

**The future of trusts as an estate planning tool**

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## **ABSTRACT**

Estate planning is an important exercise aimed at increasing, preserving and protecting assets during a person's lifetime and providing for the disposition and continued utilisation of these assets after his death. The minimisation of estate duty, however, often dominates the motivation behind estate planning and many of the tools, structures and techniques used as part of the estate planning exercise are aimed at reducing or avoiding estate duty. One of these tools is the trust. In the 2010 Budget Review National Treasury suggested that taxes upon death should be reviewed. Such review may result in estate duty being abolished. Should this happen, the motivation behind many estate plans will dissipate and many estate plans that mainly focussed on estate duty will become ineffective. The question that comes to mind is whether trusts have a future as estate planning tools.

Estate planning involves many different objectives and many of these objectives can be achieved through the use of trusts. Trusts have multiple benefits and only if a trust was set up solely to reduce or avoid estate duty, will such trust become superfluous. When looking at the use of trusts in countries that do not levy estate duty (such as Australia, Canada and New Zealand), it is clear that trusts remained useful and popular in these countries even after estate duty had been abolished. This is a strong indication that trusts have a future in South Africa and that the abolishment of estate duty will not affect the usefulness and popularity of trusts.

### **Keywords:**

Estate planning / estate planning objectives / estate planning tools and techniques / trust(s) / minimisation of tax / tax avoidance

## **OPSOMMING**

### **Die toekoms van trusts as 'n boedelbeplanningsinstrument**

Boedelbeplanning is 'n belangrike oefening wat daarop gemik is om tydens 'n persoon se leeftyd bates te vermeerder, in stand te hou en te beskerm en om voorsiening te maak vir die verdeling en voortdurende gebruik daarvan na 'n persoon se afsterwe. Die vermyding van boedelbelasting oorheers egter dikwels die motivering agter boedelbeplanning en baie van die instrumente, strukture en tegnieke wat in die boedelbeplanningsproses gebruik word, is daarop gemik om boedelbelasting te verminder of te vermy. Een van hierdie instrumente is die trust. In die 2010 Begrotingsrede het die Nasionale Tesourie voorgestel dat belastings wat by dood gehef word, hersien moet word. Sodanige hersiening mag lei tot die afskaffing van boedelbelasting. Sou dit gebeur, sal die motivering agter baie boedelplanne verdwyn en sal daardie boedelplanne wat hoofsaaklik op boedelbelasting gefokus het, hul nut verloor. 'n Vraag wat in hierdie verband na vore kom is of trusts steeds 'n toekoms as boedelbeplanningsinstrument het.

Boedelbeplanning behels verskeie doelwitte en baie van hierdie doelwitte kan met behulp van 'n trust bereik word. Trusts het 'n verskeidenheid voordele en slegs as 'n trust opgerig is met een doel voor oë, naamlik om boedelbelasting te vermy, sal sodanige trust oortollig raak wanneer boedelbelasting afgeskaf word. Wanneer daar gekyk word na die gebruik van trusts in lande wat nie boedelbelasting hef nie (soos byvoorbeeld Australië, Kanada en Nieu-Seeland), is dit duidelik dat trusts steeds nuttig en gewild gebly het ongeag die feit dat boedelbelasting nie in daardie lande gehef word nie. Dit is 'n sterk aanduiding dat trusts wel 'n toekoms het en dat die afskaffing van boedelbelasting nie die gebruik van trusts gaan beïnvloed nie.

#### **Sleutelwoorde:**

Boedelbeplanning / doelwitte van boedelbeplanning / boedelbeplanningsinstrumente en – tegnieke / trust(s) / vermindering van belasting / belastingvermyding

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## CHAPTER 1 INTRODUCTION

### 1.1 INTRODUCTION

Estate planning is an important exercise aimed at increasing, preserving and protecting assets during a person's lifetime and providing for the disposition and continued utilisation of these assets after his death. The minimisation of estate duty, however, often dominates the motivation behind estate planning and many of the tools, structures and techniques used as part of the estate planning exercise are aimed at reducing or avoiding estate duty. One of these tools is the trust, more specifically the discretionary *inter vivos* trust.

The trust is an arrangement through which the ownership in property of one person is made over or bequeathed to another person or persons (the trustees) for the benefit of another person or persons (the beneficiaries) or for purposes of achieving some impersonal objective (definition of "trust" in section 1 of the *Trust Property Control Act* (57/1988)). The fact that ownership vests in the trustees of a trust makes trusts suitable vehicles for estate planning. Trusts are therefore very popular in achieving estate planning objectives such as the minimisation and avoidance of certain taxes, protection of assets, saving of administrative costs at death, succession planning and ensuring harmony in the family.

In its suggestions for possible attention in the tax proposals for 2011 and 2012 National Treasury stated in the 2010 Budget Review (2010:80) that taxes upon death will be reviewed. The reason for this suggestion seems to be threefold:

- The taxation of both estate duty and capital gains tax at death is perceived to give rise to double taxation, despite the fact that capital gains tax qualifies as a deduction from the dutiable estate.
- Estate duty raises limited revenue and is cumbersome to administer.
- The efficacy of estate duty is questionable as many wealthy individuals escape estate duty through trusts and other means.

This suggestion had many tax practitioners on edge during the 2011 budget speech, but the matter was not addressed. This does not necessarily mean that it has been ignored or forgotten – it may well be that such review is taking longer than anticipated or has merely been postponed to a later date. Until it is announced that taxes at death has been reviewed and that estate duty will remain in place, it can be assumed that taxes at death will be

reviewed at some stage and that there is a possibility of estate duty being abolished. Should death taxes be reviewed and estate duty consequently abolished, the motivation behind many estate plans will dissipate and many estate plans that mainly focussed on estate duty will become ineffective.

## **1.2 PROBLEM STATEMENT**

From the above the following research question can be formulated as the problem statement: Will the trust have a future as an estate planning tool?

## **1.3 OBJECTIVES**

To address the problem statement in paragraph 1.2 above, the following objectives are formulated to answer the research question:

### **1.3.1 Main objective**

The main objective of this study is to determine whether the abolishment of estate duty will affect the future of trusts.

### **1.3.2 Secondary objectives**

The main objective in paragraph 1.3.1 above can be achieved by secondary objectives that aim to demonstrate that the sole motivation behind estate planning is not (and should not be) to minimise estate duty and that trusts are not only used as tools to reduce estate duty. The writer will aim to achieve these objectives by:

- 1.3.2.1 Discussing the concept and objectives of estate planning (Chapter 2)
- 1.3.2.2 Examining the tools and techniques used to achieve the estate planning objective of minimising tax (Chapter 3)
- 1.3.2.3 Examining the tools and techniques used to achieve the other estate planning objectives (Chapter 4)
- 1.3.2.4 Researching the trust as an estate planning tool (Chapter 5)
- 1.3.2.5 Considering the continued use of trusts in South Africa as well as in certain countries where estate duty has been abolished (Chapter 6)
- 1.3.2.6 Concluding on the continued use of trusts as an estate planning tool (Chapter 7)

## **1.4 SCOPE AND LIMITATION**

The scope of the study is to provide an answer to the question raised in the problem statement. In order to provide an answer there will be an in depth discussion on estate planning, the objectives of estate planning and the tools and techniques used in order to achieve those objectives. The trust is one of the tools used in this regard. A further discussion on trusts is therefore also essential for purposes of this study.

The study examines each separate estate planning objective and the tools and techniques used to achieve those objectives. In discussing these objectives the study often overlaps with other fields of study such as Financial Planning, the Law of Succession and Matrimonial Property Law. These fields are only discussed where relevant and an in depth discussion of these fields falls outside the scope of this study. With regards to the minimisation of tax, there is a short discussion on tax avoidance and the general anti-avoidance provisions, but a detailed discussion on tax avoidance and the specific anti-avoidance provisions falls outside the scope of this study.

## **1.5 RESEARCH METHODOLOGY**

The research will be conducted by way of a non-empirical literature review within the legal interpretive research paradigm and will be aimed at gathering information on estate planning and the various estate planning tools and techniques used in practice. The main focus will be on the *inter vivos* trust as an estate planning tool and how the *inter vivos* trust can be used to achieve the different estate planning objectives. The literature to be reviewed will include legislation, case law, textbooks, academic journals, articles and internet sources.

## **1.6 OVERVIEW**

The problem statement will be addressed in the following chapters:

### **1.6.1 Chapter 2: Estate planning and estate planning objectives**

This chapter defines the concept of estate planning and gives an overview of the objectives of estate planning. The aim of this chapter is to indicate that estate planning is more than just estate duty planning.

### **1.6.2 Chapter 3: Estate planning techniques and the minimisation of tax**

One of the estate planning objectives mentioned in Chapter 2 is the objective of minimising tax. Chapter 3 focuses on this objective and the tools and techniques used to achieve this objective. This is a detailed discussion on the various taxes and the role that trusts play in reducing or avoiding these taxes.

### **1.6.3 Chapter 4: Estate planning objectives and the techniques used to achieve those objectives**

Chapter 4 focuses on the remaining estate planning objectives that were mentioned in Chapter 2 and the tools and techniques used to achieve each of these objectives. Each objective is discussed separately with a focus on the tools and techniques used in achieving that specific objective.

### **1.6.4 Chapter 5: The trust as an estate planning tool**

This chapter focuses on trusts in general. It provides an introduction to trusts by focussing on the origin and development of trusts, the classification and nature of trusts, parties to trusts and the essential elements of a valid trust. This chapter also revisits Chapters 3 and 4 and summarises the uses and benefits of trusts as discussed in these chapters.

### **1.6.5 Chapter 6: The continued use of trusts: South Africa and other countries**

Chapter 6 deals with past predictions about the future of trusts, recent opinions and observations about trusts and the use of trusts in countries where estate duty has already been abolished. The aim of this chapter is to assist in determining what the future holds for trusts in South Africa.

### **1.6.6 Chapter 7: Conclusion**

The future of trusts as an estate planning tool is addressed in this chapter.

## **CHAPTER 2**

### **ESTATE PLANNING AND ESTATE PLANNING OBJECTIVES**

#### **2.1 INTRODUCTION**

Chapter 1 mentioned the review and possible elimination of taxes upon death and questioned whether such elimination will have an impact on estate planning and more specifically whether the trust has a future as an estate planning tool. This chapter will define the concept of estate planning and convey the objectives of estate planning in order to achieve the secondary objective listed in paragraph 1.3.2.1.

#### **2.2 DEFINITION OF ESTATE PLANNING**

Over the years South African authors have given the following definitions to describe the concept of estate planning:

Meyerowitz (1965:1):

“To define it in its simplest and basic terms, it is the arrangement, management, securement and disposition of a person’s estate so that he, his family and other beneficiaries can enjoy and continue to enjoy the maximum benefits from his assets or estate during his lifetime and after his death.”

Bobbert (1976:15):

“Estate planning is the process whereby a person acquires property, ensuring that he derives the maximum benefits from his ownership and the enjoyment thereof during his lifetime and that as much as possible and in the most economical manner with the minimum erosion thereof shall devolve upon his heirs when he dies.”

Van der Westhuizen (1988:46):

“The deciding in advance by an estate owner of what to do with his assets and liabilities during his lifetime and upon his death, how to do it, when to do it and who to do it.”



Olivier and van den Berg (1991:14) considered the abovementioned definitions and stated that estate planning involves the accumulation, utilisation and distribution of assets and that it consists of the following three aspects:

*(a) The evaluation of the existing state of affairs*

Evaluating the existing state of affairs will ensure the organised and responsible creation of wealth and the accumulation of assets during a person's lifetime. This involves an investigation of a person's existing economic position, business history, background and family circumstances. (Olivier & van den Berg, 1991:14)

*(b) The evaluation of the future*

The evaluation of the future aims to ensure that the future accumulation of assets take place in an orderly manner. This involves an investigation of a person's objectives, needs and prospects (Olivier & van den Berg, 1991:14).

Because a person's needs and personal circumstances are continually changing, an estate plan should be flexible and capable of being adapted to changed circumstances.

*(c) The evaluation of the position as it will be after death*

This part of the planning process involves the final distribution of assets and the preparation of a succession plan that will meet a person's objectives in a manner that is both practically efficient and fiscally beneficial (Olivier & van den Berg, 1991:14).

## **2.3 OBJECTIVES OF ESTATE PLANNING**

According to Victor and King (2010:3) the main idea behind estate planning is to enable a person to structure his affairs in such a manner that it actualises his own wants and aspirations, as well as benefit his dependants and descendants in a manner that minimises taxes and costs, is efficient and convenient, and adequately protects the assets.

The more specific objectives of estate planning will be discussed under separate headings below:

### **2.3.1 Minimisation of tax**

Tax planning is an important aspect of estate planning and, although the minimisation of tax is not an overriding objective of estate planning, it is often the initial impetus behind an estate planning operation (Davis *et al.*, 2010: paragraph 1.2.2)<sup>1</sup>.

As tax planning is such an important aspect of estate planning Chapter 3 will be devoted to a discussion on the various types of taxes and the tools and techniques used to minimise these taxes.

Tax planning should not be confused with tax evasion. “Tax planning” is concerned with the organisation of a taxpayer’s affairs so that they give rise to the minimum tax liability within the law (South African Revenue Service, 2005:4). “Tax evasion” refers to illegal activities deliberately undertaken by a taxpayer to free himself from a tax burden (Stiglingh *et al.*, 2009:657).

A taxpayer cannot be stopped from entering a *bona fide* transaction which, when carried out, has the effect of avoiding or reducing a tax liability. This principle was clearly brought out by the court in *IRC v Duke of Westminster* 1936 19 (TC) 490 (at 520) where it was stated that:

“Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow- taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.”

It is important to note that tax planning measures are subject to specific anti-avoidance provisions which are designed to prevent or counter schemes or operations aimed at the avoidance of tax. In addition to the specific anti-avoidance provisions, sections 80A to 80L of the *Income Tax Act* (58/1962) provide a general anti-avoidance rule, which can be seen as a last resort to the South African Revenue Service when the specific anti-avoidance provisions cannot be applied.

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<sup>1</sup> Davis *et al.* is an electronic publication. Whenever reference is made to this publication, the reference will be to paragraph numbers and not to page numbers.

These anti-avoidance provisions should not be overlooked when utilising estate planning tools and techniques for the purposes of tax planning. See paragraph 3.2 below for a discussion on the general anti-avoidance provisions.

### **2.3.2 Provision for liquidity**

It is important that sufficient liquidity be available to ensure that liabilities and taxes can be met without having to dispose of assets at possibly the wrong time and at relatively low prices. There should also be sufficient liquidity to provide for the dependants of a deceased person and to help facilitate an equal distribution between beneficiaries. (Davis *et al.*, 2010: paragraph 1.2.5)

### **2.3.3 Protection of business interests**

The success of a person's estate is often attributable to the success of his business. It is therefore important that the business interests be protected and that the estate plan provide for the continuity and liquidity of the business after the business owner's death. (Davis *et al.*, 2010: paragraph 1.2.11)

### **2.3.4 Provision of financial security**

The need for liquidity is often linked to the need to provide adequate income and capital during a person's lifetime as well as after his death. A good estate plan will ensure that capital generated during life can produce sufficient income for dependants, especially if a regular income flow such as a salary or pension ceases on death. (Davis *et al.*, 2010: paragraph 1.2.6)

### **2.3.5 Provision for retirement**

Just like the certainty of death is kept in mind during estate planning, so should the possibility of retirement be considered. Planning for retirement is an important objective in the estate planning process and entails the estimation of retirement goals and the identification of sources from which funds may be generated in order to ensure financial independence at retirement. (Davis *et al.*, 2010: paragraph 1.2.7)

### **2.3.6 Protection of assets**

A proper estate plan should be structured in such a way that the assets will be protected against creditors in the event of insolvency as well as against the dissipation of assets through inept administration or the spendthrift ways of beneficiaries. (Davis *et al.*, 2010: paragraph 1.2.8)

### **2.3.7 Facilitation of the administration of the estate**

An estate plan should provide for the efficient administration of a person's estate both during his lifetime and after his death. This includes the preservation of documents, the preparation of a valid will and the nomination of trustees and executors. This will ensure the methodical transfer and uninterrupted enjoyment of assets. (Davis *et al.*, 2010: paragraph 1.2.10)

### **2.3.8 Succession planning**

Succession planning is directed at planning around the death of an estate owner and the disposition of his assets. The realisation of a person's wishes with regards to the disposition of his assets is mainly governed by distributive mechanisms such as wills, trusts and donations. (Victor & King, 2010:5)

### **2.3.9 Harmony in the family**

A good estate plan will avoid family disputes and will ensure that there is no conflict amongst the beneficiaries after death.

### **2.3.10 Marriage and matrimonial property planning**

The consequences of marriage and the effect of the different matrimonial property regimes should be considered prior to marriage and should be taken into account when effecting estate planning during marriage.

## **2.4 SUMMARY**

In the light of the above discussion it is clear that estate planning is a continuous process through which a person accumulates assets and manages his financial affairs in order to increase, preserve and protect those assets for the maximum benefit during his lifetime and to provide for the disposition and continued utilisation thereof after his death. Estate planning aims to satisfy a wide range of objectives and involves the use of numerous tools, techniques and structures (hereafter referred to as techniques) in order to achieve those objectives. The different estate planning techniques will be discussed in the following two chapters. Chapter 3 will focus on the techniques used to minimise the different types of taxes and Chapter 4 on the techniques used in achieving the other objectives of estate planning.

## **CHAPTER 3**

### **ESTATE PLANNING TECHNIQUES AND THE MINIMISATION OF TAX**

#### **3.1 INTRODUCTION**

The estate planning objectives mentioned in Chapter 2 can be achieved by using a number of estate planning techniques. Meyerowitz (1965:1) suggests that estate planning should not be effected without a proper understanding and appreciation of the potential of the tools available and what can be achieved by the correct use thereof.

The following two chapters will therefore focus on the different estate planning techniques and how these techniques are used to achieve different estate planning objectives. Chapter 3 will focus on the techniques used to minimise tax (secondary objective two, paragraph 1.3.2.2) and Chapter 4 will focus on the techniques used in achieving the other objectives of estate planning. Both these chapters strongly emphasise the use of trusts in achieving the various objectives and clearly indicate that trusts can be used for more than just the minimisation of estate duty.

#### **3.2 TAX AVOIDANCE**

For as long as taxes have been levied, people have been thinking of ways to minimise or avoid their tax liability. In 1696 England<sup>2</sup> imposed a Window Tax based on the number of windows in a house. In order to avoid paying Window Tax, home owners bricked up existing windows and new houses were built with fewer windows (Khan, 2010).

Society has come a long way from robbing themselves of daylight, but the desire to avoid tax has remained an eminent consideration in the minds of taxpayers. The tools and techniques used by modern taxpayers are less drastic, but are just as effective in limiting tax opportunities and reducing the rate at which tax is levied.

It is important that tax legislation be observed and that the anti-avoidance provisions are not contravened when these tools and structures are implemented (Abrie *et al.*, 2003:175). The

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<sup>2</sup> A tax on windows was also levied in Scotland and France.

provisions of the general anti-avoidance rule<sup>3</sup> contained in sections 80A to 80L of the *Income Tax Act* (58/1962) (hereafter referred to as the *Income Tax Act*) succeeded the provisions of section 103(1) which, according to the South African Revenue Service (Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006:62) “has proven to be an inconsistent and, at times, ineffective deterrent to the increasingly sophisticated forms of impermissible tax avoidance” and that “has not kept up with international developments”.

The provisions of sections 80A to 80L apply to any arrangement entered into on or after 2 November 2006 and in terms of which all of the following questions can be answered in the affirmative:

(a) *Was an “arrangement” entered into?*

Section 80L defines an “arrangement” as “any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property.”

(b) *Is the arrangement an “avoidance arrangement”?*

Section 80L defines an “avoidance arrangement” as “any arrangement that results in a tax benefit.” The word “tax benefit” includes any avoidance, postponement or reduction of any liability for tax. The word “tax” includes any tax, levy or duty imposed by the *Income Tax Act* or any other law administered by the Commissioner. This means that these provisions not only apply to income tax, but also to value-added tax, estate duty and transfer duty.

Section 80G provides that an avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit unless and until the party obtaining the tax benefit proves that obtaining the tax benefit was not the sole or main purpose of the avoidance arrangement.

(c) *Is the avoidance arrangement an “impermissible avoidance arrangement”?*

In this regard one should first ask whether the avoidance arrangement was in the context of business or in a context other than business.

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3 The general anti-avoidance provisions will only be discussed briefly as a detailed discussion falls outside the scope of this document. The specific anti-avoidance provisions will be discussed where applicable.

If the avoidance arrangement was in the context of business, one of the following four requirements must be met:

- The arrangement was not entered into or carried out by means or in a manner which would normally be employed for *bona fide* business purposes, other than obtaining a tax benefit (section 80A(a)(i));
- The arrangement has created rights or obligations that would not normally be created between persons dealing at arm's length (section 80A(c)(i));
- The arrangement lacks commercial substance, in whole or in part (section 80A(a)(ii)). An avoidance arrangement lacks commercial substance if it would result in a significant tax benefit for a party but does not have a significant effect upon either the business risks or net cash flows of that party (section 80C);
- The arrangement would result directly or indirectly in the misuse or abuse of the provisions of the *Income Tax Act* (section 80A(c)(ii)).

If the avoidance arrangement was in a context other than business, one of the following three requirements must be met:

- The arrangement was not entered into or carried out by means or in a manner which would normally be employed for *bona fide* purposes, other than obtaining a tax benefit (section 80A(b)(i));
- The arrangement has created rights or obligations that would not normally be created between persons dealing at arm's length (section 80A(c)(i));
- The arrangement would result directly or indirectly in the misuse or abuse of the provisions of the *Income Tax Act* (section 80A(c)(ii)).

Once an arrangement is considered to constitute an impermissible avoidance arrangement, various remedies are available to the Commissioner. These remedies are contained in section 80B and provide that the Commissioner may –

- disregard, combine or re-characterize any steps in or parts of the arrangement (section 80B(1)(a));
- disregard any accommodating for tax-indifferent party or treat any such party as one and the same as another party (section 80B(1)(b));
- deem persons who are connected persons in relation to each other to be one and the same person for purposes of determining the tax treatment of any amount (section 80B(1)(c));



- reallocate any gross income, capital receipts or accruals or expenditure amongst the parties (section 80B(1)(d));
- re-characterize gross income, capital receipts or accruals or expenditure (section 80B(1)(e)); or
- treat the impermissible avoidance arrangement as if it had not been entered into or carried out, or in such other manner as in the circumstances the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit (section 80B(1)(f)).

Although the definition of the word “tax” includes any tax levied in terms of the *Income Tax Act* or any other Act administered by the Commissioner, section 80B only empowers the Commissioner to determine the tax consequences under the *Income Tax Act* and therefore the Commissioner cannot apply the provisions of section 80A to 80L to recover any tax levied in terms of any other Act. In other words, the Commissioner may not impose estate duty by applying section 80A to 80L (Honiball & Olivier, 2009:201).

### **3.3 MINIMISATION OF INCOME TAX**

The minimisation of income tax is not often seen as a major objective in estate planning. Although income tax savings are possible in estate planning, such savings should not be expected and are often only achieved by future generations (Davis *et al.*, 2010: paragraph 1.2.3).

By transferring assets to a trust income tax can be saved if the income arising from such assets is split between the beneficiaries of the trust. The income tax rules applicable to a trust are mostly contained in section 25B and section 7 of the *Income Tax Act*.

#### **3.3.1 Section 25B**

Section 25B is a regulatory provision that determines who will be taxed on trust income, and when. Until the case of *Friedman NO v CIR* (1993 1 SA 353 (A)) trust income was taxed in the hands of the trust if it did not vest in any beneficiaries, and was taxed in the hands of beneficiaries if they were vested beneficiaries (Honiball & Olivier, 2009:73). In the *Friedman* case this practice was challenged on the grounds that the trust was not a taxable entity and that the trustees were therefore not representative taxpayers. This challenge was upheld by the court, resulting in the amendment to the definition of “person” to include a trust, and resulting in the inclusion of section 25B into the *Income Tax Act*.

Section 25B provides that any amount received by or accrued to any person during any year of assessment in his or her capacity as the trustee of a trust is deemed to be an amount which has accrued to the trust and will be taxed in the hands of the trust. If the amount is derived for the immediate or future benefit of a beneficiary who has a vested right to that amount during that year (section 25B(1)) or who acquired a vested right to any amount in consequence of the exercise of a discretion of the trustee (section 25B(2)), it will be deemed to be an amount which has accrued to the beneficiary and will be taxed in the hands of the beneficiary. The same amount cannot be taxed in the hands of both the trust and the beneficiaries and will either be taxed in the hands of the trust at a rate of 40% or in the hands of the beneficiary at the beneficiary's tax rate.

These provisions are subject to section 7 and, where section 7 is applicable, section 25B will not apply. This means that, in certain circumstances, an amount will not be taxed in the hands of either the trustee or a beneficiary, but in the hands of a person who made a donation, settlement or other disposition to the trust. These provisions will, however, only apply while the person who made the donation, settlement or other disposition is still alive (Olivier *et al.*, 2008: paragraph 7.2.3)<sup>4</sup>.

### **3.3.2 Section 7**

Section 7 contains various anti-avoidance provisions which determine certain circumstances where income is deemed to have accrued or to have been received by persons who did not actually receive it or to whom it did not legally accrue (Honiball & Olivier, 2009:84). In *Ovenstone v SIR* 1980 (2) SA 721 (A), Trolip JA stated that the provisions of section 7 have to do with transactions –

“in which a taxpayer seeks to achieve tax avoidance by donating, or disposing of income-producing property to or in favour of another under the ... specified conditions or circumstances, thereby diverting its income from himself without his replacing or being able to replace it.”

In the context of a trust, the section 7 provisions have the effect that even though income accrues to a beneficiary or income is retained in a trust, someone other than the beneficiary or the trust will be taxed on that income.

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4 Olivier *et al.* is a loose leave publication. Whenever reference is made to this publication, the reference will be to paragraph numbers and not to page numbers.

In order for the section 7 provisions to apply, a person must have made a donation, settlement or other gratuitous disposition. In other words, before any deeming provision can apply, there must be a gratuitous disposal that was made “out of liberality or generosity” and whereby “the donee is enriched and the donor correspondingly impoverished” (*Ovenstone v SIR* 1980 (2) SA 721 (A)). These provisions will not apply if there has been a commercial arms-length transaction or a transaction that was entered into to extinguish a commercial or legal obligation.

An example of a gratuitous disposition would be a donation of a property to a trust. Any income arising from that property would be deemed to be income of a person other than the person to whom the income accrues. Another example would be the sale of an asset to a trust in terms of which the selling price is left owing, either as an interest-free loan or as a loan at an interest rate below a commercial rate of interest. To the extent that the loan is interest-free or below a commercial rate, the loan would be a gratuitous disposition, and any income that accrues to another person as a result of this gratuitous disposition would be deemed to be the income of the person who made the gratuitous disposition. (Geach & Yeats, 2007:245)

An example of a transaction that would not amount to a gratuitous disposition would be where assets are transferred to a trust to provide for maintenance payable in terms of a divorce settlement (*Estate Welch v Commissioner for SARS* 2004 2 SA 586 (SCA)).

Subsections 7(2) to 7(8) are of particular relevance to trust income and will therefore be discussed in more detail below.

#### **3.3.2.1 Section 7(2)**

Section 7(2) prevents spouses from splitting income between them and thereby reducing their combined tax liability. In terms of this section, any income received by or accrued to any person is deemed to be income accrued to such person's spouse in circumstances where the income was derived by the spouse in consequence of a donation, settlement or other disposition made by the other spouse.

In the context of trusts, the application of section 7(2) will ensure that if a spouse has received income from a trust, and the true cause of this benefit is a donation, settlement or other gratuitous disposition by the other spouse, such income will be deemed to be the

income of the donor spouse and not the spouse who received the income (Geach & Yeats, 2007: 247).

### **3.3.2.2 Section 7(3)**

In terms of section 7(3), income is deemed to have been received by the parent of a minor child, if by reason of any donation, settlement or other disposition made by that parent of that child, the income has been received by or has accrued to or in favour of that child or has been expended for the maintenance, education or benefit of that child, or it has been accumulated for the benefit of that child. A minor child is a child who is under the age of 18 years (section 17 of the *Children's Act* (38/2005)).

In the context of trusts, section 7(3) will apply to income distributed or allocated to a minor beneficiary of a trust where such income can be attributed to a donation, settlement or other gratuitous disposition made by that child's parent (Honiball & Olivier, 2009:85).

Before section 17 of the *Children's Act* (38/2005) came into effect on 01 July 2007, the age of majority used to be 21. The reduction in the age of majority from 21 to 18 brings with it a tax and estate planning opportunity (Carroll, 2011). A parent's expenses in respect of a child will often peak when the child reaches the university-going age at around the age of 18. With proper planning a parent can save income tax while simultaneously paying for his 18 year old child's tertiary education (Dippenaar, 2008:B45). Since a child now turns major at the age of 18, the deeming provisions of section 7(3) ceases to apply when that child turns 18. While a child is under the age of 18, any income that accrues to him as a result of a donation, settlement or other disposition made by his parent will be attributed to the parent in terms of section 7(3) and taxed in the hands of the parent. As soon as a child turns 18, any income that accrues to him will be taxable in his own hands.

If the amount accruing to the major child is less than the tax threshold (which is calculated by dividing the primary rebate by 18%) and the basic interest exemption (which is announced annually) there will be no income tax payable by the parent or the child on the income received (Carroll, 2011).

### **3.3.2.3 Section 7(4)**

According to Olivier *et al.* (2008: paragraph 7.4.5) section 7(4) was introduced to prevent parents from circumventing the provisions of section 7(3) by introducing a third party to make a donation, settlement or other disposition. In terms of section 7(4), any income received by or accrued to or in favour of any minor child of any person, by reason of any donation, settlement or other gratuitous disposition made by another person, shall be deemed to be the income of the parent of that minor child if such parent or his spouse has made a donation, settlement or other disposition or given some other consideration in favour directly or indirectly of the said other person or his family.

Although there is an obvious element of reciprocity in this section, the consideration in each case need not be of equal value. In *COT v Paice* 25 SATC 385 1963 (FC) Clayden J stated the position to be:

“There must be some causal connection between the disposition by the taxpayer to the other person, and the disposition by the other person which leads to income for the children.”

### **3.3.2.4 Section 7(5)**

The purpose of section 7(5) is to prevent the avoidance of tax where the donor does not permit the beneficiary of the gift to enjoy immediately the income to be derived therefrom (*Estate Dempers v SIR* 1977 (3) SA 410 (A)). This section deems income to have been received by or accrued to the person who made a donation, settlement or other disposition where such donation, settlement or other disposition is made subject to a stipulation or condition that has the effect that one or more of the beneficiaries will not receive the income or a portion thereof until the happening of some fixed or contingent event.

The effect of section 7(5) is that income accumulated in a trust will be deemed to be the income of a person who has made a donation, settlement or other disposition to the trust, if such income was retained and accumulated in the trust until the happening of some event, such as the attainment of a certain age or the exercise by trustees of their discretion. Section 7(5) therefore only applies to situations where income is accumulated in a trust and is not paid out, allocated or distributed to a beneficiary.

#### **3.3.2.5 Section 7(6)**

In terms of section 7(6), if a person makes a donation or an interest-free loan to a trust, and the donor or lender retains the power to vary or change the beneficiaries who are entitled to receive any income resulting from that donation or loan, then the income that is received by a beneficiary will be deemed to be that of the donor or lender for as long as the donor or lender retains the power to vary or change the beneficiaries.

Section 7(6) therefore applies when a person seeks to avoid or reduce tax by disposing of an income-producing asset while retaining control over the income generated from that asset. According to Geach and Yeats (2007:249) section 7(6) will also apply if the donor retains the right to cancel the trust and/or retains the power to amend a trust deed.

#### **3.3.2.6 Section 7(7)**

Section 7(7) applies where a person donates or otherwise gratuitously disposes of property while retaining ownership of the property or retaining the right to regain ownership at a future date. It also applies where a person does not donate the property itself but merely cedes the right to receive income generated by the property. Any income generated by the property so donated or ceded will be deemed to be that of the person who retains the right to regain that property.

In a trust context, if an asset is gratuitously transferred to a trust for a certain period of time, after which it will revert back to the person who disposed of it, any rental, interest, royalties or similar income that is earned by the trust through this asset (whether or not this income is distributed to beneficiaries) will be taxed in the hands of the person who is entitled to regain that property (Geach & Yeats, 2007:249).

#### **3.3.2.7 Section 7(8)**

Section 7(8) provides that, where by reason of or in consequence of any donation, settlement or other disposition made by a resident, an amount is received by or accrued to a person who is not a resident, which would have constituted income had that person been a resident, there shall be included in the income of that resident so much of that amount as is attributable to that donation, settlement or other disposition.

If a person who is a South African resident makes a donation or makes an interest-free loan to a local or offshore trust, and if a non-resident beneficiary has consequently received any amount that would have been taxable if that person was a resident, then the donor must include any amount received by or accrued to that non-resident in his taxable income (Geach & Yeats, 2007:250).

### **3.3.3 Special trusts**

Unlike a normal trust that is taxed at a flat rate of 40%, a special trust is taxed at the same progressive tax rates that apply to natural persons (as per the wording of clause 1 in Appendix I of the *Taxation Laws Amendment Act* of any relevant year), but without being entitled to claim the normal tax rebates contained in section 6 of the *Income Tax Act* (Section 6(1)).

The definition of “special trust” in section 1 of the *Income Tax Act* makes provision for two types of special trusts as far as income tax is concerned:

#### *(a) “Disability special trust”*

Paragraph (a) of the definition of “special trust” makes provision for a special trust that is a trust (either inter vivos or testamentary) that has been created solely for the benefit of a person who suffers from any mental illness or who suffers from any serious physical disability, and who cannot manage his or her own affairs.

There are conflicting opinions as to whether or not a disability special trust will qualify as a special trust if there are additional (or subsequent) beneficiaries other than the person who suffers from the mental illness or disability. Geach and Yeats (2007:238) are of the opinion that such a trust will still qualify as a special trust. They justify this interpretation by referring to the proviso in the definition of a “special trust” in section 1 that specifically provides that “where the person for whose benefit the trust was created dies, such trust shall be deemed not to be a special trust in respect of years of assessment ending on or after the date of such person’s death”. If the definition of a special trust had envisaged a vesting trust in terms of which there was a sole beneficiary, this proviso would not have been necessary as the trust would automatically cease at the death of the sole beneficiary. According to Honiball and Olivier (2009:235) a special trust cannot have any beneficiaries other than the mentally ill or disabled beneficiary envisaged in the definition, and the insertion of any new beneficiaries

after the death of the special beneficiary would be the creation of a new trust. They base their view on the literal interpretation of the words “created solely for the benefit of...” in the definition of “special trust” in section 1. In terms of the first interpretation the trust merely loses its status as a special trust at the death of the special beneficiary, whereas the second interpretation results in the trust coming to an end at the death of the special beneficiary.

In dealing with an application for the approval of a trust as a special trust, the South African Revenue Service seems to follow a middle ground between these two interpretations. In an information document provided by the Legal and Policy Division of the South African Revenue Service it is expressly stated that the trust document “should not make provision for or grant a discretion to the trustee(s) enabling any other person to obtain a vested right to any income or capital of the trust as long as the beneficiary for whose sole benefit the trust has been created, is alive” (SARS, 2009:3). This means that, as long as no other beneficiary can benefit during the disabled beneficiary’s lifetime, the trust will qualify as a special trust but will stop being a special trust at the death of the disabled beneficiary and continue as a normal trust for the benefit of the other beneficiaries.

*(b) “Under-21 special trust”*

Paragraph (b) of the definition of “special trust” makes provision for a special trust that is a testamentary trust that has been created solely for relatives of the testator, where the youngest beneficiary is under the age of 21 (“under-21 special trust”) (paragraph (b) of the definition of “special trust”).

From the wording of this paragraph it seems clear that a trust will constitute an under-21 special trust if the said trust was created by or in terms of the will of a deceased person, solely for the benefit of beneficiaries who are relatives in relation to that deceased person and who are alive on the date of death of that deceased person, where the youngest of those beneficiaries is under the age of 21 years. In other words, a testamentary trust that has been created for the benefit of the testator’s relatives will be a special trust if the youngest beneficiary is under the age of 21 and will remain a special trust until the youngest beneficiary reaches the age of 21. This means that an under-21 special trust will enjoy the more favourable tax rate even if the other beneficiaries, such as the surviving spouse and other family members, are over the age of 21.



### **3.3.4 Summary**

The minimisation of income tax is not often seen as a major objective in estate planning and an estate plan should aim to prevent any prejudicial income tax implications rather than to reduce income tax (Davis *et al.*, 2010: paragraph 1.2.3).

Although income tax savings may be incidental to the transfer of assets to a trust (especially if the provisions of section 7 are correctly applied or if the trust qualifies as a special trust) income tax should not be the main consideration when establishing a new trust or transferring assets to an existing trust.

## **3.4 MINIMISATION OF CAPITAL GAINS TAX (CGT)**

Just as the minimisation of income tax is not often regarded as a major objective in estate planning, so too is the minimisation of CGT not regarded as a major aim. As with income tax, an estate plan seeks to prevent any prejudicial CGT implications rather than to reduce CGT. (Davis *et al.*, 2010: paragraph 1.2.3A)

The general principles of capital gains tax as well as the provisions of the Eighth Schedule that are most relevant to estate planning will be discussed below. Any reference to the “Eighth Schedule” will be reference to the Eighth Schedule of the *Income Tax Act* and any reference to “paragraph” will be reference to a paragraph of the Eighth Schedule, unless stated otherwise. There will be a specific focus on use of trusts in the prevention of prejudicial CGT implications.

### **3.4.1 General principles**

A person's capital gain in respect of the disposal of an asset is the amount by which the proceeds received or accrued in respect of that disposal exceed the base cost of that asset (paragraph 3). The net capital gain is then multiplied by the inclusion rate (as set out in paragraph 10) to arrive at the person's taxable capital gain which must be included in his taxable income under section 26A of the *Income Tax Act*. Thereafter, the ordinary rates of tax are applied to the taxable income to determine the normal income tax liability.

In order to determine whether there had been a capital gain and to calculate such gain, it is important to understand the four key elements of paragraph 3. The four elements are “asset”, “disposal”, “proceeds” and “base cost” and are briefly explained below.

#### **3.4.1.1 Asset**

Paragraph 1 defines an “asset” as property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum, and a right or interest of whatever nature to or in such property. This definition is very wide and includes all forms of property and all rights or interests in such property.

#### **3.4.1.2 Disposal**

Except for the provisions of paragraph 12(5) and paragraph 93, CGT will not be triggered unless an asset is disposed of. In terms of paragraph 11, a “disposal” is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset. The different events that give rise to disposals (paragraph 11(1)(a) to (g)), those that are expressly excluded as disposals (paragraph 11(2)(a) to (k)) and those that are deemed to be disposals (paragraph 12(2) to (5)) need not be discussed in detail for purposes of this discussion and will only be mentioned where applicable.

