

TAX CONSEQUENCES OF ESTATE PLANNING

by

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EXECUTIVE SUMMARY

The primary objective of estate planning is to meet the short-term and long-term financial needs of the planner and to ensure a smooth transition of the planner's estate on passing on, in keeping with the needs and wishes of the individual.

The implementation of an estate plan does hold many tax advantages and care should be taken to ensure that in the process of tax structuring, we do not lose sight of other important objectives and wishes of the client, as well not contravene any legislation which may render the tax benefits null and void.

Estate Duty is levied on an estate at a flat rate of 20 % on the net value of an estate and the planner needs to ensure that his financial affairs are structured in a manner to take maximum advantage of the deductions and abatements available. This will ensure that the duty payable is kept to a minimum.

In the process of estate planning the planner must always be aware of the other taxes that could reduce or negate the intended estate duty savings for example donations tax, capital gains tax and income tax.

There are many estate planning techniques that can be implemented to meet the objective of a smooth transition of the estate as well as being tax efficient. The nature of everyone's affairs and potential estates vary considerably.

As a result there are fairly simple techniques for planners with uncomplicated financial affairs.

These would normally be appropriate to salaried employees and smaller business owner's who do not amass a large estate over their lifetime. For high net worth individuals the techniques can be fairly complex, integrating the setting up of companies and/or trusts in order to achieve the planner's objectives and tax efficiency.

Due to the specialized and complex nature of certain entities specific estate planning techniques have been designed. With the relaxation of exchange control regulations many South African residents now have offshore assets which form part of their dutiable estate.

Careful consideration has to be given to this area since it can be complex with different rules applying to different offshore centres. This is dependant on whether South Africa has a double taxation treaty with that country or not.

Income tax and estate planning are inter-related and structures designed to reduce estate duty may have differing consequences from an income tax point of view. This occurs in particular when the use of trusts and donations are envisaged and care should be taken that cognizance of all the anti-avoidance provisions of the Income Tax Act are carefully considered.

We can be certain of two things in life "death and taxes". The timing of one's death is an unknown mystery but tax is defined in terms of legislation. With careful planning one can take maximum advantage of the available "tax breaks" with the flexibility to react to changes in legislation, so that the plan can always meet the wishes of the planner irrespective when he/she may pass on (Personal Finance:2004)

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INTRODUCTION

INTRODUCTION

As Farr and Wright (*An Estate Planner's Handbook* (1979) at 30-31) have noted in their analysis of estate planning, lawyers see their role as facilitators of the wishes of the estate owner. Viewed in less parochial terms the process can be broken into two stages, namely the preparation and implementation of a plan of wealth disposition during the lifetime of the client and secondly the implementation of the client's plan following his death.

This study concerns both stages in that it seeks to examine the variety of techniques required to facilitate an estate owner's wishes both during his lifetime and after death. Income tax and estate duty considerations often become the key catalyst for any estate planning, but holistic planning goes beyond this and takes a complete view of the planner's financial affairs and presents appropriate solutions incorporating the planner's wishes.

Estate planning and tax planning are fully compatible since tax savings increase the amount of property for disposal according to the planner's wishes.

Estate planning needs to be considered irrespective of the potential size of the estate, since the plan can be as simple as drawing up a will or as complex as establishing and/or unraveling local and/or offshore trusts.

Taxpayers recognize that there is an obligation to pay tax, the extent of the contributions by the taxpayer remain an area of concern. Tax is an expropriation of a taxpayer's earnings or wealth, and the taxpayer will always seek to achieve tax efficiency by adopting effective tax planning strategies. The focus of this study is on the integration of tax efficiency with the client's wishes with regard his assets.

1.1 Objectives of the Study

- To define Estate Planning and the key objectives
- To identify the critical issues that need to be considered when embarking on an estate plan
- To examine the impact of estate planning on the planners affairs and way of minimizing the applicable taxes
- To discuss the different structures that can ensure a smooth transition of an individuals estate/assets on death
- To examine the income tax issues as they pertain to estate planning

ESTATE PLANNING

2.1 DEFINITION OF ESTATE PLANNING

Meyerowitz, 2004 has developed a comprehensive definition of estate planning in the following terms:

“The arrangement, management and securement and disposition of a person’s estate so that he, his family and other beneficiaries may enjoy and continue to enjoy maximum from his estate and his assets during his lifetime and after his death, no matter when death may occur”.

2.2 ESTATE PLANNING PROCESS

2.2.1 Phase 1: During life

This includes measures to “freeze” the value of the estate at its current value to achieve estate duty and capital gains tax savings, whilst at the same time ensuring that there are no possible liquidity problems.

2.2.2 Phase 2 : After death

This involves the implementation of the provisions of the will of the planner and the continued use of any existing inter vivos trust or the formation of a testamentary trust to achieve the objectives of the client as stated by Abrie *et al* (2003).

2.3 OBJECTIVES OF ESTATE PLANNING

In the book by Davis *et al* (2004) the objectives of estate planning can be summarized as follows:

2.3.1 Flexibility

The estate plan must make provision for changes in the legal environment and more importantly, in the personal and family circumstances of the estate planner.

2.3.2 Minimisation of all expenses including taxes

The estate plan has to ensure that the plan is cost effective and makes use of all exclusions, deductions and tax exemptions that are available.

2.3.3 The provision of liquidity

It is important that sufficient liquidity should be available after the death of the planner to ensure that liabilities can be met without having to dispose of assets at possibly the wrong time at relatively low prices. Another vital aspect is the need for liquidity for the dependants during the winding up of the estate. This problem is compounded in situations where the estate consists of one or more large assets e.g. property portfolios, farms and shareholding in private companies which may not be readily saleable.

2.3.4 Commercial soundness

Ensure assets are invested in a manner that balances potential growth, income yield and client's acceptance of associated risks. Ensure that the assets are held in a legal vehicle that provides maximum protection from reckless activities.

2.3.5 Protection against insolvency and inflation

Protection against insolvency includes the insolvency of not only the planner, but also his future beneficiaries and spouses of beneficiaries.

2.3.6 Good Governance

The planner's estate has to be properly managed during his or her lifetime and after death in accordance with his or her wishes. It is very important that the plan operates smoothly without the presence of the planner and the original advisor.

TAXES THAT IMPACT ON ESTATE PLANNING

3.1 BACKGROUND

Effective estate planning requires a thorough knowledge and application of the following Acts:

- Estate Duty Act 45 of 1955
- Donations tax provisions (Section 54-64) of the Income Tax Act No. 58 of 1962
- Capital gains tax provisions (Section 26 A) of the Income Tax Act No. 58 of 1962

These relevant sections of the Acts are discussed to obtain an understanding of the key provisions and issues that have are pertinent to estate planning.

3.2 ESTATE DUTY

Estate duty is levied on the estates of deceased persons in terms of the Estate Duty Act 45 of 1955. This Act applies to the estates of all deceased persons who were resident in South Africa at the time of death. The Act will also apply to non-residents to the extent that such persons have assets in South Africa, but any estate duty liability may be varied by the terms of a double duty agreement that exists between South Africa and many other countries.

For the purposes of the Estate Duty Act a person's estate consists of the following:

- All "property" of the deceased at the date of death; and
- All "property which is deemed to be property" of the deceased at the date of death.

3.2.1 The meaning of "Property"

The definition of "property" (which is set out in section 3(2)) defines property as "any right in or to property, movable or immovable, corporeal or incorporeal".

The definition includes property of all types, wheresoever situated, of all persons dying after 1 April 1955. Thus estate duty may potentially be levied on the estates of persons who were neither citizens of South Africa, nor domiciled nor ordinarily in the country at the date of death. In addition, it includes property both within and outside South Africa. However, this wide definition is narrowed by various exclusions and through the allowance of certain deductions in terms of section 4 of the Act.

Property therefore includes the following:

- actual property such as houses, household goods, investments, shares, farms and patents;
- rights of enjoyment which the deceased held on his or her death, such as any fiduciary, usufructuary or other like interest in property (section 3(2)(a));

- any right to an annuity charged against property which the deceased held immediately prior to his or her death (section 3(2)(a)); and
- Any other right to an annuity which accrued to some other person on death of the deceased (section 3(2) (b)). It should however be noted that an annuity that become payable on or results from the death of a member of a pension fund or retirement annuity fund is excluded from deemed property in a deceased estate (in terms of section 3(3) (a) bis (i))." Meyerowitz (2004).

Meyerowitz (2004) states that SARS accepts that the exclusion from the "deemed property" provisions (in terms 3(3)(a) bis (i)) also applies to "property" under section 3(2)(b) if the annuity passing on death is derived from a pension or retirement annuity fund.

The principal behind the inclusion of these "limited rights" is that someone will benefit as a result of the death of the deceased. The annuity must therefore form part of the "property" of the deceased estate because someone's assets will be enhanced as a result of the death of the deceased.

Annuities will only be included as "property" if another person will benefit from it on the death of the deceased. If the annuity ceases on the death of the deceased, such annuity will not be included as "property" because no one stands to benefit in respect thereof on death of the deceased.

An assurance policy owned by the deceased on the life of another person must be included as "property" at its surrender value. On the other hand, a policy owned by the deceased on his or her own life does not constitute property because, strictly speaking, the proceeds are only due the moment after death. The proceeds of such policies are, however, in some circumstances regarded as "deemed property" which have to be included in the estate.

