

**Taxation in South Africa and the use of Trusts**  
**as an Effective**  
**Estate Planning and Tax Saving Mechanism**

by

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## **DECLARATION**

I hereby declare and confirm that this research has not been previously accepted for any degree and is not currently being considered for any other degree at any other university.

I further declare that this Dissertation contains my own work except where specifically acknowledged.

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M. R. Hussain

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8 December 2015

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## ABSTRACT

The Income Tax Act, 58 of 1962 provides for the taxation of income, capital gains as well as donations which are received by, accrued to, or in favour of natural persons, companies as well as trusts however there are also other Acts which cater for the various other taxes and duties which include amongst others, the Estate Duty Act, 45 of 1955; the Transfer Duty Act, 40 of 1949 and the Value-Added Tax Act, 89 of 1991.

The use of trusts in South Africa is still relatively young, so much so, that despite this tool being brought to South Africa by the 1820 English Settlers, the first South African case to deal with its validity occurred in 1915, in the case of *Estate Kemp v Mc Donald's Trustee*, which case then led to the incorporation of trusts into South African Law.

The taxation of trusts is an ever increasing concern for the Taxman as trusts have been used and are still to an extent being used as a vehicle for the avoidance of the various taxes and duties that exist in South Africa today. The avoidance of taxes and duties is not in itself unlawful save for where the Taxpayer seeks to achieve this avoidance through means explicitly forbidden by the Taxman; this phenomenon is referred to Tax evasion.

The avoidance of taxes and duties, ultimately its evasion has led to the Taxman creating and enacting legislative provisions to counter and combat the attempts made at doing so, these are commonly known as the anti-avoidance measures of which exist both general and specific measures.

These provisions have made it increasingly more difficult for the honest Taxpayer to lawfully minimise his taxes and duties, however the minimisation of some of these taxes and duties are not entirely unattainable. Estate planning and the use of a trust as a mechanism to achieve certain objectives, one of which is the minimisation of these taxes and duties has occurred and still continues to occur in today's society. A well prepared estate plan wherein a trust is utilized by the Taxpayer (Estate planner), can still legally result in the minimisation of certain taxes and duties which ultimately is a major objective.

## **KEYWORDS**

Taxes, tax rates, duties, income tax, transfer duty, estate duty, capital gains, taxation, taxpayer, donation, disposition, ordinary trust, special trust, founder, trustee, beneficiary, vesting, estate planning, estate planner, minimisation, avoidance, evasion, anti-avoidance, *inter-vivos*, *mortis causa*, *fideicommissum*, *stipulatio alteri*.

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# TAXATION IN SOUTH AFRICA AND THE USE OF TRUSTS AS AN ESTATE PLANNING AND TAX SAVING MECHANISM

## CHAPTER 1

### INTRODUCTION

Every man is entitled if he can, to order his affairs so that the tax attaching under the appropriate acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then however unappreciative the Commissioners of the Inland Revenue or his fellow-taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.<sup>1</sup>

#### 1.1. Background

From as early as the 17<sup>th</sup> and 18<sup>th</sup> centuries, the concept of a “trust” has posed many questions to legal jurists as well as the Courts. The concept of a trust is taken to have been a creation of English Law which was brought to South Africa by the English settlers; however the trust only gained recognition much later as is seen from the case of *Estate Kemp v Mc Donald’s trustee*,<sup>2</sup> which dealt with the validity of a trust.

Today trusts are widely used as mechanisms through which various transactions are facilitated. It is however used more effectively in estate planning as it has many benefits.

The concept of trusts is not without its disadvantages, which have occurred in recent times as a result of the misuse and abuse of the trust with a view to unlawfully evade tax. This has in turn led to the enactment of legislation to combat these attempts at tax evasion. Nevertheless, the trust, when utilised correctly, still possesses beneficial attributes and as such can achieve the objectives of an estate plan.

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<sup>1</sup> Duke of Westminster v IRC (1953) 51 TLR 467, 19 TC 490 - 520.

<sup>2</sup> Estate Kemp v Mc Donald’s trustee 1915 AD 494.

## 1.2. Research Statement

Estate planning, when combined with tax avoidance schemes, provides for an effective and meaningful way in which a taxpayer can legally reduce his/her tax liability. However, it is often due to either over-zealousness or a lack of knowledge on the subject that a taxpayer crosses the Rubicon,<sup>3</sup> that is, from legally avoiding tax, to illegally evading tax, in other words, tax evasion.

This dissertation will look at taxation in South Africa and examine the concept of the trust and its use as an estate planning mechanism and its effectiveness at the reduction (avoidance) of taxes and duties.

## 1.3. Research Objectives And Methodology

The objectives of this dissertation and its methodology are aimed at analysing:

- The various taxes that a taxpayer is subjected to in South Africa;
- Tax avoidance and tax evasion and their respective effects on the,
  - Taxpayer,
  - The Commissioner – South African Revenue Service, and
  - The economy.
- The mechanisms present to combat both tax avoidance and tax evasion;
- Case law that deal with tax avoidance and tax evasion;
- Estate planning and the use of trusts;
- Effective estate planning, more so through the use of trusts and its link, if any to tax avoidance;
- Why tax avoidance has not been made illegal and the need for tax avoidance as an incentive to taxpayers;
- The minimisation of taxes and duties through the use of trusts; and
- The 2015 interim report on trusts by the Davis Tax Committee.

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<sup>3</sup> The idiom “Crossing the Rubicon” means to pass a point of no return, and refers to Julius Caesar’s army’s crossing of the river in 49 BC, which was considered an act of insurrection.  
<http://en.m.wikipedia.org/wiki/Rubicon>; accessed on 28<sup>th</sup> March 2015.

#### **1.4. Delineations And Limitations**

This dissertation only considers certain taxes applicable in South Africa and as such should not be construed or interpreted in any way or manner contrary to that. This dissertation considers and discusses tax evasion, tax avoidance and their effects. This dissertation attempts to establish a link between the use of trusts for effective estate planning and tax avoidance. This dissertation will examine case law, however; the case law considered herein is not exhaustive.

This dissertation is therefore subject to the aforementioned delineations, limitations and qualifications.

#### **1.5. Referencing Techniques**

This dissertation and the method and/or style of referencing utilized herein is as in the Potchefstroom Electronic Law Journal.

#### **1.6. Overview Of Chapters**

This dissertation comprises of 7 (seven) chapters. The next chapter briefly examines some of the most commonly known taxes levied within the boundaries of the Republic of South Africa, namely; income tax (normal tax), capital gains tax, donations tax, estate duty as well as transfer duty.

Chapter 3 explores the concept of the trust, from its origin in English Law, its arrival in South Africa through the 1820 English settlers and its incorporation into South African Law. This chapter also explains the types of trusts and lists the various role-players in a trust as well as their functions.

Chapter 4 deals with the taxation of trusts in terms of Section 25B<sup>4</sup> which Section is subject to Section 7.<sup>5</sup> This chapter also provides a detailed outline of how the anti-avoidance provisions of Section 7 operate.

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<sup>4</sup> Income Tax Act 58 of 1962 as amended, hereafter referred to as 'the Income Tax Act'.

<sup>5</sup> Ibid.

Chapter 5 looks at estate planning, its various objectives, and the techniques engaged to achieve the objectives.

Chapter 6 seeks to determine whether the trust can be used to minimise the various taxes and duties applicable in terms of South African Law in light of the findings of the Davis Tax Committee in its first interim report of 2015.

The last chapter concludes the dissertation with a brief finding on the viability of trusts both as an estate planning mechanism as well as a tax avoidance tool, taking into account the Davis Tax Committee interim report.

## CHAPTER TWO

### TYPES OF TAXES AND DUTIES LEVIABLE

Taxation as we know it today is a natural concomitant of the growth of the administrative state. Tax is an everyday reality of life and there is scarcely an economic act devoid of tax consequences. It is evident from a mere mention of some of the main forms of taxation in South Africa that the tax system is comprised of a portfolio of direct and indirect taxes, each with its own tax base. Fiscal policy has a critical impact on the political economy of any country, and plainly there are many variables to be taken into account when it comes to the pursuit of an efficient, equitable and politically acceptable system of taxation.<sup>6</sup>

#### 2.1. Introduction

Taxation is a process whereby the State seeks to collect funds from persons, natural and juristic, which funds form part of the State's revenue.

There are four (4) basic maxims regarding taxes, which are considered today and applied, and these are:<sup>7</sup>

1. The subjects of every State should contribute towards the support of the Government in proportion to their respective abilities;
2. The taxes which an individual is to pay should be certain and not arbitrary;
3. The tax being levied should be done at a time, or in a manner which is likely to be convenient for the contributor to pay it; and

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<sup>6</sup> TS Emslie; DM Davis & SJ Hutton *Income tax: Cases and Materials* 2ed (1995) 1.

<sup>7</sup> E Butler; *The Condensed Wealth of Nations* (2011) 70-71; Available online:

[http://www.google.co.za/url?sa=t&source=web&rct=j&url=http://www.adamsmith.org/sites/default/files/resources/condensed-Won.pdf&ved=0CB4QFjABahUKEwjWiaHhoMvIAhWCQhQKHYPgDu4&usg=AFQjCNFw\\_oKAu4DefgJQr91IOzcFuKplig&sig2=7XqZXAGphfFyoH5YQszmMA](http://www.google.co.za/url?sa=t&source=web&rct=j&url=http://www.adamsmith.org/sites/default/files/resources/condensed-Won.pdf&ved=0CB4QFjABahUKEwjWiaHhoMvIAhWCQhQKHYPgDu4&usg=AFQjCNFw_oKAu4DefgJQr91IOzcFuKplig&sig2=7XqZXAGphfFyoH5YQszmMA); accessed 30<sup>th</sup> August 2014.

4. Every tax should be contrived as to both take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State.

In South Africa there are both direct and indirect taxes. Direct tax is imposed on a person whilst indirect tax is imposed on transactions. Combined these include inter-alia; normal tax, dividends tax, donations tax, securities transfer tax, customs and excise duty, value-added tax and capital gains tax.

Some of these taxes will be discussed below so as to ascertain their individual natures as well the impact they have on the taxpayer.

## **2.2. Income Tax (Normal Tax)**

### **2.2.1. Overview**

Income tax, is indicated by its literal meaning, is a tax which is levied upon a taxpayer's income. Income tax (normal tax) is a charge imposed by Government on the annual gains of a person, corporation or other taxable unit derived *inter alia* through work, business pursuits, investments, property dealings, and other sources determined in accordance with the law.<sup>8</sup>

South Africa's income tax system is residence based. A South African resident's worldwide income is subjected to income tax in South Africa, whereas a foreigner's (non-resident's) taxable income is subjected to income tax in South Africa where such taxable income is restricted and limited to income derived from sources within the Republic of South Africa.<sup>9</sup>

### **2.2.2. Liability for income tax (normal tax)**

Income tax (normal tax) is imposed upon 'persons' irrespective of whether they are natural persons, companies, close corporations or other taxable entities, for example: trusts, estates of deceased persons, insolvent estates, etc. however the definition of

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<sup>8</sup> <http://Legal-dictionary.thefreedictionary.com/Income+tax>; accessed on 11<sup>th</sup> August 2014.

<sup>9</sup> M Stiglingh; A Koekemoer; L van Schalkwyk; J Wilcocks & R de Swardt. *SILKE: South African Income tax* (2014) 5-9.

person<sup>10</sup> specifically excludes a foreign partnership established or formed on or after 24 August 2010.<sup>11</sup>

A taxpayer is any person chargeable with any tax, leviable under the Income Tax Act.<sup>12</sup>

A taxpayer becomes liable for income tax (normal tax) on what is classified as ‘taxable income’. Taxable income as defined in section 1 of the Act<sup>13</sup> means the aggregate of –

- (a) the amount remaining after deducting from the income of any person all the amounts allowed under Part 1 of Chapter 2 to be deducted from or set off against such income, and
- (b) all amounts to be included or deemed to be included in the taxable income of any person in terms of this Act.<sup>14</sup>

The Act<sup>15</sup> provides for a series of steps to be followed in order to determine a taxpayer’s taxable income. The first step involves a determination of the taxpayer’s gross income.

Gross income in relation to any year or period of assessment, as defined by the Act<sup>16</sup> is

- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, or
- (ii) in the case of any person other than a resident, the total amount, in case or otherwise, received by or accrued to or in favour of such person from a source within the Republic,

During such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts<sup>17</sup> so received or accrued as are described in paragraphs (a) to (n) inclusive of both.

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<sup>10</sup> A Person as defined in Section 1 of the Income Tax Act includes –

- (a) an insolvent estate;
  - (b) the estate of a deceased person;
  - (c) any trust;
  - (d) any portfolio of a collective investment scheme,
- but does not include a foreign partnership.

<sup>11</sup> Stiglingh *et al.*, (note 9 above) 2.

<sup>12</sup> Income Tax Act 58 of 1962 as amended; section 1.

<sup>13</sup> Income Tax Act 58 of 1962 as amended.

<sup>14</sup> *Ibid.*

<sup>15</sup> *Ibid.*

<sup>16</sup> *Ibid.*, section 1.

<sup>17</sup> Whether of a capital nature or not.

Once the taxpayer's gross income is determined, the second step ensues. This step requires the determination of a taxpayer's income<sup>18</sup> which is the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part 1 of Chapter 2 of the Act.<sup>19</sup> The exemptions as mentioned are contained in sections 10 and 10A of the Act.<sup>20</sup>

Following thereon is the third step, that is, the determination of a taxpayer's 'taxable income',<sup>21</sup> which is the aggregate of –

- (a) the amount remaining after deducting from the income of any person all the amounts allowed under Part 1 of Chapter 2 to be deducted from or set off against such income; and
- (b) all amounts to be included or deemed to be included in the taxable income of any person in terms of this Act.<sup>22</sup>

Taxable income is therefore calculated as follows: income, less any deductions and allowances in terms of subsections 11-19 and 21-21N of the Act,<sup>23</sup> less any assessed losses in terms of subsections 20-20B of the Act,<sup>24</sup> plus any taxable capital gain<sup>25</sup> in terms of Section 26A of the Act,<sup>26</sup> plus all amounts included in taxable income, less deductions in terms of subsections 18 and 18A of the Act.<sup>27</sup>

The amount of tax for which a taxpayer becomes liable for during a period of assessment is calculated on the basis of the taxable income of the taxpayer and the tax rates<sup>28</sup> as determined annually by Parliament.<sup>29</sup>

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<sup>18</sup> Stiglingh *et al.*, (note 9 above) 5-7.

<sup>19</sup> Income Tax Act 58 of 1962 as amended.

<sup>20</sup> *Ibid.*

<sup>21</sup> Stiglingh *et al.*, (note 9 above) 6-7.

<sup>22</sup> Income Tax Act 58 of 1962 as amended.

<sup>23</sup> *Ibid.*

<sup>24</sup> *Ibid.*

<sup>25</sup> An amount determined in terms of paragraph 3 of the eighth schedule. Section 1

<sup>26</sup> Income Tax Act 58 of 1962 as amended.

<sup>27</sup> *Ibid.*

<sup>28</sup> The tax rates are deemed to remain in force until the next determination by parliament.

<sup>29</sup> Stiglingh *et al.*, (note 9 above) 3.

<b>Taxable Income</b>	<b>Rates of tax</b>
R 0 – R181 900	R0 + 18% of each R1
R181 901 – R284 100	R32 742 + 26% on every R1 above R165 600
R284 101 – R393 200	R59 314 + 31% on every R1 above R258 750
R393 201 – R550 100	R93 135 + 36% on every R1 above R358 110
R550 101 – R701 300	R149 619+ 39% on every R1 above R500 940
> R701 301	R208 587 + 41% on every R1 above R638 600

**Table 1: Tax Table for the year of assessment ending February 2016.**<sup>30</sup>

A taxpayer's tax liability is based on a determination of which income bracket the taxpayer falls in, and upon that determination, a calculation ensues to determine the tax liability.

All natural persons are entitled to a deduction of a primary rebate of R13 257 – 00 (thirteen thousand two hundred and fifty seven rand) for the period of assessment ending February 2016.<sup>31</sup> A further (secondary) rebate is allowed to those who are or will be 65 (sixty five) years of age or older on the last day of the year of assessment.<sup>32</sup> For those who are or will be 75 (seventy five) years of age or older on the last day of the year of assessment are given a further (tertiary) rebate.<sup>33</sup> These amounts (rebates) are subject to annual review and amendment by the Minister.

### **2.2.3. Collection of revenue generated by Income tax (Normal tax)**

The collection of income tax (normal tax) in the Republic of South Africa is facilitated through the systems of employees' tax and provisional tax payments.<sup>34</sup>

<sup>30</sup> *Budget 2015 tax Guide*

<http://www.treasury.gov.za/documents/national%20budget/2015/sars/Budget%20PocketGuide%202015-16.pdf> accessed 23<sup>rd</sup> March 2015.

<sup>31</sup> *Ibid.*

<sup>32</sup> *Ibid.*

<sup>33</sup> *Ibid.*

<sup>34</sup> Stiglingh *et al.*, (note 9 above) 2-4.

Employees' tax is deducted by employers from the remuneration payable to their employees.

Provisional tax is paid by a taxpayer who falls within the definition of a 'provisional taxpayer' in terms of paragraph 1 of the Fourth Schedule of the Act, for example; natural persons who derive taxable income other than remuneration or a section 8(1)<sup>35</sup> travel allowance, and companies.

Payment of employees' tax and provisional tax made by a taxpayer are credited against his liability for income tax (normal tax) and therefore constitute advances against that liability.

