2002 (4) SA 36 (SCA), section 102 of the Deeds Registry Act, no 47 of 1937 now states that a trust is deemed to be a person for the purpose of registration of immovable property. The effect of this provision is that a transfer of immovable property acquired by the trustee in his or her capacity as trustee is to be registered in the name of the trust.

The Income Tax Act, the Value-Added Tax Act, and the Transfer Duty Act, provide for the recognition of a trust as a person. Because a trust does not die, the trust as such will not be liable for estate duty.

In *Mariola v Kaye-Eddie*, 1995 (2) SA 728 (W), the court held that a trust is not a legal persona but a legal institution. Davis et al. (2005:5-8(3)) indicate that trust creditors should sue the trustee in his capacity as such and, if successful, execution of judgment is against trust property only. In respect of liability for taxes, it appears that the trustee is held liable.

### **3.4 Representative taxpayer or vendor**

In terms of section 1 of the Income Tax Act, a representative taxpayer in respect of a trust shall be the trustee, that is, the person who is entitled to the receipt, management, disposal or control of such income or responsible for remitting or paying to or receiving moneys on behalf of the trust

beneficiaries. If a trust is a registered vendor as defined in the Value-Added Tax Act, then the trustee has to register as a representative vendor for value-added tax purposes.

### **3.5 Registration of the trust**

In terms of the Commissioner's Practice Note 21 issued by the Revenue Services in June 1994, a trustee is required to register the trust at the office of the Receiver of Revenue in whose area the office of the trustee is situated. Where the trustees are domiciled at different places, the trustee must register the trust at any one of the Revenue offices.

### **3.6 Parties to a trust**

There are three main parties to a trust, namely, the founder, the trustee and the beneficiary.

#### **3.6.1 The founder**

The founder can, in principle, be any natural person or corporate body. In the case of a testamentary trust the founder (the testator) must have the capacity to execute a will. In the case of a trust *inter vivos* created by contract, the founder must have contractual capacity (Abrie et al., 2000:40). Honore' and Cameron (1992) indicate that the founder himself can be a trustee and the founder can be a trust beneficiary, even the sole beneficiary. In terms of section 12 of the Trust Property Control Act, a trust founder cannot be a trustee and a beneficiary at the same time. It has to be noted that South African Law adheres strictly to the substance over form principle: *plus valet quid agitur quom quod simulate concipitor*. A trust will therefore fail if it is adjudged to be a trust in form but not in substance. In this regard it has to be noted that a trust founder who has created structures through interventions aimed at retaining control over trust property may in appropriate circumstances cause the trust to fall foul of the substance over form principle (Du Toit, 2002:5, Olivier, 2001: 224-225, *Jordan v Jordan*, 2001, 3 SA 288 (C)). Variation of the trust instrument by the founder has tax consequences occasioned by such variations or revocations. A founder is also known as a settlor or a donor. For the sake of convenience, the term "founder" will be used in this thesis.

### 3.6.2 The trustee

Trustee is defined in section 1 of the Trust Property Control Act as “any person (including the founder of the trust) who acts as trustee by virtue of an authorization under section 6 of the said Act and includes any person whose appointment as trustee is already of force and effect at the commencement of this Act”. Du Toit (2002:6) indicates that this is not a comprehensive definition. The trustee is the party who holds and administers property received from the founder or another for the benefit of the trust beneficiaries or in pursuance of an impersonal object. A trustee can be a beneficiary of the trust to which he is appointed. By virtue of the fact that a trustee holds and administers property for some person other than himself, a sole trustee may however not also be a sole beneficiary of a trust (Honore’ and Cameron, 1992:7 and 469). A trustee is bound to fulfil duties imposed on him by law and the provisions of the trust instrument, that is the will or trust deed. Trusteeship is an office and a trustee is subject to control by the Master of the High Court and the Court itself. Registration of the trust and registration as representative taxpayer and or vendor are just some of the duties of the trustee.

#### The powers of a trustee

The nature of the powers vested in a trustee through a trust instrument has relevance to the taxation of trusts. Of significance are the limitations placed on a trustee’s powers.

#### Limitations

The court, in *Braun v Blann and Botha*, 1984 2 SA 850 (A), held that only a specific power of appointment may be bestowed upon the trustee of a testamentary trust. In essence, this means that a trustee is not allowed to appoint beneficiaries in accordance to his or her preference. It therefore follows that, whereas a trustee of a testamentary trust can receive the power to appoint income and or capital beneficiaries from a class of potential beneficiaries predetermined by the trust’s founder, such a trustee cannot be granted a general power of appoint anyone as a beneficiary within his discretion. Du Toit (2002:77) indicates that in an *inter vivos* trust the conferment of a power of appointment is not subjected to the strictures of testate succession.

### Wide powers

Abrie et al. (2000:51) indicate that a trustee needs wide powers to ensure proper administration and disposal of trust property at all times. These powers could include, for example: appointment of beneficiaries in terms of the provisions of the trust instrument; sale, transfer and encumbrance of immovable property; and powers to invest trust funds. Under suitable conditions, the trust instrument can be amended by agreement or by an order of court in order to define a trustee's powers more clearly or to expand them. In this regard, powers of trusteeship must always be exercised to the advantage of the beneficiaries or in pursuance of a specified impersonal object and not to the advantage of the trustee in his personal capacity.

### **3.6.3 The beneficiary**

The beneficiary is the party who derives a benefit from the creation of a trust by the founder and the administration of trust property by the trustee. A general distinction can be drawn between income and capital trust beneficiaries; the former benefit from income or proceeds generated by the trustees' administration (for example, interest, dividends and rentals), whereas the latter benefit from the trust property or capital itself, usually upon termination of the trust (Du Toit, 2002:6). A beneficiary is nominated in the trust deed or the trustee is given the power to nominate a beneficiary provided that the class from which the beneficiaries are to be selected is stated in the trust instrument.

The following aspects regarding beneficiaries are of relevance to the taxation of trusts.

### Powers of beneficiaries

A trust beneficiary is free to reject benefits under a trust. Such rejection is frequently termed 'repudiation' or 'renouncement' by the beneficiary concerned. A beneficiary who refuses to accept a benefit after a right to the benefit has vested in such beneficiary, effects a repudiation of the benefit concerned, and at the same time, a renunciation of the right to a benefit. The act of renunciation has tax implications that are discussed later.

### Amendment of trust instrument

It has to be noted that an amendment to the trust instrument is not to be confused with the renunciation of one's rights.

### Testamentary trust

In the *Braun* case (supra.), a testamentary trust is described as a legal institution *sui generis*. In this case it was held that a beneficiary is not allowed to amend the provisions in a trust instrument although Olivier (1991) thinks otherwise. Pace and van der Westhuizen (2002:59) indicate that our courts had over the years refused to authorize departures from the terms of a testamentary trust. However, there are special cases where the Court will allow a variation of a trust instrument, for example, a totally impractical provision that requires the income to be distributed to a minor beneficiary on his or her fiftieth birth anniversary. In this case the effects of inflation are taken into account to allow for a variation of the trust instrument.

### Inter vivos trust

As a general rule, it can be said that the beneficiaries cannot vary the terms of a trust. If the beneficiaries are of age and the trust has reached the stage where the trust property is due to be distributed to them, that is, if they have obtained vested rights, they can terminate the trust or vary the terms thereof (Pace and van der Westhuizen: 2002). Pace and van der Westhuizen (2002:58) indicate that this is an obvious situation because the personal rights of the beneficiaries have changed to vested rights to the trust property. If there are minor or unborn beneficiaries, actual or potential, the consent of the Court on their behalf is necessary at common law. But under the Trust Property Control Act, the trustee or curator of a beneficiary under trusteeship or curatorship may agree on behalf of the trust beneficiary to the amendment of a provision of the trust instrument, provided the amendment is to the benefit of the beneficiary. In *Crookes NO v Watson*, 1956, 1 SA 277 (A) it was held that any variation to the trust instrument can be effected only if beneficiaries who have accepted the benefits agree to such variation. The tax implications associated with such variations by beneficiaries are discussed in chapter three.

### Vested rights and contingent rights

The type of right that a beneficiary enjoys has a direct impact on the beneficiary's liability for tax. A beneficiary could either enjoy a vested right or a contingent right.

#### Vested rights

If a trust instrument provides that a beneficiary is immediately entitled to trust income and or capital, the beneficiary obtains a vested personal right against the trustee to claim payment of trust income and or capital as soon as it becomes distributable (Honore' and Cameron, 1992: 471-472). In the case of a testamentary trust such personal right vests upon the creation of a trust at the death of the testator. In the case of an *inter vivos* trust, vesting occurs according to the construction placed on the *stipulatio alteri* by South Africa's High Court, upon the beneficiary's acceptance of the income and or capital benefit. A vested right, although an asset in the right-holder's estate, need however not constitute an immediately enforceable right – enforcement may be postponed to some time after vesting. In simple terms this means that it is the beneficiary's right to property and not necessarily the actual property itself that would form part of the beneficiary's estate.

#### Contingent right

If a trust instrument provides that a trust beneficiary's acquisition of a personal right to claim payment of trust income and or capital is not immediate but rather contingent or conditional upon the occurrence of an uncertain future event, the right to trust income and or capital will only vest in such beneficiary if and when the event or contingency has taken place or the condition has been fulfilled. Before the occurrence of the contingency or fulfillment of the condition the beneficiary enjoys a mere contingent right to trust income and or capital (which essentially amounts to no more than an expectation or *spes* and which does not constitute an asset in the *spes*-holder's estate). Such a beneficiary is often categorized as a contingent beneficiary (Du Toit: 2002). In *Hofer v Kevitt* (1996 2 SA 402 (C) 404 (C)), the court employed the term "potential beneficiary" to denote a beneficiary who has not yet accepted benefits under an *inter vivos* trust. It is submitted that the term "potential beneficiary" readily carries a similar meaning and can more often be used as a synonym (Du Toit, 2002:105).

It is also important for tax purposes to distinguish between a “contingent beneficiary” and a “contingent right”. In *Stern and Ruskin v Appleson*, 1951, 3 SA 800 (W) 805D-E), it was held that a person cannot be said to have a contingent interest in something which another may or may not choose to give him in the future. In this case the learned judge further states that there is ample authority for the view that the bare possibility of getting something in the future is not a contingent interest. Du Toit (2002:110) illustrates as follows: If a trustee has the discretion to nominate either A, B or C as income and/or capital beneficiary of a trust, the exercise of a discretion will not bestow vested rights on all three, but only on the chosen one. The writer is of the opinion that A, B and C will, at the time of being nominated in a class of beneficiaries, be regarded as contingent beneficiaries who have no rights. It is only when one of the three is chosen will a contingent beneficiary enjoy a right to income or capital.

Any other non-discretionary conditional postponement imposed by a trust founder upon the acquisition of a vested right to trust income and/or capital by a trust beneficiary will indeed render such beneficiary’s right contingent upon the fulfillment of the condition. For example, if A is awarded trust income and/or capital provided he obtains an LLB degree, the obtainment of the degree will, without more, secure a vested right to trust income and/or capital for A. A is consequently, according to the *Stern* definition (supra.), endowed with a contingent right prior to the obtainment of the degree (Du Toit: 2002).

### Bewind trust

The salient feature of a bewind trust (which can be created *inter vivos* or *mortis causa*) is the trust beneficiaries’ entitlement to ownership in trust property while the powers of control and disposal over the property are vested in the trustees.

### 3.7 Types of trust

In the Financial Advisors Development Series (FADS), (Module 5 Unit 4) trusts are classified according to the following broad categories:

- based on whether the founder is dead or alive (referring to testamentary and *inter vivos* trusts);

- based on how a trust is formed (through statute, will, court order, contract, verbal agreement or undertaking, et cetera.);
- based on where a trust is formed (resident trusts or “offshore” trusts);
- based on powers of trustees and rights of beneficiaries (encompasses public trading trusts, private trading trusts and realization trusts); and
- based on rights of beneficiaries and ownership of trust property (vesting trusts, bewind trusts, discretionary trusts).

An in-depth synopsis of each type of trust is beyond the scope of this thesis, which is limited to resident testamentary and resident *inter vivos* trusts.

### **3.7.1 Meaning of resident trust**

Davis et al. (2005:2-47) state that as far as non-natural persons are concerned, for example companies, close corporations and trusts, there is a dual test to be used to determine residency. The non-natural person qualifies as a resident, either if it was incorporated, established or formed in the Republic, or if it has its place of effective management in the Republic. In the case of a trust, the place of effective management would mean the place where the trust is administered. The Commissioner’s Practice Note 21 requires that *inter vivos* trusts be registered at the office of the Commissioner for SARS in whose area the office of the trustee is situated in order to ensure that effective control is exercised by the Commissioner for SARS over the tax liability of the donor and the beneficiaries

### **3.7.2 Discretionary trust**

In such a trust, the beneficiaries do not have any vested rights and any income or capital that they may receive, is determined purely by the discretion of the trustees. The term “discretionary trust” denotes a trust (which can be created *inter vivos* or *mortis causa*) in terms of which the trustee (or sometimes the trust beneficiary) enjoys a discretionary power in terms of the trust instrument to nominate income and/or capital beneficiaries under the trust and also to determine the extent of the award to be made to each beneficiary. The discretionary power is known as the power of appointment. The discretionary trust is an important and popular tool in estate and financial planning. The power of appointment incorporates an element of utmost flexibility into the

distribution of trust benefits and allows for the award of benefits under changing circumstances (Naidoo, 2004:3).

### **3.7.3 Testamentary trusts**

A testamentary (or will) trust comes into being when the owner of an estate dies. The founding document of the trust is contained in the deceased's last will and testament. The trust assets may comprise cash, movable and immovable assets. The beneficiaries of a testamentary trust may be capital and or income beneficiaries. The rationale behind a testamentary trust is that it allows for better management and control of assets, as well as the protection of the beneficiaries of the assets (for example, minor children). The trust can be designed to dissolve at a particular point in time – for example, when the children reach the age of twenty-one. A testamentary trust can also be set up in terms of a joint survivorship will, whereby the trust only comes into existence when the surviving spouse dies. This gives the surviving spouse the right to the assets, without interference, until he or she dies. The tax authorities take a compassionate approach to testamentary trusts established for minor children or incapacitated dependants. Such trusts are subject to income tax rates applicable to special trusts (Personal Finance, 2005:72).

### **3.7.4 Inter vivos trusts**

An *inter vivos* trust (or living trust) comes into existence while the founder is alive. An *inter vivos* trust is usually created by a contract (referred to as a trust deed or *stipulatio alteri*) in terms of which a person (the donor or settlor or *stipulans*) transfers property to trustees or *promittens* who are burdened with the obligation of administering the property for the benefit of one or more persons (the beneficiaries) until the trust is terminated upon occurrence of some specified future event (Stein, 2004:105). The trustees, who owe their appointment to the donor, must administer and distribute the income and/or capital belonging to the trust in accordance with the provisions of the trust deed. After the donor transfers property to the trust, the property ceases to be the donor's property for estate duty purposes.

### **3.7.5 Special trusts**

Prior to 1 March 2002, a special trust as defined in section 1 of the Income Tax Act was a trust created solely for the benefit of a person who suffers from mental illness (as defined) or any serious physical disability, where such illness or disability incapacitates such person from earning sufficient income for the maintenance of such person or from managing his or her own financial affairs. This designation as a special trust falls away from the beginning of the financial year during which such person dies.

The definition of a special trust has, with effect from 1 March 2002, been extended to include a trust created in terms of the will of a deceased person, solely for the benefit of beneficiaries who are relatives (as defined) in relation to that deceased person and who are alive on the date of death of that deceased person (including any beneficiary who has been conceived but not yet born on that date), where the youngest of those beneficiaries is on the last day of the year of assessment of that trust under the age of twenty one years. Davis et al. (2005:6-8) emphasize that, in view of the amendment, a special trust must be a testamentary trust.

## **4 Conclusion**

This chapter has dealt with the principles of estate planning and has briefly referred to the fact that tax planning and estate planning should form an integrated whole. The nature and definition of various types of trust and the rights and duties of trustees and beneficiaries were discussed in some detail.

The discussion in this chapter highlighted the importance of integrating trust law, taxation and the principles of estate planning into the estate planning process. An estate plan will fail if tax planning takes place as an independent function. A competent financial planner will merge the principles of trust law and estate planning with the principles of tax law to arrive at an estate plan that meets with the objectives of estate planning, while at the same time ensuring that the form of the plan is legal.

It is also necessary to have a sound knowledge of the various taxes applicable to trusts. The planner or his advisor has to be adept in identifying specific areas of tax law that promote tax planning in

the context of estate planning and to be aware of changes in legislation. A survey of the various taxes applicable trusts is contained in chapter three.

### **CHAPTER THREE: TAXATION AND TRUSTS**

It was noted in chapter two that a planner or his adviser should display a high level of skill in effecting estate planning and such skill should be complemented by a thorough knowledge of relevant legislation and principles of estate planning.

A wide range of legislation and estate planning principles governs the use of trusts in an estate plan. With regard to legislation, trusts are generally subject to: (a) legislation that impact directly on trusts and parties to a trust, and (b) legislation relating to the taxation of trusts. The principles relating to estate planning as well as legislation that govern trusts have been covered in chapter two.

This chapter discusses the various taxes applicable to trusts. A trust is subject to a wide range of taxes, namely, donations tax, income tax and capital gains tax (CGT) in terms of the Income Tax Act, value-added tax (VAT) in terms of the Value-Added Tax Act, transfer duty in terms of the Transfer Duty Act and estate duty in terms of the Estate Duty Act.

An evaluation of these taxes entails an investigation of the tax consequences facing each party to a trust at each stage in the 'life cycle' of a trust. The writer of this thesis is of the opinion that there are three stages in the 'life cycle' of a trust, namely, the formation stage, the operational stage and the dissolution stage. The stages in the 'life cycle' of a testamentary trust and the *inter vivos* trust are the same. However, these trusts are distinguished by the manner in which these trusts are formed.

The aim of this chapter is to simplify and present in a logical manner the manner in which the above taxes interact at each stage in the 'life cycle' of the testamentary trust as well as the *inter vivos* trust. In order to achieve this aim, it is necessary to divide this chapter into two parts to distinguish between the taxation of a testamentary trust from the taxation of an *inter vivos* trust. The taxation of the testamentary trust and the taxation of the *inter vivos* trust are outlined in sections A and B respectively.

## **SECTION A: TAXATION OF THE TESTAMENTARY TRUST**

### **1. Introduction**

In this section, the testamentary trust is evaluated against the conceptual background relating to trusts and estate planning, which was covered in chapter two, as well as the legislative framework and commentary relating to the various taxes applicable to trusts.

Du Toit (2002:163) makes it very clear that at the very earliest, a testamentary trust comes into existence at the death of the testator. During his lifetime, the testator's estate grows through the combined effects of inflation, capital appreciation and accumulation of wealth. If the drafting of the will, which provides for the creation of a testamentary trust, is the only form of estate planning undertaken by the planner and if the estate of the planner is fairly large, the planner will probably be liable for estate duty. The use of the trust will render the trust (if it is not a special trust) liable for income tax at the rate of forty percent, which is much higher than that of companies (a rate of 29 percent on taxable income and 12,5 percent on the net amount of dividends declared) and equal to the highest marginal tax rate for natural persons (40 percent on taxable income of R300 000 or more for the 2005 year of assessment). Beneficiaries are also taxed at their respective marginal tax rates. It is therefore necessary to shift the incidence of tax to the person with the lowest marginal tax rate (Naidoo: 2003). This requires an exhaustive evaluation of the trust as an effective estate-planning vehicle.

In the evaluation process the first step involves an investigation of the tax consequences facing each party to a trust at each stage of the trust's life cycle (namely the formation stage, the operational stage and the dissolution stage). The next step, which is dealt with in chapter four entails a holistic evaluation of the testamentary trust as an estate-planning vehicle.

### **2. Evaluation of tax implications at each stage in the 'life cycle' of a testamentary trust**

As indicated in the introduction, there are three stages in the 'life cycle' of a trust, namely, the formation or creation stage, the operational stage and the dissolution stage. Each stage has tax implications for the various parties to a trust. This is discussed below under the following headings,

each of which deals with the implications of estate duty, donations tax, value-added tax, transfer duty, income tax and capital gains tax:

- formation stage:
  - founder or the trust;
- operational stage:
  - beneficiary or the trust;
- dissolution stage:
  - beneficiary or the trust.

## **2.1 Formation stage**

### **2.1.1 Background**

The testamentary trust is created by a valid will of the deceased. Pace and van der Westhuizen (2002:43) argue that there are conflicting views as to the moment at which the testamentary trust comes into being. They, however, concede to the view that the testamentary trust exists from the testator's date of death. This view was supported by Olivier (1990:26). In practice, the executor of the deceased's estate will be burdened with the task of transferring either the whole or a portion of the residue of the estate or a fixed cash sum in trust to named trustees or administrators (as they are usually called) (Stein, 2004:106). Meyerowitz (2002:23-2) indicates that the trustee's duties commence when the executor's duties cease although there may be instances when the executor and the trustee may function simultaneously. In the creation stage of the 'life cycle' of the trust there appear to be only two parties involved, namely, the executor and the trust. Because the executor is not the creator of the trust, but acts as a conduit between the provisions of the deceased's will and the trust, the *fons et origio* of the trust shall for the sake of convenience, be called the founder. The tax implications for each party follow hereunder.

### **2.1.2 The founder**

#### **(a) Estate duty**

The mere act of founding a trust will not *ipso facto* cause the assets of the trust to constitute either property or deemed property in the founder's estate for estate duty purposes (Burne, 1998:72). Furthermore, the act of creating a trust will not absolve the founder of his liability for estate duty.

However, there are instances where the use of a testamentary trust occasions estate duty implications for the founder. Before evaluating some of these specific estate duty implications, it is necessary to do a general survey of estate duty. This is done with the aid of **Figure 1** below. In terms of section 12 and 13 of the Estate Duty Act, the executor is liable for the recovery and payment of estate duty where this is applicable. In terms of section 2(1) of the Estate Duty Act, estate duty is calculated on the dutiable value of the estate of the deceased. The schematic presentation below covers some of the salient aspects of estate duty.