3.2.2 Specific Exclusions from Property

Section 3(2) (c) to (h) of the Act specifically exclude from the definition of "property" certain assets which would otherwise be included in the deceased's estate, where the deceased was not ordinarily resident in the Republic at the date of death. Before a detailed discussion of the exclusions a definition of 'ordinarily resident' is appropriate to place it into proper context.

The term 'ordinarily resident' is not defined in any South African legislation and accordingly its meaning must be sought in the cases. The position is summarized in Income Tax Interpretation Note No. 3 (February 2002) as follows:

"Although the Income Tax Act 58 of 1962 does not define 'ordinarily resident', the courts have interpreted the concept to mean the country to which a person would naturally and as a matter of course return from his/her wanderings. It might therefore be called a person's usual or principal residence and it would be described more aptly, in comparison to other countries as the person's real home. The above approach was followed in the case, *Cohen v CIR* (13 SATC 362) and confirmed in case *CIR v Kuttel* (54 SATC 298)."

3.2.3 The meaning of “Deemed Property”

Section 3(3) of the Estate Duty Act provides that certain property is “deemed” to be that of the deceased and these are as follows:

3.2.3.1 Proceeds from certain domestic policies of insurance

The proceeds of life policies are included within deemed property if they meet the following criteria:

- There must be an amount due and recoverable;
- under a policy of insurance which is a “domestic policy” as defined; and the policy concerned must be upon the life of the deceased (section 3(3)(a)).

A domestic policy (which is defined in section 1 of the Long Term Insurance Act 52 of 1998) is a policy which is payable in South Africa. These policies are “deemed” to be that of the deceased because, strictly speaking, the proceeds are only due the moment after death. As such they cannot be really regarded as “property” of the deceased at the time of death.

Since someone will benefit from these proceeds, the policies are deemed to be property of the deceased for estate duty purposes.

The amount of the life policy proceeds falling within deemed property for this purpose is, however limited to the excess of those proceeds over the sum of the following:

- Any premium or consideration paid by any person who is entitled to the amount due under the policy; and
- Interest at a rate of six percent (in practice) compounded per annum calculated upon such premiums or consideration from the date of payment to the date of death.

The proceeds of policies of the following types of are excluded from the definition of deemed property and hence effectively exempt from estate duty:

- Policies effected in terms of a duly registered antenuptial or post-nuptial contract, if the amount due under the policy is recoverable by the surviving spouse or child of the deceased under such a contract (section 3(3)(a)(i));
- Policies effected under buy-and-agreement. A policy taken out by the deceased's partner(s), co-shareholders(s) or co-member(s) for the purposes of acquiring the deceased's interest or shares in terms of a buy-and-sell arrangement (section 3(3)(a)(iA) are excluded from the "deemed property" provisions. To qualify for this exemption the Commissioner must be satisfied that the policy was taken out or acquired for the purposes of acquiring the whole or part of the deceased's interest in a partnership, company or close corporation. A further requirement is that no premium on the policy has been paid or borne by the deceased (Granger, 2004).

3.2.3.2 Payments from benefit funds

Benefits due and payable by any fund on or as a result of the death of the deceased are defined as deemed property for the purposes of the Act (section 3(3)(a)(bis)). The term "fund" is not defined but would include a pension fund, superannuation fund, provident fund, retirement annuity fund and benefit fund.

However a deduction from these proceeds is allowed of the total amount of contributions paid by any person entitled to the proceeds together with 6% interest calculated from the date of payment of those contributions to date of death of the deceased (section 3(3)(a)(bis)). It is also the practice of South African Revenue Services to grant an estate duty deduction of the income tax payable on lump sums which are included in as deemed property. Furthermore any lump sum payable to a surviving spouse on the death of the deceased while a member of a pension, provident, retirement or benefit fund will be deductible from the dutiable estate under section 4(q) (Kourie *et al*, 1997)

3.2.3.3 Donations *mortis causa*

Any property donated under a donation in contemplation of death is deemed property and hence included in dutiable amount of the deceased's estate (section 3(3) (b)), but is exempt from donations tax.

This can be important in relation to non-residents and international estate planning. A donation made by a deceased who is not ordinarily resident in the Republic at the time of death which does not constitute property will not be included in deemed property.

3.2.3.4 Claims in terms of the Matrimonial Property Act

The amount of any accrual acquired by the deceased from his spouse in terms of section 3 of the Matrimonial Property Act 88 of 1984 is deemed to be property of the deceased for estate duty purposes (section 3(3)(cA)). The accrual system seeks to ensure that all the net assets accumulated during the subsistence of the marriage are shared equally between the spouses upon dissolution of the marriage. A marriage is dissolved on death of one of the spouses.

The accrual in an estate is therefore the amount by which the net value of the estate at dissolution of the marriage exceeds the net value at commencement of the marriage. Section 3(3)(cA) of the Estate Duty Act provides for the inclusion in the estate of a deceased spouse the amount of any accrual acquired, in terms of the Matrimonial Property Act, from the surviving spouse. Section 4(1A), on the other hand, allows a deduction of the amount of any accrual acquired by a surviving spouse from the estate of the deceased. There is no need to provide for an accrual system in marriages in community of property because each spouse is entitled to half of the joint estate (Granger : 1984)

3.2.3.5 Property of which the deceased is competent to dispose

Property deemed to be property of the estate is property not belonging to the deceased but which, immediately prior to his death, the deceased was competent to dispose of for his or her own benefit or for the benefit of his or her estate (section 3(3)(d)).

If the deceased retained power over assets in a discretionary trust which the deceased had formed to freeze his or her estate, the whole estate planning exercise could be null and void. To be effective and to avoid this deeming provision, the trust deed should not permit the client to make decisions on property dispositions, whether acting alone or with notice to the trustees. Trust deeds should provide that any disposals of property can only be taken by majority decision of all trustees acting together whilst exercising their own independent judgement in arriving at a decision. If the trustees are found to be acting on the instructions of the client, this deeming provision is likely to apply. In the case *Ceighton Trust v CIR* 1955 (3) SA 498 (T) it was held that the founder's powers to vary trust benefits were so wide that the trust assets were included in his dutiable estate in terms of the deeming provision. In a community of property marriage the surviving spouse's share will be expressly excluded from this deeming provision in terms of section 3(4) (d) (Granger : 1984)

3.3 DONATIONS TAX

A donation is defined in section 55 (1) of the Estate Duty Act as:

"Any gratuitous disposition of property including any gratuitous waiver or renunciation of a right".

Donations tax is levied in terms of Part V of the Income Tax Act 58 of 1962.

Donations tax is levied at a flat rate of 20 % (25 % prior to 1 October 2001).

Section 54 subjects donations which are made

- by persons ordinarily resident in the Republic, or
- by domestic companies,

to tax at a flat rate of 20 % (25 % prior to 1 October 2001). A person can make a donation of up to R30 000 per annum free of donations tax.

Donations tax is a tax payable on the gratuitous disposal of capital, not income, by a taxpayer. It was introduced in March 1955 with the following reasons for the introduction being given by the then Finance Minister in his budget speech of 24 March 1955 (Davis *et al*, 2004):

"A method also employed for avoiding taxation is by distribution of gifts—a practice which has, during recent years, been employed on a large scale. It serves a double purpose. In the first place the donor reduces the assets on which estate duty would be payable at death, and in addition whilst he is alive, he reduces his income tax, because by means of these donations the assets, and hence also the income derived therefrom, are spread over a great number of taxpayers" (p.2-44).

Donation is an obvious method of shifting wealth from one person to another, or from one generation to another, and thereby reducing the dutiable amount of one's estate. In this way estate duty could be minimized or avoided altogether.

3.4 CAPITAL GAINS TAX

Capital gains tax became operative on 1 October 2001. In terms of section 26A of the Income Tax Act "there shall be included in the taxable income of a person for a year of assessment the taxable capital gain of that person for the year of assessment determined in terms of the Eighth Schedule of the Act". The Eighth Schedule provides the mechanism by which the gain is to be calculated.

The inclusion rate is set as 25 % of the net gain for natural persons and special trusts and 50 % of the net gain for other taxpayers. The net effect of the inclusion rate is that natural persons and special trusts at the maximum marginal rate are taxed at an effective rate of 10 % on their capital gains, ordinary trusts at 20 % and companies and close corporations at 15 %.

Capital gains are therefore levied on the growth in the value of the assets in the hands of the deceased since 1 October 2001 (i.e. market value of asset on date of death less base cost of the asset). There are certain exclusions for capital gains purposes. These are discussed briefly to put this tax into perspective.

Williams (3 rd Ed.).

3.4.1 Annual exclusion on death

In the year that a person dies, the annual exclusion increases from R10 000 to R50 000.

3.4.2. Primary residence exclusion

Any gain on the primary residence of up to R1 million will be disregarded for capital gains tax purposes.

3.4.3 Personal-use assets

No capital gains tax is payable on the deemed disposal of personal-use assets of the deceased.

3.4.4 Small business exclusion

If the deceased owned a "small business" then a gain of up to R500 000 can be excluded in calculating any capital gains tax liability arising from the deemed disposal of assets. In order to take the benefits of this exclusion the person must

- be at least 55;
- the disposal must be due to ill-health or infirmity
- the disposal must arise due to that person's death
- the interest in the "small business" must be held by a natural person
- the interest must have been held for at least 5 years and the deceased must have been substantially involved in the business
- The disposal must be in respect of a business which has a market value of not more than R5 million. If more than one business interest, the total business interests must not be more than R5 million.
- The exclusion is only in respect of the disposal of "active business assets".