## **2.3. Capital Gains Tax**

### **2.3.1. Overview**

The Republic of South Africa does not have a separate Act for capital gains tax due to it having being amalgamated into the Income Tax Act 58 of 1962, with Section 26A forming the link between the Act and the Eighth Schedule in terms of which capital gains tax is determined.<sup>36</sup>

As a result, the taxable capital gain of a person in a year of assessment is included in his/her taxable income and as such is subject to income tax (normal tax).<sup>37</sup>

In the determination of whether a disposal of an asset will be subject to capital gains tax, it becomes necessary to determine whether the disposal of that asset amounts to a capital or revenue gain as no indication is given by legislation as to whether the gain is to be capital or revenue in nature.<sup>38</sup>

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<sup>35</sup> Income Tax Act 58 of 1962 as amended.

<sup>36</sup> Stiglingh *et al.*, (note 9 above) 870.

<sup>37</sup> *Ibid.*

<sup>38</sup> Stiglingh *et al.*, (note 9 above) 872.

Due to no indication being provided by the Legislature as to the nature of a gain arising out of a disposal of an asset, it becomes necessary to firstly determine whether that disposal is revenue in nature by applying the basic principles of income tax.

### **2.3.2. Eligibility for capital gains tax liability**

Paragraph 3 of the Eighth Schedule refers to a person rather than a taxpayer which implies that every person is subject to the capital gains tax rule contained therein.

Both residents and non-residents are subject to capital gains tax.<sup>39</sup> Whilst residents are taxed on capital gains arising out of the disposal of assets situated anywhere in the world, non-residents are only taxed on gains arising out of certain assets situated in the Republic of South Africa.<sup>40</sup>

A non-resident will be subject to a withholding tax upon the disposal of any immovable property within the Republic of South Africa on the amount payable to him.<sup>41</sup>

### **2.3.3. Determination of capital gain/loss**

In determining a capital gain or loss, four requirements have to be met:

1. There has to be an asset,<sup>42</sup> which is defined in Paragraph 1 of the Eighth Schedule of the Income Tax Act 58 of 1962;
2. There must be a disposal<sup>43</sup> of the asset during the year of assessment;
3. The base cost of the asset must be ascertained as per Part V of the Eighth Schedule of the Act;<sup>44</sup> and
4. The proceeds on disposal of the asset must be determined, which determination is done in terms of Part VI of the Eighth Schedule.

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<sup>39</sup> Paragraph 2 of the Eighth Schedule of the Income Tax Act, 58 of 1962 (as amended).

<sup>40</sup> Ibid

<sup>41</sup> Stiglingh *et al.*, (note 9 above) 874.

<sup>42</sup> An asset as defined in Eighth Schedule of the Income Tax Act includes –

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

<sup>43</sup> Disposal is the act which triggers capital gains tax, an act which is determined in terms of Part III of the Eighth Schedule of the Income Tax Act of 1962.

<sup>44</sup> Income Tax Act 58 of 1962 as amended.

Upon the above being determined, that is; whether a disposal of an asset occurred during the year of assessment, then the capital gain or loss must be calculated on the basis of the following formula;<sup>45</sup>

$$\boxed{\text{Proceeds}} \quad \text{Less} \quad \boxed{\text{Base Cost}} \quad \text{Equals} \quad \boxed{\text{Capital gain/loss}}$$

The process of calculating the taxable capital gain/loss as per the Eighth Schedule has been summarised in the diagram that follows overleaf.<sup>46</sup>

Once the taxable capital gain is determined, it is then added to income in the determination of taxable income. This is due to the reason mentioned above, in that there is no separate capital gains tax, save for its incorporation into income tax via its enabling section, Section 26A and the provisions of the Eighth Schedule.

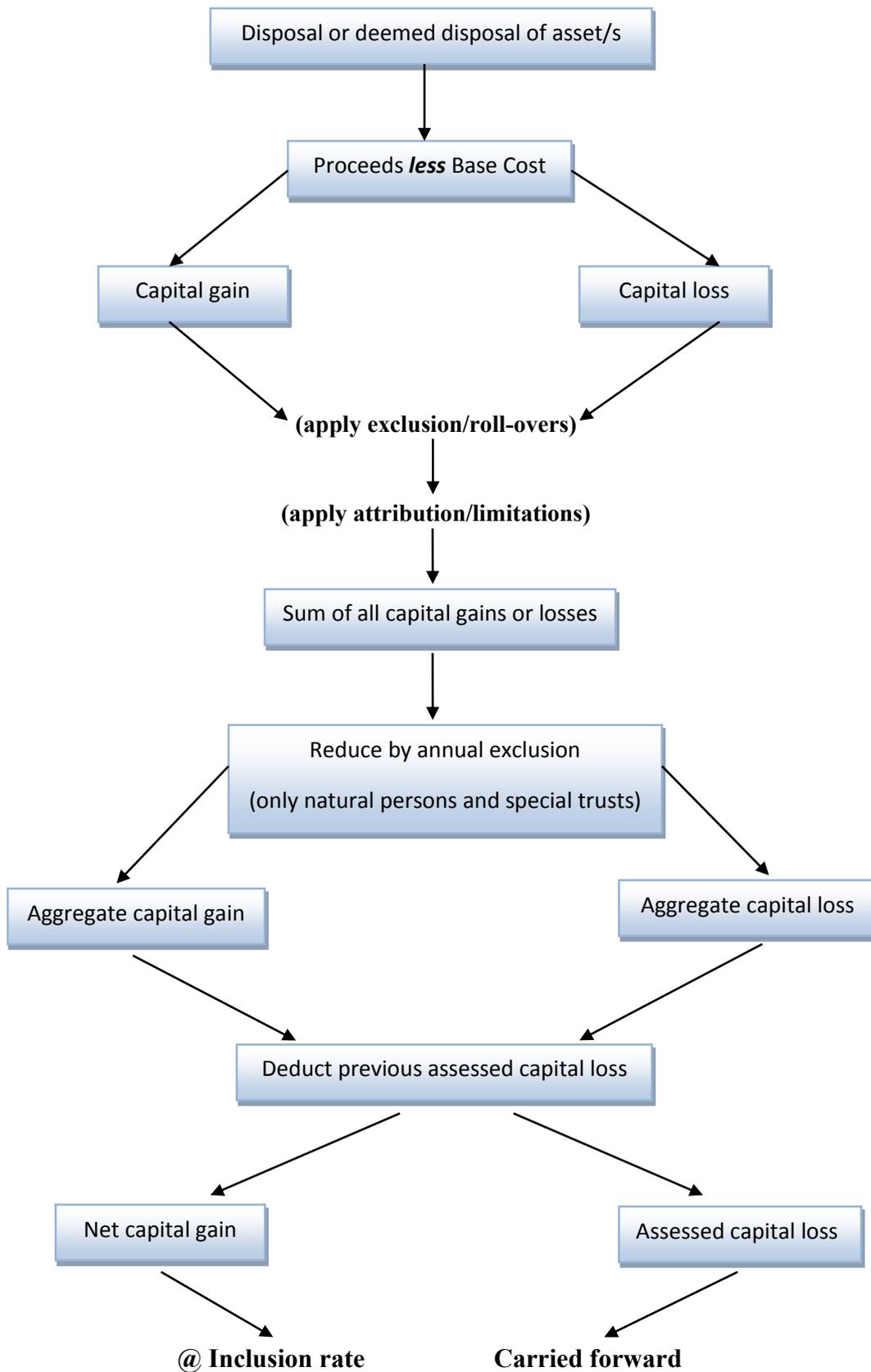
However it must be borne in mind that if there is no taxable capital gain but rather an assessed capital loss then it is not utilized in the determination of taxable income, but will be carried forward until the next year of assessment.

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<sup>45</sup> Stiglingh *et al.*, (note 9 above) 875.

<sup>46</sup> *Ibid.*

**Diagram 1: depiction of the process of calculating capital gain/loss.<sup>47</sup>**



<sup>47</sup> Stiglingh *et al.*, (note 9 above) 875.

## **2.4. Donations Tax**

### **2.4.1. Overview**

Donations tax is payable on the transfer of assets where such assets are transferred for no or inadequate consideration from one person (donor) to another (donee). Donations tax is not income tax, it is a tax on the transfer of wealth. However the provisions that govern donations tax are contained within the Income Tax Act.<sup>48</sup>

### **2.4.2. Eligibility for and levying of donations tax**

Donations tax is payable on the value of any property disposed of by a resident<sup>49</sup> of the Republic of South Africa in terms of a donation, which in terms of Section 55(1) of the Income Tax Act, 58 of 1962 is defined as:

Any gratuitous disposal of property, including any gratuitous waiver or renunciation of a right.

This tax is levied at a rate of 20% of the value of the property in terms of Section 64 of the Income Tax Act.<sup>50</sup>

Donations tax is calculated by taking into account the following steps:<sup>51</sup>

1. Identify the disposal of property by a resident.
2. Determine whether the disposal constitutes a donation.
3. If the disposal is a donation, determine whether it is specifically exempt from donations tax in terms of Sections 56(1) and 56(2)(c).
4. If it is not exempt, determine the value of the donation, that is, the taxable donation.
5. Deduct the general exemption available in terms of Sections 56(2)(a) and/or 56(2)(b) from the value of the taxable donation.
6. Multiply the value of the taxable donation by 20% to establish the donations tax payable.

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<sup>48</sup> Income Tax Act 58 of 1962 as amended; sections 54 to 64.

<sup>49</sup> According to Stiglingh *et al.*, non-residents are not liable for donations tax even if they donate assets from the Republic of South Africa.

<sup>50</sup> Income Tax Act 58 of 1962 as amended.

<sup>51</sup> Stiglingh *et al.*, (note 9 above) 827.

### **2.4.3. Payment of Donations tax**

The donations tax, once calculated as indicated above becomes payable by the end of the month, following the month during which the donation occurs, however an extended period can be granted by the Commissioner.<sup>52</sup>

The donor is liable to pay the donations tax however if the donor fails to do so, then both the donor and done become jointly and severally liable in terms of the Act.<sup>53</sup>

## **2.5. Estate Duty**

### **2.5.1. Overview**

Upon a person's death, his/her net<sup>54</sup> estate is distributed to his/her beneficiaries, either in terms of a will or according to the laws of intestate succession.

Since this distribution amounts to a transfer of wealth from the deceased's estate to the beneficiaries, a tax called estate duty is levied on the estate of a deceased person in lieu of such transfer.<sup>55</sup>

Estate duty is payable at a rate of 20%<sup>56</sup> of the dutiable amount of the estate. However due to the abatement<sup>57</sup> allowed, estate duty is only payable if the net value of the estate exceeds R3 500 000.00 (three million five hundred thousand rand).

### **2.5.2. Determination of estate duty**

There are six steps involved in calculating estate duty.<sup>58</sup>

The first step requires the gross value of the estate to be determined in terms of section 3 of the Act.<sup>59</sup>

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<sup>52</sup> Section 60(1) of the Income Tax Act 58 of 1962, as amended.

<sup>53</sup> Ibid, section 59.

<sup>54</sup> The balance after the payment of outstanding liabilities.

<sup>55</sup> Section 2 of the Estate Duty Act 45 of 1955, as amended.

<sup>56</sup> First Schedule of the Estate Duty Act 45 of 1955, as amended.

<sup>57</sup> Section 4A of the Estate Duty Act 45 of 1955 as amended.

<sup>58</sup> Stiglingh *et al.*, (note 9 above) 1003.

<sup>59</sup> Section 3 of the Estate Duty Act 45 of 1955 as amended.

The second step allows for certain deductions in terms of Section 4 of the Act<sup>60</sup> which should accordingly be deducted.

The third step allows a further deduction in terms of Section 4A of the Act<sup>61</sup> which deduction is regarded as an abatement. The amount of the abatement is currently R3 500 000.00 (three million five hundred thousand rand).<sup>62</sup>

Steps one to three result in what is known as the dutiable amount which in turn results in the fourth step, that is, the calculation of 20% of the dutiable amount which will be the estate duty, however this is still not the amount which is payable.<sup>63</sup>

Step five requires a further deduction from the estate duty amount as calculated in Step four above in terms of Section 16 and the First Schedule to the Act<sup>64</sup> which deductions are on the basis of any rebates which the deceased may have qualified for.

Step six and the last step involved in the determination of the estate duty payable is to ascertain whether anyone else is liable for a portion of the estate duty and if so that portion should then also be deducted which results in the estate duty amount payable being determined.<sup>65</sup>

### **2.5.3. Payment of Estate duty<sup>66</sup>**

Estate duty as discussed above is levied on the deceased's estate and as such, the Executor, that is, the person attending to the administration of the estate has to submit an estate duty return (REV267).<sup>67</sup> Upon receipt of this return, the Commissioner issues an estate duty notice of assessment to the Executor for payment.<sup>68</sup> Until such time that the estate duty is paid, the Master of the High Court cannot file an estate's liquidation

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<sup>60</sup> Section 4 of the Estate Duty Act 45 of 1955 as amended.

<sup>61</sup> *Ibid*, section 4A.

<sup>62</sup> *Ibid*.

<sup>63</sup> Stiglingh *et al.*, (note 9 above) 1003.

<sup>64</sup> Section 16 and the First Schedule of the Estate Duty Act 45 of 1955 as amended.

<sup>65</sup> *Ibid*, section 11.

<sup>66</sup> Stiglingh *et al.*, (note 9 above) 1024.

<sup>67</sup> Section 7 of the Estate Duty Act 45 of 1955 as amended.

<sup>68</sup> *Ibid*, section 9.

and distribution account thereby preventing the discharge of the Executor from his/her duties, until such time that the estate duty is paid.<sup>69</sup>

## **2.6. Transfer Duty**

### **2.6.1. Overview**

Transfer duty is payable on the acquisition of any property as defined in Section 1 of the Transfer Duty Act, 40 of 1949.

The most common forms of property on which transfer duty is levied and which transfer must be recorded in a Deeds Registry, includes inter-alia:<sup>70</sup>

- a. Physical property such as land and any fixtures thereon, including sectional title units,
- b. Real rights in land but excluding rights under mortgage bonds or leases (other than the leases mentioned below), and
- c. Rights to mineral or rights to mine for minerals (including any sub-lease of such a right).

The broad definition of property as contained in the Transfer Duty Act<sup>71</sup> also includes inter-alia the following, which rights and interests in and to property are not recorded in a Deeds Registry:<sup>72</sup>

- a. Certain shares, contingent rights and other interests in entities such as companies, close corporations and discretionary trusts that own residential property,
- b. Fractional ownership timeshare schemes, and
- c. Shares in a share block company.

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<sup>69</sup> Section 17 of the Estate Duty Act 45 of 1955 as amended.

<sup>70</sup> South African Revenue Services. 2013. taxation in South Africa 2013/14 (online) Available [http://taxcentre.saipa.co.za/sites/default/files/taxation\\_in\\_south\\_africa\\_-\\_external\\_guide\\_for\\_2013\\_and\\_2014\\_tax\\_year\\_0.pdf](http://taxcentre.saipa.co.za/sites/default/files/taxation_in_south_africa_-_external_guide_for_2013_and_2014_tax_year_0.pdf) accessed 30<sup>th</sup> August 2014; 74

<sup>71</sup> Section 1 of the Transfer Duty Act 40 of 1949.

<sup>72</sup> South African Revenue Services (note 70 above).

### 2.6.2. Levying and payment of transfer duty<sup>73</sup>

Transfer duty is based on the fair (market related) value of the property.<sup>74</sup> In most instances, the fair value is equivalent to that of the consideration being paid, however, in circumstances where there is no consideration or where the consideration paid does not correlate with the fair value of the property, then transfer duty is levied on the higher amount between, the consideration, the fair value, or the declared value of the property.<sup>75</sup>

A maximum period of 6 (six) months is allowed within which to make payment of the transfer duty,<sup>76</sup> after which time, interest is charged on the amount calculated for transfer duty at the prescribed rate in terms of the tax Administration Act.<sup>77</sup>

The following table illustrates how transfer duty is to be calculated:<sup>78</sup>

<b>Fair market value or Consideration</b>	<b>Rate of duty</b>
On amounts equal to or less than R750 000	0%
On the amount exceeding R750 000 but less than or equal to R1 250 000	3%
On the amount exceeding R1 250 000 but less than or equal to R1 750 000	6%
On the amount exceeding R1 750 000 but less than or equal to R2 250 000	8%
On all amounts exceeding R2 250 000	11%

**Table 2: transfer duty calculation scale.**<sup>79</sup>

The sum of the above is the amount of liability for transfer duty.

<sup>73</sup> South African Revenue Services (note 70 above).

<sup>74</sup> Section 5 of the Transfer Duty Act 40 of 1949 as amended.

<sup>75</sup> Ibid, section 5 – 8.

<sup>76</sup> Ibid, section 3.

<sup>77</sup> Tax administration Act 28 of 2011 as amended.

<sup>78</sup> The rate of transfer duty is subject to annual review and amendment by the Minister.

<sup>79</sup> *Budget 2015 tax Guide* (note 30 above).

### **2.6.3. Summary**

The general rule is that transfer duty is payable on the acquisition of all forms of property,<sup>80</sup> unless the transaction is:

- a. Subject to Value Added tax (VAT) and qualifies for an exemption in terms of Section 9(15) of the Transfer Duty Act;<sup>81</sup> or
- b. Exempt in terms of any other specific exemption provided for under Section 9 of the Transfer Duty Act;<sup>82</sup> or
- c. Exempt from transfer duty under any other Act of Parliament.

