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**LIMITED INTERESTS IN PROPERTY –  
AN OVERVIEW OF LIMITED INTERESTS IN PROPERTY WITH  
PARTICULAR REFERENCE TO THE TAXATION OF USUFRUCTS AND MORE  
SPECIFICALLY THE CAPITAL GAINS TAX EFFECTS ON DISPOSAL FOR  
INDIVIDUALS AND FOR TRUSTS.**

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## DECLARATION

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## ABSTRACT

The aim of this dissertation is to provide an overview of **limited interests in property with particular reference to the taxation of usufructs and more specifically to the capital gains tax effect on disposal for individuals and trusts**. Careful consideration needs to be taken when making any decision regarding the use of any limited interests in a tax planning strategy. Even the ‘new’ GAAR<sup>1</sup> needs to be taken into account. The financial implication of the GAAR can be catastrophic to a taxpayer if not taken into account during planning and should the South African Revenue Service challenge the tax and estate strategy being adopted. Consideration must be given to transactions that may fall into the ‘tainted element’ category, per GAAR. This includes the ‘misuse or abuse of provisions of the Income Tax Act’. Any tax planner who plans to make use of a limited right strategy will need to take cognisance of this fact.

Estate and financial planning should be an on-going process of deciding in advance on the best way to create and accumulate assets, to use them during the taxpayers lifetime, and to distribute them after death to ensure the maximum benefit for the deceased, the deceased’s family, and any other dependents. As and when taxpayers’ personal circumstances change, they need to adapt their plans to match the changes in their lives as well as the changes in legislation. Taxpayers often do not know how the economic systems function, how sociological and psychological factors may affect their estate and financial planning, nor do they always have sufficient knowledge of accountancy, administration of wills, succession, the laws of the Estate Duty Act, the Assurance Act, the Income Tax Act, the Intestate Succession Act, Law of Contract, or the Matrimonial Property Act. What matters is that the objective in tax planning must be achieved within the framework of the various applicable government statutes. One must find the best way to realise the taxpayers’ particular needs and ideals through careful planning. People often aim primarily at saving tax. There is nothing wrong with wanting to save tax, as every person has the right to plan their affairs or have them planned in such a way as to pay the lowest possible tax as is legally allowed.

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<sup>1</sup> Sections 80A to 80L of the Income Tax Act no. 58 of 1962 are collectively referred to as the General Anti-Avoidance Rules – GAAR.

Capital Gains Tax was introduced into the South African tax system with effect from 1 October 2001 and is applied to the disposal of an asset on or after that date. This new regime has brought some complex technical concepts into our Income Tax system. How it affects limited interests, for example, usufructuary and fiduciary interests can have catastrophic income tax, estate duty, and transfer duty, even value-added tax consequences, if not planned for properly.

The creation of a limited interest in property, more specifically a usufruct, has different consequences when held by an individual in their own name or when it is held by a trust. The purpose of this dissertation is to gain a more in-depth understanding of the use of a limited interest with particular reference to the taxation of usufructs and more specifically the capital gains tax effects on disposal for individuals and trusts. Trusts are often used to resolve or alleviate potential tax burdens. But, the creation of a usufruct in a trust or by an individual may result in stepping into a potential taxation minefield.

In the 'Taxation of Trusts in South Africa', Michael Honiball states that usufructs are often used in trusts and that the tax law provisions applicable to trusts are highly complicated in that there are many aspects to take into account when dealing with trusts. Honiball further states that in South Africa, the taxation of trusts varies in accordance with the actions of the trustees, or the actions of the founders or settlors. For both income tax and capital gains tax purposes, generally either the trust will have a tax liability, or the beneficiaries will have a tax liability. Sometimes, neither the trust nor the beneficiaries have a tax liability because the founder/settler retains that liability.

Whenever a trust is created, it is important that not only the income and capital gains tax consequences are taken into account, but also any donation tax consequences as trusts themselves are often funded through donations.

Apart from any income tax, and capital gains tax benefits which may flow from the use of a trust, a trust is also attractive from an estate planning point of view.

The dissertation finally compares the capital gains tax implications of creating a limited interest in a trust with that of holding a limited interest in a personal capacity. In conclusion, this dissertation will demonstrate that it appears to be more favourable to create usufruct type holdings in a trust rather than holding these in an individual capacity.

## **GLOSSARY**

CSARS – Commissioner of the South African Revenue Service.

Income Tax Act - Income Tax Act no. 58 of 1962 (the Act).

CGT – Capital Gains Tax.

Eighth Schedule – The Eighth Schedule of the Income Tax Act no. 58 of 1962.

VAT – Value-Added Tax Act no. 89 of 1991.

Estate Duty Act – Estate Duty Act no. 45 of 1955.

STC – Secondary tax on companies.

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Special thanks go to my family, especially my husband, Christo, whose encouragement and constant support continue to be an essential source of strength. I thank my mother and father who gave me the courage to succeed and to never give up.

Finally, I thank my Lord God and Saviour, Jesus Christ, for the gifts and ability, courage and the opportunity to complete this task.

Elizabeth van der Mescht

Cape Town, January 2012.

*Then, said a teacher, Speak to us of Teaching.*

*And he said:*

*No man can reveal to you aught but that which already lies half asleep in the dawning of your knowledge.*

*The teacher who walks in the shadow of the temple, among his followers, gives not of his wisdom but rather of his faith and his lovingness.*

*If he is indeed wise he does not bid you enter the house of his wisdom, but rather leads you to the threshold of your own mind.*

***(From "The Prophet" by Kahlil Gibran)***

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## CHAPTER 1

### 1. Introduction

The subject of this dissertation, Limited Interests in Property – an overview of Limited Interests in Property with particular reference to the taxation of usufructs and more specifically the capital gains tax effects on disposal for individuals and trusts, is an interesting and complex area. Below is an overview of the chapters of this dissertation which is provided as an introduction to the elements of the topic under discussion.

In Chapter 2 the overall concept of estate planning and its various components is examined as set against the background of the South African income tax system. It also focuses on the law and the different sections in the Income Tax Act, No. 58 of 1962 – (the Income Tax Act), that may apply to usufructs. Capital gains tax principles, as in the Eighth Schedule to the Income Tax Act, and the application thereof when an asset is held by way of a usufruct in the hands of an individual versus the usufruct being held in the trust are considered.

Chapter 3 sets out the various limited interests, such as a fiduciary, usufructuary or annuity interest in property. Their nature, and place in estate planning are outlined. Although usufructs provide certain continuity benefits, they also have estate duty and capital gains tax implications that need to be considered in an estate plan. These aspects are illustrated by way of examples that demonstrate the impact of limited interests on an estate as well as the valuation of the usufruct in the estate of the usufructuary.

Chapter 4 discusses the consequences of a limited interest being held by an individual and illustrates the effect of the foregoing by means of examples; such as a usufruct passing to another person, a usufruct ceasing and a usufruct being created on death.

Chapter 5 discusses the consequences of a limited interest being held by a trust in various scenarios.

Having obtained an understanding, and established the basic principles of particular limited interests Chapter 6 presents some comparisons and examples to help decide the most efficient way of using a usufruct type of interest.

Finally, chapter 7 presents some different 'out of the box' possibilities which may need to be reviewed when considering usufructs and any tax planning opportunities which may flow from the use of these rights.

### **1.1 Background**

Historically, sometime before 1630, the word 'usufruct' was first used in English literature. Usufructs were mainly used as a means of enjoying the rights to income flowing from an asset, while the right of ownership in the asset or property was vested in another person.

This right could be entitlement to all the profit or a utility or advantage which the asset may produce, provided the substance of the asset is not altered.

The person enjoying the rights to the income or use is known as the 'usufructuary' and the owner of the property itself is known as the 'bare dominium' holder.

There are two kinds of usufructs, namely a 'perfect usufruct' and an 'imperfect usufruct'.

1. 'Perfect usufructs' are rights which the usufructuary can enjoy, without altering the asset substance, though the substance may be diminished or deteriorated naturally by time or by the use to which it is applied. For example a house, a piece of land, animals or any other movable effects.
2. 'Imperfect usufructs' or a 'quasi-usufruct' over an asset, is when one has a right over the asset but the right would be useless to the usufructuary if it was not consumed, expended or the substance of it was not changed. The imperfect usufruct transfers to the usufructuary the ownership of the asset subject to the usufruct, so that it may be

consumed, sold or disposed of, on condition that if altered it must be returned in another form of the same quality as the original asset<sup>2</sup>.