**Figure 1**

**CALCULATION OF ESTATE DUTY**

<b>Classification</b>	<b>Section of Estate Duty Act</b>	<b><u>R</u></b>
All property of the deceased as at the date of death, wherever the property is situated.	3(2); 5(1)(a); 5(1)(e); 5(1)(f) <i>bis</i> ; 5(1)(g).	xxx
<i>Add:</i> Any fiduciary, usufructuary or other like interests in property held by the deceased immediately prior to his death..... Any annuity charged on property held or enjoyed by him or her immediately prior to his or her death that accrues to another person on his or her death..... All property that is deemed to be his or her property	(3)(2)(a); 5(1)(b); 5(1)(c)  3(2)(b); 5(1)(d) 3(3); 5(1)(a); 5(1)(g)	xxx  xxx
<i>The total value (gross value) of all property in the estate</i>		xxx
<i>Deduct (listed are some examples of deductions):</i> Funeral and deathbed expenses..... Costs of administration and liquidation..... Amounts that accrued to the surviving spouse..... Certain fiduciary, usufructuary or other like interests..... Charitable, educational or religious bequests in South Africa Certain foreign property.....	4 4(a) 4(c) 4(q) 4(m); 4(g) 4(h) 4(e)	(xx) (xx) (xx) (xx) (xx) (xx) (xx)

<i>Net value of property</i>		Xxx
<i>Deduct:</i> Primary abatement.....	4A	1 500 000
<i>Dutiable amount of the estate</i>		xxx
<i>Deduct (other abatements)</i>	16(c); 16(a); First Schedule;	(xxx)
The liability must be apportioned as follows: The executor..... Other persons entitled to or benefiting by property included in the estate.....	11	xxx xxx

Adapted from Stein (2004:5)

The following are noteworthy aspects indicated in Figure 1 above:

- Estate duty is calculated on the dutiable value of the deceased's estate at the time of death.
- Persons liable for estate duty include the executor and other persons if certain property or property deemed to be property accrues to them in terms of section 11 of the Estate Duty Act. In this regard, a trust is not a person as defined in section 1 of the Estate Duty Act. This means that in instances where a testamentary trust has been provided for in the will of the deceased, the executor will be liable for estate duty.
- A deduction is available if an amount accrues to a surviving spouse in terms of section 4(q) of the Estate Duty Act. The marital regime under which a person is married will then be a decisive factor in determining the applicability of section 4(q) of the Estate Duty Act. The question of the marital regime is pursued below.

### Marriage in community of property

Marriages entered into without an antenuptial contract after 1 November 1984 are automatically in community of property, as was the case in the past. In marriages in community of property, all the assets of the married couple belong to them jointly. Thus an increase (profit) or decrease (loss) in assets that occurs during the marriage affects both parties equally (Abrie et al., 2000:16).

Marriage in community of property can be regarded as an estate-planning tool insofar as marriage under this matrimonial regime has the immediate effect of halving the value of the estate of each spouse for estate duty purposes.

In instances where the spouses have individually or jointly provided for the creation of a testamentary trust, the guidelines below dictate the manner in which estate duty is calculated, notwithstanding specific provisions relating to the nomination of beneficiaries and trustees.

### Implications for the founder

When one of the spouses dies, the net joint estate (the assets less liabilities) is divided equally between the two spouses and only half of the joint estate is included in the dutiable estate of the deceased spouse for estate duty purposes (Stein 2004:115). Abrie et al. (2000:113) highlight the fact that the other half of the joint estate is subject to estate duty when the surviving spouse dies. There are certain exceptions to this general rule. In Abrie et al. (2000) these are summarized as follows:

- Funeral and death bed expenses

These expenses are not regarded as a liability of the joint estate. They are deductible in full from the deceased's half of the joint estate for estate duty purposes.

- Insurance policies

The proceeds of certain insurance policies on the life of the deceased are property deemed to be property and subject to estate duty. If the deceased was married in community of property the full amount of the policy (less any deductions) is taxed in his or her estate; it is not reduced by half, due to the marriage in community of property.

- Limited interests

Limited interests such as usufructs and fiduciary rights are regarded as personal rights that accrue to the holder thereof in person and do not form part of the joint estate. The full value of such interests is therefore subject to estate duty and it cannot be halved because of a marriage in community of property. Annuities (whether charged upon property or not) are not personal rights and constitute part of a joint estate. Only half of their value is taxable in the estate of the first dying.

- Donations and bequests

Any person who donates or bequeaths something to another can stipulate in the will or deed of donation that the inheritance or donation will never form part of a joint estate. Such items are taxed in total in the estate of the beneficiary with no deduction on account of marriage in community of property. The creator of an annuity can also stipulate that the annuity shall not form part of a joint estate. This will result in the full value thereof being taxed in the estate of the holder with no halving on account of a marriage in community of property.

### Estate and tax planning

The introduction of section 4(q) into the Estate Duty Act, and the fact that *inter vivos* donations between spouses attract no donations tax, has resulted in marriage in community of property losing much of its attractiveness as an estate-planning tool, since the identical result could be achieved using *inter vivos* or testamentary dispositions (Davis et al., 2005:10-3).

However, against the limiting factors mentioned by Davis above, providing for the future maintenance of minors or even the surviving spouse through a testamentary trust still remains a sound estate planning technique which the writer of this thesis believes should not be compromised by aggressive tax savings strategies. Kruger and Scholtz (2004:1) also argue that the tax “paranoic” is his own enemy, potentially more harmful to himself than even the Commissioner for the South African Revenue Services. Nevertheless, when drawing up his or her will, the founder has to be mindful of estate planning strategies which would provide for the future maintenance of his or her spouse and minors and at the same time provide tax savings techniques. In this regard, there arises the need for a determined search for practical ways that would serve to fulfill the objectives of a

sound estate plan using a testamentary trust. An investigation into these estate planning techniques is discussed below.

- Using the R1,5 million rebate

Owing to factors such as capital appreciation, inflation, the effect of interest rates, and the accumulation of wealth, there is always the possibility that the value of property will continue to increase in value. If a person married in community of property decides to provide for a testamentary trust in his will, it will be necessary to project the value of the estate as at a future date, albeit for all practical purposes the exact date of death is unknown. In terms of section 5(1)(g) of the Estate Duty Act, the value of the property at the date of death will generally be its fair market value. If it is assumed that there are no changes to current legislation, then the planner should strive towards restricting the value of the joint estate at all times at R3 million. Upon the death of the deceased, the joint value of the estate (R3 million) will be halved and will result in an estate with a value of R1,5 million, which will be further reduced to nil by section 4A of the Estate Duty Act which provides for a rebate of R1, 5 million. The dutiable value of the estate will amount to zero and hence estate duty is avoided (Abrie et al.: 2002 and Davis et al.: 2005). Methods used to restrict the growth of the estate are discussed in chapter four.

- Making use of relevant deductions

- Insurance policies

If a policy is taken out by a person who is married in community of property, it is deemed that the premiums were paid from the joint estate; half of the premiums are therefore deemed to have been paid from the other spouse's share of the joint estate and are, together with 6 percent interest thereon, deductible from the proceeds of the policy (Abrie et al., 2000:84).

If the surviving spouse can show that he or she alone owned a policy which falls outside the joint estate, and paid the premiums out of his or her own funds outside the joint estate, the full amount of the premiums paid (with interest compounded at 6 percent) would be deductible (Stein, 2004: 116). This type of an arrangement is not really advantageous. The

surviving spouse who owned the policy which did not form part of the joint estate will be taxed on such policy, less deductions, in his or her estate. Consequently, neither the policy payout nor the premiums would be halved, thereby not achieving any estate duty savings for either of the partners in the joint estate.

If the policy was taken out on the life of the deceased spouse, the proceeds formed part of the joint estate and the surviving spouse was therefore entitled to only half the proceeds, the executor is entitled to recover the estate duty attributable only to the survivor's half- share from the survivor.

According to Stein (2004:116), half of the surrender value of a policy on the life of the surviving spouse that formed part of the joint estate must be included in the dutiable estate of the deceased spouse. On the other hand, if the policy on the life of the surviving spouse did not form part of the joint estate but constituted the separate property of the surviving spouse, nothing would be included in the dutiable estate of the deceased spouse.

#### Donations and bequests between spouses

Although a spouse who is married in community of property may not donate joint assets to the other spouse, it is possible for a spouse with property of his or her own (that is property which does not form part of the joint estate) to donate the property to the other spouse subject to the requirement that it falls outside the joint estate. Stein (2004:120) indicates that opportunities for the saving of estate duty could emerge from such a transaction.

A deduction is allowed for property bequeathed by one spouse to another, whether that property constitutes the deceased's half share of the joint estate or his own separate property. In the case where the spouse to whom the property is bequeathed has to pay a bequest price, the writer is of the opinion that the bequest will only qualify as part of property if the surviving spouse agrees to the payment of the bequest price. If the surviving spouse does not agree to the payment of a bequest price, the estate will not have a claim against the surviving spouse. If the spouse is required to pay an amount to the estate, this would not, it is submitted, be an amount that he or she is required to dispose of to 'any other person' as contemplated in proviso (i) of section 4(q) of the Estate Duty Act and consequently the bequest price cannot reduce the deduction under section 4(q) of the Estate

Duty Act. Authority for the aforesaid statement lies in the interpretation of the word 'any other person' and the fact that there is no definition of a 'person' in the Estate Duty Act.

While such bequests may result in the saving of estate duty for the spouse making the bequest, the same will not apply to the spouse receiving such bequest. A way of ensuring a reduction of estate duty for both spouses is to structure such bequests in a manner that utilizes the benefit of the R1,5 million abatement as mentioned above. The other ways in which bequests could be used to save estate duty is discussed under a separate heading which deals with the use of limited interests in estate planning.

#### Further application of the section 4(q) deduction

The second proviso to section 4(q) provides that no deduction may be allowed under section 4(q) in respect of any property that accrues to a trust established by the deceased for the benefit of the surviving spouse, if the trustee has a discretion to allocate the property or any income from it to any person other than the surviving spouse. Where a person who is married in community of property has provided for a testamentary trust in his or her will, the limiting effects of section 4(q)(ii) could be negated. If the will provides that a surviving spouse is entitled to the usufruct over the capital of a trust and the capital of the trust should pass to the children on that spouse's death, the spouse would have a vested right to the income from the trust and the trustee would have no discretion to award the income to any other person. The proviso would therefore be inapplicable and the estate would be allowed a deduction for the value of the spouse's limited interest, that is, his or her right to income (Stein, 2004:76). The writer of this thesis emphasizes that the deduction will not apply in instances where the trustee has only discretionary powers.

Having outlined the estate duty implications for a person married in community of property, the next step would be to explore the estate duty implications for a person married out of community of property, that is, under an antenuptial contract, and the estate duty implications for a person who was never married.

### The antenuptial contract

This section explores the estate duty implications for a person married under an antenuptial contract. The method the executor will use to calculate the estate duty liability for a person who was married out of community of property differs significantly from that of a person who was married in community of property but is more or less the same as for a person who was never married.

Most antenuptial contracts made before 1 November 1984 excluded community of property, community of profit and loss, and the marital power of the husband from the marriage. Since 1 November 1984, couples that want to marry out of community of property can choose whether or not the accrual system should apply to their marriage.

For the purpose of this thesis, the accrual system will be discussed. The accrual system applies only to marriages out of community of property. During the course of the marriage each spouse retains his or her own estate. However, when the marriage dissolves, through divorce or death, the estate of one of the spouses has a claim on the amount accrued in the estate of the other. The accrual in a spouse's estate is the amount by which the net end-worth of his or her estate upon dissolution of the marriage exceeds the commencement value at the start of the marriage. The surviving spouse has an accrual claim equal to fifty percent of the difference in accrual of both estates (Abrie et al.: 2000).

### Estate duty implications

In instances where the spouses have individually or jointly provided for the creation of a testamentary trust, the guidelines below dictate the manner in which estate duty is calculated, notwithstanding specific provisions relating to the nomination of beneficiaries and trustees.

It has to be noted that the creation of a testamentary trust will not absolve the executor from his liability for estate duty. As indicated above, estate duty is calculated on the dutiable value of the estate of the deceased at the time of his death.

There are however certain specific estate duty implications and estate planning opportunities available under the antenuptial marital regime.

The implications of the accrual claim on estate duty.

In terms of section 3(3)(cA) of the Estate Duty Act, an accrual claim which the estate of the deceased has against the surviving spouse, is property deemed to be property in the deceased's estate. In the reverse situation when the surviving spouse has a claim against the estate, it constitutes an estate liability, which like any other liability, can be deducted from the gross estate. The calculation of an accrual claim is beyond the scope of the thesis. However, the following aspects relating to the calculation of the accrual claim are of importance (Abrie et al., 2000:21-22):

- Assets excluded from accrual

In terms of sections 5 and 8 of the Matrimonial Property Act, no 88 of 1984, certain assets are excluded from the calculation of the amount that has accrued in an estate. These do not, therefore, form part of the final value of an estate for the purposes of calculating the accrual. The assets that are excluded are as follows:

Any assets excluded in terms of the antenuptial contract

These are assets and returns on such assets that are specifically excluded in the contract. For example, if a spouse owns a house that he excludes from marriage, and he subsequently sells the house, the profit and any other assets he acquires with the profit are also excluded from the accrual. Such assets are called substitutive assets. Exclusions of such assets will impact on the value of the accrual claim and consequently impact on the value of the estate belonging to that person's spouse for estate duty purposes. However, exclusion of property by a person requesting such exclusion will not be excluded from the calculation of estate duty in the estate of such person.

### Inheritances, legacies and donations

Inheritances, legacies and donations that accrue to a spouse during the course of marriage, together with the substitutive assets, are excluded from accrual unless the parties have made a different agreement, or the testator or donor has stipulated otherwise. As stated above, although these assets are excluded from the calculation of the accrual claim, this will not preclude such assets from the calculation of estate duty.

### Donations between spouses

Donations between spouses are ignored when calculating accrual and do not, therefore, form part of the end values of the estates. However, property acquired through such donation will be taken into account for estate duty purposes. This was discussed above.

### Section 4(q) deduction

The second proviso to section 4(q) provides that no deduction may be allowed under section 4(q) in respect of any property that accrues to a trust established by the deceased for the benefit of the surviving spouse, if the trustee has a discretion to allocate the property or any income from it to any person other than the surviving spouse. Where a person who is married under an antenuptial contract has provided for a testamentary trust in his or her will, the limiting effects of section 4(q)(ii) could be negated in the manner discussed above.

Stein (2004:87) indicates that a testator may avoid duty completely by leaving R1,5 million to persons other than his or her spouse, for example a trust for the benefit of his or her children, and the balance of the estate to his or her spouse. The amounts left to the spouse would be deductible under section 4(q) deduction and the R1,5 million would qualify for the primary abatement.

A testamentary trust could be created where the surviving spouse is appointed as a beneficiary with a vested interest in the income of the trust. The deduction of the surviving spouse's right to income under section 4(q), was questionable. Stein (2004:76) affirms that the Commissioner will allow a deduction for the value of the spouse's right to income, that is, the value attributable to the portion of the income to which the spouse has a vested right.

### Insurance policies

In terms of section 3(a)(i) of the Estate Duty Act, if the proceeds of the policy are payable to the surviving spouse or child of the deceased in terms of a properly registered antenuptial contract, the policy is totally exempt from estate duty. This proviso has been subject to much criticism and debate. Such criticism and debate falls outside the scope of this thesis.

A testamentary trust is not liable for estate duty and therefore the executor of the founder's estate will be liable for estate duty on the dutiable value of estate at the time of death. Under the antenuptial contract, a person's estate is not halved for estate duty purposes. This means that estate duty is calculated on the full amount of the dutiable value of the estate. Adding to the woes of the planner is the fact that the Estate Duty Act is designed in a manner that makes it quite difficult for the planner or his spouse to escape estate duty. In this regard both spouses need to arrange their affairs in a manner that would serve their aim in creating a testamentary trust and at the same time restricting the value of each of the spouse's estates so that maximum advantage could be taken of the R1,5 million abatement in terms of section 4A of the Estate Duty Act. Besides a few exceptions, the principles outlined above could apply to person who is not married. This is discussed very briefly below.

### Person who is not married

A testamentary trust created in the will of a person who is not married creates the same estate duty problems for such a person as outlined above. However all references to a spouse in the Estate Duty Act will not apply to a person who is not married. Consequently, the person who is not married will be denied deductions such as the section 4(q) deduction and the section 3(a)(i) exclusion. In the case of persons who are married, the surviving spouse could ensure proper control over property. For a person who is not married a testamentary trust could be used to ensure that property entrusted to the trust is properly administered. The unmarried person has to arrange his or her affairs in a manner that would serve his or her aim in creating a testamentary trust and at the same time restrict the value of his or her estate so that maximum advantage could be taken of the R1,5 million abatement in terms of section 4A of the Estate Duty Act.

In the financial world, there are various methods that are used to curb the growth of an estate. This is commonly referred to as “pegging the value of an estate”. Methods used to peg the value of an estate are discussed under a separate heading.

With a few exceptions the estate duty implications for the founder of a testamentary trust applies equally to the founder of an *inter vivos* trust. The founder of a testamentary trust is also subject to donations tax.

**(b) Donations tax**

In terms of section 54 of the Income Tax Act, donations tax is levied on the value of any property disposed of by any resident of the Republic under a donation, whether such disposition occurred directly or indirectly and whether in trust or not. A testamentary trust is created in the will of the deceased and not through a donation, as in the case of an *inter vivos* trust. Consequently donations tax will not be applicable. The discussion in this section is confined to the evaluation of the tax consequences at the time the testamentary trust comes into existence, that is, at the time of death. Therefore donations made by the deceased during his lifetime will not be applicable. Donations made or received during the lifetime of the deceased will impact on the dutiable value of the estate and it is for this reason donations tax is levied at the same rate as the rate applicable to estate duty.

**(c) Value-added tax (VAT)**

In broad terms all supplies of goods or services made by a vendor in the course of any enterprise conducted by him are subject to VAT. The transfer of property by the executor to the trustee is of a testamentary nature and therefore will not constitute a taxable supply. Consequently there are no VAT implications (Davis et al.: 2005).

**(d) Transfer duty**

In terms of the Transfer Duty Act, transfer duty is levied on the value of property acquired by a transferee in consequence of a transaction or in any other manner, or on the amount by which the value of any property is enhanced by the renunciation of an interest in or restriction upon the use or disposal of the property concerned. “Person” is defined in section 1 of the Transfer Duty Act to

include the estate of the deceased. In the case of a testamentary trust, in terms of section 40 of the Administration of Estates Act, 66 of 1965, the transfer of immovable property necessitates an endorsement of the terms of the will against the title deed of such immovable property and any mortgage or notarial bond forming part of the property, coupled with the delivery of the title deed and such bond to the trustee.

(e) **Income tax**

The definition of a “person” in section 1 of the Income Tax Act includes a deceased estate. Section 25 of the Income Tax Act relates to the taxation of income received by the executor after the death of the deceased, for example certain annuities. The act of transferring property to a testamentary trust does not occasion any income tax implications for the executor.

(f) **Capital gains tax (CGT)**

Paragraph 40 of the Eighth Schedule to the Income Tax Act (referred to hereafter as the Eighth Schedule) provides that when a person dies, he or she is deemed to have disposed of all his assets to the deceased estate for their market value. Where an asset is disposed of by a deceased estate to an heir, or legatee, or even a trust, the estate is treated as having disposed of the asset for its base cost. The estate therefore makes no capital gain (Huxham and Haupt, 2002:592).

### 2.1.3 **The trust**

At the formation stage of a testamentary trust, the taxes discussed below may be applicable.

(a) **Estate duty**

In terms of section 2(1) of the Estate Duty Act, estate duty is levied at the time of a person’s death. A trust is not a natural person, and will therefore, not be liable for estate duty.

(b) **Donations Tax**

In terms of section 56(1)(l) of the Income Tax Act, donations tax shall not be payable in respect of the value of any property which is disposed of under and in pursuance of any trust.

(c) **Value-added tax**

Value-added tax will not apply, as the executor would not have made a taxable supply to the trust on transfer of the property to the trust.

(d) **Transfer duty**

Generally, the transferee has to pay transfer duty. Although the trustee could be regarded as the transferee in respect of landed property transferred by the executor, the trustee will not be liable for transfer duty. This is because of the specific provisions of section 40 of the Administration of Estates Act.

(e) **Income Tax**

The creation of a testamentary trust does not occasion any income tax implications for the trustee in terms of the definition gross income in section 1 of the Income Tax Act.

(f) **Capital gains tax**

A tax on capital gains arises upon the disposal of an asset. In the formation stage of the testamentary trust, the trustee receives property, and hence there are no disposals. Accordingly, there are no gains to tax. Huxham and Haupt (2002) have indicated that the value of property received by the trustee will be taken at market value.

## **2.2 The operational stage**

### **2.2.1 Background**

In the operational stage of a testamentary trust, the trustee administers the trust in terms of the provisions laid down in the deceased's will, which is presumed to be valid. However, by law, the trustee has to comply with the provisions contained in the Trust Property Control Act. An exhaustive survey of the trustee's duties falls outside of the scope of this thesis. However, for the purpose of this thesis it is necessary to highlight those duties that impact on taxation. These duties are payment of Master's fees, giving notice of address, obtainment of control over trust property, administration of the trust, conservation of trust property, rendering trust property productive, fiduciary duties, investment of trust funds, separation of private property from trust property, distribution of trust income and capital and involvement in the winding-up process of the trust (Du Toit: 2002). Furthermore, the powers attributed to the trustee and the beneficiary's rights are pivotal factors in determining the person in whose hands a liability for tax occurs. In the operational stage of a testamentary there are two parties involved, namely the trust and the beneficiary. The taxation of the trust and the beneficiaries in the operational stage is discussed below.

### **2.2.2 The beneficiary**

#### **(a) Estate duty**

Income and capital received by the beneficiary will increase the value of the beneficiary's estate if the beneficiary allows the income and the capital to accumulate in his estate. The liability for estate duty calculated on the dutiable value of the estate will only arise upon the death of the beneficiary. In other words, transfer of benefits to the beneficiary will not have immediate estate duty implications. Estate duty, which is a 'deferred tax', creates an opportunity for planners and or their advisers to defer the payment of estate duty by creating structures such as 'generation-skipping trusts'. Such generation-skipping trusts could be created in the will of the deceased. In this regard, cognizance should be taken of the recommendations of the Margo Commission, as outlined in chapter one. The writer of this thesis suggests that the recommendations of the Margo Commission should not be overlooked by a planner (the creator of the testamentary trust) whose intention is to create such 'generation skipping trusts', as an oversight could lead to serious financial consequences should the recommendations of the Margo Commission be accepted in the future. In this regard, planners should consider the use of alternate tax and estate planning strategies that are discussed in

chapter four. The estate duty implications for the beneficiary are similar to the estate duty implications for the founder of the trust.

**(b) Transfer duty**

No transfer duty is payable in terms of section 9(4)(a) of the Trust Duty Act in respect of a change in the registration of property required as a result of the termination of the appointment of an administrator of a trust under a will or other written instrument;

- (a) As from 16 March 1988, section 9(4)(b) stipulates that no duty shall be payable where trust property is transferred by the administrator of a trust in pursuance of the will or other written instrument in pursuance of which the administrator was appointed-
- i. to the persons entitled thereto under such will or
  - ii. to a relative as contemplated in the definition of “relative” in section 1 of the Estate Duty Act, where trust was founded in terms of such other written instrument by a natural person for the benefit of such relative, provided that no consideration is paid directly or indirectly by such relative in respect of the acquisition of such property.