#### **3.4.1.3 Proceeds**

The proceeds from the disposal of an asset by a person are equal to the amount received by, or accrued to, or which is treated as having been received by or accrued to or in favour of, that person in respect of that disposal (paragraph 35). This means that any amount of money or right that is capable of being valued in money that is received by a taxpayer for his own benefit and to which he has become entitled and which is connected to a disposal, will qualify as “proceeds” (McAllister, 2010:267).

#### **3.4.1.4 Base cost**

The base cost of an asset consists of the costs directly incurred in respect of the acquisition, creation, improvement or disposal of an asset (paragraph 20).

### **3.4.2 CGT provisions relevant to estate planning**

CGT planning should not be the sole purpose of any structuring, but merely one of the elements to consider as part of the estate planning process (Victor & King, 2010:334). During this process, the following provisions of the Eighth Schedule are of particular relevance and should be kept in mind:

- (a) The definition of “asset” in paragraph 1 expressly excludes any currency as an asset for purposes of CGT. It is therefore important to take note that the transfer of cash will not be a disposal for purposes of CGT (McAllister, 2010:40).
- (b) A resident will be liable for CGT on the disposal of any asset (Paragraph 2). This means that residents are taxed on the disposal of their local and offshore assets (McAllister, 2010:45).
- (c) At death a person is treated as having disposed of his assets for an amount received or accrued equal to the market value thereof on the date of death (Paragraph 40). This will place a higher burden on the liquidity of the deceased's estate. A person should therefore structure his will as efficiently as possible in order to minimise any CGT liability and at the same time ensure that there is sufficient liquidity in his estate should such a liability arise. (Victor & King, 2010:334)
- (d) A natural person or a special trust must disregard so much of a capital gain or capital loss determined in respect of the disposal of a primary residence as does not exceed R1,5 million or if the proceeds of the disposal does not exceed R2 million (Paragraph 45).
- (e) A person (or his deceased estate) must disregard any capital gain or capital loss determined in respect of the disposal (or bequest) of an asset to his spouse and such spouse must be treated as having acquired the asset on the same date and at the same base cost as the transferor spouse acquired the asset (paragraph 67). This means that CGT will be postponed until the transferee spouse subsequently disposes of these assets during her lifetime or at death.
- (f) Where a company or a trust makes a disposal of an interest in a residence, that company or trust must be deemed to have made that disposal for an amount equal to the base cost

of that interest as at the date of that disposal (Paragraph 51A(2)). This paragraph provides a window of opportunity (further to the window of opportunity provided by paragraph 51), which operates on a roll-over basis and applies to the disposal of a residence by a company or trust which meets the following requirements:

- An interest in a residence must be disposed of (section 51A(1)).
- The residence must be disposed of on or after 1 October 2010 but no later than 31 December 2012 (section 51A(1)(a)).
- A qualifying residence must be mainly used for domestic purposes by one or more natural persons who ordinarily resided in that residence during the period from 11 February 2009 to the date of disposal by the company or trust (section 51A(1)(b)).
- The natural persons who used the residence mainly for domestic purposes and ordinarily resided in the residence must be connected persons in relation to the company or trust at the time of disposal by the company or trust of the residence (section 51A(1)(c)).
- Within six months of the date of disposal certain specified steps must be taken to terminate the existence of the company or trust holding the residence (section 51A(1)(d)).

(g) A capital gain or loss determined in respect of a disposal of an asset under the circumstances listed in part VIII of the Eighth Schedule must be disregarded when calculating a person's aggregate capital gain or capital loss (Paragraph 52). This means that the proceeds from such disposal will not be subject to CGT and that a loss occurred in respect of such disposal will not be deducted from the aggregate capital gain (McAllister, 2010:341). These circumstances are the following:

- A natural person or a special trust must disregard a capital gain or capital loss determined in respect of the disposal of a personal-use asset (paragraph 53(1)). A personal-use asset is defined in paragraph 53(2) as "an asset of a natural person or a special trust that is used mainly for purposes other than the carrying on of a trade".
- A person must disregard any capital gain or capital loss determined in respect of a disposal that results in that person receiving a retirement benefit lump sum (Paragraph 54).
- A person must disregard any capital gain or capital loss determined in respect of a disposal that results in the receipt by or accrual of an amount in respect of any

policy where the person receiving the amount is the original beneficial owner, the spouse, former spouse, nominee or dependant of the original beneficial owner. (Paragraph 55(1)(a)).

- A person must disregard any capital gain or capital loss determined in respect of a disposal that results in the receipt by or accrual of an amount in respect of any policy, where the person receiving the amount is or was an employee or director whose life was insured in terms of that policy and in terms of which any premiums paid by that person's employer were deducted in terms of section 11(w) (Paragraph 55(1)(b)).
- A person must disregard any capital gain or capital loss determined in respect of a disposal that results in the receipt by or accrual of an amount in respect of a policy that was taken out to insure against the death, disability or severe illness of the person receiving the amount, but only if the policy was taken out by a person who was a partner of that person, or held any share or similar interest in a company in which that person held any share or similar interest, for the purpose of enabling that other person to acquire, upon the death, disability or severe illness of that person, the whole or part of that person's interest in the partnership concerned or that person's share or similar interest in that company and any claim by that person against that company, and if no premium on the policy was paid or borne by that person while that other person was the beneficial owner of the policy (Paragraph 55(1)(c)).
- A person must disregard any capital gain or capital loss determined in respect of a disposal that results in the receipt by or accrual of an amount in respect of a policy originally taken out on the life of a person, where that policy is provided to that person or dependant by or in consequence of that person's membership of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund (Paragraph 55(1)(d)).
- When paragraph 55(1)(e) comes into effect, a person will also be able to disregard any capital gain determined in respect of a disposal that resulted in the receipt by or accrual to that person of an amount in respect of a risk policy with no cash value or surrender value (clause 114 of the *Taxation Laws Amendment Bill (19/2011)*).
- A person must disregard any capital gain or capital loss determined in respect of the disposal of a claim owed by a debtor, who is a connected person in relation to the creditor (Paragraph 56). Where a creditor disposes of a claim owed by a debtor, who is a connected person in relation to that creditor, that creditor must

disregard any capital loss determined in consequence of that disposal. This exclusion prevents a person from receiving the benefit of a loss on a debt when such debt represents a disguised donation or capital contribution, neither of which would otherwise create a capital loss. This means that a creditor cannot receive a capital loss on any disposal of a debt claim owed by a connected person, even if the disposal of that claim is to an unconnected person (McAllister, 2010:351).

- The first R900 000 in respect of the disposal of an active small business asset or an interest in an active small business asset must be disregarded when determining a person's aggregate capital gain or capital loss (Paragraph 57(2) and (3)). An "active business asset" means an asset which constitutes immovable property, to the extent that it is used for business purposes or an asset (other than immovable property) used or held wholly and exclusively for business purposes, but excludes a financial instrument and an asset held in the course of carrying on a business mainly to derive any income in the form of an annuity, rental income, a foreign exchange gain or royalty or any income of a similar nature (Paragraph 57(1)). A "small business" means a business of which the market value of all its assets, as at the date of the disposal, does not exceed R5 000 000 (Paragraph 57(1)). In order to qualify for this exclusion, the person making the disposal should have held such asset or the interest therein for his own benefit for a continuous period of at least five years prior to the disposal, he should have been substantially involved in the operations of that small business and he should have attained the age of 55 years or the disposal should have been in consequence of ill-health, other infirmity, superannuation or death. In the light of these requirements, it is clear that this exclusion only applies to natural persons.
- A registered micro business must disregard any capital gain or capital loss determined in respect of the disposal by that business of any asset which constitutes immovable property, to the extent that it was used for business purposes and any asset (other than immovable property) used mainly for business purposes (Paragraph 57A). A "micro business" is a natural person (or the deceased or insolvent estate of that person) or a company where the qualifying turnover of that person or company for that year of assessment does not exceed R1 million (paragraph 2(1) of the Sixth Schedule of the *Income Tax Act*).
- Where, as a result of the exercise of an option, a person acquires or disposes of an asset in respect of which that option was granted, that person must disregard any capital gain or capital loss determined in respect of the exercise of that option

(Paragraph 58). This exclusion is necessary because any amount paid for an option to acquire or dispose of an asset, other than a personal-use asset, will be allowed as part of the base cost of the asset under paragraph 20(1)(c)(ix) or 20(1)(f) (McAllister, 2010:358).

- A person must disregard any capital gain or capital loss determined in respect of a disposal resulting in compensation for personal injury, illness or defamation. (Paragraph 59). This exclusion only applies to natural persons and special trusts. The reason for this exclusion is that any compensation received would normally be intended to restore the person who has suffered harm to the position he or she was in before the injury, illness or defamation (McAllister, 2010:360).
- A person must disregard any capital gain or capital loss determined in respect of a disposal of a participatory interest in a portfolio of a collective investment scheme in securities. The holder of such a participatory interest must determine the capital gain or capital loss in respect of the participatory interest only upon the disposal of that participatory interest. (Paragraph 61).
- A person must disregard a capital gain or capital loss determined in respect of the donation or bequest of an asset to public benefit organisations, the Government, any provincial administration, a person approved by the Commissioner or a recreational club. (Paragraph 62).

### **3.4.3 CGT and trusts**

Although the minimisation of CGT is not a primary consideration in estate planning, it is on occasion possible to achieve some benefit by means of a trust. With proper planning and a thorough knowledge of the relevant principles of taxation, it is possible to achieve a CGT saving through a trust. (Olivier *et al.*, 2008: paragraph 7.11.13). In light of the aforementioned it is important to understand how trusts are taxed on capital gains and how the Eighth Schedule applies to trusts.

The net capital gain of a trust (other than a special trust)<sup>5</sup> is multiplied by an inclusion rate of 50% (paragraph 10(c)) to arrive at its taxable capital gain. This is the amount that is included in the trust's taxable income under section 26A of the *Income Tax Act* and taxed at a flat rate of 40%. This gives trusts an effective CGT rate of 20%, which is much higher than the

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5 The CGT consequences applicable to special trusts will be dealt with under 3.4.4 below.

effective CGT rate for individuals (4,5% to 10% calculated by multiplying the individual's marginal tax rate with an inclusion rate of 25%).

This disadvantage should, however, not be overstated. It is important to remember that a deceased person is treated as having disposed of his assets at death (paragraph 40(1)). The joint effect of estate duty and CGT should therefore be weighed up against the effective CGT rate payable on disposal of the asset. What has to be considered is, on the one hand, the estate duty and CGT consequences if an asset remained in the individual's estate until his death, and on the other hand the case where, at the time of his death, the asset was already held in trust and the loan account (or the balance thereof) is an asset in the estate of the deceased (Olivier *et al.*, 2008: paragraph 8.5.2.4.1). After calculation it will be seen that the transfer of assets with a growth potential to a trust will in most cases still be advantageous. Refer to addendum B on page 159.

Where an asset is indeed held by a trust, it is not always obvious whether there has been a disposal and if so, whether such disposal was made by a trustee or by a beneficiary or by a donor in relation to that trust (Geach & Yeats, 2007:252). The CGT consequences applicable to trusts will now be discussed under separate headings setting out the different transactions that constitute disposals in the context of trusts.

#### **3.4.3.1    *The transfer of an asset to a trust (Paragraph 11(1)(a))***

A trust can acquire assets by way of donation, bequest or purchase. Where an asset is donated to the trust, such disposal will be subject to donations tax (Olivier *et al.*, 2008: paragraph 7.7.3). The asset will, however, be completely out of the hands of the donor and excluded from estate duty and CGT at his death. A trust can be used to receive bequests and thereby achieve effective and beneficial results for the parties involved. According to Olivier *et al.* (2008: paragraph 8.5.2.5.1) it can be to the benefit of an estate owner if a substantial inheritance is directed to a trust rather than to his personal name. It is customary for a trust to purchase property with funds borrowed from the planner (Honiball & Olivier, 2009:203). The trust then uses these funds to purchase an asset either from the planner or from an independent third party. The former requires careful consideration as the present costs involved may negate the future benefit. However, according to Geach and Yeats (2007:284) a person should not be blinded by the immediate costs, but should also take the present value of money into account. This means that the founder will have to consider whether it is better to incur a cost now or to incur a cost at some time in the future having



regard to the fact that the value of money can deteriorate. An obvious advantage of a trust is the fact that any growth in the value of the asset will take place in the trust and not in the hands of the planner. All that remains in the hands of the planner is the loan owing by the trust (or the balance thereof).

#### **3.4.3.2    *The sale of a trust asset by a trustee (Paragraph 11(1)(a))***

Although the effective CGT rate in a trust is higher than the rate which applies to individuals, the sale of a trust asset will not always result in the trust being liable for CGT. A trust will only be taxed if the gain is not deemed to be that of a beneficiary in terms of paragraph 80 and is not deemed to be that of a donor in terms of the provisions of paragraphs 68 to 73 (Geach & Yeats, 2007:255). Huxham and Haupt (2006:30.22) even go as far as referring to a trust as a taxpayer of last resort.

With regards to the disposal of a trust asset by the trustees, paragraph 80(2) provides that, where a capital gain is determined in respect of the disposal of an asset by a trust in a year of assessment during which a resident beneficiary has a vested interest or acquires a vested interest (including an interest caused by the exercise of a discretion) in that capital gain but not in the asset, the whole or the portion of the capital gain so vested must be disregarded for the purpose of calculating the aggregate capital gain or loss of the trust (sub-paragraph (a)) and must be taken into account for the purpose of calculating the aggregate capital gain or loss of the beneficiary in whom the gain vests (sub-paragraph (b)).

In terms of paragraph 80(2) the CGT consequences will therefore depend on whether a distribution was allocated to a beneficiary, when such distribution was allocated and whether the beneficiary was a resident or not. If a trustee of a discretionary trust sells a trust asset, makes a gain and retains the gain in the trust, the trust must take the gain into account for the purpose of CGT. If the trustee distributes this gain (cash) to a beneficiary in a subsequent year, the capital gain would have been taxed in the hands of the trust in the year in which the asset was disposed of. The distribution of the gain in a future year has no CGT consequences because cash is not an asset for CGT purposes (Geach & Yeats, 2007:259). If a trustee of a discretionary trust sells a trust asset, makes a gain and distributes the gain to a beneficiary in the same year that the gain is realised, then the beneficiary must take the gain into account for purposes of CGT (Geach & Yeats, 2007:260). Where the beneficiary is a non-resident, paragraph 80(2) will not apply and the gain so vested, will be taxed in the hands of the trust (McAllister, 2010: 427).

It is clear from the wording of paragraph 80(2) that these provisions do not apply to the disposal of a trust asset where the beneficiary has a vested right in the asset (as opposed to a vested right to the capital gain). When a beneficiary has a vested right in the asset, the actions of the trustees are actions on behalf of the beneficiary for purposes of determining any capital gain or loss in the beneficiary's hands (Geach & Yeats, 2007:257). Any disposal of such asset will be regarded as a disposal by the beneficiary, and the beneficiary will be liable for the CGT. This will be the case even if the gain is accumulated or retained in the trust (Geach & Yeats, 2007:260).

#### **3.4.3.3    *The distribution of a trust asset to a beneficiary (Paragraph 11(1)(d))***

In this regard a distinction can be drawn between the distribution of a trust asset to which a beneficiary has a vested right and the distribution of a trust asset to which a beneficiary does not have a vested right.

If a trustee distributes a trust asset to a beneficiary who had no vested right in the asset prior to that asset being distributed, such distribution will be regarded as a disposal of the asset by the trust in terms of paragraph 11(1)(d). The beneficiary who acquires the asset will be liable for the CGT resulting from such distribution (paragraph 80(1)). Paragraph 38 provides that, where an asset is disposed of to a person who is a connected person in relation to the person disposing of the asset, the person who disposed of the asset must be treated as having disposed of that asset for an amount equal to the market value of that asset at the date of that disposal and the person acquiring that asset must be treated as having acquired the asset at a cost equal to that market value. As a trust and its beneficiaries are connected persons in relation to each other (definition of "connected person" in section 1 of the *Income Tax Act*), the proceeds from the distribution of an asset to a beneficiary will be equal to the market value of that asset.

The distribution of a trust asset to a beneficiary who already has a vested right in that asset does not constitute a disposal for purposes of CGT (paragraph 11(2)(e)). In this regard Geach and Yeats (2007:261) distinguish between a beneficiary's right *in* a trust asset and a beneficiary's right *to* a trust asset. According to them a beneficiary has a vested right *to* an asset if he does not have ownership of the asset, but a mere personal right to claim the asset from the trustees and has a vested right *in* a trust asset if he already has ownership of the asset. It seems to be their opinion that, only where an asset is distributed to a beneficiary with a vested right *in* the asset, will there be no CGT consequences. Where the beneficiary

has a vested right to the asset, he disposes of his personal right to the asset in exchange for a real right (ownership) to the asset and has a capital gain to the extent to which the market value of the asset exceeds the base cost of the personal right (Geach & Yeats, 2007:262). There is no other authority for this view and it seems to be safe to assume that paragraph 11(2)(e) will apply to the distribution of assets to which a beneficiary either has a right *to* or a right *in* such assets. In both cases the distribution will not constitute a disposal for purposes of CGT.

#### **3.4.3.4    *The vesting of a right to a trust asset in a beneficiary (Paragraph 11(1)(d))***

If a trustee of a discretionary trust vests a right in a trust asset in a beneficiary, it will be regarded as a disposal of the asset by the trust in terms of paragraph 11(1)(d).

Paragraph 80(1) provides that, where a capital gain is determined in respect of the vesting by a trust of an asset in a trust beneficiary, that gain must be disregarded for the purposes of calculating the aggregate capital gain or aggregate capital loss of the trust and must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary.

#### **3.4.3.5    *The disposal by a beneficiary of a vested or contingent right (paragraph 11(1)(a))***

A beneficiary can dispose of his interest in a discretionary trust. This would amount to a disposal for capital gains tax purposes. In terms of paragraph 81 the base cost of a person's interest in a discretionary trust will be nil. This provision overrides paragraph 38(1)(b) which provides that an asset acquired from a connected person will be treated as having a base cost equal to market value. Even if a beneficiary paid for such interest, the base cost will remain nil at the disposal thereof. The capital gain arising from the disposal of such interest will therefore be equal to the proceeds derived from such disposal. In the absence of any proceeds, the gain would probably be equal to the market value of such interest. But in the absence of any proceeds it would be very difficult to determine a value of a purely discretionary right (Geach & Yeats, 2007:263).

While the base cost of a discretionary right is always nil, this will not be the case with a vested right. The base cost of a vested right will be the amount that the beneficiary paid for

that right, or if there was no payment, the base cost would be the market value of the interest at the time of vesting (McAllister, 2010: 428).

#### **3.4.3.6 Value-shifting arrangements (Paragraph 11(1)(g))**

Paragraph 11(1)(g) provides that the decrease in value of a person's interest in a trust as a result of a value-shifting arrangement will be a disposal for CGT purposes. Paragraph 1 defines a "value-shifting arrangement" as an arrangement by which a person retains an interest in a company, trust or partnership, but following a change in the rights or entitlements of the interests in that company, trust or partnership, the market value of the disposer's interest decreases and the value of the interest of a connected person increases.

In the context of trusts, a value shifting arrangement will arise if there is a vesting trust and there are changes in the interests of the beneficiaries without adequate compensation being received by a beneficiary whose interest is being diminished. Geach and Yeats (2007:265) as well as Honiball and Olivier (2009:164) are of the opinion that a value-shifting arrangement cannot arise when beneficiaries only have discretionary interests in a trust, because it would not be possible to determine a market value of a discretionary interest and it is not really possible to shift a portion of a discretionary interest to another.

#### **3.4.3.7 Reduction or waiver of a debt owing by the trust (Paragraph 12(5))**

As was mentioned above (under paragraph 3.4.3.1) a trust can be funded by way of a donation or by way of a loan to the trust. If the trust is funded by way of a loan, the loan remains an asset in the name of the person who made the loan. As such he may want to reduce this loan during his lifetime by way of annual donations and bequeath the balance thereof at his death. These estate planning techniques have now been adversely affected by the provisions of paragraph 12(5).

This paragraph provides that, where a debt owed by a person (the debtor) to a creditor has been reduced or discharged by that creditor for no consideration or for a consideration which is less than the amount by which the face value of the debt has been so reduced or discharged (paragraph 12(5)(a)), the debtor will be treated as having acquired a claim to so much of that debt as was reduced or discharged, which claim will have a base cost of nil (paragraph 12(5)(b)(i)) and be treated as having disposed of that claim to proceeds equal to that reduction or discharge (paragraph 12(5)(b)(ii)).

If a person therefore reduces or discharges a debt owing by a trust, the trust will be deemed to have acquired a claim to that debt and will be deemed to have disposed of such claim. The trust will therefore be liable for CGT on the full value of the debt so reduced or discharged. Before reducing or discharging a loan owing by the trust, the potential CGT consequences of such reduction (either during a person's lifetime or by way of a bequest in his will) should be considered carefully.

*(a) Reduction of a loan account (during lifetime)*

Taxpayers have for many years taken advantage of the annual donations tax exemption<sup>6</sup> to reduce an outstanding loan owing by a trust (McAllister, 2010: 91). Although these donations would escape donations tax, the reduction of the debt would amount to a disposal within the meaning of paragraph 12(5).

It may be, however, that if the amount so donated to the trust is used by the trustees to repay the loan account, the provisions of paragraph 12(5) would be legitimately avoided. This transaction may, however, be regarded as a mere cheque-swapping transaction. McAllister (2010:92) warns that, regardless of whether such a transaction circumvents paragraph 12(5), a taxpayer donating cash in this manner will have to have a paper trail to support the transaction.

*(b) Bequest of a loan account*

In *ITC 1793 67 SATC 256* a family trust owed money to the testatrix. In her will the testatrix did not provide that the trust need not repay the loan, but bequeathed the outstanding loan to the trust. SARS argued that paragraph 12(5) would apply and that a capital gain arose in the hands of the trust. The tax court agreed with SARS and held that the bequest fell within paragraph 12(5).

This case must be contrasted with *ITC 1835 71 SATC 105* where the Kimberley Tax Court held that a clause in a will which bequeathed the residue of an estate (including an outstanding loan) to a particular trust did not amount to the discharge of the loan and therefore did not give rise to a CGT event. In this case the testatrix did not bequeath the outstanding loan to the trust, but bequeathed the residue of her estate to the trust. The

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<sup>6</sup> The exemption is granted under section 56(2)(b) of the *Income Tax Act*. The amount of R100 000 applies to donations on or after 1 March 2007. Refer to paragraph 3.5 below for a discussion on donations tax.

executor of the estate did not demand or receive payment of this outstanding loan but indicated in the liquidation and distribution account that a claim was awarded to the trust to the extent of the outstanding loan. The Tax Court was of the opinion that the answer to the question of whether paragraph 12(5) was applicable depended on whether it was the intention of the testatrix to release the trust from the outstanding debt and held that it was not the intention of the testatrix to specifically bequeath the outstanding loan to the trust. The outstanding loan merely formed part of the residue of the estate, which was bequeathed to the trust. The fact that the executor did not first recover the outstanding debt before repaying it as part of the residue might have amounted to the waiver of a debt, but would not lead to an application of paragraph 12(5) as paragraph 12(5) only applies where “that creditor” (the testatrix) waives the outstanding debt.

Considering the facts of the two cases it is clear that these cases are not in conflict with each other and that the decision in the latter case did not override the decision in the former case. Where it is clearly the testator’s intention to bequeath the loan to the trust, the decision in *ITC 1835* cannot be relied upon.

There are various suggestions as to the avoidance of the negative CGT consequences of the *ITC 1793*-judgement. Olivier *et al.* (2008: paragraph 7.11.12.7) advises that an outstanding loan should be bequeathed to somebody other than the debtor. Another more liberal solution would be to bequeath cash or other assets to the trust that can be used to repay the outstanding loan (McAllister, 2010:94). Honiball and Olivier (2009:204) warns that testators should be careful not to bequeath an amount equal to the outstanding loan to the trust, but should rather bequeath the residue of the estate to the trust. They do, however, submit that paragraph 12(5) will not be applicable where an amount exceeding the outstanding loan account is bequeathed to the debtor and where it is clear that the intention was not to waive the loan but to make a bequest.

It is clear from this discussion that, where a trust’s debt is reduced or discharged, a CGT liability would arise in the hands of the trust. In the hands of the creditor, however, this will result in a capital loss equal to the market value of the loan at time of disposal (nil) less the base cost of the loan (value of the loan). As a general rule there is a restriction on losses between connected persons and paragraph 56(1) provides that, if the debtor is a connected person in relation to the creditor, the capital loss must be disregarded in the hands of the creditor. If, however, the debtor is subject to CGT on the corresponding capital gain under paragraph 12(5), the creditor will be entitled to the capital loss (paragraph 56(2)(a)).

### **3.4.3.8    *Anti-avoidance provisions***

The provisions deeming a capital gain to be that of a beneficiary (as per paragraph 80 as discussed in 3.4.3.2 and 3.4.3.4 above) will, however, only apply if the provisions deeming the capital gain to be that of a donor (paragraphs 68 to 73) do not apply. The deeming provisions contained in paragraphs 68 to 73 are equivalent to the deeming provisions contained in section 7 of the *Income Tax Act*, which has already been discussed in detail (paragraph 3.3.2 above) and will therefore only be listed briefly in this section.

Paragraph 68 contains provisions similar to section 7(2) of the *Income Tax Act* and will ensure that if a spouse has received a capital gain from a trust, and the real cause of this gain is a donation, settlement or other gratuitous disposition by the other spouse, such capital gain will be deemed to be that of the donor spouse and not the spouse who received the gain (Geach & Yeats, 2007:269).

Paragraph 69 is identical to section 7(3) of the *Income Tax Act*, and will apply to capital gains distributed or allocated to a minor beneficiary of a trust where such gain can be attributed to a donation, settlement or other gratuitous disposition made by that child's parent. The parent, and not the child, will be liable for the relevant capital gains tax (Geach & Yeats, 2007:270).

Paragraph 70 is similar to section 7(5) of the *Income Tax Act*, and aims to prevent the avoidance of tax in circumstances where a donor does not allow a beneficiary to enjoy the benefit of an asset immediately, but postpones enjoyment until the happening of some event or until trustees exercise their discretion and allow a beneficiary to enjoy the benefit of that asset. (Geach & Yeats, 2007:270). Any gain accumulated in the trust must therefore be taken into account by the donor for purposes of CGT.

Paragraph 71 is similar to section 7(6) of the *Income Tax Act*, and unlike paragraph 70 that only applies if the gain is accumulated in the trust, this paragraph only applies to gains that are actually awarded or paid out to a beneficiary (Williams, 2005:365). This paragraph provides that, where a deed of donation, settlement or other disposition confers a right upon a resident beneficiary to receive a capital gain attributable to that donation, settlement or other distribution and that right may be revoked by the donor, and the capital gain has vested in the beneficiary, then the capital gain must be disregarded in the hands of the beneficiary and taken into account in the hands of the donor.

Paragraph 72 is similar to section 7(8) of the *Income Tax Act*, and ensures that a resident takes into account any capital gain that has vested in a non-resident if that gain is attributable to a donation, settlement or other gratuitous disposition made by the resident (Honiball & Olivier, 2009:145).

Paragraph 73 is a limiting provision that applies to the attribution of both income and capital gains. This paragraph limits the total amount of the income that is deemed to accrue to a donor in terms of section 7 and the capital gain attributed to him in terms of paragraphs 68 to 72 to the amount of the benefit derived from the donation, settlement or other disposition (Stiglingh *et al.*, 2009:594).

#### **3.4.4 CGT and special trusts**

The definition of “special trust” contained in paragraph 1 is much more restrictive than the definition in section 1 of the *Income Tax Act*, as it is limited to the trust contemplated in paragraph (a) of the definition in section 1. In other words, for purposes of CGT, a special trust is a trust that has been created solely for the benefit of a person who suffers from any mental illness or who suffers from any serious physical disability, and who cannot manage his or her own affairs. It does not include a testamentary trust that has been created for beneficiaries under the age of 21.

Unlike a normal trust that has an inclusion rate of 50%, a special trust (as defined in section 1) has an inclusion rate of 25% (paragraph 10(a)). The maximum CGT that will be levied on any capital gain made by a special trust is therefore 10% as opposed to 20% in a normal trust. A special trust (as defined in paragraph 1) further qualifies for the annual CGT exclusion (paragraph 5(1) and paragraph 6(b)) as well as the primary residence exclusion (paragraph 45(1)(b) and paragraph (b) of the definition of “primary residence” in paragraph 1) available to natural persons.

Where a beneficiary of a special trust dies, that trust must continue to be treated as a special trust for purposes of CGT until the earlier of the disposal of all assets held by the trust or two years after the date of death of that beneficiary (paragraph 82). Should the trust continue to exist after this window period, then it will be subject to the normal CGT principles applicable to trusts.



### **3.4.5 Summary**

In the light of the above discussion, it should be clear that a trust has definite advantages from a CGT point of view. By holding assets in a trust, the CGT consequences at death can be minimised or eliminated. With an understanding of the provisions of the Eighth Schedule a person can create the opportunity to distribute a capital gain realised by a trust to various beneficiaries, thereby ensuring a lower effective rate of tax. The beneficiary has a lower CGT inclusion rate than the trust and is entitled to an annual exemption. Provided the provisions of paragraphs 68 to 72 do not apply, a lower rate of CGT can therefore be achieved by distributing CGT to beneficiaries.

It is, however, important to remember that the annual capital gain distributed to a beneficiary will be included in his estate for purposes of estate duty. A person will have to weigh the option of saving CGT in the trust against the eventual payment of estate duty.

In order to utilise these tax-planning opportunities Olivier *et al.* (2008: paragraph 7.11.2) warns that the trust deed must be structured correctly and that the trustees must have the necessary powers to distribute capital gains to beneficiaries.

## **3.5 DONATIONS TAX AND THE USE OF DONATIONS**

Sections 54 to 64 of the *Income Tax Act* provide for the taxation on any non-exempt donation made by a resident taxpayer. The purpose of donations tax is to prevent or discourage people from giving away assets during their lifetime in order to reduce their liability for income tax and estate duty (Victor & King, 2010:296). The use of donations can be an effective estate planning technique but donations tax and the minimisation thereof is an important consideration in the effective structuring of an estate plan (Davis *et al.*, 2010: paragraph 1.2.4).

### **3.5.1 Use of donations**

Inter vivos donations can be used to reduce a person's estate. This technique is particularly effective when making donations that are exempt from donations tax. These exemptions are contained in section 56 of the *Income Tax Act*, of which the following are most relevant for purposes of estate planning:

- Donations to or for the benefit of the spouse of the donor (section 56(1)(a) and (b));
- Donations under which the donee will not obtain any benefit until the death of the donor (section 56(1)(d));
- Donations of rights in property situated outside South Africa where such rights were acquired by a donor before he became a resident of South Africa for the first time or by inheritance from a person who at the date of his death was not ordinarily resident in South Africa or by a donation if at the date of the donation the donor was a person (other than a company) not ordinarily resident in South Africa (section 56(1)(g));
- Donations made to a public benefit organisation (section 56(1)(h));
- Donations under and in pursuance of any trust (section 56(1)(l)) (refer to paragraph (c) under 3.5.3 below for a discussion on section 56(1)(l));
- Donations by a natural person to the value of R100,000<sup>7</sup> during any year of assessment (section 56(2)(b));
- Bona fide contribution made by the donor towards the maintenance of any person as the Commissioner considers to be reasonable (section 56(2)(c)).

These exemptions constitute estate planning opportunities for married couples, people with maintenance obligations, trustees, residents who wish to make use of their annual tax free donations and non-residents holding South African assets in blocked accounts. The most common techniques used to reduce an estate by way of donations will be discussed hereunder.

*(a) Donation of growth assets*

Donations can save significant estate duty where the assets being donated are growth assets which are likely to appreciate rapidly in value in the future. It may for instance be better to pay the donations tax in respect of such an asset now and donate the asset, rather than pay significantly more estate duty in the future. (Davis *et al.*, 2010: paragraph 9.3.1)

*(b) Annual R100 000 donations*

The first R100 000 of all amounts donated by a natural person in any year of assessment are exempt from donations tax (section 56(1)(b)). This exemption is available in addition to any other exemptions which may be applicable in the circumstances and is applicable even where assets are transferred to non-natural persons.

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<sup>7</sup> The exemption was increased from R50 000 to R100 000 from 1 March 2007.

Davis *et al.* (2010: paragraph 9.3.1) warns that care must be taken in circumstances where the R100 000 exemption is used each year by making a donation to a particular person (or a trust) that the payment is not construed as an annuity and therefore subject to income tax in the hands of the recipient.

(c) *Donations between spouses*

As donations between spouses are exempt from donations tax in terms of section 56(1)(a) and (b), spouses can use donations to reduce the estate of the one spouse in favour of the other. The wording of this exemption not only applies to direct donations to a spouse, but also to donations for the benefit of a spouse. The donation of an asset to a trust under which a spouse has vested rights to income or capital would therefore, on the plain wording of the section, appear to be for the benefit of the spouse, and would consequently qualify for the exemption (Stiglingh *et al.*, 2009:672). The asset so donated will then be removed from the estate duty net in respect of the estate of the donor spouse, but the value of the vested rights would be included in the estate of the donee spouse (Davis *et al.*, 2010: paragraph 9.3.1).

A spouse may wish to make donations to the other spouse for the following reasons:

- To ensure that the spouse with the smaller estate has greater financial resources, to achieve greater equity between spouses and so that in the event of the death of the wealthier spouse the former spouse has sufficient resources to live off until such time as the deceased spouse's estate has been wound up (Davis *et al.*, 2010: paragraph 9.3.3).
- To provide the spouse with the smaller estate with the opportunity of donating R100 000 per annum to the couple's ultimate heirs free of donations tax. However, where a spouse donates R100 000 to the other spouse purportedly to enable the other spouse to make a donation free of donations tax, the exemption is unlikely to apply if the donation is made conditional on making the further donation (Davis *et al.*, 2010: paragraph 9.3.1). It is also possible that SARS may be able to attack the scheme under the general anti-avoidance provisions contained in sections 80A to 80L of the *Income Tax Act* (also refer to paragraph 3.2 above).
- To donate a limited interest over some property to the other spouse. In this way the value of the property is reduced in the donor spouse's estate and the value of the limited interest ranks for a deduction in the donee spouse's estate (Davis *et al.*, 2010: paragraph 9.3.3).
- To defer capital gains tax payable on the death of the first-dying spouse by way of bequests to the surviving spouse (also refer to paragraph 3.4.2 at (e) above).

In this regard it is important to be aware of the provisions of section 7(2) of the *Income Tax Act* and to note that no income tax advantage can be obtained from donations between spouses (also refer to paragraph 3.3.2.1 above). This section provides that all income of a spouse (donee spouse) which is received by or accrues to that spouse as a result of a donation, settlement or other disposition by the other spouse (donor spouse) is deemed to be that of the donor spouse if the sole or main purpose of the donation, settlement or other disposition was to avoid, reduce or postpone income tax.

(d) *Donation of limited interest*

Donating a limited interest can be an effective estate planning technique (Davis *et al.*, 2010: paragraph 9.3.2). If a person donates a usufruct over a property, donations tax is payable on the value of the usufruct, which is calculated by capitalising at 12% the annual value of the right of enjoyment of the property, over the life expectancy of the donor (section 62(1)(a) of the *Income Tax Act*). This value can be insignificant in the case of an aged donor. At the death of the donor only the value of the bare dominium is included in his estate. This value will then again be insignificant where the usufructuary (donee) is still very young. This is best illustrated by way of an example. Refer to addendum C on page 161 in this regard.

(e) *Donations in order to reduce an outstanding loan*

As was mentioned in paragraph 3.4.3.7 above the provisions of paragraph 12(5) of the Eighth Schedule will cause the reduction or discharge of a debt to give rise to a gain in the hands of the debtor for capital gains tax purposes. In order to reduce or discharge a debt without attracting capital gains tax, the debtor can repay R100 000 of the debt to the creditor who in turn donates R100 000 to the debtor (Davis *et al.*, 2010: paragraph 9.3.1).

This may, however, indicate that the real nature of the loan was in fact to make a donation to the creditor and thereby be subject to donations tax (Geach & Yeats, 2007:277). Although this practice has never been regarded as a donation by the authorities, taxpayers should be careful as to their intention when not reclaiming a loan.

(f) *Donations by non-residents*

In terms of section 54 donations tax is levied on donations by residents. Non-residents are therefore not subject to donations tax in South Africa. They are, however, subject to estate duty on their property situated in South Africa. A non-resident can enter into a very effective estate duty saving scheme by simply donating their assets to another party or entity prior to their death (Botha *et al.*, 2011:840). In this way a person who has emigrated from South Africa can donate their remaining South African assets to their children or other chosen beneficiaries free of donations tax and, ultimately, free of estate duty.

### **3.5.2 Donations and CGT**

A donation of an asset is a disposal for capital gains tax purposes (paragraph 11(1)(a) of the Eighth Schedule). The donor is treated as having disposed of the asset for proceeds equal to the market value of that asset at the date of the disposal (paragraph 38(1)(a) of the Eighth Schedule). The person who acquired the asset is treated as having acquired it at a cost equal to the market value (paragraph 38(1)(b) of the Eighth Schedule).

When a disposal of an asset gives rise to donations tax, then in determining the capital gain or loss for capital gains tax purposes, a portion of the donations tax paid is added to the base cost of the asset (paragraph 20(1)(vii) and (viii) of the Eighth Schedule). The portion to be added to the base cost is effectively the donations tax that is attributable to the “capital gain” realised from the disposal (paragraph 22 of the Eighth Schedule).

### **3.5.3 Donations and trusts**

(a) *Dispositions to a trust for purposes of estate planning*

One of the essential reasons for setting up a trust is to transfer assets to the trust. Such transfer may take place by way of a donation or by way of a sale at market value. A transfer by way of donation or a sale at an inadequate consideration will give rise to donations tax. A sale at market value on the other hand would not constitute a donation and would not give rise to donations tax, even if the selling price is left outstanding on interest-free loan account (Geach & Yeats, 2007:276). In *Commissioner, SARS v Woulidge* 2002 (1) SA 68 (SCA) the court held that a disposition, where the selling price was left outstanding on loan account,

contained appreciable elements of gratuitousness (the interest-free loan account) as well as proper consideration (the sale at market value) and that the purchase price constituted due consideration even though it was left outstanding on loan account.

It should, however be noted that Treasury is not turning a blind eye to the fact that people are leaving these loan accounts outstanding and have raised their concern (Response Document, 2008:B.1) over the widespread use of various techniques that lack true arm's length principles. In this regard they specifically mention the use of sales where interest-free loans is never repaid or is repaid over extended periods.

Geach and Yeats (2007:277) submits that, if there is a loan account arising as a result of a sale of an asset to a trust and the real intention is to donate the asset to the trust, legal effect might be given to the transaction and the transaction taxed as a donation. This submission can be supported by the fact that the Supreme Court of Appeal (*Relier (Pty) Ltd v CIR* 1998 (1) All SA 183 (SCA)) has made it clear that parties cannot arrange their affairs through or with the aid of simulated transactions.