### **2.7. Conclusion**

It is clear that South Africa has various taxes and duties in place and these are either direct or indirect in nature and provide revenue to the State.

Although not the only source of revenue, taxes and duties amount a considerable percentage of the State's revenue which is utilized to fund the State's expenditure.

Taxes and duties are thus an integral part of any country and as such play a vital role in the functioning of that country, however there exists way by which persons can decrease the taxes and duties for which they are liable for and in certain instances, avoid them completely.

An understanding of the different taxes and duties is important as without a proper knowledge of what these taxes and duties are, how they are imposed, who is liable for payment, etc. it becomes a daunting task when one has to engage in estate planning and tax saving exercises.

The use of a trust has over the years been fraught with controversy as it has been the means by which taxes and duties are minimised. The trust and its use in the minimisation and avoidance of some of the taxes and duties discussed above will be dealt with in the chapters to follow.

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<sup>80</sup> South African Revenue Services (note 30 above).

<sup>81</sup> Transfer Duty Act 40 of 1949 as amended.

<sup>82</sup> Ibid.

## CHAPTER THREE

### THE TRUST

#### 3.1. Introduction And Background

Over the years the use of trusts has become somewhat of a norm especially as an estate planning mechanism with one of the main aims being the achieving of tax savings.

This paper, as mentioned earlier, deals with taxation in South Africa and the concept of the Trust, specifically its use and effectiveness as an estate planning mechanism and in the minimisation of the taxes and duties discussed in the preceding chapter.

##### 3.1.1. Origins of trusts

Trusts are a creation of English Law and the concept of trusts was therefore brought to South Africa by the 1820 English settlers.<sup>83</sup>

The concept of a trust seems to have commenced during feudal times in England during the time of William the Conqueror.<sup>84</sup> The reason for the creation of the trust was to protect a landowner's interest during prolonged absences on military duty, whereby the ownership of the property was held in a trust and would revert to the landowner on his return; alternatively if he did not return then the property would be passed over by the custodian to the landowner's family.<sup>85</sup> These trusts were known as 'uses'.<sup>86</sup>

The arrival of the Franciscan monks in England also played an important role in the development of the concept of trusts.<sup>87</sup> These monks arrived as missionaries and used the concept of trusts to hold and enjoy property donated to them, whilst vesting the beneficial interests in the local community.<sup>88</sup>

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<sup>83</sup> M Kock; R Kind; B Victor; and R Whitehead. *The Momentum Law and Estate Planning Easiguide 2002/2003* (2002) 200.

<sup>84</sup> Ibid.

<sup>85</sup> Ibid, 201.

<sup>86</sup> Ibid.

<sup>87</sup> Ibid.

<sup>88</sup> Ibid.

By the sixteenth century, *uses* were commonplace, with much of the land in England being held in use by religious interests.<sup>89</sup> In the year 1535, Henry VIII passed the Statute of Uses which outlawed uses for land ownership and forced the concept of a trust ‘underground’.<sup>90</sup> The concept of a trust re-emerged between the seventeenth and eighteenth centuries as an effective method of custodianship and distribution of assets on a settlor’s death.<sup>91</sup>

### **3.1.2. Incorporation of trusts into South African Law**

#### **3.1.2.1. Testamentary trust as *fideicommissum***

The concept of a trust was not known to Roman and Roman Dutch Law and as such was not known to South Africa’s Common Law *ergo*, the difficulty experienced by the Courts in explaining the concept of a trust.<sup>92</sup> However many English settlers in Natal and the Cape utilized trust terminology in their wills and legal documents.<sup>93</sup>

The first South African case on the validity of a trust was that of *Estate Kemp v Mc Donald’s Trustee*,<sup>94</sup> which case dealt with a testamentary trust. The Court in this case concluded with three important points:<sup>95</sup>

1. The English Law of trusts formed no part of our Jurisprudence;
2. The concept of placing assets under a trustee’s custodianship for the benefit of others (and whereby the trustee has no beneficial interest in the trust property) is so firmly rooted in practice that it needs to be given legal recognition; and
3. There is nothing in Roman-Dutch Law which is inconsistent with the workings of trusts, and that it could therefore be accommodated in our Common Law.

The majority finding in *Kemp* classified a trust as a *fideicommissum purum*.<sup>96</sup> This classification was later disregarded on the basis of *Braun v Blann and Botha*<sup>97</sup> wherein it was stated that testamentary trusts should be enforced in terms of the wishes of the testator. This case further stated that:

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<sup>89</sup> Kock et al., (note 83 above) 201.

<sup>90</sup> *Ibid.*

<sup>91</sup> *Ibid.*

<sup>92</sup> *Ibid.*

<sup>93</sup> *Ibid.*, 202.

<sup>94</sup> *Estate Kemp v Mc Donald’s trustee* 1915 AD 494.

<sup>95</sup> *Ibid.*, 509 – 513.

<sup>96</sup> *Ibid.*, 503.

<sup>97</sup> *Braun v Blann and Botha* 1984 (2) SA 850 (A).

A testamentary trust is not a form of *fideicommissum* if the trustees have no beneficial interest in the trust property – rather it is in these circumstances an institution *sui generis* (being in a class of its own).<sup>98</sup>

### 3.1.2.2. Inter vivos trusts as a *stipulatio alteri*

The three landmark cases concerning *inter vivos* trusts are:<sup>99</sup>

1. *CIR v Estate Crewe* 1943 AD 656;
2. *CIR v Smollan's Estate* 1955 (3) SA 266 (A); and
3. *Crookes and Another v Watson and Another* 1956 (1) SA 277 (A).

The main focus and emphasis of these cases was that the English Law of trusts did not form part of South African Law, but that there existed no reason why the problems presented by such trusts could not be solved by the application of South Africa's Roman-Dutch Law principle of contract.<sup>100</sup>

The cases of *CIR v Estate Crewe*<sup>101</sup> and *CIR v Smollan's Estate*<sup>102</sup> classified an *inter vivos trust* as being a contract for the benefit of a third party (*stipulatio alteri*).

The effect of a *stipulatio alteri* is that the original settlor may, with the agreement of the trustee, revoke the original settlement, provided the third party has not yet accepted the benefits.<sup>103</sup>

The case of *Crookes v Watson*<sup>104</sup> dealt with the question of whether a trust could be revoked in the absence of an express right of revocation and where not all the beneficiaries had consented. The court had to decide the extent to which English Law was to be followed, if at all.<sup>105</sup> The majority favoured the retention of the *stipulatio alteri* as the judicial foundation for these South African trusts.<sup>106</sup>

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<sup>98</sup> Ibid, 859.

<sup>99</sup> Kock et al., (note 83 above) 202.

<sup>100</sup> Ibid, 202 – 203.

<sup>101</sup> *CIR v Estate Crewe* 1943 AD 656 at 657.

<sup>102</sup> *CIR v Smollan's Estate* 1955 (3) SA 266 (A).

<sup>103</sup> Kock et al., (note 83 above) 203.

<sup>104</sup> *Crookes v Watson* 1956 (1) SA 277 A at 302.

<sup>105</sup> *Crookes v Watson* 1956 (1) SA 277 A at 285.

<sup>106</sup> Ibid, 280.

### 3.2. Definition Of A ‘Trust’

The Hague Convention on Trusts has in Article 2 defined a ‘trust’ as ‘the legal relationship created during the lifetime of the founder (*inter vivos*) or on death (*mortis causa*) by a person (the founder) who places assets under the control of another (the trustee) for the benefit of a beneficiary or for a specified purpose’.<sup>107</sup>

The definition of a trust as per the Trust Property Control Act<sup>108</sup> is:

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

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

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

### 3.3. Parties To A Trust

Several parties are involved in the formation of a trust. It usually involves the founder or settlor who hands over an asset or assets to the trustees, who in turn manage that asset or assets for the benefit of the beneficiaries.

The formation of the trust in itself is not necessarily complicated, however it is important that the parties to a trust and their specific roles and duties are understood.

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<sup>107</sup> Convention on the law applicable to trusts and on their recognition 1985 (online) Available [http://www.hcch.net/index\\_en.php?act=conventions.text&cid=59](http://www.hcch.net/index_en.php?act=conventions.text&cid=59); accessed 27<sup>th</sup> September 2015.

<sup>108</sup> Trust Property Control Act 57 of 1988 as amended.

### 3.3.1. The founder or settler

According to de Kock,<sup>109</sup> a founder or settlor is:

- The person who establishes the trust.
- In most circumstances, the original owner of the property being disposed of to the trust.
- The person who would appoint the trustees.
- The person who would transfer legal ownership to the trustees. This is usually done by way of a trust deed.
- The person who specifies the beneficiaries.

The founder of a trust can be any person or institution who is capable of making a will or capable of entering into a contract.<sup>110</sup>

The founder, other than of a *mortis causa* (testamentary) trust is alive at the time of the trust coming into operation or being formed.<sup>111</sup>

### 3.3.2. The trustee

#### 3.3.2.1. Appointment as trustee

Most persons and institutions are qualified to be appointed as a trustee.<sup>112</sup> The trust deed would normally stipulate the criteria for the appointment of a trustee.<sup>113</sup>

Abrie and Graham have stated that no person can be appointed as a trustee against his will and have further listed various persons who cannot be appointed as trustees.<sup>114</sup> Some of those persons include:<sup>115</sup>

- a. A person or institution which cannot perform a legal act, namely not being able to enter into a contract,

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<sup>109</sup> Kock et al., (note 83 above) 202.

<sup>110</sup> W Abrie and CR Graham. *Estates: Planning and Administration* (1989) 135.

<sup>111</sup> Ibid.

<sup>112</sup> Ibid.

<sup>113</sup> Ibid.

<sup>114</sup> Abrie and Graham (note 110 above) 136.

<sup>115</sup> Ibid.

- b. A person or institution who is specifically excluded as a possible trustee in terms of the trust deed,
- c. In the case of a testamentary trust, a witness or the spouse of a witness to the will by which the trust was formed, and in which he or she is nominated as a trustee, is disqualified from acting as a trustee.

### **3.3.2.2.Rights and obligations of a trustee**

In terms of Section 9(1) of the Trust Property Control Act,<sup>116</sup> a trustee shall:

In the performance of his duties and the exercise of his powers act with the care, diligence and skill which can reasonably be expected of a person who manages the affairs of another.

Certain rights of and obligations placed on the trustee are as follows:<sup>117</sup>

- a. The duty to acquaint himself with his task,
- b. The duty to comply with the formalities,
- c. The right to take possession of the trust assets,
- d. The obligation to administer trust assets,
- e. The duty to keep the trust assets separate,
- f. A right to a remuneration for the work performed.

### **3.3.2.3.Discharge of a trustee**

A trustee can be caused to vacate his office in the following ways:<sup>118</sup>

- 1. By a natural cause;
  - a. Due to death.
  - b. If a term of trusteeship is contained in the trust deed.
  - c. Upon the dissolution of the trust.
- 2. By resignation;<sup>119</sup> or

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<sup>116</sup> Trust Property Control Act 57 of 1988 as amended.

<sup>117</sup> Abrie and Graham (note 110 above) 136.

<sup>118</sup> Ibid, 140-141.

<sup>119</sup> Section 21 of the Trust Property Control Act 57 of 1988 as amended.

3. By dismissal.<sup>120</sup>

### **3.3.3. The beneficiaries**

According to de Kock, beneficiaries are the equitable or beneficial owners of the trust property and all conduct should be for their benefit.<sup>121</sup>

The beneficiaries' beneficial interests are varied as follows:

#### **3.3.3.1. Income beneficiaries**

The income beneficiaries in a vested trust<sup>122</sup> normally have vested rights with regards to the income of the trust.<sup>123</sup> The trustees are obliged to pay out any net income to them.<sup>124</sup>

In the case of a discretionary trust,<sup>125</sup> the income beneficiaries are only entitled to the income from the trust when the trustees make an allocation to them.<sup>126</sup>

The beneficiaries, although being entitled to the income of the trust, do not have access to the capital of the trust.<sup>127</sup>

#### **3.3.3.2. Capital beneficiaries**

These types of beneficiaries are the owners of the trust capital, or they might become the ultimate owners of the trust asset, this obviously being dependant on the type of trust.<sup>128</sup>

The beneficiaries are the only parties who can enforce the trust provisions, and in the circumstances where there is no distinction between a capital and income beneficiary,

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<sup>120</sup> Ibid, Section 20.

<sup>121</sup> Kock *et al.*, (note 83 above) 205.

<sup>122</sup> A vested trust is one where ownership and control of the trust assets vests in the trustee in his representative capacity on behalf of the trust, and the beneficiaries have only personal rights to claim their portion of the trust benefits from the trustee upon the happening of a certain event (de Kock *et al.*, 2002).

<sup>123</sup> Kock *et al.*, (note 83 above) 205.

<sup>124</sup> Ibid.

<sup>125</sup> A discretionary trust is one where ownership and control vest in a trustee in his representative capacity. However, the trust beneficiaries have no rights whatsoever to claim the trust benefits, except and until the trustees have exercised their discretion and physically paid over a benefit to a trust beneficiary (de Kock *et al.*, 2002).

<sup>126</sup> Kock *et al.*, (note 83 above) 205.

<sup>127</sup> Ibid.

<sup>128</sup> Abrie and Graham (note 110 above) 141 – 142.

then the beneficiary will be entitled to the income and will also become the owner of the capital/trust asset.<sup>129</sup>

### 3.3.4. Summary

There are in essence 3 (three) parties to a trust, namely, the founder, the trustee and the beneficiary. The founder is responsible for the formation of the trust, the trustee is responsible for the management of the trust, and the beneficiary benefits from the trust.

However, although not mentioned above, the Trust Property Control Act<sup>130</sup> confers upon the Master<sup>131</sup> certain powers to ensure accountability for the trust by the trustees.

## 3.4. Types Of Trusts

The definitions from both Article 2 of the Hague Convention<sup>132</sup> and Section 1 of the Trust Property Control Act<sup>133</sup> indicates that trusts are classified into 2 (two) categories, namely; *mortis causa* (testamentary) and *inter vivos* trusts.

Section 1 of the Trust Property Control Act,<sup>134</sup> contains further evidence of the categories of trusts in its definition of ‘trust instrument’ which it defines as:

A written agreement or a testamentary writing or a court order according to which a trust was created.

From this it is seen that a trust can be formed by written agreement, in terms of a testamentary writing, which normally takes the form of a will, or upon the court ordering its creation.

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<sup>129</sup> Kock *et al.*, (note 83 above) 205.

<sup>130</sup> Section 16 of the Trust Property Control Act 57 of 1988 as amended.

<sup>131</sup> Master in relation to any matter, means the Master, Deputy Master or Assistant Master of the Supreme Court appointed under section 2 of the Administration of Estate Act, 1965 (Act 66 of 1965), who under section 3 of this Act has jurisdiction in respect of the matter concerned, (Trust Property Control Act 57 of 1988, section 1)

<sup>132</sup> Convention on the law applicable to trusts and on their recognition (note 107 above).

<sup>133</sup> Trust Property Control Act 57 of 1988 as amended.

<sup>134</sup> Trust Property Control Act 57 of 1988 as amended.

### 3.4.1. *Mortis causa* trust

The *mortis causa* trust is a trust which is formed upon the death of a person and which formation is facilitated through the deceased's will.<sup>135</sup> The *mortis causa* trust is also referred to as the testamentary trust in light of it being formed on the basis of a person's will and upon that person's death.<sup>136</sup>

In terms of the *mortis causa* trust, the trustees will manage the assets which were bequeathed to this trust on behalf of the deceased's dependants, namely his spouse and children.<sup>137</sup> This management will ensure that the deceased's dependants remain financially stable.

The creation of a *mortis causa* (testamentary) trust is always created by means of a bequest in terms of the last will and testament of the deceased.<sup>138</sup>

A *mortis causa* trust is taxed on the income it retains whilst the beneficiaries are taxed on the income they receive from distributions.<sup>139</sup>

### 3.4.2. *Inter vivos* trust

An *inter vivos* trust is a trust which is created during the lifetime of the founder, which creation is usually funded through a donation by the founder.<sup>140</sup>

According to Stiglingh an *inter vivos* trust is regularly used to reduce the estate duty liability of the founder upon death, but may also have tax benefits during the founder's lifetime.<sup>141</sup>

An *inter vivos* trust is taxed in accordance with the provisions of section 25B and section 7 of the Income Tax Act.<sup>142</sup>

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<sup>135</sup> P Haupt, *Notes on South African Income Tax* 3 ed (2014) 804.

<sup>136</sup> Stiglingh *et al.*, (note 9 above) 842.

<sup>137</sup> *Ibid*, 842 – 843.

<sup>138</sup> *Ibid*, 843.

<sup>139</sup> Haupt., (note 135 above) 804.

<sup>140</sup> Haupt., (note 135 above) 804.

<sup>141</sup> Stiglingh *et al.*, (note 9 above) 843.

<sup>142</sup> The Income Tax Act 58 of 1962, as amended.

### **3.5. The Essentials Of A Valid Trust**

The 5 (five) basic requirements for a valid trust are:<sup>143</sup>

#### **3.5.1. The founder must intend to create a trust**

There must be an intention of placing the administrator/trustee in office.<sup>144</sup> This intention may be express or implied from the circumstances.<sup>145</sup>

#### **3.5.2. The founder must express his intention in a mode apt to create an obligation**

The mode can take the form of a contract, will, statute, or a court order, provided that the mode places obligations upon the trustee once he has accepted the office.<sup>146</sup> In South Africa a unilateral declaration to create a trust is insufficient.<sup>147</sup>

#### **3.5.3. The subject matter of the trust must be defined with reasonable certainty<sup>148</sup>**

Simply put, the property of the trust must be defined, alternatively must be capable of being determined.