A good example of an imperfect usufruct is a 'sheep lease'. A 'sheep lease' arrangement may provide the asset as a bare dominium to help the next generation or usufructuary to get started in business while also deferring capital gains tax. In the American sheep industry, investors were expressing an interest in owning sheep, while the working farmers and ranchers were looking for alternative ways to finance their sheep flock expansion. One way for an investor to capture some of the economic profits from the sheep production was to own sheep and lease them to a working farmer. The investor provides the investment capital and the working farmer in return provides the labour, feed, and all the other inputs needed to manage the flock of sheep. A leasing or sharing arrangement allows the two business persons to share the production costs and, in turn, share the income from the sheep.

Usufructs are often used, with trusts, as estate planning tools. Estate duty is saved when assets, like share and immovable property portfolios, with the potential for capital growth, are transferred to an *inter vivos* trust as these assets will then no longer form part of the transferor's estate. The trust in turn provides for the needs of the transferor until his death.

South Africa has a mixed legal system which contains both common law and civil law. Our common law is mainly derived from case law, whereas civil law is derived from legislation. English law has influenced the property law to a certain extent, as in ninety nine year leasehold arrangements and various forms of land tenures, including perpetual quitrent systems. Laws of different jurisdictions have in the past often been employed to inform statutory innovations in the South African law of property. An example can be taken from the sectional title legislation, which was originally based mainly on the New South Wales Strata Titles Act.<sup>3</sup>

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<sup>2</sup> Definition of a usufruct and a usufructuary from the Lectric Law Library's Lexicon. 'Usufruct, Usufructuary'. (Online), Retrieved 20 November 2010 from: [http://www.bkglawfirm.com/newsletters/Real-Estate/?launch\\_pg=NewsletterDetailLayout&launch\\_sel=1000350&title=Usufruct](http://www.bkglawfirm.com/newsletters/Real-Estate/?launch_pg=NewsletterDetailLayout&launch_sel=1000350&title=Usufruct).

<sup>3</sup> Badenhorst, P J. and others. November 2002, *The Law of Property*, 4th Ed, Silberberg and Schoeman, Cape Town, paragraph 1.3.2.

Trusts were introduced into England shortly after the Norman Conquest and were introduced into South African tax legislation after the British occupation of the Cape in 1815. Throughout the years, trusts and usufructs have become increasingly popular in estate and financial planning. The concept of ‘trust’ stems from British law and literally means ‘to trust’. The rules of trust law are a mixture of English, Roman-Dutch and distinctively South African rules, as influenced by the Roman-Dutch law practice in South Africa.<sup>4</sup>

The basic concept of a trust and trustees can be understood by the quote of the 1915 Appellate Division case of *Estate Kemp & others v McDonald’s Trustee*, where Solomon JA said the following:

‘The constitution of trusts and the appointment of trustees are matters of common occurrence in South Africa at the present day. Thus it is a recognised practice to convey property to trustees under antenuptial contracts; trustees are appointed by deed of gift or by will to hold and administer property for charitable or ecclesiastical or other purposes; the property of limited companies and other corporate bodies is vested in trustees and the term is used in a variety of other cases, as e.g. in connection with assigned or insolvent estates. The underlying conception in these and other cases is that while the legal dominium of property is vested in the trustees, they have no beneficial interest in it but are bound to hold and apply it for the benefit of some person or persons or for the accomplishment of some special purpose. The idea is now so firmly rooted in our practice, that it would be quite impossible to eradicate it or to seek to abolish the use of the expression trustee, nor indeed is there anything in our law which is inconsistent with the conception’.<sup>5</sup>

## 1.2 Objectives and approach

The main objective for this dissertation is to gain a more in-depth understanding of the use of a limited interest with particular reference to the taxation of usufructs and more specifically the capital gains tax effects upon disposal for both individuals and trusts. To achieve this objective it is necessary to analyse the capital gains tax provisions in the Income Tax Act as they relate to a usufruct type interest held in a trust versus a usufruct held by an individual in their own name. The subsidiary purpose is to reflect on the judicial response to both the Commissioner of the South African Revenue Service (CSARS) and

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<sup>4</sup> Ibid 1.3.2.

<sup>5</sup> *Estate Kemp & others v McDonald’s Trustee*, 1915, AD 491, at 507. Also see Honiball, M. and Olivier, L. 2009, *The Taxation of Trusts in South Africa*, 4th ed, Siber Ink CC, Cape Town, page 249, paragraph 3.1.

the taxpayer's interpretation of a usufruct and the legislature's attempt to regulate the trust environment.

In the analysis, types of limited interests will be discussed briefly and then the nature of trusts and trust income will be considered together with the application of sections 7 and 25B of the Income Tax Act as it relates to the chosen topic. Apart from income tax, the other important taxes relating to the law of trusts, namely donations tax, estate duty and transfer duty will also be considered. They will not be discussed in depth, as details of these taxes fall outside the scope of this dissertation. Particular reference will also be made to the implications of capital gains tax legislation as it relates to trusts and to individuals.

There are two questions to be raised when considering the use of a trust.

1. Why would anyone feel the need to consider creating a usufruct in a trust?
2. What would the advantage and disadvantage be of using a trust rather than having the property or limited interest in the individual's name?

An attempt is made in this dissertation to set out the tax consequences of the two alternatives and to compare the outcomes.

An individual owns his or her assets directly and personally. The assets held by the individual will always be at a risk if the individual goes insolvent or gets divorced. When the individual dies, all the assets in his or her individual name attract estate duty and are available for settlement of claims by creditors. An individual may therefore wish to make use of a trust to shield assets to some extent from claims of creditors and others. Assets held by a trust are not owned by any trustee; the assets are owned by all the trustees jointly and for one purpose only - for the benefit of the beneficiaries as named in the trust deed. The creator, settler or founder of the trust transfers ownership of assets to a trust to validate it and later may add further assets by way of donation or sale to it. The trustees thereafter manage the trust assets for the benefit of the beneficiaries.

The value of the assets held by trustees will grow within the trust and not in the personal hands of any individual who donated or sold them to the trust. Individuals often make use

of trusts as part of their estate plan to accumulate assets or the growth in the value of their assets within their trusts. The result of this is that they shield their estate from any increased value of those assets and their estate will therefore have a lower value which is subject to estate duty upon their death. Estate planning not only includes traditional estate planning techniques, but also requires a more comprehensive view of each individual's life expectancy and testamentary planning needs. Trusts can be valuable tools in the hands of estate planners and can continue over a number of generations. They have the advantage of providing a separate vehicle within which to hold assets and provide a means of administering them. A trust is therefore a very effective way to 'freeze' the value of the estate of the planner as noted above.

A testamentary trust (a trust created on death) and a usufruct are usually applied to achieve the same or similar result. Therefore, it is important to compare the two legal instruments; as to when to apply them and in what circumstances. Both the testamentary trust and a usufruct could fulfil more or less the same estate planning objective.

The usufructuary has the right to use the returns produced by an asset and the asset is protected for the bare dominium holder in terms of the usufruct conditions. The usufructuary is entitled to the entire income and no provision is made for unforeseen circumstances or retention by someone else. In terms of a testamentary trust, income received may be awarded according to the beneficiary's needs at the discretion of the trustees and the unspent portion may be retained for contingencies.

In this dissertation a number of significant problem areas are highlighted which exist under the current tax system. For example, who at date of death holds the base cost, if an asset is donated or sold and what base cost value will be used? Paragraph 40 of the Eighth Schedule to the Income Tax Act deals with the capital gains tax provisions applicable on the death of an individual. An attempt will also be made to seek clarity on the valuation of limited interests and whether the base value valuation always has to be done according to the suggested rules. Section 5 and section 4(m) of the Estate duty Act will also be considered.

This dissertation opens the debate on some issues, but does not attempt to provide solutions for all the issues raised here.

### **1.3 Methodology**

In order to achieve the stated objections an expository method is used in that the relevant sections of the various applicable Acts are highlighted and where necessary terms and interpretational issues are discussed using appropriate case law and writings of experts. Where treatment in various scenarios is required extracts from guides issued by the revenue authorities are utilised.

### **1.4 Limitation of scope**

This dissertation will focus on limited interests and how they would affect an individual when the limited interest is being held personally verses the limited interest being held in a trust for the individual. It concentrates on the capital gains tax implications as they relate to limited interests. Other transfer taxes, such as the tax payable on the transfer of immovable property, also known as transfer duty, share and security transfer taxes are therefore specifically excluded from this study.

Property taxes, except for capital gains tax, are not dealt with in this dissertation, but they are mentioned here, because they must be taken into account when considering limited interests in property.