*(b) Donations to a trust for purposes of fulfilling a legal obligation*

The transfer of assets to a trust for purposes of estate planning should be distinguished from the situation where assets are transferred to a trust for the purpose of fulfilling a legal obligation. In *Estate Welch v Commissioner for SARS* 2004 (2) All SA 586 (SCA) Mr and Mrs Welch, who were getting a divorce, signed a settlement agreement in terms of which the husband acknowledged and accepted that he has a legal duty to maintain his former spouse and their minor child. The agreement also stated that Mr Welch would create a trust with the main object of providing maintenance payments. If, at any given time, the trust could not comply with the duty of support, the obligation would revert to Mr Welch. Mr Welch then established the trust with a donation of assets worth R3 216 760. He nominated not only his minor child and former wife as income beneficiaries, but also himself and his son from a previous marriage. However, Mr Welch passed away before the capital could be transferred to the trust and the South African Revenue Services tried to tax the donation. The issue was whether the disposal of the assets to the trust was a donation upon which donations tax was payable. In the court *a quo* (*Welch's Estate v C:SARS* 66 SATC 303) Judge Foxcroft found in favour of the estate and held that "...the transaction was undertaken to discharge a legal obligation rather than constituting a gratuitous intention..."

The South African Revenue Services appealed to the Cape High Court (*C:SARS v Welch's Estate* 2003 (1) SA 257 (C)) where the court found in favour of the appellant and held that the transfer of assets to the trust was for no consideration, in the sense that the trust had not given any *quid pro quo* for the transfer.

The respondent then appealed to the Supreme Court of Appeal (*Welch's Estate v C:SARS* 2004 (2) All SA 586 (SCA)) where Judge Marais expressed the opinion that the basis on which the Cape High Court had made its decision was wrong (at [19]). He stated that the common law test for determining whether a renunciation of assets is a donation or not is that the donation must have been motivated by "pure liberality" or "disinterested benevolence". In other words, if the motive for the renunciation was something other than pure generosity and goodwill towards the beneficiary, it was not a donation (at [22]). The extent to which the statutory definition of a "donation" (in section 55) differs from the common law definition was considered and Judge Marais held that "the legislature has not eliminated from the statutory definition the element which the common law regards as a donation..." and that "...the definition does not eliminate the need to enquire whether the motive for the disposal was or was not pure liberality or disinterested benevolence..." The motive for the underlying donation was consequently analysed and the court found that

"...the defendant has certainly not made a donation motivated by sheer liberality nor has it gratuitously disposed of the money paid to the trustee. In the present case, the facts are such that whatever view one takes of the definition of "donation" there has been no donation of R3 216 760. If one accepts that a motive of sheer liberality or disinterested benevolence remains an essential element in the enquiry and has not been excluded by the definition, it is clear that the assets were not settled upon the trustees with any such motive. The primary and dominant purpose was to enable them to satisfy the legal obligations which the consent paper which has been made an order of court imposed upon Mr Welch."

Judge Marais also stated that, even if the statutory definition of a donation excluded an enquiry into the motive behind the transfer of assets, it then merely had to be asked whether there was an identifiable *quid pro quo* for the transfer of the assets. In this particular case, a substantial *quid pro quo* could be identified. Mrs Welch's renunciation of her right to claim maintenance from Mr Welch as well as the renunciation of her future right to income from another existing trust amounted to the consideration for the transfer of the assets to the trust.

The court therefore held that, in this case, the transfer of the assets to the trust could not be seen as a donation. This decision has created a number of new possibilities for the establishment of trusts where assets are transferred to the trust with the object of relieving the founder of his legal duties (Olivier *et al.*, 2008: paragraph 7.7.6).

(c) *Trusts and exempt donations*

There are two exemptions that are of particular relevance when it comes to trusts. The first is the exemption contained in section 56(1)(l) which provides that no donations tax will be payable in respect of property which is disposed of under a donation, if such property is disposed of under and in pursuance of a trust. This means that any distribution of trust property to the beneficiaries is not regarded as a donation for purposes of donations tax (Cameron *et al.*, 2002:464). The distribution should, however, be made in accordance with provisions of the trust deed (Geach & Yeats, 2007:279).

The second exemption that might be of relevance here, is the one contained in section 56(2)(b) which exempts donations that do not exceed a prescribed amount (currently R100 000). This exemption can be used each year to give up or waive a portion of a person's loan account in a trust. Geach and Yeats (2007:279) warn of the potential pitfalls in this practice. Firstly, if a taxpayer gives up or waives a portion of a loan account each year it could ultimately indicate that the real intention was not to lend an amount to the trust, but to donate it to the trust. This will lead to donations tax being payable as well as the provisions of section 7 and paragraphs 68 to 72 of the Eighth Schedule being applicable. Secondly, if there is a reduction or waiver of a debt, the trust will be liable for CGT in terms of paragraph 12(5) of the Eighth Schedule. These are, however, merely potential pitfalls and have not yet been applied by the authorities in this way.

#### **3.5.4 Summary**

Although donations tax aims to prevent or discourage people from giving away assets during their lifetime, with successful estate planning and consideration of the different exemptions, a person can reduce his estate without attracting any donations tax.



### 3.6 MINIMISATION OF ESTATE DUTY

The *Estate Duty Act* (45/1955) (hereafter referred to as the *Estate Duty Act*)<sup>8</sup> imposes an estate duty of 20% on the estates of deceased persons who were resident in South Africa at the time of death or non-residents who owned property in South Africa at the time of death. The estate duty liability of a non-resident may be varied by the terms of a double estate duty agreement that exists between South Africa and the relevant country.<sup>9</sup>

Although the minimisation of estate duty should not be the main or only objective behind estate planning, it is often the overriding element that leads to the estate planning exercise (Davis *et al.*, 2010: paragraph 1.2.2). In the following paragraphs the general estate duty principles will be summarised after which the different tools and techniques used to avoid or minimise estate duty as well as the use of trusts in this regard will be discussed.

#### 3.6.1 General estate duty principles

For the purposes of estate duty, a person's estate consists of all property as well as any property that is deemed to be property of the deceased at the date of death (section 3(1)). This will constitute the gross value of a person's estate. The net value is calculated by deducting the various deductions permitted in terms of section 4 from the total gross value. The dutiable amount will then be determined by deducting the allowable rebate permitted in section 4A (currently R3 500 000)<sup>10</sup> from the net value. Estate duty shall then be charged upon the dutiable amount (section 2(2)).

##### (a) Property

Section 3(2) defines "property" as "any right in or to property, movable or immovable, corporeal or incorporeal". It also includes rights of enjoyment such as any fiduciary, usufructuary or other like interest in property (including a right to an annuity charged upon property) held by the deceased immediately prior to his death (section 3(2)(a)) as well as any right to an annuity (other than a right to an annuity charged upon any property) enjoyed by the deceased immediately prior to his death which accrued to some other person on the death of the deceased (section 3(2)(b)).

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8 For purposes of paragraph 3.6, any reference to sections of the act, will be references to sections of the *Estate Duty Act*, unless expressly provided otherwise.

9 At present South Africa has only entered into such agreements with the United Kingdom, United States of America, Zimbabwe, Botswana, Lesotho and Swaziland.

10 In terms of section 1(1) of the *Taxation Laws Amendment Act* 8 of 2007.

It should be noted that section 3(2) expressly excludes the following assets as “property” in the case where the deceased was not ordinarily resident in South Africa at the time of his death:

- Any right in immovable property situated outside South Africa (section 3(2)(c));
- Any right in movable property physically situated outside South Africa (section 3(2)(d));
- Any debt not recoverable or right of action not enforceable in the Courts of South Africa (section 3(2)(e));
- Any goodwill, licence, patent, design, trade mark, copyright or other similar right not registered or enforceable in South Africa or attaching to any trade, business or profession in South Africa (section 3(2)(f));
- Any stocks or shares held by the deceased in a body corporate or company whereby any change of ownership in such stocks or shares is not required to be registered in the Republic (section 3(2)(g));
- Any rights to any income produced by or proceeds derived from any property referred to in paragraphs (e), (f) or (g) of subsection 3(2) (section 3(2)(h)).

As of 1 January 2009<sup>11</sup> section 3(2) also expressly excludes so much of any benefit which is due and payable by, or in consequence of membership or past membership of, any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund on or as a result of the death of the deceased (section 3(2)(i)).

*(b) Deemed property*

Section 3(3) provides for certain amounts to be deemed to have been property of the deceased. The reason why these amounts are not included under “property”, is either because it only becomes due the moment after death or because it did not belong to the deceased at the time of his death. The following will be deemed to be property of the deceased:

- Proceeds from certain domestic policies of insurance on the life of the deceased; (section 3(3)(a))
- Property that was donated by the deceased in terms of a donation which was exempt from donations tax under section 56(1)(c) (donations *mortis causa*) or section 56(1)(d)

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<sup>11</sup> Section 2(1)(a) of the Revenue Laws Amendment Act (60/2008).

(donations in terms of which the donee will not obtain any benefit thereunder until the death of the donor) of the *Income Tax Act*, (section 3(3)(b))

- The amount of any accrual claim acquired by the estate of the deceased under section 3 of the Matrimonial Property Act, against the estate of his spouse; (section 3(3)(cA))
- Property of which the deceased was immediately prior to his death competent to dispose for his own benefit or for the benefit of his estate. (section 3(3)(d))

These deeming provisions will be discussed in more detail and where relevant under paragraphs 3.6.2 and 3.6.3 below.

#### (c) *Deductions*

The *Estate Duty Act* allows certain deductions against the gross value of the estate in order to determine the net value of the estate. These deductions are contained in section 4 which provides for the following amounts to be deducted from the gross value of the estate:

- So much of the funeral, tombstone and death-bed expenses of the deceased which the Commissioner considers to be fair and reasonable (section 4(a))
- All debts due by the deceased to persons ordinarily resident within the Republic (other than any debt which constitutes a claim by such a person to property donated by the deceased in terms of a donation which was exempt from donations tax under section 56(1)(c) or (d) of the *Income Tax Act*) which it is proved to the satisfaction of the Commissioner have been discharged from property included in the estate (section 4(b))
- All costs which have been allowed by the Master in the administration and liquidation of the estate, other than expenses incurred in the management and control of any income accruing to the estate after the date of death (section 4(c))
- All expenditure incurred in carrying out the requirements of the Master or the Commissioner in pursuance of the provisions of the *Estate Duty Act* (section 4(d))
- The amount included in the total value of all property of the deceased as representing the value of any right in or to property outside the Republic which the deceased acquired before he became ordinarily resident in the Republic for the first time or after he became ordinarily resident in the Republic for the first time, by a donation if at the date of the donation the donor was a person (other than a company) not ordinarily resident in the Republic or inheritance from a person who at the date of his death was not ordinarily resident in the Republic or out of the profits and proceeds of any such

- property proved to the satisfaction of the Commissioner to have been acquired out of such profits or proceeds (section 4(e))
- Any debts due by the deceased to persons ordinarily resident outside the Republic (other than any debt which constitutes a claim by such a person to property donated by the deceased in terms of a donation which was exempt from donations tax under section 56(1)(c) or (d) of the *Income Tax Act*), which have been discharged from property included in the estate to the extent that the amount of such debts is proved to the satisfaction of the Commissioner to exceed the value of any assets of the deceased outside the Republic and not so included (section 4(f))
  - The value of any limited interest that were included as property of the deceased where such interest was held by the deceased by virtue of a donation to him by the person who owns the property in which the deceased held the interest (section 4(g))
  - The value of any property included in the estate which has not been allowed as a deduction under any other provision of this section which is bequeathed to any public benefit organisation or any institution, board or body, which has as its sole or principal object the carrying on of any public benefit activity or to the State or any municipality (section 4(h))
  - The amount by which the value of any property included in the estate has been enhanced by any improvements that were made during the lifetime of the deceased with his consent, at the expense of the person to whom such property accrues on the death of the deceased (section 4(i))
  - The amount by which the value of any fiduciary, usufructuary or other like interest which ceased upon the death of the deceased has been enhanced by any improvements that were made during the lifetime of the deceased with his consent, at the expense of the person to whom the benefit arising by reason of the cessation of such interest upon the death of the deceased accrues (section 4(j))
  - The amount of any accrual claim against the estate acquired under section 3 of the Matrimonial Property Act by the surviving spouse of the deceased or by the estate of his deceased spouse (section 4(la))
  - The value of any usufructuary or other like interest in property and of any right to an annuity charged upon property, if such interest or right was created by a predeceased spouse of the deceased and the property over which the deceased enjoyed such interest or right formed part of the estate of such predeceased spouse and no deduction in respect of the value of such interest or right was allowable in the determination of the net value of the estate of the predeceased spouse under the provisions of section 4(q) (section 4(m))

- Any amount included in the estate in respect of the value of books, pictures, statuary or other objects of art or so much of the value of any shares in a body corporate as is attributable to such body's ownership of books, pictures, statuary or other objects of art, if such books, pictures, statuary or other objects of art have been lent under a notarial deed to the State or any local authority within the Republic for a period of not less than thirty years, and the deceased died during such period (section 4(o))
- So much of the proceeds of a life insurance policy as has not been deducted under any of the other provisions of section 4 and which has been taken into account in the determination of the value of the shares or member's interest in a business which were included in the gross value of the estate (section 4(p))
- So much of the value of any property that accrues to the surviving spouse of a deceased person (section 4(q))

These deductions will be discussed in more detail and where relevant under paragraphs 3.6.2 and 3.6.3 below.

*(d) Section 4A rebate*

Once the net value of the estate has been established an amount of R3 500 000 is deducted to determine the dutiable value of the estate (section 4A(1)). Where a person was the spouse of one or more previously deceased persons, this rebate will be multiplied by two and reduced by the amount previously deducted from the net value of the predeceased spouse's estate in terms of section 4A(1) (section 4A(2)). This means that the section 4A rebate is portable between spouses and that a couple will effectively benefit from a R7 000 000 rebate at the death of the survivor of them. However, in order to benefit from the provisions of section 4A(2), the executor of the surviving spouse's estate should submit a copy of the return which were submitted in respect of the estate of the previously deceased spouse to the Commissioner (section 4A(5)). It is interesting to note that, where a couple die simultaneously, the person of whom the net value of the estate is the smallest must be deemed for the purposes of section 4A to have died immediately prior to his or her spouse (section 4A(6)).

### **3.6.2 Methods of saving estate duty**

There are a number of transactions and schemes which lead to the successful reduction of estate duty. The main principle behind these transactions and schemes are that assets which

need not form part of the dutiable estate should not form part of the dutiable estate and that all deductions allowed in terms of the *Estate Duty Act* should be used to full effect (Botha *et al.*, 2011:831). These transactions and schemes, which will be discussed in more detail in paragraphs (a) to (g) below, are the following:

- Transactions with a spouse
- The utilisation of the section 4A rebate
- Donations
- Single premium retirement annuities and once-off pension contributions
- The use of limited rights
- Valuation of limited rights for donations tax and estate duty purposes
- The use of policies

(a) *Transactions with a spouse*

Transactions between spouses hold various tax advantages: donations between spouses are free from donations tax (section 56(1)(a) and (b) of the *Income Tax Act*); bequests to a spouse are free from estate duty (section 4(q)); and both donations and bequests to spouses are free from CGT (paragraph 67 of the Eighth Schedule). The use of these transactions are crucial to estate planning and, although the payment of these taxes are often merely postponed, it can be very effective in saving estate duty at the death of the first dying spouse (Botha *et al.*, 2011:836).

A “spouse” is defined in both the *Income Tax Act* (section 1) and the *Estate Duty Act* (section 1) as a person who is (or was) the partner of a person in a marriage or customary union recognised in terms of the laws of the Republic, or in a union recognised as a marriage in accordance with the tenets of any religion, or in a same-sex or heterosexual union which the Commissioner is satisfied is intended to be permanent.

Section 4(q) provides that so much of the value of any property included in the estate which has not been allowed as a deduction under any of the other provisions of section 4, as accrues to the surviving spouse of the deceased may be deducted from the value of the gross estate. It should be noted that the deduction does not only include a bequest by the deceased to his spouse in terms of his will, but also other property which is included in the estate that accrues to the surviving spouse. Proceeds of policies accruing to a spouse on the death of the deceased will therefore also be allowable as a deduction.

The provisos to section 4(q) should be carefully considered when drafting a will in which a person intends his spouse to benefit. If an amount is bequeathed to a spouse subject to a condition that another amount be transferred to a trust or any other person, the deduction will be reduced by this other amount (section 4(q)(i)). If an amount accrues to a trust that was established by the deceased for the benefit of his spouse, the deduction will not be allowed if the trustees of the trust has a discretion to allocate such property or any income therefrom to any person other than the surviving spouse (section 4(q)(ii)).

*(b) The utilisation of the section 4A rebate*

The rebate in section 4A (currently R3 500 000) is conferred over and above the Section 4(q) deduction and, where a person bequeaths his entire estate to his spouse, the Section 4A rebate remains unused. In the past, this would have resulted in the estate of the first-dying spouse forfeiting this rebate. In order to fully utilise this rebate and to ensure an ultimate rebate of R7 000 000 between spouses, an amount equal to the section 4A rebate would be bequeathed to a discretionary trust (with the surviving spouse as one of the beneficiaries) and the residue would be bequeathed to the surviving spouse. The testator would then benefit from the full use of the concessions provided by the *Estate Duty Act*.

However, as of 1 January 2010 this rebate has become portable between spouses (section 5(1) of the *Taxation Laws Amendment Act* (17/2009)). This means that the whole or part of R3 500 000 that were not deducted from the net value of the first-dying spouse's estate, will be carried forward to the estate of the surviving spouse. At the death of the surviving spouse, a total rebate of R7 000 000 would have been utilised.

This amendment immediately reduces the estate duty burden on married couples (Escott-Watson, 2010:F16) and has made it unnecessary to provide for a separate bequest equal to R3 500 000 to someone other than the spouse (Botha *et al.*, 2011:831). This does not mean that this estate planning technique has become completely redundant. In certain circumstances and taking into account the age of a person, the nature of the asset so bequeathed and the future value of money, it would still be advisable for the first dying spouse to bequeath R3 500 000 to a third party (usually a discretionary trust of which the surviving spouse is a beneficiary). The couple will still benefit from a total ultimate rebate of R7 000 000. The only difference is that the growth in the R3 500 000 which was bequeathed to the third party at the first dying's death has grown in the hands of such third party and not

in the estate of the survivor (Riddle, 2009). This is best illustrated by way of an example. Refer to addendum D on page 162.

*(c) Donations*

An effective estate plan will not only “freeze” a person’s estate, but would also “reduce” that estate (Botha *et al.*, 2011:838). The ways in which donations can be used to reduce a person’s estate were discussed in detail under paragraphs (a) to (f) under 3.5.1 above and need not be repeated here.

*(d) Single premium retirement annuities and once-off pension contributions*

Section 3(3)(a)*bis* of the *Estate Duty Act* previously regarded certain fund benefits as deemed property of the deceased for purposes of estate duty. Section 3(3)(a)*bis* was repealed with effect from 1 January 2009 (sections 2(1)(b) and 2(2) of the *Revenue Laws Amendment Act* (60/2008)) and a new paragraph (i) was added to section 3(2) (section 2(1)(a) of the *Revenue Laws Amendment Act* (60/2008)). This new paragraph provides that any benefit that is due and payable by, or in consequence of membership or past membership of, any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, is excluded from “property” for estate duty purposes. This means that any lump sum benefit or annuity paid by a retirement fund at a person’s death will no longer be deemed to be property in his estate.

This amendment has made pension funds, retirement annuities and provident funds attractive instruments to use in order to reduce estate duty. Additional and once-off contributions to these funds provide opportunities for astute investment- and tax planning (Carroll, 2010:26).

With estate duty on retirement funds out of the way, a person can reduce the value of his dutiable estate by contributing to a retirement annuity fund without incurring donations tax, capital gains tax or transfer duty. Also refer to paragraph 4.4.1 in Chapter 4 below as well as the example in addendum A on page 158.



(e) *The use of limited rights*

Assets can be bequeathed to a testamentary trust and a surviving spouse can have a vested right to the income of that trust. Such right is an interest similar to a usufruct and qualifies for the section 4(q) estate duty deduction (Botha *et al.*, 2011:838).

A popular technique which used to be very effective in avoiding estate duty was to bequeath the whole estate to a trust with the spouse as the sole income beneficiary (or lifelong usufructuary). For a period of one year one year after the spouse's death, the usufruct will pass to another person (usually the testator's children). Upon the completion of the one year period, the usufruct will pass to the trust for perpetuity. This reduced the value of the usufruct in the surviving spouse's estate and resulted in huge savings in estate duty. As such this technique caught the attention of the South African Revenue Service.

The first attempt was to propose anti-avoidance measures which were to be included as section 25B in the *Estate Duty Act* (clause 4(1) of the *Revenue Laws Amendment Bill* (80/2008)). These measures would have been similar to the general anti-avoidance provision contained in the *Transfer Duty Act*, but have been withdrawn on the grounds of being too broad (Response Document, 2008:B.1). The next attempt was to introduce measures to specifically block the use of this scheme by proposing that all usufructs (including usufructs over limited periods) be valued over the expected lives of the beneficiaries (clause 6 of the *Taxation Laws Amendment Bill* (10/2009)). However, this proposal unfairly penalises all usufructs, many of which have valid non-tax estate planning purposes. In acceptance of this concern, treasury withdrew this amendment for reconsideration (Response Document, 2009:2.6.2).

Although treasury withdrew both these proposals, they have not turned a blind eye and have confirmed that these schemes "remain of concern and still warrant an appropriate remedy" (Response Document 2009:2.6.2).

(f) *Valuation of limited rights for donations tax and estate duty purposes*

The value, for purposes of donations tax, of a donation of a usufruct compared with its valuation for estate duty purposes can also result in an effective estate planning technique (Botha *et al.*, 2011:838). If a person donates a usufruct over a property, donations tax is payable on the value of the usufruct, which is calculated by capitalising at 12% the annual

value of the right of enjoyment of the property, over the life expectancy of the donor, or if such right of enjoyment is to be held for a shorter period than the life of the donor, over such shorter period (section 62(1)(a) of the *Income Tax Act*). The value, for purposes of estate duty, of a usufruct is determined over the life expectancy of the person to whom the usufruct will pass (section 5(1)(b) of the *Estate Duty Act*). Also refer to paragraph (d) under 3.5.1 and addendum C on page 161.

(g) *The use of policies*

As policy proceeds are deemed to be property for purposes of calculating a person's net estate (section 3(3)(a)) such proceeds will increase the estate duty payable. There are, however, certain policies that are excluded from this deeming provision and which will not be included in the deceased's net estate. These excluded policies (contained in sub-paragraphs (i), (iA) and (ii) of section 3(3)(a)) are discussed in Chapter 4 and will not be repeated here. Paragraph 4.2.1.4 focuses on the impact of estate duty when planning for liquidity and protection of business interests.

Except for the excluded policies, there are also policies of which the proceeds will be deductible in terms of section 4 of the *Estate Duty Act*. These deductions should be considered when nominating beneficiaries on insurance policies. If the proceeds of the policy is payable to a public benefit organisation or to the surviving spouse of the deceased such proceeds will be deductible in terms of section 4(h) and section 4(q) respectively.

### **3.6.3 The use of trusts to save estate duty**

One of the many reasons for a discretionary trust being regarded as an effective estate planning tool is the fact that the trust assets are separate from those of the trustees (section 12 of the *Trust Property Control Act*) and are regarded as separate from the assets of the founder and the beneficiaries (Honiball & Olivier, 2009:198). It is for this reason that discretionary trusts are very useful in minimising or avoiding estate duty. The techniques used in this regard will now be discussed in more detail.

(a) *"Estate-pegging"*

The technique whereby an increase in the value of an asset occurs in a trust rather than in the estate of an individual, is referred to as "estate-pegging" (Du Toit, 2007:158) and is done

either to avoid estate duty upon the death of the estate planner, or to avoid estate duty upon the death of the estate planner's heirs (Geach & Yeats, 2007:283).

Estate-pegging is generally achieved by selling growth assets to a trust on loan account. In this way, there is effectively substitution of growth assets for a debt that will be pegged at the value of the assets when they were sold to the trust. The growth assets now belong to the trust while only the non-growth asset (the loan account) remains in the planner's personal estate. Future growth of these assets takes place in the trust and not in the hands of an individual (Botha *et al.*, 2011:837).

It should be noted that, although this technique is very effective and has many benefits, it is not without disadvantages or pitfalls. These disadvantages mainly include the high costs involved in transferring assets to the trust and the fact that the assets are removed from the former owner's control (Honiball & Olivier, 2009:198).

#### *High costs*

In determining the costs associated with establishing a trust or transferring assets to a trust, consideration should be given to the present value of money. This means that a person should weigh up a present cost against a future cost while having regard to the fact that, due to inflation, the value of money will deteriorate over time. It might be that the future saving exceeds the present cost. (Geach & Yeats, 2007:284).

#### *Loss of control*

Section 3(3)(d) of the *Estate Duty Act* provides that property of which the deceased was competent to dispose of immediately prior to his death for his own benefit or for the benefit of his estate, to be part of his net estate will be deemed to property for purposes of calculating the net estate value.

Based on the wording of this provision there are two important observations worth mentioning. The first is that the mere power to dispose of the relevant property is not sufficient to invoke section 3(3)(d). There has to be a power to dispose of the property for a person's own benefit or for the benefit of his estate. If neither the person exercising such power nor his estate could obtain any benefit by the exercise of the power, section 3(3)(d) will not apply (Honiball & Olivier, 2009:196). The second is that, if a person does have the

power to dispose of the relevant property for his own benefit or for the benefit of his estate, section 3(3)(d) will apply regardless of whether or not the powers has in fact been exercised (Du Toit, 2007:159).

Section 3(5)(b) provides that a person will be deemed to have been “competent to dispose of” any property if he had the power to appropriate or dispose of such property as he saw fit, whether exercisable by will, power of appointment or any other manner (section 3(5)(b)(i)), or where he retained the power to revoke or vary the provisions of any deed of donation, settlement, trust or other disposition made by him (section 3(5)(b)(ii)). The aforementioned powers (to appropriate, dispose, revoke or vary) shall be deemed to exist if the deceased could have obtained such power directly or indirectly by the exercise, either with or without notice, of power exercisable by him or with his consent (section 3(5)(c)).

To avoid this deeming provision, trust deeds should be carefully drafted to ensure that none of the trustees are competent to dispose of any of the trust assets for his own benefit or for the benefit of his estate. In the case of *Creighton Trust v CIR* (1955 (3) SA 498 (T)) it was held that the founder’s powers to vary trust benefits were so wide in this case that the trust assets were to be included in his dutiable estate in terms of this deeming provision.

In order to retain some measure of control, while still pegging the growth of his estate, a person may consider using a company together with a trust (Botha *et al.*, 2011:837). A company would be formed with a trust as its shareholder and growth assets would be sold to that company on loan account or for debentures in the company. In addition or alternatively to the loan, a person could acquire preference shares in that company, while the trust holds the ordinary shares. The preference shares would entitle the owner thereof to certain voting rights, which would give him some measure of control over the activities of the company. In this way, a person can ensure that no decisions that would adversely affect him, are made (Botha *et al.*, 2011:838).

#### *(b) The use of loans*

The making of loans can be very effective in estate planning (Botha *et al.*, 2011:839). For estate planning purposes loans are often made to or from a trust.

When assets are sold to a trust, such sale is often financed by way of a loan from the founder. These loans usually do not provide for a fixed repayment date, or for the payment of

interest. A person should, however, take care not to create the impression that the real intention was to donate the assets to the trust (Geach & Yeats, 2007:277). This impression can be created if the loan lacks true arm's length principles and is left outstanding or is being repaid over extended periods.

If the trust deed provides that the trustees are permitted to make loans to beneficiaries, amounts can be loaned by the trust to beneficiaries. Rather than making a distribution, the trustees distribute an amount by way of lending money to a beneficiary. (Geach & Yeats, 2007:282). Provided the trust deed allows this and provided it will not be to the detriment of the beneficiaries, loans can also be made to the founder from the trust from time to time (Botha *et al.*, 2011:839). On the death of the borrower, any amounts owing to the trust would be regarded as a liability in determining the net estate for purposes of estate duty (section 4(b) of the *Estate Duty Act*).

(c) *Trust-owned policies*

Another estate planning technique which is often used in conjunction with trusts, is the use of the concession contained in section 3(3)(a). If the proceeds from a life policy are not exempt in terms of the provisions of section 3(3)(a)(i), (iA) and (ii) (paragraph 4.2.1.4 in Chapter 4 below), estate duty becomes payable thereon. However, it should be noted that Section 3(3)(a) contains a proviso which allows for a deduction of the aggregate amount of any premiums or consideration proved to the satisfaction of the Commissioner to have been paid by the person who is entitled to the amount due under the policy, together with interest at 6% per annum calculated upon such premiums or consideration from the date of payment to the date of death. Depending on the growth factor of the particular policy, the deduction allowed may be equal to a significant percentage of the total proceeds (Davis *et al.*, 2010: paragraph 15.3.1).

In order to take advantage of this concession, someone other than the life insured must pay the premiums and receive the proceeds of the policy. It is important that the third party have the funds to pay for the premiums and that the relationship between the life insured and the third party is not such that the arrangement can be attacked on the basis that it is the deceased who paid the premiums. An *inter vivos* trust can be a useful tool to use in this regard. If the trust owns income producing assets, the income from these assets can be used to fund the premiums and the trust will become the third party taking advantage of this concession (Davis *et al.*, 2010: paragraph 15.3.1).

When using this technique it is important to remember that section 3(3)(a) does not create a right to the deduction, but rather provides that the Commissioner will have a discretion to award or deny the deduction (Davis *et al.*, 2010: paragraph 15.3.4). Therefore, when considering this technique, a person should take heed and carefully determine whether there is an insurable interest and ensure that it is the trust that pays the premiums and not the life insured. (Davis *et al.*, 2010: paragraph 15.3.1).

#### *The question of insurable interest*

The question of insurable interest arises when the trust takes out a policy, the argument being that it has no insurable interest upon the life of the insured. In order to avoid this argument from causing any problems Davis *et al* (2010: paragraph 15.3.2) recommend that the life insured affects the policy on his own life and then cede it to the trust. Since a person has an unlimited insurable interest on his own life, the requirement of insurable interest will be met at the time of the policy being affected.

However, as the trust is not the original beneficial owner of the policy, the policy will be seen as a second-hand policy for purposes of CGT. This means that the trust, as the beneficial owner, will not benefit from the exclusion in paragraph 55(1)(a)(i) of the Eighth Schedule of the *Income Tax Act*. Paragraph 55(1)(a)(i) provides that any capital gain or loss on disposal of a long-term policy must be disregarded by its original beneficial owner. In this regard the saving in estate duty and any other benefits of this technique need to be weighed up against the CGT liability.

#### *Funding of the policy premiums*

It is important that the trust funds the premiums out of its own resources and that the trustees act independently from the life insured in agreeing to pay the premiums on the policy (Combrink, 2010:3). The founder cannot simply pay the premiums from his personal account and create a loan account in the trust (Combrink, 2010:3).

### **3.6.4 Summary**

Although minimising or avoiding estate duty is often an important consideration when doing estate planning and setting up a trust, there is much more to estate planning than simply divesting a person of his assets in order to save estate duty (refer to Chapter 4 in this

regard). An estate plan should not only cater for the saving of tax at death, but should also cater for the needs of a person while he's alive. It would be irresponsible to merely create a trust and transfer all assets to the trust in order to save estate duty at death and then being left destitute having to go cap in the hand to the trustees for financial awards (Geach & Yeats, 2007:283).

### **3.7 MINIMISATION OF TRANSFER DUTY**

The *Transfer Duty Act* (40/1949)<sup>12</sup> levies transfer duty on the value of any property acquired by any person by way of a transaction or in any other manner, or on the amount by which the value of property is enhanced by the renunciation of an interest in, or restriction upon, the use or disposal of that property.

The minimisation of transfer duty is not as much an objective behind estate planning as it is an important consideration which needs to be observed during the estate planning exercise. However, there have been some effective techniques that succeeded in avoiding and reducing transfer duty. Some of these techniques have been hindered by changes in law and others border on breaching the anti-avoidance provisions in section 20B. The following paragraphs will summarise the general transfer duty principles and will look at the techniques used to avoid or minimise transfer duty.

#### **3.7.1 General transfer duty principles**

To determine the liability for transfer duty it is necessary to know what is included as "property", what is the "value" on which the duty is levied, what is meant by "transaction" and what is the rate of transfer duty payable. It is also necessary to determine whether any specific person, property or transaction is excluded from transfer duty. (Botha *et al.*, 2011:457)

##### **3.7.1.1 Property**

For purposes of transfer duty "property" is defined in section 1 as land in the Republic and any fixtures thereon, and includes –

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<sup>12</sup> Hereafter referred to as the *Transfer Duty Act*. For purposes of paragraph 3.7, any reference to sections of the act, will be references to sections of the *Transfer Duty Act*, unless expressly provided otherwise.

- any real right in land but excluding any right under a mortgage bond or a lease of property (paragraph (a) of the definition of “property”);
- a lease or sub-lease of any lot or stand which is registrable in the office of the Rand Townships Registrar (paragraph (b) of the definition of “property”);
- any right to minerals (including any right to mine for minerals) and a lease or sub-lease of such a right (paragraph (c) of the definition of “property”);
- a share (other than a share in a share block company) or member’s interest in a residential property company (paragraph (d) of the definition of “property”);
- a share (other than a share in a share block company) or member’s interest in a holding company if that company and all of its subsidiary companies would be a residential property company if all such companies were regarded as a single entity (paragraph (e) of the definition of “property”);
- a contingent right to any residential property or a share or member’s interest in a residential property company, held by a discretionary trust (other than a special trust as defined in section 1 of the *Income Tax Act*) if the acquisition of such right was a consequence of, or attendant upon, the conclusion of any agreement for consideration with regard to property held by that trust, and accompanied by the substitution or variation of that trust’s loan creditors, or by the substitution or addition of any mortgage bond or mortgage bond creditor, or accompanied by the change of any trustee of that trust (paragraph (f) of the definition of “property”);
- a share in a share block company (paragraph (g) of the definition of “property”).

A “residential property company” is defined in section 1 as –

“any company that holds residential property or a contingent right to residential property, where the fair value of that property or contingent right comprises more than 50% of the aggregate fair market value of all the assets held by that company on the date of acquisition of an interest in that company.”

“Residential property” in turn is defined in section 1 as –

“any dwelling-house, holiday home, apartment or similar abode, improved or unimproved land zoned for residential use in the Republic (including any real right thereto), but does not include an apartment complex, hotel, guesthouse or similar structure consisting of five or more units held by a person which has been used for renting to five or more persons, who are not connected persons in relation to that person or any fixed property of a vendor forming part of an enterprise.”



This means that transfer duty is also payable by the purchaser of shares in a company which owns residential property. Normally, securities transfer tax would be payable at 0,25% in respect of any registration of transfer of shares in a South African company (section 2(1) of the *Securities Transfer Tax Act* (25/2007)). However, in circumstances where the acquisition of shares in a company which owns immovable property is subject to transfer duty, and if the shares are unlisted securities, then no securities transfer tax will be payable (section 8(1)(n) of the *Securities Transfer Tax Act* (25/2007)).

#### **3.7.1.2 Value of property**

The manner in which property will be valued for purposes of transfer duty is set out in section 5 and will depend on the manner in which payment is made. Section 5 distinguishes between transactions where consideration is payable (section 5(1)(a)), transactions where no consideration is payable (section 5(1)(b)), transactions that were cancelled or dissolved before registration in the deeds registry (section 5(2)), transactions where the consideration (or part thereof) will be paid by way of periodic payments (section 5(3)) and transactions where one property is exchanged for another (section 5(4)).

#### **3.7.1.3 Transaction**

Section 1 defines “transaction” in relation to the type of property involved.

In relation to any real right in land, a lease of property, a lease or sub-lease of a lot or stand in a township, a right to minerals and a lease or sub-lease of such right a “transaction” is an agreement whereby one party thereto agrees to sell, grant, waive, donate, cede, exchange, lease or otherwise dispose of property to another person or any act whereby any person renounces any right in or restriction in his or her favour upon the use or disposal of property (paragraph (a) of the definition of “transaction”).

In relation to any shares or member’s interest contemplated in a residential property company a “transaction” is an agreement whereby one party thereto agrees to sell, grant, waive, donate, cede, exchange, issue, buy-back, convert, vary, cancel or otherwise dispose of any such shares or member’s interest to another person or any act whereby any person renounces any right in or restriction in his or her favour upon the use or disposal of any such shares or member’s interest (paragraph (b) of the definition of “transaction”).

In relation to a discretionary trust, a “transaction” is the substitution or addition of one or more beneficiaries with a contingent right to any property of that trust, which constitutes residential property or shares or member’s interest in a residential property company (paragraph (c) of the definition of “transaction”).

#### **3.7.1.4 Exemptions from transfer duty**

Section 9 contains a list of exemptions where no transfer duty will be payable. The exemptions that are most relevant from an estate planning point of view and which should be considered when preparing and implementing an estate plan are the following:

##### *(a) Acquisition of property by heirs or legatees*

No transfer duty shall be payable in respect of the acquisition of property by an heir or legatee in respect of property of the deceased acquired by *ab intestato* or testamentary succession or as a result of a redistribution of the assets of a deceased estate in the process of liquidation (section 9(1)(e)(i)) or the amount by which the value of property so acquired is enhanced by the renunciation of an interest in or restriction upon the use or disposal of such property (section 9(1)(e)(ii)).

##### *(b) Acquisition of property by joint owners and partners*

No transfer duty shall be payable in respect of the acquisition of property by –

- a joint owner of property in respect of the acquisition and registration in his name of a defined portion of the property allotted to him upon partition of the property, but not in respect of any consideration payable by him in order to equalize the partition or for any other reason (section 9(1)(g)).
- a joint owner of property who acquires the sole ownership in the whole or a portion of the property, in respect of so much of the value of the property in which sole ownership is acquired as represents his share in the joint ownership of that property (section 9(1)(h)).
- partners who jointly acquire the property of a partnership in their own names (section 9(3)).

*(c) Acquisition of property by former spouses*

No transfer duty shall be payable in respect of the acquisition of property by a surviving or divorced spouse who acquires the sole ownership in the whole or any portion of property registered in the name of a deceased or divorced spouse where that property or portion is transferred to the surviving or divorced spouse as a result of the death of his or her spouse or dissolution of their marriage or union (section 9(1)(i)).

*(d) Acquisition of property by a spouse married in community of property*

No transfer duty shall be payable in respect of the acquisition of property by a spouse in a marriage in community of property in respect of the acquisition of an undivided half-share in property by operation of law by virtue of the contraction of such marriage, if such property had been acquired by the other spouse prior to the date of contraction of the marriage (section 9(1)(k)).

*(e) Correction of registration errors*

No transfer duty shall be payable by a person who requires his ownership in property to be registered in his name in a deeds registry where there has been an error in the registration of the acquisition of the property, provided the duty payable in respect of that acquisition has been duly paid (section 9(2)).