#### **3.5.4. The trust object must be defined with reasonable certainty**

In terms of this requirement, the trust fund must be for the benefit of named or ascertainable beneficiaries; alternatively, it should at least have an impersonal object.<sup>149</sup>

#### **3.5.5. The trust object must be lawful**

The objectives of the trust as set out in the trust deed must be legal and lawful so as to maintain and preserve the integrity of the Constitution<sup>150</sup> as well as other laws which may impact and affect the trust and its objects, directly or otherwise.<sup>151</sup>

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<sup>143</sup> Kock *et al.*, (note 83 above) 208 – 209.

<sup>144</sup> Ibid, 208

<sup>145</sup> Ibid.

<sup>146</sup> Ibid.

<sup>147</sup> Ibid.

<sup>148</sup> Kock *et al.*, (note 83 above) 208.

<sup>149</sup> Ibid.

<sup>150</sup> Constitution of the Republic of South Africa, 1996 (1996 Constitution).

<sup>151</sup> Kock *et al.*, (note 83 above) 209.

Apart from these 5 (five) basic requirements, the Trust Property Control Act<sup>152</sup> imposes 2 (two) further requirements, which are:

### **3.5.6. Registration**

Unless the Master is already in possession of the trust deed, as would be the case with testamentary trusts, the trust deed must be lodged with the Master together with; the prescribed fee, and the acceptance of trusteeship by all the trustees.<sup>153</sup>

### **3.5.7. Duty of care**

This is an important requirement in terms of which the trustees are required to exercise the care, diligence, and skill which can reasonably be expected of persons managing the affairs of another.<sup>154</sup> In addition to this, the Common Law fiduciary duties continue to apply.<sup>155</sup>

## **3.6. Conclusion**

The concept of trusts have been a part of society for centuries, however gained recognition in South Africa in the early 19<sup>th</sup> century after having being brought to our shores by the English Settlers.

The use of trusts has undoubtedly increased since its incorporation into South African Law and has become an integral aspect in the preservation of wealth for the future generations.

To be able to utilize a trust and its many uses, knowledge on how to establish and maintain a trust is critical as an incorrectly formed trust may not provide the desired outcomes.

In order for a trust to be established and registered, there are various requirements which must be met, that is; the determination and distinguishing of the parties to the trust,

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<sup>152</sup> Trust Property Control Act 57 of 1988 as amended.

<sup>153</sup> Ibid, section 4.

<sup>154</sup> Trust Property Control Act 57 of 1988 as amended, section 9.

<sup>155</sup> Kock *et al.*, (note 83 above) 209.

namely; the donor, the trustees and the beneficiaries, the identification of the trust property and the creation of the trust Deed which will form the basis and constitution of the trust.

As was briefly mentioned above, the *mortis causa* and *inter vivos* trusts are taxed differently. This is due to the former not falling within the ambit of section 7<sup>156</sup> in that the section requires there to be a donor so as to be applicable which due to its nature is not present in a *mortis causa* trust. This distinction must be borne in mind when deciding to establish a trust.

The rise in popularity of the trust can be attributed to the various uses that the trust provides, whether it be a form of housing for one's assets; for the purpose of conducting transactions or to minimise taxes. This latter use has not been without much controversy and scrutiny as is now seen from the Davis Tax Committee's interim report<sup>157</sup> which suggests changes to certain tax laws which in turn will place a greater burden on trusts thus hindering its effectiveness as a tax minimisation tool.

An analysis of this interim report, its recommendations, its implications and its effect on the use of trusts in effectively minimising taxes will be dealt with in the chapters that follow.

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<sup>156</sup> Income tax Act 58 of 1962 as amended.

<sup>157</sup> N Monkam; I Wooland; T Ajam. First Interim Report on Estate Duty. January 2015. Available online: <http://www.taxcom.org.za/docs/20150723%20DTC%20First%20Interim%20Report%20on%20Estate%20Duty%20-%20For%20public%20comment%20by%2030%20September%202015.pdf>; accessed on 21<sup>st</sup> September 2015.

## CHAPTER FOUR

### TAXATION OF TRUSTS

#### 4.1. Overview

The trust, for tax purposes, is considered to be a person<sup>158</sup> and as such is subject to taxation. However due to the trust being classified merely as a person, it does not qualify for the primary, secondary or tertiary rebates in terms of Section 6<sup>159</sup> or for the exemptions allowed in terms of limited interest<sup>160</sup> which are only applicable to natural persons.

This is one of the differences in the taxation of trusts and the taxation of natural persons. Other differences would include, inter-alia, the tax rates applicable to normal tax and the inclusion in terms of capital gains tax.

If a trust is to be used as an estate planning and tax saving mechanism it becomes vital to understand how a trust is taxed especially on income received, accrued to, or in favour of the trust. A failure to consider these factors could lead to the formation and use of the trust incorrectly which would not achieve the intended outcomes, one of the important outcomes being that of a tax saving.

#### 4.2. Tax Rates

##### 4.2.1. Introduction

The rate at which a trust is taxed is dependent on the type of trust in question, namely whether it is an ordinary trust or a special trust.<sup>161</sup>

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<sup>158</sup> In terms of Section 1 of the Income tax Act 58 of 1962 a person includes –

- (a) An insolvent estate;
- (b) The estate of a deceased person;
- (c) Any trust; and
- (d) Any portfolio of a collective investment scheme.

<sup>159</sup> Income tax Act 58 of 1962 as amended.

<sup>160</sup> Section 10(1)(i), Income tax Act 58 of 1962.

<sup>161</sup> Stiglingh *et al.*, (note 9 above) 843.

#### 4.2.2. Special trusts

A special trust as defined in section 1<sup>162</sup> means a trust created –

- (a) Solely for the benefit of one or more persons who is or are persons with a disability as defined in section 6B (1)<sup>163</sup> where such disability incapacitates such person or persons from earning sufficient income for their maintenance, or from managing their own financial affairs: Provided that –
  - (aa) such trust shall be deemed not to be a special trust in respect of years of assessment ending on or after the date on which all such persons are deceased; and
  - (bb) where such trust is created for the benefit of more than one person, all persons for whose benefit the trust is created must be relative in relation to each other; or
- (b) By or in terms of the will of a deceased person, solely for the benefit of beneficiaries who are relatives in relation to that deceased person and who are alive on the date of the death of that deceased person (including any beneficiary who has been conceived but not yet born on that date), where the youngest of those beneficiaries is on the last day of the year of assessment of that trust under the age of 18 years.

From this definition it is evident that a special trust can be created in 2 (two) ways, that is, during the lifetime of a person or upon a person's death, (*inter vivos* and *mortis causa*).

The rate of taxation of a special trust is the same as for natural persons, that is, a sliding scale. This scale ranges from 18% to 41%.<sup>164</sup>

#### 4.2.3. Ordinary trusts

An ordinary trust is a trust which does not fall within the definition of a 'special trust' as defined in Section 1 of the Act<sup>165</sup> and as mentioned above.

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<sup>162</sup> Income tax Act 58 of 1962 as amended.

<sup>163</sup> In terms of Section 6B (1) of the Income tax Act 58 of 1962, disability means a moderate to severe limitation of any person's ability to function or perform daily activities as a result of a physical, sensory, communication, intellectual or mental impairment, if the limitation –

- (a) Has lasted or has a prognosis of lasting more than a year; and
- (b) Is diagnosed by a duly registered medical practitioner in accordance with the criteria prescribed by the Commissioner.

<sup>164</sup> *Budget 2015 tax Guide* (note 30 above).

<sup>165</sup> Income tax Act 58 of 1962 as amended.

The tax liability of an ordinary trust, unlike that of a special trust is not determined on sliding, but rather on a fixed rate of 41%.<sup>166</sup>

### **4.3. Liability For Tax On Income Earned By Trusts**

#### **4.3.1. Introduction**

Careful consideration must be given to the provisions of the trust deed, the relevant sections of the Act and the legal principles relating to the vesting of rights when determining the tax liability of the income of a trust.<sup>167</sup>

The principal section relating to the taxation of the income of a trust is section 25B of the Income Tax Act.<sup>168</sup> However this is subject to section 7 of the Income Tax Act<sup>169</sup> and it is thus that the income of the trust is taxed either in the trust or in the hands of the beneficiaries.<sup>170</sup> If the income vests in the beneficiaries, then it is taxed in their hands. However if it does not vest in the beneficiaries, then it falls to be taxed in the trust.<sup>171</sup>

As a result of the above and in order to determine who is liable for taxation on the income earned, a determination of what a vested right is needs to be made, this due to the trust being taxed on the income which it retained during the year of assessment; that is, if income is received and distributed to the beneficiaries within the same year/period of assessment in question, then said income is treated as having not been received by the trust.<sup>172</sup>

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<sup>166</sup> *Budget 2015 Tax Guide* (note 30 above).

<sup>167</sup> Stiglingh *et al.*, (note 9 above) 847.

<sup>168</sup> Income tax Act 58 of 1962 as amended.

<sup>169</sup> *Ibid.*

<sup>170</sup> Stiglingh *et al.*, (note 9 above) 847.

<sup>171</sup> *Ibid.*

<sup>172</sup> *Ibid* 847 – 848.

It has been held in the case of *ITC 76* that:<sup>173</sup>

A vested right was something substantial; something which could be measured in money; something that had a present value and could be attached, whilst a contingent interest was merely a *spes* – an expectation which might never be realised.

A vested right is in relation to income to which the beneficiary has an unconditional entitlement, that is, the beneficiary will receive it.

However even if a beneficiary has a vested right, it does not necessarily mean that the beneficiary has received the income. In *ITC 1328* the Court held that<sup>174</sup> “it is not a necessary consequence of vesting that the beneficiary should have a legal right to claim payment”.

From this it can be seen that although the income may vest in the beneficiary, there may be no right to claim payment. However, the beneficiary still has a right to the income.

#### **4.3.2. Section 25B**<sup>175</sup>

It is due to section 25B(1)<sup>176</sup> that a vested right can be understood as it is, that is, an amount received by or accrued to a trustee of a trust will be deemed to accrue to an ascertained beneficiary if that beneficiary has a vested right to it.<sup>177</sup>

Section 25B(1)<sup>178</sup> is however, subject to section 7<sup>179</sup> and whilst section 7(1)<sup>180</sup> maintains that where an amount is deemed to accrue to a person, that person has a vested

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<sup>173</sup> *ITC 76* (1927) 3 SATC 68(U) at 70.

<sup>174</sup> *ITC 1328* (1980) 43 SATC 56(N) at 57.

<sup>175</sup> Section 25B of the Income tax Act 58 of 1962 as amended.

<sup>176</sup> Section 25B(1) Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.

<sup>177</sup> *Stiglingh et al.*, (note 9 above) 848.

<sup>178</sup> Income tax Act 58 of 1962 as amended.

<sup>179</sup> *Ibid.*

<sup>180</sup> Section 7(1) Income shall be deemed to have accrued to a person notwithstanding that such income has been invested, accumulated or otherwise capitalized by him or that such income has not been actually paid over to him but remains due and payable to him or has been credited in account or reinvested or accumulated or

right, sections 7(2) to 7(8) state that even though the beneficiary has a vested right, tax liability for that amount can be borne by another.

Thus in an attempt to determine the identity of the taxpayer, the provisions of section 7<sup>181</sup> must be applied first and thereafter, that of section 25B.<sup>182</sup> If it is found that section 7<sup>183</sup> does not apply then section 25B<sup>184</sup> will apply as follows:

#### **4.3.2.1. Section 25B(1)**

Any amount received by or accrued to, or in favour of any person in his capacity as a trustee of a trust during any year of assessment will be deemed to be an amount which has accrued to an ascertained beneficiary to the extent that it has been derived for the immediate or future benefit that beneficiary who has a vested right to such an amount, and if not so derived, then be deemed to be an amount which has accrued to the trust.<sup>185</sup>

As a result of this section, any amount not vesting in an ascertained beneficiary will be deemed to accrue to the trust and if the trust is an ordinary trust as opposed to a special trust, then that amount will be taxed at the flat rate of 41 %. However had it been a special trust or had the amount vested in an ascertained beneficiary, then that amount would be taxed on the sliding scale which is applicable to both special trusts as well as natural persons.

#### **4.3.2.2. Section 25B(2)**

Where a beneficiary has acquired a vested right to an amount in consequence of the exercise by the trustee of a discretion vested in him by the trust deed then such amount is deemed to be derived for benefit of the beneficiary.<sup>186</sup>

As such, if a vested right has not been conferred on a beneficiary directly by the trust deed, then such beneficiary can still acquire that vested right through a trustee

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capitalized or otherwise dealt with in his name or on his behalf, and a complete statement of all such income shall be included by any person in the returns rendered by him under this Act.

<sup>181</sup> Income tax Act 58 of 1962 as amended.

<sup>182</sup> Ibid

<sup>183</sup> Ibid.

<sup>184</sup> Ibid.

<sup>185</sup> Ibid.

<sup>186</sup> Ibid.

conferring such right to the beneficiary in terms of the ability/discretion afforded to the trustee by the trust deed. This is normally seen in a discretionary trust. The result of the beneficiary being granted this right is that the amount which then vests in the beneficiary will be taxed in his hands on the sliding scale as opposed to being taxed at 41% in the trust.

#### **4.3.2.3. Section 25B(2A)**

Where in any year of assessment any resident acquires a vested right to an amount representing capital of a foreign trust, then that amount shall be included in the income of the resident and taxed in his hands if it has not already been subject to tax in South Africa provided such amount would have been income of the trust had it been a resident in any previous year of assessment during which the resident had a contingent right to that amount.<sup>187</sup>

#### **4.3.2.4. Section 25B(3)**

Any deduction or allowance which may be made under the Act in determining taxable income which has accrued to a beneficiary or to the trust is deemed to be a deduction or allowance which is permitted in the hands of the person who is deemed to have derived the amount, to the extent to which the amount is deemed to accrue to the beneficiary or to the trust.<sup>188</sup>

#### **4.3.2.5. Section 25B(4)**

Any deduction of allowance contemplated in section 25B(3) of the Act<sup>189</sup> which has been allocated to a beneficiary shall be limited to the income accruing to that beneficiary from the trust in the year of assessment.<sup>190</sup>

#### **4.3.2.6. Section 25B(5)**

The amount in excess between the deductions and allowances in section 25B(4) and the amount included in the income of the beneficiary shall be deducted by the trust in that year however it shall be limited to the taxable income of the trust before the allocation

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<sup>187</sup> Income tax Act 58 of 1962 as amended.

<sup>188</sup> Ibid.

<sup>189</sup> Ibid.

<sup>190</sup> Ibid.

of any such deduction or allowance; and where the trust is not subject to tax in South Africa, then the amount in excess is carried forward and treated as a deduction or allowance which the beneficiary may claim in the next year of assessment from the income derived by that beneficiary.<sup>191</sup>

#### **4.3.2.7. Section 25B(6)**

If the trust is unable to accommodate the full amount of the deduction or allowance disallowed to the beneficiary as contemplated in sections 25B(4) and 25B(5) then the excess may be granted as a deduction or allowance to the beneficiary in the next year of assessment subject to the limitations in section 25B(4).<sup>192</sup>

#### **4.3.2.8. Section 25B(7)**

Sections 25B(4) to 25B(6), inclusive do not apply in respect of any amount deemed to have accrued to any beneficiary in terms of section 25B(1) where the beneficiary is not subject to tax in South Africa on that amount.<sup>193</sup>

### **4.3.3. Section 7**

#### **4.3.3.1. Overview**

The provisions of Section 7<sup>194</sup> are anti-avoidance provisions specific to trusts and to apply there must be a disposition in the form of a donation, settlement or some other type of gratuitous disposition.<sup>195</sup>

In the context of a trust such gratuitous disposition could be a donation with the donee being the trust, or it could be the sale of a property to the trust on the basis of a loan account which could be left unpaid, the tax liability in this instance, would fall on the person making such gratuitous disposition. Conversely if it was a non-gratuitous disposition as was seen in the case of *Estate Welch v CSARS* 2004 (2) SA 586 (SCA)<sup>196</sup> where the court held that if the disposition was not prompted by the motive of sheer liberality then the disposition cannot be said to be gratuitous.

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<sup>191</sup> Income tax Act 58 of 1962 as amended.

<sup>192</sup> Ibid.

<sup>193</sup> Ibid.

<sup>194</sup> Ibid, Section 7.

<sup>195</sup> Ibid.

<sup>196</sup> *Estate Welch v CSARS* 2004 (2) SA 586 (SCA) at 317.

It is for this reason that sections 7(2) to 7(8) will deem the income taxable in a different person's hands other than that of the person who is entitled to the income.

#### 4.3.3.2. Section 7(2)<sup>197</sup>

This section is aimed at preventing married couples, irrespective of their matrimonial property regime from reducing their liabilities for normal tax by splitting taxable income between the spouses.<sup>198</sup>

If the recipient spouse received income in consequence of a donation made by, or scheme carried out by the donor spouse wherein the sole purpose is to reduce, postpone or avoid tax, then the donor spouse will be liable for tax on the income received by the recipient spouse.<sup>199</sup> This will be a deemed inclusion in the donor spouse's income.