Any capital gains tax liability will reduce the net value of the deceased estate for estate duty purposes.

3.5 DONATIONS TAX AND CAPITAL GAINS TAX

A donation constitutes a "disposal" for capital gains tax purposes, and therefore a donation will attract donations tax as well capital gains tax. The disposal is deemed to be at market value.

DETERMINATION OF ESTATE DUTY

4.1 FRAMEWORK FOR ESTATE DUTY CALCULATION

Table 4.1 : Sets out a framework for the determination of estate duty:

Step 1	Determine a deceased's "property" As provided for in section 3(2) and as valued in the manner provided for in section 5	Rxxx
Step 2	Determine what amounts must be included as "deemed property" as provided for in section 3(3), (4) and (5) and value these amounts in the manner provided for in section 5.	Rxxx
Step 1 + Step 2 =	Total gross value of the property	Rxxx
Step 3	Determine what deductions are allowed in terms of the Estate Duty Act (section 4 of the Act)	(Rxxx)
Gross value of estate less deductions =	Net value of the estate	Rxxx
Step 5	Subtract the abatement provided for in section 4A of R1 500 000	(R1 500 000)
	Dutiable amount (if any) of estate for estate duty purposes	Rxxx
Step 6	Apply the rate of estate duty (20 %) to the dutiable amount	Estate duty payable: Rxxx

Source: The South African Financial Planning Handbook 2004 (p 533)

The items that would be included in Step 1 and Step 2 (i.e. property and deemed property) have been discussed in detail in Chapter 3.

Certain deductions are permitted in arriving at the dutiable amount. The following are some of the more important allowable deductions permitted in terms of section 4 of the Estate Duty Act:

- Death-bed, tombstone and funeral expenses
- Debts and liabilities
- Administration and liquidation expenses and also expenses necessary to comply with the Estate Duty Act
- Property situated outside of South Africa and acquired by the deceased before he or she became ordinarily resident in South Africa for the first time, or acquired by donation or inheritance from a non-South African resident after he or she became a South African resident for the first time, is excluded from the dutiable estate
- Improvement made to property resulting in an enhancement of that property are deductible if they were made by the person who becomes entitled to that property on the deceased's death
- Claims under the Matrimonial Property Act are deductible
- Bequests to public benefit organizations
- Accruals including bequests to the surviving spouse
- Certain limited rights which were held by the deceased and which revert back to the donor of those rights
- Domestic policies: avoidance of double estate duty

The dutiable amount of an estate is calculated by subtracting from the net value of the estate a single deduction of R1.5 million – sometimes referred to as the abatement. The resultant balance is the dutiable amount which attracts tax at a flat rate of 20 %. (Botha *et al.* 2004).

4.2 PERSONS LIABLE FOR ESTATE DUTY

Any estate duty shall be payable by and recoverable from the executor of the estate. However, the executor may recover the duty attributable to :

- The proceeds of any policy on the life of the deceased deemed to have been his property, from the person to whom it is payable
- Any benefit payable by a pension or other fund deemed to have been property of the deceased, from the person to whom it is payable
- Any usufructuary or other life interest, from the person to who such limited interest accrued.

BASIC ESTATE PLANNING TECHNIQUES

When developing an estate plan estate duty savings can be achieved, but the objectives discussed in Chapter 2 must be considered to ensure that the plan is holistic and does not compromise the estate or the planner.

According to Botha *et al* (2004), there are a number of transactions and schemes which lead to successful reduction of estate duty and these are discussed in detail.

5.1 USE OF DONATIONS

The possible use of donations to reduce one's estate include at least the following:

- The first R30 000 of all amounts donated by a natural person in any year of assessment are exempt from donations tax (Section 56(2) (b) of the Income Tax Act 58 of 1962). This exemption is applicable per person. Accordingly, a married couple may in aggregate donate assets worth R60 000 per annum without incurring donations tax. This exemption is applicable even where assets are transferred to non-natural persons for example, to a trust.

- 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 donations tax in respect of such an asset now and donate the asset, rather than pay significantly more estate duty in the future.
- Assets may be donated to achieve an outright saving if donations tax and estate duty. For example, assume that the net value of a person's estate is R3.5m. On death he would have to pay estate duty on a dutiable amount of R2.0 million (after deduction of the R1.5m abatement). However, if prior to death he donates assets of R1.7m, he is liable for R0.34m in donations tax. However the donations tax plus the donation itself reduce the net value of the estate to a value of R1.46m. Since the estate would now be below the R1.5m abatement no estate duty would be payable. In this example a net saving of R0.06m in tax/duty would be achieved.
- Section 56(1)(d) of the Income Tax Act exempts from donations tax a donation in contemplation of death and section 56(1)(d) exempts a donation in terms of which the donee will not obtain any benefit thereunder until death of the donee. It vests only on the donor's death and may be revoked by the donor at any time even if it has been delivered to the donee.

- Generally the foreign assets of a person ordinarily resident in South Africa at death are included in his/her estate for estate duty purposes. Certain foreign assets are, however, excluded.
- Donating a limited interest can be an effective technique, particularly in the case of an aged minor, as illustrated below. For example, a donor aged 75 donates a usufruct over a farm with a fair market value of R300 000 to his grandson aged 25. The donor dies five years later when the value of the property is R400 000.

Table 5.1 Donation of a limited interest calculation

	R	R
Usufruct value for donations tax purposes:		
Annual Value of usufruct-12% of R300 000	36 000	
Life expectancy of donor-factor 4.7349		
Value of usufruct for donations tax		170 456
On death of donor:		
Bare dominium valued for estate duty purposes as		
Value of Property	400 000	
Less: Value of usufruct based on life		
Expectancy of heir aged 30-factor 8.22694	394 893	
Value of bare dominium		5 107
Total Value for estate duty and donations tax		175 563
Market value of property at date of death		400 000
Savings in donations tax / estate duty (R400 000 less R175 563)		224 437
Saving in tax / duty @ 20 % thereon		44 887

Source: Estate Planning 2004 (p9-8(7))

- Donations between spouses are exempt from donations tax. This is an important provision which may be used to reduce the estate of one spouse in favour of the other. This exemption applies to donations not only to spouses, but also for the benefit of a spouse.

A donation by a husband of an asset into a trust under which his wife has a vested right to income or capital would, qualify for the exemption. This means that the assets may be removed from the estate duty net in respect of the estate of the donor. However the value of the vested rights would be included in the estate of the donee spouse for estate duty purposes.

One spouse may wish to donate to the other spouse:

1. To ensure full use of the R1.5m abatement in both parties estates.
2. To provide the spouse with the smaller estate with the opportunity of donating R30 000 per annum to the spouse's ultimate heirs free of donations tax. These types of donations can in some instances attract donations tax if for example the donation to the spouse was made on that the receiving spouse donate the sum to a trust. This may be construed as a donation from the donor spouse to the trust, thereby attracting donations tax. It is also possible that Revenue may be able to attack the scheme under the general anti-avoidance provisions (section 103(1) of the Income Tax Act 58 of 1962.

3. A limited interest over some of his property. In this way not only is the value of the property reduced in his estate as it is subject to a limited interest, but the value of the limited interest itself ranks for a deduction in the estate of his spouse, assuming that his spouse survives him and the property over which the limited interest is granted forms part of the estate.

5.2 USE OF R1.5M ABATEMENT

Section 4A of the Estate Duty Act provides for an amount of R1.5m to be deducted from the net value of a deceased's estate to arrive at the dutiable amount – this being the sum on which the duty is calculated. Accordingly, maximum use should be made of this abatement to minimize the impact of estate duty.

Where a couple has, in aggregate, net assets of more than R3.0m, one should ensure that during their lifetimes each party's estate is worth at least R1.5m. In this way, irrespective of which spouse dies first, the couple may potentially ensure that in aggregate they pass assets worth in R3.0m to their heirs without paying estate duty thereon.

It is not sufficient in a situation where one spouse has a very substantial estate, for that spouse merely to provide in his/her will for a bequest of R1.5m to the spouse with the smaller estate. If the spouse with the smaller predeceases the spouse with the larger estate, the benefit of the full use of the R1.5m abatement is lost.

It is vital for each spouse in his/her will to bequeath at least R1.5m of assets to their ultimate beneficiaries e.g. their children or a trust. The advantage is lost if the first dying merely bequeaths his/her full estate to the surviving spouse, as the benefit of the section 4A abatement is therefore lost in the first dying estate.

Where spouses are married in community of property, there is no need for the spouses to pass assets between themselves during their lifetime to ensure maximum use of the R1.5m abatement. Their total assets are, by operation of law, split 50/50 on the death of the first dying.

Where spouses are married under the accrual system, notwithstanding the fact that this system equalizes to some extent the growth in their estates on dissolution of the marriage (as in the case of death), the parties should still attempt to ensure that if their combined assets exceed R3.0m during their lifetime, each party's estate is worth at least R1.5m.

As donations between spouses are no longer voidable since the advent of the Matrimonial Property Act, 1984 and as they are exempt from donations tax, spouses may freely donate assets from one to another to structure their assets in a manner that is tax efficient.