*(f) Insolvent persons*

No transfer duty shall be payable in respect of a change in the registration of property required as a result of the termination of the appointment of a trustee of an insolvent estate (section 9(4)(a)) or where property is restored by a trustee of an insolvent estate to the insolvent (section 9(4)(c)).

No transfer duty shall be payable in respect of the acquisition of property, if the transaction in terms of which the property is acquired becomes void by reason of the subsequent sequestration of the person from whom the property is acquired (section 9(7)(b)) or is abandoned by the trustee of such person's insolvent estate (section 9(7)(c)).

(g) *Transfers to and by trustees*

No duty shall be payable in respect of a change in the registration of property required as a result of the termination of the appointment of a trustee or administrator of a trust (section 9(4)(a)). There is in fact no transaction in this case, but merely a change of name of the trustee or administrator.

Trust property that is transferred by the administrator of a trust to persons entitled thereto under a will or other written instrument (which implies to be the “Trust Deed”) is exempt from transfer duty (section 9(4)(b)). If the sub-paragraphs of this subsection are read separately, it is clear that there is a distinction between a testamentary trust and an *inter vivos* trust. Section 9(4)(b)(i) provides that no transfer duty shall be payable where trust property is transferred by the administrator of a trust in pursuance of a will to the persons entitled thereto under such will. Section 9(4)(b)(ii) provides that no transfer duty shall be payable where trust property is transferred by the administrator of a trust in pursuance of a written instrument 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 trust property.

The exclusion in section 9(4)(b) is therefore intended to apply to testamentary trusts where beneficiaries are entitled to the benefits or to *inter vivos* trusts where the beneficiaries who are entitled to the benefits are related to the founder of the trust (Franzen, 2007:49).

No transfer duty shall be payable in respect of the registration of trust property in the name of a trustee in his capacity as trustee, if such trust property is held by that trustee as trust property at the date of commencement of the *Trust Property Control Act* (57/1988), and such registration is required in terms of section 11(2) of the said Act (section 9(4)(d)).

(h) *Value-added tax*

No transfer duty shall be payable in respect of the acquisition of any property under any transaction which is a taxable supply of goods to the person acquiring such property if –

- the transferor of the property under such transaction certifies that value-added tax has been paid to him in respect of the said supply by the transferee and has been

accounted for by him in a relevant return required to be furnished by him or will be so accounted for in such return within the time allowed for the rendering of such return, or where such supply was subject to the said tax at the rate of zero per cent, such information regarding such supply as the Commissioner may require has been furnished to him (section 9(15)(a));

- any security required by the Commissioner for the payment of such tax has been lodged, if such tax has not yet been paid (section 9(15)(b)); and
- the Commissioner has issued a certificate to the effect that the requirements of this subsection for the granting of the exemption have been met (section 9(15)(c)).

(i) *Corporate owned residence*

No duty shall be payable in respect of any acquisition of any interest in a residence as contemplated in paragraph 51 or 51A of the Eighth Schedule to the *Income Tax Act*, where that acquisition takes place as a result of a transfer or disposal contemplated in either of those paragraphs (section 9(20)).

These paragraphs deal with the window of opportunity during which a residence can be transferred from a company or trust into the hands of individuals free of transfer duty, capital gains tax, secondary tax on companies, and dividends tax. This window period initially applied from 11 February 2009 to 30 September 2010 (in terms of paragraph 51), but was extended (subject to some further conditions) to 31 December 2012 (in terms of paragraph 51A). Refer to paragraph (f) under 3.4.2 above for a discussion on paragraph 51A of the Eighth Schedule of the *Income Tax Act*.

**3.7.1.5 Rate of transfer duty**

Up until 23 February 2011 all persons other than natural persons (i.e. trusts, close corporations and companies) were liable for transfer duty at a flat rate of 8% (section 2(1)(a)), while the transfer duty rate applicable to natural persons ranged from 0% to 8% depending on the value of the property. However, in the 2011 National Budget Review (2011:73) Treasury proposed a significant and favourable amendment in this regard by adding that the revised rate structure and increase in the exemption threshold (as applicable to natural persons) “will also be applicable to legal persons (close corporations, companies and trusts)”.

In the light of this proposal section 2(1) of the *Transfer Duty Act* will be amended, with effect from 23 February 2011, as follows: (clause 2 of the *Taxation Laws Amendment Bill* (19/2011)):

- The deletion of section 2(1)(a) which previously provided that persons other than natural persons be liable for transfer duty at a flat rate of 8% (clause 2(1)(a) of the *Taxation Laws Amendment Bill* (19/2011));
- The substitution of section 2(1)(b) with a new section which, amongst others, does not contain the sentence at the end which previously provided that the provisions of this paragraph will apply “if the person who acquires the property or in whose favour or for whose benefit the said interest or restriction is renounced is a natural person” (clause 2(1)(b) of the *Taxation Laws Amendment Bill* (19/2011));
- The substitution of section 2(5), which previously provided that, “where a natural person acquires any property ... the duty payable in respect of such acquisition shall be calculated in accordance with the formula”, with a new section which does not contain the word “natural” in front of “person” (clause 2(1)(c) of the *Taxation Laws Amendment Bill* (19/2011)).

The revised rate structure, which is now also applicable to trusts, close corporations and companies, can be illustrated as follows:

Value of property	Transfer duty rate
0 – R600 000	0%
R600 001 – R1 000 000	3%
R1 000 001 – R1 500 000	R12,000 plus 5% on the value above R1 000 000
R1 500 001 and above	R37 000 plus 8% on the value above R1 500 000

### 3.7.2 Techniques used to avoid or minimise transfer duty

The most popular techniques used (or previously used) to avoid transfer duty mainly involved trusts. The one technique involved the sale of trusts (instead of selling the property) and the other technique involves the sale of the bare dominium in a property (instead of full ownership) to a trust.

### **3.7.2.1 The sale of a trust**

Until 2002, attempts to avoid the payment of transfer duty through the so-called “sale of a trust” occurred on a regular basis (Honiball & Olivier, 2009:228). Under a sale of trust, the existing beneficiaries and trustees of a particular trust, holding a specific fixed property, were generally replaced by new beneficiaries and new trustees in exchange for an agreed sum of money. Instead of an outright sale, the trustees of a trust would therefore simply resign in favour of new trustees, who would then amend the trust deed to replace the existing beneficiaries with new beneficiaries. The South African Revenue Service has always been of the opinion that such a sale would result in a transfer duty being payable, but in practice a lot of these transactions were not picked up because no transfer clearance was necessary (Olivier *et al.*, 2008: paragraph 7.9.4).

To put it beyond doubt that transfer duty will be payable when an interest in a trust holding residential property is disposed of, the definition of “property” in the *Transfer Duty Act* was extended in 2002 (*Revenue Laws Amendment Act (74/2002)*) to include a contingent right to any residential property, or share or member’s interest in a residential property company, the acquisition of which is a consequence of or attendant upon the conclusion of any agreement for consideration with regard to property held by that trust. Also included is an acquisition which is accompanied by the substitution or variation of the trust’s loan creditors, or by the substitution or change of any trustee of the trust (section 2 of the *Revenue Laws Amendment Act (74/2002)*).

It is important to note that this amendment only provides for trusts owning “residential property.” This does not mean that no transfer duty will be payable on the sale of a trust owning property other than residential property. In such cases the South African Revenue Service will merely rely on the 2007 decision of the Gauteng Tax Court in *T Trust v C:SARS* (2007) ZATC 5. In this case all the trustees and beneficiaries of a trust, of which the primary asset was an immovable property, were substituted by new trustees and beneficiaries. It was argued that transfer duty will be payable on two grounds, first, that the immovable property was acquired by the incoming beneficiaries, which was a “transaction” as envisaged in the *Transfer Duty Act* (at [26]), and secondly, that the replacement of one set of trustees and beneficiaries with another set amounted to the existing trust being terminated and a new trust being created (at [46]). The court upheld both these arguments and held that transfer duty was indeed payable by the new trust.

### **3.7.2.2 The sale of a bare dominium**

The higher transfer duty rate previously applicable to trusts inspired a creative initiative whereby property would be transferred to a trust without being liable for transfer duty on the full value of the property. This was done by selling the bare dominium in the property to the trust and retaining the usufruct over the property. Transfer duty would then only be levied on the value of the bare dominium and not on the full value of the property. If this technique is used solely to save or reduce transfer duty, the provisions of section 20B might be invoked.

Section 20B provides that whenever the Commissioner is satisfied that any transaction, operation, scheme or understanding has been entered into or carried out which has the effect of granting a tax benefit to any person, and was entered into abnormally or has created non-arm's length rights or obligations, and was entered into solely or mainly for the purpose of obtaining a tax benefit, then the Commissioner may determine any liability for transfer duty as if the transaction, operation, scheme or understanding had not been entered into.

### **3.7.3 Summary**

From the above discussion it is clear that transfer duty is an important factor to consider during the estate planning exercise, but that the avoidance or minimisation thereof is not an overriding consideration. The techniques used to avoid transfer duty have either been hindered by the changes in 2002 (in terms of the *Revenue Amendment Act (74/2002)*) or have become redundant as a result of the reduction in the transfer duty rate applicable to trusts. Even if it weren't for these changes, the application of the anti-avoidance provisions in section 20B might have (eventually) brought these techniques under the scrutiny of the South African Revenue Service.

## **3.8 THE MINIMISATION OF OTHER TAXES**

The various taxes discussed above, are the main taxes considered during the estate planning process. This does not mean that the other taxes are irrelevant. The minimisation of other taxes such as value-added tax (VAT), secondary tax on companies (STC), dividends tax and securities transfer tax (STT) can be very important in the effective structuring of an estate plan. These taxes are, however, not often a concern when utilising and administering a trust as an estate planning tool and an in depth discussion on these taxes will therefore not



assist in providing an answer to the question regarding the future of trusts as estate planning tools.

An estate plan should, however, when considering the minimisation of the various taxes, be forward looking in the sense that it anticipates taxes which may be introduced in the future. The only practical method of achieving this objective is the use of flexible structures which can bend to accommodate changes of this sort, which cannot be anticipated accurately in advance. (Davis *et al.*, 2010: paragraph 1.2.4)

### **3.9 SUMMARY**

Although the minimisation of tax is merely one of many objectives behind estate planning, it is clear from the discussion above that it is a very important objective that certainly warrants some consideration when an estate plan is embarked upon. As Olivier *et al.* (2008: paragraph 8.2.1) suggest, “no person is legally or morally bound to pay more tax than is absolutely necessary.” The use of a trust as a tool to minimise or avoid tax featured quite prominently throughout the discussion. However, the minimisation of tax (especially taxes such as income tax and transfer duty) is not portrayed as the main purpose of a trust and the trust is not presented as the only means for minimising a tax liability.

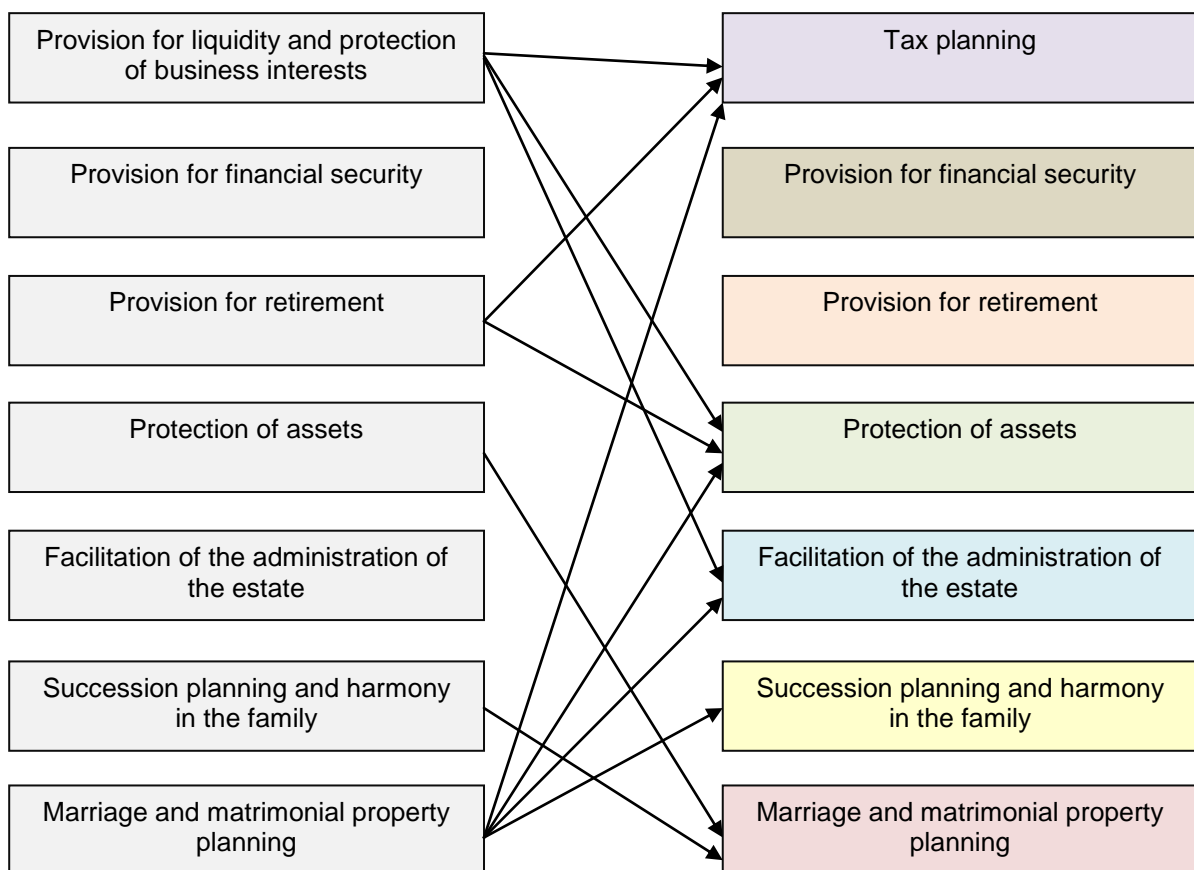
Farr and Wright (1995:14) explain that estate planning is “far too worthwhile as an intellectual exercise to be made dependant on tax quirks and rebates; and [that] it deserves to be co-joined with a motive far nobler than mere tax economics.” The following chapter will therefore focus on the other motives which also form an important (often overriding) part of estate planning.

## CHAPTER 4

### ESTATE PLANNING OBJECTIVES AND THE TECHNIQUES USED TO ACHIEVE THOSE OBJECTIVES

#### 4.1 INTRODUCTION

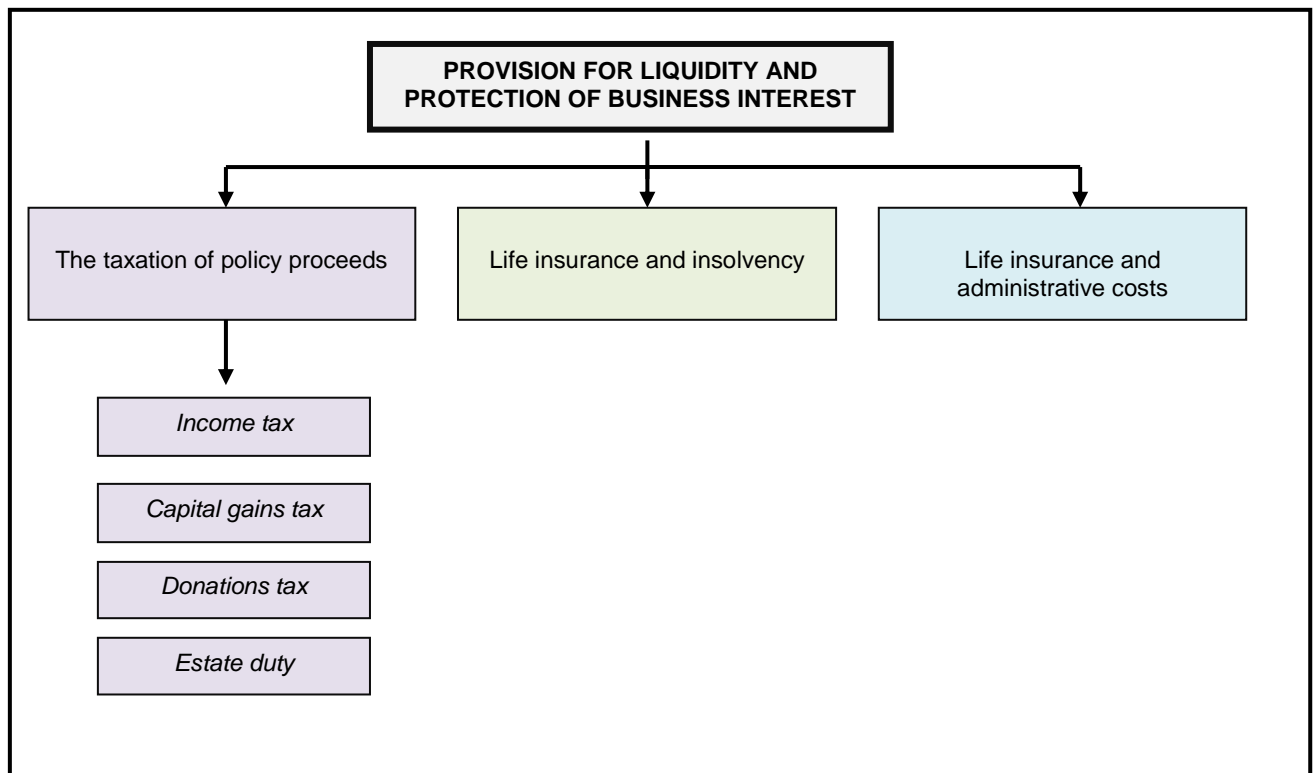
Chapter 3 focused on the minimisation of tax as an estate planning objective and discussed the different techniques used to minimise the different taxes. Chapter 4 will focus on achieving secondary objective three (paragraph 1.3.2.3) namely examining the remaining estate planning objectives and the techniques used in achieving these objectives. These objectives are often interrelated and a technique used to achieve one objective may simultaneously or ultimately also achieve another objective. Each objective will therefore be discussed separately, focussing on the different techniques used to achieve that specific objective and observing the other objectives that correspond with that objective. The structure of this chapter can be illustrated as follows:



The main purpose of this chapter is to show that estate planning is far wider than just estate duty planning and that a trust is a useful estate planning tool that can be used to achieve more objectives than just the minimisation of estate duty.

## 4.2 PROVISION FOR LIQUIDITY AND PROTECTION OF BUSINESS INTERESTS

The discussion in this paragraph will be based on the following framework:



Sufficient liquidity should be available to cover administration costs, liabilities and taxes at death, to make provision for cash bequests and to provide for the liquidity needs of dependants. Other important aspects are the protection and continuity of business interests. Life insurance is the only method of providing a large sum of money by means of a relatively small regular payment (Botha *et al.*, 2011:678).

When making provision for liquidity using life insurance a person should also consider the effect that this will have on other aspects of his estate plan. The tax consequences and certain cost and structuring issues should be taken into account when providing for liquidity. In this regard each of the following, which will be discussed separately, will play a role when dealing with life insurance:

- The taxation of policy proceeds
- Life insurance and insolvency
- Life insurance and administrative costs

## **4.2.1 The taxation of policy proceeds**

### **4.2.1.1 Income Tax and policy proceeds**

A receipt or accrual that is of a capital nature is not included in a taxpayer's gross income (definition of "gross income" in Section 1 of the *Income Tax Act*). There is no definition of "capital" nor is the expression "of a capital nature" interpreted anywhere (*CIR v George Forrest Timber Company Ltd* 1924 AD 516 1 SATC 20). Unless a capital receipt or accrual falls under one of the special inclusions contained in paragraphs (a) to (n) of the definition of "gross income", it will not be included in the taxpayer's gross income and will not be subject to income tax.

As the proceeds from a long-term insurance policy are regarded as capital in nature, it will not be included in a person's gross income and will therefore not be subject to income tax (Abrie *et al.*, 2003:77).

With regards to business owners who have insurance on the life of an employee (also known as key person insurance), section 11(w)(ii) of the *Income Tax Act* (which has recently been amended in its entirety by section 19(1)(i) of the *Taxation Laws Amendment Act (7/2010)*) provides for the deduction of any premium which was paid in respect of a policy that meets all of the following requirements:

- The employer is insured against any loss occasioned by the death, disability or severe illness of the employee (Section 11(w)(ii)(aa));
- The policy is a pure risk policy with no cash value or surrender value prior to the maturity date thereof (Section 11(w)(ii)(bb));
- The policy is not the property of anyone other than the employer at the time of the payment of the premium (Section 11(w)(ii)(cc));
- No transaction, operation or scheme exists in terms of which any amount recoverable under the policy or an amount equivalent to or in lieu of such amount will be made over by the employer to or in favour of the employee or a connected person in relation to the employee, the estate of the employee or any person who is or was dependent upon the employee (Section 11(w)(ii)(dd)).

The proceeds of such a policy, of which the premiums were deductible under Section 11(w)(ii), will however, be included in the gross income of the business in terms of paragraph (m) of the definition of “gross income”.

Prior to the amendments to section 11(w), business owners often elected to be issued with a policy which did not conform to the requirements of section 11(w). These “non-conforming” policies were elected with the express intention that the premiums would not be deductible and that the proceeds would be received tax free. With the coming into operation of the changes to section 11(w), the distinction between “conforming” and “non-conforming” policies has been removed. This lead to the unintended result where these previously “non-conforming” policies now meet the requirements of the new section 11(w), meaning that the premiums will be deductible and the proceeds taxable. The draft Taxation Laws Amendment Bill, 2011 therefore proposed (in clause 33(1)(c)) that paragraph (dd) be substituted in its entirety by a new paragraph (dd) which will provide for the taxpayer to state in the policy agreement whether the provisions of section 11(w)(ii) should apply. This proposal is now contained in clause 30(1)(d) of the *Taxation Laws Amendment Bill (19/2011)* which makes provision for the policy agreement (and not the taxpayer) to state whether the provisions of section 11(w)(ii) should apply. In respect of any policy entered into on or after 1 March 2012 the policy agreement can state that paragraph 11(w)(ii) applies in respect of premiums payable under that policy. In respect of policies concluded before 1 March 2012, the taxpayer can state in an addendum to that policy agreement by no later than 31 August 2012 that paragraph 11(w)(ii) will apply in respect of premiums payable under that policy.

A business owner seeking an upfront deduction in this regard will now have to opt into the regime. Inaction will mean that the policy will be non-conforming (despite satisfying the other objective requirements) with the premiums being deductible and the proceeds taxable. A business owner seeking to opt into the regime must express a choice in the policy agreement by stating that section 11(w)(ii) is intended to apply to that policy agreement. Business owners with pre-existing policies that satisfies the post-effective date objective criteria for conforming plans may opt into the regime by adding an addendum to the existing policy agreement. This addendum, which has to be added by 31 August 2012, will state that section 11(w)(ii) is intended to apply to that policy agreement.

#### **4.2.1.2 Capital Gains Tax and policy proceeds**

Under Paragraph 40(1) of the Eighth Schedule of the *Income Tax Act* a deceased person is treated as having disposed of his assets to his deceased estate for proceeds equal to the market value of those assets on the date of that person's death. An exception to this rule can be found in Paragraph 55.<sup>13</sup> Paragraph 55(1)(a) specifically provides that a person must disregard any capital gain or capital loss determined in respect of a disposal that resulted in the receipt by or accrual to that person of an amount in respect of a policy, where that person:

- is the original beneficial owner or one of the original beneficial owners of the policy (Paragraph 55(1)(a)(i));
- is the spouse, nominee, dependant as contemplated in the *Pension Funds Act* (24/1956), or deceased estate of the original beneficial owner of the relevant policy and no amount was paid or is payable or will become payable, whether directly or indirectly, in respect of any cession of that policy from the beneficial owner of that policy to that spouse, nominee or dependant (Paragraph 55(1)(a)(ii); or
- is the former spouse of the original beneficial owner and that policy was ceded to that spouse in consequence of a divorce order (Paragraph 55(1)(a)(iii).

This means that, when a long-term insurance policy is disposed of by the original beneficial owner or the spouse (or former spouse), nominee, dependant or deceased estate of the original beneficial owner, any capital gain or capital loss in respect of such policy is to be disregarded and will not be subject to Capital Gains Tax.

This further means that capital gains and losses arising on the disposal of second-hand policies (of which the owner is not the original beneficial owner) will not be disregarded and will be subject to CGT in the hands of the second-hand recipient (McAllister, 2010:349). In this regard it is interesting to note that clause 114 of the *Taxation Laws Amendment Bill* (19/2011) now proposes that all risk policies (including second-hand policies) should be additionally excluded from the application of capital gains tax. The reasoning behind this proposal is that the nature of risk policies prohibits these policies from being regularly traded as "second-hand" policies because these policies do not have an inherent tradable value (Explanatory Memorandum on the *Draft Taxation Laws Amendment Bill*, 2011:23).

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13 Other exceptions can be found in Paragraph 67(2)(a) which relates to transfers to a spouse and Paragraph 54 which relates to an interest in pension, pension preservation, provident, provident preservation or retirement annuity funds.

In light of this proposal an additional sub-paragraph (sub-paragraph (e)) will be added to paragraph 55(1) and will provide that a person can disregard any capital gain determined in respect of a disposal that resulted in the receipt by or accrual to that person of an amount in respect of a risk policy with no cash value or surrender value. This means that the proceeds from these policies (risk policies without a cash value or surrender value) will be disregarded irrespective of whether such policies are second-hand policies or not.

Second-hand (non-risk) long-term insurance policies will, however, remain subject to capital gains tax. The intention is to continue to discourage the trade in second-hand policies (that is, policies purchased from or ceded to another person by the original beneficial owner) (Explanatory Memorandum on the *Draft Taxation Laws Amendment Bill*, 2011:23).

#### **4.2.1.3    *Donations Tax and policy proceeds***

Where the person who pays the premiums of a life policy is also the beneficiary under the policy, donations tax is not an issue. Where that person is not the beneficiary, it can be argued that he is making a donation of the premiums giving rise to donations tax (Davis *et al.*, 2010: paragraph 15.1B). Meyerowitz (2005:168) argues that there will be no gratuitous disposal for purposes of donations tax where the right to be substituted as beneficiary is retained or where the insured is the beneficiary at inception and later substitutes a third party as beneficiary, retaining the right to revoke the nomination.

#### **4.2.1.4    *Estate Duty and policy proceeds***

Section 3(3) of the *Estate Duty Act* provides for certain property to be deemed to be the property of the deceased. This relates to assets or rights in which the deceased had an interest of some sort at some stage during his lifetime, but which he did not own or enjoy at the time of his death (Botha *et al.*, 2011:479).

Section 3(3)(a) provides that so much of any amount due and recoverable under a domestic policy on the life of the deceased shall be deemed to be property of the deceased for purposes of estate duty. This provision shall, however, not apply in respect of any amount due and recoverable under any of the following policies:

- *Policies donated under a duly registered ante-nuptial or postnuptial contract.* An amount due under a policy which is recoverable by the surviving spouse or child of the deceased under a duly registered ante-nuptial or postnuptial contract is not deemed to be property of the deceased and is exempt from estate duty (Section 3(3)(a)(i)).
  
- *Policies affected under a buy-and-sell arrangement.* The proceeds of a policy will not be deemed to have been the property of the deceased if the Commissioner is satisfied that the policy was taken out or acquired by a person who on the date of death of the deceased was a partner of the deceased, or held any share or like interest in a company in which the deceased held any share or like interest. The policy should have been taken out for the purpose of enabling that person to acquire the whole or part of the deceased's interest or share in the partnership or company concerned and no premium on the policy should have been paid or borne by the deceased (Section 3(3)(a)(iA)).
  
- *Policies payable to someone other than the deceased's estate, his relatives or a family company.* If the Commissioner is satisfied and remains satisfied that the policy was not effected by or at the instance of the deceased, that no premium on such policy was paid or borne by the deceased, that no amount due or recoverable under such policy has been or will be paid into the estate of the deceased and that no such amount has been or will be paid to, or utilized for the benefit of, any relative or dependant of the deceased or any family company, the proceeds of such policy will not be deemed to have been the property of the deceased for purposes of estate duty (Section 3(3)(a)(ii)). An example of such a policy is a so-called "key-man policy". This is where a business effects a policy on the life of a key employee at its own instance to safeguard itself against sustaining a financial loss on the employee's death. Another example is where a person takes out a policy on another person's life in order to protect himself against financial loss in the event of that other person's death (Botha *et al.*, 2011: 479).

If the proceeds from a life policy are not exempt in terms of the abovementioned exemptions, estate duty becomes payable thereon. If the policy proceeds are paid to the estate, the executor is liable for the payment of the estate duty on behalf of the estate (Botha *et al.*, 2011:480). If the policy proceeds are payable directly to a beneficiary, the estate duty that is due on the proceeds of the policy will be payable by the beneficiary (Section 11(b)(i)).



However, it should be noted that Section 3(3)(a) allows for a deduction of the aggregate amount of any premiums or consideration proved to the satisfaction of the Commissioner to have been paid by the person who is entitled to the amount due under the policy, together with interest at 6% per annum calculated upon such premiums or consideration from the date of payment to the date of death. Depending on the growth factor of the particular policy, the deduction allowed may be equal to a significant percentage of the total proceeds (Davis *et al.*, 2010: paragraph 15.3.1).

Advantage may be taken of this concession for estate planning purposes by having someone other than the life insured pay the premiums and receive the proceeds of the policy. It is important that the third party have the funds to pay for the premiums and that the relationship between the life insured and the third party is not such that the arrangement can be attacked on the basis that it is the deceased who paid the premiums. An *inter vivos* trust can be a useful tool to use in this regard. If the trust owns income producing assets, the income from these assets can be used to fund the premiums and the trust will become the third party taking advantage of this concession (Davis *et al.*, 2010: paragraph 15.3.1). For a detailed discussion on trust owned policies see paragraph 3.6.3 in Chapter 3 above.

Save for the exclusions in section 3(3)(a)(i),(iA) and (ii) and the concession discussed above, the *Estate Duty Act* also provides for the deduction of certain policy proceeds. If the proceeds of the policy is payable to a public benefit organisation or to the surviving spouse of the deceased such proceeds will be deductible in terms of section 4(h) and section 4(q) respectively. Where a policy is taken out in order to provide liquidity to pay the Estate Duty, Davis *et al.* (2010: paragraph 15.4) suggest that the surviving spouse should be the beneficiary with the condition that he or she pays the amount of the estate duty liability to the estate as a bequest price. In this way the policy will be excluded from Estate Duty through its deduction in terms of section 4(q).

#### **4.2.2 Life insurance and insolvency**

If a person's estate is declared insolvent, his creditors are entitled to attach his property. Certain property may, however, be excluded from an insolvent estate (Meskin *et al.*, 2010:5.3).

Section 63 of the *Long-Term Insurance Act* (52/1998) provides for limited protection against insolvency of the benefits from certain long-term insurance policies. Such protection is

afforded to policy benefits which are provided under one or more assistance, life, disability or health policies in which a person or the spouse of that person is the life insured and which have been in force for at least three years (Section 63(1)). Unless a debt is secured by the policy, the benefits from such policy shall not form part of a person's insolvent estate during his lifetime (Section 63(1)(a)) and shall not be available for the payment of his debts upon his death, if he is survived by a spouse, child, stepchild or parent (Section 63(1)(b)).

The protection afforded in Section 63(1) applies to assets acquired solely with the policy benefits (Section 63(2)(a)) and to policy benefits and assets so acquired to an aggregate amount of R50,000 (Section 63(2)(b)).

In *Warricker and Another NNO v Liberty Life Association of Africa Ltd* 2003 (6) SA 272 (W) the Court expressed the opinion that the nomination of a beneficiary created a *stipulatio alteri* for the benefit of the nominated beneficiary and that the benefits payable does not form part of the owner's estate. The contrary conclusion was reached in *Shrosbree and Others NNO v Van Rooyen NO and Others* 2004 (1) SA 226 (SE) in which the Court held that section 63 has the effect that the proceeds of the policy, save for R50,000, form part of the insolvent estate, and must therefore be used to pay his creditors. This conclusion was rejected in *Love and Another v Sanlam Life Insurance Ltd and Another* 2004 (3) SA 445 (SE) in which it was held that section 63 had no application where beneficiaries had been nominated and that the right to the policy benefits vested in the beneficiaries and not in the deceased or his estate. These two conflicting cases went on appeal (*Pieterse v Shrosbree & Others; Shrosbree NO v Love & Others* 2005 (1) SA 309 (SCA)) and the Supreme Court of Appeal held that, where a beneficiary is nominated on a life insurance policy, the proceeds of the policy are payable directly from the insurer to the beneficiary. Section 63 does not purport to divert the proceeds from the nominated beneficiary to the insolvent estate and does not vest the trustee in either these cases with any interest in and to the proceeds of the policies. The judgment of the court *a quo* in the first case was thus set aside and replaced with an order declaring that the beneficiary was entitled to the proceeds of the life insurance policy and the judgment in the second case was upheld.

The estate planning moral of this judgement is that it is advisable to nominate a beneficiary on a life insurance policy. The proceeds from the policy will not form part of the insolvent estate, but will be paid directly to the nominated beneficiary.

#### 4.2.3 Life insurance and administrative costs

An executor is entitled to charge a fee of 3,5% of the gross value of the assets comprising the deceased's estate plus a collection fee of 6% on any post death revenue collected (Section 51(1)(b) of the *Administration of Estates Act* (66/1965)). An executor is, however, not entitled to charge a fee on the proceeds of any life insurance payable directly to a nominated beneficiary (Knott, 2010). By nominating a beneficiary on a life policy, this cost can be eliminated.

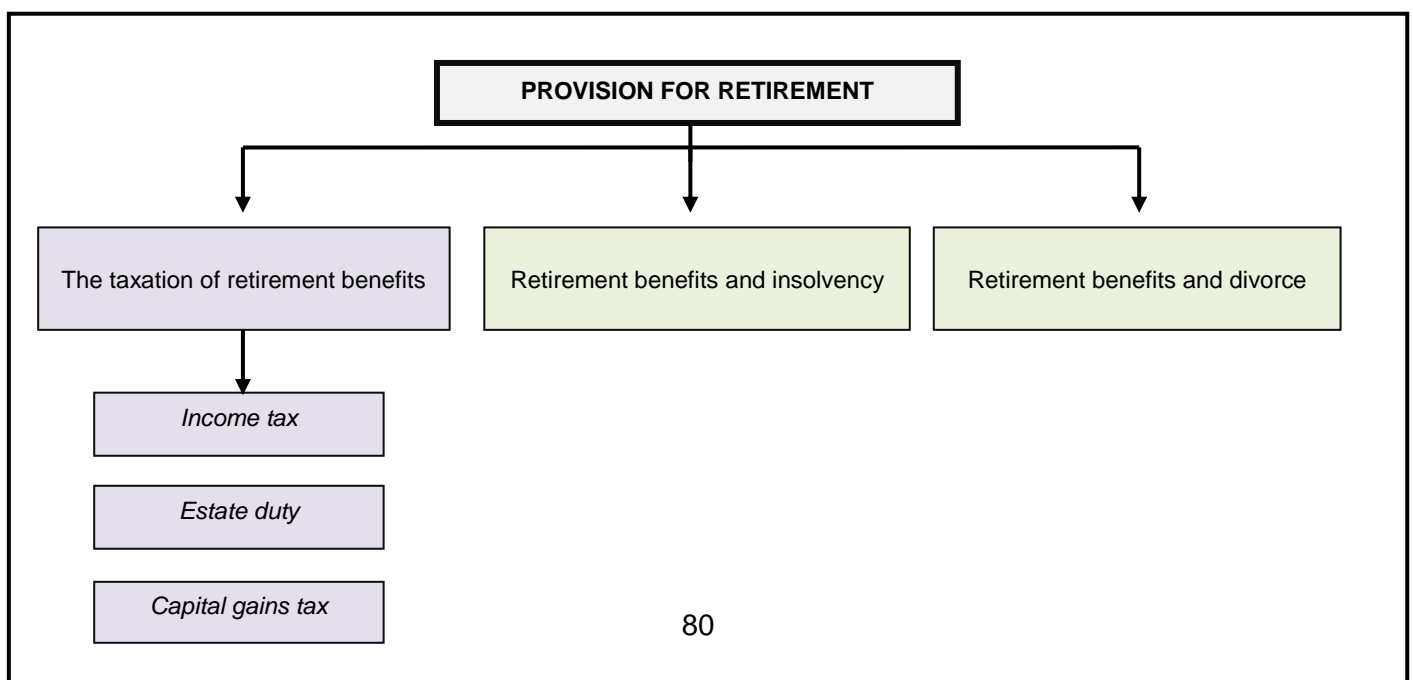
#### 4.3 PROVISION FOR FINANCIAL SECURITY

The need for liquidity is often linked to the need to provide adequate income and capital during a person's lifetime as well as after his death. This is where investment planning comes into play. The objective of investment planning is to devise strategies that will move the investor towards his investment goals with the least amount of risk (Botha *et al.*, 2011: 746).

Diversification is an important aspect of investment planning. In order to determine how the investment will be allocated across the various asset classes, a person's profile needs to be analysed and his investment objectives determined (Botha *et al.*, 2011:751). A good knowledge of the expected returns on the different investments and the volatility thereof are essential.

#### 4.4 PROVISION FOR RETIREMENT

The discussion in this paragraph will be based on the following framework:



Retirement planning and investment planning are closely linked as the attainment of one goal normally facilitates the achievement of the other. A person needs capital to generate income to replace his salary when he retires. Investment planning is about investing money in such a way that economic growth is achieved. The additional capital is then available to finance living costs and to contribute towards retirement (Abrie *et al.*, 2003: 55).

Retirement funds are mainly regulated by the *Pension Funds Act* (24/1956) (hereafter referred to as the *Pension Funds Act*) in which pension funds are defined as “pension fund organisations” which includes pension funds, provident funds, preservation funds and retirement annuity funds. These different types of retirement funds can be split into two broad categories, namely occupational schemes and individual schemes (Botha *et al.*, 2011:879).

Occupational retirement funds contribute to the welfare and efficiency of an organisation and its employees. Pension funds and provident funds are essentially the two main types of occupational retirement funds. From a business owner’s viewpoint the overall efficiency of his organisation is likely to be increased if there is an orderly retirement of senior employees at a reasonable age, which will allow for employment and promotional opportunities for younger employees. In addition, a fund which provides ancillary benefits such as life and disability cover, will relieve the business owner of the moral responsibility to provide maintenance to the widow and children of an employee who dies while in the service of the organisation, or to the employee himself, should he become incapacitated during his working lifetime. The employees on the other hand are assured that adequate provision has been made for retirement (Botha *et al.*, 2011:883).

Individual retirement funds are available for persons who do not belong to an occupational retirement fund, who wish to make additional retirement savings outside of an occupational retirement fund or who wish to preserve amounts paid out from an occupational retirement fund. Retirement annuity funds are the most popular tool for individual retirement planning as an employee-employer relationship is not required in order to be a member of a retirement annuity fund (Botha *et al.*, 2011:888).