Transfers to beneficiaries of testamentary trusts are, therefore, exempt from transfer duty and the requirement of family relationship does not apply. In the case of an *inter vivos* trust, the requirement does apply, and “relative” in terms of the Estate Duty Act, means in relation to any person, the spouse of such person or anybody related to him or his spouse within the third degree of consanguinity, or any spouse of anybody so related. For the purpose of determining the relationship between any child referred to in the definition of child in section 1 of the Estate Duty Act, and any other person, such child shall be deemed to be related to its adoptive parent in the first degree of consanguinity (Pace and van der Westhuizen, 2002:85).

**(b) Donations tax**

Income and capital is distributed to the beneficiary of a testamentary trust in terms of the provisions of the trust instrument that is to be found in the will of the deceased and not by donation. Hence neither the trust nor the beneficiary will be subject to donations tax.

(d) **Value-added tax (VAT)**

The transfer of a business to a testamentary in terms of a deceased's will falls outside the scope of this section.

(e) **Income tax and CGT**

The beneficiary is taxed on his or her taxable income at the applicable marginal rate. Taxable income is defined in section 1 of the Income Tax Act as the aggregate of the amount remaining after deducting from the income of any person all the amounts allowed under Part I of Chapter II of the Income Tax Act to be deducted from or set off against such income; and all amounts to be included or deemed to be included in the taxable income of a person in terms of the Income Tax Act. Income in terms of section 1 of the Income Tax Act means the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from the normal tax under Part I of Chapter II of the Income Tax Act. The definition of income and taxable income leads to the development of an income tax framework. This is shown in figure three below.

**Figure 3**

**Framework for computation of normal tax**

Gross income (section 1 of the Income Tax Act)	RXX	Note 1
<u>Less:</u> exempt income (section 10 of the Income Tax Act)	(XX)	Note 2
= Income	XX	Note 3
<u>Less:</u> deductions (mainly sections 11 – 19 and 23 of the Income Tax Act)	(XX)	Note 4
<u>Add:</u> Taxable capital gains (section 26A of the Income Tax Act)	XX	Note 5
= Taxable income	XX	Note 6

Figure 3 is used to illustrate the income tax consequences for a beneficiary by explaining each note in figure 3.

#### Note 1: Gross income

Gross income is defined in section 1 of the Income Tax Act. The beneficiary's gross income could include amounts derived from various sources. Trust income, being one of the sources, whether received or accrued, is included in the beneficiary's gross income. A beneficiary receives income from the trust when the trustee actually distributes such income to the beneficiary. However, there are instances where a beneficiary receives an amount in the present year of assessment in respect of an amount that accrued to the beneficiary in the previous year of assessment. Such a situation emanates through the vesting provisions of the trust deed.

In terms of section 25B(1) of the Income Tax Act, income is deemed to accrue to an ascertained beneficiary if such beneficiary has a vested right to trust income. It therefore follows that a beneficiary will be taxed on trust income in the year of assessment in which the beneficiary had acquired the vested right.

Commenting on the provisions of section 25B(2), Arendse et al. (2002:534), indicate that, unless section 7 intervenes, retained income awarded to a beneficiary at the discretion of the trustee will not be treated as the beneficiary's income because such income was already taxed in the hands of the trust.

Where a distribution is made to a beneficiary both out of income accruing to the trust during the year and accumulated income from the previous year, Davis et al. (2005:6-5) indicate that an apportionment is required.

#### Nature of income:

The income distributed to a beneficiary is generated from investments made by the trustee and could therefore take the form of rentals, interest, dividends or even profits from a business administered under the trusteeship of a testamentary trust. The 'conduit pipe principle', which emerged from the *Armstrong v CIR*, 1938 AD, 10 SATC 1, provides that income that is the subject of a trust retains its identity until it reaches the parties in whose hands it is taxable. For example, interest received by a trustee and distributed to a beneficiary will retain its identity as interest in the hands of the beneficiary.

In *Rosen v SIR*, 1971 (1) SA 173 (A), 32 SATC 249, it was held that trust income may change its nature if it is retained and accumulated by the trustee and paid out to beneficiaries in a later year.

#### Note 2: Exemptions

Interest: A portion of the interest received by or accrued to a beneficiary is exempt in terms of section 10(1)(i) of the Income Tax Act.

Dividends: Dividends received by or accrued to a beneficiary are exempt in terms of section 10(1)(k)(i) and section 9E(7) of the Income Tax Act.

Annuities: The decision in *Rosen's case (supra.)*, in so far as it deals with annuities, has been nullified by the introduction of section 10(2)(b) of the Income Tax Act. This section provides that income received by or accrued to any person in the form of an annuity out of dividends received by a trust will not qualify of the dividend exemption in section 10(1)(k)(i) or the interest exemption for interest on government stock in section 10(1)(h).

#### Note 3: Income

Income as defined in section 1 of the Income Tax Act is the amount that remains after deducting exemptions from gross income.

#### Note 4: Deductions

The income of the beneficiary is reduced by all relevant deductions in terms of sections 11 to 19 and the prohibitive conditions in terms of section 23 of the Income Tax Act. In terms of the will of the deceased, a trustee may be compelled to incur expenses on behalf of the beneficiary, for example, a contribution to a medical fund. In this regard it is necessary to ascertain the person in whose hands the deduction is allowed. In this regard, the writer of this thesis believes that the expense is attributed to the beneficiary and not to the trust. However, where the trust incurs an expense in order to generate an income, section 25B(3) allows for the apportionment of such expenses between the trust and the beneficiary. This means that if the trust has incurred administration expenses to generate rentals, then the expenses must be apportioned between the trust and the beneficiaries on a *pro rata* basis. The basis of apportionment will depend on the application of section 25B(1) and section 25B(2). If the income vests in the beneficiary, the beneficiary could claim for a proportionate deduction of the administration expense. The amount to be deducted is in the same proportion as the proportion according to which the total income of the trust is attributed to the beneficiary.

For example:

Total rentals received by the trust	R1 000
Vested right of beneficiary to the rentals received by the trust	25%
Income accrued to the beneficiary	R250
Total administration expenses incurred by the trust to generate rentals in respect of rentals	R200
Therefore expenses attributed to a beneficiary (25% of R200)	R50

Expenses incurred to generate exempt income such as interest will not be allowed as a deduction in terms of section 23(f) of the Income Tax Act.

#### Distribution of losses to beneficiaries

In terms of section 25B(4) to (6) of the Income Tax Act, a beneficiary may no longer claim losses in respect of trust income that accrue to him.

#### Limitations of expenses (or ring-fencing of expenses)

Section 25B(4) of the Income Tax Act provides that any deduction or allowance which is deemed to be made in determining of the taxable income of a beneficiary of a trust during any year of assessment is limited to the income which is deemed to accrue to the beneficiary in terms of section 25B in that year of assessment. The excess of the deductions and allowances over the income may in terms of section 25B(5)(a), be deductible in the hands of the trust.

In terms of section 25B(6), the deductions or allowances that exceed the income of the beneficiary or the trustee or the taxable income of the trust are carried forward and deemed to be a deduction or allowance which may be made in the determination of taxable income of the beneficiary in the succeeding year of assessment

#### Note 5: Taxable capital gains

In terms of paragraph 3 of the Eighth Schedule, a person's capital gain for a year of assessment is defined as the amount by which the proceeds from the disposal of an asset exceed the base cost of the asset during that year. 'Proceeds', 'base cost', 'disposals' and asset are defined in paragraphs 35, 20, 11(i) and paragraph 1 of the Eighth Schedule. A portion of the capital gain is included in the

taxable income of the beneficiary. If the beneficiary is a natural person, the inclusion rate is twenty-five percent. The capital gain is be taxed at an effective rate of ten percent if such a person is taxed at a marginal rate of forty percent (the maximum marginal tax rate).

The application of capital gains tax (CGT) is fairly complicated. Factors such as the vesting principles, attribution rules and valuation rules are complicating factors in the application of CGT. The vesting principle is probably the most important principle in determining the person in whose hands the liability for CGT rests. A beneficiary could acquire a vested right to trust income, trust property and/or capital gains in terms of the will of the deceased. Such vested right could be conferred upon a beneficiary in one of two ways, namely, (a) where the trust instrument provides that a beneficiary is immediately entitled to trust income, property and or capital gains or (b) where the trust instrument provides that a trust beneficiary's acquisition of a personal right to claim payment of trust income and or capital gains from the trust's trustee is not immediate but rather contingent or conditional upon the occurrence of an uncertain future event. The right to trust income and or capital gains will only vest in such beneficiary if and when the contingency has occurred or the condition has been fulfilled. In the former case the vesting is immediate while in the later case the vesting is postponed.

A testamentary trust could either be a discretionary trust or a non-discretionary trust and the very nature of the trust complicates the application of CGT, more especially, with regard to the determination of the base cost of the asset.

The anti-avoidance provisions in the form of attribution rules in Part X of the Eighth Schedule do not apply to a testamentary trust because a testamentary trust is created in the will of a person and not through a donation, settlement or similar distribution. The implications of CGT for the beneficiary are best understood by examining each transaction between the trustee and the beneficiary independently. In all instances the base cost of an asset is the market value of the asset at the time of death of the deceased.

- The vesting of a capital asset in a resident beneficiary

In terms of paragraph 80(1) of the Eighth Schedule, the vesting by a trust of an asset in a resident beneficiary constitutes a disposal of that asset, and it is the beneficiary who

becomes liable for any tax on the capital gain when the asset is vested in him. The aggregate capital gain or aggregate capital loss in the hands of the beneficiary is determined as the difference between the base cost of the asset to the trust and its market value on the date that the vesting occurs. Thus the beneficiary will be liable for tax on this difference, but at the rate applicable to natural persons. This rule will only apply if the beneficiary is a resident as defined.

- The vesting of an interest in an asset of a trust in a resident beneficiary

In this case a disposal is deemed to have taken place on the date the interest vests, in terms of paragraph 11(1)(d) read with paragraph 13(1)(d) of the Eighth Schedule. It follows that if the beneficiary had a vested interest in a trust asset prior to 1 October 2001 and the asset is distributed to him after that date, there would be no capital gains implications since the vesting of the interest constitutes a disposal that occurred prior to the valuation date.

When an asset in which the beneficiary has a vested interest is subsequently distributed to him there is no disposal and hence there are no CGT implications. A disposal is deemed to have taken place upon vesting of an interest in the asset of the trust and not the actual distribution of the asset.

The aggregate capital gain or aggregate capital loss in the hands of the beneficiary is determined as the difference between the base cost of the asset to the trust and its market value on the date that the vesting occurs. Thus the beneficiary will be liable for tax on this difference but at the rate applicable to natural persons. This rule will only apply if the beneficiary is a resident as defined in the Income Tax Act.

- Beneficiary acquires a vested interest in the capital gains made by the trust

This is a situation that occurs when the beneficiary acquires a vested interest only in the capital gains made by the trust and has no interest in the asset itself. So when the trustee sells an asset to a person other than a beneficiary, the capital gain on this transaction will vest in the beneficiary. The capital gain will be included in the taxable income of the beneficiary. In Silke (2005) it is pointed out that even though the gain is included for the

purposes of calculating the aggregate capital gain or aggregate capital loss of the beneficiary in whom the asset or the gain vests, the disposal is made by the trust and, as a result, the beneficiary will not be entitled to any exclusions such as a primary residence rebate that are usually available to a natural person.

- Beneficiary's interest in a discretionary trust

In terms of paragraph 81(1) of the Eighth Schedule, a beneficiary's interest in a discretionary trust must be treated as having a base cost of nil. This base cost is the base cost of the interest before any vesting occurs. This rule does not augur well for the beneficiary who decides to sell a trust asset prior to vesting. His capital gains will be the full proceeds from the sale of the asset because the base cost was nil.

- Debts

Where a testator in his will wishes to relieve a debtor of his debt, he should bequeath a sum to the debtor sufficient to allow the debtor to pay the debt, rather than to direct that the debtor should be excused from paying the debt. In the former event the debtor will have acquired the funds at a base cost equal to the amount of the funds, so that their disposal in discharging the debt will be neutral for the purpose of CGT. In the latter event the beneficiary will obtain a gain equal to the amount of the debt owed him (Davis et al., 2005:2A-14).

Twenty-five percent of the aggregate capital gains of the beneficiary must then be included in the calculation of the beneficiary's taxable income. In determining the taxable capital gains the following procedure is applied:

**Figure four**

**Method of calculating a taxable capital gain for a resident beneficiary (natural person)**

Sum of capital gains for the year of assessment in terms of paragraph 3 of the Eighth Schedule		Rxxx
<u>Less:</u> The sum of capital losses for the year of assessment in terms of paragraph 4 of the Eighth Schedule Annual exclusion in terms of paragraph 5 of the Eighth Schedule	Note 1 Note 2	(Rxxx) (Rxxx)
<u>Less:</u> Assessed capital loss brought forward in terms of paragraph 9 of the Eighth Schedule		(Rxxx)
Net capital gain in terms of paragraph 8 of the Eighth Schedule		Rxxx
Multiplied by		25%
Taxable capital gain in terms of paragraph 10 of the Eighth Schedule		Rxxx
<u>Note 1</u> In terms of paragraph 69 of the Eighth Schedule, a trust is not allowed to distribute its capital loss to a beneficiary.		
<u>Note 2</u> The exclusions only apply to natural persons and special trusts. Where disposals are made by the trust and the gain vests in the beneficiary, the beneficiary is not entitled to exclusions.		

**Note 6: Taxable income**

Income tax is calculated on the taxable income of the beneficiary at the applicable rate. Once the income tax is calculated, the applicable primary rebate in terms of section 6 of the Income Tax Act has to be deducted to calculate the tax liability of the beneficiary.

### 2.2.3 The trust

#### (a) Estate duty

In terms of section 2(1) of the Estate Duty Act, estate duty is levied at the time of a person's death. A trust is not a natural person, and will therefore, not be liable for estate duty.

#### (b) Transfer duty

If in terms of the trust deed, the trustee purchases immovable property for investment purposes, the trust will be liable for transfer duty in terms of the Transfer Duty Act. The transfer duty rate for trusts is fixed at flat rate of ten percent.

#### (c) Donations tax

Donations tax will not apply because donations tax is payable by a donor. However, in the case of testamentary trust, distributions to the beneficiary are done in terms of the will and not through donations. In practice, the terms of the will of the deceased may require the trustee to make donations to charitable organizations. These donations are exempt in terms of section 56(1)(l) of the Income Tax Act because the property is disposed of in terms of the trust deed.

#### (d) Value-added tax

Value-added tax will not apply as the trustee would not have made a taxable supply to the beneficiary on transfer of the property to the beneficiary.

#### (e) Income tax and CGT

A testamentary trust is subject to the provisions of section 25B of the Income Tax Act. Section 25B will apply, subject to the provisions contained in section 7, subsections (3) to (8) of the Income Tax Act. These sub-sections are generally regarded as anti-avoidance provisions. These anti-avoidance provisions are not applicable in the case of a testamentary trust because a testamentary trust is created in the will of the deceased and not through a donation, settlement or other similar disposition. Consequently, a testamentary trust is subject to the provisions of section 25B of the



Income Tax Act as well as other sections of the Income Tax Act relating to deductions and exemptions. Section 25B dictates that the person in whose hands income will be taxed and the manner in which expenses and losses are to be treated. Included in the calculation of a person's taxable income is the relevant portion of capital gains. Capital gains tax is covered under a separate heading. The conduit pipe principle arising out of case law is also considered in this section. The income tax implication for the trust is done with the aid of figure three.

#### Note 1: Gross income

The gross income of a trust could constitute amounts received or accrued from investments made by the trustee. These amounts could include interest, dividends, rentals and even profits from a business administered by a trustee in pursuance of a trust object. In terms of sections 25B(1) and 25B(2) income which does not vest in a beneficiary in a year of assessment will be deemed to be income of the trust and such income will then be taxed at a flat rate of forty percent.

#### Note 2: Exemptions

Interest and dividends received by a trust are not exempt from normal taxation in terms of section 10(1)(i) of the Income Tax Act.

#### Note 3: Income

Income as defined in section 1 of the Income Tax Act is the amount that remains after deducting exempt income from gross income.

#### Note 4: Deductions and allowances

The income of the trust is reduced by all relevant deductions in terms of sections 11 to 19 and the prohibitive conditions in terms of section 23 of the Income Tax Act. An example of such a deduction is administration expenses. Where the trust incurs an expense in order to generate an income, section 25B(3) provides for the apportionment of such expenses between the trust and the beneficiary, provided that the beneficiary has a vested right to such income. The basis of apportionment will depend on the application of section 25B(1) and section 25B(2). If the income vests in the beneficiary, the beneficiary could claim a proportionate deduction of the administration expense. The amount to be deducted is calculated in the same proportion as the proportion according to which the total income of the trust is attributed to the beneficiary. Any amount of the expense that remains after allocating the expense to the beneficiaries will then be a trust expense.

For example:

Total rentals received by the trust	R1 000
Vested right of beneficiary to the rentals received by the trust	25%
Income accrued to the beneficiary	R250
Total administration expenses incurred by the trust to generate rentals in respect of rentals	R200
Expenses attributed to a beneficiary (25% of R200)	R50
Therefore, the expense attributed to the trust	R150

Expenses incurred to generate exempt income will not qualify as an allowable deduction in terms of section 23 (f) of the Income Tax Act.

Limitations of expenses (or ring-fencing of expenses)

In terms of section 25B(5)(a) of the Income Tax Act, the excess of the deductions and allowances that are apportioned to a beneficiary over the income of the beneficiary in a year of assessment is carried over to the trust. If the trust is subject to tax in the Republic, the excess is deemed to be a deduction or allowance which may be made in the determination of the taxable income of the trust during that year of assessment. The deduction or allowance is, however, limited to the taxable income of the trust for that year and may not, therefore, create or increase an assessed loss in the trust. However, in terms of section 25B(6), the deductions or allowances that exceed the income of the beneficiary or the trustee or the taxable income of the trust are carried forward and deemed to be a deduction or allowance which may be made in the determination of taxable income of the beneficiary in the succeeding year of assessment

Note 5: Capital gains tax (CGT)

Other than the provisions that are stated hereunder, disposals of assets by a trust will occasion CGT implications for a trust.

- Vesting of capital asset in a resident beneficiary

In terms of paragraph 80(1) of the Eighth Schedule, the capital gain must be disregarded in determining the aggregate capital gain or aggregate capital loss of the trust.

- Vesting of an interest in an asset of the trust

The rule in paragraph 11(1)(d) read together with paragraph 13(1)(d) of the Eighth Schedule states that this capital gain must be disregarded for the purposes of calculating the aggregate capital gain or capital loss of the trust.

- Vested right to capital gain

This vested capital gain must be disregarded for the purposes of calculating the aggregate capital gain or capital loss of the trust (Silke: 2005). In the case of a trust other than a special trust, fifty percent of the aggregate capital gain is included in the taxable income of the trust. Because trusts are subject to income tax at a flat rate of forty percent, the effective rate at which the gain will be taxed will be twenty percent.

- Exclusions

In terms of paragraph 5 of the Eighth Schedule, the annual exclusion of R10 000 in each year of assessment applies only to natural persons and special trusts. In terms of paragraph 45(2) of the Eighth Schedule, the R1 million gain on the disposal of a primary residence does not apply to a testamentary trust.

#### Note 6: Income tax liability

Income tax is calculated on the taxable income of the trust at a flat rate of forty percent. The testamentary trust does not qualify for a primary rebate in terms of section 6 of the Income Tax Act.

## **2.3 The dissolution stage**

### **2.3.1 Background**

When a testamentary trust is terminated the residual provisions of the will, if any, take effect. In default of such provisions the property is disposed of in terms of intestacy. Whether, in such cases the intestate heirs are to be determined as at the date of the testator's death or the date when it becomes clear that the trust will fail has been resolved by the Appellate Division as the latter case (*Harris v Assumed Administrator Estate MacGregor*, 1987 3 SA 563 (A)). Honore' (1992:467-468) explains that, in default of intestate heirs, the assets will vest in the state as *bona vacantia*.

If it is assumed that, in terms of the will, the testamentary trust will terminate upon the distribution of accumulated income and capital to a beneficiary who comes of age, then the tax implications are as follows.

### **2.3.2 The beneficiary**

#### **(a) Estate duty**

The income and capital, if distributed to the beneficiary will constitute dutiable property in terms of section 3(2) of the Estate Duty Act.

#### **(b) Donations tax**

There are no donations tax implications for either the beneficiary or the trust.

#### **(c) Transfer duty**

In terms of sections 9(4)(a) and 9(4)(b) of the Transfer Duty Act, the beneficiary is exempt from transfer duty liability in instances where the trustee distributes immovable property to the beneficiary.

(d) **Value-added tax**

VAT will not apply, as the trustee would not have made a taxable supply to the trust on transfer of property to the beneficiary.

(e) **Income tax and capital gains tax**

Based on the assumption that is stated above, the beneficiary is not liable for income tax (Arendse, et al.: 2002). In terms of section 25B(6) of the Income Tax Act, the deductions or allowances that exceed the income of the beneficiary or the trustee or the taxable income of the trust are carried forward and deemed to be a deduction or allowance which may be made in the determination of taxable income of the beneficiary in the succeeding year of assessment. Based on the above assumption, the liability for capital gains tax will fall on the beneficiary in terms of paragraph 80(1) of the Eighth Schedule. The trust is not liable for CGT. The base cost of such an asset is the market value at time of disposal in terms of paragraph 40 of the Eighth Schedule (Scholtz, 2005:66).

(f) **General**

Scholtz (2005:66) argues that specific directives in the will regarding the manner in which the trust has to be wound up is a prerequisite for the application of paragraph 80(1), 80(2) and paragraph 11(d).

In relation to assets that are realized and proceeds distributed, the governing provisions will be paragraph 80(2) of the Eighth Schedule.

In terms of paragraph 80(1) and paragraph 38 of the Eighth Schedule, the value of the proceeds from in *specie* transfers, is the market value of the assets at the time of their allocation amongst the beneficiaries.

In the case of asset realizations followed by cash distributions amongst beneficiaries, the value of the proceeds is the consideration received for the asset.

### **2.3.3 The trust**

#### **(a) Estate duty**

The trust is not liable for estate duty in terms of section 2(1) of the Estate Duty Act.

#### **(b) Transfer duty**

Transfer duty is payable by the transferee and not the transferor and as such the trust is not liable for the payment of transfer duty.

#### **(c) Value-added tax (VAT)**

VAT will not apply, as the trustee would not have made a taxable supply to the beneficiary on transfer of property to the beneficiary.

#### **(d) Donations tax**

There are no donations tax implications for either the beneficiary or the trust.

#### **(e) Income tax and capital gains tax**

In the year of assessment in which the trust is terminated, the trustee is accountable for taxation on all income that is received and accrued by the trust up to the date of termination. Capital gains implications have been covered in paragraph 2.3.2 (e).