Property taxes are divided into three categories:

1. The taxation of the ownership of property (Rates and taxes),
2. The taxation of the movement or transfer thereof (Transfer Duty and Value Added Tax, (VAT)),
3. The taxation of the net increase in the monetary value of a taxpayer's property (Capital Gains Tax, (CGT)).

Transfer taxes can also extend to the transfer of property other than immovable property. In South Africa transfer duty is levied on the transfer of immovable property in terms of the Transfer Duty Act, No. 40 of 1949.

Value-Added Tax is levied on the supply of goods or services made by a person liable to charge VAT, in terms of the Value-Added Tax Act, No. 89 of 1991. If VAT is not applicable in the respect of the transfer of immovable property then transfer duty will be levied.

Aspects of compliance and tax administration are also excluded from the focus of this dissertation and it does not take account of any developments after December 2011.

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## CHAPTER 2

### 2. Income tax and legal concepts and principles relating to trusts and individuals

As Benjamin Franklin once quoted, 'there are only two certainties in life, namely death and taxes'.

Not many South Africans give much thought to estate duty and are even unaware of a tax of twenty percent that will be levied on the net value of their assets upon their death. The most common form of estate planning revolves around the reducing of the value of an individual's estate by making use of *inter vivos* trusts, interest free loans and/or donations. There is however, much more to estate planning than simply divesting a planner of his or her assets and saving estate duty on their death.

Meyerowitz has defined estate planning in the following terms: 'The arrangement management and securement and disposition of a person's estate so that he, his family and other beneficiaries may enjoy and continue to enjoy the maximum from his estate and his assets during his lifetime and after his death, no matter when death occurs'.<sup>6</sup>

#### 2.1 The concept of estate planning

Estate planning is not solely or mainly for minimizing estate duty. It is a much wider and deeper concept. For instance, to structure an estate plan so as to minimise estate duty on the growth in value of assets by breaking the link between the planner and the growth assets, while at the same time not losing control of the assets, and also to fairly provide for the needs of the beneficiaries. To achieve this, the settler may sell his/her assets to the trust by way of loan account which remains repayable on demand. This gives the settler financial 'control', vests the ownership of the assets in the trust and allows the trustees their power to make distributions to the beneficiaries as needed.

Timely estate and financial planning seldom ever seems urgent, and many people leave it

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<sup>6</sup> Davis. D and et al, 1989, *Estate Planning*, Butterworths, Durban, paragraph 1.1.

until it is too late. It can then prove costly solving the estate and financial problems which have arisen.

Estate and financial planning is an on-going process of deciding in advance on the best way to create, accumulate and deal with assets:

- a) to use them during ones' lifetime and to distribute them after death, and
- b) to ensure the maximum benefit for the planner and for his or her family or any other dependents.

Everyone primarily wants to save tax. Although there is nothing wrong with that, it should always be kept in mind that financial planning involves more than mere tax avoidance. Everyone has every right to plan their affairs in such a way as to pay the least tax possible, provided that they remain within the law. 'Render unto Caesar that which is Caesar's, and not what he asks' - this is a favourite saying in the financial environment regarding taxes.

There is a mistaken view that estate planning only entails the drafting of a will, saving estate duty, exposing cash deficits and taking out life assurance. These are all important aspects of estate planning, but they are not the only considerations. Any decision relating to the accumulation and use of assets during ones' lifetime and on their distribution after death should be part of an estate planning decision. If, throughout the planner's lifetime, by way of careful planning and changes to his estate, the planner would be able to legitimately minimise the impact of normal tax on income earned, transfer taxes<sup>7</sup> on the acquisition of assets and any exit taxes<sup>8</sup> on the disposal of his assets, then the cumulative compound effect on the value of his estate could be substantial. An astute planner will enjoy the benefits of timely planning throughout his life and his heirs will continue to reap the benefits after his death.

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<sup>7</sup> Transfer Duty in terms of the Transfer Duty Act 40 of 1949 and Marketable Securities Tax in terms of section 23, paragraph 15(3) of schedule 1 of the Stamp Duty Act 77 of 1968.

<sup>8</sup> Donations Tax in terms of section 54 of the Income Tax Act 58 of 1962. Capital gains tax or normal tax imposed on disposal of assets.

It therefore needs regular review and amendment to best suit any new circumstances of the planner, and take cognisance of changes in legislation.

If the estate plan is to transfer the appreciation in value of the assets to another person, by way of divesting, the earlier it happens, the more effective the impact will be. By doing this, not only will the planner save on transfer costs on the lower value of the asset, but also the extent of the growth of the asset value will take place outside of his estate over the longer period of time.

The planner needs to ensure that there is sufficient liquidity in his estate to meet its liabilities and that it will not be necessary for the executor or beneficiaries to sell any assets which the remaining family members need to keep intact after his death, particularly their family home. Whatever the astute planner may or may not save during the process, the planner should constantly assess the potential exposure of his estate to estate duty and to any capital gains tax. Estate and financial planning is a multi-disciplinary and complex subject, and therefore some knowledge of how our economic system functions and how sociological and psychological factors may affect the situation is required.

The planner needs to have knowledge of the administration of wills, capital gains tax, donation tax, estate duty, the Law of Succession and the Immovable Property Act,<sup>9</sup> to name but a few. It may be necessary for the planner to consult a Certified Planner (CFP) or other suitable qualified person for proper estate planning. Estate and financial planning should not be taken lightly as it requires precise preparation and foresight to eliminate uncertainties and maximise the value for all parties involved.

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<sup>9</sup> The Immovable Property Act 94 of 1965, regulates the law relating to the removal or modification of restrictions on immovable property imposed by a will or other instrument. The Act imposes a limit on the duration of fideicommissa created by a will or other instrument in respect of immovable property, and on the duration of restrictions on the alienation of immovable property imposed by a will or other instrument otherwise than by way of a fideicommissum.

## 2.2 Trust and tax law principles

Trusts have been used in Common Law countries for many years. With the development of international business, international tax and estate planners were quick to realise the benefits of using trusts in low tax jurisdictions to help mitigate tax liabilities and to assist with flow of family wealth across the generations. The basic concept of a trust is that a trust is not a separate legal entity, but more a legal obligation or agreement between two parties: the settlor and the trustees.

In England, the law of trusts evolved during the Middle Ages from within the body of English law known as 'equity'. This body of law was developed by the Court of Chancery, as opposed to the Court of Common Law. The Courts of Common Law developed the law of torts, substantial portions of the laws of contract, of restitution and of property. The result is that the trust (equity law) is inseparably linked to the English law of property with its dual system of the legal and beneficial ownership. In terms of this system it is possible to have two kinds of ownership in respect of the same property, namely the trustees can be the legal owner under the common law, and the beneficiary can be the beneficial owner in terms of the law of equity. This concept of dual ownership is foreign to the Roman Dutch Law in terms of which only one kind of ownership can exist of one and the same thing.<sup>10</sup> It is therefore not strictly correct to refer to an English-Law trust as a 'common-law' trust,<sup>11</sup> although such references are widespread. It is only natural that the English trust was incorporated into the South African legal system after the first British occupation of the Cape as that legal foreign institution had been imported.<sup>12</sup> Although much of South African law is based on Roman-Dutch law, the South African courts have over the years created a unique South African trust law through the legislation, Acts of Parliament or statutes, and decided case law,<sup>13</sup> which bears little resemblance to its current English law counterpart.<sup>14</sup>

In 1988 the legislature intervened for the first time to regulate the use of trusts, by the

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<sup>10</sup> *Lucas' Trustee v Ismail and Amod*, 1905, TS 239.

<sup>11</sup> As was done by the IBFD in their International Tax Glossary, 4<sup>th</sup> Edition, 'Trust', page 368.

<sup>12</sup> Olivier, P.A., et al. 2008, *Trust Law and Practice*, Lesis Nexis, page 1-16.

<sup>13</sup> Geach, W.D. with Yeats, J. 2007, *Trusts Law and Practice*, Juta & Co LTD, page 4.

<sup>14</sup> Honiball, M. and Olivier, L. 2009, *The Taxation of Trusts in South Africa*, 4<sup>th</sup> Ed, Siber Ink CC, Cape Town, paragraph 6.

introduction of the Trust Property Control Act 57 of 1988. In this Act, a 'trust' is defined as:

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

- a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or
- a) to beneficiaries designated in the trust instrument, where the property is to be 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 of 1965'.