Retirement planning also affects other aspects of estate planning and the following should be considered when providing for retirement:

- The taxation of retirement benefits
- Retirement benefits and insolvency
- Retirement benefits and divorce

#### **4.4.1 The taxation of retirement benefits**

##### **4.4.1.1 Income tax**

When it comes to the taxation of pension funds benefits, the *Income Tax Act* provides various provisions dealing with the contributions made to pension funds and the taxation of benefits received from pension funds. These provisions will now be discussed in more details.

##### *(a) Contributions to pension funds*

In determining a person's "taxable income" there are certain amounts that may be deducted from a person's gross income. These deductions are allowed by virtue of a so-called general deduction formula which consists of section 11(a), which sets out what may be deducted, and section 23(g), which stipulates what may not be deducted. Section 11(a) provides for the deduction of expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature. Section 23(g) provides that no deductions shall be made to the extent that the taxpayer is not engaged in the carrying on of a trade. Although "employment" is included in the definition of "trade" in Section 1 of the *Income Tax Act*, Section 23(m) provides that a person may not deduct an expenditure, loss or allowance which relates to any employment or office in respect of which remuneration is received. Contributions to a pension or retirement annuity fund may, however, be deducted from a person's gross income in terms of Section 11(k) or Section 11(n) (Section 23(m)(i)).

Section 11(k) allows for the deduction of current and arrear contributions to a pension fund. With regards to current contributions, a taxpayer can deduct the greater of R1 750 or 7,5% of his remuneration from retirement-funding employment (section 11(k)(i)). "Retirement-funding employment" refers to employment in respect of which an employee derives income by way of remuneration for services rendered, an office in respect of which the holder derives a salary, emoluments, fees or other remuneration or a partnership or membership from which a partner or member receives income in the form of profit-share (summary of definition for "retirement-funding employment" in section 1 of the *Income Tax Act*). A record of any current contributions in excess of the amount qualifying as a deduction must be kept because, even though they are not deductible in the year that they are made, they are deductible when the retirement benefits are eventually received (paragraph 5(1)(a) of the Second Schedule of the *Income Tax Act*). With regards to arrear contributions, a taxpayer can deduct up to a

maximum of R1 800 per year. Any excess above R1 800 may be carried forward to the next year and will qualify as a deduction, again subject to the maximum deduction of R1 800 (section 11(k)(ii)).

Section 11(n) allows for the deduction of current and arrear contributions to a retirement annuity fund. With regards to current contributions, a taxpayer can deduct the greater of 15% of income from non-retirement-funding employment, R3 500 less any amounts allowed for tax purposes in respect of current contributions to a pension fund in terms of section 11(k) and R1 750 (section 11(n)(aa)). Current contributions to a retirement annuity fund, which are in excess of the allowable deduction, may be carried forward to the succeeding year of assessment and are deemed to be current contributions made in that year (proviso (iii) to section 11(n)). This process may be continued until all contributions, previously not deducted, have been deducted from the taxpayer's income in the succeeding years. This is not an additional deduction, but forms part of the contributions taken into account to determine the maximum deductible contribution for such year. With regards to arrear contributions, a taxpayer can deduct up to a maximum of R1 800 per year. Any excess above R1 800 may be carried forward to the next year and will qualify as a deduction, again subject to the maximum deduction of R1 800 (section 11(n)(bb)). Any contributions that do not qualify for deduction for income tax purposes are deductible when the lump sum benefit is taxed on death, retirement or withdrawal (paragraph 5(1)(a) of the Second Schedule of the *Income Tax Act*).

*(b) Benefits received from pension funds*

Paragraph (a) of the definition of "gross income" in section 1 of the *Income Tax Act* includes in a person's gross income any amount received or accrued by way of an annuity or living annuity. Paragraph (e) of the same definition includes any retirement fund lump sum benefit and a retirement fund lump sum withdrawal benefit in a person's gross income.

*Annuity income*

A "living annuity" is defined as "a right of a member or former member (or his dependant or nominee) of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund to an annuity purchased from a person or provided by that fund on or after the retirement date of that member or former member" (section 1 of the *Income Tax Act*).

Annuity income is included in a person's gross income (paragraph (a) of the definition of "gross income" in section 1 of the *Income Tax Act*) and is taxed at the recipient's marginal rate of tax.

#### *Lump sum withdrawal benefits*

A "retirement fund lump sum withdrawal benefit" is defined as "an amount determined in terms of paragraph 2(1)(b) of the Second Schedule to the *Income Tax Act* (section 1 of the *Income Tax Act*). Paragraph 2(1)(b) includes the following into a taxpayer's gross income:

- Any amount assigned in terms of a divorce order under section 7(8)(a) of the *Divorce Act* (70/1979) to the extent that the amount so assigned is deducted from the minimum individual reserve of that person's former spouse in terms of section 37D(1)(d)(i) of the *Pension Funds Act*, or is so deducted in terms of section 37D(1)(d)(ii) of that Act as a result of the deduction contemplated in section 37D(1)(d)(i) of that Act (paragraph 2(1)(b)(iA)) (Refer to paragraph 4.4.3 below with regards to retirement benefits and divorce);
- Any amount that is transferred for the benefit of that person to any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund from any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund of which that person is or previously was a member (paragraph 2(1)(b)(iB)); and
- Any amount other than an amount contemplated in sub-items (iA) or (iB) above and other than a lump sum payable as a result of retirement, death or retrenchment (paragraph 2(1)(b)(ii)).

It is not the full amount that is included in the gross income of the taxpayer. In terms of paragraph 6 of the Second Schedule certain deductions can be deducted from a retirement withdrawal benefit before it is taxed. In respect of the lump sums contemplated in sub-items (iA) and (iB) of paragraph 2(1)(b), paragraph 6(1)(a) allows for the following deductions:

- pension fund into any pension fund, pension preservation fund or retirement annuity fund (paragraph 6(1)(a)(i)(aa) and 6(1)(a)(ii)(aa));
- pension preservation fund into any pension fund or pension preservation fund (paragraph 6(1)(a)(i)(bb) and 6(1)(a)(ii)(bb));

- provident fund into any pension fund, provident fund, provident preservation fund or retirement annuity fund (paragraph 6(1)(a)(i)(cc) and 6(1)(a)(ii)(cc));
- provident preservation fund into any provident fund or provident preservation fund (paragraph 6(1)(a)(i)(dd) and 6(1)(a)(ii)(dd)); and
- retirement annuity fund into any retirement annuity fund (paragraph 6(1)(a)(i)(ee) and 6(1)(a)(ii)(ee)).

In respect of any other lump sum withdrawal benefits paragraph 6(1)(b) allows for the following deductions:

- Member contributions that did not rank for a deduction under section 11(k) or section 11(n) of the *Income Tax Act* (paragraph 6(1)(b)(i));
- Any amount transferred into the fund for the benefit of the taxpayer as a result of an election made in terms of section 34D(4)(b)(ii)(cc) of the *Pension Funds Act* (paragraph 6(1)(b)(ii));
- Any amount transferred into the fund on previous withdrawal from another fund and was taxed on such transfer (paragraph 6(1)(b)(iii));
- Any amount transferred to a preservation fund as an unclaimed benefit which was taxed prior to such transfer (paragraph 6(1)(b)(iv)); and
- Any amount transferred into the fund from a Government Pension Fund to a private sector fund that represents the tax-free portion (paragraph 6(1)(b)(v)).

#### *Lump sum benefits*

A “retirement fund lump sum benefit” is defined as “an amount determined in terms of paragraph 2(1)(a) of the Second Schedule to the *Income Tax Act* (section 1 of the *Income Tax Act*). In terms of this paragraph a retirement fund lump sum benefit is any amount received by or accrued to that person by way of a lump sum benefit derived in consequence of or following upon his retirement or death or the termination of his employment due to his employer having ceased to carry on the trade in respect of which he was employed or that person having become redundant in consequence of his employer having effected a reduction in personnel. A lump sum received because of the retrenchment or redundancy of a taxpayer will not be taxed as a withdrawal benefit if the taxpayer’s employer is a company and the taxpayer was at any time a director of that company or at any time held more than 5% of the issued share capital or member’s interest in that company. The amount that must be included in the gross income of the taxpayer is the lump sum that was received less any deduction permitted under the provisions of paragraph 5 of the Second Schedule.



Paragraph 5 allows for the following deductions from a lump sum benefit:

- Member contributions that did not rank for a deduction under section 11(k) or section 11(n) of the *Income Tax Act* (paragraph 5(1)(a));
- Minimum individual divorce withdrawal amount transferred into the fund in terms of selection under section 34D(4)(b)(ii) of the *Pension Funds Act* (paragraph 5(1)(b));
- Withdrawal benefit contemplated in paragraph 2(2)(b) deemed to have accrued to the taxpayer (paragraph 5(1)(c));
- Amount transferred to a preservation fund as an unclaimed benefit which was taxed prior to such transfer (paragraph 5(1)(d)); and
- Amount transferred from a Government Pension Fund to a private sector fund that represents the tax-free portion transferred (paragraph 5(1)(e)).

#### **4.4.1.2 Estate duty**

Section 3(3)(a)*bis* of the *Estate Duty Act* previously regarded certain fund benefits as deemed property of the deceased for purposes of estate duty. Section 3(3)(a)*bis* was repealed with effect from 1 January 2009 and a new paragraph (i) was added to section 3(2) (section 2(1)(b) and 2(1)(a) respectively of the *Revenue Laws Amendment Act* (60/2008)). This new paragraph provides that any benefit that is due and payable by, or in consequence of membership or past membership of any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, is excluded from “property” for estate duty purposes. This means that any lump sum benefit or annuity paid by a retirement fund at a person’s death will no longer be deemed to be property in his estate.

The abolition of estate duty on retirement funds has made retirement annuities an attractive estate planning tool. Additional and once-off contributions to retirement annuities provide opportunities for astute investment- and tax planning (Carroll, 2010:26). There is no limit to the amount that may be contributed in this manner. When diversifying an investment across the different asset classes, a person should consider holding the asset classes with a higher tax exposure (for example cash and property) in a retirement annuity (Carroll, 2010:27).

With estate duty on retirement funds out of the way, a person can reduce the value of his dutiable estate by contributing to a retirement annuity fund without incurring donations tax,

capital gains tax or transfer duty. There is also an added benefit of an income tax deduction. Section 11(n) provides for the deduction of contributions to a retirement annuity fund and was discussed in paragraph 4.4.1.1 above. When it comes to the payment of a lump sum benefit, the provisions of paragraph 5(1)(a) of the Second Schedule of the *Income Tax Act* provides for a deduction of contributions that “did not rank for a deduction” under section 11(n). Any contributions that were not deductible will therefore be deducted from the total lump sum benefit that will be included in the recipient’s gross income.

The benefit of using a retirement annuity as an estate planning tool can be best explained by way of an example. Refer to addendum A on page 158 in this regard.

#### **4.4.1.3 Capital gains tax**

Paragraph 54 of the Eighth Schedule of the *Income Tax Act* provides that retirement benefits paid in lump sums will be disregarded in determining any capital gain or capital loss.

#### **4.4.2 Retirement benefits and insolvency**

There are a number of statutes which excludes pensions and other like benefits from a person’s insolvent estate:

- Section 23(7) of the *Insolvency Act* (24/1936) permits an insolvent to recover, for his own benefit, any pension to which he may be entitled for services rendered by him.
- Section 37B of the *Pension Funds Act* provides that, where a fund member or fund beneficiary is sequestrated, no benefit payable by the fund (including pension annuities) to which such person is entitled may form part of the assets of his insolvent estate, nor will any such interests be capable of being attached by any creditor.
- Section 3 of the *General Pensions Act* (29/1979) provides that any benefit received under any pension law shall not form part of the assets of a person’s insolvent estate.
- Section 14(3) of the *Aged Person’s Act* (81/1967) provides that any sum that is payable to the insolvent estate of a pensioner by virtue of the fact that he is a pensioner, shall not form part of the assets in his insolvent estate.

- Section 131(1) of the *Occupational Diseases in Mines and Works Act* (78/1973) provides that a right to a benefit or gratuity to which a person is entitled in terms of this Act shall not form part of such person's insolvent estate.

In applying these provisions it is necessary to determine the Legislature's intention as to whether the exclusion only relates to benefits which become payable to the insolvent after the sequestration or whether it extends to those already paid to him, and still in his possession, at such date. Victor and King (2010:54) are of the opinion that Section 37B of the *Pension Funds Act* also protects those benefits that were already paid to the member prior to insolvency. However, in *Foit v First Rand Bank Limited* 2002 (5) SA 149 (T) the court held that the protection afforded by Section 3 of the General Pensions Act only applied where the insolvent receives the relevant benefit after the date of sequestration of his estate and did not afford protection for pension benefits received by the insolvent prior to the sequestration of his estate.

#### **4.4.3 Retirement benefits and divorce**

Section 7(7) of the *Divorce Act* (70/1979) deems a person's pension interest to be part of his or her assets for purposes of determining the patrimonial interest to which his or her spouse may be entitled at divorce.

In respect of a retirement annuity fund, "pension interest" means the total amount of a member's contributions made to the fund until date of divorce plus simple interest on those contributions up to date of divorce. The interest rate that is applicable is the rate as prescribed by the Minister of Justice in terms of section 1(2) of the *Prescribed Rate of Interest Act* (55/1975) (paragraph (b) of the definition of "pension interest" in section 1 of the *Divorce Act*). This rate is currently 15.5% but may change from time to time.

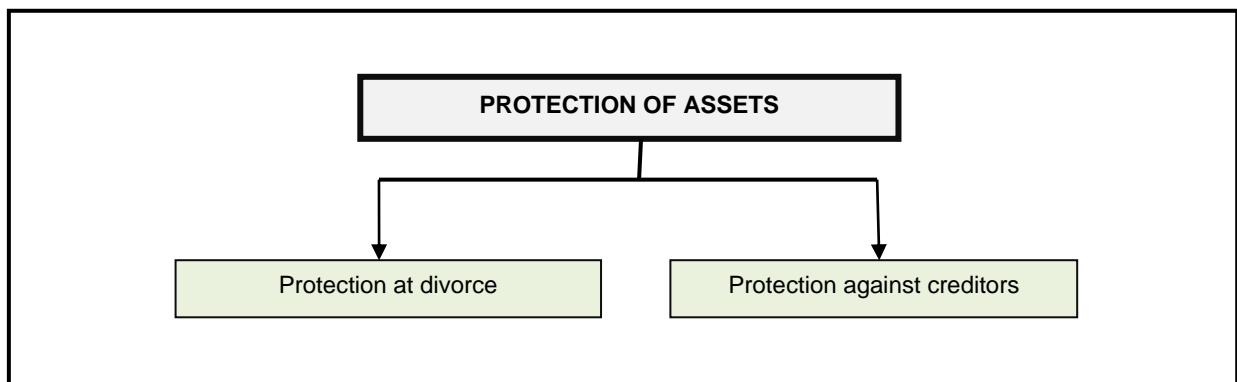
In respect of a pension fund, provident fund and preservation funds, "pension interest" means the benefits to which the member would have been entitled in terms of the rules of the fund if his or her membership was terminated on the date of divorce on account of his or her resignation (paragraph (a) of the definition of "pension interest" in section 1 of the *Divorce Act*).

For years the position has been that the non-member spouse could not get his or her share of the pension interest before the pension benefit accrues to the member of the fund (Botha

*et al.* 2011:877). An amendment to the *Pension Funds Act* introduced a “clean break” principle with regards to pension interests at divorce (section 28 of the *Pension Fund Amendment Act* (11/2007)). In terms of this principle the non-member spouse will be entitled to receive immediate payment or transfer of the portion of the member’s pension interest allocated to him or her thereby effecting a clean break between the parties as far as the non-member’s claim to a portion of the members pension interest is concerned (section 37D(1)(e) of the *Pension Funds Act*).

## 4.5 PROTECTION OF ASSETS

The discussion in this paragraph will be based on the following framework:



This part of the estate planning process mainly refers to the protection of a person and/or his relatives from their own mistakes and indiscretions. In this regard a person should consider the possibility of failed marriages and squandering habits and plan for protection against divorce and insolvency.

### 4.5.1 Protection at divorce

Matrimonial property planning is another important part of the estate planning process and is discussed in paragraph 4.8 below. The choice of matrimonial regime will have an effect on the division of assets at divorce. Apart from the choice of matrimonial regime, there is the use of a trust in order to exclude certain assets from matrimonial property or to assist with the division of assets at divorce.

Many trust deeds contain clauses that seek to ensure that trust benefits are excluded from any community of property or are not subject to any accrual or other claims on termination of marriage. Whether or not these clauses will protect assets against claims of a former spouse

will depend on when the trust was formed, by whom the trust was formed and also on the manner in which the trust assets were controlled or otherwise dealt with (Geach & Yeats, 2007:222). Also refer to paragraph 4.8.2.3 below.

In the event of divorce, where substantial assets have to be divided and maintenance has to be paid, it can be very useful to resort to a trust (Olivier *et al.*, 2008: paragraph 8.5.2.5.9). Any assets so transferred to a trust will then be available for the use of a former spouse or funds will be available for that spouse's maintenance, but the capital will eventually devolve upon the children and not upon a next spouse or children from a further marriage (Wunsh in Wiechers & Roos (eds.), 1993:65). If a person donates capital to a trust as a result of a divorce and in terms of a court order, the donation will not be subject to donations tax (*Welch's Estate v C:SARS* 2004 (2) All SA 586 (SCA) as well as the discussion in paragraph 3.5.3 in Chapter 3 above).

#### **4.5.2 Protection against creditors**

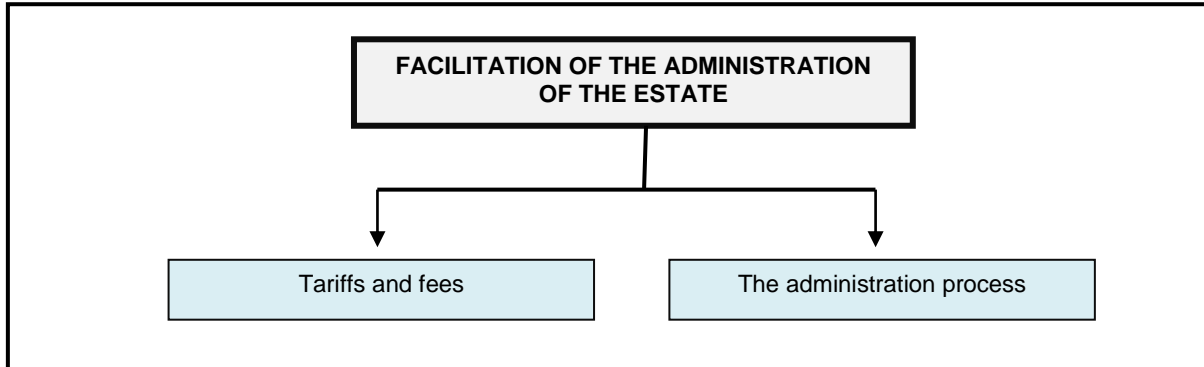
In paragraphs 4.2.2 and 4.4.2 it was mentioned that policy proceeds and pension benefits are protected against creditors at insolvency. A person can, however, also ensure further protection of other assets by holding such assets in a trust. Section 12 of the *Trust Property Control Act* (57/1988) provides that trust property shall not form part of the personal estate of the trustee except in so far as he as a trust beneficiary is entitled to the trust property. This means that trust assets that have not vested in a beneficiary exist independently of the trust beneficiaries and, provided the trust assets have not been given as security on behalf of a beneficiary, such assets cannot be subject to claims by creditors (Geach & Yeats, 2007:216).

This protection is, however, subject to the normal insolvency rules in respect of impeachable transactions and if the transfer of assets to the trust took place at a time when the owner's liabilities were already exceeding his assets, it will be easy for the creditors to set aside the trust transaction (Victor & King, 2010:362).

It is also important to note that, if the trustees do not properly manage the affairs of the trust or do not use the trust for proper commercial or estate planning purposes, the South African courts will not hesitate to look through the trust and declare that the assets do not belong to the trust, but to an individual who used the trust as a structuring vehicle (*Nel v Cilliers NO* [2008] ZAFSHC 22 and *First National Bank v Britz and others* [2011] ZAGPPHC 119).

## 4.6 FACILITATION OF THE ADMINISTRATION OF THE ESTATE

The discussion in this paragraph will be based on the following framework:



An estate plan should provide for the efficient administration of a person's estate. In this regard it is important to consider the remuneration tariffs applicable to executors, trustees and other statutory administrators as well as the extensive estate administration process.

### 4.6.1 Tariffs and fees

Pursuant to Government Notice (GN R1602 of 1991) the executor's remuneration, as referred to in section 51(1)(b) of the *Administration of Estates Act* (66/1965), is assessed at a tariff of 3,5% of the gross value of the assets in the estate and 6% on income accrued and collected after the death of the deceased. In the case of a communal estate, the executor's remuneration is based on the combined value of the joint estate and not merely on the undivided share of the deceased spouse (Victor & King, 2010:291).

During the estate planning process a person should consider these fees and plan in order to reduce or avoid unnecessary costs. The following three strategies are imperative in this regard:

#### *(a) Negotiating a reduced fee*

The executor's fee may be reduced in terms of the express provisions of a person's will. Many executors are willing to negotiate a reduced fee which will be based on the complexity of the administration and the size of the estate (Victor & King, 2010:291).

*(b) Nominating beneficiaries on life insurance policies*

An executor is not entitled to charge a fee on the proceeds of any life insurance that is payable directly to a nominated beneficiary (Knott, 2010). By nominating a beneficiary on a life policy, the executor's fee on the proceeds of such policy will be eliminated.

*(c) Inter vivos discretionary trust*

The informed use of an inter vivos discretionary trust has the benefit of substantially reducing executor's fees and administration costs in the event of death. This is by reason of the assets in the trust not forming part of the deceased's estate and therefore not being subject to the executor's fee (Victor & King, 2010: 292).

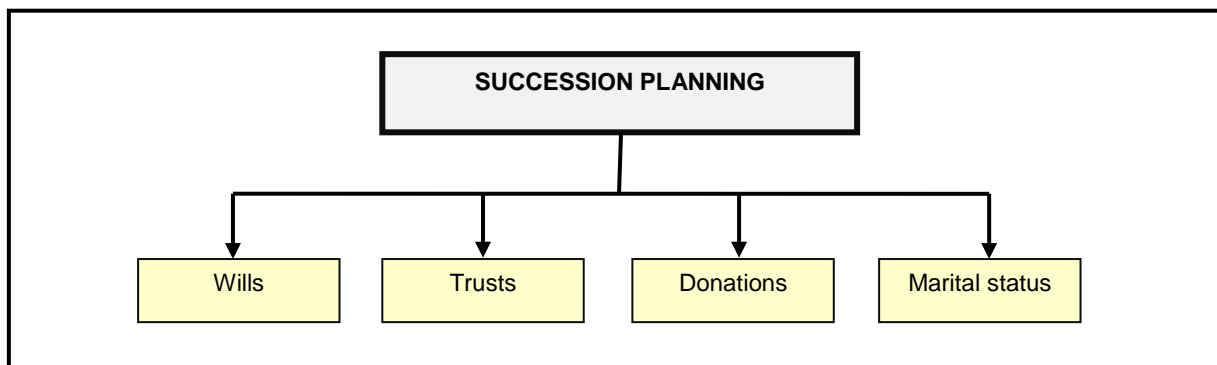
#### **4.6.2 The administration process**

Estate administration seeks to facilitate the process of fulfilling a deceased person's legal obligations and expunging liabilities due to other persons, while at the same time transferring the deceased's balance of available assets to those persons entitled thereto (Victor & King, 2010:271). During this process the executor takes control of the estate and interrupts the dependants' and beneficiaries' enjoyment of the assets for the duration of the administration process.

In so much as an inter vivos discretionary trust will reduce the executor's fees and administration costs in the event of death, it will also simplify and expedite the administration process. The existence of the trust alongside the deceased estate has the benefit that the deceased's family may, with minimum inconvenience and interruption, look to the trust for their upkeep and resources pending finalisation of the estate (Victor & King, 2010:292). There is no need to wait for the estate of the deceased to be wound up, because the trust assets do not fall into the deceased person's estate (Geach & Yeats, 2007:217).

## 4.7 SUCCESSION PLANNING AND HARMONY IN THE FAMILY

The discussion in this paragraph will be based on the following framework:



Succession planning is directed at planning around death and involves the realisation of a person's wishes with regards to the disposition of his assets and the prevention of family disputes. This part of the planning process is mainly governed by distributive mechanisms such as wills, trusts and donations and can also be affected by a person's marital status. Each of these mechanisms will now be discussed separately.

### 4.7.1 Wills

A will is a written representation of a person's wishes with regards to the distribution of his assets at his death. A person can have a complete estate plan represented by a will but he cannot have a complete estate plan of his own selection without a will (Casner, 1961:17). A will on its own can constitute an effective and important instrument for sound estate planning.

If a person does not have a valid will, his estate will be administered in terms of the provisions of the *Intestate Succession Act* (81/1987) (hereafter referred to as the *Intestate Succession Act*).<sup>14</sup> This does not constitute proper planning and will have the following consequences:

- The owner of the estate does not choose his heirs and beneficiaries and cannot prescribe the extent of entitlement or provide for any conditions upon which persons may benefit (Olivier & van den Berg, 1991:27). This can cause family members to

<sup>14</sup> A full discussion on intestate succession and distribution in terms of the *Intestate Succession Act* falls outside the scope of this study.



become embroiled in unpleasant disputes over the division of estate assets (Jones, 2005:15).

- The principle of *collatio* will automatically apply. This means that any benefit received by a descendant during the lifetime of the deceased can be taken into account when calculating the value of the residue.
- Not having a will means forgoing the opportunity to choose an executor. The difficult and time-consuming task of nominating an executor is left to the family of the deceased. This gives rise to unnecessary delays in the administrative process (Davis *et al.*, 2010: paragraph 8.1.2).
- Not having nominated an executor also means that the provision of security has not been excluded. The Master of the High Court may therefore request the executor to provide security as financial guarantee that the estate will be administered properly. This security usually takes the form of a security bond from a short term insurance company for the value of the assets reflected in the preliminary inventory. Obtaining this bond and having to raise security causes further delays and results in additional costs (Jones, 2005:15).
- In the absence of a Will, a minor beneficiary's bequest will be held in the Guardian's Fund until he reaches the age of majority (Section 43 of the *Administration of Estates Act* (66/1965)). The Guardian's Fund is currently administered by the Master of the High Court<sup>15</sup> which invests the money with the Public Investment Commission. Interest payable on amounts paid into the Fund is calculated at a rate determined from time to time by the Minister of Finance, which can be lower than the rate that can be achieved had the money been invested elsewhere. All payments into the Fund are required to be in cash and this might mean that assets will have to be sold in order to raise money to be paid into the Fund (Jones, 2005:16).
- A will allows the testator to nominate guardians for minor children in the event that the children are left without a natural guardian. Although this is merely a nomination (and not an enforceable appointment), it will be considered when the best interest of the child is decided by the relevant authorities (Davis *et al.*, 2010: paragraph 8.1.3).
- In a will a testator can provide for immature or handicapped beneficiaries by setting up a testamentary trust stipulating how the assets are to be managed and when it is to be distributed. Where there is no will, there is no provision for the protection of the bequests to these beneficiaries.

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15 The Fiduciary Institute of South Africa has called on the Department of Justice to outsource this responsibility to a regulated financial services institution (Gibson, 2010).

- A will can be used as a tax planning tool whereby the deceased's estate duty position can be reduced by means of bequests that are excluded from estate duty in terms of section 4 of the *Estate Duty Act* (45/1955). If a person does not have a will, his estate and beneficiaries will not benefit from these planning strategies (Jones, 2005:16).
- Section 5 of the *Matrimonial Property Act* (88/1984) excludes inheritances and legacies from the accrual in a marriage under the accrual system. Bequests by a spouse married in community of property are not automatically excluded from the communal estate and should be excluded in the testator's will. It is important that the testator not only excludes the community of property, but that he also excludes the profit and loss elements. This will ensure that the fruits of the bequeathed asset also fall outside the communal estate (Davis *et al.*, 2010: paragraph 8.3.10).

When a person already has a will in place it is important to ensure that the existing will complies with the legal formalities and requirements of a valid will and that it corresponds with the testator's current wishes and circumstances. The opening words of the judgment in *Van Deventer v Van Deventer and another* 2006 SCA 144 RSA serves as a reminder that "there is nothing quite like a will for fomenting family dissension" and that wills are to be drafted in clear terms and with care and precision.

#### **4.7.2 Trusts**

There are many advantages for setting up and utilizing trusts as part of the estate planning process.<sup>16</sup> The advantages that are of relevance here, and which will ensure smooth succession and harmony in the family, are the following:

##### **4.7.2.1 Continuity**

A trust can exist in perpetuity and can provide for continued existence. This has great advantages because beneficiaries can come and go, beneficiaries can die, get divorced, go insolvent or suffer from some other mishap, and trust assets will continue to be held in trust and be protected from the consequences resulting from these misfortunes. (Geach & Yeats, 2007:217)

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<sup>16</sup> The advantages of trusts will be discussed in Chapter 5 below.

#### **4.7.2.2 Smooth succession**

To the extent that a beneficiary is not clothed with vested rights in the trust property, the trust property does not form part of the beneficiary's personal estate (*CIR v Estate Sive* 1955 (1) SA 249 (A)) and to the extent that as a trustee is not a beneficiary with a vested right in the trust, the trust property does not form part of a trustee's estate (Section 12 of the *Trust Property Control Act* (57/1988)). A trust can therefore provide for easy succession of interests in property. When a beneficiary dies, another beneficiary can immediately start enjoying some or all of the benefits that were enjoyed by the deceased. There is no need to wait for the estate of the deceased to be wound up, because trust assets do not form part of the deceased beneficiary's estate (Geach & Yeats, 2007:218).

#### **4.7.2.3 Protection in the interest of heirs and legatees**

A trust can be used very effectively for inheritance purposes so that an heir or legatee does not inherit directly, but via a trust. This can result in effective estate planning for future generations as the assets bequeathed to the trust do not form part of a beneficiary's estate for purposes of the administration process or for purposes of estate duty (Botha *et al.*, 2011:802). It also contributes to protecting an heir or legatee against divorce, creditors or bad business decisions (Botha *et al.*, 2011:803). This means that an heir or legatee can have all the benefits of the assets that are held in the trust without any of the disadvantages of ownership (Geach & Yeats, 2007:217).

#### **4.7.2.4 Protection in the event of second marriages**

Trusts may be utilized to deal with difficult situations arising from second marriages. Separate trusts can be created for the benefit of children from previous marriages and children born from the existing marriage (Abrie *et al.*, 2003:150).

#### **4.7.2.5 Testamentary trusts**

The *usufruct*, *fideicommissum* and annuity are often used in wills to create an intervening interest for one person under circumstances where the capital must ultimately devolve upon other persons. The use of these devices usually results in unnecessary estate duty and tax

complications. Both a *usufruct* and an annuity can create unnecessary income tax problems and the value of a *fideicommissum* is always subject to estate duty. A testator who wishes to dispose of his property and to burden it or a portion thereof with a *usufruct*, *fideicommissum* or annuity will be well-advised to consider creating a testamentary trust instead (Olivier *et al.*, 2008: paragraph 8.3.6).

Olivier *et al.* (2008: paragraphs 8.3.6 and 8.4.2) states that using a trust instead of a *usufruct*, *fideicommissum* or annuity will have the following beneficial results:

- A trust has an inherent flexibility and provides the trustees with enough powers to improve its usefulness should it prove to be less beneficial than originally envisaged.
- The trustees have a fiduciary obligation to employ the trust funds for the preservation of the trust property, and need not pay attention to the personal or selfish considerations of a beneficiary.
- Income can be allocated according to the needs of the beneficiaries.
- Income which is distributed to beneficiaries converts the trust into a conduit and consequently allows for a beneficial tax structure whereby the recipient of the income pays the income tax.
- The provisions of section 7 of the *Income Tax Act*, which attributes income back to a donor under certain circumstances, does not apply to a testamentary trust, because the donor is no longer alive.
- Trust property does not form part of the personal estates of either the trustees or the beneficiaries and will therefore never be subject to estate duty.

#### **4.7.2.6 Minor beneficiaries**

In paragraph 4.7.1 above it was mentioned that, in the absence of a will, a minor beneficiary's bequest will be paid into the Guardian's Fund until he reaches the age of majority. Where minor children are involved it is of utmost importance to have a will in place and to ensure that assets are not bequeathed directly to minor beneficiaries. These bequests should rather be made to the trustees in trust to be administered for the minors until they attain a more mature age at which the assets can be transferred to them.

If the trust property consists of income producing assets, the following beneficial income tax results can be achieved through a testamentary trust for the benefit of minor beneficiaries:

- Section 7(3) of the *Income Tax Act* provides that income that accrues to a minor beneficiary, shall be deemed to have been the income of the parent of such minor

child if the income so accrued is received by reason of a donation, settlement or other disposition made by the parent of that child. This provision is not applicable to testamentary trusts and any income distributed to the minor beneficiary will be taxed in the minor's hands at his or her marginal tax rate and subject to the personal rebates provided for in Section 6(1) and (2) of the *Income Tax Act*.

- A trust that has been created by or in terms of a will of a deceased person, solely for the benefit of relatives of that deceased person, where the youngest beneficiary is, on the last day of a year of assessment, under the age of 21 qualifies as a special trust (paragraph (b) of definition of "special trust" in Section 1 of the *Income Tax Act*). For income tax purposes, special trusts for minor beneficiaries are taxed at the same rate as natural persons and are entitled to the general dividend and interest exemption in Section 10(1)(i)(xv) of the *Income Tax Act*. For capital gains tax purposes, special trusts for the benefit of minors have the same inclusion rate as natural persons (paragraph 10(a) of the Eighth Schedule). Also refer to paragraphs 3.3.3 and 3.4.4 in Chapter 3 and paragraph 5.3.2.6 in Chapter 5 for a discussion on special trusts.

#### **4.7.2.7 Disabled beneficiaries**

Beneficiaries who suffer from a mental illness or any serious physical disability and who cannot earn sufficient income for self-maintenance, or who cannot manage his own affairs, should preferably receive their inheritances in trust so that responsible trustees can control and preserve the assets for them. A trust which is created for this purpose (and which need not only be created in the event of death), qualifies as a special trust in terms of paragraph (a) of the definition of "special trust" in Section 1 of the *Income Tax Act*. This trust has the same tax benefits as a special trust created for the benefit of beneficiaries under the age of 21, but also has the following capital gains tax benefits (also refer to paragraphs 3.3.3 and 3.4.4 in chapter 3 and paragraph 5.3.2.6 in Chapter 5 for a discussion on special trusts):

- It qualifies for an annual capital gains tax exclusion (paragraph 5(1));
- It must disregard a capital gain or loss on the disposal of a primary residence to the extent that the capital gain or loss does not exceed R1,5 million or if the proceeds on the disposal does not exceed R2 million (paragraph 45(1));
- A capital gain or loss determined in respect of the disposal of a personal-use asset of a special trust must be disregarded (paragraph 53(1));
- A special trust must disregard a capital gain or a capital loss in respect of a disposal of a claim resulting in the trust receiving compensation for personal injury, illness or defamation of the beneficiary of the trust (paragraph 59).

### 4.7.3 Donations

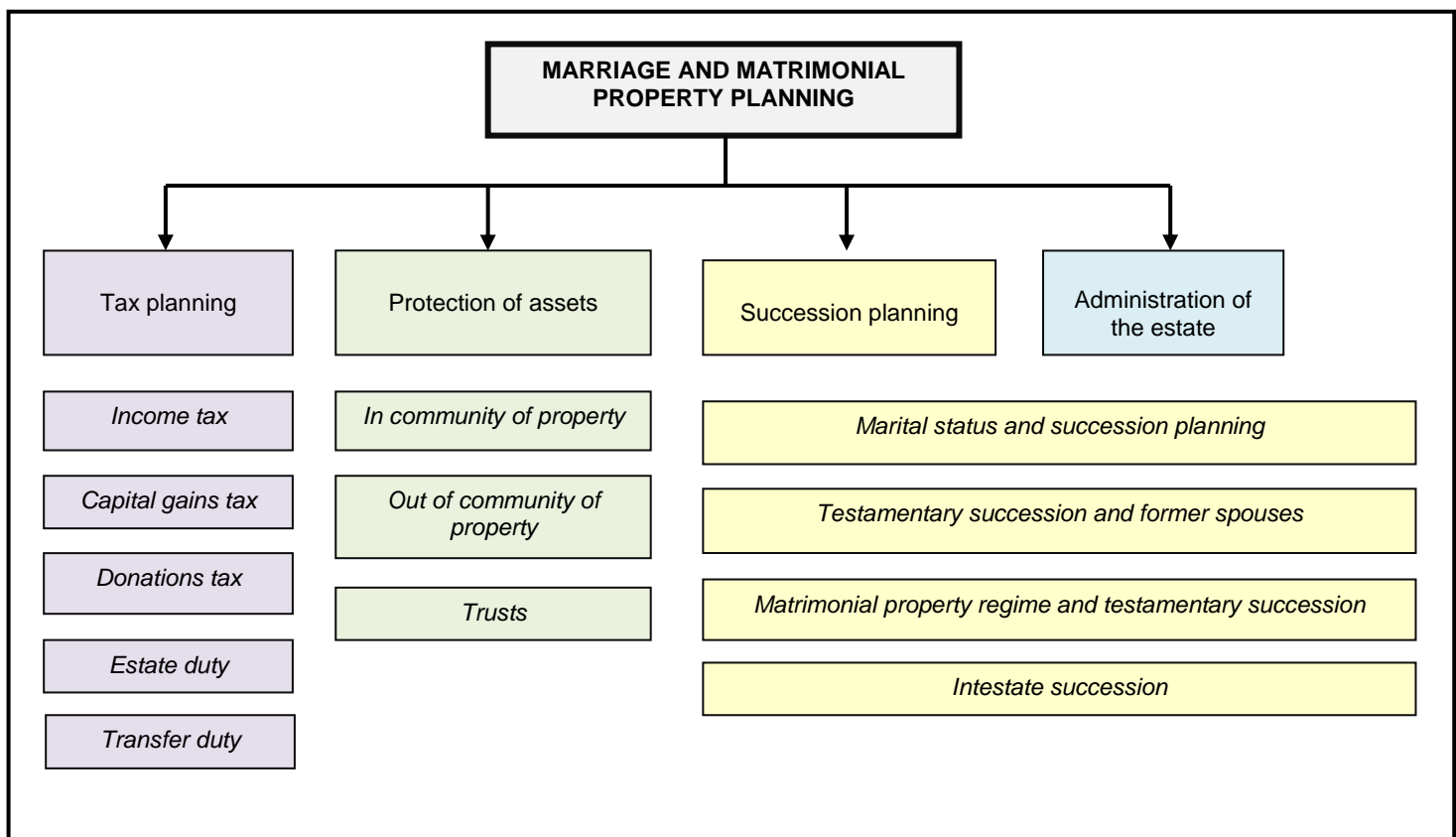
The use of donations can be an effective estate planning technique and is very useful in reducing a person's estate. This is particularly effective when making donations that are exempt from donations tax, but can also be effective when the asset donated is a growth asset which is likely to appreciate in future. Refer to paragraph 3.5 in Chapter 3 above for a discussion on donations tax and the use of donations in estate planning.