### **3. Conclusion**

The aim of this section of the chapter was to demonstrate the complexities relating to the interaction of the various taxes at each stage in the life cycle of the testamentary trust. It was noted that factors such as the nature of the trust, the marital regime of the founder, as well as the provisions contained in the founder's will, are decisive in determining the party in whose hands the liability for tax arises. It was also found that the act of creating the testamentary trust does not absolve the founder

of his liability for estate duty. This section had also outlined some of the strategies that are commonly used by planners to minimize the effects of taxes.

In this regard, many planners use the discretionary *inter vivos* trust to minimize the effects of the various taxes, more especially, the minimization of estate duty. Compared with the testamentary trust, however, the *inter vivos* trust is subjected to a wide range of anti-avoidance measures that are aimed at frustrating certain tax planning techniques. The taxation of the *inter vivos* trust is discussed in section B.

## **Section B: TAXATION OF THE *INTER VIVOS* TRUST**

### **1. Introduction**

In the introduction to the chapter it was stated that the *inter vivos* trust is a common estate-planning vehicle that is used by planners to reduce their liability for estate duty. In this section, the *inter vivos* trust is evaluated against the conceptual background relating to trusts and estate planning, which was covered in chapter two, as well as the legislative framework relating to the taxation of trusts.

An *inter vivos* trust is usually created by a contract (referred to as a trust deed or *stipulatio alteri*) in terms of which a person (the donor or settlor or *stipulans*) transfers property to the trustee (or *promittens*) who is burdened with the obligation of administering the property for the benefit of one or more persons (the beneficiaries) until the trust is terminated upon the occurrence of some specified future event (Stein, 2004:109). Transfer of the property to the trust is effected either through a donation of property to the trust or by selling property to the trust.

*Inter vivos* trusts are extensively used by planners as a means by which income could be shifted to persons who enjoy lower marginal rates of tax as well as a means by which estate duty could be reduced. In order to curb the use of *inter vivos* trusts as tax avoidance vehicles, the Commissioner, with effect from 1 March 2004, introduced tax at a punitive income tax rate of forty percent for trusts other than special trusts. In chapter one it was noted that trusts (other than a special trust) pay taxes at the highest tax rate. Clearly this has a severe negative effect on the use of trusts as estate

planning vehicles. *Inter vivos* trusts are also subject to a wide range of specific anti-avoidance measures contained in section 7(3) to 7(8) as well as the general anti-avoidance provisions of section 103 of the Income Tax Act.

Noting the changes made to the taxation of trusts, financial planners and authors have developed numerous tax and estate planning models aimed at neutralizing the effects of the various taxes that impact on the *inter vivos* trust. This section covers an in-depth evaluation of the various taxes applicable to *inter vivos* trusts. An evaluation of various case studies relating to *inter vivos* trust as well as the development of a holistic estate-planning model is dealt with in chapter four.

## **2. Evaluation of tax implications at each stage in the 'life cycle' of an *inter vivos* trust**

The writer of this thesis is of the opinion that there are three stages in the 'life cycle' of a trust. These are: the formation or creation stage, the operational stage and the dissolution stage. Each stage occasions tax implications for the various parties to a trust. This is discussed below.

### **2.1 Formation stage**

#### **2.1.1 Background**

As indicated above, an *inter vivos* trust is formed by the transfer of the founder's property to the trust. A founder may either sell all or part of his property to the trust or donate all or part of the property to the trust. The trust deed is essential to the formation of the trust. In the formation stage, there are two parties to the trust namely, the founder and the trust. The tax implications occasioned by such transfer are discussed below.

#### **2.1.2 Estate duty**

##### **(a) The founder**

A founder may either sell or donate all or part of his property to the trust. In instances where the founder has during his lifetime transferred all of his property to the trust, then upon his death, the value of the founder's estate has a zero value and hence there are no estate duty implications for the founder. In instances where the founder has during his lifetime transferred part of his property to an *inter vivos* trust, then the dutiable value of the remaining property at the time of his death will be

subject to estate duty. There are no estate duty implications at the time of transfer, however, owing to such factors as inflation, capital appreciation, et cetera, his remaining property will grow in value and will be subject to estate duty at the time of his death.

**(b) The trust**

In terms of Section 2(1) of the Estate Duty Act, a trust is not subject to estate duty.

**2.1.3 Transfer duty**

**(a) Founder**

The transferee generally pays transfer duty. The transferee in this case is the trustee. Hence, the founder will not be liable for transfer duty.

**(b) The trust**

In instances where property as defined in section 1 of the Transfer Duty Act is sold or donated to the trust, the trustee will be liable for transfer duty at a rate of ten percent on the value of the property.

**2.1.4 Value-added tax**

For the purpose of this thesis both the founder and the trust are assumed not to be registered vendors and hence VAT implications will not arise.

**2.1.5 Donations tax**

**(a) The founder**

The founder will be liable for donations tax under the following circumstances:

- Where property (including limited interests) is donated to a trust, donations tax is payable subject to the R30 000 exemption in terms of section 56(2)(b) of the Income Tax Act. A common practice followed by founders of trusts is to utilize the R30 000 exemption from

donations tax to waive a portion of the loan owing to them by the trust. This could give rise to a CGT liability in the hands of the trust.

- The revocation of a trust deed or the right to revoke a trust deed by the founder may have donations tax implications. Olivier (1990:208-209) is of the opinion that in the absence of a power to revoke, a transfer of the trust assets to the founder pursuant to an agreement to cancel may constitute a donation to the founder. In such a case, transfer does not take place in pursuance of a trust as required by section 56(1)(1) of the Income Tax Act, but in terms of an agreement outside the ambit of the trust and therefore, causes it to be taxable. He expresses his doubts as to the validity of a cancellation of a trust in terms of a power that the founder had reserved for himself (Olivier, 1990:208; *Creighton Trust v CIR*, 1995 3 SA 498 (T)). Honore' (1992: 387) is of the opinion that if it was possible to reserve such right, it would seem that the exemption of section 56(1)(1) of the Income Tax Act would apply since the transfer of the property by the trustee to the founder would be a disposition in pursuance of the trust.
- In terms of section 58 of the Income Tax Act, the so called 'disguised sale' in the form of a donation where any property has been disposed of for a consideration which in the opinion of the Commissioner is not an adequate consideration, that property shall be deemed to have been disposed of under a donation. In the determination of the value of the property a reduction shall be made of an amount equal to the value of the consideration given. After having surveyed the legal implications of section 58 of the Income Tax Act, Davis et al. (2005:2-57) indicate that once a *prima facie* intention to donate has been established, the Commissioner should then have regard to all the subjective circumstances of the transaction in concluding whether or not the consideration received is adequate. In this regard the writer is of the opinion that the founder's *ipse dixit* is necessary to prove that a 'disguised sale' was not transacted and it is submitted that the Commissioner will concede to validations made by the founder.
- The valuation of property for donations tax purposes is similar to the valuation rules contained in section 5 of the Estate Duty Act, which may apply.
- There are numerous exemptions contained in section 56 of the Income Tax Act.
- Where the donated property formed part of the joint estate, each spouse is deemed to have made half of the donation. Where the property is excluded from the joint estate, the donation is deemed to have been made solely by the donor spouse in terms of section 57A of the Income Tax Act.

- Deemed donations provided for in section 7 of the Income Tax Act are not subject to donations tax (Pace and van der Westhuizen, 2005:46).

(b) **The trust**

In terms of section 1 of the Income Tax Act, the trustee is a representative taxpayer. If the founder does not pay donations tax within six months, the trustee to whom the assets were transferred is jointly and severally liable for donations tax in terms of section 59 and section 60(1) of the Income Tax Act. However, a trustee may, notwithstanding any provision to the contrary contained in the particular trust instrument, recover any donations tax payable by him in his capacity as trustee, which recovery is effected from trust property.

2.1.6 **Income tax and capital gains tax**

(a) **The founder**

Figure 3 is reproduced to illustrate the computation of the founder's liability for income tax.

**Figure 3**

**Framework for computation of normal tax**

Gross income (section 1 of the Income Tax Act)	Rxx	Note 1
<u>Less:</u> exempt income (section 10 of the Income Tax Act)	(xx)	Note 2
= Income	xx	Note 3
<u>Less:</u> deductions (mainly section 11 – 19 and 23 of the Income Tax Act)	(xx)	Note 4
<u>Add:</u> Taxable capital gains (section 26A)	xx	Note 5
= Taxable income	xx	Note 6

**Note 1: Gross income**

The gross income of the founder will constitute all income received and accrued from various sources. These sources could include remuneration, annuities, rentals and income attributed to the founder in terms of the anti-avoidance rules.

#### Donation:

Where assets have been donated to the trust, the anti-avoidance provisions contained in section 7 of the Income Tax Act will decisively determine the amount to be included in the gross income of the founder.

#### Section 7(2)

This section is an anti-avoidance provision aimed at preventing married couples from reducing their liabilities for normal tax by arranging for taxable income to be split between the spouses. The provision, according to Arendse et al. (2002:538), will apply, for example, where the husband creates a trust in favour of his wife by donating income-producing assets to a trust. The husband would be liable to tax on the income produced by those assets.

#### Section 7(3)

This section would ensure, for example, that if a father created a trust in favour of his minor child by donating assets to the trust, he, the father, would be liable to tax on the income produced by those assets irrespective whether the income had been received by or accrued to the child or had been expended or accumulated for the child's benefit.

#### Section 7(4) 'cross-donations'

This section caters, for example, for the situation in which the father or his wife makes a donation, settlement or other disposition or gives some other consideration to another person or that person's family and that person makes a donation to a trust created for the benefit of the father's minor child. The income received or accrued to the minor child will be deemed to be that of the father.

#### Section 7(5)

If any person has, in any deed of donation, settlement or other disposition, made a stipulation to the effect that the beneficiaries thereof or some of them shall not receive the income or some portion of the income thereunder, until the happening of some event, so much of any income as would, but for such stipulation, in consequence of the donation, settlement or other disposition, be received by or accrue to or in favour of the beneficiaries, shall, until the happening of the event or the death of that person, whichever first takes place, be deemed to be the income of that person.

Section 7(5) is simplified as follows: the income retained in the trust cannot be taxed in the hands of the beneficiaries and tax will be levied upon the person who made the donation to the trust. Each donor would be taxed on:

- the income retained in the trust, which is
- attributable to the donation made by **that** donor (Arendse et al., 2002:539).

Section 7(5) also extends to new donors. In this regard, when a trust has been created by a donor who has made a withholding stipulation or condition in the trust deed, the income derived by the trustees from a further donation made by a new donor to the existing trust will be deemed to be the income of the new donor.

On the death of the donor, section 7(5) of the Income Tax Act, will no longer apply and the income of the trust would be taxable in the hands of the beneficiaries or the trust in accordance with the terms of the trust deed.

#### Section 7(6)

Where a deed of donation, settlement or other disposition contains a stipulation that the right to receive income thereby conferred may, under powers retained by the person by whom that right is conferred, be revoked or conferred upon another, so much of the income as in consequence of the donation, settlement or other disposition is received by or accrues to or in favour of the person on whom that right is conferred, is deemed to be the income of the person by whom it is conferred, as long as he retains those powers.

Section 7(6) would apply, for example, to a donor who donates assets in trust to trustees on condition that, although the specified beneficiary is to receive the income, the donor will be entitled at any time to revoke the beneficiary's right to receive the income and will be free to confer the right to receive the income on any other person. Under these circumstances, as long as the donor retains these powers, the income received by or accrued to the specified beneficiary is deemed to be the income of the donor and the beneficiary is therefore relieved from liability for tax.

Section 7(6) deals only with the income provisions of a deed of donation, settlement or other disposition and is not concerned with any stipulations in respect of the trust capital.

### Section 7(7)

Section 7(7) was introduced in order to curb a practice whereby a taxpayer would cede an income-producing asset to another (usually tax-exempt) person for a number of years on condition that the asset is ceded back to the taxpayer at the end of the specified period. During this period the income accrues to the cessionary and the cedent thereby effectively donates money to another taxpayer from non-taxed income. Huxham and Haupt (2002:549) are of the opinion that section 7(7) only applies to investment income (rental, interest, royalties, or similar income). A donation, settlement or other similar disposition is necessary. Basically, the donor is taxed on the investment income if he cedes it to someone else but retains the underlying property, or if he gives the underlying property to someone else but retains the right to regain the right to property in the future.

### Section 7(8)

This section requires the inclusion in the income of a resident of any income actually received by or accrued to a non-resident by reason of any gratuitous disposition made by the resident. In the case of foreign dividends, which are included in the income of a resident in this manner, the 'drill down' provisions of section 9E of the Income Tax Act must, up to years of assessment commencing on or after 1 June 2004, be applied in appropriate circumstances. Until 2001 this provision did not apply where the foreign entity was a controlled foreign entity in relation to the South African resident – in such a case the normal provisions of section 9D of the Income Tax Act applied to attribute the income (with much the same effect). There are no exclusions available for an attribution under section 7(8) of the Income Tax Act.

### Note 2: Exemptions

Exemptions generally follow the income and therefore the source of the income will dictate the extent to which that income is exempt. For example, a portion of the interest received from the trust will be exempt in the hands of the donor in terms of section 10(1)(i) of the Income Tax Act. Exemptions are contained in section 10 of the Income Tax Act.

### Note 3: Income

In terms of section 1 of the Income Tax Act, income is defined as the difference between gross income and qualifying exemptions.

#### Note 4: Deductions

For the year of assessment, the income of the founder is reduced by all relevant deductions in terms of sections 11 to 19 of the Income Tax Act and the prohibitive conditions in terms of section 23 apply. Examples of such deductions are: medical expenses, pension deductions, et cetera.

#### Note 5: Capital gains tax

In the case of an *inter vivos* trust, a founder would incur a liability for CGT in terms of paragraph 11 of the Eighth Schedule, through any one of the following modes of disposal:

- selling his property to the trust, or
- donating his property to the trust, or
- by not charging interest on a loan to the trust in terms.

#### Sale of property to the trust

The base cost of the asset sold to the trust must be subtracted from the proceeds received from the trustee to arrive at the capital gain or capital loss. Normal valuation rules relating to the value at which the base cost of the asset is determined will apply.

#### Donating property to the trust

A donation of an asset is a disposal in terms of paragraphs 1 and 11 of the Eighth Schedule and such donation will therefore trigger a capital gain or loss. The capital gain or loss has to be calculated by subtracting the base cost of the asset from the proceeds derived therefrom.

In terms of paragraph 38 of the Eighth Schedule, when a person disposes of an asset by means of a donation or for a consideration not measurable in money, or to a connected person for a consideration that does not reflect an arm's length price, he is treated as having disposed of it for proceeds equal to the market value on the date of the disposal. The person who acquires it from the disposer, in turn, is treated as having acquired the asset for a base cost equal to its market value on the date of the disposal. It follows that when a person donates an asset, or disposes of an asset to a trust for a consideration that does not reflect an arm's length price, and he is a connected person in relation to the trust, he will be deemed to have disposed of the relevant asset at its market value and the trust will be deemed to have acquired it at a cost equal to the same value. The date of disposal will be the date of compliance with all the legal requirements for a valid donation.

If the asset donated to the trust consists of a primary residence or a 'personal-use asset', the capital gain will be subject to the primary residence exclusion or the personal-use asset exclusion, provided all the requirements are met. Furthermore, a donation of cash to a trust will not amount to a disposal of an asset and will not give rise to proceeds for capital gains tax purposes.

#### Ant-avoidance measures

The Eighth Schedule contains anti-avoidance provisions similar to those found in section 7 of the Income Tax Act. These provisions mirror the sections contained in section 7 and have the effect of deeming a capital gain made by a trust to be that of a person (the donor) to the trust, if the capital gain is attributable to the donation. The anti-avoidance provisions in the Eighth Schedule could be summarized as follows:

- Spouses

In terms of paragraph 68(1) of the Eighth Schedule, if by reason of a donation made by spouse A or a transaction, operation or scheme entered into by spouse A, a capital gain accrues to spouse B, the capital gain will be deemed to be the capital gain of spouse A, if the purpose of spouse A was to reduce, postpone or avoid any tax administered by the Commissioner. This rule mirrors the provisions of section 7(2) of the Income Tax Act. The writer of this thesis is of the opinion that such a scheme could involve the use of an *inter vivos* trust.

- Beneficiary a minor child

A special rule applies in terms of paragraph 69 of the Eighth Schedule when a capital gain is made by, or vests in, or is treated as vesting in, or is used for the benefit of, a person's minor child during a year of assessment in which the capital gain arises, and it can be attributed wholly or partly to a donation, settlement or other disposition made by a parent of the child. This rule mirrors the provisions of section 7(3) of the Income Tax Act. The rule states that so much of the capital gain as can be so attributed must be disregarded in the determination of the minor child's aggregate capital gain or aggregate capital loss and must instead be taken into account in the determination of the parent's aggregate capital gain or loss. Section 7(4) of the Income Tax Act provides a basis for the further application of paragraph of the Eighth Schedule. Accordingly, paragraph 69 of the Eighth Schedule will also apply if the capital gain can be attributed wholly or partly to a donation,

settlement or other disposition made by another person to a minor child, in return for a donation, settlement or other disposition or some other consideration made or given by a parent of the child in favour, directly or indirectly, of the person concerned or his family.

It follows that when a donation was made to a trust by the parent of a minor or by another person in return for a donation by the parent in favour, directly or indirectly, of the other person or his family, the amount of the capital gain attributable to the donation, settlement or other disposition must be taken into account in determining the aggregate capital gain or aggregate capital loss of the parent of the minor.

- Conditional vesting

When a person (the donor) has made a donation, settlement or other disposition that is subject to a stipulation or condition, imposed by him or anyone else, in terms of which a capital gain, or a portion of it, attributable to the donation, settlement or other disposition will not vest in all or some of the beneficiaries until some fixed or contingent event occurs, a special rule applies. This rule mirrors the provisions of section 7(5) of the Income Tax Act. The rule in terms of paragraph 70 of the Eighth Schedule provides that if a capital gain attributable to the donation, settlement or other disposition has arisen during a year of assessment throughout which the donor has been a resident and the capital gain, or a portion, has not vested in any resident beneficiary during that year, the capital gain or portion must be taken into account in the determination of the donor's aggregate capital gain or aggregate capital loss. In other words, it must be disregarded in the determination of any other person's aggregate capital gain or aggregate capital loss.

Clearly, this provision applies only when the capital gain has not yet vested in a beneficiary and does not impact on the provisions of paragraph 80 of the Eighth Schedule, since the latter addresses the situation when a capital gain is already vested in a beneficiary.

It is submitted that the Commissioner is entitled to invoke the provisions of paragraph 70 where, for example, a donation to a trust contains a stipulation or condition imposed by the donor in terms of which the capital gain is not to vest in the resident beneficiaries, or some of them, until the happening of some fixed or contingent event and during the relevant year of assessment the gain

has not vested in the beneficiaries. In these circumstances the capital gain must be taken into account when determining the aggregate capital gain or aggregate capital loss of the donor.

- Revocable vesting

If any deed of donation, settlement or other disposition confers upon a resident beneficiary the right to receive a capital gain, or a portion, which is attributable to the donation, settlement or other disposition and the deed of donation, settlement or other disposition contains a term that the right may be revoked or conferred upon another by the person by whom the right was conferred, a special rule applies. This rule mirrors the provisions of section 7(6) of the Income Tax Act. The rule in terms of paragraph 71 of the Eighth Schedule states that any capital gain, or a portion of it, attributable to the donation, settlement or other disposition that has in terms of that right vested in the beneficiary, must be taken into account in the determination of the aggregate capital gain or aggregate capital loss of the person retaining the power of revocation. In other words, it must be disregarded in determining the aggregate capital gain or aggregate capital loss of the beneficiary concerned. This rule will apply as long as the person by whom the right was conferred, first, remains a resident throughout the relevant year of assessment and, secondly, retains the power to revoke that right.

It is to be observed that paragraph 71 deals only with capital gains attributable to a donation, settlement or other disposition and is not concerned with any capital losses. Such a capital loss will remain with the trust or be attributed to the relevant person depending on the terms of the deed of donation, settlement or other disposition. Ironically this anti-avoidance provision might have the effect of reducing the amount of tax payable. For example, if a capital gain arises because of an asset donated to a trust that is subject to a right of revocation, the gain will be attributed to the donor and taxed in his hands at the lower effective rate applicable to natural persons and not at the higher rate applicable to trusts.

- Vesting in a non-resident

A special anti-avoidance rule contained in paragraph 72 of the Eighth Schedule applies when a resident has made a donation, settlement or other disposition to any person and a capital gain attributable to that donation, settlement or other disposition has arisen and has vested in, or is

treated as having vested in, a non-resident during a year of assessment. This rule mirrors the provisions of section 7(8) of the Income Tax Act. The rule states that the capital gain must be disregarded in the determination of the aggregate capital gain or aggregate capital loss of the non-resident beneficiary in whom it vests. Instead, it must be taken into account in the determination of the aggregate capital gain or aggregate capital loss of the resident who made the donation. This rule does not apply to donations, settlements or other dispositions to an entity, which is not a resident and which is similar to a public benefit organization referred to in section 30 of the Act. This means that when a resident makes a donation to a trust and a capital gain attributable to that donation arises which vests in or is treated as vesting in a non-resident, the gain must be taken into account in determining the aggregate capital gain or aggregate capital loss of the resident donor. It is to be observed that paragraph 72 deals only with capital gains arising from a deed of donation, settlement or other disposition and is not concerned with any capital losses. Such a capital loss will remain with the trust or be attributed to the relevant person depending on the terms of the deed of donation, settlement or other disposition.

- Attribution of income and capital gains

When an amount of income and a taxable capital gain are derived by reason of or are attributable to a donation, settlement or other disposition, the total amount of the income and capital gain may be subjected to the deeming provisions of section 7 of the Income Tax Act and the attribution rules shown above. Inevitably, this treatment will result in the deemed income and the attributed capital gain being subjected to tax in the hands of the person who made the donation, settlement or other disposition. Paragraph 73 of the Eighth Schedule provides relief in this situation by limiting the total amount of the income that is deemed to accrue to the donor and the gain to be attributed to him or her, to the amount of the benefit derived from the donation, settlement or other disposition. This has the effect of ensuring that normal tax on both the deemed income and the capital gains will not be payable by reason of the same donation. Davis, et al. (2005:2A-13), illustrates by way of an example: If a donation of R100 is made to the trust and the total sum of the income and the capital gain is R120, only R100 thereof can be attributed to the donor. The problem, however, hinges on the basis of apportioning the R100 between the income and capital gain. It is vital to establish an equitable method of resolving the issue owing to the different tax treatment of income and capital gains. It is submitted that the R100 has to be apportioned in the ratio that the attributable income and capital bear to the R100. So, for example, if the income in question is R80 and the capital gain

is R40, the portion of the R100 that will be attributed to the donor's income would be R66,66 and the portion attributable as a capital gain would be R33, 33 (Davis et al. (*supra*)).

- Recovery of attributed capital gains

In terms of section 90 of the Income Tax Act, where a capital gain has been attributed to a person by virtue of one of the anti-avoidance provisions in Part X of the Eighth Schedule, that person is entitled to recover the tax he has to pay, as a result of the attribution, from the person entitled to the capital gain.