From the definition it is clear that for the purposes of the Trust Property Control Act the term 'trust' includes both *inter vivos* (created during lifetime) and *mortis causa* (testamentary, created on death) trusts. In Honore's South African Law of Trusts, Judge Edwin Cameron<sup>15</sup>, considered trusts to be in the narrow sense of the word, e.g. where ownership of the trust assets vests in either the trustee or the beneficiaries.<sup>16</sup>

A discretionary trust is usually where the beneficiaries have no right to the income or capital of the trust until the happening of an event. An event includes the decision of the trustees to distribute income or capital to a beneficiary. Once the event occurs vesting takes place. Trust deeds may provide that capital vests immediately but not the income or vice versa. This is discussed in chapter 5.5.

The Trust Property Control Act of 1988 came into operation on 31 March 1989 and thus replaced the Trust Moneys Protection Act 34 of 1934. The Trust Property Control Act does not deem a trust to be a person or an entity, but it does set out how a trust is to be regulated under South African law. The Trust Property Control Act<sup>17</sup> provides for the lodging of

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<sup>15</sup> Judge of the Supreme Court of Appeal of South Africa.

<sup>16</sup> Honiball, M. and Olivier, L. 2009, *The Taxation of Trusts in South Africa* 4th Ed, Siber Ink CC, Cape Town, paragraph 2.1.

<sup>17</sup> Trust Property Control Act no. 57 of 1988.

trust deeds with the Master of the High Court. It makes certain provisions for the administration of the trust, but does not deal with the legal nature of a trust. The Trust Property Control Act has the effect that, if the trust deed is in writing, the trustees have no power to act on behalf of the trust until such time as they have been authorised to do so in a 'letter of authority' issued by the Master.<sup>18</sup>

The Trust Property Control Act contains the following important provisions:

- a) a requirement that a copy of the trust instrument must be lodged with the Master of the High Court<sup>19</sup>
- b) written authorisation to act as a trustee must be given by the Master<sup>20</sup>
- c) a requirement that the trustee exercise due care and skill<sup>21</sup>
- d) the separate identification and registration of trust assets<sup>22</sup>
- e) trust property shall not form part of the personal estate of the trustees<sup>23</sup>

The term 'trust instrument' is also defined in section 1 of the Trust Property Act as:

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

Section 2 of the Trust Property Control Act provides that if a document represents the reduction to writing of an oral agreement by which a trust was created or varied, then such document will be deemed to be a trust instrument<sup>24</sup>. Therefore, the Trust Property Control Act 57 of 1988 provides for effective control over the administration of trusts.<sup>25</sup>

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<sup>18</sup> Huxham, K. and Haupt, P. 2009, *Notes on South African Income Tax*, 28th Ed, H&H Publications, Cape Town, South Africa.

<sup>19</sup> See section 4 of the Trust Property Control Act no. 57 of 1988.

<sup>20</sup> Ibid, section 6.

<sup>21</sup> Ibid, section 9.

<sup>22</sup> Ibid section 11.

<sup>23</sup> Ibid section 12.

<sup>24</sup> Honiball, M. and Olivier, L.2009, *The Taxation of Trusts in South Africa* 4th Ed, Siber Ink CC, Cape Town, paragraph 4.2.

<sup>25</sup> Abrie, W. and et al. 2003, *Deceased Estates*, 5th Ed, V& R Printing Works, Pretoria, page 4.

### 2.3 Legal nature of trusts

A 'person' as defined in section 1 of the Income Tax Act, 'includes any insolvent estate, the estate of a deceased person and any trust'. The definition of a 'person' in section 2 of the Interpretation Act 33 of 1957 includes any body of persons, corporate or unincorporated.

There are three types of trusts in South Africa:

- a) The first is where a founder transfers ownership of assets to a trustee for the benefit of the beneficiaries. This is also referred to as an 'ownership trust',
- b) The second is where a founder transfers ownership of assets to the beneficiaries, but the control rest with the trustees. This is also sometimes known as a 'bewind trust' in Roman Dutch Law, and
- c) The third kind of trust is where the trustee is entrusted to administer the affairs of another, for example, a mentally challenged person, in the capacity of a curator. (*Zinn NO v Westminster Bank* (1936) AD)

### 2.4 Capital Gains Tax principles

The disposal of limited interests in property will have capital gains tax consequences.

An *asset*<sup>26</sup> in terms of paragraph 1 of the Income Tax Act is defined for tax purposes as:

- (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 to or in such property.

Examples of movable property are motor vehicles, furniture, office equipment, ships, aircraft and livestock. The (CSARS) Capital Gains Tax<sup>27</sup> guide also gives as an example of

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<sup>26</sup> Paragraph 1 of the Eighth schedule of the Income Tax Act 58 of 1962.

<sup>27</sup> Comprehensive Guide to Capital Gains Tax (Issue 3), 6 May 2010, page 33, paragraph 4.1.2.

incorporeal movable property; or: real rights over movable property, a usufruct over movable assets and personal rights. It further gives as examples of immovable property; land, buildings with foundations in the soil, mineral rights, a registered servitude, trees, growing crops and real rights over immovable property, such as a usufruct over such property, or registered lease of immovable property.

It is clear from this definition that an 'asset' includes limited interests in property.

'Property' is defined as:

1. any right in and to property movable or immovable,
2. corporeal or incorporeal, where so ever situated.'<sup>28</sup>

To establish whether or not an asset complies with a 'right in and to property', the general property law principles are of importance. The definition is wide and includes personal as well as real rights in property.<sup>29</sup> Personal servitudes,<sup>30</sup> such as a usufruct, right of use and habitation are real rights and would therefore also be included in the definition, as well as a fiduciary interest in property under a fideicommissum. Although these rights are usually not transferable, the renunciation of any such right would in principle be taxable, because it constitutes a waiver of a right. My interpretation is that the definition only embraces vested rights and would therefore; seem to exclude a *spes* and a conditional right.<sup>31</sup> Although rendering of labour or services would not constitute property,<sup>32</sup> it must, however, be distinguished from the situation where a person waives a right to receive compensation for services rendered.

Capital gains have been taxed in the United States of America since 1913. In Europe, England and other common-law countries they generally applied a legal concept of income in terms of which no provision was made for capital profits. However, many of these

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<sup>28</sup> Asset as defined in paragraph 1 of the Eighth Schedule.

<sup>29</sup> Section 55 (1) of the Income Tax Act no.58 of 1962.

<sup>30</sup> Badenhorst, P.J. and et al. 2002, *The Law of Property*, 4th Ed, Silberberg and Schoeman, Lexis Nexis, Durban, paragraph 14.12.

<sup>31</sup> Badenhorst, P.J. and et al. 2002, *The Law of Property*, 4th Ed, Silberberg and Schoeman, Lexis Nexis, Durban, paragraph 2.2.

<sup>32</sup> Meyerowitz, D. 2007-2008, *The Taxpayer – Meyerowitz on Income tax*, The Taxpayer, Cape Town, paragraph 31.3.

countries do impose a net wealth tax on capital assets. Worldwide, the taxation of capital gains therefore barely existed prior to 1950, but was introduced between 1958 and 2000 in most OECD<sup>33</sup> countries, mainly to improve the equity, neutrality and redistributive justice of tax systems. Some countries provide for capital gains taxation within the existing income tax legislative framework, whereas other countries have elected to introduce separate legislation.

Capital gains tax is usually imposed on a realisation basis, whereby the gains that have accrued to a taxpayer on the disposal, usually by way of a sale or exchange of his or her capital assets during the year of assessment, are taxed.

When a trust or individual disposes of an asset, they are liable for capital gains tax, unless a special rule applies. The introduction of capital gains tax was brought into the South African income tax system to form an essential backstop to personal and corporate tax, and to bring South Africa's tax systems more in line with international benchmarks.<sup>34</sup>

With effect from 1 October 2001, capital gains tax was introduced into the South African tax system, despite the fact that the Margo Commission<sup>35</sup> and the Katz Commission<sup>36</sup> had rejected the proposal for the introduction of such a tax.

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<sup>33</sup> The Organisation for Economic Co-operation and Development (OECD) is an international organisation of the third world countries committed to the principle of a free economy and a representative democracy. It originated in 1948 to assist with the reconstruction of Europe after World War II. The membership was later extended to non-European countries. The OECD provides a forum where governments and policy makers can compare policy experiences on various economic, social and environmental issues.

<sup>34</sup> Williams, R.C. 2005, *Capital gains tax – A Practitioner's Manual*, 2nd Ed, Juta & Co LTD, page 1.

<sup>35</sup> Margo Report, 1986, paragraph 20.42.

<sup>36</sup> Third Interim Katz Report, 1995, paragraph 7.1.11 and see <http://www.info.gov.za/view/DownloadFileAction?id=70508>.