However this provision will only apply if the income received by or that which accrues to the recipient spouse exceeds the 'reasonable income'<sup>200</sup> which the recipient spouse is entitled to.<sup>201</sup>

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<sup>197</sup> Section 7(2); Any income received by or accrued to any person married in or out of community of property (hereinafter referred to as the recipient) shall be deemed for purposes of this Act to be income accrued to such person's spouse (hereinafter referred to the donor) if –

- (a) such income was derived by the recipient in consequence of a donation, settlement or other disposition made by the donor on or after 20 March 1991 or of a transaction, operation or scheme entered into or carried out by the donor on or after that date, and the sole or main purpose of such donation, settlement or other disposition or of such transaction, operation or scheme was the reduction, postponement or avoidance of the donor's liability for any tax, levy or duty which, but for such donation, settlement, other disposition, transaction, operation or scheme, would have become payable by the donor under this Act or any other Act administered by the Commissioner; or
- (b) income was received by or accrued to the recipient –
  - (i) from any trade carried on by the recipient in partnership or association with the donor or which is in any way connected with any trade carried on by the donor; or
  - (ii) from the donor or any partnership of which the donor was at the time of such receipt or accrual a member of any private company of which the donor was at such time the sole or main holder of shares or one of the principal holder of shares,and such income represents the whole or any portion of the total income so received by or accrued to the recipient which exceeds the amount of income to which the recipient would reasonably be entitled having regard to the nature of the relevant trade, the extent of the recipient's participation therein, the services rendered by the recipient or any other relevant factor.

<sup>198</sup> Haupt., (note 135 above) 806.

<sup>199</sup> Stiglingh *et al.*, (note 9 above) 351.

<sup>200</sup> This reasonable income is to be established in light of the nature of the relevant trade concerned with the recipient spouse (Stiglingh *et al.*, 2014).

<sup>201</sup> Section 7(2) of the Income Tax Act 58 of 1962 as amended.

This provision ensures fairness between spouses working together in the same trade and spouses who work separately<sup>202</sup>.

In the context of trusts, if a recipient spouse receives income from the trust and it is found that the source of that income was a gratuitous disposition by the donor spouse then that income will be taxed in the hands of the donor spouse and not the recipient spouse. In this way, the tax liability of the recipient spouse would be less.

Section 7(2A)<sup>203</sup> and section 7(2C)<sup>204</sup> deal specifically with spouses married in community of property. By virtue of this matrimonial property regime, income received by, accruing to, or in favour of spouses is done so equally except in certain circumstances.<sup>205</sup> These sections, in an attempt to avoid any confusion which may arise in determining the tax liability of each spouse have set out rules that determine whose hands the income will be taxed in.

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<sup>202</sup> Stiglingh *et al.*, (note 9 above) 351 – 353.

<sup>203</sup> Section 7(2A); in the case of spouses who are married in community of property –

- (a) any income (other than income derived from the letting of fixed property) which has been derived from the carrying on of any trade shall, if such trade is carried on –
  - (i) by only one of the spouses, be deemed to have accrued to that spouse; or
  - (ii) jointly by both spouses, be deemed, subject to the provisions of subsection (2) (b), to have accrued to both spouses in the proportions determined by them in terms of the agreement that regulates their joint trade or, if there is no such agreement, in the proportion to which each spouse would reasonably be entitled to having regard to the nature of the relevant trade, the extent of each spouse's participation therein, the services rendered by each spouse or any other relevant factor; and
- (b) any income derived from the letting of fixed property and any income derived otherwise than from the carrying on of any trade shall be deemed to have accrued in equal shares to both spouses: Provided that any such income which does not fall into the joint estate of the spouses, shall be deemed to be income accrued to the spouse who is entitled thereto.

<sup>204</sup> Section 7(2C); For the purposes of subsection (2A) –

- (a) any benefit paid or payable to spouse in his or her capacity as a member or past member of a pension fund, pension preservation fund, provident fund, provident preservation fund, benefit fund, retirement annuity fund or any other fund of a similar nature shall be deemed to be income derived by such spouse from a trade carried on by him or her;
- (b) any annuity amount (as defined in section 10A) paid or payable to a spouse shall be deemed to be income derived by such spouse from a trade carried on by him; and
- (c) where any spouse is the –
  - (i) registered holder of a patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act; or
  - (ii) author of a work on which copyright has been conferred in terms of the Copyright Act or the owner of such copyright by reason of assignment, testamentary disposition or operation of law; or
  - (iii) holder of any other property or right of a similar nature, any income derived from the grant of the right of use of such patent, design, trade mark, copyright or other property or right shall be deemed to be income derived by such spouse from a trade carried on by him.

<sup>205</sup> Stiglingh *et al.*, (note 9 above) 352-353.

These rules are as follows:

- In respect of trade income<sup>206</sup>

Income derived from the carrying on of a trade is deemed to accrue to the spouse who is carrying on the trade. Where the trade is being carried on jointly by the spouses in partnership, then the income is deemed to have accrued to both spouses in the proportions as per the partnership agreement, however in the absence of such agreement, then in the proportions to which each spouse would reasonably be entitled with due consideration being had to various factors such as; the nature of the trade, the extent of each spouse's participation, the services rendered by each spouse.

- In respect of rental and non-trade income<sup>207</sup>

Income which does not fall within the joint estate is deemed to have accrued to the spouse who is entitled to it, whilst income resulting from the letting of fixed property or any other income other than from carrying on of a trade is deemed to have accrued equally to both spouses.

Non-trade income are; interest, dividends, and annuities other than section 10A<sup>208</sup> annuities.

- Capital gains<sup>209</sup>

Upon the disposal of property by a spouse, which property falls within the joint estate, the disposal is regarded as being made in equal shares by the spouses, and as such the resulting gain or loss will be shared equally between the spouses. Each spouse can deduct the annual exclusion and will thereafter be taxed on 25% of the resulting net capital gain. In the event that the property being disposed of is the spouses' primary residence, then a 'primary residence exclusion' will be shared between them.

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<sup>206</sup> Stiglingh *et al.*, (note 9 above) 352-353.

<sup>207</sup> Ibid.

<sup>208</sup> Income tax Act 58 of 1962 as amended.

<sup>209</sup> Stiglingh *et al.*, (note 9 above) 353.

However if the property does not form part of the joint estate, then gains and losses arising from the disposal thereof remain those of the disposing spouse.

For purposes of sections 7(2), 7(2A) and 7(2C), the term ‘income’ must be given its ordinary meaning, that is, profits or gains, and not its meaning as defined in Section 1 of the Income Tax Act.<sup>210</sup>

#### **4.3.3.3. Sections 7(3)<sup>211</sup> and 7(4)<sup>212</sup>**

When a minor<sup>213</sup> child<sup>214</sup> or stepchild receives income in his own right, the income is subject to tax in his own hands, unless the provisions of sections 7(3) or 7(4) apply.

Section 7(3) of the Income Tax Act provides that if a parent makes any donation, settlement or other disposition to his minor child or stepchild, which results in income being:

- Received by the child; or
- Accruing to the child; or
- Expended for the child’s maintenance, education or benefit, or
- Accumulated for the child’s benefit,

then the income is deemed to have been received by or accrued to the parent of that child, and as such, the donor parent would be liable for tax on that income.<sup>215</sup>

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<sup>210</sup> Income tax Act 58 of 1962 as amended.

<sup>211</sup> Section 7(3); Income shall be deemed to have been received by the parent of a minor child or stepchild, 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.

<sup>212</sup> Section 7(4); Any income received by or accrued to or in favour of any minor child or stepchild 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 that child, if such parent or his or her 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 or her family.

<sup>213</sup> The Children’s Act 38 of 2005 changed the age of majority from 21 years to 18 years.

<sup>214</sup> In terms of Section 1 of the Income tax Act 58 of 1962, a child in relation to any person, includes any person adopted by him or her –

- (a) Under the law of the Republic; or
- (b) Under the law of any country other than the Republic, provided the adopted person is under such law accorded the status of a legitimate child of the adoptive parent and the adoption was made at a time when the adoptive parent was ordinarily resident in such country.

<sup>215</sup> Section 7(3) of the Income Tax Act 58 of 1962.

According to Stiglingh, case law has confirmed that if the effective cause of the receipt or accrual of the income was from a donation, settlement or other disposition by a parent of the child, then that income is deemed in terms of Section 7(3) to have been received by or accrued to the parent.<sup>216</sup>

It was concluded in the case of *Ovenstone v SIR* that the expression “donation, settlement or other disposition” should be read as “donation, settlement or other similar disposition”.<sup>217</sup> The term disposition was further interpreted to mean, any disposal of property made wholly or to an appreciable extent gratuitously out of the liberality or generosity of the disposer.<sup>218</sup>

It would follow then that section 7(3)<sup>219</sup> would not apply to dispositions made at full value or settlements made for full consideration.

In the context of trusts where the child is the beneficiary with a vesting right to the income, then any income received from the parent by means of a donation, settlement or other disposition will be taxable in the hands of the parent making such donation, settlement or other disposition.

In terms of section 7(4) income received by a minor child or stepchild from a donation, settlement or other disposition made by a third party will be taxable in the hands of the parent of the child in whose favour such donation, settlement or other disposition was made.<sup>220</sup>

This section is in place to counteract attempts to escape liability by the parent of a minor child through the use of a third party. A simple yet effective example of this situation is provided by Stiglingh;<sup>221</sup>

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<sup>216</sup> Stiglingh *et al.*, (note 9 above) 356 – 357.

<sup>217</sup> *Ovenstone v SIR* 1980 (2) SA 721 (A) at 737.

<sup>218</sup> *Ibid.*

<sup>219</sup> Section 7(3) of the Income Tax Act 58 of 1962.

<sup>220</sup> *Ibid.*, section 7(4).

<sup>221</sup> Stiglingh *et al.*, (note 9 above) 357.

“Parent A donates R10 000 to a minor child or stepchild of Parent B. Parent B reciprocates by donating R10 000 to a major child or step child of Parent A. Were it not for the provisions of Section 7(4), the income received by Parent B’s minor child or stepchild would be taxed in the minor child’s or stepchild’s own hands. However with the effect of Section 7(4) any income received by or accruing to the major child or stepchild of Parent A will be taxed in the hands of that child or stepchild, whilst the income received by or accruing to Parent B’s minor child or stepchild will be taxed in the hands of parent B.”

The above example denotes equal donations. However it should be borne in mind that it need not be equal, there merely needs to be some causal connection between the disposals.<sup>222</sup>

#### **4.3.3.4. Section 7(5)<sup>223</sup>**

This section subjects, in certain circumstances, the donor to tax on the income received by a trust.<sup>224</sup> However, for Section 7(5) to be applicable there must be a donation which is subject to a stipulation or condition, probably imposed by the donor.<sup>225</sup> This can be interpreted to mean that prior to the stipulation or condition occurring, the beneficiaries shall not receive the income in question.

Section 7(5) can only apply to income that:<sup>226</sup>

1. Is retained in the trust, and
2. Arose from a donated asset.

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<sup>222</sup> COT v Paice 25 SATC 285 1963 (FC), in this case, it was held that, ‘there must be some causal connection between the disposition by the taxpayer to the other person, and the disposition by the other person which leads to income for the children’.

<sup>223</sup> 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 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.

<sup>224</sup> Income Tax Act, 58 of 1962 as amended; Section 7(5).

<sup>225</sup> Ibid.

<sup>226</sup> Stiglingh *et al.*, (note 9 above) 850.

The reason why the income is retained in the trust is vital in the determination of whether or not the donor will be liable for tax on the income retained in the trust.<sup>227</sup> Should the delay in distribution of the income be that the beneficiary has a vested right, then section 7(5) does not apply. However, if the delay is due to a stipulation or condition, then the retained income will accordingly be taxed in the hands of the donor until the stipulation or condition occurs or the donor's demise, whichever shall occur first.<sup>228</sup>

It should be borne in mind that section 7(5)<sup>229</sup> not only applies to donations, but rather to any donation, settlement or other disposition which is subject to a stipulation or condition.

#### **4.3.3.5. Section 7(6)<sup>230</sup>**

Section 7(6)<sup>231</sup> will be applicable whereby the donor has a right of revocation in respect of a beneficiary's right to receive income or to confer that beneficiary's right upon another person.<sup>232</sup> According to the case of *ITC 673*<sup>233</sup> there must be a specific provision or clause in the deed of donation which grants the donor the right of revocation.

If the above clause or provision is present in the deed of donation and/or if the donor has exercised his/her right of revocation, section 7(6)<sup>234</sup> will lead to the donor being taxed on the income in question.

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<sup>227</sup> Ibid.

<sup>228</sup> Ibid.

<sup>229</sup> Income Tax Act, 58 of 1962 as amended; Section 7(5).

<sup>230</sup> 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.

<sup>231</sup> Income Tax Act, 58 of 1962 as amended; Section 7(6).

<sup>232</sup> Stiglingh *et al.*, (note 9 above) 852.

<sup>233</sup> *ITC 673* (1948) 16 SATC 230 (U) at 231 – 231.

<sup>234</sup> Income Tax Act, 58 of 1962 as amended; Section 7(6).

#### 4.3.3.6. Section 7(7)<sup>235</sup>

In terms of section 7(7), a person will be taxed on investment income if:<sup>236</sup>

1. The investment income is ceded by that person to someone else, or
2. The asset producing the income is transferred, delivered, or made over to another person for a limited time.

This section was introduced to counteract ‘schemes’ where a taxpayer cedes the right to receive income generated by his asset but retains ownership or the right to regain ownership thereof.<sup>237</sup> Upon the cession of the taxpayer’s right to income prior to it accruing to him, his taxable income would decrease accordingly.<sup>238</sup>

The types of investment income which this section is applicable to are:<sup>239</sup>

1. Rent,
2. Dividends,
3. Interest,
4. Royalties, and
5. Other similar income.

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<sup>235</sup> Section 7(7); if by reason of any donation, settlement or other disposition made, whether before or after the commencement of this Act, by any person (hereinafter referred to as the donor) –

- (a) the donor’s right to receive or have paid to him or for his benefit any amount by way of rent, dividend, foreign dividend, interest, royalty or similar income in respect of any movable or immovable property (including without limiting the foregoing any lease, company share, marketable security, deposit, loan, copyright, design or trade mark) or in respect of the use of, or the granting of permission to use such property, is ceded or otherwise made over to any other person or to third party for that other person’s benefit in such manner that the donor remains the owner of or retains an interest in the said property or if the said property or interest is transferred, delivered or made over to the said other person or to third party for the said other person’s benefit, in such manner that the donor is or will be at a fixed or determinable time be entitled to regain ownership of or the interest in the said property; or
- (b) the donor’s right to receive or have paid 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 is ceded or otherwise made over to any other person or to a third party for that other person’s benefit in such manner that the donor is or will at a determinable time be entitled to regain the said right,

Any such rent, dividend, foreign dividend, interest, royalty or income (including any amount which, but for this subsection, would have been exempt from tax in the hands of the said other person) as is received by or accrues to or for the benefit of the said other person on or after 1 July 1983 and which would otherwise, but for the said donation, settlement or other disposition, have been received by or have accrued to or for the benefit of the donor, shall be deemed to have been received by or to have accrued to the donor.

<sup>236</sup> Haupt., (note 135 above) 661.

<sup>237</sup> Stiglingh *et al.*, (note 9 above) 853.

<sup>238</sup> Ibid.

<sup>239</sup> Haupt., (note 135 above) 661.

The result of this section is that if the taxpayer had to cede his right to income whilst retaining ownership of the asset given rise to the income, then the income ceded will be taxed in the hands of the taxpayer.

#### **4.3.3.7. Section 7(8)<sup>240</sup>**

Section 7(8)<sup>241</sup> allows for income to be taxed in the hands of a South African resident, where said income was received by or accrued to a non-resident, provided the income arose as a result of a direct or indirect disposition made by the resident.<sup>242</sup>

This section does not apply to:<sup>243</sup>

1. Donations made by the resident to a non-resident public benefit organization, and
2. Amounts accruing to a controlled foreign company.

#### **4.3.3.8. Section 7(9)<sup>244</sup>**

Section 7(9) deals with assets which are disposed of for less than market value, in this instance, the difference between the selling price and the market value is regarded as a donation for purposes of Section 7.<sup>245</sup>

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<sup>240</sup> Section 7(8)

- (a) Where by reason of or in consequence of any donation, settlement or other disposition (other than a donation, settlement or other disposition to an entity which is not a resident and which is similar to a public benefit organisation contemplated in section 30) made by any resident, any amount is received by or accrued to any person who is not a resident (other than a controlled foreign company in relation to such resident), which would have constituted income had that person been a resident, there shall be included in the income of that resident so much of that amount as is attributable to that donation, settlement or other disposition.
- (b) So much of any expenditure, allowance or loss incurred by the person contemplated in paragraph (a) as does not exceed the amount included in the income of the resident in terms of that paragraph and which would be allowable as a deduction under this Act in the determination of the taxable income derived from that amount had that person been a resident, is deemed to be an expenditure, allowance or loss incurred by that resident for the purposes of the determination of the taxable income of that resident from that amount.

<sup>241</sup> Income Tax Act, 58 of 1962 as amended; Section 7(8).

<sup>242</sup> Ibid.

<sup>243</sup> Stiglingh *et al.*, (note 9 above) 853-854.

<sup>244</sup> Section 7(9); where any asset has been disposed of for a consideration which is less than the market value of such asset, the amount by which such market value exceeds such consideration shall for the purposes of this section be deemed to be a donation.

<sup>245</sup> Income Tax Act, 58 of 1962 as amended; Section 7(6).