5.3 THE WILL

The will is an important tool in estate planning since it is only on death that the full estate plan comes into fruition. There are many issues and formalities that have to be complied with to ensure that the will is structured correctly. The focus of the following discussion as per Pace *et al* (2003) is limited to the tax consequences and the use of the will to gain maximum tax advantage.

For estate duty purposes it generally makes no difference how property is actually disposed off by a testator, except in two situations.

The first is where a bequest of the property is made directly or indirectly to what can loosely be called a charitable institution. In this situation, section 4(h) of the Act applies and in some situations this may be a fruitful avenue for reducing estate duty in cases where the testator has charitable leanings.

The second arises where property is disposed of by will to a surviving spouse.

In the drafting of the will the following points need to be considered to ensure that it minimizes the estate duty payable:

- Bequests to the surviving spouse to make use of the section 4(q) deduction, merely delays the payment of estate duty until the death of surviving spouse. If there are substantial growth assets it may compound the estate duty problem in the future.

- The manner in which the residue of the estate is bequeathed changes the amount of estate duty payable. This illustrated by the following example: Suppose that a person with net assets of R10m (before any bequests) wishes to leave R3.5m to his wife and the balance after paying any duty to his children. He could achieve this in one of two ways:

(a) He makes a specific bequest in his will of R3.5m to his wife with the residue of his estate going to his children. In this case estate duty of R1m would be payable calculated as follows:

Table 5.2 Will – A tool to reduce estate duty : Scenario 1

	R million
Net assets	10.0
Less : Deduction for accrual to surviving spouse	(3.5)
Net asset value of estate	6.5
Less : Section 4A abatement	(1.5)
Dutiable amount	5.0
Duty thereon at 20%	1.0
Distribution to the estate	
Wife	R3.5 million
Children	R5.5 million
Duty	R1.0 million
Total	R10.0 million

Source: Estate Planning (2004) (p.9-17)

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

Table 5.3 Will - A tool to reduce estate duty : Scenario 2

	R million
Net assets	10.0
Less : Deduction for accrual to surviving spouse (10.0 - 5.5)	(4.5)
Net asset value of estate	5.5
Less : Section 4A abatement	(1.5)
Dutiable amount	4.0
Duty thereon at 20%	0.8
Distribution to the estate	
Wife	R3.7 million
Children	R5.5 million
Duty	R0.8 million
Total	R10.0 million

Source: Estate Planning (2004) (p.9-18)

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

This form of estate planning may, however, become complex where, owing to the needs of the surviving spouse, certain specific assets need to be given to her.

5.4 PARTNERSHIPS

This is a useful tool that has the major advantage of being flexible, in that the profit sharing ratio in the partnership need not necessarily be the same as the capital contribution ratio. This can be a means of shifting wealth from one partner to another over time, without incurring any donations tax implications.

This can also serve as a mechanism to shift wealth between generations in family partnership thus circumventing donations tax and estate duty.

For example, a parent may have his own business in which his son is employed fulltime. Instead of the son merely being an employee, the parent could run the business with the son as a partner. As the son's contribution to the business increases his profit ratio can also increase. In this way the parent reduces the portion of the value of the business to be included in his estate on death. This arrangement is particularly appropriate where the sole trader does not have a large capital contribution in the business, although the profit sharing ratio does not have to be in the ratio as the ratio of capital contribution.

These basic estate planning techniques have their disadvantages for example:

- A planner often needs to dispose of his growth assets. However was he merely to donate the assets, he might be subject to donations tax thereon. The cost may be unacceptable and needs to be paid immediately.

- Even if he donates assets to his spouse, which may be done free of donations tax, this merely transfers the problem to his spouse's estate.
- Where a planner is able to dispose of his growth assets without any significant fiscal disadvantage, there is often a desire to maintain some control over the assets on the part of the planner.

In view of these and other concerns, the use of these basic tools only is insufficient and more complex tools are available (discussed in later chapters) to address these and other relevant issues.

PEGGING THE VALUE OF THE ESTATE

6.1 BACKGROUND

Where a planner has a large capital base with assets that have growth potential, the growth in nominal value can have quite a severe impact on the estate duty. Therefore it is vital to use techniques to peg the value of the estate, which is usually achieved by disposing of the assets in a means that would not constitute a donation.

Whilst the primary reason for wanting to peg the value of an estate is to prevent further growth in the estate and hence save future estate duty, pegging the value of the estate also assists in overall planning. By more or less freezing the value of an estate many years before his death, one is establishing well before death what the maximum estate duty likely to be payable. In this way arrangements can be made in an orderly manner to ensure that there is sufficient liquidity in the estate to pay any duty.

6.2 SALE ON LOAN ACCOUNT

A typical means of disposing of growth assets is for the planner to sell them to his future heirs. As the latter would generally not have the means to pay for the assets immediately, the purchase consideration is usually left outstanding on loan account. In order that the estate does not grow any further, such a loan is generally interest free.

The risk of incurring donations tax can be reduced in the following manner:

- Independent valuations are obtained of the assets sold;
- Where possible, Revenue approval is obtained for the transfer values; and
- The loan is repayable on demand;
- The loan is recorded. If it remains unrecorded Revenue may contend that there was no consideration for the disposal of the asset and that it has accordingly been donated.

South African Revenue Services (SARS) are monitoring this area closely and any caution must be exercised to ensure that the planning mechanism does not become futile due to SARS treating the transaction as a donation.

The asset can be sold by suspensive sale which still gives the planner control over the asset and ownership only passes once the full amount has been repaid.

The main advantage of a sale of growth assets is enjoyed when the property increases in value, for with the property pegged at the sale price for estate duty purposes any increase in value does not attract estate duty in the planner's estate.

The planner may reduce the amount owing on the loan by donating R30 000 per annum to the debtor to enable the debtor to reduce the indebtedness. However, cash donations must be used for this purpose because they do not give rise to capital gains tax (Para 1 of the Eighth Schedule to the Income Tax Act 58 of 1962). Partial waivers of loans will, however be regarded as disposals for capital gains tax purposes (Para 12(5) of the Eighth Schedule). So if, for example, a planner sells his assets to an heir on loan account and each year waives R30 000 of the debt, no donations tax arises, but each year the heir has a capital gain of R30 000. On the other hand, if the planner donated R30 000 of cash each year to the heir which the heir used to repay a portion of the loan account the heir makes no capital gains.

6.3 USE OF OPTIONS

A further method of pegging an estate for estate duty purposes is using the option contract. For example, a wealthy farmer with a farm, the value of which has been growing rapidly, grants an option to his son to purchase the farm at Land Bank value. The terms of the option are such that the option is exercisable within a three months period of the planner's death. The estate will be liable for estate duty on the price of the option and not on the fair market value (or Land Bank) value of the farm as at the death of the farmer.

The advantages of the scheme would be as follows:

- It is a simple method which can be utilized to peg the growth of the estate for estate duty purposes;
- It is a simple plan which avoids the complexities of trusts or family investment companies, as well as the costs of incorporation and on going management.
- It enables the planner to maintain full control of the property until death;
- The planner can grant the option so as to ensure that the beneficiaries of his property obtain the maximum advantage from his estate.

6.4 SALE IN EXCHANGE FOR PREFERENCE SHARES

Where a company is integrated into the estate plan, the planner can sell the asset in exchange for preference shares. Such preference shares may or may not have voting rights, depending upon whether the planner would want to enjoy control of the asset.

However when shares are used to "peg" the value of the planner's estate, the rights to dividends and return of capital will result in the effect of the pegging being negated. A low dividend rate to the shares and not giving the preference shareholder any right to participation in any surplus on winding up can overcome this problem.

THE USE OF LIMITED INTEREST

7.1 BACKGROUND

For estate duty purposes the valuation of a limited interest is made over the life expectancy of the person succeeding to it or, if the interest is to be enjoyed for a lesser period, over this lesser period. If that person is young the value can be large and estate duty consequences punitive.

7.2 THE USE OF LIMITED INTEREST

If a person dies holding a usufructuary or like interest in an annuity, the younger the successor to the interest or annuity is, the higher the value will be for estate duty purposes. If the successor is a person other than a natural person, for example, a trust, company or close corporation, then the interest or annuity is valued over a period of 50 years.

If a person dies holding the bare dominium in property, the younger the usufructuary is, the lower the value of the bare dominium will be for estate duty purposes, and vice versa. So the older the usufructuary gets, the greater the estate duty liability becomes.

There is a difference between the valuation of usufructs and the valuation of fiduciary interests. The value of a usufruct ceasing cannot be greater than the difference between the market value of the property (at the date of valuation) over which the usufruct is enjoyed and the value of the bare dominium at the date the usufruct was first created.

For example, on the testator's death the market value of the property is R1 000 000 and the value of the usufruct is R400 000. The value of the bare dominium is therefore R600 000. Assume that on death of the usufructary the market value is still R1 000 000 and the value of the usufruct valued over the successor's life expectancy is R700 000. The limitation reduces the value to $R1\ 000\ 000 - R\ 600\ 000 = R400\ 000$.

If on the death of an annuitant, the recipient cannot be determined until a future date then the annuity will be exempt from estate duty. So, for example, if spouse A left an annuity to spouse B and provided that after B's death the annuity was to be paid to the children of the marriage still living five years after spouse B's death, the annuity would not be included in spouse B's estate for estate duty purposes.