The government appointed three commissions to enquire and report on aspects of the tax structures.

1. The Commission of Enquiry into the fiscal and monetary Policy in South Africa, chaired by D.G. Franzen, also called the "Franzen Commission. They issued two reports under the title Taxation in South Africa in 1968 (the First Franzen report) and in 1970 (the Second Franzen report).
2. The Commission of Inquiry into the Tax Structure of the Republic of South Africa, chaired by C.S. Margo, also called the Margo Commission. The Margo Commission issued a single wide-ranging report in 1986 called the Margo Report.
3. The Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, chaired by M.M. Katz, called the Katz Commission. The Katz Commission issued nine interim reports during the period 1994 to 1999.

Also see Taxtalk article written by Kader, N, Issue no. 12, September/October 2008, page 21.

The rules for Capital gains tax are set out in the Eighth Schedule to the Income Tax Act.

A capital gain is generally assessed as the difference between the:

1. original acquisition price plus value enhancement expenditure and
2. the consideration received for the asset on disposal. Therefore, the tax is levied on the “profit” made by the taxpayer on the disposal of his or her capital asset.

For capital gains tax purposes a taxpayer has a deemed disposal on death, because the deceased person will have no future opportunity to realise a capital asset.

The unrealised gains may be captured in the tax base in one of the two following ways:

1. The taxpayer’s assets may be deemed to have been realised at the date of death resulting in the deceased being taxed as if he or she had disposed of the assets to his or her deceased estate, or,
2. The liability for capital gains tax on any unrealised gains may be deferred until the heir actually disposes of the asset. (This however only applies in South Africa in the case of transfers to a spouse). The heir receives the asset and takes over its acquisition cost or base cost from the deceased. The heir will be liable for capital gains tax on the total gain only upon his/her eventual disposal of the property. This method is referred to as the “carry-over” approach. Or, the heir takes over the asset at base cost equal to market value at the date of death of the deceased – this is also called the ‘stepped-up’ approach. South Africa does not have a ‘carry-over’ or ‘deferred’ approach, except in the case of ‘roll-overs’ for spouses. The taxpayer’s assets may be deemed to have been realised on the date of death resulting in the deceased being taxed as if he or she had disposed of the assets in his or her deceased estate.

The Income Tax Act provides for the taxation of the prescribed percentage of the net capital gain realised upon the disposal of a capital asset. The capital gain or loss is basically the difference between the selling price of an asset and its base cost. All gains and losses are aggregated and any specific exclusions are deducted to arrive at the net

capital gain. The base cost of assets which are disposed of after 1 October 2001, but which were acquired before this date, are adjusted to eliminate any gain made prior to this date. A person's net capital gain and taxable gain is separately determined in terms of the rules and provisions of the Eighth Schedule.

A detailed discussion of the Eighth Schedule to the Income Tax Act, which deals with the detail of how capital gains tax operates, falls outside the scope of this report. But, where appropriate, the basic provisions of the Eighth Schedule and some uncertainties pertaining to trusts and individuals will be addressed.

Section 26A of the Income Tax Act includes any taxable capital gain made by a person in any year in that person's taxable income and it is therefore subject to normal tax, at the normal tax rates published under the said Act. A taxable capital gain is determined by multiplying the net capital gain with a prescribed inclusion rate. In the case of a natural person or special trust, the inclusion rate is 25 percent.

In the case of most corporate entities and ordinary trusts the inclusion rate is 50 percent. A person's taxable gain is then added to other taxable income and subject to normal tax. This means that a taxable capital gain is taxed at an effective rate of 4.5 to 10 percent for individuals, 20 percent for trusts and 14 percent for companies.<sup>37</sup>

The Eighth Schedule of the Income Tax Act has certain deeming provisions to cater for the situation where there are no proceeds and also for situations where proceeds may be inadequate.

The application of these provisions results in the current market value being substituted where an inadequate, or no, proceeds value is available.

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<sup>37</sup> For the 2011 year of assessment, the maximum rates payable on capital gains are: natural persons and special trusts -  $25\% \times 18\%$  to  $40\%$  and for ordinary trusts -  $50\% \times 40\% = 20\%$ , whereas for corporate entities such as companies and close corporations it is -  $50\% \times 28\% = 14\%$ .

The applicable paragraphs of the Eighth Schedule of the Income Tax Act relevant to this study are:

Paragraph 12(5)	donation of a loan or forgiveness of a debt
Paragraph 38	donations and sales at less than market value
Paragraph 40	disposal to the deceased estate on death
Paragraph 80	capital gain distributed to a beneficiary
Paragraph 70	capital gains retained by the trust
Paragraphs 70 and 72	attribution of capital gains distributed by a trust
Paragraph 73	capital gains attributed to the donor

Some of these paragraphs are examined in more detail in chapter 4 and 5.

## **2.5 Sections of the Income Tax Act that may be applicable when considering a usufruct for individuals and trusts**

The holding of a limited interest can give rise to an income stream which will be subject to income tax. For example, when a usufruct created over shares gives rise to the receipt of dividend income or a usufruct over a fixed property gives rise to rental income.

The following sections of the Income Tax Act are relevant in that not only must the income be identified but the person who is to be subjected to the tax must also be identified. A more detailed discussion of the nature of the income is described in chapter 4.

### **2.5.1 Section 1**

Section 1 of the Income Tax Act contains definitions that directly affect trusts and beneficiaries. This section includes the definitions of a 'person', 'connected person', 'trusts', 'trustees', 'beneficiaries', 'resident' and 'special trusts'.

### **2.5.2 Section 5**

Section 5 of the Income Tax Act provides that the Minister of Finance will determine the rate of tax applicable to taxpayers, including trusts.

### **2.6 Section 7**

Section 7 contains various anti-avoidance provisions and is aimed at preventing taxpayers from abusing the tax system by shifting their tax liability to persons in lower income tax brackets. In terms of section 7 of the Income Tax Act, income may be taxed in the hands of the donor in certain circumstances whether the transfer of assets giving rise to the income is by donation, settlement or other similar disposition.

#### **2.6.1 Section 7, in general**

Section 7 of the Income Tax Act has eight sub-sections which may be summarised as follows:

- a) Section 7(1), deems income to have accrued to a person notwithstanding that it has been invested, accumulated, or capitalised by him or on his behalf.
- b) Section 7(2) covers the situation where one spouse makes a 'donation, settlement or other disposition' for the benefit of the other spouse, with the purpose of avoiding, postponing or reducing their liability for tax. If the 'purpose test' fails then the section will not apply.
- c) In terms of section 7(3) and section 7(4), income of a minor child is deemed to be that of his or her parent in certain circumstances. It may, inter alia, be of relevance where a parent makes a 'donation, settlement or other disposition' to a trust for the benefit of a minor. If the parent dies then these sections cannot apply and the child is taxed in his or her own right.
- d) In terms of section 7(5) income received as a result of a 'donation, settlement or other disposition' to a trust, is deemed to be the donor's to the extent that the income is not vested in a beneficiary because of a condition or stipulation in the trust deed. In these circumstances, if the donor dies then the trust will be taxed as no vesting can take place

until the condition or stipulation occurs, for example the trust deed stipulates that a child must turn 25 before income vests.

- e) In terms of section 7(6) income is deemed to be that of the donor where he retains certain powers over the said 'donation, settlement or other disposition'.
- f) In terms of section 7(7) income is deemed to be the donor's if the asset that produces the income is to be returned to the donor at some stage in the future.
- g) In terms of section 7(8) income received by or accrued to a non-resident by reason of, or in consequence of a 'donation, settlement or other disposition' by a resident, is deemed to be the income of the resident.<sup>38</sup> The non-resident could be an individual or a trust.

In all the above situations (b) to (g), the income arising in consequence of a donation, settlement or disposition (or some other consideration – section 7(4)) will be subject to tax in the hands of the person making the donation, settlement or disposition.

The term disposition would include the situation where an asset is sold by means of an interest free loan. In *Ovenstone v SIR*<sup>39</sup> the court held that the word 'other disposition' should be interpreted *eiusdem generis* with the words 'donation' and 'settlement'.

In the *Ovenstone* case the father lent his four children the amount required to buy shares at par in a private company. He lent the money at the same rate (initially 8,5 percent per annum) which the bank would have charged him. The children however did not qualify for the same bank rate as the father and the rate the father was charging them was significantly much lower than the rate the children would have been able to borrow funds at on the open market. The court found that the interest rate was not market related and therefore constituted a gratuitous disposal to the children.