As far as the resultant income is concerned, the transaction would fall into the provisions of Sections 7(2) to 7(8).<sup>246</sup>

#### **4.4. Conclusion**

What is drawn from the above is that section 25B<sup>247</sup> is the principal taxing section relating to trusts. However section 25B<sup>248</sup> is subject to section 7<sup>249</sup> of the Income Tax Act. This means that an initial investigation needs to be made which will in turn determine in whose hands income received by, accrued to, or in favour of the trust is to be taxed.

In terms of section 25B,<sup>250</sup> income which is received by, accrued to, or in favour of the trust will either be taxed in the trust or if the income vests in the beneficiaries then it will be taxed in their hands. Should section 7<sup>251</sup> however apply, then some other person may be taxed.

The provisions of section 7<sup>252</sup> are essentially anti-avoidance provisions which have been enacted to prevent income shifting and the avoiding and evading of taxes through the use of trusts. This however does not necessarily mean no tax savings can be achieved.

The trust however, still forms an integral part of our society and an understanding of how it works is important, more-so when deciding to utilize a trust as an estate planning tool. Estate planning will be discussed further in the chapter that follows as it has become necessary for almost everyone especially those with larger asset portfolios to engage in estate planning to not only secure their estate for their future but also for after their demise.

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<sup>246</sup> Haupt., (note 135 above) 662.

<sup>247</sup> Income Tax Act, 58 of 1962 as amended.

<sup>248</sup> Ibid.

<sup>249</sup> Ibid.

<sup>250</sup> Ibid.

<sup>251</sup> Ibid.

<sup>252</sup> Ibid.

An efficient way of doing this is through the use of a trust and verily an understanding of its taxation becomes key as although a trust can be rewarding, if formed and managed incorrectly the consequences could be dire.

## CHAPTER FIVE

### ESTATE PLANNING

#### 5.1. Introduction

As aptly stated by Benjamin Franklin; in this world nothing can be said to be certain except death and taxes.<sup>253</sup> However death is not without consequence to those left behind in that the deceased's assets, liabilities and family remain.

In an attempt to provide for those left behind trusts are employed and by placing income bearing assets in a trust liquidity is provided even after death. This process is referred to as estate planning.

Due to its nature as a separate legal entity the trust is the ideal tool to be used in estate planning, however cognizance needs to be given to the manner in which trusts are taxed as has been set out in the previous chapter.

Estate planning can be defined as, the arrangement, management, securement and disposition of a person's estate so that he, his family and other beneficiaries can enjoy and continue to enjoy the maximum benefits from his assets or estate during his lifetime and after his death.<sup>254</sup>

The concept of estate planning has been defined as follows;<sup>255</sup>

A person's estate consists of whatever he owns. If he formulates a plan in order to manage his belongings, he is doing estate planning.

Estate planning consists of the preparation of a plan to deal with estate assets, in circumstances when the estate owner is no longer personally able to exercise control over his assets.

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<sup>253</sup> [http://mobile.brainquote.com/quotes/keywords/death\\_and\\_taxes.html](http://mobile.brainquote.com/quotes/keywords/death_and_taxes.html); accessed 21<sup>st</sup> September 2015.

<sup>254</sup> T Burger; *The future of trusts as an estate planning tool* 2011, 5.

<sup>255</sup> Abrie and Graham (note 110 above) 2.

Estate planning has further been defined as follows:

Van der Westhuizen:<sup>256</sup>

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

William C Clay:<sup>257</sup>

The art of designing a programme for the effective management, enjoyment and disposition of property at the least possible tax cost. A simple will hastily drafted by an attorney does not constitute an estate plan. There is more to it than that.

From these definitions, it is evident that the concept of estate planning is a vast and complex one. As has been previously pointed out by William C Clay, estate planning involves more than simply drafting a will.

Upon consideration of the various definitions estate planning can be said to involve the accumulation, utilisation and distribution of assets and consists of 3 (three) aspects; namely:<sup>258</sup>

1. The evaluation of the existing state of affairs;
2. The evaluation of the future; and
3. The evaluation of the position as it will be after death

As mentioned earlier, 2 things are certain, death and taxes, it is for this latter certainty that a person tends to engage in estate planning. Estate planning allows a person not only to control their assets (estate) whilst alive, but also allows a person to determine how their assets are to be controlled and handled when that person is no longer in a position to do so, significantly due to the inevitability of death.

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<sup>256</sup> WM van der Westhuizen “the multidisciplinary nature of estate planning as a science” 2002 Journal for Estate Planning Law Vol 11 at 4-5.

<sup>257</sup> Ibid.

<sup>258</sup> PA Olivier; GPJ van de Berg, *Praktiese Boedelbeplanning* (1991) 14.

## 5.2. Objectives Of Estate Planning

The primary objective of estate planning is the minimisation of estate duty.<sup>259</sup> In order to achieve the primary objective as well as the various other objectives of estate planning it is necessary for an individual, referred to as the ‘planner’, to arrange his financial affairs so that he and his heirs can enjoy the maximum benefit from his assets, during his lifetime and his heirs can derive the maximum benefit after his death.<sup>260</sup>

Flexibility in estate planning, more so in the estate plan itself, is crucial. The reason why flexibility is considered so crucial is due to the ever evolving, ever developing nature of legislation. Flexibility in an estate plan would allow amendments to be made if there are legislative changes which would in turn affect the estate plan adversely.<sup>261</sup>

However, legislative changes are not the only changes which would affect an estate plan. There could be changes in the estate planner’s personal and/or family circumstances, which circumstances would not have been envisaged on the creation of the estate plan; hence an estate plan should be flexible insofar as amendments thereof are concerned.<sup>262</sup>

Some of the most common objectives of estate planning are as follows:

### 5.2.1. Minimisation of taxes and duties

The minimisation of the various taxes is an important aspect of estate planning, however it should not be construed as overriding the other equally important objectives of estate planning.<sup>263</sup> The minimisation of taxes and duties still remain the primary reason many estate planners create estate plans.

It should be borne in mind that although it is possible to minimise certain taxes and duties payable there are provisions in place which have been enacted specifically to deal with the avoidance of taxes, these provisions are known as the anti-avoidance

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<sup>259</sup> Haupt., (note 135 above) 882.

<sup>260</sup> Stiglingh *et al.*, (note 9 above) 1027.

<sup>261</sup> *Ibid*; 1030.

<sup>262</sup> *Ibid*; 1030-1031.

<sup>263</sup> Davis, D.M., Beneke, C. & Jooste, B. A. 2010. Estate Planning. LexisNexis Butterworths. Electronic Publication. Para 1.2.2.

provisions and are contained in the Income tax Act, 58 of 1962.<sup>264</sup> These provisions will be discussed in the next chapter.

However, the minimisation of tax is not illegal, as long as such minimisation is in compliance with the laws. This aspect was seen in the case of *IRC v Duke of Westminster*,<sup>265</sup> wherein it was held that a taxpayer cannot be stopped from arranging his affairs so as to attract less tax.

There nevertheless is a difference between tax planning (tax avoidance) and tax evasion. The former merely denotes a situation wherein a taxpayer has arranged his affairs in a perfectly legal manner, with the result being reduced tax liability, whilst the latter refers to activities deliberately undertaken by the taxpayer to rid himself of a tax burden.<sup>266</sup> These aspects as well as their consequences will be discussed later.

### **5.2.2. Provision of liquidity**

An important objective of an estate plan is to avoid liquidity problems on the death of the estate planner.<sup>267</sup> Some of the liabilities which the executor of the estate planner's estate would need to settle are;<sup>268</sup>

- a. The balance owing on a home loan,
- b. Normal tax, owing for the period prior to death,
- c. Capital gains tax which may become payable, and
- d. Estate duty which is payable on the dutiable amount.

It is therefore important for the estate planner to ensure that sufficient liquidity is available for both the sustenance of his dependents as well as the payment of liabilities which accrue to the estate planner upon his death.

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<sup>264</sup> Section 7; Section 8E; Section 9D; Section 80A-L.

<sup>265</sup> *Duke of Westminster v IRC* (1953) 51 TLR 467, 19 TC 490.

<sup>266</sup> *Stiglingh et al.*, (note 9 above) 811.

<sup>267</sup> *Haupt.*, (note 135 above) 899.

<sup>268</sup> *Stiglingh et al.*, (note 9 above) 1029-1030.

### **5.2.3. Provision of Income and security for dependants**

A good estate plan would provide adequate income and financial security for the estate planner and his family during his lifetime and also for his family after his death.<sup>269</sup>

The concern of having sufficient income for both the sustenance and maintenance of a person's family exists during his lifetime however it does not cease at death and as such it becomes imperative for a person to ensure that the capital/income generated during a person's lifetime is sufficient for the dependants left behind at the time of a person's death.<sup>270</sup>

### **5.2.4. Provision of retirement capital and income**

Next to death, retirement is a certainty for most provided the former doesn't occur first. In anticipation of the later occurring first, it then becomes vital to the estate planner to make provisions for his retirement.

Planning for a person's retirement not only requires a person to set and maintain retirement goals, but also requires a person to identify and utilize the available sources to derive sufficient income which will ensure financial independence upon retirement.<sup>271</sup>

### **5.2.5. Protection of business interests**

The success of a person's estate is often attributable to the success of his business.<sup>272</sup> It is therefore important that the business interests be protected and that the estate plan provide for the continuity and liquidity of the business after the business owner's death.<sup>273</sup>

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<sup>269</sup> Stiglingh *et al.*, (note 9 above) 1030.

<sup>270</sup> Davis *et al.*, (note 263 above) para 1.2.6.

<sup>271</sup> *Ibid*, para 1.2.7.

<sup>272</sup> *Ibid*, para 1.2.11.

<sup>273</sup> *Ibid*.

#### **5.2.6. Protection of assets**

When drawing up an estate plan, the estate planner must recognise the possible risks posed to his assets due to the nature of his business.<sup>274</sup> For example, the estate planner, if conducting his business as a sole proprietor will be susceptible to unlimited liability.

The estate planner, in seeking to protect his assets from possible insolvency may dispose of his assets to a trust where the assets will be protected against any claims from the estate planner's creditors.

As another example, the estate planner may, in the protection of his assets from the control of his heirs who do not have the necessary maturity to manage them, bequeath them to a testamentary trust which would be created upon his death.<sup>275</sup>

#### **5.2.7. Disposition of assets**

The estate plan should provide for the disposition of the planner's assets to his chosen heirs and beneficiaries before and after his death.<sup>276</sup> The estate planner may dispose of his/her assets to one or more *inter vivos* trusts during his/her lifetime, to testamentary trusts, or directly to the heirs and beneficiaries after his/her death, in terms of a will.

#### **5.2.8. Avoidance of fragmentation of assets**

An estate may include one or more valuable assets that the estate planner would prefer not to be disposed of upon his death, either by the sale thereof or the division of the asset between his heirs.<sup>277</sup> The estate plan should therefore recognise this and make the necessary provisions to avoid the fragmentation of these valuable assets.

An example of this could be a family farm which has been passed down through the generations. In the estate plan, the estate planner should ensure that the farm is left to his heirs collectively, possibly held in trust from which the heirs would benefit thus avoiding fragmentation of the asset.<sup>278</sup>

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<sup>274</sup> Stiglingh *et al.*, (note 9 above) 1030.

<sup>275</sup> *Ibid.*

<sup>276</sup> *Ibid.*, 1031.

<sup>277</sup> *Ibid.*, 1030.

<sup>278</sup> *Ibid.*

### **5.2.9. Facilitation of the administration of the estate**

The estate plan should provide for the administration of the estate planner's estate both before and after his death.<sup>279</sup>

Often the ensuring of an efficient administration of the estate planner's estate can be attributable to a well organised estate which if maintained, will undoubtedly prove to be both time and cost efficient.<sup>280</sup>

Usually the starting point for an estate planner, other than creating/drawing an estate plan would be to prepare a valid will, wherein the executors as well as trustees (if applicable) are appointed.<sup>281</sup>

### **5.3. Techniques Of Estate Planning**

An estate planning technique can be described as a method or technique which is utilized by an estate planner in the creation of his estate plan which includes a reconciliation of the planner's objectives and preferences with that of the current legal framework.<sup>282</sup>

Abrie and Graham contend that estate planning techniques for comprehensive estate planning may be divided into 3 (three) categories:<sup>283</sup>

1. Timely planning techniques

These techniques are applied during the estate planner's lifetime which enables him to take effective measures for the protection and care of assets and dependants.

2. Testamentary techniques

These are techniques which are purely will-based and are much simpler to apply.

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<sup>279</sup> Stiglingh *et al.*, (note 9 above) 1031.

<sup>280</sup> Davis *et al.*, (note 263 above) para 1.2.10.

<sup>281</sup> Stiglingh *et al.*, (note 9 above) 1031.

<sup>282</sup> Abrie and Graham (note 110 above) 90.

<sup>283</sup> *Ibid.*

### 3. Other techniques

These comprise of a combination of techniques which can form part of a comprehensive estate plan. These techniques are a subspecies of the timely technique.

## 5.4. Summary

Estate planning as seen from the aforementioned is a progressive process, whereby an estate planner utilizes various techniques and mechanisms in order to attain certain objectives, with the main objective being the arrangement of an estate planner's affairs in such a way so as to ensure maximum benefit during the lifetime of the estate planner as well as after his demise.

The following chapter explores the use of the trust as an estate planning mechanism through which various benefits are achieved.

## CHAPTER SIX

### THE USE OF TRUSTS AS AN ESTATE PLANNING MECHANISM

#### 6.1. Introduction

The benefits of estate planning alternatively tax planning for a taxpayer are essential not only for the possibility of reducing and minimising tax and duty liabilities but also for decreasing the complexity of administering an estate upon a person's/taxpayer's death. These are collectively known as the objectives of estate planning.

There are various techniques which are utilized in estate planning. The trust is one of those techniques and if utilized correctly and effectively can be vital to a taxpayer's 'quest' for minimising his tax liabilities. However in doing so, the anti-avoidance provisions of section 80 A-L and section of the Income Tax Act<sup>284</sup> must be borne in mind.

The anti-avoidance provisions housed in section 7<sup>285</sup> and its effects have already been discussed. The provisions of section 80 A-L<sup>286</sup> will therefore be discussed now, albeit briefly.

The trust has once again come under the spotlight in the Davis Tax Committee's interim report<sup>287</sup> for its ability to assist the taxpayer with an outlet to minimise taxes and duties, specifically estate duty. The concerns raised indicate that the trust is indeed effective at achieving the objectives of estate planning.

The findings and recommendations of the Davis Tax Committee will be discussed later in this chapter.

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<sup>284</sup> Income Tax Act, 58 of 1962 as amended.

<sup>285</sup> Ibid.

<sup>286</sup> Ibid.

<sup>287</sup> Monkam et al., (note 157 above).

## 6.2. General Anti-avoidance Provisions

### 6.2.1. Introduction

Tax avoidance is whereby a taxpayer arranges his affairs in such a manner which results in the taxpayer reducing his/her taxable income alternatively in the taxpayer having no income on which tax is payable. This arrangement of affairs is considered legal.

A taxpayer can enter into bona fide transactions which, when carried out, has the effect of either avoiding or reducing a tax liability, provided however that there is no provision in law which is specifically or indirectly designed to prevent the avoidance or reduction of that tax.

No obligation rests upon a taxpayer to pay a greater tax than is legally due under the taxing Act.<sup>288</sup>

The above principle is contained in the judgment of Lord Tomlin in the case of *Duke of Westminster v IRC*<sup>289</sup> in which it was held that:

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

The Act contains various provisions that have been designed to prevent or counter the effects of specific schemes or operations aimed at tax avoidance. These so-called anti-avoidance provisions are known as the ‘specific anti-avoidance measures which include:<sup>290</sup>

- Paragraph (c) of the definition of gross income in Section 1<sup>291</sup> deals with the receipt and accrual by a person of amounts for services rendered or to be rendered or to be rendered by another person.

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<sup>288</sup> Stiglingh *et al.*, (note 9 above) 811.

<sup>289</sup> *Duke of Westminster v IRC* (1953) 51 TLR 467, 19 TC 490 – 520.

<sup>290</sup> Stiglingh *et al.*, (note 9 above) 811-812.

<sup>291</sup> Income tax Act 58 of 1962 as amended.

- Section 7(2) to (10)<sup>292</sup> deals with income derived by a person in consequence of certain donations by another person.
- Section 8E<sup>293</sup> deems certain dividends to be interest.
- Section 8F<sup>294</sup> deals with interest paid on hybrid debt instruments.
- Section 9D<sup>295</sup> deals with certain income from foreign sources.
- Section 22(8)<sup>296</sup> deals with the donation or private consumption of trading stock.
- Sections 54 to 64<sup>297</sup> deals with donations tax.

In the event of these specific anti-avoidance provisions not sufficing, the provisions on impermissible tax avoidance arrangements as contained in sections 80A to 80L of the Act,<sup>298</sup> act like a safety net in respect of certain transactions.

### **6.2.2. Sections 80A-L (GAAR)**

The safety net provisions are much broader and as such are known as the general anti-avoidance regulations, (GAAR).<sup>299</sup>

The reasons for anti-avoidance legislation are manifold<sup>300</sup> and can best be explained through the words of Lord Houghton in Taxes, the Journal of the Inland Revenue Staff Federation, which stated:<sup>301</sup>

Tax-gatherers dislike people who get the better of them. They see themselves as the custodians of the fiscal morals of the nation. Tax avoiders, they say, are bad citizens who dodge the column and put part of their burden on to others. While the small fry get up to minor tricks, the big boys employ specialists to launch tax-avoidance rackets on a scale which makes bank robbers envious. The picture is one of the hapless tax-gatherer constantly following his astute quarry through a revolving door and never coming out in front. The tax avoider keeps one move ahead an all the complicated anti-

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<sup>292</sup> Income tax Act 58 of 1962 as amended.