- General anti-avoidance in terms of section 103 of the Income Tax Act

Davis et al. (2005:2A-12) warn that sight must not be lost of the fact that section 103(1) of the Income Tax Act, may be applicable where CGT has been avoided, reduced or postponed through the use of trusts. Also, if a trust is a sham, Revenue can simply treat the "trust's" capital gains as those of the settlor of the trust.

Method of calculating a taxable gain for a natural person

**Figure 4** is reproduced with amendments to illustrate the method of calculating CGT for the founder.

**Figure four**

**Method of calculating a taxable capital gain for the founder (natural person)**

Sum of capital gains for the year of assessment in terms of paragraph 3 of the Eighth Schedule		Rxxx
<u>Less:</u> Sum of capital losses for the year of assessment in terms of paragraph 4 of the Eighth Schedule Annual exclusion in terms of paragraph 5 of the Eighth Schedule.	Note 1 Note 2	(Rxxx) (Rxxx)
<u>Less:</u> Assessed capital loss brought forward in terms of paragraph 9 of the Eighth Schedule		(Rxxx)
Net capital gain in terms of paragraph 8 of the Eighth Schedule		Rxxx
Multiplied by		25%
Taxable capital gain in terms of paragraph 10 of the Eighth Schedule		Rxxx
<u>Note 1</u> In terms of paragraph 69 of the Eighth Schedule, a trust is not allowed to distribute its capital loss to a beneficiary.		
<u>Note 2</u> The exclusions only apply to natural persons and special trusts. Where disposals are made by the trust and the gain vests in the beneficiary, the beneficiary is not entitled to exclusions		

**Note 6: Taxable income**

Income tax is calculated on the taxable income of the founder at the applicable marginal rate. Once the income tax is calculated, the applicable rebate in terms of section 6 has to be deducted to calculate the tax liability of the beneficiary.

(b) **The trust**

The act of receiving the property from the donor will not occasion any income tax implications for the trust. For CGT purposes, however, the base cost of assets that are acquired will depend on the manner in which the asset was acquired. If the asset was acquired through a purchase and sale agreement, then the base cost will be determined in terms of Part V of the Eighth Schedule. If the asset was acquired through a donation, then the base cost will be the market value at date of acquisition in terms of paragraph 38 of the Eighth Schedule.

**2.2 The operational stage**

**2.2.1 Background**

In the operational stage of an *inter vivos* trust, the trustee administers the trust in terms of the provisions laid down in the trust deed. By law, the trustee has to comply with the provisions contained in the Trust Property Control Act. An exhaustive discussion of the trustee's duties falls outside the scope of this thesis. However, for the purpose of this thesis it is necessary to highlight those duties that impact on taxation. These duties are: payment of Master's fees, giving notice of address, obtainment of control over trust property, fiduciary duties, administration of the trust, conservation of trust property, rendering trust property productive, investment of trust funds, separation of private property from trust property, distribution of trust income and capital and involvement in the winding-up process of the trust (Du Toit: 2002). Furthermore, the powers attributed to the trustee and the beneficiary's rights are pivotal factors in determining the person in whose hands a liability for tax occurs. In the operational stage of an *inter vivos* trust, there are two parties involved, namely the trust and the beneficiary. The taxation of the trust and the beneficiaries in the operational stage is discussed below.

**2.2.2 Estate duty**

The estate duty implications for the trust and the beneficiary in the operational stage of an *inter vivos* trust are the same as in the case of a testamentary trust.

### 2.2.3 Transfer duty

The transfer duty implications for the trust and the beneficiary in the operational stage of an *inter vivos* trust are the same as in the case of a testamentary trust. However it is necessary to highlight the transfer duty implications for the beneficiary. No transfer duty in terms of section 9(4)(a) of the Transfer Duty Act is payable in respect of a change in the registration of property required as a result of the termination of the appointment of an administrator of a trust under a will or other written instrument. As from 16 March 1988, section 9(4)(b) stipulates that:

no duty shall be payable where trust property is transferred by the administrator of a trust in pursuance of the will or other written instrument in pursuance of which the administrator was appointed-

- i. to the persons entitled thereto under such will or
- ii. to a relative as contemplated in the definition of “relative” in section 1 of the Estate Duty Act, where the trust was founded in terms of such other written instrument by a natural person for the benefit of such relative, provided that no consideration is paid directly or indirectly by such relative in respect of the acquisition of such property.

In the case of an *inter vivos* trust, the requirement for exemption does apply, and “relative” in terms of the Estate Duty Act means, in relation to any person, the spouse of such person or anybody related to him or his spouse within the third degree of consanguinity, or any spouse of anybody so related. For the purpose of determining the relationship between any child referred to in the definition of child in section 1 of the Estate Duty Act, and any other person, such child shall be deemed to be related to its adoptive parent in the first degree of consanguinity (Pace and van der Westhuizen, 2002:85).

Where an *inter vivos* trust obtains property, and that property is subsequently transferred to a beneficiary of the *inter vivos* trust, the requirement for a relative as stated above does apply.

### 2.2.4 Value-added tax

The scope of the thesis is limited to natural persons and as such VAT implications will not arise.

### **2.2.5 Donations tax**

#### **(a) The trust**

Donations tax will not apply because donations tax is payable by a donor. However, in the case of *inter vivos* trusts, distributions to the beneficiary are made in terms of the trust deed and not through donations. Donations made by a trust in terms of the will of the trust deed to persons other than beneficiaries will be subject to donations tax in terms of sections 54 to 66 of the Income Tax Act. In practice, the terms of the trust deed may require the trustee to make donations to charitable organizations. These donations are exempt in terms of section 56(1)(l) because the property is disposed of in terms of the trust deed.

#### **(b) The beneficiary**

Donations made by the beneficiary in his or personal capacity will attract donations tax in terms of section 54 to 66 of the Income Tax Act.

### **2.2.6 Income tax and capital gains tax (CGT)**

#### **(a) The beneficiary**

**Figure 3** is used to illustrate the income tax consequences for a beneficiary, by explaining each note in the figure.

#### **Note 1: Gross income**

Gross income is defined in section 1 of the Income Tax Act. The beneficiary's gross income could include amounts derived from various sources. Trust income, being one of the sources, either received or accrued will be included in the beneficiary's gross income. A beneficiary receives income from the trust when the trustee actually distributes such income to the beneficiary.

However, there are instances where a beneficiary receives an amount in the present year of assessment in respect of an amount that was accrued to the beneficiary in the previous year of assessment. Such a situation arises through the vesting provisions of the trust deed. Section 25B of the Income Tax Act, dictates the circumstances in which a beneficiary is taxed on his income from the trust. In this regard the principles of vested right and contingent rights are critical factors in

determining the person in whose hands the income is taxed. These principles were discussed in paragraph 2.2.2 (e) above. In relation to an *inter vivos* trust, section 25B of the Income Tax Act, is applied subject to the anti-avoidance provisions contained in sections 7(3) to 7(8). The main aim of these anti-avoidance rules is to prevent donors from manipulating structures in order to shift the incidence of tax to persons who enjoy a lower marginal tax rate, and at the same time reducing the donor's liability for income tax. These anti-avoidance rules ensure that the beneficiary of such income is not held liable for tax by shifting the incidence of tax back to the donor. These anti-avoidance rules were discussed in paragraph 2.1.6 (a) above.

Nature of income:

This has been discussed in paragraph 2.2.2 (e) above.

Note 2: Exemptions

This aspect was discussed in paragraph 2.2.2 (e) above.

Note 3

Income as defined is the amount which remains after deducting exemptions from gross income in terms of section 1 of the Income Tax Act..

Note 4: Deductions

The discussion on deductions is also relevant to *inter vivos* trusts and this aspect was covered in paragraph 2.2.2 (e) above.

Note 5: Taxable capital gains

In terms of paragraph 3 of the Eighth Schedule, a person's capital gain for a year of assessment is defined as the amount by which the proceeds from the disposal of an asset during that year an asset exceeds the base cost of the asset. 'Proceeds', 'base cost', 'disposals' and asset are defined in paragraphs 35, 20, 11(i) and paragraph 1 of the Eighth Schedule, respectively. A portion of the capital gain is included in the taxable income of the beneficiary. If the beneficiary is a natural person, the inclusion rate is twenty-five percent. If such a person is taxed at a marginal rate of forty percent (the maximum marginal tax rate), this means that the capital gain will be taxed at an effective rate of ten percent.

The application of capital gains tax (CGT) is a fairly complicated process. Factors such as the vesting principles, attribution rules and valuation rules complicate the application of CGT. The vesting principle is probably the most important principle in determining the person in whose hands the liability for CGT rests. A beneficiary could acquire a vested right to trust income, trust property and or a capital gain in terms of the trust deed. Such vested right could be conferred upon a beneficiary in one of two ways, namely, (a) where the trust instrument provides that a beneficiary is immediately entitled to trust income, property and or capital gains or (b) where the trust instrument provides that a trust beneficiary's acquisition of a personal right to claim payment of trust income and or capital gains from the trustee is not immediate but rather contingent or conditional upon the occurrence of an uncertain future event, the right to trust income and or capital gains will only vest in such beneficiary if and when the contingency has taken place or the condition has been fulfilled. In the former case the vesting is immediate while in the later case the vesting is postponed.

The anti-avoidance rules attribution rules in terms of Part X of the Eighth Schedule are applicable to an *inter vivos* trust. This has been discussed in paragraph 2.1.6 above.

#### Note 6: Taxable income

Income tax is calculated on the taxable income of the beneficiary at the applicable marginal rate. Once the income tax is calculated, the primary rebate has to be deducted to calculate the tax liability of the beneficiary.

#### **(b) The trust**

The income tax implications for the trust are discussed with the aid of **Figure 3**.

#### Note 1: Gross income

In terms of section 1 of the Income Tax Act, the gross income of the trust could include amounts received or accrued from investments made by the trustee. These amounts could include, for example, interest, dividends, rentals and even profits from a business administered by a trustee in pursuance of a trust object. In terms of sections 25B(1) and 25B(2) and in the absence of the anti-avoidance rules contained in section 7 of the Income Tax Act, income which does not vest in a beneficiary will be deemed to be the income of the trust. Trust income is taxed in the hands of the trust at a flat rate of 40 percent. The gross income for the trust for the year of assessment is arrived

at by deducting from the total amount received by the trust, any amounts that accrue to the beneficiaries in terms of their vested rights.

#### Note 2: Exemptions

Dividends received by the trust are exempt from income tax in terms of section 10(1)(k) of the Income Tax Act. The interest exemption in terms of section 10(1)(i)(xv) does not apply to a trust.

#### Note 3: Income

Income is the amount that remains after deducting exempt income from gross income in terms of section 1 of the Income Tax Act.

#### Note 4: Deductions and allowances

The income of the trust is reduced by all applicable deductions in terms of sections 11 to 19 and the prohibitive conditions in terms of section 23 of the Income Tax Act also apply. An example of such a deduction is administration expenses. Where the trust incurs an expense in order to generate income, section 25B(3) allows for the apportionment of such expenses between the trust and the beneficiary. In this regard the principles that apply to a testamentary trust also apply to an *inter vivos* trust and this was discussed in paragraph 2.2.2 above. Expenses incurred to generate exempt are not allowed in terms of section 23(f) of the Income Tax Act.

#### Limitations of expenses (or ring-fencing of expenses)

This has been discussed in paragraph 2.2.2 above.

#### Note 5: Capital gains tax

Disposals of assets by a trust will occasion CGT implications for a trust.

- Vesting of capital asset in a resident beneficiary

In terms of paragraph 80(1) of the Eighth Schedule, the capital gain attributed to the beneficiary must be disregarded in determining the aggregate capital gain or aggregate capital loss of the trust.

- Vesting of an interest in an asset of the trust

The rule in paragraph 11(1)(d) read together with paragraph 13(1)(d) of the Eighth Schedule states that the capital gain attributed to the beneficiary must be disregarded for the purposes of calculating the aggregate capital gain or capital loss of the trust.

- Vested right to capital gain

The vested right of the beneficiary to the capital gain must be disregarded for the purposes of calculating the aggregate capital gain or capital loss of the trust (Silke: 2005). The trustee should also take into account the attribution rules mentioned above. These attribution rules apply over and above the general rules guiding the treatment of vested rights and contingent rights. These rules were discussed in paragraph 2.1.6 above.

#### Loans

The annual waiver of a loan to a trust in an amount of R30 000 could result in a capital gain of R30 000 in the hands of the trust which, depending on the circumstances, would be attributed to the trust beneficiaries or the trust. In this regard the attribution rules relating to the waiver of the loan are decisive in determining the party in whose hands the liability for CGT will fall.

- Exclusions

This has been discussed in paragraph 2.2.2 above.

#### Value-shifting arrangements

A situation may arise where a beneficiary, in terms of the trust deed, acquires an interest in the trust. Such a beneficiary may find himself being subjected to value-shifting arrangements in the trust.

The concept of value shifting deals with the shifting of value between connected persons in a way that would otherwise not have constituted a disposal in terms of the Eighth Schedule. In this regard,

Deidre Pieterse (2002:29-31) uses the following example to outline the difficulties and the risk involved in applying value-shifting arrangements. Assuming that a beneficiary of a discretionary trust is a person with an interest in the trust (say a discretionary trust), the question then arises as to whether a value-shifting arrangement occurs when a trustee of such a trust with two beneficiaries exercises his or her discretion to add a third beneficiary. A similar difficulty occurs when a trustee of a trust with three beneficiaries exercises his or her discretion by vesting a substantial asset of the trust in only one of these beneficiaries. Given the wide meaning of the word arrangement and the vague nature of the section, there is a real risk that this kind of transaction falls foul of the value-shifting concept.

#### Note 6: Income tax liability

Income tax is calculated on the taxable income of the trust at a flat rate of forty percent. An *inter vivos* trust does not qualify for a rebate in terms of section 6 of the Income Tax Act.

### **2.3 The termination stage**

#### **2.3.1 Background**

All aspects relating to the termination of the *inter vivos* trust are found in the trust deed. A trust can terminate after the lapse of time or at the happening of a future event or it can be left to the discretion of the trustees to terminate the trust (Olivier: 1992). It is beyond the scope of this thesis to survey the law surrounding the termination of a trust. When a trust is terminated the destination of the remaining trust property, if any, depends on the mode of termination. If the beneficiaries have effected the termination of the trust, they are entitled to direct how the property should be distributed. If the founder has revoked the trust by virtue of a unilateral power of revocation or with the concurrence of the trustee, he or she is entitled to recover the trust property by *condictio* (personal action).

In any other case of termination of a trust *inter vivos* the provisions, if any, of the trust instrument apply, but in default of such provisions, the founder or his successors may recover the trust property by *condictio*, unless the founder intended to part permanently with any claim to the property, or he or his successors have since the commencement of the trust waived any such claim, in which case the property vests in the state as *bona vacantia* (Honore', 1992:467). However, Burne (1999:64)

indicates that most trust deeds provide for the devolution of the wealth accumulated in the trust to the beneficiaries on the winding up of the trust.

Where the wealth accumulated in the trust is distributed to beneficiaries, the tax implications thereof are similar to that of a testamentary trust.

### 3 **Conclusion**

The aim of this chapter was to demonstrate the complexities relating to the interaction of the various taxes at each stage in the life cycle of the testamentary trust. It was noted that the act of creating the testamentary trust does not absolve the founder of his liability for estate duty.

In this regard, many planners use the discretionary *inter vivos* trust to minimize the effects of the various taxes, more especially, the minimization of estate duty. It was noted that, compared with the testamentary trust, the *inter vivos* trust is subjected to a wide range of anti-avoidance measures that are aimed at frustrating certain tax planning techniques. Furthermore, the *inter vivos* trust pays the highest rate of income tax.

Noting the changes made to the tax rates applying to trusts, financial planners and authors of articles on taxation have developed numerous estate planning models and have published various case studies. These models are evaluated in chapter four with a view to developing a holistic estate and tax-planning model.

## **CHAPTER FOUR: TAX AND ESTATE PLANNING**

### **Introduction**

Chapter three dealt with the application of the various taxes at each stage in the 'life cycle' of a testamentary trust as well as the *inter vivos* trust. It was noted that the complex nature of the application of these taxes might cause a planner to reconsider his planning strategy involving trusts. The writer of this thesis is of the opinion that the impact of taxes alone should not detract from a planner's intention to create a trust. In this regard, the planner or his adviser should display a high level of skill in developing an appropriate estate-planning model and such skill should be complemented with a thorough knowledge of relevant legislation and the principles of estate planning. The principles and legislation relating to estate planning were covered in chapter two and legislation relating to the taxation of trusts was covered in chapter three. The writer of this thesis believes that a holistic estate-planning model involving the use of trusts should incorporate the principles and legislation relating to estate planning as well as legislation relating to the taxation of trusts. This chapter aims to develop a holistic estate-planning model involving the use of a testamentary trust as well as a holistic estate-planning model involving the use of an *inter vivos* trust. This chapter is divided into two sections for the purposes of the discussion, namely, sections A and B.

Section A outlines the instrument against which the testamentary trust is evaluated and the factors that are critical in developing a holistic estate-planning model involving the use of the testamentary trust. Section B outlines the instrument against which the *inter vivos* trust is evaluated and the factors that are critical in developing a holistic estate-planning model involving the use of the *inter vivos* trust.

## **SECTION A: EVALUATION OF THE TESTAMENTARY TRUST**

### **1. Introduction**

The testamentary trust, more so than most other estate planning vehicles, lends itself to the achievement of a number of purposes. These purposes include making provision for the disposition of income and assets to beneficiaries upon the simultaneous death of both spouses, administration of property and income from the deceased estate on behalf of minors and/or other persons who are incapable of managing their own affairs and ensuring the financial security of the surviving spouse and his or her children, as testamentary heirs. These purposes, as well as amendments made to the definition of a special trust, have helped to enhance the popularity of the testamentary trust.

The writer of this thesis is of the opinion that it is necessary to test the popularity of the testamentary trust against the principles of estate planning, as well as legislation relating to the taxation of the testamentary trust. In this regard, this section outlines the instrument against which the testamentary trust is evaluated and the factors that are critical in developing a holistic estate-planning model involving the use of the testamentary trust.

### **2. Evaluation of the testamentary trust**

The following criteria constitute the instrument that is used to evaluate the testamentary trust:

- i. the objectives of estate planning;
- ii. the legality of the trust; and
- iii. the suitability of the trust, with regard to the different marital regimes.

This instrument is discussed below.

#### **2.1 The objectives of estate planning**

The objectives of estate planning, which were covered in detail in chapter two, are used as a yardstick to evaluate the viability of a testamentary trust in an estate plan. These objectives are discussed below.

- **Saving of estate duty and CGT**

The objective of saving estate duty and CGT is evaluated with reference to the planner and the beneficiaries.

### **Beneficiaries**

Exposure to estate duty and CGT depends on whether the trust is a discretionary trust or a vesting trust. Probably the only instance where estate duty and CGT can be saved is where, on the death of the beneficiary, the beneficiary enjoys a contingent interest in the corpus and income of the trust.

If the trustee is empowered to make discretionary payments to beneficiaries and to vest assets in the hands of the beneficiaries in terms of the trustee's discretionary power, then the beneficiary of the trust is said to enjoy a discretionary entitlement. Until such time of vesting, the beneficiaries merely enjoy an interest in the corpus of the trust and have no real right in the asset concerned. If, in such circumstances, the beneficiary were to die prior to vesting of the asset, the interest in the asset will not constitute property for estate duty purposes (*Commissioner for Inland Revenue & Others v Sive's Estate*, 20 SATC 66). Furthermore, the beneficiary is not subjected to any capital gains tax.

### **Founder**

As was noted in chapter three, the creation of a testamentary trust does not absolve the executor of the founder's deceased estate of his or her liability for estate duty and CGT. The executor is liable for estate duty on the dutiable value of the estate in excess of R1,5 million. A critical factor working against the founder is the time value of money. Because estate duty is calculated at the time of death, there is always the possibility that the dutiable value of the estate will increase from the date of signing of the will to the date the testamentary trust takes effect.

- **Liquidity**

If the estate of the planner is large, the planner may experience cash flow problems with regard to the payment of estate duty and CGT. The objective of maintaining a liquid estate is not met by the

creation of a testamentary trust. In this regard planners are encouraged to take out insurance policies to remedy cash flow problems that may arise at the time of the planner's death.

- **Control and flexibility**

Goldswain (2003:21) indicates that a testator may not delegate the appointment of beneficiaries of a testamentary trust to trustees. The testator himself must appoint the beneficiaries. Because the trust does not take effect during the founder's lifetime, the founder is able to amend the terms of the trust at any time before his death thereby enabling the exercise maximum of control over his or her assets.

The flexibility of the testamentary trust depends on the wording of the trust deed. A very rigidly structured trust causes unnecessary hardship and misery for dependants of the planner. A testamentary trust that provides for discretionary payments to be made to beneficiaries is a suitable planning vehicle in instances where it is anticipated that the needs of the beneficiaries will change in the future.

- **Savings of income tax**

The object of saving income tax is evaluated at the level of the trust as well as at the level the beneficiary. The extent to which these parties are liable for income tax will depend on whether the trust is a discretionary trust or a vesting trust and whether the trust qualifies as a special trust as defined in section 1 of the Income Tax Act.

Income tax is saved by applying the following techniques:

- ⇔ The trust deed must provide for distribution of income out of the retained income of the trust. In this instance, the beneficiary is not be taxed on receipt of the trust's retained income.
- ⇔ The trust deed must be carefully worded so that the trust would qualify as a special trust in terms of section 1 of the Income Tax Act. The trust would then pay income tax at a lower marginal rate applicable to natural persons.

⇔ Under a discretionary testamentary trust, the trust instrument should provide for the distribution of trust income in accordance with the needs of individual beneficiaries. Trust income under a discretionary testamentary ownership trust can be allocated in accordance with the needs of individual beneficiaries, resulting in benefits for multiple taxpayers once the total income is distributed amongst them, thus spreading income tax liability in an egalitarian manner. Moreover, should only a portion of trust income be distributed to trust beneficiaries in a given year of assessment, section 25B of the Income Tax Act dictates that the remainder will be taxed in the hands of the trust and not in the hands of the beneficiaries, thereby relieving the latter's income tax burden (Du Toit, 2002:166).

- **Provision of income and capital for dependants**

The testamentary trust is ideal for the provision of income and capital for dependants. In this regard, the definition of a special trust was specially amended in 2002 to allow for a broader category of beneficiaries who may benefit under such a trust. Provided that the trust is a testamentary trust, that the youngest beneficiary is a relative as defined in section 1 of the Income Tax Act and is below the age of twenty-one years on the last day of assessment, the trust will qualify as a special trust. Planners are encouraged to take advantage of the benefits that flow from the use of a special trust.