From an estate planning point of view the annuity may have certain advantages over the usufruct. Due the method of calculation it is possible for the value of an annuity to exceed the capital value producing the annuity. This could occur where the annual annuity exceeds a 12% return on the underlying property. For example, the deceased enjoyed an annuity of R150 000 a year from property with a value of R1 000 000. A male, aged 40, now succeeds to the annuity. The value of the annuity for estate duty purposes is R1 206 045 Abrie (2003).

THE USE OF COMPANIES AND CLOSE CORPORATIONS

8.1 LIMITATIONS OF ESTATE PEGGING TECHNIQUES

A corporate entity can be used to overcome the limitations that are created by estate planning techniques:

- The planner losing control of the assets and or the income generated there from.
- Has to distribute assets long before death and no cognizance is taken of changing circumstances.
- There is a danger of assets being dispersed. For example, if one child acquires the holiday home and he/she decides to sell it, the family as a whole is denied future use of it.
- As growth assets are passed directly to the children, an estate duty problem may in due course be created in their hands.

It is for these and other reasons that it is often desirable to transfer the planner's assets into a corporate entity.

8.2 STRUCTURE USING A CORPORATE ENTITY

Assuming a planner has three children whom he wishes to benefit more or less equally, the integration of a company or close corporation into an estate plan could be structured along the following line:

- The planner could form a company (or close corporation), say A CC.
- A CC would be established having both ordinary and preference shares. Both the ordinary and preference shares would carry one vote per share and issued at a nominal amount of for example, R1 per share.
- The preference shares would have a low dividend rate to ensure that the wealth transfer to the planner is kept to minimum.. If the CC is wound up the preference shareholder would only receive a share of the surplus of assets over liabilities. All other surpluses will accrue to the ordinary shareholders, who the planner intended to pass the benefit to.
- The ordinary shares would be issued in equal proportion to each of the children (e.g. 100 ordinary shares to each of the children), with the planner being issued with more than 300 preference shares – for instance, 325 preference shares.

- All the growth assets of the planner would be transferred to A CC.
- The assets are transferred at market value and the purchase amount remains outstanding on an interest free loan. The purpose of having an interest free loan is to prevent any further growth in the planner's estate.

The result is the only asset in the planners estate is the loan and the par value of the preference share.

This preference share structure gives the planner some control and on death there are various options that can be considered:

- The shares can be bequeathed to the surviving spouse who can also exercise some control over the structure.
- On death of the surviving spouse the shares could be distributed in a pre-determined proportion to the ordinary shareholder's (the children).

To take advantage of the R1.5 m abatement on death the planner could bequeath the R1.5 m worth of the shares to the children and the balance to the surviving spouse. This saves estate duty of R300 000 on the death of the surviving spouse.

8.3 ADVANTAGES AND DISADVANTAGES OF STRUCTURE

The introduction of A CC into the plan holds the following potential benefits:

- The planner has exchanged his growth assets for non-growth assets, namely preference shares in, and an interest free loan in A CC.
- By structuring the voting rights the planner could retain control by holding the majority of the votes.
- By doing this it avoids the danger of assets being disposed prematurely and contrary to the planner's wishes.
- The planner does not have to make a choice as to which child inherits what asset, since they effectively get an equal share in all the assets.
- Since assets in most cases are indivisible this mechanism involves the transfer of shares which simplifies the process.

The use of a company (or close corporation structure) does hold certain disadvantages. These include:

- If the disposal of the assets to the company results in a capital loss for capital gains tax purposes the planner can set off the loss against capital gains arising on the disposal of assets to that company in the future. The loss cannot be set off against the planner's other capital gains.
- Companies pay capital gains at a higher rate than individuals.
- By having the children as ordinary shareholders, one may be creating an estate duty problem for them in due course, as they now own growth assets.
- The structure can be rigid in that one is giving each child exact shares in a CC. Can be difficult to vary the ratio at a later stage.
- No income splitting can take place to reduce the effective tax rate. All income will be taxed in the corporate entity at 30 %.
- After the death of the settlor (and say his wife), there could be differences of opinion which could lead to problems of control within the entity. If all children have an equal share they could deadlock on key issues with no means of resolution.

THE USE OF TRUSTS

9.1 BACKGROUND

Establishing a trust can reduce the estate duty liability and ensure that the beneficiaries receive more of the residual estate as well as having their share of the trust assets based on the manner in which the planner set it up.

9.2 TYPES OF TRUSTS

Testamentary trust comes into being only after the death of the planner and is founded by the terms of the last will and testament. Such a trust can contain cash, movable or immovable assets and is managed by the nominated trustee as per the will. It allows for the management and control of assets and protects beneficiaries in particular minors. A testamentary trust has no benefits from an estate duty perspective since the deceased owned the assets at time of death and estate duty will be payable on the net value of the estate.

The inter vivos trust is set up during the planner's lifetime and has many benefits since it involves the transfer of assets whilst alive thereby reducing the net value of the estate. A living trust comes into existence when it is registered with the Master of the High Court. The trust deed is the document which includes the wishes of the founder and gives direction as to how the assets are to be managed.

9.3 THE BENEFITS OF TRUSTS

Trusts can achieve many tax benefits both from an estate duty and income tax perspective. By transferring assets to the trust either by way of sale on loan account or donation, savings can be achieved particularly on high growth assets and in situations where the planner passes on many years after the transfer. This will effectively peg the value of the estate which will have the loan account as an asset. Each taxpayer can donate R30 000 free of donations tax per annum. A trust is an ideal vehicle to receive these donations since it well structures and set up in terms of the planner's wishes. This will have the effect of reducing the value of the respective estate on an ongoing basis. These donations can be used to repay any loans that were created during the process of transferring the assets. Caution must be exercised here and the donations must actually be made and the mount must be repaid to the planner. There should be paper trail, since the practice of merely writing off an amount of the loan equivalent to he donation has capital gains tax implications and should be avoided.

When an income producing asset is sold to the trust by way of an interest free loan the anti avoidance provisions (section 7 of the Income Tax act) could deem that income to be the income of the planner. An example of this would be a person disposes of an income producing property to a trust that has an income of R100 000. The effect of sections 7(5) and 7(8) earned by the trust will not be taxable in the hands of the trust, but will be deemed to be taxable income of the planner who made the interest free loan.

This will negate the benefit, since if the income formed part of the trust income and it is able to distribute to the beneficiaries of the trust it is possible to reduce the rate of tax considerably, in comparison to the trust tax rate of 40 % and the higher marginal rate of the planner. One way around this is to charge a rate of interest that is acceptable to the Receiver but this interest will be taxable in the hands of the planner. This may still be better than having all the income deemed back to the planner and losing the benefits of income splitting.

There are other benefits of trusts that reflect the wider considerations when embarking on an estate planning exercise. The most important factors are outlined by Graham Mcpherson in Personal Finance 2004 are as follows:

- Ensuring that the beneficiaries have access to income and capital immediately after death.
- Protection of assets in the event of insolvency.
- Providing continuity by creating a new vehicle that does not cease to exist on death.
- Structure the multi-ownership of assets. It is not easy to divide some assets – such as business, a farm or other fixed property between heirs. By placing the asset in a trust, you can hold the asset intact, while your heirs become beneficiaries of the income generated by the asset.

9.4 INCOME TAX AND CAPITAL GAINS CONSIDERATIONS

The trusts pay taxes at a rate 40 % of the net income after distributions of vested rights to the beneficiaries. The only exception is special trusts which have been set up for the benefit of minors and physically or mentally handicapped persons, which pays tax as per the sliding scales for individuals. The rate of tax can be viewed as a disincentive to consider trusts but with the benefits of estate pegging and income splitting there are still merits in considering trusts as an efficient estate planning vehicle.

Capital gains tax can also be viewed as being punitive since 50 % of the gain is taxed at the rate of 40 %, giving an effective rate of 20 % of the gain. This is significantly higher than for individuals but with careful structuring of the trust deed capital gains can be distributed to the beneficiaries which can eliminate this dilemma.

Mcpherson warns that although inter vivos trusts are an excellent estate planning vehicle, they can be fraught with difficulties, and could prove counter-productive if they are established merely to reduce your estate duty liability. The government trusts "in its sight", because the authorities believe that they are being set up merely to avoid tax.

ASSURANCE PLANNING

10.1 BACKGROUND

Capital gains tax has had a profound impact on estate planning. There are many benefits to using assurance policies which achieve the aim of minimizing estate duty.

The proceeds of life policies are deemed property and therefore it is included in the estate for duty purposes.

With regards the minimizing of estate duty there are a few options::

- Ensure that the policy is exempt from estate duty in terms of one of the exemptions provided for in section 3(3)(a) of the Act; or
- Ensure that the policy attracts as little duty as possible; or
- Ensure that the policy is deductible in terms of section 4, that is were it is bequeathed to the surviving spouse..

10.2 CAPITAL GAINS TAX

In terms of the Long Term Insurance Act the policies are taxed according to the Four Fund Approach. The capital gains on the fund are paid by the fund and not the policy holder to prevent double taxation.

The exclusion of life policies from capital gain tax only applies to "long-term" policies as defined in the Long-Term Insurance Act of 1998, namely, life, sinking fund, assistance, disability fund and health policies.