<sup>293</sup> Ibid.

<sup>294</sup> Ibid.

<sup>295</sup> Ibid.

<sup>296</sup> Ibid.

<sup>297</sup> Ibid.

<sup>298</sup> Ibid.

<sup>299</sup> Stiglingh *et al.*, (note 9 above) 814.

<sup>300</sup> Haupt (note 133 above) 639.

<sup>301</sup> Ibid.

avoidance legislation fails to stop him. In desperation the tax-gatherer is driven to the conclusion that to administer and construe the Income tax and Finance acts is not enough. He must have the power to search the taxpayer's conscience and compel him to bare his soul. Was he up to something? To protest innocence is not enough: there must be proof of it.

This led to the incorporation of the current anti-avoidance sections of 80A – 80L in *Part IIA* of the Act<sup>302</sup> which deal with impermissible avoidance arrangements.

An impermissible avoidance arrangement has been defined in section 80A of the Act<sup>303</sup> wherein certain requirements have been listed which must be satisfied prior to the general anti-avoidance regulations being applied. There are 4 such requirements which are as follows:<sup>304</sup>

***Requirement One:***

There must be an arrangement.

***Requirement Two:***

The arrangement must result in a tax benefit which constitutes an avoidance arrangement. Tax benefit, includes any avoidance, postponement or reduction of any liability for tax. The word tax; includes any tax, levy, or duty imposed by the Act<sup>305</sup> or any other law.

***Requirement Three:***

The sole or main purpose of the avoidance arrangement must be to obtain a tax benefit.

***Requirement Four***

This requirement differentiates between the context of business and that of a personal or private context in one regard, that is, whilst 3 sub-requirements are the same, if in the context of a business, then there is one more sub-requirement, which is 'a lack of commercial substance'.

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<sup>302</sup> Income tax Act 58 of 1962 as amended.

<sup>303</sup> Ibid.

<sup>304</sup> Stiglingh *et al.*, (note 9 above) 812-816.

<sup>305</sup> Ibid.

If the avoidance arrangement is in the context of a business then one of the four sub-requirements must be met;

- i.** Means or manner not normally employed – Section 80A(a)(i)<sup>306</sup>
- ii.** Rights or obligations not normally created – Section 80A(c)(i)<sup>307</sup>
- iii.** Misuse or abuse of provisions of the Act – Section 80(c)(ii)<sup>308</sup>

The misuse or abuse requirement seems to have developed from the Canadian GAAR (general anti-avoidance regulations). Guidance in this regard is sought from the case of *Canada Trustco Mortgage Co v Canada* (2005 SSC 54) wherein the Court indicated a two stage process, that is:

- a. Interpret the provisions relied on by the taxpayer, giving rise to the tax benefit to determine its object, spirit and purpose, and
- b. Determine whether the transaction frustrates or defeats the object, spirit and purpose of the provisions.

- iv.** Lack of commercial substance – Section 80A(a)(ii)<sup>309</sup>

If the avoidance arrangement is in a context other than business, that is, in a personal or private context, then one of three of the aforementioned sub-requirements must be met, to the exclusion of requirement “iv” (section 80A(a)(ii)) which sub-requirement is for the avoidance arrangements falling in the context of business.

The requirements which are necessary in order for the South African Revenue Service (SARS) to be able to apply the provisions of Part *IIA* can be diagrammatized as per the overleaf:

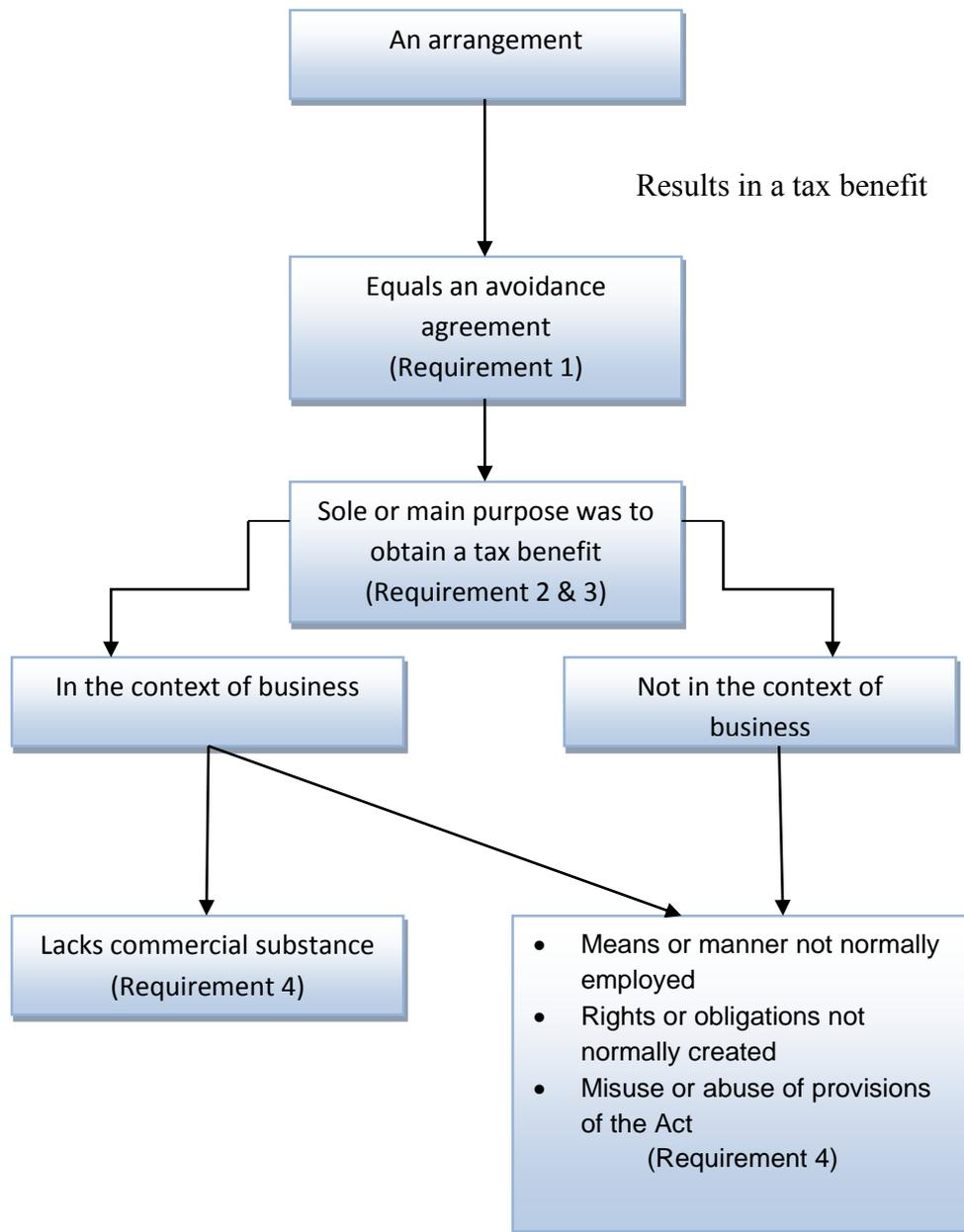
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<sup>306</sup> Stiglingh *et al.*, (note 9 above) 812-816.

<sup>307</sup> Ibid

<sup>308</sup> Income tax Act 58 of 1962 as amended.

<sup>309</sup> Ibid.



**Diagram 3: Avoidance arrangement.**<sup>310</sup>

<sup>310</sup> Stiglingh *et al.*, (note 9 above) 813.

### 6.2.3. Remedies available to the Commissioner

Upon the determination that the section 80A<sup>311</sup> requirements of an ‘impermissible avoidance arrangement’ are present and have been satisfied insofar as is necessary, then section 80B of the Act<sup>312</sup> empowers the Commissioner to take certain action.

The Commissioner is afforded both general and specific remedies in terms of the Act.

1. The general remedy, Section 80B(1)(f)<sup>313</sup>

In terms hereof, the Commissioner may determine the tax consequences as per the Act on the presumption that the transaction had never been entered into or carried out.

Alternatively, the Commissioner may determine the tax consequences in such other manner wherein the Commissioner deems appropriate for the prevention or diminution of the relevant tax.

However the powers of the Commissioner in making such determinations are limited and restricted in that, there has to be a positive finding of an arrangement to be an impermissible avoidance arrangement.

2. The specific remedy, Section 80B(1)(a) to (e)<sup>314</sup>

Over and above the general remedies afforded to the Commissioner, the Commissioner is further equipped with specific remedies, contained in sections 80B(1)(a) to (e) which allows the Commissioner to;

- Disregard or combine any steps in, or parts of the arrangement,
- Disregard any accommodating or tax-indifferent party or deem the party and any other party as one and the same person,
- Deem connected persons to the impermissible avoidance arrangement as one and the same person, or
- To re-allocate or re-classify any gross income, receipts or accrual of a capital nature, expenditure or rebates.

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<sup>311</sup> Income tax Act 58 of 1962 as amended.

<sup>312</sup> Ibid.

<sup>313</sup> Ibid.

<sup>314</sup> Ibid.

Although the Commissioner has, at his disposal, an ever increasing amount of remedies, the possibility of an abuse of power by the Commissioner is curtailed by the tax Administration Act<sup>315</sup> which imposes upon the Commissioner time limits within which to make the necessary adjustments according to the aforementioned remedies. These adjustments are subject to the normal 3 (three) year prescription period and are further subject to objection and appeal.<sup>316</sup>

#### **6.2.4. Substance over form**

In determining tax liability, it has been accepted that the Courts can only take into consideration the actual transaction (form) of a scheme and not the true essence (substance or true intention) of the transaction.<sup>317</sup>

However from Court cases dating back to the early 1940's the contrary has been proved, namely by ignoring the form of the transaction of a scheme and have based their findings on the true intention (substance) of the transaction.<sup>318</sup>

In *Commissioner of Customs and Excise v Randles, Brothers and Hudson Limited*,<sup>319</sup> the Court held that;

A disguised transaction is in essence a dishonest transaction: dishonest, inasmuch as the parties to it do not really intend it to have, *inter partes*, the legal effect which its terms convey to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties. The parties wish to hide the fact that their real agreement or transaction falls within the prohibition or is subject to the tax, and so they dress" it up in a guise which conveys the impression that it is outside the prohibition or not subject to the tax. Such a transaction is said to be in *fraudem legis* and is interpreted by the Courts in accordance with what is found to be the real agreement or transaction between the parties.

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<sup>315</sup> Tax Administration Act 28 of 2011 as amended.

<sup>316</sup> Stiglingh *et al.*, (note 9 above) 822.

<sup>317</sup> Ibid.

<sup>318</sup> Ibid.

<sup>319</sup> Commissioner of Customs and Excise v Randles, Brothers and Hudson Limited 1941 AD 369 at 395-396.

The Court in the same case further held that;

Before the Court can find that a transaction is in fraudem legis, it must be satisfied that there is some unexpressed agreement or tacit understanding between the parties.

In *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR*<sup>320</sup> the court acknowledged the principle that taxpayers could arrange their affairs in such a way that meant they fell outside the ambit of a certain provision of the Act, but maintained that it was for the Courts to decide whether they were successful in doing so.

The principle of substance over form has been vastly debated by the Courts and in the 1999 case of *Cape Consumers*<sup>321</sup> the Court held that the principle of substance over form is not without its limitations and as such it cannot be used to ignore agreements wherein the parties, both in fact and law intend to give effect to an agreement.

Judge Lewis JA in *CSARS v NWK*,<sup>322</sup> affirmed that a taxpayer is free to arrange his affairs so as to minimise tax liability and that there is nothing wrong with arrangements that are tax-effective, with the qualification:

But there is something wrong with dressing up or disguising a transaction to make it appear to be something that it is not...

From the above cases which have dealt with the principle of substance over form it is made clear that a taxpayer is allowed to arrange his affairs in a way so as to minimise his tax liability, however that arrangement must not appear to be something other than what it purports to be.

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<sup>320</sup> Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR 1996 (3) SA 942 (SCA) at 949.

<sup>321</sup> Cape Consumers (Pty) Ltd v CIR 1999 (4) SA 1213 (C) at 1224H-I:

The doctrine of the disguised transaction is not a panacea to ignore agreements where the parties in fact and in law intend that they must be given their legal effect.

<sup>322</sup> CSARS v NWK Ltd 2011 (2) SA 67 (SCA) at 76

The test should go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated, and the mere fact that the parties perform in terms of the agreement/contract does not show that it is not simulated.

### **6.2.5. Summary**

The arrangement of a taxpayer's affairs in a manner which reduces his tax liability is not prohibited however there are provisions in place which prevent and negate certain types of tax avoidance. In an attempt to minimise tax liability, a taxpayer may be tempted to disguise certain transactions, however, together with the anti-avoidance provisions, the principle of substance over form ensures that transactions cannot be disguised as something that it is not.

As such a taxpayer/estate planner must take care not to falter and fall victim to these provisions.

## **6.3. Benefits Of Trusts In The Minimisation Of Taxes And Duties**

### **6.3.1. Introduction**

It is often suggested that the trust if utilized correctly can be an effective mechanism in estate planning. As alluded to in the previous chapter, estate planning has become an integral aspect of life in that it allows a person to arrange their assets in a way which is to be beneficial not only whilst they remain alive but also after their demise.

The use of a trust as the means to achieve this benefit has without a doubt increased exponentially although many benefits may not necessarily be seen in respect of all taxes and duties.

The tax benefits are dependant on and vary according to the taxpayer utilizing the trust as his personal circumstances will determine what assets are placed in the trust and what assets are retained personally.

However the taxpayer should be cautious when placing certain assets in a trust, especially those with income earning capacities.

### 6.3.2. Income tax

Although possible and achievable over a period of time, the minimisation of income tax is not seen as a major objective of estate planning.<sup>323</sup>

The ordinary trust which would under normal circumstances be utilized in estate planning attracts liability at a flat rate of 41% on retained trust income for the year/period of assessment in question.

Nevertheless, where income received by the trust is distributed within the same year/period of assessment, then for tax purposes, it is treated as if the income had not been received by the trust but rather by the beneficiaries. This would in turn reduce the income retained in the trust thereby reducing the taxable income of the trust.

As alluded to in Chapter 4, the taxation of trusts occurs through Section 25B(1) and Section 7 of the Act,<sup>324</sup> with the former being subject to the later. Section 7<sup>325</sup> contains anti-avoidance measures and as such certain attempts at minimising income tax liability through dispositions to a trust will result in the said disposition being taxed in the hands of the taxpayer making such disposition. As such much care has to be given to attempts made at reducing tax liability.

Section 7<sup>326</sup> will apply if there has been a disposition in the form of a donation, settlement or some other type of gratuitous disposition. If it is found that section 7<sup>327</sup> does not apply, then the taxation will occur in terms of section 25B.<sup>328</sup> However if section 7<sup>329</sup> does apply then the amount/s in question will be taxed in the hands of another.

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<sup>323</sup> Davis et al., (note 265 above) para 1.2.3.

<sup>324</sup> Income tax Act 58 of 1962 as amended.

<sup>325</sup> Ibid.

<sup>326</sup> Ibid.

<sup>327</sup> Ibid.

<sup>328</sup> Ibid.

<sup>329</sup> Ibid.

### **6.3.3. Capital gains tax<sup>330</sup>**

#### **6.3.3.1. Overview**

A trust will have a disposal for capital gains tax purposes in one of two ways:<sup>331</sup>

1. By concluding a transaction for disposal with a third party, or
2. By vesting a trust asset in a beneficiary.

#### **6.3.3.2. Disposal to a third party**

An arm's length transaction with a third party will result in a normal capital gain calculation whereby the base cost will be the market value upon acquisition by the trust of the asset and the selling price of the asset will be the proceeds.<sup>332</sup>

#### **6.3.3.3. Vesting of a trust asset in a beneficiary**

As alluded to earlier, vesting (vested right) is an unconditional entitlement to the asset. When an asset vests in a beneficiary, the base cost for the trust will usually be the value upon acquisition by the trust of the asset and the proceeds will be deemed to be the market value as the trust and the beneficiary as connected<sup>333</sup> persons.<sup>334</sup>

The time of disposal of the asset is the date on which the interest in that asset vested in the beneficiary.<sup>335</sup> Vesting may arise in terms of the trust deed or as a consequence of a discretion exercised by a trustee.<sup>336</sup>

#### **6.3.3.4. Treatment of capital gains and losses**

Upon a disposal of an asset by a trust, the trust is liable for capital gains tax unless a special rule in terms of the Eight Schedule of the Act<sup>337</sup> applies thereby diverting the liability to another person.<sup>338</sup>

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<sup>330</sup> Eight Schedule of the Income Tax Act 58 of 1962.

<sup>331</sup> Stiglingh *et al.*, (note 9 above) 859.

<sup>332</sup> Ibid.

<sup>333</sup> Connected persons as defined in Section 1 of the Income tax Act 58 of 1962, where a trust is the taxpayer, is any beneficiary of the trust and/or and connected person in relation to a beneficiary.

<sup>334</sup> Stiglingh *et al.*, (note 9 above) 859.

<sup>335</sup> Ibid.

<sup>336</sup> Ibid

<sup>337</sup> Income tax Act 58 of 1962 as amended.