- **Saving of donations tax and transfer duty**

The transfer of benefits to trust beneficiaries in terms of the provisions of a trust instrument is exempt from donations tax in terms of section 56(1)(1) of the Income Tax Act. Repudiation by a testamentary trust beneficiary of trust benefits, the right to which has not yet vested or is merely contingent, will occasion no liability for the payment of donations tax by virtue of the fact that property as contemplated in section 55(1) is not disposed of.

In terms of Section 9 of the Transfer Duty Act, no transfer duty is payable where trust property is transferred to a beneficiary in pursuance of a will or any other instrument in terms of which an administrator is appointed, where such transfer is effected to either the persons entitled thereto under such will or to a relative as contemplated in section 1 of the Estate Duty Act.

- **Capital appreciation and income protection**

A testamentary trust is created, not as a result of commercial considerations and decisions, but mainly for the provision of income and capital for the beneficiaries. In so doing, planners tend to overlook the object of limiting the growth of capital, thereby creating a liability for estate duty and CGT in the hands of the executor.

- **Protection against insolvency and inflation**

Protection against insolvency includes the insolvency of not only the planner, but also his or her future beneficiaries and spouses of beneficiaries. The testamentary trust is not exempt from the effects of inflation and insolvency. Inept administration could create serious financial problems for the trust. Sound administration of the trust is only possible if the trustee is given clear directions. It is therefore vital that clear directions regarding matters affecting the administration of the trust are incorporated into the trust deed.

## **2.2 Legality of the trust**

Trust law and well as the Income Tax Act are used to test the legality of the testamentary trust. With regard to trust law, Du Toit (2002:23) indicates that, in its strictly technical sense, the testamentary trust is a legal institution *sui generis*, that is, an independent institution governed by its own peculiar legal rules and principles. With regard to the Income Tax Act, the testamentary trust is not subject to anti-avoidance measures in terms of sections 7(3) to 7(8) or section 103 of the Income Tax Act. Section 103(1), which is used to test the legality of tax avoidance structures, will not apply to a testamentary trust because a testamentary trust is created by the will of the deceased and not by a deliberate attempt to avoid taxes.

## **2.3 Suitability with regard to the different marital regimes**

Since 1 January 1954, the capacity to make a will is governed by section 4 of the Wills Act, no. 7 of 1953, which gives every person aged sixteen years or more the right to make a will unless, at the time of making the will, he or she is mentally incapable of appreciating the nature and effect of his or her act. It therefore stands to reason that, subject to the provisions of section 4 of the Wills Act,

any person, irrespective of his or her marital regime or marital status, will qualify to make will. However, the testamentary trust is best suited to persons who are married with dependants.

One could conclude from the above evaluation that the testamentary trust is a viable estate-planning vehicle. However, a major disadvantage associated with the use of a testamentary trust as an estate-planning vehicle, is that the executor and/or the surviving spouse of the founder and the beneficiary and/or the beneficiary's spouse, are not absolved from the liability to pay estate duty and or CGT.

In this regard, authors of estate planning textbooks and financial advisers have developed numerous strategies aimed at reducing or eliminating exposure to CGT and estate duty. Stated hereunder is a strategy, which the writer of this thesis considers to be a useful technique that could be used in the estate planning process.

#### **Bequest of the residue of the estate to the surviving spouse**

The authority for this technique is *C:SARS v Estate Frith*, 63 SATC 77. In this case it was held that where the residue of an estate is deductible in arriving at the dutiable amount, the quantum of any such deduction is not reduced by the amount of any estate duty payable in respect of any other bequests. This situation will apply where the residue heir is the surviving spouse. By making such person the residue heir, a saving of estate duty may be achieved where other persons are also to benefit from the estate.

The planner could have employed this technique as follows:

Assume that the planner whose net assets amounted to R10 million (before any bequests) wishes to leave R3,5 million to his wife and the balance, after paying any duty, to a testamentary trust in favour of his children . He could have achieved this outcome in of two ways:

- (a) Makes a specific bequest in his will of R3,5 million to his wife with the residue of his estate going to his children. In this case estate duty of R1 million would be payable, calculated as follows:

Net assets	R10 000 000
<u>Less: Deduction for accrual to surviving spouse (section 4(q) of the Estate Duty Act)</u>	(3 500 000)
Net value of estate	6 500 000
<u>Less: Section 4A abatement</u>	(1 500 000)
Dutiable amount	5 000 000
Duty thereon at 20%	1 000 000
<u>Distribution to the estate:</u>	
Surviving spouse	3 500 000
Testamentary trust	5 500 000
Estate duty	1 000 000

- (b) He makes a specific bequest in his will of R5,5 million to a testamentary trust in favour of his children, with the residue of his estate going to his wife. In this case estate duty of R0, 8 million would be payable, calculated as follows:

Net assets	R10 000 000
<u>Less: deduction for accrual to surviving spouse (section 4(q) of the Estate Duty Act) (R10 million less R5,5 million)</u>	(4 500 000)
Net value of estate	5 500 000
<u>Less: Section 4A abatement</u>	(1 500 000)
Dutiable amount	4 000 000
Duty thereon at 20%	800 000
<u>Distribution to the estate:</u>	
Surviving spouse	3 700 000
Testamentary trust	5 500 000
Estate duty	800 000

Adapted from Davis et al (2005: 9-18)

Under alternative (b) the residue heir, the wife receives an extra R0,2 million of the assets, being the saving in duty as compared with alternative (a).

With regard to this technique Scholtz (2005) indicates that, in order to exploit the section 4A primary abatement from estate duty to the full, it is suggested that the planner might in appropriate circumstances bequeath R1,5 million to a discretionary trust for the benefit of the spouse and the children, while bequeathing the balance of the assets to the surviving spouse.

If the trust conferred fixed entitlements upon the survivor, these entitlements, will attract a section 4(q) deduction in terms of the Estate Duty Act in the hands of the estate of the first-dying. These entitlements will nevertheless attract estate duty in the hands of the surviving spouse. This would defeat the objective of reducing the estate of the survivor.

There will be considerable scope for refinement in determining what ought to be allocated to the discretionary trust and what ought to be allocated to the survivor. If there is substantial cash in the estate, this might advisably be left to the trust, with other assets being preferentially allocated to the surviving spouse. There is no CGT payable on the transfer of money.

Where the surviving spouse is a discretionary beneficiary under the trust, and the trustee's discretion is appropriately expressed and exercised, the survivor may continue to enjoy the financial benefits to be derived from the assets, but without such assets being included in the survivor's estate. There is no CGT exposure on the transfer of money, and there is a postponement of CGT liabilities on the transfer of assets to the surviving spouse. By allocating the money to the trust, and other assets to the surviving spouse, CGT exposures might be drastically reduced at the level of the first dying.

The basic (and, perhaps, simplistic) pattern of allocating cash to the trust, and other assets to the survivor, may have to be varied in the face of contrary considerations. If an asset has shown relatively little appreciation over and above the base cost to the deceased, but is expected to grow significantly in value over the life expectancy of the survivor, it might well be wiser to allocate that asset to the trust. In such cases, allocating the asset to the survivor would effect a relatively small saving in CGT at the level of the first-dying, at the expense of a substantial CGT exposure upon the death of the survivor if the expected growth in the value should materialize.

As a further refinement of this technique, Scholtz (2005:90) suggests that the estate that devolves upon the surviving spouse should be subjected to an obligation that the survivor leaves an amount

equal to the inheritance or R1,5 million – whichever is less – to a trust in favour of the founder's dependants. The obligation imposed on the survivor should give rise to a deduction at the level of the survivor's deceased estate, on the basis that it is a debt to be discharged by that deceased estate.

Where, with this approach, the survivor obtains or retains the full ownership of all the assets, there will be no CGT exposure unless and until the survivor sells the assets, or dies holding the assets. The price of postponement is inherent in the survivor's position as a recipient of a roll over in terms of paragraph 67 of the Eighth Schedule. The assets acquired by the survivor from the first dying will essentially have their base cost determined by reference to their base costs in the hands of the first dying, leaving the survivor with substantial CGT exposure on the subsequent disposal. This is to be contrasted with the CGT planning opportunities where assets falling within the estate of the first dying can be judiciously allocated to a trust on death of the first dying, in a trade-off between lesser, immediate CGT exposures, and greater, postponed exposures.

#### **Summary of the tax implications relating to the above strategy**

There are two distinct parts to this strategy, namely:

- bequeathing an amount of R1,5 million to a testamentary trust and bequeathing the residue of the estate to the surviving spouse; and
- an obligation that the surviving spouse bequeaths an amount equal to the inheritance or R1,5 million whichever is less, to a trust in favour of her children.

#### **Tax implications for each party**

##### **Founder**

- **Estate duty**

By bequeathing the residue of the estate to the surviving spouse, the founder's estate will qualify for a section 4(q) deduction in terms of the Estate Duty Act and, as was noted in the above example, a further saving of estate duty is possible by bequeathing the residue of the property to the surviving spouse.

- **Capital gains tax**

The bequest of the residue of the property to the surviving spouse will not attract CGT at the level of the founder in terms of section 67 of the Income Tax Act.

### **Surviving spouse**

- **Estate duty**

The surviving spouse is subject to estate duty on his or her inheritance. The obligation to bequeath a portion of his or her estate to a trust should qualify for a section 4(b) deduction in terms of the Estate Duty Act.

- **Capital gains tax**

The base cost of assets that are inherited by the surviving spouse is the market value of the property at the time of death of the first dying. Exposure to CGT arises when the surviving spouse disposes of the property. The extent to which the surviving spouse is subject to CGT depends on whether or not the asset is a growth asset.

### **Beneficiary**

- **Estate duty and capital gains tax**

If the beneficiary dies while enjoying a contingent right to the corpus of the trust, the beneficiary will not be subjected to estate duty or CGT. If the beneficiary survives the termination date of the trust and if assets are disposed of to the beneficiary, the beneficiary will be subject to both estate duty and CGT.

### **3 A holistic estate planning model involving the use of a testamentary trust**

The aspects outlined above form the basis on which a holistic estate-planning model involving the use of a testamentary trust is developed (adapted from Pace and van der Westhuizen, 2003: 38-39). It was noted that the testamentary trust is most suitable in instances where the testator has minor

children. The model or guidelines indicated below relate to a testamentary trust that involves beneficiaries who are dependants of the testator.

Although the trust deed can be standardized to a great extent, it is important to keep in mind that it remains a “creature of document” compared to the company and close corporation which can be termed “creatures of statute” (Pace and van der Westhuizen, 2003:35). A trust, therefore, is only as good as the document creating it allows it to be. The document in the case of a testamentary trust is the will.

With regard to the will, special attention must be given to the following:

- The will must comply with all the formalities prescribed by the Wills Act 7 of 1953.
- The clauses providing for the trust can be incorporated in the will itself or as an annexure to the will. The annexure must also comply with all the formalities prescribed by the Wills Act 7 of 1953.

With regard to the trust instrument, special attention must be given to the following:

- The parties involved in the trust must be properly identified. The capacities of these parties as founder, trustees and beneficiaries must be properly described in the will. The trust deed must also include the date of birth of each beneficiary. The wording of the trust deed should make a clear distinction between income and capital beneficiaries.
- Words such as children, trust fund, trust capital, trust income, trust property, vesting date (if any) or any other word or phrase used in the trust deed must bear a clear description in the trust deed.
- The trust should be given a name although this is not mandatory.
- The appointment of trustees, including provisions relating to the number of trustees, must be clearly stated in the trust deed.
- The trust object must be clearly defined.
- The grounds for the termination of the trustee’s office must be clearly stated in the trust deed.

- The trustees' powers, competencies and obligations, including a clear description of the trustees' discretionary powers and duties as well as their remuneration, must be dealt with in the trust deed. Because trustees do not have statutory powers, the powers given to trustees in the trust deed are the only powers they have.
- The trustees' exemption from security must be specifically stated in the trust deed.

With regard to tax and estate planning matters, special attention must be given to the following:

- The value of the bequest to the testamentary trust must be clearly captured in the trust deed, for example, "an amount of R1,5 million must be bequeathed to the Trustees of the XYZ Trust".
- The wording of the will must clearly highlight that the residue of the estate is to be bequeathed to the surviving spouse.
- The following must be clearly stated in the trust deed:
  - △ the discretionary powers of the trustee, and
  - △ factors that the trustee should consider before distributions are made and the date (if possible) on which such vesting should take place. Some of these factors are expounded below;
    - θ the specific needs of beneficiaries, for example, school fees, clothing, holiday expenses et cetera;
    - θ income that is partially or fully exempt from income tax is one of the factors that the trustee has to consider when distributing income to the beneficiary. Since interest is either partially or fully exempt in the hands of a natural person, such interest should be distributed to a beneficiary and not retained in the trust;
    - θ The marginal tax rates of beneficiaries must be considered when determining the amount that has to be distributed to the beneficiary;
    - θ The type of the asset (fixed property, cash, et cetera) that will ultimately vest in the hands of the beneficiaries is a decisive factor in determining the manner in which assets are distributed to the beneficiaries. There are no CGT effects for the distribution of cash.

- The utilization of income and or capital must be stated in the trust deed. In this regard, specific powers to deal with income and or capital must be given to the trustee. The trustee must be given specific discretionary powers to invest the capital of the trust in a manner, which in the opinion of the trustee, is best suited to the trust and will yield optimum returns for the trust. As a suggestion, the trustee should select an investment vehicle that yields income that is either fully or partially exempt from income tax.
- If it is the testator's intention that donations are to be made to charitable organizations, and if expenses such as medical expenses and school fees are to be met by the trustee, then such intentions must be clearly stated in the trust deed.
- The trustee must ensure that all title deeds in respect of the transfer of immovable property are properly endorsed.
- All aspects relating to the termination of the trust must be clearly stated in the trust deed.

**General remarks:**

The above serves as a model against which the trust deed should be drafted. Vigorous tax planning at the expense of other estate planning objectives must be avoided at all costs. The object of saving taxes is one of the many objectives of estate planning. With regard to tax planning, the planner should aim to neutralize the effects of all applicable taxes rather than to save a specific tax.

The writer of this thesis suggests that the creation of "sub-trusts" whereby distributions in terms of a trust deed are made to trusts rather than beneficiaries should be avoided in view of the recommendations made by the Margo Commission (dealt with in chapter one) as well the amendments relating to the definition of a special trust.

**4. Conclusion**

From the evaluation outlined above, it could be concluded that the use of the testamentary trust in an estate plan is a viable planning technique especially in estates where dependants are involved.

However, the same cannot be said if the testator is an unmarried person or a single parent. Exposure to estate duty as well as CGT is unavoidable for these persons.

Initiatives taken by the Commissioner for SARS to encourage planners to hold their assets until death, to be personally liable for income tax and to make use of the testamentary trust rather than an *inter vivos* trust, include the recent amendment to the definition of a special trust as well as a progressive reduction over the years in the marginal tax rate applicable to individuals. The writer of this thesis is of the opinion that it appears that these initiatives were intended only for persons who have dependants.

For the single parent, the unmarried person and estates where there are no dependants, exposure to estate duty is unavoidable. Furthermore, a testamentary trust created by an unmarried person or parents who have dependants that are over twenty-one years of age will be taxed at a flat rate of forty percent. These individuals have at their disposal a number of techniques aimed at reducing estate duty, the most common one being the *inter vivos* trust. An evaluation of the use of the *inter vivos* trust in an estate plan is discussed in section B. An evaluation of alternate estate planning techniques aimed at reducing estate duty falls outside the scope of this thesis.

## **SECTION B: EVALUATION OF THE *INTER VIVOS* TRUST**

### **1. Introduction**

The aim of this section is to evaluate the *inter vivos* trust against the broad objectives of estate planning as well as the principles relating to the taxation of the *inter vivos* trust. The broad objectives of estate planning were outlined in chapter two as well as in section A of this chapter and the principles relating to the taxation of the *inter vivos* trust were outlined in section B of chapter two.

The *inter vivos* trust, more so than most other estate planning vehicles aimed at reducing estate duty, lends itself to the achievement of a number of different purposes. These purposes include the savings of estate duty, administration of property and income from the deceased estate on behalf of minors and or other persons who are incapable of managing their own affairs, ensuring the financial security of the surviving spouse and his or her children and ensuring that the estate is liquid. There are, however, certain disadvantages associated with the use of the *inter vivos* trust.

The writer of this thesis is of the opinion that it is necessary to test the popularity of the *inter vivos* trust against the principles of estate planning as well as legislation relating to the taxation of the trust. In this regard, this section outlines the instrument against which the *inter vivos* trust is evaluated and factors that are critical in developing a holistic estate-planning model involving the use of the *inter vivos* trust.

### **2. Evaluation of the *inter vivos* trust**

It has been authoritatively decided that the trust *inter vivos* is created by a *stipulatio alteri* – a contract between a trust founder (*stipulans*) and the trustee (*promittens*) for the benefit of a trust beneficiary (the third party) (Du Toit: 2002:23). The *inter vivos* trust comes into existence from the moment the contract or trust deed is executed. Assets are either donated or transferred to the trust. These assets are administered by the trustee for the benefit of the beneficiaries of the trust.

Before exploring the use of the *inter vivos* trust as an estate-planning vehicle, it is necessary to tabulate some of the differences between an *inter vivos* trust and a testamentary trust.

**Basic differences between a testamentary trust and an *inter vivos* trust**

<b>TESTAMENTARY TRUST</b>	<b><i>INTER VIVOS</i> TRUST</b>
1. Created in the will of the planner.	1. Created by donating and/or selling assets to the trust.
2. Can be a special trust as defined in section one of the Income Tax Act.	2. Cannot be a special trust.
3. Anti-avoidance legislation does not apply.	3. Specific anti-avoidance rules contained in sections 7(3) to 7(8) and Chapter X of the Eighth Schedule as well as general anti-avoidance rules in terms of section 103 of the Income Tax Act, apply.
4. The will is the founding document.	4. The trust deed or the trust contract is the founding document.

It is clear from the above that one of the basic differences between a testamentary trust and an *inter vivos* trust is the anti-avoidance legislation that applies to the *inter vivos* trust. Anti-avoidance rules were incorporated into the Income Tax Act to curb the use of trusts as tax-avoidance vehicles.

The *inter vivos* trust, like the testamentary trust, has three stages, namely, the formation stage, the operational stage and the dissolution stage. While the operational and the dissolution stages are similar for both the testamentary trust and the *inter vivos* trust (and will not be dealt with in detail in this section), there is a notable difference in the creation stage. It is in the creation stage of the *inter vivos* trust that a planner could discover to his dismay that his noble intentions could come under the attack of the anti-avoidance rules. Together with the anti-avoidance rules, there are also other factors that compound the dilemma facing the founder. These are captured in the evaluation that follows.

The following criteria constitute the instrument used to evaluate the *inter vivos* trust:

- i. the objectives of estate planning;
- ii. the legality of the trust; and
- iii. its suitability with regard to the different marital regimes.

The objectives of estate planning, which were covered in detail in chapter two, are used as a yardstick to evaluate the viability of using an *inter vivos* trust in an estate plan. These objectives are discussed below.

## **2.1 The objectives of tax planning**

- **A safeguard against insolvency and personal debt**

Du Toit (2002:175) indicates that the trust instrument must state emphatically that the beneficiary's interest under the trust will cease (and not merely be suspended) and revert to the trust upon his insolvency or when his personal indebtedness exceeds a particular limit. The trustee is then duty bound to hold and use the reverted beneficiary's interest for the benefit of the beneficiary or his or her relatives.

- **Saving of estate duty and CGT**

The objective of saving estate duty and CGT is evaluated with reference to the various parties to the trust.

### **Founder**

#### **Estate duty**

By transferring assets to the trust, the dutiable value of the founder's estate is reduced, thereby reducing or eliminating the liability for estate duty. However, in instances where the founder has transferred only part of his assets during his lifetime to an *inter vivos* trust, the founder will be liable for estate duty on the dutiable value of his or her estate at the time of death.

#### **Capital gains tax**

A detailed discussion on the effects of CGT for the founder is outlined in paragraph 2.1.6 of chapter three. A summary of the CGT implications for the founder is outlined below. The founder is liable for CGT when:

- the founder sells property to the trust;

- the founder donates property to the trust,
- the founder does not charge interest on a loan to the trust in terms of paragraph 11 of the Eighth Schedule; and
- the founder is subject to anti-avoidance measures (outlined in paragraph 2.1.6 in chapter three) that attribute the capital gain to the founder.

## **Trust**

### **Capital gains tax**

If the planner transfers a primary residence into a trust and the trust subsequently sells the property, neither the R1 million capital gains tax exclusion in terms of Part VII of the Eighth Schedule nor the transfer duty exemption in terms of section 2(1) of the Transfer Duty Act is available. The trust is taxed at an effective rate of twenty percent and is not subject to the annual exclusion of R10 000 applicable to natural persons.

It is therefore noted that the creation of an *inter vivos* trust enables the founder to reduce estate duty but not CGT.

### **Beneficiary**

Exposure to estate duty and CGT depends on whether the trust is a discretionary trust or a vesting trust. Probably the only instance where estate duty and CGT may be saved is in the instance where, upon the death of the beneficiary, the beneficiary enjoys a contingent interest in the corpus and income of the trust.

- **Liquidity and cash flow**

By transferring assets to an *inter vivos* trust, the estate of the founder is reduced, thereby reducing his or her liability for estate duty and CGT at the time of death. The need to maintain a liquid estate is therefore negated. The writer of this thesis suggests, as a cautionary note, that it is vitally important for the founder to have his or her financial affairs structured in a manner that will provide regular income for the founder. The founder's need for financial resources could be drawn from the trust in the form of loan repayments made by the trust to the founder.

- **Control and flexibility**

People do not like to part with their hard-earned assets. In this regard, the founder loses control over his or her assets by transferring property to an *inter vivos* trust. Because the trustees control the assets of the trust, the planner may, for the purpose of exercising control over the assets of the trust, find it necessary to control the decisions of the trustee. This could lead to a power struggle between the trustee and the founder.

In order to maintain some control over his assets, the estate owner may give assets to a trust or to another person subject to a proviso that he may demand them back or that he has the right to transfer them to another person. In this regard, the estate-owner will find himself being subjected to various taxes thereby creating a dilemma. These taxes are indicated hereunder:

#### **Estate duty**

The estate owner will be taxed on these assets in terms of section 3(3)(d) read together with section 3(5) of the Estate Duty Act. It therefore stands to reason that section 3(3)(d) of the Estate Duty Act has the effect of counteracting such control mechanisms incorporated in the trust deed. To counteract the application of section 3(3)(d), read with section 3(5)(b)(ii) of the Estate Duty Act, the founder, should not make a donation which is subject trust provisions, and retain the right to vary the trust provisions. Abrie et al. (2000: 142) stress that the donor will be liable for duty even if he or she does not exercise this right, simply because he or she has the ability to make such amendments.