The exclusion as outlined by Miller and Irwin (1998) applies to all gains and losses made by a person arising on the maturity or other "disposal" of such policies provided such person is:

- The original owner of the policy or his or her spouse, nominee or dependant (as contemplated in the Pension Funds Act 24 of 1956), or deceased estate of the original beneficial owner, provided that no amount has been or will be directly or indirectly paid in respect of the cession of the policy from the beneficial owner of that policy to that spouse, nominee or dependant;
- The former spouse of the original beneficial owner, provided it was ceded on divorce or in terms of a court ordered division of assets.

Also excluded are:

- Amounts paid in respect of a policy taken on the life of an employee or director and any premiums paid by that person's employer were deducted in terms of section 11(w) of the Income Tax act 58 of 1962,

- Amounts paid in respect of a policy in order to acquire a partnership interest or a share in a company (or interest in a close corporation) and no premiums were paid by the deceased;
- A life insurance benefit where the policy is provided as a result of membership of a pension, provident or retirement annuity fund.

The policies excluded above are also not deemed to have disposed of by the deceased owner thereof to his or her deceased estate in terms of paragraph 40 of the Eighth Schedule.

10.3 POLICIES EXEMPT FROM ESTATE DUTY

There are three forms of assurance policy which do not attract estate duty. These are dealt with below.

10.3.1 Policies effected or ceded under an antenuptial contract

Amounts recoverable under life policies which have been effected or ceded in terms of an antenuptial or post-nuptial contract are exempt from duty provided that the following requirements are present:

- The amount due under the policy (i.e. the proceeds) must be recoverable by the surviving spouse or child; and
- The antenuptial contract (or post-nuptial contract) must have been duly registered.

(Section 3(3) (a) (i))

This exemption can be used to solve liquidity problems without attracting estate duty on the policy proceeds. One scheme requires the planner to effect a large term policy on his life, with an option to convert the policy to a whole life policy. When the planner's child marries, the planner becomes a party to the antenuptial contract.

Hahlo (4th ed.) provides authority for the view that a third person, for instance the father or an uncle of the bride, may become a party to the antenuptial contract and undertake to settle property, money or income conditionally or unconditionally on one or both of the spouses or create a trust in their favour.

Unless the third person expressly reserves a right of reservation, the settlement becomes irrevocable as soon as the marriage has been contracted and may be enforced by the promise when it falls due.

Thus in terms of the antenuptial contract the planner can cede a term policy to his child by way of a marriage settlement. The child then exercises the conversion option and pays the further premiums. On the death of the planner, the child receives the proceeds of the policy which are exempt from estate duty in terms of S3 (3) (a) (i) of the Estate Duty Act. To ensure that the estate receives liquidity from the policy proceeds, the planner may provide that portion of the estate bequeathed to that child is subject to a bequest price to the estate which will be funded by the policy proceeds.

In relation to antenuptial contract insurance planning has been suggested by AA Granger (1984) to draft a clause in the antenuptial contract to the effect:

"That in further consideration of the aforementioned marriage the said planner gives and makes over to the said wife or child all furniture as well as the proceeds from all life policies plus bonuses, which at the time of his death are on his life, subject to the condition that is the said wife or child dies before the said planner then all the above donations shall be null and void and shall revert back to him" (p37).

The purpose of such a clause would be to ensure that the policy proceeds will be totally exempt from estate duty by virtue of the operation of section 3(3)(a), provided that the proceeds are recoverable by the surviving spouse or child of the deceased under a duly registered antenuptial contract.

Clearly, where such proceeds are not recoverable by the spouse or child, such as where the policy has been ceded to another, the proceeds will not be recoverable in terms of this section.

It might be argued that such a clause is void either for vagueness or because it is made subject to a suspensive condition. The argument in respect of vagueness is potentially the more powerful given the wording of the clause as set out above. As (Banks J put it in *Turnbull v Van Zyl* NO cited in *Davis et al* (2004):

"The terms of the contract must be such as to define with reasonable certainty whether the donor must do in order to comply with his obligation. In the present case it can be inferred that the husband undertook to purchase some furniture; it was left to him to decide what furniture he should purchase for what amount and at what period of time. I agree that the promise is too vague to be enforced" (p15-5).

The better approach would be to insert an undertaking into the clause that the planner cedes all his policies of insurance to the minimum of Rx, an alteration which would clearly defeat the vagueness and for which there is clear authority.

As far as suspensive condition is concerned, in *Cumming v Cumming* 1984 (4) SA 585 (T) provide authority for the view that such an objection has little substance in law.

10.3.2 Key-man policies

The proceeds of the key-man policies are exempt, provided that Commissioner is satisfied and that:

- The policy was not effected by or at the instance of the deceased;
- No premium on the policy was paid or borne by the deceased;
- No amount due and recoverable under this policy has been or will be paid into the estate of the deceased; and

- No amount has been paid to, or utilized for the benefit of, any relative of the deceased, or any company which was at any time a family company in relation to the deceased. Kourie and Ryder (1997).

10.3.3 Policies taken out by partners or co-shareholders

According to Miller and Irwin (1998) qualifying policies for this purpose are those in respect of which the Commissioner is satisfied:

- Were 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 shares or any like interest in a company in which the deceased was a co-shareholder at the date of the death;
- Were taken out or acquired by the partner or co-shareholder for the purpose of enabling him to acquire the whole or part of:
 - the deceased's interest in the partnership; or
 - the deceased's interest in the company and any claim by him against the company;
- No premium on the policy was paid or borne by the deceased.

(Section 3(3) (a) (iA))

A popular manner of providing for the dissolution of a partnership or a change in shareholding in a private company or close corporation as a result of the death of one or more partners or shareholders is the use of a buy and sell agreement. In terms of such an agreement, A effects an insurance policy on the life of B the sum assured approximating the value of B's share of the partnership. B similarly effects a policy on A's life. In the event of the death of a partner, for example B, A will receive the proceeds on the policy and utilize these to purchase B's partnership share from the executor. The buy and sell agreement provides a relatively inexpensive and useful solution to the succession difficulties in private companies, close corporations and partnerships. The proceeds of these policies are free from estate duty as long as the premiums were not paid by the deceased.

It is possible, therefore, to provide liquidity for an estate in terms of a buy and sell agreement. Two or more partners or co-shareholders can, for example, effect reciprocal insurance policies on the life of the others which can be used on death to fund the purchase of the deceased partner's share in the partnership, or shares and/or loan accounts against the company or close corporation, as the case may be. In this way the executor receives cash from the sale of the deceased's share which may be used to meet the liquidity requirements of the estate Botha *et al* (2003).

10.3.4 Policies exempt from estate duty and capital gains

The inclusion of life policies in an estate for estate duty purposes as stated by Miller and Irwin (1998) only applies to "domestic policies". A life policy made payable offshore at its owners request is not a "domestic policy" for estate duty purposes. Accordingly, if such a policy meets the criteria laid down in paragraph 55 of the Eighth Schedule to the Income Tax Act it will be free of both estate duty and capital gains tax.

10.4 THE FUNDED LIFE ASSURANCE TRUST

One further concession is available to minimize the duty arising on the proceeds of an assurance policy.

Section 3(3) (a) provides that all premiums paid plus interest at the rate of 6% (in practice compound interest is permitted) will be allowed as a deduction from the gross proceeds of policies on a deceased's life provided that the following conditions are met.

- Someone other than the life assured paid the premiums; and
- The person who paid the premiums was entitled to the proceeds of the policy

On this basis it may well be that, depending on the growth factor of the particular policy, the deduction allowed may be equal to a significant percentage of the total proceeds.

In order that this concession may be taken advantage of, someone other than the life assured must pay the premiums and receive the proceeds of the policy. This third party may be another individual such as the wife or child of the planner and they must have the capacity to pay for the premiums on their own. This is vital since revenue could attack the scheme on the basis that the deceased did in fact pay the premiums indirectly.

As a result of these limitations, the idea of using an *inter vivos* trust to exploit the concession was received. The trust used is normally known as the funded life assurance trust, an *inter vivos* trust which owns one or more life assurance policies on the life of the planner, as well as income producing assets. The income from the latter is used to pay the premiums on the policy or policies. Therefore the trust becomes the third party taking advantage of the concessions available Miller (1998).

10.5 FUNDING OF THE POLICY PREMIUMS

The most important consideration arising when the funded life assurance trust is utilized is that of the funding of the assurance premiums. The trust is effectively a discretionary trust to which income-producing assets have been passed by way of donation or sale (generally on interest free loan account).

The assets thus transferred should produce sufficient income to allow the trustees to pay the premiums on all policies owned by the trust. The crucial question is whether Revenue will allow, or legally be required to allow, the premiums plus 6% concession.

There is only one South African case, that of *Reynolds Estate V CIR* 1937 AD 57, 8 SATC 203. The case was decided on the Death Duties Act 29 of 1922. The facts were that the deceased had formed an *inter vivo trust* upon which he had settled certain policies on his life to the value of 120 000 pounds. The trust deed provided that the income generated by the capital sum was to be utilized to pay premiums on the policies, with the balance of the income to be dealt with as directed.