### 4.7.4 Marital status

Another distributive mechanism that should not be lost sight of in succession planning is the marital status of a person. The manner in which a person's estate devolves at his death (whether by way of his will or intestate) will be influenced by his marital status as well as by his marital regime. This subject will be discussed in more detail under paragraph 4.8.3 below.

## 4.8 MARRIAGE AND MATRIMONIAL PROPERTY PLANNING

The discussion in this paragraph will be based on the following framework:



A person's marital status and marital regime is an important factor to be taken into account in estate planning and will also have an impact on the way in which a person deals with the following aspects of estate planning:

- Tax planning
- Protection of assets
- Succession planning
- Administration of the estate

#### **4.8.1 Tax planning**

In 2001 section 5(j) of the *Taxation Laws Amendment Act (5/2001)* introduced a definition of "spouse" to the *Income Tax Act*, the *Estate Duty Act* and the *Transfer Duty Act*. In terms of this definition, "spouse" means –

in relation to any person, a person who is the partner of that person:

- (a) in a marriage or customary union recognised in terms of the Laws of the Republic;
- (b) in a union recognised as a marriage in accordance with the tenets of any religion; or
- (c) in a same sex or heterosexual union which the Commissioner is satisfied is intended to be permanent,

and "married", "husband" or "wife" shall be construed accordingly: Provided that a marriage or union contemplated in paragraph (b) or (c) shall, in the absence of proof to the contrary, be deemed to be a marriage or union without community of property.

The recognition of a person as a "spouse" holds various fiscal implications and benefits with regards to different taxes. These implications and benefits will be discussed below in the light of the following taxes:

- Income tax
- Capital gains tax
- Donations tax
- Estate duty
- Transfer duty

#### **4.8.1.1    *Income tax***

Each spouse in a marriage is taxed separately on his or her income and deliberate attempts to shift income between spouses are prevented by the anti-avoidance provisions and attribution rules contained in Section 7 of the *Income Tax Act*.

Section 7(2) aims to prevent the splitting of income between spouses and provides that any income received by or accrued to a married person as a result of a donation, settlement or other disposition made by that person's spouse, shall be deemed (for income tax purposes) to be the income of the donor spouse. This anti-avoidance provision applies if the sole or main purpose of the donation, settlement or other disposition was to reduce, postpone or avoid the donor spouse's liability for tax.

Section 7(2A) deals with the question as to when the income of spouses, married in community of property, accrues to the joint estate (and is taxable in equal shares in the hands of the spouses). If the income does not accrue to the joint estate, such income accrues to each spouse individually for tax purposes, and thereafter becomes part of the joint estate. Section 7(2A)(a) provides that income (other than income derived from the letting of fixed property) that has been derived from the carrying on of a trade shall be taxed in the hands of the spouse carrying on such trade. If such trade is carried on jointly by both spouses the income accrues to them both in the proportions determined by them in terms of the agreement that regulates their joint trade. The provisions of section 7(2) will, however, prevent the channelling of excessive remuneration to a spouse. Where no such agreement exists, the income accrues to the spouses in the proportion to which each spouse would reasonably be entitled having regard to the nature of the trade, the extent of each spouse's participation therein, the services rendered by each spouse or any other relevant factor. Section 7(2A)(b) provides that rental income derived from the letting of fixed property and any income derived otherwise than from the carrying on of any trade shall be deemed to have accrued in equal shares to both spouses. This means that investment income, such as interest, will be taxable in equal shares in the hands of the spouses.

Section 7(2B) provides that where any income is taxed in the hands of a spouse, any deduction or allowance relating to that income will be allowed to the spouse.



#### **4.8.1.2 Capital gains tax**

Paragraph 67 of the Eighth Schedule of the *Income Tax Act* offers a form of rollover relief with regards to disposals between spouses. Where a person (the transferor) disposes of an asset to his or her spouse, the transferor spouse must disregard any capital gain or loss in respect of that disposal (paragraph 67(1)(a)). The transferee spouse, on the other hand, must be treated as having –

- acquired the asset on the same date that it was acquired by the transferor (paragraph 67(1)(b)(i));
- incurred an amount of expenditure equal to the expenditure that was incurred by the transferor in respect of that asset (paragraph 67(1)(b)(ii));
- incurred that expenditure on the same date and in the same currency that it was incurred by the transferor (paragraph 67(1)(b)(iii));
- used that asset in the same manner that it was used by the transferor (paragraph 67(1)(b)(iv)); and
- received an amount equal to any amount received by or accrued to that transferor in respect of that asset that would have constituted proceeds on disposal of that asset had that transferor disposed of it to a person other than the transferee (paragraph 67(1)(b)(v)).

This means that there will be no capital gains tax payable on the disposal (sale, donation or bequest) of an asset from one spouse to the other and that the base cost will remain the same in the hands of the transferee spouse as it had been in the hands of the transferor spouse.

#### **4.8.1.3 Donations tax**

Donations between spouses are free from donations tax (section 56(1) of the *Income Tax Act*). Section 56(1)(a) provides that no donations tax will be payable in respect of the value of any property which is disposed of under a donation to or for the benefit of the spouse of the donor under a duly registered ante nuptial contract, post-nuptial contract or notarial contract.

Section 56(1)(b) provides that no donations tax will be payable in respect of the value of any property which is disposed of under a donation to or for the benefit of the spouse of the donor who is not separated from him under a judicial order or notarial deed of separation.

#### **4.8.1.4 Estate duty**

There is no estate duty payable on the value of property that accrues to the surviving spouse of a deceased person. In this regard Section 4(q) of the *Estate Duty Act* provides that the net value of a person's estate shall be determined by deducting from the total value of all property so much of the value of any property as accrues to the surviving spouse of the deceased.

Section 4A(1) of the *Estate Duty Act* allows for a rebate of R3,5 million to be deducted from the net value of a person's estate (section 1(1) of the *Taxation Laws Amendment Act* (8/2007)). This rebate is conferred over and above the Section 4(q) deduction and, where a person bequeaths his entire estate to his spouse, the Section 4A rebate remains unused. In the past, this would have resulted in the estate of the first-dying spouse forfeiting the Section 4A abatement. Married couples therefore used trusts and other structures in order to ensure that R7 million is ultimately distributed free of Estate Duty. Due to the fact that these structures caused compliance costs and many taxpayers could not easily afford the advice of estate planning experts, it was proposed that this deduction becomes portable between spouses (Explanatory Memorandum to the *Draft Taxation Laws Amendment Bill*, 2009:74). Section 5(1) of the *Taxation Laws Amendment Act* (17/2009) therefore amended Section 4A and as of 1 January 2010 section 4A provides that, where a person was the spouse of one or more previously deceased persons, the dutiable amount of that person's estate shall be determined by deducting from the net value of that estate an amount of R3,5 million multiplied by two and reduced by the amount (if any) previously deducted in terms of section 4A from the net value of a deceased spouse's estate (section 4A(2)).

This means that, if a person did not utilise the Section 4A rebate, such rebate (or the balance thereof) will be carried over to the surviving spouse's estate, effectively granting the couple a total deduction of R7 million (Escott-Watson, 2010:F16). This will, however, only apply if the executor of the surviving spouse's estate submits a copy of the estate duty return in respect of the first dying spouse's estate to the Commissioner (Section 4A(5)).

Section 4(1)(b) of the *Taxation Laws Amendment Act* (7/2010) added another paragraph to section 4A which provides for the event of simultaneous death of both spouses. Section 4A(6) provide that, where the spouses die simultaneously, the person with the smallest net estate will be deemed to have died immediately prior to his or her spouse.

#### **4.8.1.5    *Transfer duty***

No transfer duty is payable on the transfer of property between spouses on termination of the marriage. In this regard section 9(1)(i) of the *Transfer Duty Act* provides that no transfer duty shall be payable in respect of the acquisition of property by a surviving or divorced spouse who acquires the sole ownership in the whole or any portion of property registered in the name of his or her deceased or divorced spouse where that property or portion is transferred to that surviving or divorced spouse as a result of the death of his or her spouse or dissolution of their marriage or union.

#### **4.8.2    *Protection of assets***

When it comes to tax planning, a person's marital *status* is relevant, but when it comes to the protection of assets, it is his marital *regime* that is of relevance.

The South African Matrimonial Property Law is governed by the *Matrimonial Property Act* (88/1984) (hereafter referred to as the *Matrimonial Property Act*) and effectively provides for marriages to be either out of community of property (Chapter I of the *Matrimonial Property Act*) or in community of property (Chapter III of the *Matrimonial Property Act*).

##### **4.8.2.1    *Marriages in community of property***

A marriage conducted without an antenuptial contract is automatically regarded as a marriage in community of property. This means that there is one joint estate that consists of all the assets and liabilities that both spouses had before and after entering into the marriage (Robinson *et al.*, 2009:129). The advantage of this system is that the spouses share in each other's financial prosperity. Unfortunately, this means that they also share in each other's financial misfortune and there is very little or no protection against one spouse irresponsibly wasting the assets of the joint estate.

Spouses married in community of property may, however, still retain separate estates consisting out of assets that fall out of the joint estate. Assets will be excluded from the joint estate in the following circumstances (Robinson *et al.*, 2009:141):

- Where an antenuptial contract contains a provision that excludes certain specified assets from the joint estate.

- Where a third party made a bequest or donation to one of the spouses, stipulating that such bequest or donation may not form part of the joint estate.
- Assets that are subject to a fideicommissum or a usufruct.
- Small gifts between spouses.
- Any benefit granted to a person in terms of Section 17 of the *Friendly Societies Act* (25/1956).
- Non-patrimonial compensation received by a spouse for a delict committed against him or her (section 18(a) of the *Matrimonial Property Act*).

Income from such excluded assets will, however, fall into the joint estate unless also explicitly excluded in the antenuptial contract, the will or the deed of donation (Cronje & Heaton, 2004:88). If these assets are sold or replaced, the monetary value thereof or the replacing assets will fall into the separate estate of that spouse (*Ex parte Lelie* 1945 WLD 167).

Where a spouse incurs a private debt on behalf of his or her own separate estate, the creditor can lay claim to the private estate of that spouse. If the separate estate is insufficient, the creditor can lay claim to the assets in the joint estate. The spouse who did not incur the debt would then have a right of recourse at the dissolution of the marriage. The creditor cannot claim from the separate estate of the spouse who did not incur the debt (Cronje & Heaton, 2004:89).

Where a spouse incurs a debt on behalf of the joint estate, the creditor can claim from either the joint estate or the separate estate of the spouse who has contracted the debt. The *Insolvency Act* (24/1936) makes no provision for the existence of separate estates as far as marriages in community of property are concerned and no protection is afforded to the separate estate of the other spouse (Robinson *et al.*, 2009:147). In *Badenhorst v Bekker NO en andere* 1994 (2) SA 155 (N) the court held that the assets that the wife inherited from her father, which were expressly excluded from the joint estate, could be used to pay the creditors of the insolvent joint estate.

#### **4.8.2.2 Marriages out of community of property**

A marriage conducted with an antenuptial contract will be out of community of property and any community of property and community of profit and loss will be excluded. This means that both spouses retain their own separate estates, consisting of all the assets and liabilities

they have obtained before and after entering into the marriage (Robinson *et al.*, 2009:130). However, every marriage out of community of property entered into after the commencement of the *Matrimonial Property Act* on 1 November 1984, will be subject to the accrual system, except in so far as the accrual system is expressly excluded by the antenuptial contract (Section 2 of the *Matrimonial Property Act*).

During the subsistence of the marriage, the consequences of a marriage out of community of property are the same irrespective of whether or not the accrual system applies. Each spouse has full capacity to act regarding his or her own separate estate and can conclude any transaction or juristic act without the consent or knowledge of the other spouse. The spouses cannot be held responsible for each others' debts and do not bear the risk of sharing each others' financial losses (Robinson *et al.*, 2009:130).

Only at the time of the dissolution of the marriage does the accrual system come into operation. Where the accrual system does not apply, a spouse that has been economically inactive and whose estate is smaller than that of the other spouse, will not share in the financial prosperity of the other spouse and may be seriously prejudiced despite the indirect contribution that he or she has made towards the growth of the other spouse's estate. This disadvantage is negated by the operation of the accrual system in terms of which the spouse whose estate has shown the smaller growth can share in the growth of the other spouse's estate. Such spouse has a claim against the other spouse for an amount equal to half of the difference between the accrual of the spouses' respective estates (Section 3(1) of the *Matrimonial Property Act*). The accrual is the amount by which the net value of a spouse's estate at the dissolution of the marriage exceeds the net value of his or her estate at the commencement of the marriage (Section 4(1)(a) of the *Matrimonial Property Act*).

The following amounts will, however, not be taken into account when calculating the accrual in a person's estate:

- Any amount which accrued to a spouse's estate by way of damages, other than damages for patrimonial loss (section 4(1)(b)(i) of the *Matrimonial Property Act*).
- Any asset which has been excluded from the accrual system in terms of the antenuptial contract, as well as any other asset which was acquired by virtue of the possession or former possession of such asset (section 4(1)(b)(ii) of the *Matrimonial Property Act*).

- Any inheritance, legacy or donation received by a spouse during the subsistence of the marriage, as well as any other asset which was acquired by virtue of the possession or former possession of such inheritance, legacy or donation, unless the spouses agree otherwise in their antenuptial contract or if testator or donor stipulates otherwise (section 5(1) of the *Matrimonial Property Act*).
- Any donation made by one spouse to the other (section 5(2) of the *Matrimonial Property Act*).

The accrual claim only arises at the dissolution of the marriage and the right of a spouse to share in the accrual of the estate of the other spouse is not transferable or liable to attachment during the subsistence of the marriage and does not form part of the insolvent estate of a spouse (Section 3(2) of the *Matrimonial Property Act*).

#### **4.8.2.3    *Trusts and matrimonial property planning***

One of the benefits of a trust is the protection of assets against insolvency, claims of creditors, divorce, claims of a former spouse or any other financial difficulty that a beneficiary may be faced with (Geach & Yeats, 2007:216).

Many trust deeds contain clauses that seek to ensure that trust benefits are excluded from any community of property or are not subject to any accrual or other claims on termination of marriage. Whether or not trust assets will be beyond the reach of claims of a spouse will depend on when the trust was formed, by whom the trust was formed and how the trust assets were controlled or otherwise dealt with after the trust has been formed (Geach & Yeats, 2007:222).

##### *(a) The formation of the trust*

If a trust is formed by a person who is about to be divorced and the sole purpose of the trust is to attempt to place assets beyond the reach of the claims of a spouse or a former spouse, it is likely that the formation of a trust will be seen as a deliberate attempt to conceal assets and to place them beyond the reach of a court that would decide upon an equitable distribution of assets. (Geach & Yeats, 2007:223).

Another reason why an attempt to conceal assets in a trust might be ineffective is the timing thereof and the lack of authority if the trust formation or the transfer of assets is conducted in

haste. In *Van der Merwe v Van der Merwe* 2002 (2) SA 519 (C) a husband who was getting divorced formed a trust and then proceeded to sell the family home to that trust while divorce proceedings were pending. The wife argued that the sale was void because the sale agreement had been entered into by the husband as trustee prior to him being authorised to act as such in terms of section 6(1) of the *Trust Property Control Act* (57/1988). The court held that the sale was void *ab initio*. The transfer of the property was declared void and the property deemed to still be owned by the husband who sought to sell it.

*(b) The manner in which trust assets are controlled*

The question whether assets that have been placed in a trust may be taken into account when dividing assets between spouses at divorce came under scrutiny in the cases of *Jordaan v Jordaan* 2001 (3) SA 288 (C) and *Badenhorst v Badenhorst* 2006 (2) SA 255 (SCA).

In the *Jordaan* case the parties were married out of community of property and, after the marriage has broken down, the wife instituted a divorce action and requested a redistribution order in terms of Section 7(3) of the *Divorce Act* (70/1979). The husband was a successful businessman who had built up a large estate during the marriage while the wife stayed at home and cared for their two children, one of whom was mentally handicapped. The husband had created several trusts and argued that the assets of these trusts should not be regarded as his property and should not be considered in the computation of the redistribution order. The court rejected this defence and emphasised that the manner in which the trusts had been used in the past was a very important factor. The court held that the trusts could be said to be the husband's alter ego and that they were merely structures and methods of ensuring financial advantages for him. The court therefore took the trust assets into account in determining the scope of the redistribution order.

In the *Badenhorst* case the parties were married out of community of property and the husband instituted an action for divorce. The wife lodged a counterclaim and applied for a redistribution order. The court held that the mere fact that the assets vest in the trustees of the trust, and not the husband's own personal estate, should not *per se* mean that such assets should not be included in the computation of the redistribution order. The trust deed should be perused and the manner in which the trust assets were handled should be investigated. If it is found that the husband controlled the trust and that, if it were not for the intervention of the trust, the husband would have owned such assets, the court can take

those assets into account in quantifying the redistribution order. In this case the husband was one of two trustees who possessed an unfettered discretion as to the administration of the trust. The husband seldom required authorisation or confirmation from the other trustee. He utilised the trust for business purposes and made no distinction between his own assets and those of the trust. As founder of the trust, the husband was empowered to vary the provisions of the trust deed and could remove and appoint trustees. These factors lead to the court deciding that the husband had *de facto* control of the assets and treated the trust as his alter ego.

In this regard Olivier *et al.* (2008: paragraph 6.4) emphasise that the court, in both these cases, did not find that any of the trust assets ought to be seen as the defendant's personal assets, or that any of the trust assets should be awarded to the wife. The trust assets were merely seen as part of the husband's assets in order to determine the quantum for the purposes of the redistribution order.

#### **4.8.3 Succession planning**

In paragraph 4.7.4 above it was mentioned that a person's marital status and matrimonial property regime is a distributive mechanism that will influence that manner in which his estate devolves at his death. The question whether or not a person is married and how he is married will directly influence the application of his will if he has a will and the application of the *Intestate Succession Act* if he does not have a will.

##### **4.8.3.1 Marital status and testamentary succession**

Freedom of testation is an important principle in the South African Law of Succession and a testator has the freedom to leave his assets to whoever he pleases (Corbett *et al.*, 2001:39). One of the exceptions to the principle of complete freedom of testation is contained in the *Maintenance of Surviving Spouses Act* (27/1990). Section 2(1) of this Act provides that a surviving spouse has a claim for reasonable maintenance needs against the estate of the first-dying spouse until the death or remarriage of the survivor insofar as the survivor is unable to provide for such maintenance.



#### **4.8.3.2 Testamentary succession and former spouses**

When a marriage is dissolved by way of a divorce, it is assumed that the former spouses intended to disinherit each other. Section 2B of the *Wills Act* (7/1953) provides that, if either spouse dies within three months after the divorce, his or her will shall be implemented in the same manner as it would have been implemented had the former spouse died before the divorce. This assumption is only valid for three months and if a person does not amend his will within three months after the dissolution of the marriage, his former spouse will inherit in terms of his existing will as if he intended to benefit her notwithstanding the dissolution of the marriage.

#### **4.8.3.3 Matrimonial property regime and testamentary succession**

A person married in community of property is only half owner of the joint estate. If a testator neglects this fact when drafting his will, it could result in serious maldivision and practical difficulties at the death of the first-dying spouse. When one spouse bequeaths a community asset to a person other than the surviving spouse, a joint ownership is created between the beneficiary and the survivor. This consequence may not have been contemplated and might require onerous procedures for rectification (Davis *et al.*, 2010: paragraph 8.2.1).

A person married out of community of property and subject to the accrual system will either have a liability in the form of an accrual claim against his estate or will have an asset in the form of an accrual claim against the estate of his spouse. Provision will have to be made for the said claim and cannot be disregarded when drafting a will. An oversight in this regard might result in the intended beneficiaries not receiving as much as they otherwise would have received.

#### **4.8.3.4 Intestate succession**

The *Intestate Succession Act* provides that, if a person dies without a will, and is survived by a spouse, but not by a descendant, such spouse will inherit the entire estate (Section 1(1)(a)). If a person is survived by a spouse as well as a descendant, such spouse will inherit the greater of a child's share of the deceased's estate or R125,000 (Section 1(1)(c)).

#### **4.8.4 Administration of the estate**

At the death of a person married in community of property, the executor will administer the entire estate and not only the deceased person's half share in the combined estate. The executor's remuneration will therefore be based on the value of the combined estate and not merely on the undivided share of the deceased spouse (Victor & King, 2010:291).

#### **4.9 SUMMARY**

It is clear that the estate planning process entails numerous tools and techniques aimed at achieving the wide range of estate planning objectives. One tool that stands out above the rest is the trust. Not only does the trust offer significant tax advantages (refer to Chapter 3), but it is also useful in achieving other estate planning objectives such as the protection of assets, succession planning, provision for dependents and minor children and facilitation of the administration process at death.

The trust, and more specifically the *inter vivos* trust, will therefore be discussed in more detail in Chapter 5.

## **CHAPTER 5**

### **THE TRUST AS AN ESTATE PLANNING TOOL**

#### **5.1 INTRODUCTION**

In Chapter 2 the concept of “estate planning” was summarized as a continuous process through which a person accumulates assets and manages his financial affairs in order to increase, preserve and protect those assets for the maximum benefit during his lifetime and to provide for the disposition and continued utilisation thereof after his death. There are various tools and techniques that are used to achieve the different estate planning objectives. The future use of a trust as such tool was questioned in Chapter 1. Chapter 3 focused on the different tools and techniques used to minimise and avoid tax and Chapter 4 focused on the tools and techniques used to achieve other (non-tax related) objectives of estate planning. In both these chapters, the trust featured quite prominently in achieving several of the objectives of estate planning.

Before the question regarding the future use of trusts can be addressed, a discussion on trusts is warranted. This chapter will therefore focus on the concept and background of trusts in South African Law as well as the application and benefits of the trust as an estate planning tool. Secondary objective four (paragraph 1.3.2.4) – researching the trust as an estate planning tool – is discussed here.

#### **5.2 BACKGROUND**

##### **5.2.1 The origin and development of trusts in South Africa**

The basic idea of holding property as owner, not for own benefit, but for the benefit of another can be observed throughout legal history in various customs and transactions, such as the “*fideicommissum purum*” and “*stipilatio alteri*” in the Roman law, the “Treuhand” in the Germanic law and the “Use” in English Law (Victor & King, 2010:349). Amongst ancient people, this concept, in one form or another, was known to the Egyptians, Greeks, Japanese, Indians, Burmese, Arabs, Romans and the Germanic tribes (Olivier *et al.*, 2008: paragraph 1.3.2). It is, however, widely accepted that the trust concept is an English law creation that found its way into South African law after the British settlement in South Africa in the Nineteenth Century (Olivier *et al.*, 2008: paragraph 1.3.1).

#### **5.2.1.1    *The testamentary trust as a fideicommissum purum***

British settlers would incorporate trusts by using the words “trust” and “trustees” in their wills, their deeds of gifts, their antenuptial contracts and their transfers of land. This went on for about a century before the courts (in *Estate Kemp v McDonald’s Trustee* 1915 AD 494) were called upon to decide whether the South African law could and should give legal effect to a South African trust, and, if so, upon what basis (Corbett in Wiechers & Roos (eds.), 1993:3).

This was the first South African case on the validity of a trust and both the Appellate Division and the Cape Provincial Division (*Estate Kemp v McDonald’s Trustee* 1914 CPD 1084) were adamant that the English law of trusts formed no part of our jurisprudence and had not been adopted by our courts. Both courts were also of the view that, from a legal policy point of view, it was necessary that a testamentary disposition expressed in the form of a trust, should be accommodated and given effect to by our law. Solomon JA explained it as follows (at 507-508):

“the constitution of trusts and the appointment of trustees are matters of common occurrence in South Africa at present day. Thus it is a recognised practice to convey property to trustees under antenuptial contracts; trustees are appointed by deed of gift or by will to hold and administer property for charitable or ecclesiastical or other public purposes; the property of limited companies and other corporate bodies is vested in trustees and the term is used in a variety of other cases, as, eg, in connection with assigned or insolvent estates. The underlying conception in these and other cases is that while the legal *dominium* of property is vested in the trustees, they have no beneficial interest in it but are bound to hold and apply it for the benefit of some person or persons or for the accomplishment of some special purpose. The idea is now so firmly rooted in our practice, that it would be quite impossible to eradicate it or to seek to abolish the use of the expression trustee, nor indeed is there anything in our law which is inconsistent with the conception.”

The difficulty which confronted the court, however, was to find an appropriate legal niche in which to place the South African trust. Solomon JA did not attempt to translate the English terms in the will under consideration into the language of Roman-Dutch law and simply accepted that legal effect had to be given to the intention of the testator and that such a trust would be recognised and enforced by South African Courts. Innes CJ and Maasdorp JA (at 501-503), on the other hand, used the *fideicommissum purum* as the means to accommodate or classify what the testator had devised.

The following arguments were, however, raised against the equation of the *fideicommissum purum* with a testamentary trust (Honoré & Cameron, 1985:42-48):

- Under the *fideicommissum purum* the *fiduciarius* was bound to immediately convey the trust property that he received to the *fideicommissary*. This is not the case with a trust and there is no such obligation on the trustee.
- A trust beneficiary's interest can also be of a fiduciary nature. It can be confusing to call both the trustee and a beneficiary a *fiduciarius*.
- A trustee holds a public office from which he can be dismissed. A *fiduciarius* is merely a private owner who has to deliver property to someone else.
- While the *fiduciarius* holds a beneficial interest in the use and fruits of the property, the trustee holds a mere administrative interest in the property.
- Testamentary trusts should be enforced on the basis of the wishes of the testator without reliance on the *fideicommissum* concept. Otherwise it would force the trust institution into a mould never intended for it, and would contaminate principles relating to *fideicommissa* and freedom of testation.

These arguments were satisfied when the Appellate Division rejected the equation of the *fideicommissum purum* with a testamentary trust as untenable in *Braun v Blann and Botha* 1984 (2) SA 850 (A) (at 866). In this case the court held (at 860A-861H) that a testamentary trust is not a form of *fideicommissum* if the trustees have no beneficial interest in the trust property and that it is an institution *sui generis* (being a class of its own).

#### **5.2.1.2 The *inter vivos* trust as a *stipulatio alteri***

The landmark cases concerning *inter vivos* trusts are *CIR v Estate Crewe* 1943 AD 656, *CIR v Smollen's Estate* 1955 (3) SA 266 (A) and *Crookes and Another v Watson and Another* 1956 (1) SA 277 (A). In dealing with the issues in the first two cases, which primarily dealt with questions of death duty, the court also had to characterise a trust deed and the rights of the parties under it. In both cases the court treated the trust as a *stipulatio alteri* (which is a contract for the benefit of a third party). In these cases, as in the case of *Estate Kemp v McDonalds Trustees*, it was emphasised that the English law of trusts formed no part of South African Law. There was no reason why the problems presented by trusts created *inter vivos* could not be solved by the application of the Roman Dutch law principles of contract (Corbett in Wiechers & Roos (eds.), 1993:5).

One of the legal effects of a *stipulatio alteri* is that the original founder may, with the agreement of the trustee, revoke the original settlement, provided the third party has not yet accepted the benefits (Victor & King, 2010:351). This means that, prior to acceptance of any benefits by a beneficiary, the trust would be susceptible to a variation, or even a cancellation, agreed to by all the other interested parties. This, however, is in conflict with the English common law, where the rule is that once a trust is completely constituted it is generally binding and irrevocable in the absence of an express power of revocation (Honoré & Cameron, 1985:418).

The immediate issue in the third case, *Crookes and Another v Watson and Another* 1956 (1) SA 277 (A), was whether a trust could be revoked in the absence of an express right of revocation and where not all the beneficiaries had consented. As the case developed on appeal, the court was confronted with the issue of the juristic nature of a trust *inter vivos* in our law. The majority, consisting of Centlivres CJ, Van den Heever JA and Steyn JA, favoured the retention of the *stipulatio alteri* as the juridical foundation for *inter vivos* trusts in South Africa and held that the founder and trustee could cancel the contract before the third party had accepted the benefits conferred on him under the trust. The minority, consisting of Schreiner JA and Fagan JA, were not in favour of identifying the trust *inter vivos* with the contract for the benefit of a third party and voiced various objections to a founder and a trustee being permitted to cancel or amend the trust prior to acceptance by the beneficiary. Schreiner JA (at 290D) held that –

“our modern law of trusts should not be unduly hampered by views regarding its association with other branches of our own law which may not be historically justified and which, in any event, should not govern, though they may sometimes assist the development of the law of trusts”.

He also warns (at 291A) that –

“Care must be exercised not to force a legal instrument of great potential, efficiency and usefulness into a mould that is not properly shaped for it”.

The critics at the time tended to side with the minority point of view (Corbett in Wiechers & Roos (eds.), 1993:8), but the notion of the *inter vivos* trust being a *stipulatio alteri* has been accepted in subsequent cases, and is now well entrenched in our jurisprudence. The Supreme Court of Appeal very recently (on 30 September 2011) again confirmed this principle in *Potgieter v Potgieter* 2011 ZASCA (181) where Brand JA summarised the legal principles in this regard as follows:

“I believe these principles can be formulated thus: a trust deed executed by a founder and trustees of a trust for the benefit of others is akin to a contract for the benefit of a third party, also known as a *stipulatio alteri*. In consequence, the founder and trustee can vary or even cancel the agreement between them before the third party has accepted the benefits conferred on him or her by the trust deed. But once the beneficiary has accepted those benefits, the trust deed can only be varied with his or her consent. The reason is that, as in the case of a *stipulatio alteri*, it is only upon acceptance that the beneficiaries acquire rights under the trust”

According to Honorè and Cameron (1985:26) the identification of the *inter vivos* trust with the *stipulatio alteri* does not mean that the trust is a contract or a species of contract. It merely means that problems relating to the formation and revocation of *inter vivos* trusts can be solved by reference to the law of contract.

### **5.2.2 The Trust Property Control Act**

Although, after the landmark decisions mentioned above, the broad outline regarding the assimilation and accommodation of the trust idea in our jurisprudence was reasonably clear, much of the detail remained relatively obscure. There was uncertainty about the precise legal relationship between the trustee and the trust property committed to his administration, what was to happen on the insolvency of the trustee, what powers and duties did the trustee have, the legal nature of the trust, the vesting of beneficiaries' rights to trust property, the powers of the court to vary and administer trusts and many more (Corbett in Wiechers & Roos (eds.),1993:9).

Over the years these topics have to some extent been dealt with by judicial decision, but in the 1980's a feeling arose that some of these issues raised intractable problems and that the intervention of the legislator was needed. In April 1983 the South African Law Commission published a working paper which identified some of the shortcomings in the law of trusts, discussed them and produced a draft bill designed to remedy the shortcomings. This working paper was circulated and comments were received from various sources. These comments were considered and assimilated by the Law Commission, which in June 1987 published a report reviewing the law of trusts and containing a modified draft bill. Parliament passed the *Trust Property Control Act* (57/1988) (hereafter referred to as “the *Trust Property Control Act*”), which came into operation on 31 March 1989. (Corbett in Wiechers & Roos (eds.),1993:9)

This was a major landmark in the evolution of South African trust law and was favourably received. In this regard Honorè and Cameron (1985:Introduction) stated that the drafting of this Act deserves high praise and that it –

“...rightly makes no attempt to codify the South African law of trusts. Instead it contributes to its development as a distinctive body of trust law by settling certain important issues which were in dispute...”

### **5.2.3 The definition of a “trust”**

Section 1 of the *Trust Property Control Act* defines a trust as –

“the arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed –

- (a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or
- (b) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument,

but does not include the case where the property of another is to be administered by any person as executor, tutor or curator in in terms of the provisions of the *Administration of Estates Act* (66/1965).”

The term “trust instrument” which is used in the above definition, is also defined in section 1 of the Act as –

“a written agreement or a testamentary writing or a Court order according to which a trust was created.”

From this definition it is clear that a trust can either be established by way of a written agreement between the founder and trustee(s) or by way of a testamentary writing in the will of the founder. This leads to the classification of trusts as either *inter vivos* trusts or *mortis causa* trusts (also known as testamentary trusts). Paragraph 5.2.4 will deal with the classification of trusts.



#### **5.2.4 Classification of trusts**

Trusts can be categorised in a number of different ways, depending on the factors or criteria taken into account when making the classification. These factors include the way in which the trust was established, the rights of the beneficiaries and ownership of the trust assets. These will now be discussed separately.

##### **5.2.4.1 *The way in which the trust was established***

If the trust was established by way of a written instrument during the founder's lifetime the trust is classified as an *inter vivos* trust. If the trust was established at the death of the founder in terms of his will, the trust is classified as a *mortis causa* trust (also known as a testamentary trust) (Victor & King, 2010:354).

##### **5.2.4.2 *Ownership of the trust assets***

In this regard a trust can be classified as either a trust in the strict sense or a trust in the wide sense (better known as a bewind trust) (Geach & Yeats, 2007:18).

In the case of trust in the strict sense, all the assets, liabilities, rights and duties regarding the trust vest in the trustee(s) in his/their official capacity. The trustees are the owners and administrators of the trust assets, but do not acquire any beneficial rights or other benefits (as trustee) in respect of those assets (Geach & Yeats, 2007:19).

A bewind trust, on the other hand, is a trust where the real rights of ownership of the trust assets vest in the beneficiaries and not in the trustee(s). Only the management, control and administration of the trust assets vest in the trustee(s) (Victor & King, 2010:355) who hold the assets on behalf of the beneficiaries (Geach & Yeats, 2007:19). This trust is usually used where a beneficiary who has some limitation, such as lack of contractual capacity or is suffering from some mental or physical disability, needs to be protected and provided for.

A critical difference between a trust in the strict sense and a bewind trust is that, in the case of a bewind trust, the trust assets may be exposed to the claims of a beneficiary's creditors, and could therefore be at risk in the event of insolvency, divorce or other mishap suffered by the beneficiary (Geach & Yeats, 2007:19). When the beneficiary of a bewind trust dies, ownership is included in his estate for estate duty purposes, and the asset itself is

transmissible to his heirs, either subject to trust conditions or unconditionally, depending on the terms of the trust deed (Victor & King, 2010:355). This is not the case with trusts in the strict sense. With a trust in the strict sense the assets are owned by the trustees, and the rights of a beneficiary will depend on the terms of the trust deed and/or on the decisions of the trustees (Geach & Yeats, 2007:19).

#### **5.2.4.3    *The rights of the beneficiaries***

Another important method of distinguishing trusts is based on the rights of the beneficiaries. A beneficiary can have any number and a variety of rights, depending on the terms and conditions of the trust deed or upon the manner in which the trustees have (or have not) exercised their discretion in favour of a beneficiary. The most common classifications of beneficiaries' rights are those between income rights and capital rights and also between discretionary rights and vested rights (Geach & Yeats, 2007:19).

##### *(a)    Income rights versus capital rights*

Income beneficiaries can only be awarded income of a trust whereas capital beneficiaries can only receive the capital of the trust (Geach & Yeats, 2007:22). A beneficiary may, however, have a combination of rights or be a beneficiary entitled to both the income and the capital of the trust (Geach & Yeats, 2007:20).

##### *(b)    Discretionary rights*

A discretionary right has the nature of a contingent right or a *spes* or hope. If the trustees exercise their discretion in favour of a beneficiary with a discretionary right, that beneficiary will benefit to the extent that the discretion has been exercised in their favour. However, until the trustees have exercised their discretion, the beneficiary only has a hope to receive some benefit in the future (Geach & Yeats, 2007:20).

In the case of a discretionary trust, the beneficiaries only have discretionary rights and not vested rights. Any income or capital that such a beneficiary may receive is determined purely in the discretion of the trustees (Botha *et al.*, 2011:791).

This structure is the most effective structure from an estate planning point of view as the assets of the trust do not form part of the beneficiary's estate and is thus protected against

taxes and expenses in the event of death and against creditors in the event of insolvency (Victor & King, 2010:355).

(c) *Vested rights*

A vested right is a personal right which, unlike a contingent right, gives a beneficiary an expectation to receive a benefit and not just a mere hope to receive a benefit.

In the case of a vested trust, the ownership and control of the trust assets vests in the trustees on behalf of the trust, and the beneficiaries have a personal right to call on the trustees to deliver the benefit that is the subject matter of that right (Geach & Yeats, 2007:21).

Due to the fact that a beneficiary with a vested right has an absolute right to claim a benefit, such benefit will form part of his estate in the event of death and will be subject to expenses and taxes payable at death (Victor & King, 2010:355) and will also be subject to the claims of creditors and be exposed to risk in the event of insolvency or financial misfortune (Geach & Yeats, 2007:22).

### **5.2.5 The nature of trusts**

The legal nature of a trust in South Africa is a difficult aspect to grasp. The position at common law is that a trust is not a separate legal person (Corbett in Wiechers & Roos (eds.), 1993:12) and the courts have consistently refrained from clothing trusts with legal personality (Victor & King, 2010:358). In *CIR v MacNeillie's Estate* 1961 (3) SA 833 (A) the Appeal Court held that a trust is not a separate legal person and that "neither our authorities nor our Courts have recognised it as such a persona or entity" (at [840G]).

Notwithstanding the common law position and the decision of the Appeal Court, in practice the trust is very often, and for many reasons, treated as a separate legal person (De Waal in Wiechers & Roos (eds.), 1993:25). It is also by statute that a notional legal personality is often ascribed to trusts (Corbett in Wiechers & Roos (eds.), 1993:12). These practical and statutory "exceptions" to the common law rule, will now be discussed separately.

#### **5.2.5.1 The taxation of trusts**

In *Friedman v CIR: Phillip Frame Will Trust* 1991 (2) SA 340 (W) the court had to deal with the question of whether a trust can be classed as a “person” for purposes of the *Income Tax Act* (58/1961). The court found that a trust is not a person and that the trustee cannot be the responsible representative of the trust for purposes of levying income tax. Shortly after this decision the legislature intervened and retrospectively amended the definition of “person” in order to also include a trust (section 2(1)(d) of the *Taxation Laws Amendment Act* 129 of 1991). The implication of this was that trusts attained legal personality for income tax purposes and became taxable for all undistributed income (Victor & King, 2010:359). The same applies to capital gains tax and donations tax which are also regulated by the *Income Tax Act* (58/1961).

The definition of “person” in the *Transfer Duty Act* (40/1949) and the *Value-Added Tax Act* (89/1991) also deems a trust to be a person for purposes of levying these taxes. This is, however, not the case with the *Estate Duty Act* (45/1955) which does not contain any provision deeming a trust to be a person.

#### **5.2.5.2 Corporate law principles**

Despite the fact that a trust is not a separate legal entity, various corporate law principles have been applied by the courts in cases involving trusts. The decision in *Knoop NO v Birkenstock Properties (Pty) Ltd* [2009] ZAFSHC 67 had the effect that a trust is a legal person with a “corporate veil” which can be “pierced”. A more recent case (*Van der Merwe NO v Hydraberg Hydraulics; van der Merwe NO v Bosman CC* [2010] ZAWCHC 129, 2010 (5) SA 555 (WCC)) had a similar effect when the court held that the matter at hand would have been an appropriate case to have disregarded the veneer of the trust form. In the particular circumstances of this case, however, it was not practically possible to disregard such veneer as the peremptory requirements of the *Alienation of Land Act* (68/1981) could not be ignored. The court expressed its willingness to disregard the relevant trust’s status as a legal entity but reluctantly concluded that such an order could not be made in this case.