#### **Donations tax**

The power to revoke a trust may have donations tax implications in terms section 56(1)(1) of the Income Tax Act. Honore' (1992:387) is of the opinion that the exemptions (from donation tax) under section 56(1)(1) of the Income Tax Act would apply, if the founder reserves this right through the trust deed,. The writer of the thesis is of the opinion that the exemption enjoyed in terms of section 56(1)(1) of the Income Tax Act merely serves to avoid double taxation because section 3(3)(d) read together with section 3(5)(b)(ii) of the Estate Duty Act would in any case deem such property to be dutiable in the estate of the founder.

### **Capital gains tax**

With regard to CGT, if a capital gain arises because of an asset donated to a trust that is subject to a right of revocation, the gain will be attributed to the donor in terms of paragraph 71 of the Eighth Schedule. The only advantage arising from such revocation is that the capital gain is taxed in the hands of the donor at the lower effective rate applicable to natural persons and not at the higher rate applicable to trusts ( Silke: 2005).

### **Income tax**

The founder who has reserved for himself the right to revoke a beneficiary's vested right to income or to confer it to another person will be subject to income tax in terms of section 7(6) of the Income Tax Act.

It is therefore important for the planner to effect suitable control techniques, which would not occasion the application of the taxes mentioned above.

With regard to flexibility, the trust deed must be flexible enough to cater for changing circumstances. Flexibility is achieved by providing for variations to the trust deed, as well as by conferring discretionary powers to the trustee.

- **Provision of income and capital for dependants**

The *inter vivos* trust is ideal for the provision of income and capital for dependants. The *inter vivos* trust, however, does not qualify as a special trust.

- **Savings of donations tax and transfer duty**

Property (including limited interests) donated to a trust is subject to donations tax. Such donations are subject to the R30 000 exemption in terms of section 56(2)(b) of the Income Tax Act. A common practice followed by founders of trusts is to use the R30 000 exemption from donations tax to waive a portion of the loan owing to them by the trust. There could, however, be CGT implications associated with technique.

There are no transfer duty implications for the founder. In terms of Section 9 of the Transfer Duty Act, no transfer duty is payable where trust property is transferred to a beneficiary in pursuance of a will or any other instrument in terms of which an administrator is appointed, where such transfer is effected to either the persons entitled thereto under such will or to a relative as contemplated in section 1 of the Estate Duty Act.

- **Savings of income tax**

The object of saving income tax is evaluated at the level of the trust as well as at the level the beneficiary. The extent to which these parties are liable for income tax will depend on whether the trust is a discretionary trust or a vesting trust.

Income tax is saved by applying the following techniques:

- ⇔ The trust deed must provide for distribution of income out of the retained income of the trust. In this instance, the beneficiary is not be taxed on receipt of the trust's retained income.
- ⇔ Under a discretionary *inter vivos* trust, the trust instrument should provide for the distribution of trust income in accordance with the needs of individual beneficiaries. Trust income under a discretionary ownership trust can be allocated in accordance with the needs of individual beneficiaries, resulting in benefits for multiple taxpayers once the total income is distributed amongst them, thus spreading income tax liability in an egalitarian manner. Moreover, should only a portion of trust income be distributed to trust beneficiaries in a given year of assessment, section 25B of the Income Tax dictates that the remainder will be taxed in the hands of the trust and not in the hands of the beneficiaries, thereby relieving the latter's income tax burden (Du Toit, 2002:166).

### **Anti-avoidance rules**

Careful consideration should be given to the specific anti-avoidance rules that are contained in sections 7(3) to 7(8), Chapter X of the Eighth Schedule, as well as general anti-avoidance rules in terms of section 103 of the Income Tax Act. A noble intention to donate assets to the trust for the benefit of a minor could expose the income flowing from the asset to income tax in the hands of the

parent in terms of section 7(3) of the Income Tax Act. Anti-avoidance rules were incorporated into the Income Tax Act to curb the use of trusts as tax avoidance vehicles and will apply even if the donor has good intentions.

- **Economy**

If the planner transfers assets to a trust, any capital gains taxed in the hands of the trust will be taxed at the higher rate of twenty percent. Although the deemed disposal on death in terms of paragraph 40 of the Eighth Schedule as well as estate duty in terms of section 3(2) of the Estate Duty Act is avoided, the planner is faced with a dilemma in justifying the economic viability of the savings that flow from such a transfer. The following example is used by Davis et al. (2005:14-6) to illustrate this point. If the planner is, say, forty year old and lives to eighty, the estate duty saving will only occur in forty years' time. It is very likely that the disposal of trust assets will take place during that time, giving rise to capital gains tax at an extra ten percent. It may not make sense therefore to pay an extra ten percent CGT on disposals in the interim so as to save twenty percent estate duty in forty years time.

## **2.2 Legality of the trust**

Trust law and the Income Tax Act, are used to test the legality of the *inter vivos* trust. With regard to trust law, Du Toit (2002:24) indicates that, despite the reservations that are held by some members of the judiciary regarding the legal nature of the *inter vivos* trust, the contract that enables the formation of the *inter vivos* trust has been accepted by South Africa's highest court as being legal. With regard to the Income Tax Act, the *inter vivos* trust is subject to anti-avoidance measures in terms of sections 7(3) to 7(8) as well as section 103. Section 103(1) is used to test whether the *inter vivos* trust has been deliberately structured to avoid taxes.

## **2.3 Suitability with regard to the different marital regimes**

The *inter vivos* trust is suited to the needs of any person, irrespective of his or her marital regime or marital status.

From the above, it is clear that there is a need to neutralize the compromising effects of the various taxes governing the *inter vivos* trust as well as formulating techniques that will enable the founder to exercise control over his assets. In this regard, authors and financial planners have published numerous case studies and models.

In a case study published by David Clegg (Star: 2001), the dual effect of capital gains tax and estate duty was illustrated. This study does not illustrate the overall effects of all the taxes applicable to trusts nor does it offer alternate tax planning strategies. In a case study published by Deidre Pieterse (De Rebus, 2002:30), the focus fell on capital gains tax. This study also fails to offer alternate planning strategies.

Professor Goldswain's case study (2002) provides an elaborate plan to save estate duty and addresses some of the shortcomings found in the case study developed by Deidre Pieterse. However, one of the major shortcomings of Professor Goldswain's model is that the focus falls chiefly on the saving of estate duty. Although Professor Goldswain highlights the need to be cognizant of the various taxes applicable to trusts, he makes no reference to the manner in which this has to be done. With regard to these shortcomings, there is a definite need to develop a holistic estate-planning model that involves the use of the *inter vivos* trust.

### **3 A holistic estate-planning model involving the use of an *inter vivos* trust**

The development of a holistic model involving the use of an *inter vivos* trust involves the following stages:

- (a) evaluation of the following techniques (building blocks);
  - sale of assets against a loan;
  - use of preference shares; and
  - use of a company structure;
- (b) developing a holistic model.

### 3.1 Evaluation of techniques incorporated in the holistic model

These techniques include the sale of assets against a loan, the use of preference shares, and the use of a company structure.

- Sale of assets against an interest-free loan

A typical means of disposing of growth assets is for the planner to sell them to his future heirs. As the latter would generally not have the means to pay for the assets immediately, the purchase price is usually left outstanding on loan account. In order that the estate of the planner is not further enhanced such loan is generally interest-free (in addition, any interest charged may well not be deductible for income tax in the hands of the party paying it).

The question arises as to whether such an arrangement may be said to constitute a donation in terms of section 58(1) of the Income Tax Act, by the party disposing of the assets? In order to reduce any risk of donations tax, Davis et al. (2005:11-3) suggest the following:

- independent valuations are obtained of the asset sold;
- where possible, Revenue approval is obtained for the transfer values; and
- the loan is recorded. If it remains unrecorded, Revenue may contend that there was no consideration for the disposal of the asset and that it has accordingly been donated. To this the writer adds that terms and conditions relating to the interest-free loan should be noted in the records of the recipient of the asset. In this regard, the loan must be repayable on demand, and no stipulations laid down with regard to the interest on the loan. Davis et al. (2005:13-12) contend that when money is lent, no inherent right to interest arises. By not stipulating for interest in the loan agreement there is no "waiver or renunciation of a right" within the meaning of the definition of a "donation" for donations tax purposes.

An important consideration in respect of a transfer of assets by sale concerns the capital or revenue nature of the transaction for income tax purposes. In this regard, there are numerous cases cited. In *Natal Estates Ltd v SIR*, 37 SATC 193, it was held that the nature of the asset could change from that of a capital asset to that of a revenue asset. If the disposal date is soon after the acquisition

date, this may well lead to Revenue construing such disposal as revenue in nature, thus creating an income tax exposure.

Sale of assets by way of a suspensive sale may assist the planner in maintaining some sort of control over the asset. A formalized lease, however, particularly if it is long-term, may result in there being a right subject to estate duty arising in the planner's estate on his death in terms of section 3(2) of the Estate Duty Act.

If the sale of the assets results in a capital loss to the planner, that loss can only be set off for CGT purposes against capital gains made from future disposals of assets by the planner to the trust (the so called "clogged loss" rule) in terms of paragraph 39 of the Eighth Schedule.

Where the planner intends reducing the amount owing on the loan by donating R30 000 per annum to the debtor to enable the debtor to reduce the indebtedness, cash donations must be used because they do not give rise to CGT. Partial-waivers of the loan will, however, be regarded as disposals for CGT purposes in terms of paragraph 12(5) of the Eighth Schedule. Donations tax will not arise in instances where R30 000 is donated to the debtor by way of a waiver of R30 000 of the debt. However, the heir has a capital gain of R30 000 (Davis et al., 2005:11-5).

- **Sale in exchange for preference shares**

A planner may sell his assets to any company (not necessarily a company which he has structured) in exchange for preference shares of the company. In order to ensure that this technique complies with the basic requirements of a sound estate plan, the following aspects should be given due consideration:

**Control**

In order to ensure at least a certain degree of control over the assets sold to the company concerned, it is suggested that preference shares carrying voting rights be issued to the planner. There may be exposure to section 3(3)(d) and section 5(1)(f)*bis* of the Estate Duty Act in the case of an unlisted company. The conventional wisdom in respect of both sections 3(3)(d) and 5(1)(f)*bis* is generally to ensure that the planner holds less than seventy five percent of the overall votes in the

company. Furthermore, Davis et al. (2005:13-13) indicate that in order to ensure that the plan is not susceptible to Revenue attack in terms of section 3(3)(d) and 5(1)(f)*bis*, it is advisable to set out the rights of the shares in the memorandum of association and to include provisions such as the following:

- The rights attaching to or conferred by the preference shares shall not be capable of being varied or cancelled in any manner whatsoever, including by scheme of arrangement;
- no member of the company holding any of the shares shall be capable, by way of the variation or cancellation of the rights attaching to or conferred by the shares, or otherwise
  - of conferring upon himself any benefit or advantage in respect of the assets or profits of the company; or
  - of disposing of any of the assets or profits or property of the company for his own benefit or that of his estate.

A clause of this nature will not be effective where the planner has the power to alter the memorandum of his own accord through being able to pass a special resolution unaided. To ensure that this problem does not occur, a mechanism has to be put in place to allow the planner to hold less than seventy five percent of the total votes. In this regard section 199 of the Companies Act, no 73 of 1961, requires that the formal requirement for the passing of a special resolution is that of affirmative votes by not less than seventy five percent of the members present or by proxy.

### **Exposure to donations tax**

The intention behind section 58 of the Income Tax Act would appear to be to bring within the net of 'donation' a donation disguised, for example, as a sale, with the purchase price of the asset being set at a ridiculously low price. Viewed in this light, the section is aimed at putting excluding any purely technical argument which might otherwise have been raised. One needs to be mindful that, with regard to the intention to donate, the Commissioner respects all arguments validating or invalidating an intention to donate, and follows both the letter and the spirit of the law.

When selling assets to a company in exchange for preference shares, due consideration should be given to the following:

- section 58 of the Income Tax Act presupposes the *animo donandi*, the intention to donate, for its operation;
- in determining whether such an intention exists the Commissioner may, in the exercise of his discretion, have regard to the relative market values of the consideration given and received in a particular transaction;
- having decided that a *prima facie* intention to donate is present, the Commissioner must have regard to all the subjective circumstances of the transaction in concluding whether or not the consideration received is adequate. In this context, the market value of such consideration may be a decisive factor and which factor could be overruled by other factual elements;
- alternatively, if the intention to donate is not a prerequisite for the operation of the section, the Commissioner must nevertheless follow the lines of enquiry set out above in deciding on the adequacy or otherwise of the consideration received (Davis et al., 2005:13-20).

#### **Evaluation of the above techniques**

This evaluation is based on the work of Davis et al. (2005: 13-3). The use of the above technique on its own holds certain disadvantages. The key issue often faced by a planner is that of pegging the growth in the value of a person's estate without losing control over his assets and without the dispersion of assets. Techniques that aim at pegging the growth in the value of a person's estate while at the same time affording the planner a degree of control over the assets, include the sale of assets to a company in exchange for preference shares and the use of options. Control over assets is lost where assets are sold against a loan account. Notwithstanding this, the writer envisages the following disadvantages of using the above techniques:

- the planner is forced to decide on precisely who will benefit from the transfer of the asset and which transfer could create animosity between family members;
- assets could be dispersed; a beneficiary may, over time, dispose of an asset thereby depriving family members the benefit of using the asset;
- the liability for estate duty is merely shifted from one person to another;
- an obsession to save estate duty could detract from the broader principles of estate planning.

In view of the above shortcomings, authors and financial advisers alike have developed models and case studies centred on developing a holistic estate-planning model. A popular technique is the use of a corporate entity.

- **The corporate entity model**

- **Brief overview of this model**

The model developed by Davis et al. (2005) is based on the following:

- the planner has three children whom he wishes to benefit more or less equally;
- integration of a company or close corporation (referred to hereafter as the parent company) into an estate plan;
- the parent company would be established having both ordinary shares and preference shares; both the ordinary and preference shares would carry one vote per share and be issued at a nominal amount of, for example, R1 per share;
- the preference shares would carry a low dividend coupon of, say, five percent (non-cumulative) per annum on the par value of the shares. On any winding up of the parent company (whether by way of a liquidation or deregistration) a preference shareholder would be only entitled to share in any surplus of the value of the company's assets over its liabilities to the extent of the par value of the shares. Any further surplus on a winding up of the company would accrue to and be shared amongst the ordinary shareholders only;
- the ordinary shares would be issued in equal proportions to each of the three children (for example, one hundred ordinary shares to each of the three children), with the planner being issued with more than three hundred preference shares (for example, 325 preference shares);
- all the growth assets (and possibly the non-growth assets) of the planner would be transferred to the parent company;
- the assets would be transferred at their market values (or in the case of farmland at its Land Bank value). The purchase consideration would be left outstanding on interest-free loan account repayable on demand. If the sale of assets to the company results in a capital loss to the planner, the loss can only be set off for CGT purposes against capital gains made as a

result of future disposals by the planner to the company in terms of paragraph 39 of the Eighth Schedule;

- placing of an existing business into a separate company to shield the assets of the parent company from any of the existing business's creditors. This separate company could be a fully owned or partly owned subsidiary of the parent company and could probably be managed by one of the children and accordingly give that child the majority of the ordinary shares of the parent company;
- in a similar manner, property held by a planner and which is not used in an enterprise for VAT purposes could be placed in a separate property-owning company;
- if property is held in a company which is registered for VAT, the transfer of such property to another company will attract the provisions of the Value-Added Tax Act;
- a valid will to outline testamentary provisions with regard to property belonging to the deceased, for example, preference shares;
- the planner's need for financial resources for his personal use could be drawn from the parent company. Receipts in the form of loan repayments by the parent company will satisfy the planner's need for financial resources over and above his pension annuities, et cetera.

#### **Evaluation of the model developed by Davis et al. (2005:13-8)**

The writer of this thesis is of the opinion that this technique, if used on its own, has certain inherent advantages and disadvantages. It is therefore necessary to evaluate this technique to ascertain the viability of incorporating this technique in the holistic estate-planning model.

#### **Advantages**

1. The planner has in essence swapped his (usually mainly) growth assets for non-growth assets, namely preference shares in, and a loan to, the parent company. The preference shares are 'non-growth' assets as any increase in the value of the parent company's assets does not accrue to the preference shareholders but to ordinary shareholders. Any dividend payable on the preference shares is limited to a certain amount, for example, five percent of the par value of the shares. On any winding up of the parent company the most a preference

shareholder would receive is an amount equal to the par value of (or original subscription price for) the shares.

2. However, by utilizing voting preference shares, the planner may hold a majority of the votes in any general meeting of the shareholders of the parent company. Accordingly, he may, for example, control the composition of the parent company's board of directors. As a result, although he may have transferred some or all of his assets to the parent company (or its subsidiaries) he still has considerable say in how the assets are used. For example, he may ensure that he is elected as one of the directors of the parent company.
3. If there is a business involved, by placing it in a separate company, the benefits of limited liability are achieved.
4. By consolidating all the assets in the parent company, or any subsidiaries, there is less danger of the asset base being dissipated in the foreseeable future, as all the assets are held in a company over which the planner has significant control. The assets are not being distributed between several beneficiaries at this stage.
5. Furthermore, there is no need at the stage when the structure is set up for, the planner to identify precisely which child will ultimately "inherit" which asset; they would merely, by way of their ordinary shareholdings in the parent company, own an effective undivided share in all the assets.
6. The transfer of the business is generally easier to facilitate if shares in the subsidiary company are transferred rather than the individual assets and liabilities of the business, which would be the case if it is not owned by a corporate entity.

### **Disadvantages**

1. If the disposal of the assets to the company results in a capital loss for CGT purposes the planner can only set off the loss against capital gains arising on the disposal of assets to that company in the future. The loss cannot be set-off against the planner's other capital gains in terms of paragraph 39 of the Eighth Schedule.

2. Companies pay CGT at a higher rate than individuals.
3. By having the children as ordinary shareholders, one may be creating an estate duty problem for them in due course, as they now own growth assets.
4. The structure can be fairly rigid in that one is now giving each child an exact number of shares in the parent company. This means that it is more difficult to change this ratio at a late stage.
5. There is no income splitting as all the income is earned by the parent company and its subsidiaries and is taxed at the corporate tax rate of twenty-nine percent. Accordingly, where there are persons who are financially dependent on the planner for their maintenance cannot be paid out of the pre-tax income of the parent company or its subsidiaries.
6. After the death of the planner, and assuming that each child then holds a portion of the preference shares as well, differences of opinion between the children may occur as to who acquires ultimate control or ownership of which assets. With no independent arbitrator, this may lead to deadlock between them as to the future direction and control of the parent company. Fragmentation of control may take place, and the possibility exists of interference in businesses by children not involved in running them.
7. By holding all the assets under a single holding company structure it is difficult to give any one shareholder sole ownership of individual assets without creating a secondary tax on companies (STC) liability. If the parent company was liquidated or deregistered, STC liability is limited in the sense that if an asset was acquired before 1 October 2001, the profit on which STC is payable is limited, in terms of section 64B(5)(c)(ii) of the Income Tax Act, to the amount of profit determined as if that asset had been acquired on 1 October 2001 at a cost equal to the market value of the asset on that date.
8. Companies are more readily classed as “share dealers” by Revenue. Accordingly, from this perspective, share portfolios are possibly better placed in a trust or in individual ownership (the latter being viewed more favourably by Revenue).

9. This model is suitable for estates that are large and in instances where planners are “risk-takers”.

From the above, it is clear that a holistic model involving the use of trusts should accommodate all persons. In this regard the holistic estate-planning model should provide for alternatives, namely, an estate-planning model for ‘risk-averters’ and an estate-planning model for ‘risk-takers’.

### 3.2 A holistic estate planning model involving the use of an *inter vivos* trust.

An *inter vivos* trust can only be as good as the document creating it. When forming an *inter vivos* trust, it is advisable that the following are properly attended to in the trust deed:

- The proper identification of the parties involved in creating the trust and a proper description of their capacities as founder, trustees and beneficiaries (preferably a clear distinction should be made between income and capital beneficiaries), making sure of their contractual capacity and allowing for enough flexibility in the description of the beneficiaries within the scope of the special power of appointment as to whether the beneficiaries are parties to the agreement);
- Definitions of words such as children, trust fund, trust capital, trust income, trust property, vesting date (if any) or any other word or phrase that is used in the trust deed and that needs a clear description;
- A name should be allocated to the trust although this is not mandatory;.
- The trust object must be clearly defined;
- The appointment of trustees, including provisions concerning the number of trustees must be dealt in the trust deed.
- The grounds for the termination of trustee’s office must be indicated.

- The trustees' powers, competencies and obligations, including a clear description of the trustees' discretionary powers and duties, as well as their remuneration, must be dealt with.
- Depending on the financial circumstances of the planner, the planner could choose to use either the 'first alternative' or the 'second alternative' (which appears below) in his or her estate plan (the tax and estate-planning consequences occasioned by each plan is outlined in each plan).

The models that are outlined below merely serve as guides to planners and planners are advised to adapt these models according to their special circumstances.

### **3.2.1 First alternative: The use of an *inter vivos* trust without a corporate entity**

This model was developed by Davis et al. (2005: 14-8 – 14-16). It is envisaged that this model will serve as an appropriate model for all individuals who are interested in creating an *inter vivos* trust. A trust could be integrated into an estate plan along the following lines:

- A trust would be set up with a small initial donation (say fifty rand) by an aged relative. The relative would accordingly be the donor or settlor of the trust. Having an aged relative as donor may achieve certain income tax or transfer duty savings. In respect of income tax savings, the use of the grandfather trust can circumvent the provisions of section 7 of the Income Tax Act provided that the grandparent and not the parent is the actual donor of the trust property. In respect of transfer duty savings in terms of section 9(4)(b) of the Transfer Duty Act, no transfer duty is payable on the acquisition of property by a relative of the founder of an *inter vivos* trust in respect of trust property acquired in terms of the trust deed, provided no consideration is paid directly or indirectly by such relative in respect of the acquisition of such trust property.
- The trust would be set up with three trustees.
- The trust would normally be a "discretionary" trust, in that only contingent rights to income and capital are created. Accordingly, a class of income beneficiaries and a class of capital (including capital gain) beneficiaries are provided for in the trust deed whose rights are

contingent upon some event as specified in the trust deed (which could be the exercise of the trustee's discretion). In practice the trustees are given a broad discretion to determine the timing and *quantum* of income and capital distributions to the beneficiaries.

- The trustees, in their discretion and by way of a majority decision, would decide what income, capital or capital gain is distributed in any one year.
- The planner would sell his growth (and possibly non-growth) assets at their market value to the trust (this would include, for example, shares, unit trusts, properties, a farm, endowment policies and any business).
- The purchase consideration could be left outstanding on interest-free loan account repayable on demand.
- Within limits, the trustees should be given the power to vary the trust deed.

The intention with this structure is that on the death of the planner, the only significant assets falling into his estate would be the outstanding balance on the loan account. The loan account balance would be the initial balance created on the sale of the assets to the trust, less any capital repayments, plus any interest charged.