In terms of Section 3(4) of the Death Duties Act 29 of 1922, the decision of the Appellate Division was short and to the point as stated in Davis *et al* (2004):

"Put shortly, we are of the opinion that the deceased kept-up the policies within the meaning of the sub-section after the assignment to the trustees by reason of the commands he apposed upon them in the trust deed. He supplied the funds and directed the application to payment of premiums on the policies. One looks in vain for any other author other than the deceased of these payments. Neither the trustees nor the beneficiaries have any say in the matter" (p15-10).

In short, the deceased was regarded as the real and effective payer of the premiums. Meyerowitz (5th Ed at 27.43) distinguishes the case on the basis that the trustees paid the premiums upon the mandate of the deceased from funds supplied to him. He argues, therefore, that there had been no mandate, the payment having been left to the discretion of the trustees.

In practice, many trust deeds utilized for the formation of funded life assurance trusts grant the planner excessively wide powers of control. Even if these powers do not directly contravene the provisions of section 3(3)(d), it is possible to argue that the provisions of the deed afford the planner the incidence of ownership and thus allow Revenue to exercise its discretion against the planner and refuse the premiums plus 6% concession.

10.6 POLICIES DEDUCTIBLE FOR ESTATE DUTY PURPOSES

A policy over the life of the deceased which is payable to a public benefit organisation referred to in Section 4(h) of the Estate Duty Act is deductible in terms of Section 4(h). Similarly a policy over the life of the deceased which is payable to the surviving spouse of the deceased is deductible in terms of Section 4(q) of the Estate Duty Act.

The tax benefits with regards Assurance Planning can be rather significant and need to be carefully structured to maximize the potential benefits.

OFFSHORE ESTATE PLANNING

11.1 BACKGROUND

The offshore trust is an important part of any estate plan since approximately a quarter of the world's assets are in offshore trusts. This vehicle has now become more relevant to South Africans with their ability to invest offshore being enhanced by the relaxation of the existing regime of exchange control legislation. As these regulations ease, the wealthy South Africans will be able to diversify his portfolio of assets, such that a larger proportion of his estate will be located offshore (Kruger *et al* : 2003).

In general property, wheresoever situate, forms part of the South African dutiable estate of the deceased. However, where the deceased is not ordinarily resident in South Africa at the time of death, certain assets are excluded from the dutiable estate, which include assets located outside the country.

The need for sensible estate planning exists for assets which are located offshore for a number of reasons:

- In order to ensure that any increase in value in the offshore assets is "pegged" as far as the South African planner is concerned. This can have a significant impact on the rand value of the offshore assets based on the prospect of a weaker rand;

- In order to minimize any foreign taxes and death duties, particularly if the planner himself were to emigrate and settle in a foreign country;
- In order to cater for bequests trusts will often play a key role in the development of such a plan.

11.2 ESTABLISHMENT OF AN OFFSHORE TRUST

According to Abrie *et al* (2003), the most important component of any offshore estate plan is the offshore trust.

Once a trust has been established offshore, it is important to ensure that the trust is not held to be resident onshore. A trust may be held resident on a particular jurisdiction unless two conditions are satisfied:

- All or a majority of the trustees are neither resident nor ordinarily resident in the country concerned;
- The general trust administration is carried on outside of the country concerned.

Whilst in South Africa a trust can in theory, exist forever, offshore trusts are not allowed to continue in perpetuity in most offshore jurisdictions. The longevity of the trust will be determined by the jurisdiction chosen.

11.3 PROPERTY ON WHICH ESTATE DUTY IS LEVIED

In terms of the Estate Duty Act 45 of 1955, where an ordinary resident of South Africa dies, his estate will consist of all his worldwide assets (and rights in property) whether movable or immovable, corporeal or incorporeal. In terms of section 4(e) a deduction is available against foreign property that the deceased obtained:

- before he became ordinarily resident in South Africa for the first time,
- after he became ordinarily resident in South Africa for the first time and the property was donated to him by a person not resident in South Africa or the property was inherited from a person who at the date of his death was not ordinarily a resident in South Africa.

The importance of the foregoing lies in the fact that a South African resident's investment offshore will constitute "property" in his estate and that he will lose this deduction to the extent that such assets are repatriated to South Africa. In the ordinary course, the deduction under 4(e) will not avail a South African resident, unless he emigrated to South Africa some time before.

11.4 DOUBLE ESTATE DUTY LIABILITY

It may happen that an investment by a South African may be subject to death taxes in the jurisdiction where the investments are made. At the same time, the investments may be subject to estate duty in South Africa. Two situations need to be distinguished in this regard as defined by Kruger *et al* (2003) :

- Where there is no double tax agreement in place, relief is to be found in Section 16 of the Estate Duty Act. In order to qualify for the Section 16(c) deduction it would have to be proved to the satisfaction of Revenue that estate duty has been paid to any other state in respect of property or investment situated outside South Africa. The amount of relief will be limited to the estate duty due to South Africa on the relevant property. If the amount due in the foreign jurisdiction is smaller than the amount of estate duty payable here, the smaller amount will constitute the relief. If the amount is larger than the estate dutiable amount, the amount is limited to the estate duty payable here.
- Where there is a double tax agreement in place the rebate for foreign death duties may not modify or add to the rights of any person in terms of any double tax agreement. In this case the provisions of the relevant double estate duty agreement will apply and the rebate for foreign duties will not be available

11.5 NON-RESIDENT PLANNING

Immovable property and movable property situated outside South Africa, and debts and immaterial property rights not enforceable by the South African courts, belonging to a non-resident do not fall within the South African estate duty net. It is therefore important to establish the residence of the person as well as the location of the asset in order to determine liability for estate duty (Kruger *et al* : 2003).

11.6 FOREIGN TESTAMENTARY TRUSTS

If the testator has, by his will, foreign or local, appointed a South African resident as beneficiary and left the whole estate to such a beneficiary, the estate of the beneficiary will be liable for capital gains and/or estate duty in future. Should the testator in his foreign will, provide for foreign assets in his estate to be distributed to a foreign trust, the assets will be secured in jurisdiction of choice (Kruger *et al* : 2003).

11.7 DONATIONS TO A NON-RESIDENT

A South African non-resident is liable for estate duty upon his South African assets (subject to double tax treaty relief). Such a non resident is, however, free to donate the whole or part of his South African estate without incurring any liability for donations tax.

An estate planning solution available to non-residents with South African assets, for example emigrants with large amounts of blocked rands assets, is to donate such assets to children and or remote family, thereby circumventing the eventual estate duty liability on such assets. Account must however be taken of any foreign tax provisions, which may impact negatively on such scheme (Kruger *et al* : 2003).

With a fair number of South Africans moving their R750 000 offshore allowance abroad this area of estate planning is gaining increasing attention. The Income Tax amnesty for undeclared funds abroad have brought larger assets to the attention of SARS. These will obviously have to be declared in the respective estates and careful planning need to be done to limit the estate duty liability. We could have a scenario where the planner dies at a time of rand strength and it does not make sense to repatriate funds to South Africa to pay the amount due, thereby creating liquidity problems in the estate.

INCOME TAX AND ESTATE PLANNING

12.1 BACKGROUND

The death of a taxpayer results in the termination of one taxpaying entity and the creation of another for the period commencing at the beginning of the year of assessment and ending at the date of death, and assessment will be raised on the tax payer. The executor is the representative taxpayer in this regard. If the period of assessment is partial the rebates will have to be apportioned. Subsequent to death a new entity comes into existence namely the estate, which is a taxable person (the definition includes the deceased estate). The deceased estate is taxed at the rates applicable to natural persons but is not entitled to the primary rebate. The provisions in the Income Tax Act applicable to the taxation of deceased estates came into being as a result of two cases in the early 1960s, namely *Estate Smith v CIR* 1960 AD and *CIR v Emary* NO 1961 AD (both cases related to the same deceased estate). In estate *Estate Smith v CIR* the Commissioner tried to tax the deceased estate. The court held that the executor did not have to render income tax returns for the estate as they were not representative tax payers as defined. The Commissioner then appointed one of the executors as an agent of the estate under the then S74 (S99 in the current Act) which empowered the Commissioner to appoint a person as an agent in order to collect tax due. This lead to the Emary's Case in which it was held that a deceased estate did not constitute a person under the common law, and the Commissioner did not have the power to appoint an agent of something which was not a person. The estate was therefore not liable for tax.

Subsequent to these two decisions certain amendments were made to the Income Tax Act to overcome the problem. The result was:

- s1 The definition of person includes a deceased estate.
- s1 the definition of representative taxpayer includes the executor of a deceased estate.
- s25(1) Any income received by or accrued to the executor
 - which would have been income in the hands of the deceased
 - shall, if such income has been derived from the immediate or future benefit of any ascertained heir or legatee, to be deemed to be income of such heir or legatee, and, if not, be deemed to be income of the deceased estate.
- s25(2) Any deduction or allowance which relates to any income which is deemed to be income of an heir or legatee in terms of s 25(1), shall be deemed to be a deduction or allowance of such heir or legatee.
- s25(3) A liability for tax shall not arise in both the heirs hand and the estate in respect of the same amount of income, i.e. the possibility of double taxation is prevented.
(Huxham:2004)

12.2 GENERAL ANTI-AVOIDANCE PROVISION

The important aspects of section 103 (1) of the Income Tax Act No 58 of 1962 (as amended) can be summarized as follows:

- There must be an avoidance, reduction or postponement of a liability to pay tax levied in terms of the Income Tax Act
- The avoidance must be as a result of a transaction, operation or scheme
- There must be abnormality (either in relation to business purpose, means or manner employed, or in relation to rights and obligations created)
- The purpose of the scheme must have been solely or mainly to avoid any levy administered by the Commissioner.