Another corporate law principle that has been applied to trusts is the “Turquand rule”. The Turquand rule was originally laid down in *Royal British Bank v Turquand* (1856) 119 ER 886 and was accepted in the South African company law in cases such as *The Mineworkers’ Union v Prinsloo* 1948 3 SA 831 (A) and *Big Dutchman (South Africa) (Pty) Ltd v Barclays*

*National Bank Ltd* 1979 2 SA 267 (W). In terms of this rule an innocent third party who contracts with a company may assume that all internal formalities have been complied with (Honiball & Olivier, 2009:437). The company will therefore be bound by the contract even if the internal formalities have not been complied with (De Waal & Schoeman-Malan, 2003:160). In *Man Truck and Bus Ltd v Victor* 2001 (2) SA 562 (NKA) a trustee bound the trust as surety for the debts of another trust. The deed of surety was signed without the consent of the other trustee and without the trust deed authorising the trustees to stand surety. The court held that the trust was liable on the basis of the Turquand rule making this rule applicable to trusts. This decision was again applied in *Vrystaat Mielies (Pty) Ltd v Nieuwoudt* 2003 (2) SA 262 (OPA), but on appeal (*Nieuwoudt v Vrystaat Mielies (Pty) Ltd* 2003 JOL 12151 (SCA)) the court refused to express a view on the applicability of the Turquand rule. In *Land and Agricultural Bank v Parker* 2005 (2) SA 77 (SCA) the court expressed an *obiter* view that the Turquand rule “may well in suitable cases have a useful role to play in securing the position of outsiders who deal in good faith with trusts that conclude business transactions” (at [86B]).

Notwithstanding the common law position and the view of the courts that a trust is not a separate legal entity, a notional legal personality is often (as in the case with the taxation legislation mentioned in 5.2.5.1 above) ascribed to trusts by way of statute. In this regard it is interesting to note that the *Companies Act* (71/2008), which came into effect on 1 May 2011, now expressly includes a trust in the definition of “juristic person” in section 1. This means that, for purposes of this Act, a trust will be seen as a juristic person.

### **5.2.5.3 Registration of trust property**

The practice concerning the registration of trust property does not reflect the theoretical view that a trust is not a separate legal person. This can be seen in the way in which immovable property is transferred and registered in the deeds office as well as in the way in which certain movable assets are registered in the name of a trust (De Waal in Wiechers & Roos (eds.), 1993:18).

#### **(a) Immovable property**

When it comes to testamentary trusts, section 40(1)(b) of the *Administration of Estates Act* (66/1965) provides that, if a trustee has been appointed to administer any property of a deceased person under his will, the executor shall

“cause the terms of the will, or a reference thereto, in so far as they relate to the administration, to be endorsed against the title deeds of such of the property as is immovable, and against any mortgage or notarial bond forming part of the property, and deliver the title deeds and any such bond [...] to the trustee.”

Such an endorsement has the effect that the ownership is transferred to the trustee.

When it comes to *inter vivos* trusts, registration is either done in the name of “the trustees for the time being” or in the name of the trust itself (Honoré & Cameron, 1992:228). Both these methods result in the trust being treated as a separate legal entity.

*(b) Movable property*

The practice of treating a trust as a separate legal entity for registration purposes also occurs outside the context of immovable property. In this regard there are two examples worth mentioning. The first is the registration of shares in an unlisted company which is often registered in the name of the trust (De Waal in Wiechers & Roos (eds.), 1993:19). The second is the provisions of section 4 of the *Financial Institutions (Investment of Funds) Act* (39/1984) which provides that a director or officer of a financial institution, who invests trust property on behalf of a client, can register such investment in the name of the relevant trust.

**5.2.5.4 Insolvency of a trust**

When looking at the theoretical construction of the trust, one would imagine that the consequences of insolvency in the context of trusts will be quite predictable (De Waal in Wiechers & Roos (eds.), 1993:20). With regards to the insolvency of the trustee, one would expect the assets of the trust to form part of the insolvent estate of that trustee (as the owner of the assets). Because a trust is not a separate legal entity, one would expect that a trust cannot be insolvent. Neither of these predictions would, however, be correct.

Section 12 of the *Trust Property Control Act* expressly provides that trust property shall not form part of the personal estate of the trustee except in so far as he, as trust beneficiary, is entitled to the trust property. This means that, in the event of the insolvency of a trustee, the assets of the trust will not form part of his insolvent estate.

With regards to the question as to the insolvency of a trust one cannot simply assume that a trust's lack of legal personality will protect a trust against insolvency. In *Magnum Financial*

*Holdings (Pty) Ltd (in Liquidation) v Summerly and another NNO* 1984 (1) SA 160 (W) the court had to decide whether a trust can be sequestrated in terms of the provisions of the *Insolvency Act* (24/1936). This would only be possible if the trust could be enveloped under the definition of “debtor” in section 2 of the said Act. The court mentioned that a trust is able to possess an estate, borrow money and incur liabilities, and held (with reference to *Ex parte Milton* 1959 (3) SA 347 (SR)) that a trust “is a debtor in the usual sense of the word” and accordingly susceptible of sequestration (at [163A-B]).

#### **5.2.5.5 Inheritance by a trust**

Given the fact that a trust is not a separate legal entity, the question arose in *Burnett v Kohlberg* 1984 (2) SA 134 (OK) whether a testamentary disposition to an *inter vivos* trust was valid. In its decision, which was confirmed by the Appeal Court (*Kohlberg v Burnett* 1986 (3) SA 12 (A)), the court held that such bequest was not improper and that: (at [142E-F])

[...] although a trust cannot strictly be a beneficiary under a will, a bequest can be made to a trustee *qua* trustee for the benefit of an existing trust and he can adiate in favour of the “separate entity” which is the trust estate. It makes no difference if the bequest is to the trust and not to the trustee so long as the intention is clearly to benefit the trust, which can only happen if the trustee takes the property.

#### **5.2.5.6 Summary**

It is ironic that one of the greatest benefits of a trust, being its complexity and flexibility, is also the cause of great uncertainty regarding the exact legal nature thereof. The disparity between theory and practice further contributes to this uncertainty. In an analysis regarding this disparity and the fact that the trust has been treated as a separate legal person by legislation, court decisions and trust practice one might conclude that there seems to be a movement towards awarding the trust with legal personality.

#### **5.2.6 Parties to a trust**

There are different parties involved in setting up, administering and managing a trust. These parties can broadly be classified as the planner, the founder, the trustees, the beneficiaries and the Master.

#### **5.2.6.1 The planner**

The planner is the person who wants to use a trust for some purpose and who initiates its formation (Geach & Yeats, 2007:52). In practice, the planner is often also the founder or at least a trustee and is therefore seldom a separate or additional party to a trust.

#### **5.2.6.2 The founder**

The founder (also known as the donor or settlor) is the person who establishes the trust (Botha *et al.*, 2011:794). The founder of an *inter vivos* trust can be a natural person or a legal person and there need not only be one founder. Any person who is able to enter into a contract can create an *inter vivos* trust, and anyone who is competent to make a will can create a testamentary trust (Olivier *et al.*, 2008: paragraph 2.2.1). The founder appoints the trustees and specifies who the beneficiaries are (Victor & King, 2010:352). It must be clear that the founder intended to create a trust and to transfer or bequeath assets to the trustees (Geach & Yeats, 2007:59).

The founder can also be a trustee and/or a beneficiary of the trust (*Pretorius v CIR* 1986 (1) SA 238 (A) and *Goodricke & Son (Pty) Ltd v Registrar of Deeds, Natal* 1974 (1) SA 404 (N)). However, since a person cannot contract with himself, the founder cannot be the sole first trustee of a trust (Geach & Yeats, 2007:59).

#### **5.2.6.3 The trustees**

A person is appointed as trustee in terms of a trust deed (Geach & Yeats, 2007:59). In the absence of any provisions in the trust instrument relating to the appointment of trustees, the Master is required, in terms of section 7 of the *Trust Property Control Act*, to appoint a trustee. An appointed trustee must accept such appointment and be authorised, in terms of section 6 of the *Trust Property Control Act*, by the Master to act as trustee. The Master authorises a trustee by issuing written letters of authority and any actions taken prior to such authorisation cannot be ratified retrospectively (*Simplex v Van der Merwe* 1996 (1) SA 111 (W) and *Van der Merwe v Van der Merwe* 2000 (2) SA 519 (K)).

By being appointed as trustee, by acceptance and by subsequently being authorised by the Master to act, a person assumes all the duties and obligations attaching to the office of trustee, and is obliged to take an active part in the affairs of the trust (Geach & Yeats,



2007:60). There are onerous duties on trustees and they must comply with the provisions of both the trust deed and the *Trust Property Control Act*. In exercising their duties, trustees have to act with the “care, diligence and skill which can reasonably be expected of a person who manages the affairs of another” (section 9(1) of the *Trust Property Control Act*).

Although a trustee is the owner of trust property, the trustee cannot be held personally liable for the debts of the trust (*Ehrlich v Rand Cold Storage & Supplies* 1911 TPD 170) and the trust property does not form part of the trustee’s personal estate except in so far as he is entitled to the trust property as a beneficiary (section 12 of the *Trust Property Control Act*).

#### **5.2.6.4 The beneficiaries**

The essence of a trust is that trustees hold trust assets on behalf of beneficiaries or on behalf of some impersonal object (such as a charity). A trust without a named or ascertainable beneficiary or without an impersonal object is a nullity (Olivier *et al.*, 2008: paragraph 4.1). Named beneficiaries are those whose names are quoted in the trust deed. Ascertainable beneficiaries refer to those beneficiaries who can be elected from a well-defined class of persons (Olivier *et al.*, 2008: paragraph 2.2.3).

The *Trust Property Control Act* does not define a beneficiary and the nature, number and rights of beneficiaries are accordingly determined by reference to the trust deed. Generally speaking, the rights that a beneficiary has are not real rights but merely personal rights (Geach & Yeats, 2007:115).

The identification and nomination of beneficiaries is usually done in terms of the express provisions of the trust deed. Some trust deeds authorise the trustees to identify a new beneficiary or to add to the class of beneficiaries or nominate additional beneficiaries (Geach & Yeats, 2007:62). When it comes to testamentary trusts, however, the trustees cannot have the power to identify, nominate or add to the list of beneficiaries as this will amount to a delegation of testamentary power, which is not permitted by law (*Braun v Blann and Botha* NNO 1984 (2) SA 850 (A)).

Any person, born or still to be born, can be a beneficiary of a trust. The founder of a trust and a trustee, in his personal capacity, can also be beneficiaries. Even legal persons and the trustees of another trust can be beneficiaries of a trust (Olivier *et al.*, 2008: paragraph 4.1).

#### **5.2.6.5    *The Master***

The *Trust Property Control Act* bestows certain responsibilities, duties and powers in relation to trusts upon the Master of the High Court. These include the power to authorise trustees to act as trustees (section 6(1)), the power to require security (section 6(2)), the power to call upon a trustee to account to the Master to the Master's satisfaction and in accordance with the Master's requirements for the trust's administration and disposal of trust property (section 16) and the power to appoint (section 7) or remove (section 20) trustees.

The allocation of a registration number by the Master to a document that purports to create a trust does not confirm that a valid trust has been created. The Master is not empowered to approve or reject any document that purports to create a trust and is not required to scrutinise a trust instrument to establish whether or not the document contains the essentials for the creation of a valid trust (Geach & Yeats, 2007:35). It is up to the founder and the trustees to ensure that these essentials (which will be discussed in 5.2.7 below) are present and that the instrument they created is in fact a valid trust.

#### **5.2.7    Essential elements of a trust**

Based on the provisions of the *Trust Property Control Act* that apply to the formation of a trust, common law principles and good business practice, the following requirements are essential for creating a valid trust:

- Intention to create a trust and the imposition of an obligation
- Capacity to create a trust
- Transfer of trust assets
- Acceptance by trustees
- Appointment and authorisation of trustees
- Separation of enjoyment from ownership
- The trust object must be well defined and certain
- The trust object must be lawful
- Beneficiaries must be identifiable

##### **5.2.7.1    *Intention to create a trust and the imposition of an obligation***

There must be an intention by the founder to create a trust, and this intention must be expressed in a way that imposes an obligation on the trustees (Geach & Yeats, 2007:38).

The obligation must be to administer assets for the benefit of the trust beneficiaries in accordance with the terms and conditions of the trust deed (*Goodricke & Son (Pty) Ltd v Registrar of Deeds, Natal* 1974 (1) SA 404 (N)).

#### **5.2.7.2 Capacity to create a trust**

In the case of an *inter vivos* trust, the founder must have contractual capacity and be capable of entering into a contract. In this regard it is important to note that a person cannot contract with himself and that the founder cannot be the sole first trustee of a trust (Geach & Yeats, 2007:38). In the case of a testamentary trust, the founder must be capable of making a will. Any person of sixteen years or older can make a will provided the person is mentally capable of doing so and appreciates the nature and effect of his actions (section 4 of the *Wills Act* (7/1953)).

#### **5.2.7.3 Transfer of trust assets**

There must be a making over or bequest of assets to at least one trustee. Where the founder of an *inter vivos* trust makes a nominal amount available in order to establish the trust, it is important that this amount is actually received and banked by the trustee(s). Although the amount may be nominal, it is the act of making over assets to the trustees, and the trustees accepting these assets that actually forms the trust (Geach & Yeats, 2007:38).

In this regard it is important to note that the *Trust Property Control Act* requires trustees to deposit any money received by them in a separate trust account at a banking institution (section 10). The trustees are therefore required to open a separate bank account for the trust (Geach & Yeats, 2007:46).

#### **5.2.7.4 Acceptance by trustees**

There must be a formal acceptance by trustees of the assets that are made over or bequeathed on the formation of the trust. The trustees must accept the assets and the terms and conditions in accordance with which these assets, and future trust assets, will be administered, invested and distributed (Geach & Yeats, 2007:38).

#### **5.2.7.5 Appointment and authorisation of trustees**

As was mentioned above (in 5.2.6.3), the trustees are appointed by the founder in terms of the trust deed. After acceptance of their appointment, the trustees must still be authorised by the Master in terms of section 6 of the *Trust Property Control Act* to act as trustees.

#### **5.2.7.6 Separation of enjoyment from ownership**

If a founder or planner does not separate enjoyment from ownership and retains control over the assets of the trust and enjoys it as his own property, those assets will be regarded as his own assets and the courts will not hesitate to look through the trust as if it does not exist.

In *Land Agricultural Bank of South Africa v Parker* 2005 (2) SA 77 (SCA) the court stressed the importance of separation between control and enjoyment and stated that, in appropriate cases, the courts will ensure that the trust form is not abused. In *Badenhorst v Badenhorst* 2006 (2) SA 255 (SCA) the same court stated that, while the legal control of a trust is in the hands of the trustees, the founder very often appoints close relatives or friends who are either supine or do the bidding of their appointer and that in reality, the founder controls the trust. The court held that, in these cases, the trust could be seen as the alter ego of the founder and the assets could be regarded as those of the founder.

If a person moves assets to a trust while retaining control and having beneficial ownership, the assets allegedly vesting in the trustees will be treated as belonging to the person or persons who control and benefit from those assets. A trust that is controlled in this way runs every risk of being disregarded as a trust, and all the protection and other benefits of holding assets in trust will be lost (Geach & Yeats, 2007:40).

#### **5.2.7.7 The trust object must be well defined and certain**

The object or purpose of the trust should be stated in the trust deed (Geach & Yeats, 2007:42). This can have a direct impact in deciding whether or not a trustee acted within his powers and, since the trustee cannot have powers contrary to the stated objective, this may well result in the protection of trust assets (Geach & Yeats, 2007:44).

#### **5.2.7.8 The trust object must be lawful**

This requirement is self-evident and a trust deed cannot contain clauses that are *contra bonos mores* or against common law or legislative provisions (Victor & King, 2010:356). An interesting example is found in the *Minister of Education v Syfrets Trust Ltd* 2006 (10) BCLR 1214 (CC) where the Constitutional Court ordered the deletion of discriminatory words in a trust deed where only students of European descent, not of Jewish descent and not female were entitled to bursaries from the trust fund.

#### **5.2.7.9 Beneficiaries must be identifiable**

The beneficiaries of the trust must be ascertained, defined or ascertainable, or the impersonal object of the trust must be clearly defined. A trust without a beneficiary or impersonal object is a nullity (Geach & Yeats, 2007:44). It is, however, possible to allow the trustees of an *inter vivos* trust to choose beneficiaries from an appointed, well defined set or class of beneficiaries (Victor & King, 2010:356).

#### **5.2.7.10 Formalities relating to the making of a valid Will**

In the case of testamentary trusts, the formalities relating to the making of a valid Will in section 2 of the *Wills Act* (7/1953) must be complied with. The testator must show that it is his intention to create a trust and must clearly identify the property that is to be the subject matter of the trust. The testator must also state, with sufficient clarity, who the beneficiaries of the trust are or the objects for which the trust is constituted (Geach & Yeats, 2007:46). The testator should be careful not to delegate his testamentary power by leaving the selection of the persons or objects to be benefited by the trust, in the unfettered discretion of the trustees (*Braun v Blann and Botha NNO* 1984 (2) SA 850 (A)).

### **5.3 THE USE, USEFULNESS AND BENEFITS OF TRUSTS**

#### **5.3.1 Introduction**

The different techniques used to achieve the various objectives of estate planning as set out in Chapter 2 were discussed in Chapters 3 and 4 above. Chapter 3 focused on the techniques used in the minimisation of tax and Chapter 4 focused on the techniques used in achieving the remaining objectives of estate planning. In both these chapters the trust

featured quite prominently as a means of achieving different estate planning benefits. This paragraph will revisit those chapters and focus on the trust as an estate planning tool and the uses and benefits of trusts in estate planning.

### **5.3.2 Tax planning benefits**

The trust is eminently suitable for the purpose of protecting a person's estate against the erosion by various forms of taxation (Olivier *et al.*, 2008: paragraph 8.5.2.2). This benefit is attributable to various legislative provisions applicable to the taxation of trusts as well as to some of the unique characteristics of the trust. These will be discussed under the relevant headings below.

#### **5.3.2.1 Income tax benefits**

The general method of taxation of a trust, contained in section 25B of the *Income Tax Act* and embodying the conduit principle, is that any trust income earned, which is not paid over to a beneficiary in the year it is earned, is taxed in the hands of the trust (section 25B(1)) and that trust income which is paid over to a beneficiary retains its original identity and is taxed in the hands of the beneficiary and not in the hands of the trust (section 25B(2)). Refer to paragraph 3.3.1 in Chapter 3 above.

This method of taxation is subject to the anti-avoidance provisions contained in section 7 of the *Income Tax Act* which provides for circumstances in which an amount will not be taxed in the hands of the trust or a beneficiary, but in the hands of a person who made a donation, settlement or other disposition to the trust. Refer to paragraph 3.3.2 in Chapter 3 above.

With proper planning and a thorough knowledge of these provisions, it is possible to achieve various income tax advantages such as the splitting of income and the variation of income payments to beneficiaries (Victor & King, 2010:366). These advantages will, however, depend on factors such as the gratuity involved in setting up the trust or transferring assets to the trust, whether the person who made a donation, settlement or other disposition to the trust is still alive, whether the beneficiary is major or minor, whether income is accumulated in the trust or paid out and whether the trust is a bebind trust, vested trust or discretionary trust (Victor & King, 2010:367).

### **5.3.2.2 Capital gains tax benefits**

Paragraph 40(1) of the Eighth Schedule of the *Income Tax Act* provides that a deceased person is treated as having disposed of his assets at death. This means that, at his death, the estate of a deceased person will be liable for capital gains tax on all assets owned by the deceased. As the assets held by a trust do not form part of any natural person's estate, there will not be a capital gains tax liability in respect of such assets at the death of a trust beneficiary. Trusts can therefore be very effective in reducing or eliminating capital gains tax on the death of a person (Geach & Yeats, 2007:220). Refer to paragraph 3.4.3 in Chapter 3 above as well as Addendum B.

The provisions relating to the taxation of capital gains in respect of trusts are similar to those contained in section 25B and section 7 of the *Income Tax Act* and are contained in paragraph 80(2) and paragraphs 68 to 73 of the Eighth Schedule to the *Income Tax Act*. With a thorough knowledge of these provisions a person can achieve capital gains tax benefits. When a capital gain is realised in a trust, and the trustees award vested rights in that gain to the beneficiaries, the gain will be deemed to be that of the beneficiaries. Not only are the rates applicable to individuals lower than those applicable to a trust, but there is a possibility that a capital gain can be split between beneficiaries in order to achieve a lower effective capital gains tax rate (Olivier *et al.*, 2008: paragraph 8.5.2.4.3).

### **5.3.2.3 Donations tax benefits**

Section 56(1)(l) of the *Income Tax Act* provides that no donations tax will be payable in respect of property which is disposed of under a donation, if such property is disposed of under and in pursuance of a trust. This means that any distribution of trust property to the beneficiaries is not regarded as a donation for purposes of donations tax (Cameron *et al.*, 2002:464). Refer to paragraph 3.5.3 in Chapter 3 above.

### **5.3.2.4 Estate duty benefits**

Discretionary trusts are very useful in minimising or avoiding estate duty. Most trusts can continue to exist in perpetuity and will continue to exist after the death of a beneficiary. If the trust is properly structured, the trust assets do not form part of the deceased estate of a beneficiary. Assets with a high potential for growth can be transferred to a trust and the growth takes place in the trust and not in the hands of the beneficiary. This effectively results

in the “freezing” or “pegging” of a person’s estate. (Geach & Yeats, 2007:216). Refer to paragraph 3.6.3 in Chapter 3 above.

#### **5.3.2.5    *Transfer duty benefits***

Section 9(4)(b) of the *Transfer Duty Act* provides that there will be no transfer duty payable if trust property is transferred by the administrator of a trust to persons entitled thereto under a will or other written instrument. Section 9(4)(b)(i) provides that no transfer duty shall be payable where trust property is transferred by the administrator of a trust in pursuance of a will to the persons entitled thereto under such will. Section 9(4)(b)(ii) provides that no transfer duty shall be payable where trust property is transferred by the administrator of a trust in pursuance of a written instrument 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 trust property. Refer to paragraph (g) under 3.7.1.4 in Chapter 3 above.

It is also worth noting that the more favourable transfer duty rates, that were determined according to a sliding scale and which were only applicable to transfers to natural persons, are now also applicable to trusts (clause 2 of the *Taxation Laws Amendment Bill*, 2011). Refer to paragraph 3.7.1.5 in Chapter 3 above.

#### **5.3.2.6    *Tax benefits relating to special trusts***

The definition of “special trust” in section 1 of the *Income Tax Act* makes provision for two types of special trusts ((i) and (ii) below) while the definition of “special trust” in paragraph 1 of the Eighth Schedule of the *Income Tax Act* only makes provision for one type of special trust ((i) below):

##### **(c)    *“Disability special trust”***

Paragraph (a) of the definition of “special trust” makes provision for a special trust that is a trust (either inter vivos or testamentary) that has been created solely for the benefit of a person who suffers from any mental illness or who suffers from any serious physical disability, and who cannot manage his or her own affairs.



Unlike a normal trust that is liable for income tax at a flat rate of 40% and that has an inclusion rate of 50% for purposes of capital gains tax, a disability special trust is liable for income tax at the same progressive tax rates that apply to natural persons (as per the wording of clause 1 in Appendix I of the *Taxation Laws Amendment Act* of any relevant year) and has an inclusion rate of 25% for purposes of capital gains tax (paragraph 10(a) of the Eighth Schedule of the *Income Tax Act*). This trust also qualifies for the annual CGT exclusion (paragraph 6(b)) as well as the primary residence exclusion (paragraph 45(1)(b) and paragraph (b) of the definition of “primary residence” in paragraph 1) available to natural persons, but is not entitled to claim the income tax rebates applicable to natural persons (section 6(1) of the *Income Tax Act*).

(d) “Under-21 special trust”

Paragraph (b) of the definition of “special trust” makes provision for a special trust that is a testamentary trust that has been created solely for relatives of the testator, where the youngest beneficiary is under the age of 21 (paragraph (b) of the definition of “special trust”)

Unlike a normal trust that is liable for income tax at a flat rate of 40% an under-21 special trust is liable for income tax at the same progressive tax rates that apply to natural persons (as per the wording of clause 1 in Appendix I of the *Taxation Laws Amendment Act* of any relevant year), but is not entitled to claim the income tax rebates applicable to natural persons (section 6(1) of the *Income Tax Act*).

### 5.3.3 Protection of assets

Trust property cannot, for the duration of the trust, form part of a particular individual’s estate (*CIR v Estate Sive* 1955 (1) SA 249 (A)) and does not form part of the personal estate of a trustee (section 10 of the *Trust Property Control Act*). This separation between ownership, enjoyment and control provides a trust with the ability to protect a beneficiary against creditors and other claimants as well as against his own mistakes and indiscretions. This means that trust assets are not subject to claims of creditors or former spouses and will not be affected by a beneficiary’s insolvency, financial difficulty or divorce. Refer to paragraphs 4.5 and 4.8.2.3 in Chapter 4 above.

#### **5.3.4 Administration at death**

A trust can provide for smooth succession at death (Geach & Yeats, 2007:217). This is because the trust assets are owned by the trustees and not by the beneficiaries. When a beneficiary dies, another beneficiary can immediately start enjoying some or all of the benefits that were enjoyed by the deceased. There is no need to wait for the estate of the deceased to be wound up. This has the benefit of substantially reducing executor's fees and administration costs and will result in a much more simplified and expedited administration process in the event of death (Victor & King, 2010:292). Refer to paragraph 4.6 in Chapter 4 above.

#### **5.3.5 Succession planning and harmony in the family**

Trusts are useful distributive mechanisms when it comes to succession planning and effective mediators to facilitate harmony in the family.

Trusts can exist in perpetuity and provide for future beneficiaries, easy succession and continued existence (Geach & Yeats, 2007:217). This makes a trust an excellent generation-skipping vehicle for estate duty purposes (Honiball & Olivier, 2009:11). In this regard an *inter vivos* trust can be used to receive an inheritance (refer to paragraph 4.7.2.3 in Chapter 4 above) or a testator can make use of a testamentary trust created in his will (refer to paragraph 4.7.2.5 in Chapter 4 above). Both these techniques have their own benefits. A testamentary trust is ideal for purposes of holding property for the benefit of minors or persons who are incapable of attending to their own affairs, holding property which cannot be held in undivided shares, protecting beneficiaries against themselves and preventing an unnecessary increase in the surviving spouse's estate (Olivier *et al.*, 2008: paragraph 8.2.2). Where the provisions of a testamentary trust is usually brief, succinct and to the point, the trust deed of an *inter vivos* trust is an elaborate document in which provision is made for a wide range of eventualities. There are, therefore, cases where an *inter vivos* trust will be ideal to receive a bequest from an estate owner, his spouse or their parents. A person may not necessarily have tax problems in his own right, but circumstances could change drastically when he receives a substantial inheritance from a deceased parent's estate. If such an eventuality can be anticipated, it would be of significant benefit if the inheritance was rather bequeathed directly to a trust (Olivier *et al.*, 2008: paragraph 8.5.2.5.1).

Trusts are also very useful in facilitating harmony in the family and providing for the special needs of certain family members. In this regard a trust can be set up for the benefit of a minor beneficiary (refer to paragraph 4.7.2.6 in Chapter 4 above). If this trust is created at the death of the testator, it will qualify as a special trust for tax purposes. Another type of special trust that may be of relevance here, is the special trust created for the benefit of a person who suffers from a mental illness or serious physical disability (refer to paragraph 4.7.2.7 in Chapter 4 above).

### **5.3.6 Other benefits**

There are many other benefits that were not discussed in the preceding paragraphs as they do not directly relate to any of the estate planning objectives as set out in Chapter 2. These benefits are however worth mentioning and will be discussed briefly in the following paragraphs.

#### **5.3.6.1 Lack of regulation**

Trusts are to a large extent regulated by South African common law which has been developed by practice and through the courts. The *Trust Property Control Act* is not a codification of the law regulating trusts and does not place onerous regulatory requirements on a founder or trustees (Honiball & Olivier, 2009:10). The absence of such regulatory requirements provides the following benefits:

- (a) Trusts can be easily and quickly formed, and there is no detailed process required in forming a trust (Geach & Yeats, 2007:217). Although section 4 of the *Trust Property Control Act* provides that a trust document must be lodged with the Master, the trust itself does not have to be registered nor does it need to comply with any drafting or formation formalities (Honiball & Olivier, 2009:10).
- (b) Trust names are not regulated to the extent that names of companies and close corporations are regulated (Geach & Yeats, 2007:217).
- (c) No limitation exist on a trust regarding the provision of financial assistance to obtain an interest in itself (Honiball & Olivier, 2009:11).
- (d) No rules regulate the maintenance of trust capital (Honiball & Olivier, 2009:11).

- (e) Although any amendment to the trust deed has to be lodged with the Master (section 4(2) of the *Trust Property Control Act*), no other documents have to be lodged on a regular basis (Honiball & Olivier, 2009:11).

#### **5.3.6.2 Limited liability**

The trustees are only liable for the debts of the trust in their representative capacity (*Ehrlich v Rand Cold Storage & Supply Co Ltd* 1911 TPD 170). A trust therefore provides limited liability for the trustees (Honiball & Olivier, 2009:11).

#### **5.3.6.3 Flexibility**

Beneficiaries can have different rights to trust property (refer to paragraph 5.2.4.3 above) and can receive a variety of different benefits from a trust. These rights and benefits will depend on the beneficiaries' needs and circumstances or upon the intention of the founder (Geach & Yeats, 2007:218). These rights could be discretionary, vested, variable or any combination of rights and the benefits can be in the form of a loan from the trust, an actual distribution by the trustees or the vesting of a benefit without the actual transfer thereof (Geach & Yeats, 2007:218).

#### **5.3.6.4 Minimum accounting and disclosure requirements**

There are no specific accounting and disclosure requirements relating to a trust's activities and there is no statutory obligation on trustees to prepare annual financial statements. There is also no obligation for the financial statements of a trust to be audited and a trust deed can specifically provide that an auditor need not be appointed (Geach & Yeats, 2007:219).

The provisions of section 16(1) of the *Trust Property Control Act* should, however, be kept in mind. This section provides that the Master may request the trustees to account for their administration and disposal of trust property and may request the trustees to deliver to the Master any book, record, account or document relating to their administration or disposal of the trust property. The trustees must account to the Master in this regard and must deliver any of the requested information to the best of their ability.

#### **5.3.6.5 Anonymous ownership**

Although lodged with the Master (section 4 of the *Trust Property Control Act*), trust deeds are generally not regarded as being open for public inspection (Honiball & Olivier, 2009:12). The affairs of the trust are therefore, to a large extent, kept confidential and the identity of beneficiaries is generally not disclosed to the public (Geach & Yeats, 2007:219).

### **5.4 SUMMARY**

From the discussion in this chapter it is clear that the South African trust is a distinct vehicle with an interesting history and a peculiar nature. As such it is a vehicle with unique characteristics that renders it a popular and useful estate planning tool.

Although trusts offer significant tax advantages (refer to Chapter 3 and paragraph 5.3.2 above), they are also useful in achieving other estate planning objectives such as the protection of assets, succession planning, provision for dependents and minor children and facilitation of the administration process at death (refer to Chapter 2 and paragraphs 5.3.3 to 5.3.5 above).

This chapter focused primarily on the past and present in that the history, background and development of trusts in South African Law were discussed and that the uses, usefulness and benefits of trusts were set out. The next step is to look at the future. Chapter 6 will look at past predictions about the future of trusts, recent opinions about trusts and the use of trusts in countries where estate duty has already been abolished.

## **CHAPTER 6**

### **THE CONTINUED USE OF TRUSTS: SOUTH AFRICA AND OTHER COUNTRIES**

#### **6.1 INTRODUCTION**

The previous chapter focused on the history, background and development of trusts in South African Law as well as the application and benefits of the trust in practice. It is clear from the discussion thus far that the trust has been and still is a popular and useful estate planning tool with significant advantages. The question that was raised in Chapter 1, however, is whether the trust will continue to be such a useful estate planning tool. In other words, does the trust have a future as an estate planning tool? Secondary objective four (paragraph 1.3.2.5) – considering the continued use of trusts in South Africa as well as certain countries where estate duty has been abolished will be addressed here.

This chapter will assist in determining what the future holds by looking at past predictions about the future of trusts, recent opinions about trusts and the use of trusts in countries where estate duty has already been abolished.

#### **6.2 PAST OBSERVATIONS AND PREDICTIONS**

It seemed appropriate to begin this paragraph with two interesting quotes made early in the previous century. One made by a famous English Professor and the other by a French Jurist.

In a paper written between 1901 and 1903 Professor Maitland wrote:

“The idea of a trust is so familiar to us all that we never wonder at it. And yet surely we ought to wonder. If we were asked what is the greatest and most distinctive achievement performed by Englishmen in the field of jurisprudence I cannot think that we should have any better answer to give than this, namely, the development from century to century of the trust idea.”

In an article published in the Yale Law Journal, Pierre le Paulle (1927:1126) wrote:

“Trusts have now pervaded all fields of social institutions in common law countries. They are like those extraordinary drugs curing at the same time toothache, sprained ankles, and baldness sold by peddlers on the Paris boulevards; they solve equally well family troubles, business difficulties, religious and charitable problems. What amazes the sceptical civilian is that they do really solve them!”

Being an English law concept in a Roman-Dutch law environment, the South African trust has had an interesting development over the past century (Chapter 5, paragraph 5.2.1) and is now firmly rooted in our legal system. With its unique characteristics and peculiar nature the trust became an interesting topic and many authors, practitioners, academics and judges have made various observations and predictions about the trust, its usefulness and its future.

In the first South African court case on the validity of a trust (*Estate Kemp v McDonald's Trustee* 1914 CPD 1084), Solomon JA explained (at 507-508) that –

“the constitution of trusts and the appointment of trustees are matters of common occurrence in South Africa at present day [...] The idea is now so firmly rooted in our practice, that it would be quite impossible to eradicate it or to seek to abolish the use of the expression trustee, nor indeed is there anything in our law which is inconsistent with the conception.”

With regards to the development of trusts in South Africa, Hahlo (1952:349) wrote –

“When it comes to trusts in our law, even the most elementary proposition cannot be regarded as settled [...] It will take the work of several generations of Judges and text writers before the law of trust reaches maturity.”

Walter Pollak (1956:180) wrote that –

“The trust, the greatest achievement in the field of jurisprudence performed by Englishmen, has long found a welcome home in South Africa. The reasons are not far to seek. As a device for making dispositions of property it is more flexible a tool than any of our Roman-Dutch instruments. It is not surprising that men of property and their legal advisors have seized upon this device and have put it to many uses.”

In 1983 the South African Law Commission published a preliminary report on trust law. In paragraph 1-10 of the report, the Commission pointed out that in South Africa the development of trust law has taken place sporadically through court judgements, and that this evolutionary process is continuing to adapt the basic trust idea of English law to South African legal principles. In practice particularly, trust law is still very much in a developmental stage. The Law Commission expressed no reservation about the trust's right to existence in South African law. In fact, they highlighted the popularity, flexibility and usefulness of the trust. This report confirmed that the trust is a permanent fixture and dismissed any doubts which still existed in this regard.

In *Braun v Blann & Botha* 1984 (2) SA 850 (A) Joubert JA remarked that our trust law is still in the process of development and that, during the last decade or so, the South African trust has undergone considerable refinement. He stated (at 859) that –

“Our Courts have evolved and are still in the process of evolving our own law of trusts by adapting the trust idea to the principles of our own law.”

At a seminar presented by the Department of Private Law of the University of South Africa, held on 12 June 1992, Chief Justice Corbett presented on the challenges and change in trust law in the Nineties. When looking at the future of trusts (Corbett in Wiechers & Roos (eds.),1993:13) he stated that –

“the trust is more popular than ever before. Its uses and purposes are multifarious; and such is its inherent flexibility that new applications are constantly being invented”

He then concluded (Corbett in Wiechers & Roos (eds.),1993:14) by saying that –

“I do not visualise a great deal of change during this decade in the inherent nature of the trust or in the traditional, incremental, ad hoc approach of the courts in accommodating and giving legal effect to the trust as an institution. Nor do I visualise major legislative change in the law of trusts. In fact, one of the challenges of the Nineties will be to avoid statutory regulation as far as possible. I further visualise that the trust will continue to play a useful, flexible and ubiquitous role in our society.”

At the same seminar presented by the Department of Private Law of the University of South Africa in 1992, another presenter presented on trusts in practice and stated (Wunch in Wiechers & Roos (eds.),1993:115) that –

“it is clear that trusts, both *inter vivos* and testamentary, remain a very popular vehicle for the safeguarding and management of family and business assets [...] the reception into and adaptation by South African law of the English legal concept of a trust, separating beneficial ownership from formal ownership, has been and continues to be extremely functional and successful.”

Taking the above into consideration it seems that the general opinion was that trusts are useful, that they have found a place in South African law and that they have a future going forward. To date this has been true and trusts have indeed remained useful. The question however is whether they will remain useful going forward.



### 6.3 RECENT OPINIONS

According to Olivier *et al.* (2008: paragraph 1.9) “the trust is here to stay”. This paragraph will aim to confirm this statement and will do so by referring to remarks and statements by various authors with regards to trusts, their use, benefits and future.

Starting with Olivier *et al.*, they also wrote (2008: paragraph 1.9) that –

“The trust is very cosmopolitan and South African courts have shown strength and perception in accepting it. It is a welcome import and although the original window dressing to grant it citizenship was rather questionable, this is no longer important. The original *fideicommissum* and stipulation in favour of a third party construction did nothing to deter the growth and popularity of the trust. The trust is inherently strong enough to continue to flourish despite technical and, possibly temporary, labels to try explain it.”

And that (2008:1.1) –

“The trust is one of the most efficient of all the forms of enterprises available to someone wishing to arrange his assets and financial affairs in order to provide in the best way possible for his needs and those of his family during his lifetime and after his death. The inherent flexibility of the trust institution makes it eminently suitable for addressing various problems and for being applied in numerous ways.”

Abrie *et al.*, (2003:146) focus on the *inter vivos* trust and write that –

“The trust *inter vivos* is therefore the most popular type of trust used in practice to facilitate planning. In fact, it is no exaggeration to say that it plays a dominant role in estate and financial planning”

Geach and Yeats (2007:4) write that –

“A trust is a very useful device [...] Apart from estate planning uses, a trust can effectively protect assets from a beneficiary’s personal creditors and indiscretions. A trust can also be used for business purposes, instead of the use of a company, close corporation or partnership.”

Honiball and Olivier (2009:198) write that –

“A trust, especially a discretionary *inter vivos* trust, is a popular vehicle for estate planning purposes because the trust assets are regarded as separate from those of the founder/settlor as well as from those of an individual beneficiary.”