As noted above, the trust should have classes of beneficiaries, both income and capital (including capital gains). The members of each class could be the same persons. The trustees would be given discretion as to the timing, *quantum* and proportions allocated between the beneficiaries *inter se* of any income and capital distributions.

It is important not to give beneficiaries vested rights to income or capital so as not to create an estate duty problem in their hands. In this regard care must be taken in directing the trustees to use the trust income for the maintenance of the beneficiaries as they deem fit, because it may be contended that the beneficiaries have a vested right to claim maintenance, which right would constitute property in their estates. The validity of such contention will depend on the terms of the trust.

The class of income beneficiaries would typically include the planner, his wife, their children and other descendants of theirs. The class of capital beneficiaries would include more or less the same persons. The planner and his wife are often included as potential capital beneficiaries. Although the purpose of the estate plan is for the planner, in particular, to divest himself of assets, should the need arise to dissolve the trust it must be possible for the trustees to pass assets to him if, for example, it is not considered appropriate to transfer all his assets to his children. The trust could also provide for "sub"-trusts of the main trust to be formed for the benefit of specific beneficiaries.

In addition, any persons who may be financially dependent on the planner could be added as potential income or capital gain beneficiaries, for example, aged relatives. Consideration should also be given to including bodies such as "charities, educational bodies or religious institutions of public character". In this way pre-tax income or capital gains of the trust could in future be distributed to such dependents or institutions by the trust. In this way, neither the trust nor the planner will pay tax on the income and it will only be subject to income tax, if any, in the hands of the recipient. However, the planner will be taxed if section 7 of the Income Tax Act attributes the income to the planner.

It often occurs that a trust earns various types of income, for example, dividend, interest and rental income. Dividend income is exempt from income tax whilst interest and rental income is subject to tax. Where a trust receives, say, dividend income (R4 000) and interest income (R6 000), trustees have been known to attempt to distribute all the dividend income (R4 000) to, for example, the donor and all the interest income (R6 000) to a tax-exempt beneficiary, say a charity, and in so doing seek to avoid all income tax in the hands of the beneficiaries on the income received by the trust. Davis et al. (2005:14-10) indicate that Revenue has been known to challenge such distributions on the basis that each beneficiary receives dividend and interest income in the same proportion that it is received in the first instance by the trust, thereby taxing the donor interest income of R2 400 ( $R4\ 000 \times 6/10$ ). Unless the trustees actually keep each type of income receipt in separate bank accounts, Revenue's challenge is probably correct in that the income receipts when they are banked in the same account lose their nature by operation of *commixtio*.

The planner could provide in his will that on his death, the first R1 million of the outstanding balance on the loan account be bequeathed to the trust. The balance could pass to his surviving spouse, and failing her, on her death the balance could pass to the trust.

It is suggested that the trustees should, within limits, be granted the right to vary the trust deed. This may be provided for in the trust deed itself. The position in this regard was already outlined above. It is preferable, however, that:

- The trustees not be given the right to add beneficiaries from outside a defined class of beneficiaries;
- the trustees be required to follow a special procedure (for example, unanimous consent of all trustees) when amending the trust deed.

Whilst this power of amendment may be important as circumstances change, it is vital that this administrative provision does not provide Revenue with grounds for the application of section 3(3)(d) of the Estate Duty Act. Davis et al. (2005:14-10) suggest that the normal method of avoiding this is to provide that the trust deed can be amended, but with a proviso which follows the actual wording of section 3(3)(d) of the Estate Duty Act, namely:

*The provision of this Trust Deed may be varied in writing by the Trustees and planner (during his lifetime) acting jointly, and after the death of the planner the provisions of the Trust Deed may be varied in writing by the trustees acting unanimously. Provided that the Trustees and the planner may not vary the provisions of this Trust Deed to benefit themselves or their estates.*

A provision of this kind should be sufficient to ensure the inapplicability of section 3(3)(d) of the Estate Duty Act.

### **Evaluation of this model**

The use of such a structure would result in the following advantages over using only a company in such a structure (Davis et al., 2005:14-11 and the writer of this thesis):

- As none of the potential beneficiaries acquire any vested rights to property, no future estate duty problem is created in their hands. Furthermore, the trust may be used as a generation-skipping device, in that the children draw only income and capital gains from the trust

during their lifetime, with ownership in the assets only passing in due course to the grandchildren. Thus the trust, if properly structured, may assist the children with their own estate planning.

- The trustees have the flexibility of awarding assets in future to specific beneficiaries as and when their personal circumstances require it – or as and when it may be appropriate from a fiscal standpoint. In the meantime, the assets of the planner may be administered as one pool of assets.
- Income or capital gains of the trust may be distributed before income tax to, for example, aged parents dependent for support on the planner, grandchildren or charities. Although the recipients will be liable for tax thereon, the tax they pay is likely to be less than the tax the planner (who is probably paying tax on investment income at the maximum marginal rate of forty percent) or a company (at twenty nine percent) would pay.
- Assets may be distributed out of a trust without the payment of any STC. Thus the capital profit on the sale of the asset of the trust may, for example, be distributed to a beneficiary without any STC being payable. On the other hand, in the case of a company generating such a profit, the profit may only be distributed STC-free to the shareholders if the company is liquidated or deregistered. This exception only applies if the capital profits have been declared before 1 January 2003. The latter would be inappropriate if the company is the cornerstone of an estate plan and it still holds other significant assets.
- The planner is able to potentially access income or capital of the trust without creating any additional estate duty problems in his hands.
- The trustees can act as independent administrators of the assets, particularly once the planner has passed away. In the company structure, should differences of opinion arise between the beneficiaries (say the children) after the planner's death, this can lead to a power struggle amongst them for ultimate control of the company.

- The structure allows the planner to freeze the growth in the value of his estate (as the only major asset that would fall into his estate on death would be the outstanding loan account balance), whilst maintaining an element of control over his former asset base.
- The planner's need for financial resources for his personal use could be drawn from the trust in the form of loan repayments made by the trust to the planner.

#### **Disadvantages of this model**

- Because the trustees control the assets of the trust, the planner may, for the purpose of exercising control over the assets of the trust, find it necessary to control decisions of the trustees. This could lead to a power struggle between the trustees and the planner. The writer of this thesis is of the opinion that relinquishment of the planner's control over his or her assets is probably the major disadvantage associated with an *inter vivos* trust. If through the trust deed, the founder reserves for himself or herself the right to amend the trust deed to effect control over his or her assets, the founder may be subject to section 3(3)(d) of the Estate Duty Act or may even be attacked by section 103 of the Income Tax Act. The 'second alternative' (outlined below) could be considered to overcome this disadvantage.
- Section 7 of the Income Tax Act and paragraph 70 of the Eighth Schedule may be invoked by Revenue to tax income or capital gains retained in the trust, in the hands of the planner in view of his interest-free loan to the trust. The provisions of this section are generally not available to Revenue in the case of income retained in a company financed by an interest-free loan to a company (which is discussed in the 'second alternative' which is outlined below).
- Capital gains attract capital gains tax at a higher rate in the hands of a trust than in the hands of a natural person. The writer of this thesis is of the opinion that Part X of the Eighth Schedule offers a solution to this problem. If the attribution rules in terms of Part X of the Eighth Schedule apply, the incidence of CGT could be shifted to the beneficiaries or the planner by vesting the capital gains in the beneficiaries or the planner.

- Should the planner's estate include a business, the absence of a corporate entity or a second trust places the other assets of the trust at risk of being attached by creditors of the business.
- In the event of there being fixed property in the trust, transferring it out will generally attract transfer duty (unless the property is used in an enterprise for VAT purposes).

In order to counteract some of the disadvantages mentioned above, Professor Goldswain (2003) together with other writers on estate planning, have advocated the integration of the both the trust and a company into an estate plan, to form a holistic tax-planning model. However, the writer of this thesis asserts that this model will suit those persons who are willing to engage in business activities. A model developed by Davis et al. (2005:14-18 – 14-24) outlines the mechanics of such a structure.

### 3.2.2 **The second alternative : the “trust and company” model**

This model was developed by Davis et al. (2005:14-18 – 14-24). Davis et al (2005:14-18) indicate that close corporations would not be used in the structure, as an *inter vivos* trust may not be a member of a close corporation. The integration of a company into the structure may be summarized as follows:

- the trust which has been formed subscribes for, say, 100 ordinary shares in a newly formed family holding company (Holdco);
- Holdco would be established having both ordinary and preference shares. Both the ordinary and preference shares would carry one vote per share and be issued at a nominal amount of, say, one rand per share;
- the preference shares would carry a low dividend coupon of, say, five percent (non-cumulative) per annum on the par value of the shares. On any winding up of Holdco (whether by way of a liquidation or deregistration) a preference shareholder would only be entitled to share in any surplus of the value of the company's assets over its liabilities to the extent of the par value of the shares; any further surplus on a winding up of the company would accrue to and be shared amongst the ordinary shareholders only;

- ordinary shares would be issued only to the trust, with the planner being issued with slightly more preference shares than the number of ordinary shares in issue, for example, 125 preference shares;
- the planner would sell his growth (and possibly non-growth) assets at their market value to Holdco, or to other entities;
- the purchase consideration could be left outstanding on interest-free loan account repayable on demand.

The intention of this structure is that on the death of the planner, the only significant assets falling into his estate would be the outstanding balance on any loan accounts and the value of the preference shares. The loan account balance would be the initial balances created on the sale of the assets to Holdco (or any other companies or the trust) less any capital repayments, plus interest charged. The value of the preference shares would also be included in the estate. However, these are unlikely to be worth more than their par value – R125 in the case of preference shares to Holdco.

As the preference shares are used as a mechanism to allow the planner some control over the structure, the question arises as to what happens to the preference shares on the death of the planner? Options that a planner could consider would be:

- To bequeath the shares to his or her surviving spouse, thereby allowing the surviving spouse to continue to exercise some control over the structure during the latter's lifetime;
- to bequeath the shares (probably after the death of the surviving spouse) to the trust, or to provide that the shares should at that stage be redeemed by the relevant company.

The planner should provide in his will that on his death the first R1,5 million of the outstanding balance on any loan accounts be bequeathed to the trust. The balance could pass to his surviving spouse, and failing her on her death, the then remaining balances could pass to the trust. The outstanding balances should not be left to the companies as it is always useful to have "credit" loan accounts in a company – they can be used to extract assets from a company without paying STC - and it may lead to income tax recoupments in terms of section 8(4)(m) of the Income Tax Act.

### **Use of more than one company**

It may be desirable for the planner to sell some of the assets to one or more other companies for a variety of reasons. For example, if the planner owns a business, consideration would have to be given to placing the business in a separate company (Opco) to shield the other assets of Holdco from any creditors of the business.

There is no longer a transfer duty savings through the use of property-owning companies. There may be reasons for transferring some assets directly to the trust. For example, if the planner is supporting aged relatives, paying grandchildren's school fees or contributing on a regular basis to a charity, it would be useful for the trust to be earning some income directly. If, for example, Holdco has cash on deposit earning interest income, this income would be subject to corporate income tax at twenty-nine percent and, in addition, if one wished to pass the earnings up to the trust STC is payable on any dividend paid (or loan made) to the trust. On the other hand, if the trust holds the interest-bearing deposit, the interest may be distributed directly to the relatives or grandchildren or charity without the structure paying any tax. Whilst the recipients are liable for income tax thereon, because of their tax status or financial position, little or no income tax may actually be paid in their hands.

It is envisaged that Opco or Propco (which is another new company established by the planner) would be a wholly owned subsidiary of Holdco. Alternatively, Opco's or Propco's ordinary shares could be held directly by the trust. Where this occurs the planner should consider holding preference shares in such company.

If the shares in either Opco or Propco are not held by Holdco, the structure can become fairly complex to administer. Accordingly, Holdco usually holds the shares in Opco or Propco. In addition, STC problems can be created if funds are lent from Holdco to a company held directly by the trust, whilst funds may be freely transferred between Holdco any of its wholly owned subsidiaries.

However, there is a limited STC advantage to having the ordinary shares in Opco and Propco held directly by the trust. Should the planner (and trustees) wish in future to transfer the business run by Opco or any property held by Propco to specific family members (and assuming that the latter do

not have the cash to pay for the assets passed to them), if the shares in the relevant company are held by Holdco the transfer will probably attract STC unless Holdco is itself liquidated or deregistered. The winding up of Holdco on the other hand would often undermine the estate planning structure.

**Evaluation of the structure** (Davis et al., 2005:14-22)

The above structure overcomes most of the disadvantages of only using a trust. The advantages that flow from this structure are as follows:

- The planner maintains control of Holdco or any other company held by the trust through the preference shares, but all growth in the value of the ordinary shares and the other assets is taken up in the trust and falls outside his estate. Because the planner is in control of the underlying companies, it is not essential for the planner to control the trustees of the trust. The planner therefore controls both the underlying assets and the income and capital flows up to the trust. However, the planner will not have the same degree of control over assets that are directly held by the trust.
- The planner has various options when it comes to having access to funds for either himself or his spouse. He could call up portion or all of his loan accounts, charge interest thereon and, as a potential income and capital beneficiary of the trust, he may receive funds from that source as well.
- To the extent that income or capital gains are retained in the company rather than the trust, the attribution rules in section 7(5) of the Income Tax Act and paragraph 70 of the Eighth Schedule are not applicable.
- Individual assets may be owned by separate companies, thereby shielding assets from business creditors and facilitating the future transfer of assets, whilst having one overall structure.

**Disadvantages** (Davis et al., 2005: 14 – 22, and the writer of this thesis)

- Companies, like trusts, pay capital gains at a higher rate than natural persons and special trusts. The writer of this thesis is of the opinion that, in instances where only a trust is used, the incidence of CGT could be shifted to natural persons who enjoy a lower marginal rate of taxation. This has been discussed above.
- It is possible that capital losses may be isolated with no capital gains to neutralize them and assessed capital losses may be wasted. The writer of this thesis is of the opinion that in the trust only situation, this problem is circumvented by the use of vesting the capital gain in a beneficiary.
- With a trust and one or more companies, the overall cost in terms of trustees' fees and accounting and auditing costs can be quite high. Furthermore, a multiplicity of entities creates a compliance burden in terms of income tax returns, VAT returns and annual financial statements.
- The presence of a company in the structure creates possible STC problems when taking assets out of the structure or when moving funds around within the structure.
- Companies are usually more easily seen as share-dealers than trusts or natural persons.

Davis et al. (2005:14-22) indicate that the planner must always give consideration to the flexibility and viability of the structure, once neither he nor his spouse is alive. To guide the trustees in their future decisions the planner should consider leaving a letter of wishes to the trustees indicating his intentions as to which beneficiary should ultimately "inherit" or have effective use of which asset. Such a letter of wishes is, on the basis of comparative precedent, not legally binding, but provides guidance to the trustees.

The writer of this thesis points out that there are other disadvantages associated with the models (namely, the 'corporate entity model', the 'trust only model' and the 'trust and company model') outlined by Davis et al. (2005). These disadvantages would include:

- with regard to the 'trust only' model, it is not always possible to use a grandparent to initiate a donation to the trust. For example, the donor's parents may be dead or the grandparent may be reluctant to initiate such donation;
- the costs involved in creating a trust that incorporates a corporate entity can be high;
- the personality of the planner is a critical factor in any estate plan, and was not considered in the above models; the 'trust and company' model will suit those planners who are categorized as risk takers;
- the administration of the 'trust and company' model requires a high level of expertise and in this regard not all trustees are endowed with such skills;
- the complexities surrounding the integration of a company into the structure of the trust may lead one to believe that such a model is purely hypothetical;
- the 'trust and company' model will be appropriate for estates that are fairly large and accordingly this model will serve only a minority of individuals. However, owing to factors such as low interest rates and increase in salaries, a large number of individuals now own estates that are valued in excess of R1,5 million but are not large enough to warrant the application of the 'trust and company' model. In the 'trust and company' model, there is no guarantee that income will be provided for those beneficiaries who are dependants of the planner.
- The 'trust and company' model fails to address estate-planning opportunities available to the beneficiaries of the trust.

The disadvantages indicated above should not deter the planner from using these models. Owing to the manner in which the Commissioner for SARS has structured the provisions of the various Acts relating to taxation, it is sometimes difficult to achieve an optimum tax position. In this regard, the planner is advised to evaluate his or her intentions against the overall objectives of estate planning as well as his or her financial circumstances to develop an estate plan that best suits his or her

purpose. The above models merely serve as guides and accordingly these models can be adjusted according to the special needs and circumstances of the planner.

#### 4 Conclusion

From the evaluation outlined above it can be concluded that the use of the *inter vivos* trust in an estate plan is a viable planning technique especially in estates where dependants are involved. It was also demonstrated that, in view of the disadvantages that were associated with estate planning techniques that were used in isolation, it was necessary to integrate these techniques with the structure of the trust. The advantages associated with the use of *inter vivos* trusts (either on their own or by including corporate entities), include *inter alii* the flexibility of the trust; particularly when couched as a discretionary trust, it provides a suitable vehicle for the overall administration and control of the founder's assets, it is suitable for pegging the growth in the value of the planner's estate and it is an ideal vehicle to provide for dependants who are not in a position to handle their own finances. It was noted that the complexities relating to the taxation of the *inter vivos* trust has to a large extent limited the scope of tax planning. In this regard it was clearly demonstrated that vigorous tax planning distorts the true intentions of the founder in creating the trust, in other words, vigorous tax planning should not create hardship for any party associated with the trust. Planners have, however, used the *inter vivos* trust as tax-avoidance vehicles rather than estate planning vehicles and in the regard the Commissioner for SARS encourages planners to hold their assets until death, to be personally liable for income tax and to make use of the testamentary trust rather than an *inter vivos* trust. To undermine the use of the *inter vivos* trust, the Commissioner for SARS has introduced numerous tax-avoidance provisions into the Income Tax Act. It also appears that the recent amendment to the definition of a special trust as well as the progressive reduction in the marginal tax rate applicable to individuals, are strong indicators that the Commissioner for SARS encourages the use of the testamentary trust in an estate plan.

## **CHAPTER 5: CONCLUSION**

The focus of this thesis has been on an evaluation of the use of testamentary and *inter vivos* trusts as estate planning vehicles and the development of a holistic estate-planning model involving the use of these trusts. It was noted that testamentary trusts as well as *inter vivos* trusts play an important role in the context of estate planning. The role of the testamentary trust in the estate planning process was highlighted in section A of chapter four. This section dealt with the evaluation of the testamentary trust against the principles of estate planning as well as the principles relating to the taxation of trusts. It was concluded that, despite exposure to estate duty and CGT, the testamentary trust is an indispensable estate-planning vehicle. It was also noted that wealthy unmarried individuals and wealthy individuals without dependants are unlikely to benefit from the use of a testamentary trust.

The use of an *inter vivos* trust is a popular technique used by planners to 'freeze' or 'peg' the growth assets in the planner's estate. The role of the *inter vivos* trust in the estate-planning process was highlighted in section B of the chapter four. This section dealt with the evaluation of the *inter vivos* trust against the principles of estate planning as well the tax provisions relating to the taxation of trusts. It was concluded that one of the major disadvantages associated with the use of the *inter vivos* trust is that the planner loses control over assets that are transferred to the trust.

A trust pays the highest rate of income tax compared to the effective tax rates applicable to individuals and companies. A trust, other than a testamentary trust, is also subject to a wide range of anti-avoidance measures in terms of section 7(3) to 7(8) and section 103 and of the Income Tax Act. It was noted in chapter four that in order to further prevent the use of the *inter vivos* trust, the Commissioner for SARS had initiated strategies that were aimed at dissuading individuals from transferring assets to a trust, as well as holding individuals personally liable for income tax. The Commissioner for SARS had also reduced estate duty to promote this.

However, there still are good reasons for using trusts, in estate planning in particular, and the taxpayer should not lightly declare the death of the trust as a tool in estate planning. It should always be borne in mind that, although the trust is now the most severely taxed entity in South Africa, there are still numerous tax and estate planning opportunities available to the planner. These

techniques were outlined in chapters three and four. Although the cost of using a trust is now higher than it ever has been, the current tax costs should not cause the planner to reject trusts as useful if not indispensable tools in the estate planning process. Vigorous tax planning, for example, should not compromise the provision of income for minor beneficiaries. In this regard the planner should aim at neutralizing the effects of the various taxes rather than avoiding them. A simple technique that could be used to determine the viability of using a trust is to compare the advantages and disadvantages that flow from the use of a trust against the advantages and disadvantages of making direct transfers to dependants.

It was noted in chapter three that trusts are subject to a wide variety of taxes. It was noted that by being subject to estate duty as well as CGT, the estate is subject to double taxation. The writer of this thesis has demonstrated that there is no need to pay CGT as well as estate duty. On the other hand, transfer of assets to an *inter vivos* trust has the effect of attracting only CGT whilst reducing the founder's liability for estate duty. This leads to contradictory conclusions with regard to the attitude of the Commissioner for SARS towards trusts. The writer of this thesis recommends the scrapping of estate duty. It is envisaged that the scrapping of estate duty will curb the use of trusts as tax-avoidance shelters. As an alternative to estate duty, the writer suggests that the Commissioner for SARS should consider scrapping the R50 000 exclusion which applies to the deemed disposal of the deceased's assets to the estate of the deceased. The writer of this thesis also suggests that the recommendations of the Margo Commission, relating to the retention of a capital tax on an estate, should be ignored by the Commissioner for SARS. The high rate at which trusts are taxed has created further avenues for tax avoidance. In instances where the marginal rates of taxation applicable to individuals is lower than the taxation rate applicable to trusts, planners will shift the incidence of tax to individuals who enjoy a relatively low marginal rate of taxation. A planner may the use of the attribution rules that are contained in Part X of the Eighth Schedule to shift the incidence of tax to individuals. The use of this technique has the effect of defeating the objective of such anti-avoidance measures. In view of this argument, the writer of this thesis suggests that the Commissioner for SARS should reconsider the current tax rates that are applicable to trusts and consider the option of taxing trusts on a sliding scale. It is envisaged that the above recommendations, if accepted, will also provide much relief to farmers who are faced with unique estate-planning problems.

It is therefore necessary to research the feasibility of adopting the above recommendations. It is envisaged that such research will entail an evaluation of estate planning techniques that are used in countries where estate duty has been scrapped, as well as an evaluation of principles that serve as alternatives to estate duty. Trusts are governed by common law and unlike companies and close corporations, are not subject to extensive legislative regulation. In this regard, it is suggested that the legislature must reconsider its current approach towards trusts and initiate legislative processes aimed at establishing the trust as a statutory body.

In conclusion, it should be cautioned that tax avoidance should not be the primary consideration when creating a trust. Strategically, it would be unwise to create a trust or, for that matter, to use any other technique mainly for tax benefits. The approach to estate planning should be seen from a holistic perspective rather than a tax planning perspective.

“Perhaps the most important, single rule in tax planning: do not lightly allow tax considerations to distort a sound commercial bargain. The tax paranoic is his own enemy: potentially more harmful to himself than even the Commissioner for the South African Revenue Services” (Kruger and Scholtz, 2003:1).

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