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<sup>38</sup> Meyerowitz, D. 2007 - 2008, *The Taxpayer – Meyerowitz on Income tax*, The Taxpayer, Cape Town, paragraph 16.133.

<sup>39</sup> *Ovenstone v SIR*, 1980, (2) SA 721 (A), 42 SATC 55.

‘Disposition’ should therefore be interpreted as any disposal of property made wholly or to an appreciable extent gratuitously out of the liberality or generosity of the disposer. The court further confirmed in *Joss v SIR*<sup>40</sup> that ‘other disposition’ excluded transactions made for full value in money or money’s worth and that there had to be an element of liberality.

The facts of the *Joss v SIR* case, in short, were as follows:

Shares in a newly formed company were allotted to the taxpayer’s minor daughter at their normal value of R1 each. The money had been donated to her by her grandfather. After the allotment the taxpayer sold certain shares in two companies and ceded his loan account against one of these companies to the holding company. The loan account disposed of did not bear interest and the taxpayer also did not charge the holding company any interest on the amount owing by it to him in respect of the loan account ceded by him to it. The taxpayer also did not charge any interest on the purchase price of the shares he had sold to the holding company. The holding company repaid the whole amount owing to him in respect of the loan account ceded to it, and substantially reduced the amount owing in respect of the shares purchased by it.

The holding company therefore paid off its debt much quicker than the case would have been if it had been required to pay interest. The dividends declared by the company would also have been substantially less.

The Secretary (of the South African Revenue Service) invoked section 7(3) of the Income Tax Act and deemed the total dividend that accrued to the taxpayer’s daughter to be income in his hands. It was held that since the disposal of the shares was for the full value, only the subsequent interest free loan could be said to have been a donation, settlement or other disposition. Where a disposition is partly gratuitous and partly for consideration, an apportionment of the income attributable to the element of gratuity and to the element of consideration could be made.

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<sup>40</sup> *Joss v SIR*, 1980, (1) SA 664 (T), 41 SATC 206.

## 2.7 Section 25B

Section 25B was introduced into the Income Tax Act after the amendment of the definition of 'person' in section 1 to specifically include a trust. Section 25B of the Income tax Act deals with the income and the beneficiaries of trusts. It is more a regulating provision in the sense that it determines who will be taxed on the trust income and when. In terms of section 25B(1), any income received by, or accrued to, or in favour of any person, in his capacity as the trustee of a trust, is subject to the provisions of section 7. This means that the provisions of section 7 (if applicable) override section 25B. To the extent to which such income is not so derived it shall be deemed to be income which has accrued to the trust. Further, in terms of section 25B(2), income is deemed to be derived for the benefit of the beneficiary where the beneficiary acquires a vested right in consequence of the trustees exercising their discretion which has been vested in them by the trust deed.

In the cases *Armstrong v CIR* (1938) 10 SATC 1 and *SIR v Rosen* (1971) 32 SATC 249 it was held that income flowing into a trust retains its identity when it is on-distributed to beneficiaries. This is known as the 'conduit pipe' principle.

The question of the meaning of the term 'income' in section 25B was raised by Ernest Mazansky in an article called 'Dividend distributions from a trust' in 'Tax Planning' in 1992. According to Mazansky the structure of section 25B precludes the term 'income' in this section from having the meaning of 'net income' or 'net profit'. Section 25B(3) provides that if the income is deemed to accrue to a beneficiary then any deduction or allowance must similarly be deemed available to the beneficiary with the vested right. According to Mazansky, section 25B(3) would be irrelevant if the word 'income' meant 'net income'. There would then have been no need to 'allocate' deductions and allowances between beneficiaries and the trust. He submits therefore that the word 'income' cannot mean 'net income'.

Exempt income, such as dividends, is however not 'income, as defined and the provisions of section 25B would therefore not apply. If dividends are distributed in the same year of assessment in which they are received by or accrue to a trust, the dividends retain their identity and are treated as tax-free receipts or accruals in the beneficiary's hands. If,

however, dividends are distributed in a year subsequent to that in which they are derived by the trust, they may not retain their identity as exempt dividends. Mazansky's concern is based on the following comment made in *Rosen's*<sup>41</sup> case:

'It suffices to say that the trust deed may itself entitle or oblige the trustee to administer the dividends in such a way that he is not a mere conduit pipe for the passing them on to the beneficiary, that in his hands the source as dividends can no longer be identified or they otherwise lose their character and identity as dividends, and that the beneficiary is thus entitled to receive mere trust income in contradistinction to the benefit of the dividend rights.... Thus, a trust may endow the trustee with discretion to pass on dividends to the beneficiary or retain and accumulate them. If he decides on the latter, I think (but express no firm view) that the dividends might lose their identity and character as dividends, so that if they are subsequently paid out to the beneficiary, they might possibly no longer be dividends in his hands, for the conduit pipe had turned itself off at the relevant time'.

Mazansky noted that the court did not state that any retained dividends would lose their identity as income. All that was said was that 'the dividends might then lose their identity and character as dividends'. It could well be that the distribution still remained as income, in the general sense, and not as dividends specifically. But, being income, it is then possible that the amount distributed could be taxable in the beneficiary's hands.

The same issue was also considered by the Appellate Division, in *Estate Dempers v SIR*<sup>42</sup>. The court held that when a trust retains income that had already been deemed to accrue to and had been taxed in the hands of the donor (who established the trust) such income retains its character as 'income', even though the trust deed speaks of 'such income being capitalised and added to the trust fund'<sup>43</sup> Upon any subsequent distribution of the income the beneficiaries are not taxed on that income. This is so because, according to the Dempers decision, the income which had been deemed to accrue to the donor under the provisions of section 7(5), is so deemed for all time and therefore subsequently it cannot accrue to the beneficiary/donee as his or her income.

It would appear that, had the *Dempers* case been heard after the addition of section

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<sup>41</sup> *SIR v Rosen*, 1971, (1) SA 172 (A), 32 SATC 249, 1971, Taxpayer 24.

<sup>42</sup> *Estate Dempers v SIR*, 1977, (3) SA 410 (A), 39 SATC 95, 1977, Taxpayer 167.

<sup>43</sup> *Ibid*, *Rosen* at 110.

25B(2A) the court might have reached a different decision. Section 25B(2A) reads as follows:

‘Where during any year of assessment any resident acquires any vested right to any amount representing capital of any trust which is not a resident, that amount must be included in the income of that resident in the year, if-

a) that capital arose from any receipt and accruals of such trust which would have constituted income if such trust had been a resident, in any previous year of assessment during which that resident had a contingent right to that amount; and

b) that amount has not been subject to tax in the Republic in terms of this Act’.

If the distribution arose from a non-resident trust that had not been subject to tax in South Africa in the year the income accrued, the beneficiary’s receipt in a later year would be of a capital nature (capitalised profits) but would still be taxed, in terms of section 25B(2A), and the receipt or accrual would be included in the income of the resident beneficiary. If, however, the distribution arose from a resident trust, any distribution of retained dividends for example would not be taxable in the hands of the beneficiary, not because it had already been subject to tax as stated in the *Dempers* case, but because it is considered to be of a capital nature. Section 25B(2A) would not apply as the amount had been taxed previously in the donor or trusts hands.

Mazansky points out that Revenue has never attempted to subject any beneficiary to tax on a distribution made by a trust out of accumulated income, whether such income had been taxed in the hands of the donor, or the trust, or not at all. Should the Commissioner decide to issue revised assessments on distributions from accumulated income, the taxpayer should be able to avail himself of the defence offered by the proviso(iii) in section 79(1) of the Income Tax Act. In that the income was not assessed in accordance with the practice generally prevailing at the date of the original assessment.

Where section 7 does not apply, section 25B(2A) is the only provision which will apply to raise tax on the income of an offshore trust when received as capital in the hands of a South African tax resident beneficiary. According to some arguments flowing from the

findings in *Estate Dempers* it was argued that section 25B(2A) is unnecessary. In *Estate Dempers*<sup>44</sup> the court at 110 stated as follows:

‘It was also submitted that section 9(5)<sup>45</sup> could not be applicable because on the happening of the events postulated (the attainment of the various ages) the donee would not receive any ‘income’ but only capital, the accumulated income in the meanwhile having been capitalised. This argument is unsound. Assuming that it is implicit in the subsection that upon the happening of the event the beneficiary should receive the income that has hitherto been withheld, it is clear to me that this is precisely what would happen under clause 17 and 18. The fact that the trust deed speaks of such accumulated income being capitalised and added to the trust fund cannot alter its essential character, in the eye of the income tax law, of being ‘income’.