Victor and King (2010:361) write that –

“Trusts are very useful estate and financial planning tools, and the fact that they combine fiscal benefits with the non-tax benefits of custodianship and asset protection have made them increasingly popular.”

It is clear from these quotes that present day authors who write on trusts and estate planning still believe that trusts are very useful, efficient and popular vehicles for estate planning and other purposes.

## **6.4 TRUSTS IN OTHER COUNTRIES**

In Chapter 1 the possibility of estate duty being abolished was mentioned. A question that was raised in this regard was whether the trust will remain useful as an estate planning tool if estate duty is indeed abolished. It would therefore be appropriate to also look at the use of trusts in countries where estate duty (or inheritance tax) has already been abolished.

There are many countries where estate duty has never been levied or where estate duty has been abolished and are no longer being levied. For purposes of this study and for reasons mentioned below, there will only be a focus on the use of trusts in Australia, Canada and New Zealand.

Although South African law is based on Roman-Dutch law, English law also had an important influence on South African law and forms part of South African law. It is for this reason that this paragraph will be limited to a discussion on common law countries of which the legal systems are based on English law.

### **6.4.1 Australia**

#### **6.4.1.1 *Background: Tax system and trust law***

##### **(a) *The Australian Tax system***

The Australian tax system taxes income when it is derived, irrespective of whether it has been physically received by the recipient or paid by direction on the recipient's behalf to a third party. Australian residents are taxed on their worldwide income and capital gains,

regardless of the source of the income and non-residents are taxed on Australian source income and capital gains from Australian real property assets (Bevan *et al.*, 2010:71). There is no federal estate duty or death duty nor any federal Australian gift tax or gift duty (Bevan *et al.*, 2010:72).

(b) *Trust law in Australia*

Australia is a federation of six states and two federal territories and has a common law legal system. The common law of trusts is based on English principles of trust law. One must look at the statute law in all six states and the two territories in order to ascertain the law regulating the creation and administration of trusts (Bevan *et al.*, 2010:67).

Australian trust law makes provision for three categories of trusts. Their categorisation is determined by the manner of their creation. These are express trusts, resulting trusts and constructive trusts (Bevan *et al.*, 2010:67). Express trusts are the most common type of trust used and arise when a person (the settlor) expresses the intention, either orally or in writing, whether express or implied, to create a trust. Express trusts may be *inter vivos* or testamentary and are generally divided into public express trusts (charitable trusts) and private express trusts (non-charitable trusts) (Insall & Dal Pont, 1999). Resulting trusts and constructive trusts are non-express trusts that do not arise from the express or implied intention of the settlor (Insall & Dal Pont, 1999). Resulting trusts arise to give effect to what the law presumes to be the intention of the settlor. Constructive trusts do not arise as a result of any actual, inferred or even presumed intention, but as a result of conduct which is inconsistent with the dictates of equity (Insall & Dal Pont, 1999).

The duration of a trust (other than a charitable trust) is limited by the common law rule against perpetuities or remoteness of vesting, modified by statute to allow a settlor to select a period not exceeding eighty years. This rule has been abolished in South Australia, but still applies in the other jurisdictions (Bevan *et al.*, 2010:67).

**6.4.1.2 Taxation of trusts in Australia**

The Australian tax system looks through trusts and taxes the beneficiaries on the share of trust net income to which they have a present entitlement in the particular year of income. This applies irrespective of whether a beneficiary actually receives a physical distribution of the trust income. A beneficiary who is a natural person will be taxed at the graduated

individual rate of tax (Bevan *et al.*, 2010:71). Resident beneficiaries may also be taxed on foreign trust income accumulated abroad for them, and pay additional tax in respect of any period of deferral of recognition of such income (Bevan *et al.*, 2010:72).

Trustees are only liable to pay tax on the net income of the trust where there are no “presently entitled” beneficiaries at the end of the taxation year. In this situation, the trustees of an *inter vivos* trust are liable for tax at the highest marginal rate of tax (which is 47.5%) without any graduation of tax rates or the benefit of a tax-free threshold. Where the trust is a testamentary trust, the trust is taxable on its net income with benefit of the tax-free threshold and graduated tax rates (Bevan *et al.*, 2010:72).

#### **6.4.1.3 Australian trusts and estate planning**

Although estate and death duties no longer play a part in the estate planning methodologies of trust and estate practitioners in Australia (Bevan *et al.*, 2010:72), estate planning still remains important and trusts are still being used as estate planning tools (Anon. 2011). The usefulness of trusts has not been affected by the abolishment of estate duty. Apart from the advantages in relation to tax, trusts also provide great flexibility for asset protection and the future divestment of assets for retirement and estate planning (Anon. 2010).

Bembrick (2011:1) summarises the benefits of trusts (in Australia) as follows:

- Trusts are very good vehicles for building wealth and passing on assets to subsequent generations. These assets can be transferred tax effectively to the next generation through a family trust without capital gains tax becoming payable each time.
- Trusts provide protection of investment and personal assets from business and other risks. Such assets cannot be claimed by creditors in the event of a business liquidation.
- Trusts have the flexibility to allow tax-effective structuring of investments and businesses, including in the way income is distributed to family members.
- Having a family trust as part of a business structure can ensure that any future sale is more tax effective (particularly so that full advantage of capital gains tax concessions on retirement can be taken).
- Trusts give a high degree of flexibility in dealing with income from assets and its distribution to family members.

- Trusts can be used to set up income for younger family members rather than having a lump sum paid at a time when they may be too young to use it sensibly.

In an article on the “Darwinian evolution of the taxation of trusts” Pinto and Karlinsky (2007) concludes that –

“it is worthwhile restating that in Australia family trusts – which are in the main discretionary trusts where the trustee has complete discretion to apply the income of the trust estate among the beneficiaries of the trust – continue to flourish [...] and given the additional advantages of wealth planning and the flexibility that trusts offer for tax planning, it is likely to continue as an important feature of business planning in Australia.”

## **6.4.2 Canada**

### **6.4.2.1 Background: Tax system and trust law**

#### *(a) The Canadian Tax system*

Canada has a comprehensive tax system that has high tax rates, few exemptions and tax incentives, extensive reporting and filings, aggressive enforcement of self-assessment, and copious tax avoidance rules (Cadesky *et al.*, 2010:133). Canada levies tax on worldwide income of residents and on certain Canadian source income of non-residents.

Canada does not levy any form of wealth tax or stamp duties on individuals. Land transfer tax are levied on the transfer of real property interests at a rate of up to 1,5%. Neither the federal government nor any of the provinces in Canada levy estate or gift taxes or any other kind of succession duty (Cadesky *et al.*, 2010:140).

On death, a Canadian individual is deemed to sell all property at fair market value, with certain limited exceptions. This deemed disposal results in capital gains tax where capital property has appreciated in value. A major exception occurs when property is transferred to a spouse or spousal trust. In this case, assets are transferred at cost, but gains will arise on death of the surviving spouse. A “spousal trust” is a trust created under a will whereby the spouse is entitled during his/her lifetime to all income deriving from the trust and no person other than the spouse may, prior to the death of the spouse, have access to the capital (Cadesky *et al.*, 2010:140).

(b) *Trust law in Canada*

Canada is a federal country made up of ten provinces and three territories. All jurisdictions, except Quebec, follow a common law tradition. Although contemporary trust law in Canada generally follows a common law tradition, it has been influenced by American law (Cadesky *et al.*, 2010:133).

In order for a trust to be validly constituted, there are three requirements that must be met. There must be certainty of the intention of the settlor to create a trust; the trust object or beneficiaries must be identified and certain; and the initial property that is to be subject to the trust must be specified (Rochweg, 2010). No registration is required when creating a trust. When it comes to immovable property, provincial statutes require writing, but a trust of movable assets can be created orally (Cadesky *et al.*, 2010:134).

Case law imposes no maximum duration on trusts, but in all jurisdictions (except Manitoba) it is required that all beneficial interests created by a private trust must vest within a given period of time. In all jurisdictions the settlor can provide for the time and manner of terminating the trust. If the beneficiaries are ascertained, adult and capacitated, they can together prematurely terminate the trust and recover the trust property (Cadesky *et al.*, 2010:140).

**6.4.2.2 *Taxation of trusts in Canada***

Trusts are taxed as individuals at personal tax rates. Personal tax in Canada is composed of both federal and provincial components, with the provincial component dependent on where the trust is resident. If the trust is resident in a territory, then an additional level of federal tax is charged in lieu of provincial tax. *Inter vivos* trusts are taxed at the top personal tax rate of 46%, while testamentary trusts are taxed at graduated rates (Cadesky *et al.*, 2010:139).

Trust income is computed with the normal Canadian rules applicable to individuals, but a trust is not entitled to personal exemptions and certain other deductions. In most cases, a trust may obtain a deduction for income that is distributed to a beneficiary. The amount so distributed will be included in the income of the beneficiary and taxable in such beneficiary's hands (Cadesky *et al.*, 2010:139). There are, however, certain attribution rules that apply in order to prevent income splitting. These rules are similar to the attribution rules contained in

section 7 of the South African *Income Tax Act* (58/1962) and will deem income or capital to be the income or capital of the person who contributed the property to the trust.

#### **6.4.2.3 Canadian trusts and estate planning**

The minimisation or avoidance of estate duty is not one of the objectives of estate planning in Canada and is not a consideration when setting up a trust. There are, however, many other reasons for setting up trusts and trusts are generally used in the context of family law, incapacity, creditor proofing and testamentary planning (Rochwerg, 2010).

In an article on the use of trusts in estate planning, the following uses of trusts are discussed (Anon, 2003):

- Trusts can be used to preserve estate property in cases where the intended beneficiaries are deemed incapable of responsible administration for reasons such as minor age, mental disability, infirmity, or lack of business experience.
- Trusts can provide for the maintenance and education of children. Although the child would be taxed on the income, presumably the child's tax rate would be lower than that of the parent, resulting in a saving of tax. If the child were 18 years of age or over, the trust could be funded directly by the parent without triggering the income attribution rules.
- In order to avoid or reduce capital gains tax on death an "estate freeze" can be implemented. An *inter vivos* trust is a useful and flexible vehicle for an estate freeze. During the settlor's lifetime, the trust would acquire property of the settlor so that gains accrued on the portion of property within the trust would not be included in the settlor's income at death.
- *Inter vivos* trusts can reduce probate fees payable at death because the trust property does not form part of the deceased's estate.
- *Inter vivos* and testamentary spousal trusts are effective where the settlor wishes to provide an income for the spouse during the spouse's lifetime, without transferring full ownership of the underlying property. Upon the spouse's death, the capital of the spousal trust could pass to the children (or any other beneficiaries named by the settlor).

- Some income-splitting effect can still be achieved through the use of *Inter vivos* trusts although changes to the income tax attribution rules have significantly restricted these schemes. For example, where the beneficiaries of the trust are minor children, capital gains arising on the disposition of any property which was transferred by a parent will be included in the children's' incomes without attribution to the parent. Where the children are 18 and over, any income from the property can similarly be taxed in their hands and not the hands of the parent.
- Testamentary trusts can be very useful income splitting devices. Testamentary trusts, unlike *inter vivos* trusts, are subject to the graduated tax rates such as those applicable to ordinary individuals. Income can be spread amongst numerous taxpayers, especially where a separate trust is set up for each beneficiary. In this way the total income arising from the estate property can be shared amongst various taxpayers who are each subject to tax at their individual graduated rates.

### **6.4.3 New Zealand**

#### **6.4.3.1 Background: Tax system and trust law**

##### *(a) The New Zealand Tax system*

Residents of New Zealand are liable for tax on their worldwide income. Non-residents are taxed only on income that has its source in New Zealand (Hart, 2010:463). New Zealand does not levy capital gains tax (Hart, 2010:464) and no longer levies estate duty (*Estate Duty Abolition Act* (13/1993)) and gift duty is no longer payable on gifts made after 1 October 2011 (section 245 of the *Taxation (Tax Administration and Remedial Matters) Act* (63/2011)).

##### *(b) Trust law in New Zealand*

New Zealand is a constitutional monarchy with a democratically elected Parliament and has a common law legal system. Trusts have been a feature of the New Zealand legal landscape for many years and New Zealand trust law is substantially derived from the laws of England (Hart, 2010:463).

Trusts are created by deed, and the formalities of a deed under New Zealand law are that the deed must be executed by all parties purporting to be bound by the deed, and those



signatures must be properly witnessed. No particular form of words is required, and sealing or delivery of deeds is not required (Hart, 2010:464).

The duration of a trust (that is not a charitable trust) is limited by the common law rule against perpetuities as contained in the *Perpetuities Act* (47/1964). Most trust deeds provide that the trust will continue for a fixed period (which may not exceed eighty years) (Hart, 2010:464).

#### **6.4.3.2      *Taxation of trusts in New Zealand***

New Zealand identifies three types of trusts for taxation purposes: complying trusts, foreign trusts and non-complying trusts. The tests that determines whether a particular trust constitute a complying, foreign or non-complying trust are applied each time a distribution is made to a beneficiary (Hart 2010:468).

A complying trust is an ordinary, domestic New Zealand trust with a resident settlor and resident trustees and which satisfied all its obligations under the relevant trust legislation. Except to the extent that distributions from a complying trust constitute current-year beneficiary income, distributions will not be assessable to beneficiaries. “Beneficiary income” is income paid or applied during the income year or within six months after the end of the income year in which the income is derived. This means that beneficiary income is taxed in the hands of the beneficiary and income that has been accumulated in the trust is taxed in the hands of the trustees. Beneficiary income is taxed at the beneficiary’s marginal tax rate while accumulated income is taxed at a flat rate of 33%. As New Zealand does not levy capital gains tax, capital gains can be passed through to beneficiaries tax-free (Hart 2010:468).

A foreign trust is a trust of which the settlor is not a New Zealand resident. Such a trust is not subject to tax in New Zealand except on income that has its source in New Zealand. This is the case even if all the trustees and/or beneficiaries are New Zealand residents. This regime is also known as the “settlor trust regime” because the tax treatment of the trust is determined by the residency of the settlor. “Settlor” is defined broadly, and includes anyone who provides goods, services or money to a trust for less than full market value. There are extensive provisions designed to prevent indirect settlements through nominees and by other means. In order to preserve a trust’s foreign status it is therefore crucial that no inadvertent settlements be made upon the trust by a New Zealand resident (Hart 2010:468).

A trust will constitute a non-complying trust where, at the time a distribution is made, it is neither a complying trust nor a foreign trust. Distributions to beneficiaries of non-complying trusts are subject to full New Zealand tax on worldwide income. Beneficiary income is taxed at the beneficiary's personal marginal tax rate while accumulated income is taxed at a rate of 45% (Hart 2010:468).

#### **6.4.3.3      *New Zealand trusts and estate planning***

Trusts in New Zealand gained in popularity from the 1950s due to people wanting to avoid estate duty and other high rates of taxation. Estate duty was not charged on distributions from a trust, so it long provided an incentive for people to gradually transfer their property to a trust for distribution to others. Although estate duty was abolished, the trusts set up when it was in force remained in force and new trusts continued to be set up (Law Commission Issues Paper, 2010:9).

Trusts retained their popularity in New Zealand and are still being set up for the following reasons:

- Trusts are very useful in providing protection against matrimonial property claims. Individuals wishing to avoid the equal sharing regime and parents wanting to leave property to their children (and to protect it from their children's partners) are using trusts in order to shield property from the far reaching impact of the *Property (Relationships) Act* (166/1976) (formerly known as the *Matrimonial Property Act* (166/1976), but expanded to also provide for *de facto* couples in permanent relationships) (Law Commission Issues Paper, 2010:10).
- Significant differences in the income tax rates for individuals or other entities have provided an incentive to establish trusts. Redirection of income by way of a trust to individuals on the lowest tax rate (such as children) was therefore a beneficial option for those liable to such taxes. This led to more family trusts being established to take advantage of the disparity. On 1 April 2000, the top personal income tax rate was increased to 39% and the rate at which trustee income were taxed left at 33%. This meant that trusts could be used to shelter income from higher personal tax rates. The top personal and trust rates were realigned at 33% from 1 October 2010, thereby reducing, but not eliminating, the advantage of using trusts for income-splitting (Law Commission

Issues Paper, 2010:10). Trusts can still be used to distribute income between family members in order to obtain a possible lower average marginal tax rate – especially if the tax rate of a beneficiary is lower than that of the trustee or settlor.

- The residential care subsidy, available for long term residential care, often creates a significant incentive for people to transfer assets to a trust. At 1 July 2010 the permitted asset levels were \$200 000 for a single or widowed person in care and for couples with both partners in care. The permitted asset levels for couples with one partner in care were \$105 000 not including the value of their house and car or \$200 000, including the value of their house and car (Schedule 27(1) of the *Social Security Act* (136/1964)). If assets exceed the allowed amounts the applicant is not financially eligible for the subsidy. The *Social Security Act* (136/1964) allows a settlor to use a trust to reduce his or her assets and income in order to satisfy the eligibility criteria for the subsidy. In the 2009–2010 year the Ministry of Social Development processed approximately 10,000 applications for the residential care subsidy that involved a trust (Law Commission Issues Paper, 2010:12).
- Another motivation for the use of trusts has been to protect assets from being subject to claims from creditors. Family trusts have long provided a way for people with businesses to ensure that their private assets are not available to business creditors and can be kept for beneficiaries in the event of a bankruptcy (Law Commission Issues Paper, 2010:13).
- A trust is the ideal way to pass assets to future generations and to achieve testamentary wishes. By using a trust in this way a person can prevent children from wasting capital inheritances as well as avoid claims under the *Family Protection Act* (88/1955) and the *Property (Relationships) Act* (166/1976). These acts confer rights of claim upon persons (such as children, spouses and partners) for whom testamentary provision is not made. Such claims are limited to the deceased's estate. If assets are disposed of during the deceased's lifetime to a family trust, they can be dealt with in accordance with the trust's provisions and can be put out of reach of the claims of persons disappointed at the testamentary provision made for them (Cambridge, 2010).

#### 6.4.4 The continued use of trusts in Australia, Canada and New Zealand

Research conducted by the Law Commission in New Zealand indicates the estimated number of trusts in Australia, Canada and New Zealand (Law Commission Issues Paper, 2010:7). These numbers illustrate a particular familiarity with the trust vehicle and emphasise its popularity in these countries.

There is no definite record of trusts in New Zealand, but indications from the records that are kept (tax returns filed by trusts) indicate a high number of trusts per head of population. For the 2007-2008 tax year, there were at least 237 500 trusts that filed tax returns with Inland Revenue. This number increased from 145 900 in the 2000–2001 tax year. Based on the 2008 figure, the most cautious assessment is that there is one trust for every 18 people in New Zealand. Trusts are, however, only required to file a tax return if they earn income during the financial year and are not required to inform Inland Revenue of their existence if they are not income-earning (Law Commission Issues Paper, 2010:7).

In Australia, an annual tax return must be lodged for a trust, regardless of the amount of income derived, even if it derives no income or incurs a loss for tax purposes. In the 2007–2008 income year, 660 324 trusts filed returns. This equates to around one trust for every 34 Australians (Law Commission Issues Paper, 2010:8).

Canada's rate of trust usage appears to be much less than that of Australia and New Zealand. For the 2009–2010 fiscal year, the Canada Revenue Agency processed around 229 000 resident trust returns and 2 200 non-resident returns. In Canada, trusts must file a tax return where income from the trust property is subject to tax. This equates to approximately one income-earning trust for every 148 Canadians (Law Commission Issues Paper, 2010:8).

The following table summarises the above discussion and sets out the position regarding the use of trusts in these countries:

	Estate duty	Gift tax	CGT	Trusts	Estimated number of trusts
<b>Australia</b>	No	No	Yes	Yes	237 500 1 trust for every 18 people
<b>Canada</b>	No	No	Yes	Yes	660 324 1 trust for every 34 people
<b>New Zealand</b>	No	No	No	Yes	229 000 1 trust for every 148 people

## **6.5 SUMMARY**

From the discussion on past predictions and observations regarding trusts it seems that the general opinion was that trusts were useful, that they had found a place in South African law and that they were to have a future going forward. To date this has been true and trusts have indeed remained useful, efficient and popular estate planning tools.

This is also true for trusts in countries such as Australia, Canada and New Zealand, where the saving of estate duty is not an objective of estate planning or a consideration when setting up a trust. Existing trusts that were in effect when estate duty was abolished are still being used and new trusts are still being established. It is clear that estate duty saving was never the main purpose for setting up trusts in these countries and shouldn't be the main purpose for setting up a trust in South Africa.

## **CHAPTER 7**

### **CONCLUSION**

#### **7.1 INTRODUCTION**

The purpose of this chapter is to answer the question regarding the future of trusts as an estate planning tool which was raised in Chapter 1 (secondary objective five, paragraph 1.3.2.6). This question was raised in light of the suggestion regarding the review of taxes upon death which was made in the 2010 Budget Review (2010:80). The link between the aforementioned question and the abolishment of estate duty lies in the fact that many people regard estate planning as estate duty planning and regard trusts as tools to avoid or reduce estate duty. A significant part of the study therefore focused on the concept of “estate planning”, the objectives of estate planning and the tools and techniques used to achieve those objectives.

In Chapter 2 the concept of “estate planning” was summarized as a continuous process through which a person accumulates assets and manages his financial affairs in order to increase, preserve and protect those assets for the maximum benefit during his lifetime and to provide for the disposition and continued utilisation thereof after his death. This chapter listed the various objectives of estate planning and aimed to illustrate that estate planning is more than just estate duty planning.

Chapter 3 and 4 focused on the different tools and techniques that are used to achieve the different estate planning objectives. Chapter 3 focused on the minimisation and avoidance of tax while Chapter 4 focused on the other (non-tax related) objectives of estate planning. In both these chapters, the trust featured quite prominently in achieving several of the objectives of estate planning. The purpose of these chapters was to illustrate that trusts are not only used to avoid or reduce estate duty but are also used to achieve other tax and non-tax objectives.

From the discussion in the first four chapters it is clear that estate planning is not only concerned with the reduction and avoidance of tax and, where the reduction and avoidance of tax is considered, it is not only estate duty that is relevant. It is also clear that trusts are not only used to reduce or avoid estate duty but that they are also very useful in achieving other objectives of estate planning. It is for this reason that Chapter 5 and 6 focussed on trusts. Chapter 5 discussed the origin and development of trusts in South Africa, the definition and

classification of trusts, the nature of trusts, the essential elements of a trust and the uses and benefits of trusts. Chapter 6 considered past predictions about trusts and found that the general opinion was that trusts are useful and that trusts have a future going forward. When looking at more recent opinions about trusts it is clear that these predictions came true and that trusts did in fact remain useful. Due to the fact that this study questions the future of trusts in light of the possible abolishment of estate duty, Chapter 6 (paragraph 6.4) also considered the use of trusts in countries where estate duty has already been abolished. This discussion aimed to illustrate that, even without the saving of estate duty as an objective, trusts remained useful in these countries and are still being used for various other estate planning reasons.

## **7.2 THE FUTURE OF TRUSTS AS AN ESTATE PLANNING TOOL**

In light of the discussion in Chapters 2 to 5 it is clear that estate planning is more than just estate duty planning and that trusts are more than just tools to reduce or avoid estate duty. These chapters discussed the different estate planning objectives and the tools used to achieve these objectives – the trust often surfaced as a tool to use in achieving a particular objective. These included the following (non-estate duty related) objectives:

- Income splitting between beneficiaries in circumstances where the attribution rules contained in section 7 of the *Income Tax Act* (58/1962) are not applicable (Chapter 3, paragraph 3.3 and Chapter 5, paragraph 5.3.2.1);
- Splitting of capital gains between beneficiaries in circumstances where the attribution rules contained in paragraphs 68 to 73 of the Eighth Schedule of the *Income Tax Act* (58/1962) are not applicable (Chapter 3, paragraph 3.4.3 and Chapter 5, paragraph 5.3.2.2);
- Capital gains tax saving at death on assets held in a trust (Chapter 3, paragraph 3.4.3 and Chapter 5, paragraph 5.3.2.2);
- Protection of assets at divorce (Chapter 4, paragraphs 4.5.1 and 4.8.2.3 and Chapter 5, paragraph 5.3.3)
- Protection of assets against creditors (Chapter 4, paragraph 4.5.2 and Chapter 5, paragraph 5.3.3);
- Reduction of executor's fees and administration costs at death (Chapter 4, paragraph 4.6.1 and Chapter 5, paragraph 5.3.4);
- Provision of continuity and easy succession of interests in property (Chapter 4, paragraph 4.7.2.1 and Chapter 5, paragraph 5.3.5);

- Provision for minor beneficiaries (Chapter 4, paragraph 4.7.2.4 and Chapter 5, paragraph 5.3.2.6);
- Provision for beneficiaries who suffer from a mental illness or physical disability (Chapter 4, paragraph 4.7.2.5 and Chapter 5, paragraph 5.3.2.6).

The mere fact that trusts have so many other objectives, uses and benefits should be an indication that trusts have a future as an estate planning tool and will continue to be useful. The reduction or avoidance of estate duty is only one of many benefits of trusts and, should estate duty be abolished, all the other benefits of trusts will continue to exist. In order to prove this statement, Chapter 6 (paragraph 6.4) looked at the use of trusts in countries where estate duty has already been abolished. This discussion focussed on common law countries such as Australia, Canada and New Zealand and found that, in all three countries, trusts are still being used as estate planning tools. Although estate duty has been abolished in these countries and the saving of estate duty is not a relevant objective, trusts remained useful (and popular) in these countries and are still being used for various other estate planning reasons. Chapter 6 (paragraph 6.4.4) also referred to a study conducted by the Law Commission in New Zealand that indicates the estimated number of trusts in these countries. According to this study there is one trust for every 34 people in Australia, for every 148 people in Canada and for every 18 people in New Zealand.

If estate duty is abolished in South Africa, the same will likely be true for trusts in South Africa. Trusts would remain useful (and popular) and will continue to be used to achieve the other (non-estate duty related) estate planning objectives.

### **7.3 SUMMARY**

One of the many reasons for a discretionary trust being regarded as an effective estate planning tool is the fact that the trust assets are separate from those of the founder, the trustees and the beneficiaries (Chapter 3, paragraph 3.6.3). This makes the minimisation or avoidance of estate duty a very popular benefit of trusts. If, however, estate duty is abolished the trust will lose this benefit and the reduction or avoidance of estate duty will no longer be a consideration when setting up a trust. The question throughout this study was whether this will mean the end of trusts. In other words, does the trust have a future as an estate planning tool?



It would be disappointing if something once referred to as “the greatest and most distinctive achievement performed by Englishmen” (Maitland, 1901) would fall into total disuse as a result of the fact that it lost one of its uses (or benefits). It would be like putting down a healthy dog because it lost a leg. If it can still fetch a ball and bark at intruders, why put it down?

In light of the discussion in the chapters above, it is clear that trusts have multiple benefits and that the reduction or avoidance of estate duty isn't and shouldn't be the main reason for setting up a trust. The future of trusts is only a concern if the sole motivation behind establishing the trust was the avoidance of estate duty. If trusts remained useful in other countries where estate duty has been abolished, they will very likely remain useful in South Africa.

## ADDENDUM A

### THE BENEFIT OF USING A RETIREMENT ANNUITY AS AN ESTATE PLANNING TOOL (Paragraph 3.6.2 (d) and paragraph 4.4.1)

Mr Smith is 68 years old and has an estate exceeding R3 500 000. Should he pass away, his estate will be liable for estate duty. Part of his estate consist of a share portfolio of R5 000 000 (the base cost of which was R4 000 000).<sup>17</sup>

The table below sets out a comparison between the positions where Mr Smith retains the share portfolio in his estate and where he sold the shares and transferred the proceeds to a retirement annuity with the same underlying portfolio. For purposes of this example it is assumed that he never leaves the fund and that his beneficiaries elect to take the full benefit as a lump sum. The section 4A estate duty rebate and CGT exclusion in year of death is ignored.

Retained in own estate until death		Transferred to a retirement annuity	
Gross dutiable value of shares	R 5 000 000	CGT on disposal of shares	R 100 000*
Less: CGT on disposal of shares	(R 100 000)*	Income tax on lump sum	R 0**
Dutiable value	R 4 900 000	Estate duty	R 0
Estate duty @ 20%	<b>R 980 000</b>		
Total costs		Total costs:	
Estate duty	R 980 000	Estate duty	R 0
CGT	R 100 000	CGT	R 100 000
<b>Total:</b>	<b>R 1 080 000</b>	<b>Saving:</b>	<b>R 980 000</b>

\* [CGT on disposal of shares](#)

Proceeds	R5 000 000
Less: base cost	(R4 000 000)
Capital gain	R1 000 000
Taxable capital gain @ 25%	R 240 000
CGT payable @ 40%	<b>R 100 000</b>

\*\* [Income tax on lump sum](#)

Assuming the contribution did not rank for a deduction in terms of section 11(n). Paragraph 5(1)(a) of the Second Schedule of the *Income Tax Act* provides for a deduction of contributions that did not rank for a deduction under section 11(n).

It is also assumed that Mr Smith did not draw down more income (which would have been subject to income tax at the time) from the fund than the growth that took place in the fund and that the growth that took place in the fund did not exceed the value of the drawdowns over time. In other words, for purposes of this calculation, it is assumed that the value was still R5 000 000 at the time of Mr Smith's death.

<sup>1</sup> This example is based on an example by Carroll (2010:27).

**ADDENDUM B**  
**CGT AND THE TRANSFER OF GROWTH ASSETS TO A TRUST**  
**(Paragraph 3.4.3)**

Mr Smith's estate consists of his primary residence in Johannesburg, non-growth assets to the value of R5 000 000 and an additional fixed property situated in Knysna. His primary residence was purchased in 2005 for R1 500 000 and has a present (2011) market value of R2 300 000. The property in Knysna was purchased in 2007 for R2 000 000 and has a present (2011) market value of R4 800 000. Assuming an average rate of inflation of 4% and assuming that Mr Smith has 20 years left to live, the expected future market value of his primary residence will be R5 111 939 and that of the property in Knysna will be R10 668 394.<sup>18</sup>

The table below sets out a comparison between the positions (in 20 years' time) where Mr Smith retained the Knysna property in his estate and where he transferred the property to a trust in 2011. For purposes of this example it is assumed that the estate duty rebate (section 4A of the *Estate Duty Act*) remained R3 500 000, that the primary residence exclusion (paragraph 45 of the Eighth Schedule of the *Income Tax Act*) remained R1 500 000 and that the CGT deduction at death (paragraph 6 of the Eighth Schedule of the *Income Tax Act*) remained R200 000.

The initial taxes payable in transferring the Knysna property to the trust are as follows:

<b>Tax payable on transferring the Knysna property to a trust</b>	
<b>TRANSFER DUTY</b>	
On a property exceeding R1 500 001	R 37 000
Plus: 8% on R4 800 000 – R1 500 000)	R 264 000
<b>Total transfer duty payable</b>	<b>R 301 000</b>
<b>CGT</b>	
Proceeds	R4 800 000
Less: base cost	(R2 000 000)
<b>Capital gain</b>	<b>R2 800 000</b>
Less annual exemption	(R 20 000)
<b>Taxable capital gain</b>	<b>R2 780 000</b>
<b>CGT @ 10%</b>	<b>R 278 000</b>
<b>TOTAL COSTS</b>	
Transfer duty	R 301 000
CGT	R 278 000
<b>Total:</b>	<b>R 579 000</b>

<sup>18</sup> This example is based on an example in Olivier *et al.* (2008: Addendum C).

Knysna property retained in own estate		Knysna property transferred to a trust	
ESTATE DUTY		ESTATE DUTY	
<b>Assets</b>	<b>R20 780 333</b>	<b>Assets</b>	<b>R12 911 939</b>
Non-growth assets	R 5 000 000	Non-growth assets	R 5 000 000
Primary residence	R 5 111 939	Primary residence	R 5 111 939
Knysna property	R10 668 394	Loan account *	R 2 800 000
<b>Less: Liabilities</b>	<b>(R 2 037 168)</b>	<b>Less: Liabilities</b>	<b>(R 856 380)</b>
Administration costs	(R 829 135)	Administration costs	(R 515 186)
CGT	(R 1 208 033)	CGT	(R 341 194)
<b>Net estate</b>	<b>R18 743 165</b>	<b>Net estate</b>	<b>R12 055 559</b>
Less: Section 4A rebate	(R 3 500 000)	Less: Section 4A rebate	(R 3 500 000)
Dutiable estate	<b>R15 243 165</b>	Dutiable estate	<b>R 8 555 559</b>
Estate duty @ 20%	<b>R 3 048 633</b>	Estate duty @ 20%	<b>R 1 711 112</b>
ADMINISTRATION COSTS		ADMINISTRATION COSTS	
Gross estate	R20 780 333	Gross estate	R12 911 939
Executor's fee @ 3,99% **	<b>R 829 135</b>	Executor's fee @ 3,99%**	<b>R 515 186</b>
CGT		CGT	
<b>Total capital gains</b>	<b>R12 280 333</b>	<b>Total capital gains</b>	<b>R 3 611 939</b>
Gain on primary residence ***	R 3 611 939	Gain on primary residence ***	R 3 611 939
Gain on Knysna property	R 8 668 394	Gain on Knysna property	R 0
Less: exemption on death	(R 200 000)	Less: exemption on death	(R 200 000)
<b>Taxable capital gain</b>	<b>R12 080 333</b>	<b>Taxable capital gain</b>	<b>R 3 411 939</b>
<b>CGT @ 10%</b>	<b>R 1 208 033</b>	<b>CGT @ 10%</b>	<b>R 341 194</b>
TOTAL COSTS		TOTAL COSTS	
Estate duty	R 3 048 633	Estate duty	R 1 711 112
Executor's fee	R 829 135	Executor's fee	R 515 186
CGT	R 1 208 033	CGT	R 341 194
		Initial transferring costs	R 579 000
<b>Total</b>	<b>R 5 085 801</b>	<b>Total:</b>	<b>R 3 146 492</b>

**R 1 939 309**

\* Loan account reduced by annual allowable donation of R100 000

\*\* Prescribed fee of 3,5% (Government Notice R1602 of 1991) plus VAT at 14% levied over gross value of assets

\*\*\* Proceeds (R5 111 939) less base cost (R1 500 000)

The immediate costs (transfer duty and CGT) payable when the property is transferred to the trust often make the transfer of assets to a trust unattractive. It will therefore be ideal to rather transfer growth assets directly to a trust when purchasing or acquiring such assets. Where, however, the asset was not acquired in the trust from the start, and the estate owner wants to transfer it to a trust, these immediate costs will be absorbed by the future financial advantages thereof (Olivier *et al.*, 2008:C-4). It is clear from the example above that Mr Smith will save a significant amount (R2 175 467) as a result of the transfer of the Knysna property to the trust. After transferring the Knysna property to the trust, his net assets and the receivable loan from the trust will constitute the assets on which estate duty will be payable. If he did not transfer the Knysna property to the trust, his estate will be liable for estate duty on his current net assets, as well as estate duty and CGT on the growth assets.

**ADDENDUM C**  
**DONATION OF A LIMITED INTEREST AS AN ESTATE PLANNING TECHNIQUE**  
**(Paragraph 3.5.1 (d))**

Mr Smith (age 75) owns a property which has a market value of R4 500 000. The full market value (plus any growth) will be included in his estate for purposes of estate duty. If he donates a usufruct over the property to a younger person, estate duty savings are possible. The table below sets out a comparison between the position (5 years later) where Mr Smith retained the property in his own name and the position where he donated a usufruct over the property to his grandson (who was 25 years old at the time of the donation). Assume that the property is worth R6 000 000 at the time of Mr Smith's death.<sup>19</sup>

Property retained in own name	Usufruct over property donated
<b>ESTATE DUTY</b>	<b>ESTATE DUTY</b>
Value of property R 6 000 000	Value of bare dominium * R 76 603
Estate duty payable in respect of this property: R 1 200 000	Estate duty payable in respect of the bare dominium R 15 321
	<b>DONATIONS TAX AT TIME OF DONATION</b>
	Value of usufruct ** R 2 556 846
	Donations tax R 511 369
<b>TOTAL COSTS</b>	<b>TOTAL COSTS</b>
Estate duty R1 200 000	Estate duty at death R 15 321
Total R1 200 000	Donations tax at time of donation R 511 369
	Total R 526 690

**R 673 310**

\* Bare dominium = market value less the value of the usufruct (valued over the life of the usufructuary)  
= R6 000 000 less (R6 000 000 x 12% x 8,22694)  
= R6 000 000 less R5 923 397  
= R76 603

\*\* Value of usufruct at time of donation = market value x 12% x donor's life expectancy  
= R4 500 000 x 12% x 4,7349  
= R2 556 846

<sup>19</sup> This example is based on an example in Botha *et al.* (2010:825).

**ADDENDUM D**  
**UTILISATION OF THE SECTION 4A REBATE**  
**(Paragraph 3.6.2)**

Although the portability of the section 4A rebate simplifies matters for many estates, the need for estate planning still exists and in many cases it will still be worthwhile to use the section 4A rebate at the death of the first dying spouse. A planner should consider the growth potential of assets and the time value of money principle when deciding whether to use the section 4A rebate or to leave his entire estate to the surviving spouse and then utilise the combined exemption. If there is a growth asset and if the surviving spouse is relatively young, it may be wise to consider leaving the asset to a trust and using the rebate in the first-dying spouse's estate. This will limit or reduce the estate duty liability when the surviving spouse dies.

Mr Smith owns assets to the value of R8 000 000 and Mrs Smith owns assets to the value of R3 000 000. They are married out of community of property and the accrual system does not apply. The table below compares the position where Mr Smith bequeaths his whole estate to Mrs Smith with the position where he bequeaths an amount of R3 500 000 to a trust and the residue to Mrs Smith. In both cases there will be no estate duty payable at Mr Smith's death. Assume that Mrs Smith dies 15 years after Mr Smith and that the assets grew at an average rate of 8%. Liabilities (administration costs and CGT) will be ignored for purposes of this illustration.

<b>Mr Smith's death</b>		<b>Mrs Smith's death (15 years later)</b>	
Whole estate to spouse			
Assets	R 8 000 000	Assets	
Less:		Own assets (FV)	R 9 920 764
Bequest to spouse (section 4(q))	(R 8 000 000)	Assets inherited from Mr Smith (FV)	R26 455 372
Net estate	R 0	Net estate	R36 376 136
Less:		Less:	
Section 4A rebate	(R 0)	Section 4A rebate *	(R12 000 000)
Dutiable estate	R 0	Dutiable estate	R24 376 136
Estate duty @ 20%	R 0	Estate duty @ 20%	R 4 875 227
R3 500 000 bequeathed to trust			
Assets	R 7 000 000	Assets	
Less:		Own assets (FV)	R 9 920 764
Bequest to spouse (section 4(q))	(R 4 500 000)	Assets inherited from Mr Smith (FV)	R14 881 147
Net estate	R 3 500 000	Net estate	R24 801 911
Less:		Less:	
Section 4A rebate	(R 3 500 000)	Section 4A rebate *	(R6 000 000)
Dutiable estate	R 0	Dutiable estate	R18 801 911
Estate duty @ 20%	R 0	Estate duty @ 20%	R 3 760 382

\* Assume the section 4A rebate is increased to R6 000 000 over time.

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