The courts have held that for 103 (1) to apply, all four criteria (listed above) must be present (*SIR v Geustyn, Forsyth and Joubert, 1971 AD*), and that if any one is absent the Commissioner will not be able to apply s 103.

"Tax benefit" is defined (in s 103 (7)) as including any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by the Income Tax Act or any other law administered by the Commissioner (e.g. Estate Duty, VAT, Stamp Duty, Transfer Duty).

In terms of s 103(4), whenever it is proved that tax or any other duty or levy in terms of any Act administered by the Commissioner has been avoided, postponed or reduced as a result of a transaction, operation or scheme, there is a presumption that the scheme or operation was entered into solely or mainly to avoid, postpone or reduce such tax, duty or levy and the onus of proof is on the taxpayer to prove otherwise.

So for example, a scheme which is entered into in an abnormal manner with the intention of reducing estate duty will fall into the s 103 net if, in addition to saving estate duty, it also has the effect of avoiding tax (even though the result may be unintentional). Section 103 (1) only provides a remedy against tax avoidance and not against the estate duty saving (Huxham : 2004).

12.3 INCOME TAX AND TRUSTS

The taxation of trusts has been codified in section 25B of the Income Tax Act. Changes were introduced to the taxation of trusts in the 1998/1999 Budget speech. The section has been amended so that a trust's tax losses cannot be channeled to beneficiaries, but will be retained in the trust. These losses can, however, be retained in the trust, and they may be carried forward to the following year to be set off against income of the trust in that year. All new trusts created from 11 March 1998 will have to comply immediately. As far as existing trusts are concerned, it will apply from years of assessment on or after 1 January 1999.

Income vesting in the trust as taxpayer (not income vesting in the beneficiaries) will be taxed at a flat rate of 40 %. Exceptions to the latter are trusts for mentally and seriously physically disabled persons, and testamentary trusts set up for the benefit of minor children. These trusts are taxed in accordance with the tax rates applicable to natural person.

12.3.1 The Settlor / Founder

Trusts are integral to large value estates and therefore understanding the income tax implications and the various sections to ensure that the plan does not fall foul of the Income Tax Act. There are certain circumstances where trust income is deemed to be the income of the settlor. The relevant sections of the Income Tax Act according to Huxham (2004) are:

12.3.1.1 Section 7(2)

Where income is derived by a spouse as a result of a donation settlement or other disposition made on or after 20 March 1991 by the other spouse, or as a result of a transaction, operation or scheme after that date and the sole or main purpose of such donation, transaction, operation or scheme is the reduction, postponement or avoidance of any tax, levy or duty the donor spouse will be the taxpayer on such income.

Hence if a spouse (donor spouse, i.e. the settlor) sets up an inter vivos trust for the benefit of his/her spouse (donee spouse) and donates assets into the trust, the income generated by such asset which is for the benefit of the donee spouse, will still be taxed in the hands of the donor spouse if the purpose was for example a reduction in the tax rate.

12.3.1.2 Section 7(3)

"Income shall be deemed to have been received by the parent of any minor child, if by reason of any donation, settlement or other disposition made by that parent of that child:

- a. it has been received by or has accrued to or in favour of that child or has been expended for the maintenance, education or benefit of that child; or
- b. it has been accumulated for the benefit of that child."

Any income received by a minor child as a result of a donation made by the parent of that child will be deemed, for tax purposes, to be the parent's income.

In terms of section 7(3), if a parent creates a trust in favour of his minor child by means of donating assets to the trust, he would have to pay tax on the income derived from the assets donated, whether or not the child receives the income or the income has accrued for the benefit of the child.

If a grandparent makes a donation, settlement or other disposition to his/her minor grandchild, such grandparent would not have to pay tax on the income derived therefrom. The child would have to pay tax on such income.

If, in terms of a donation, settlement or other disposition, income is received by or accrued to a major child, such income will not be taxed in the hands of the donor, but in the hands of the major child, (as long as the provisions of section 7(5), (6) and (7) do not apply).

It is evidently the practice of the Commissioner of Inland Revenue to accept that an illegitimate child is to be regarded as a child for the purposes of section 7(3).

12.3.1.3 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 disposition made by any other person, shall be deemed to be the income of the parent of such 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".

This subsection prevents the possible avoidance of section 7 (3) by means cross donations.

This means that if X donates R30 000 to the minor child of Y, and Y donates R30 000 to the minor child of X, any income received by the minor children as a result of such a transaction, will be taxed in the hands of the parents of such minor children. Section 7(4) only applies in the case of minor children.

12.3.1.4 Section 7(5)

"If any person has made any donation, settlement or other disposition which is subject to a stipulation or condition, whether made or imposed by such person or anybody else, to the effect that the beneficiaries thereof or some of them shall not receive the income or some portion of the income thereunder until the happening of some event, whether fixed or contingent, so much of any income as would, but for such stipulation or condition, in consequence of the donation, settlement or other disposition be received by or accrue to or in favour of the beneficiaries, shall, until the happening of that event or the death of that person, whichever first takes place, be deemed to be the income of that person"

This section is most frequently encountered where income accrues to a trust and is not distributed to the beneficiaries because of a stipulation in the trust deed. This section applies to any beneficiary whether or not the beneficiary is related to the person who imposed the stipulation or whether or not the beneficiary is a major or minor.

12.3.1.5 Section 7(6)

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

For the provisions of section 7(6) to be invoked, the donor does not actually have to exercise the power which he has retained. It is enough that the donor possesses the power to cancel the benefits or elect another beneficiary for the donor to be the taxpayer.

The provisions of section 7(5) and (6) only apply to donations, settlements or dispositions in respect of income and do not apply to any stipulations in regard to the trust capital.

12.3.1.6 Section 7(7)

In terms of this provision, if a person (the donor) cedes or otherwise makes over to another person (the donee/beneficiary) or to a third party for the benefit of the beneficiary, any income to which he (the donor) is entitled to have paid over to him or for his benefit, is deemed to be the income of the donor and is taxable in his hands.

The income referred to above includes rent, dividends, interest, royalties or similar income in respect of movable or immovable property.

In this context, property includes any lease, company share, marketable security, deposit, loan, copyright, design or trademark or income in respect of the use of or the granting of permission to use such property.

The income derived in respect of such property will be taxable in the hands of the donor of such income if:

1. the donor is still the owner of or retains an interest in the property providing the income; or
2. if there is a transfer of the property or an interest therein, delivery of the property or the making over thereof to the beneficiary or to a third party for the beneficiary's benefit, the donor will have the right to regain ownership of the property or the interest therein at a fixed or determinable date.

In addition, the provisions of section 7(7) will also be invoked if the donor has a right to receive or have paid over to him or for his benefit any income that is or may become due to him by any other person acting in a fiduciary capacity and that income is ceded or otherwise made over to a beneficiary or to a third party for the benefit of such beneficiary by means of a method in terms of which the donor is or will be entitled to regain the right to the income on a date which can be determined.

When a trust is used as part of an estate plan careful consideration must be given to the anti-avoidance provisions. If the plan contravenes these provisions it would attract taxes that may not have been anticipated and it would negate the expected tax benefits.

CONCLUSION

While South Africa did not have a so-called wealth tax or capital gains tax prior to 1 October 2001, it has had a donations tax and estate duty for many years, which is payable on the dutiable estate of a deceased person and is in reality a type of wealth tax. But it is a relatively mild tax, which brings in little revenue for the state and is collected from a small percentage of the population.

Nevertheless, for those estates that are subject to the tax the imposition may be heavy and even for moderately wealthy individuals whose estates are potentially liable for the duty may take timeous steps to legitimately reduce or limit its impact (Stein 1979). This study has focused on these techniques and structures that can within the framework of the law ensure tax savings.

With the introduction of Capital Gains Tax (effective 1/10/2001) the rate of estate duty was reduced from 25 % to 20 % to reduce the possible double taxation that could arise. Death is a capital gains event and capital gains liability could arise, increasing the tax burden on an estate.

The allowable abatement permitted in terms of section 4A of the Estate Duty Act was increased to R1.5 million in the 2003/2004 tax year. This effectively increases the number of estates that are free from duty. Historically there has been a lack of consistent adjustment in the abatement to compensate for inflation. This meant that more estates fall into the tax net due to inflationary increases in asset values rather than real increases in value.

Estate and tax planning are done based on the current tax regime. The taxes that are imposed are in control of the government and they make changes in order to achieve their financial and social objectives. One of the challenges in putting together an estate plan is to build in flexibility so that we can respond to changes in tax legislation.

Many of these changes in legislation aim to close the "loop holes" used by tax practitioners to structure their client's affairs to best tax advantage. If trusts or any corporate entity is used, then the necessary founding documents need to empower the trustees/directors with discretionary powers to make changes that they deem appropriate. If these powers are not incorporated then the estate plan could become irrelevant in time defeating the aims of reducing the taxes payable.

As macabre as it may sound, death is an unavoidable part of your financial future. This makes estate planning an essential aspect of your long term financial management. You need to be proactive about estate planning, as you can never predict when you are going to be hit by the proverbial bus (Cameron:2004).

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