Counsel sought to reinforce his argument that the accumulated income could not be regarded as income in the hands of the donee, when ultimately received by him under clause 18, and generally that section 9(5) could not apply to this situation, by contending that if the accumulated income were so regarded and section 9(5) applied, double taxation would result; the donee would be taxable on the accumulated income when he received it and the donor will have been taxed thereon from time to time in the tax years in which it originally accrued. The answer to this contention is that once this income has been deemed under section 9(5) to be that of the donor, it is so deemed for all time and there is no room for any finding that subsequently it accrued to the donee as income’.<sup>46</sup>

Although this case deals with section 9(5) as it then was it is clear that for income tax purposes, income retains its nature even if capitalised in the trust.<sup>47</sup> And, that section 25B(2A) only applies when a resident beneficiary acquires a vested right to the income.

After the judgement in *CIR v Friedman and Others NNO* 1993 (1) SA 353 (A), 55 SATC 39, section 25B was introduced into the Act. Section 25B can apply to both *inter vivos* trusts, where section 7 does not apply, and also to all *testamentary* trusts. Section 7 only applies if a ‘donation, settlement or other disposition’ has been made. For section 25B to operate it is necessary to determine, per the trust deed, in whom the income received by the trust vests. If it vests in a beneficiary, then the settler or the beneficiary will be taxed in

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<sup>44</sup> *Estate Dempers v SIR*, 1977, (3) SA 410 (A), 39 SATC 95, 1977, Taxpayer 150.

<sup>45</sup> Section 9(5) is the forerunner to section 7(5).

<sup>46</sup> Honiball, M. And Olivier, L. 2009, *The Taxation of Trusts in South Africa*, Siber Ink CC, Cape Town, paragraph 4.3.

<sup>47</sup> Described as a conduit or channel through which income and capital gains flow through to the beneficiaries.

terms of section 7. If the settler or donor dies and no vesting has taken place, then the trust will bear the tax on its income.

### **2.7.1 The deduction of losses and expenses**

Section 25B(3) reads as follows:

‘Any deduction of allowance which may be made under the provisions of this Act in the determination of the taxable income derived by way of any income referred to in subsection (1) shall to the extent to which such income is under the provisions of that subsection deemed to be income which has accrued to a beneficiary or to the trust, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by such beneficiary or trust, as the case may be’.

Due to the abuse of section 25B by taxpayers using trusts for the purpose of income splitting, section 25B(3) was introduced into the Income Tax Act. Taxpayers had reduced their marginal tax rate by channelling losses, incurred as a result of the deduction of expenditure and allowances, via trusts to themselves as beneficiaries, and then set off such losses against their other income. The consequence of these subsections is that a loss may not be distributed to beneficiaries.

The conduit principle and the attribution of income in terms of section 7 read with section 25B are all applicable to determine the taxable person in respect of ‘income’ in certain circumstances as discussed above. The attribution of capital gains in similar circumstances is discussed in chapters 4 and 5. The concept of ‘vesting’ is discussed in chapter 5.5.

## **2.8 Tax rates applicable to trusts versus the tax rates of an individual**

### **2.8.1 Individuals**

Individuals, including special trusts, and insolvent and deceased estates are taxed on a sliding scale of 18 to 40 percent, reaching 40 percent at a taxable income level of R552 000 (2011 tax year).

The primary and secondary rebate may be deducted in terms of section 6 of the Income Tax Act from the normal tax payable by a natural person. The primary rebate of R10 260 is available to any taxpayer who is a natural person. If any taxpayer is 65 years of age or older on the last day of the year of assessment, they are entitled to the secondary rebate of R5 675 in addition to the primary rebate.

Interest received is exempt up to certain limits. The interest exemption for taxpayers 65 years and older is R32 000, and for taxpayers under 65 it is R22 300. The exemption is however subject to the following limitation:

The first R3 700 (2011 tax year) of foreign dividend income is exempt from tax according to section 10(1)(i)(xv) of the Income Tax Act. The remainder of foreign dividends and foreign earned interest is taxed in South Africa if none of the special dividend exemptions as laid out in section 10(1)(k)(ii) are applicable (details of dividends fall outside the scope of this dissertation). Domestic dividends are currently generally fully exempt in terms of section 10(1)(k)(i) of the Income Tax Act.

### **2.8.2 Trusts**

The tax rate of a trust will depend on whether the trust is an ordinary or a special trust. Trusts are not natural persons and therefore do not qualify for a primary or secondary rebate<sup>48</sup>, nor for the R3 700 foreign dividend and interest exemption in terms of section 10(1)(i)(xv) of the Income Tax Act. Trusts do qualify for the domestic dividend exemption as set out in section 10(1)(k)(i) of the Income Tax Act.

Different trusts have different tax rates:

- a) The tax rate of an ordinary trust is fixed at a flat rate of 40 percent and,
- b) a special trust<sup>49</sup>, as defined in section 1 of the Income Tax Act, has a sliding scale rate that varies from 18 to 40 percent, as is applicable to individuals.

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<sup>48</sup> In terms of section 6 of the Income Tax Act.

<sup>49</sup> Special trusts are trusts created for the benefit of persons suffering from a mental illness or physical disability or for minor children.

The effect of the addition of the Eighth Schedule and section 26A<sup>50</sup> to the Income Tax Act is that natural persons and special trusts will be taxed at an effective rate of 4.5 to 10 percent and trusts at an effective rate of 20 percent on any capital gains.

Despite the close link between trusts and individuals, trusts are taxed on 50 percent of their net capital gain. On the other hand, individuals are taxed on 25 percent of their net capital gain. Individuals and special trusts enjoy a primary exemption for capital gains tax on the first R17 500 of any aggregate gain<sup>51</sup> made in a tax year, before the 25 percent is applied. This benefit is not shared by ordinary trusts.

The table below makes a comparison between trusts and individuals:

<u>Trust</u>	<u>Individual</u>
Assets are owned by the trustees on behalf of the beneficiaries and they will not fall into a beneficiary's estate on death or insolvency.	An individual owns assets in his or her name and therefore, they will fall into the individuals' estate on death or insolvency.
Trusts are seen as a legal person for certain specific statutory purposes of taxation.	A natural person is a person for both legal and tax purposes.
Trustees can act only within their powers and capacity as stated in the trust deed.	A natural person usually has full contractual capacity.
The trustees act on behalf of the beneficiaries.	An individual acts on behalf of himself or herself.
Trustees cannot make a profit or act in a manner to promote self interest	An individual may act out of self-interest.

<sup>50</sup> States that a person's taxable income for a year of assessment shall include the 'taxable capital gain' for that year of assessment, as determined under the provisions of the Eighth Schedule. If there is an aggregate loss, this too is reduced by the R17 500 but then if any net loss remains this is carried forward to be set off against a future net capital gain as a net loss cannot reduce taxable income.

A well-considered, carefully constructed *inter vivos*, non-vesting, discretionary trust structure is very effective in achieving asset protection and estate planning. Trusts provide an effective mechanism to minimise the costs on death, such as estate duty, executor's fees and even capital gains tax. They can also provide protection to minor heirs. Trusts can also be very tax efficient considering the well-established 'conduit principle'<sup>52</sup>. The downside of trusts however is that they are often not correctly administered and then the benefit of the asset protection and estate planning which was sought after in creating the trust structure in the first place, are lost.

## 2.9 Donations Tax and Estate Duty

Although a detailed study of donation tax and estate duty tax falls outside the scope of this dissertation it is of relevance to consider these briefly from a capital gains tax and an estate planning point of view. Estate duty is also further discussed in chapter 3.

Donations tax, was introduced into South African tax legislation in 1955 by means of amendments to the existing Income Tax Act. It was aimed at inhibiting the avoidance of income tax and estate duty, and was never intended to raise revenue *per se*. Tax was made payable on the cumulative value of donations made by a taxpayer after March 1955. The drafting of donations tax into our income tax legislation was presumably a convenient way to make the many definitions and administrative provisions of the Income Tax Act applicable to donations tax as well.

A donation is defined in section 55(1) of the Income Tax Act as:

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

The Estate Duty Act no.45 of 1955 replaced the Death Duty Act on the 1st of April 1955. Its structure is generally based on the part of the Death Duties Act that levied estate duty

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<sup>52</sup> The application of this principle, read together with Section 25B of the Income Tax Act, in respect of income, and paragraph 80(2) of the 8th Schedule, in respect of capital gains, can provide further tax efficiencies in the form of the so-called income and gain splitting under appropriate circumstances.

on a deceased estate. The provisions relating to succession duty,<sup>53</sup> which was introduced by the Death Duties Act no. 29 of 1922, were not re-enacted, although some of the characteristics were retained in the form of relief in respect of the surviving spouse and children as well as progressive tax rates. Therefore, the Estate Duty Act no. 45 of 1955 levies a transferor-based estate duty on the deceased estate, not on the inheritance acquired by the heir.