<sup>338</sup> Stiglingh *et al.*, (note 9 above) 859-860.

Paragraph 80(1)<sup>339</sup> applies when the resident beneficiary acquires an interest in an asset whilst Paragraph 80(2)<sup>340</sup> applies when the beneficiary receives a gain and not the asset.<sup>341</sup> The effect of this is that the capital gain must be disregarded by the trust and included in the beneficiary's calculation of his aggregate capital gain or loss.<sup>342</sup> However, if there is a loss, it cannot be diverted to the beneficiary and as such remains in the trust.<sup>343</sup>

### 6.3.3.5. Conclusion

The effectiveness of the use of trusts in estate planning has to an extent been hindered by the introduction of capital gains tax which is payable by South African trusts on gains made through the disposal of assets after 1<sup>st</sup> October 2001.<sup>344</sup>

Ordinary trusts have a higher inclusion rate than that of special trusts created for the mentally ill or physically disabled which rate is the same as that of a natural person. Ordinary trusts also do not qualify for a primary rebate and/or primary residence rebate which are afforded to natural persons.<sup>345</sup>

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<sup>339</sup> Paragraph 80(1); Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect of the vesting by a trust of an asset in a trust beneficiary (other than any person contemplated in paragraph 62 (a) to (e)) who is a resident, that gain –

- (a) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate loss of the trust; and
- (b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary to whom that asset was so disposed of.

<sup>340</sup> Paragraph 80(2); Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect of the disposal of an asset by a trust in a year of assessment during which a trust beneficiary (other than any person contemplated in paragraph 62 (a) to (e)) who is a resident has a vested interest or acquires a vested interest (including an interest caused by the exercise of a discretion) in that capital gain but not in the asset, the disposal of which gave rise to the capital gain, the whole or the portion of the capital gain so vested –

- (a) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and
- (b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary in whom the gain vests.

<sup>341</sup> Stiglingh *et al.*, (note 9 above) 859.

<sup>342</sup> Ibid.

<sup>343</sup> Ibid, 860.

<sup>344</sup> Stephens, M. *Estate Planning Guide* (online) 17. Available: [https://www.google.co.za/url?sa=t&source=web&rct=j&ei=rbAiVc1cpaLsBtzrgPgJ&url=http://moorestephens.co.za/pdf/estate\\_planning\\_guide.pdf&ved=0CBoQFjAA&usg=AFQjCNGvBFv5bAF6bK7CcqY9A-U8s1ldhw&sig2=tBegnfwK10EaN8SSQITbSQ](https://www.google.co.za/url?sa=t&source=web&rct=j&ei=rbAiVc1cpaLsBtzrgPgJ&url=http://moorestephens.co.za/pdf/estate_planning_guide.pdf&ved=0CBoQFjAA&usg=AFQjCNGvBFv5bAF6bK7CcqY9A-U8s1ldhw&sig2=tBegnfwK10EaN8SSQITbSQ); accessed on 11<sup>th</sup> August 2014.

<sup>345</sup> Ibid.

On this basis the trust does not provide a capital gains tax benefit as the inclusion upon disposal of a capital asset will be higher than the rate of a natural person who will also qualify for the rebates available.

#### **6.3.4. Transfer duty**

The definition of person in terms of the Transfer Duty Act<sup>346</sup> includes ‘any trust’ and as such a trust will be subject to the same rates as mentioned in chapter 2 and unless the trust acquiring property is exempt by any other provision or another Act of Parliament, the acquisition will be dutiable.

With regard to the estate planner, his heirs and/or legatees are exempt from the payment of transfer duty upon his death in terms of Section 9(e) of the Transfer Duty Act<sup>347</sup> and in this regard, should an estate planner wish to transfer property to his heirs and/or legatees, he should make provision for such in his will thereby rendering the acquisition by the heirs and/or legatees free from transfer duty.

However, if property is acquired by the trust then the estate planner as well as his heirs/family can enjoy the use of the property without the need to transfer the property since the trust’s life span is not limited and/or affected by death and upon the demise of the estate planner there exists no reason for a transfer of property. By the estate planner divesting himself of the property which is then placed in the trust, the value of his estate to be subjected to estate duty upon his demise is effectively reduced. In this regard, the trust proves advantageous.

#### **6.3.5. Estate duty**

As alluded to in Chapter 2, estate duty is levied at a rate of 20% upon a person’s death on the net value of their estate. On that basis, to reduce the amount of estate duty payable, a reduction in the net value of a person’s estate is required.

A person (estate planner) to achieve this reduction must transfer or donate assets with a growth potential from his/her personal estate to a trust in which his heirs (his children

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<sup>346</sup> Transfer Duty Act 40 of 1949 as amended.

<sup>347</sup> Ibid.

and grandchildren and possibly their children) are the beneficiaries.<sup>348</sup> Any subsequent growth to the asset will not impact on the estate planner's personal estate but will be restricted within the trust, however what will accrue to the estate planner's estate is the value for which the asset was transferred. In respect of a donation to a trust, the estate planner will pay donations tax on the value of the asset donated to the trust.<sup>349</sup> Caution must be had when selling assets to a trust as assets sold for less than fair market value could be regarded by the Commissioner as a donation alternatively a gratuitous disposition which would in turn trigger the anti-avoidance provisions of Section 7.<sup>350</sup>

An estate planner when acquiring assets can also utilize the trust as the purchaser thereby preventing his personal estate from increasing and this would also negate the effects of Section 7<sup>351</sup> provided the agreement for the acquisition is an arm's length, that is; the value of acquisition is the fair market value.

Other than the provisions of Section 7 of the Income Tax Act,<sup>352</sup> the Estate Duty Act<sup>353</sup> has its own anti-avoidance measure which is contained in Section 3(3)(d)<sup>354</sup> which states that where an asset is transferred to a trust during the lifetime of an estate planner but the estate planner retains such power as a trustee which would allow him to dispose of the now trust asset unilaterally for his own or for his beneficiaries benefit during his lifetime, then such asset may be deemed to be the property of the estate planner and included in his estate and subject to estate duty.<sup>355</sup>

Despite these anti-avoidance provisions, if utilized correctly, a trust can prove useful in the reduction, if not avoidance of estate duty provided the reduction does not trigger the operation of the anti-avoidance provisions. The current abatement is R3.5 million and if the bulk of an estate planner's assets are housed within the trust then this reduces the

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<sup>348</sup> Stephens, M (note 343 above) 16.

<sup>349</sup> Stephens, M (note 343 above) 17.

<sup>350</sup> Income tax Act 58 of 1962 as amended.

<sup>351</sup> Ibid.

<sup>352</sup> Ibid.

<sup>353</sup> Estate Duty Act 45 of 1955 as amended.

<sup>354</sup> Section 3(3) Property which is deemed to be property of the deceased includes –

(d) property (being property not otherwise chargeable under this Act of the full value of which is not otherwise required to be taken into account in the determination of the dutiable amount of the estate) of which the deceased was immediately prior to his death competent to dispose for his own benefit or for the benefit of his estate.

<sup>355</sup> Stephens, M (note 343 above) 18.

value of the assets which he holds in his personal capacity. If the value of his assets held in his personal capacity upon his demise is less than R3.5 million then there is no estate duty payable.

#### **6.4. The Davis Tax Committee's Interim Report**

The Davis Tax Committee (DTC) was instructed by the Minister of Finance to enquire into:<sup>356</sup>

The progressivity of the tax system and the role and continued relevance of estate duty to support a more equitable and progressive tax system. In this inquiry, the interaction between capital gains tax and estate duty should be considered.

The DTC made the following recommendations:

##### **6.4.1. General anti-avoidance regulations**

Section 80 of the Income Tax Act<sup>357</sup> as well as the judicial precedents do not currently provide an effective deterrent against the wide range of estate duty saving mechanisms that exist.<sup>358</sup>

The DTC's opinion is that the pursuit of further GAAR provisions has little prospect of success.<sup>359</sup>

##### **6.4.2. Trusts**

The attribution rule in section 7<sup>360</sup> which allows a trustee of a trust to cause the trust income to vest and be taxed in the hands of the beneficiary was intended as an anti-avoidance measure aimed at preventing a trust from being used as an income splitting device.<sup>361</sup>

The DTC's recommendations to counteract the deficiencies in the current legislation are that:<sup>362</sup>

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<sup>356</sup> Monkam et al., (note 157 above).

<sup>357</sup> Income tax Act 58 of 1962 as amended.

<sup>358</sup> Monkam et al., (note 157 above) 6.

<sup>359</sup> Ibid.

<sup>360</sup> Income tax Act 58 of 1962 as amended.

<sup>361</sup> Monkam et al., (note 157 above) 7.

<sup>362</sup> Ibid.

- Trusts be taxed as separate tax payers and the flat rate for ordinary trusts be maintained at the current rate;
- The deeming provisions of section 7<sup>363</sup> and section 25B<sup>364</sup> be repealed insofar as they relate to South African residents;
- The deeming provisions of section 7<sup>365</sup> and section 25B<sup>366</sup> be retained insofar as they relate to non-residents;
- The only relief to the rule should be the special trust definition contained in section 1<sup>367</sup> which allows a trust to be taxed at personal income tax rates in limited special circumstances;
- Taxpayers must be allowed to make use of trusts when it makes sound sense to do so in the pursuit of a commercial benefit, as opposed to an estate duty benefit.

The DTC has stated that due to the diverse and far-reaching implications the repeal of the attribution provisions will have, it would be in the interests of equity and certainty that the repeal only be implemented with effect from 1 March 2016.<sup>368</sup>

The DTC is of the opinion that by addressing the income tax regime for trusts a substantial deterrent against estate planning will have been created without the necessity of devoting substantial resources towards the implementation of further tax provisions.<sup>369</sup>

#### **6.4.3. Estate duty**

The DTC stated that the South African estate duty system contains generous allowances that allow most estates to be subject to both capital gains tax and estate duty only on the death of both spouses which results in estate duty collection being deferred for many years.<sup>370</sup>

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<sup>363</sup> Income tax Act 58 of 1962 as amended.

<sup>364</sup> Ibid.

<sup>365</sup> Income tax Act 58 of 1962 as amended.

<sup>366</sup> Ibid.

<sup>367</sup> Ibid.

<sup>368</sup> Monkam et al., (note 157 above) 7.

<sup>369</sup> Ibid, 8.

<sup>370</sup> Ibid, 5.

The DTC recommended that:<sup>371</sup>

- The current rate of 20% be maintained in light of the retention of both capital gains tax and estate duty/donations tax being levied on capital transfers.
- The primary abatement be increased to R6 million per taxpayer.

#### **6.4.4. Donations tax**

The DTC has recommended that the section 56(1)(c)<sup>372</sup> be removed in order to prevent the diminution of estates in anticipation of death. This exemption is in respect of donations made in anticipation of death, ‘donatio motis causa’.<sup>373</sup>

#### **6.4.5. Capital gains tax**

The DTC was to investigate the ‘double taxation on death’ created by the imposition of both capital gains tax and estate duty.<sup>374</sup>

The DTC concluded that as was reflected in the review by the International Monetary Fund in December 2000, capital gains tax is regarded as an income tax on capital income and not a wealth tax while estate duty and donations tax are wealth taxes. Accordingly there is no double taxation on death.<sup>375</sup>

### **6.5. Conclusion**

Trusts can undoubtedly be said to be an effective estate planning mechanism. However its effectiveness as a tax saving mechanism has as a result of the Davis Tax Committee’s interim report<sup>376</sup> been brought into question.

Without the ability to attribute income to a beneficiary, the trust would seem an illogical choice wherein to place income producing asset as the income retained will be taxed at a flat rate of 41% whereas if the taxpayer held that asset in his personal capacity his tax

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<sup>371</sup> Ibid, 11.

<sup>372</sup> Income tax Act 58 of 1962 as amended.

<sup>373</sup> Monkam et al., (note 157 above) 9.

<sup>374</sup> Ibid, 10.

<sup>375</sup> Ibid.

<sup>376</sup> Ibid.

liability would be determined on a sliding scale and he would further qualify for the rebates not available to the trust.

Nevertheless, the trust may still be considered significant in respect of estate duty in that if housed within a trust, assets will not form part of a taxpayer's estate upon his death. These assets will therefore not be subject to estate duty.

In light of the proposed increase to the primary abatement, the housing of assets in a trust may only benefit those with assets in excess of R6 million. However, due to the various other benefits of placing assets in a trust, this may not be the case. These benefits were discussed in the previous chapter with one of the most important benefits being the protection of assets.

Despite the many provisions aimed at discouraging taxpayers from utilizing trusts in estate planning, the trust remains a key mechanism with which an estate plan achieves its objectives.

## CHAPTER SEVEN

### CONCLUSION

#### 7.1. Synopsis Of Findings

##### 7.1.1. Types of taxes and duties

There are various taxes and duties for which a taxpayer attracts liability, both whilst alive as well as upon his death. Some of the most common include; income tax, capital gains tax, donations tax, estate duty and transfer duty.

There are various requirements which must be considered and satisfied in order for a taxpayer to be liable for any such tax and/or duty. These taxes and duties are somewhat specific in that they each have their own objectives, for example; income tax is taxation of income received by, accrued to, or that which is in favour of a taxpayer; capital gains tax is levied upon the disposal of an asset which is capital in nature; estate duty is levied on the net value of the taxpayer's estate at the time of his death; transfer duty is payable upon the transfer of fixed property; and so on. It is therefore apparent that taxes and duties are a part our lives.

These taxes and duties are regulated by legislation which has been enacted for the facilitation, determination and collection of amounts due in terms thereof by the taxpayer. It is important to bear in mind that the reason these taxes and duties are in place, is to ensure and to an extent, sustain economic stability within the Country and as such the taxpayer plays an important role with regard to the economy.

##### 7.1.2. The trust and its taxation

The use of trusts have evolved from the earlier times when it was used to house the assets of those who went out into war to now being commonly used by all. Since its incorporation into South African Law, the question of how to deal with trusts has always been at the fore.

There are various parties to a trust, those being; the founder (the creator of the trust), the trustees (those selected to maintain the trust), and the beneficiaries (those who receive some sort of benefit from the trust).

Over the years the laws pertaining to the taxation of trusts have gone through much scrutiny and the trust today is taxed in terms of Section 25B of the Income tax Act which subject to Section 7 of the Income tax Act.

There are ideally, two types of trusts, the special trust which is subject to taxation according to the sliding scale used in calculating normal tax for natural persons whilst the ordinary trust is taxed on retained income at a flat rate of 41%.

The trust to the taxpayer is a way by which he can attempt to reduce his taxes and duties, and if done correctly, this can be achieved, however trusts are synonymously linked to the unlawful avoidance/evasion of taxes and duties and as such shall always be scrutinized so as to determine the true purpose of the trust.

The Davis Tax Committee's interim report has now brought the effectiveness of trusts into question. As discussed above, the report makes certain findings and recommendations which will upon becoming operational render amongst other things, the attribution ability of a trust ineffective.

Even though the trust can still be used to reduce the value of a taxpayer's assets which will upon his death be subject to estate duty the use of the trust to achieve any other tax benefit seems unattainable.

### **7.1.3. Estate planning mechanisms and objectives**

Estate planning is understood to be the arrangement by a taxpayer of his assets in an attempt to prepare for the future both whilst alive and after his demise. The main objective is to ensure that the assets of a taxpayer are arranged in such a manner so as to result in the heirs having maximum enjoyment during his lifetime as well as after.

The objectives of estate planning include amongst other, the minimisation of taxes and duties; the provision of liquidity; the protection of assets; and the facilitation of the administration of the estate.

Two of the most common mechanisms of estate planning are that of the taxpayer's will and the trust.

#### **7.1.4. The trust as an estate planning mechanism**

As mentioned previously, one of the most common mechanisms of estate planning is that of the trust. It is simple to create and manage and allows for effective estate planning by the transferring (at arm's length) of assets from the taxpayer's personal estate to the trust so as to ensure continuity and to avoid the need to transfer the assets upon the estate planner's death.

Despite the recommendations of the Davis Tax Committee, the trust remains an effective estate planning mechanism.

#### **7.2. Conclusion And Recommendations For The Estate Planner**

In the preceding chapters, attention was drawn to the taxation of trusts and its use as an estate planning and tax saving mechanism with which to protect assets and minimise and/or avoid certain taxes and duties which are levied in South Africa.

Despite the current anti-avoidance legislation in place it was possible to achieve tax savings through the effective use of a trust. However this will not be the case upon the implementation of the recommendations made by the Davis Tax Committee which will see the demise of the most significant tax saving ability of the trust, that is; the ability to attribute income to the beneficiaries resulting in that income being taxed in their hands as opposed to in the trust.

It must at all times be borne in mind that a taxpayer is not prohibited from finding ways or utilizing those already in existence to avoid and/or minimise the payment of taxes and duties provided that these attempts remain within the legal boundaries for once the threshold has been crossed, it is no longer mere avoidance and/or minimisation but unlawful evasion.

The trust will like any other entity have its fair share of disadvantages, however, as alluded to in the preceding chapters, the trust has many advantages, some of which include the fact that it does not die; assets in the trust will not be subjected to estate duty as would be the case if the assets were in the estate of the taxpayer; the assets in

the trust are not capable of being attached by creditors if the beneficiary becomes insolvent or is sued thus ensuring the protection of the assets.

The trust therefore remains and will continue to be an effective estate planning mechanism regardless of the ever evolving and increasing anti-avoidance provisions provided the estate planner is aware of and understands these provisions.

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