When the bill was read in parliament, the then Minister of Finance said:

‘...die belangrikste aspek van hierdie boedelwetsontwerp is die afskaffing van suksessiereg...Dit is omrede die baie moeilike en ingewikkelde probleme wat gepaard gaan met die aanslaan, en die invordering van suksessieregte. Daar is ‘n ernstige tekort aan personeel in die Meesterskantoor, waardeur ernstige vertraging plaasgevind het met die afhandeling van boedels, wat groot ongerief veroorsaak het, nie alleen vir die eksekuteurs nie, maar ook vir die erfgename’.<sup>54</sup>

With reference to the above, the then Minister remarked that he would personally have favoured the retention of the succession duty, rather than have estate duty, as there were numerous difficulties experienced in the area of limited interests in, and the bare dominium of, property. Although there were objections raised in respect of the Estate Duty Act replacing the Succession Duty Act, the bill was passed effective to persons dying on or after the 1<sup>st</sup> of April 1955.

The impact of donations tax and estate duty should be taken into account by any tax planner when making considered decisions on the use of any limited right in his tax planning strategy.

Chapter 3 provides an overview of various types of limited interests before the discussion in chapters 4 and 5 which deal with the comparison of the tax effects of a usufruct held by an individual compared to the use of a trust to achieve the same result.

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<sup>53</sup> The Succession Act 23 of 1874, provided that no legitimate portion will be claimable of the right by any one out of the estate of any person who dies after the commencement of this Act. It further provides that a testator will have the full power to disinherit any child, parent, relative or descendant without assigning any reason for such disinheritance.

<sup>54</sup> Volksraad Debatte 89, (1955) 7236.

## CHAPTER 3

### 3. Limited interests in general

An interest in immovable property, such as land or a building, is a limited real right that is a registered right which one person has over the property of another person<sup>55</sup>.

There are two categories of real right, namely:

- a) ownership rights and
- b) limited rights

A real right can be distinguished from a personal right, which is a right which confers upon its holder the capacity to claim something from another person.

Limited rights include;

- a) a fiduciary right,
- b) a usufruct, (also includes a usus and habitatio)

And even may include:

- c) a bare dominium, and
- d) an annuity

This is important for the purposes of this study as the capital gains tax legislation merely refers to these 'types of assets'. Chapter 4 of the Capital Gains Tax guide, in section 4.1.2 deals with the definition of assets for Capital gains tax purposes and was discussed in chapter 2.4.

Limited interest transactions are subject to income tax, estate duty, transfer duties, capital gains tax (CGT) and even secondary tax on companies (STC) as they are assets or property. Different taxes apply in different instances, and the methods of valuing a limited interest for taxation purposes may be extremely complex. The way a limited interest is

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<sup>55</sup> *Ex Parte Geldenhuys*, 1926, OPD 155 and *Registrar of Deeds (Tvl) v. The Ferreira Deep Ltd*, 1930, AD 169.

taxed, depends on the nature of the right involved and the circumstances surrounding the transaction or disposal which could take the form of a sale, donation, distribution upon death or distribution to a beneficiary of a trust.

### 3.1 Fiduciary rights

There are two types of fiduciary rights, namely *fideicommissum* and *fideicommissum residui* as set out below:

a) In *fideicommissum*, an asset is bequeathed to a person or a spouse on condition that it must pass to someone else or the children upon the survivor's death. The *fideicommissary* (holder of the right) has the same rights as a usufructuary (discussed in 3.2). The *fideicommissum* involves a succession of interests, not concurrent interests of the owner and user or trustee and beneficiary.<sup>56</sup>

b) In the case of a *fideicommissum residui*, the surviving spouse, for example as the *fiduciary* may use some of the asset capital, on condition that, says, a minimum of 25 percent passes on to the children who will inherit the asset after the death of the spouse.

Fiduciary rights were often bequeathed in the past, but it is not particularly effective in practice,<sup>57</sup> as they have more disadvantages than benefits to be really functional. A *fideicommissum* which means 'to leave a faithful person in charge' enables you to leave a benefit to a beneficiary on condition that, after the death of that beneficiary (also known as the *fiduciary*); the benefit is passed on to another beneficiary (the *fideicommissary*). Unlike a usufruct, if the *fideicommissary* dies before the *fiduciary*, full ownership passes to the *fiduciary*.

For example, you bequeath your house to your spouse (the *fiduciary*) and, on his/her death, to your child (the *fideicommissary*). Your spouse becomes the owner of the asset, but his/her right to use the asset for security against a loan or dispose of the asset is restricted.

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<sup>56</sup> *Braun v Blann & Botha NNO & another*, 1984, (2) SA 850 (A) at 859.

<sup>57</sup> Abrie, W. and others. 2001, *Estate Planning and Administration*, 4<sup>th</sup> Ed, V&R Printing Works, Pretoria, page 70, paragraph 4.3.4.

C.J. Langenhoven said the following about fideicommissum: ‘Verbind jou kinders se erfenis onder fideikommiss en die vreemde wat jy daaruit will hou sal dit des te goedkoper kry ter wille van die las wat daarop is.’<sup>58</sup> (Tying up your children’s inheritance with a fideicommissum, the stranger from whom you meant to exclude it will obtain it even more cheaply as a result of the burden upon it.)

Under South African law, the duration of a fideicommissum is limited to two successive fideicommissaries. Some hold the view that the fideicommissary does not have a vested right during the existence of the fideicommissum, but only a *spes fideicommissi*, where others submit that the interest should be categorised as a personal right. There are however two divergent views in the nature of such a right. One view is that the fideicommissary has a vested personal right against the fiduciary that is subject to a resolutive condition, for example, if the fideicommissary dies before the condition has been fulfilled. The other view is that where the fideicommissary’s right is subject to a suspensive condition it is therefore contingent until the condition has been fulfilled. Both views explain why the personal right of the fideicommissary who dies before the fulfilment of the conditions cannot be transferred to his or her heirs as the final owner has already been determined.

A fiduciary right is valued by taking the market value of the asset (the subject of the right) and multiplying it by 12 percent to get the annual value. The annual value is then multiplied by a factor which represents either a life expectancy or a fixed period, as per Table A or B (as per annexure A). The main difference between a *fideicommissum* and a usufruct is that the *fideicommissum* has no bare dominium (see 3.3).

### 3.2 Usufruct

The term ‘*usufruct*’ is derived from the Latin words ‘*usus*’ (‘use’) and ‘*fructus*’ (‘enjoyment’). An usufructs grant someone a limited right to use another person’s property with the stipulation that eventually the property must be returned to the residuary heir (the person that holds the ‘bare dominium’ and who will eventually inherit the asset). It may be movable or immovable, corporal or incorporeal.

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<sup>58</sup> Jordaan, J.H. and others. 1988, *Estate & Financial Planning A Practical Guide*, Old Mutual Printing Works, Cape Town, page 36, paragraph 3.8.2.

There are different types of usufructs which are all basically valued in the same way. These include a *usus*, a *habitatio* and the ordinary usufruct:

A *usus* is a personal servitude similar to a usufruct, but the holder's rights are far more restricted. The use of the property is limited to personal use by the usufructuary (the person who holds the *usus*). The holder of a *usus* cannot rent out an asset that is part of the *usus* agreement. The holder of the *usus* may, for example, only take fruits of the property for his or her household's daily needs, but nothing in excess of that. Furthermore, the fruits may not be sold.

A *habitatio* (Latin for 'dwells') has since time immemorial been recognized as one of the personal servitudes which confers on its holder the right to live in another person's house. The agreements give a person the right to live on a property for a specific period of time and the holder may lease or sublease the property. A person who has been granted habitation cannot sell or cede his or her right to another person.<sup>59</sup>

The best-known limited interest structure is '*a usufruct*'. A usufruct is a personal servitude providing the usufructuary with a limited real right to use another person's property and to enjoy the fruits thereof, subject to the obligation to return the property eventually to the owner, having preserved its quality substantially. Although a usufruct is usually employed as an estate-planning tool, it can also be used to reduce tax. Usufructs are associated with wills because they are usually created by means of a will; however a usufruct can also be created during the estate owner's lifetime and be used to reduce the value of his/her estate for estate duty purposes.

The concept of usufruct is a very old and established custom, especially in the farming community to provide for a surviving spouse's needs. A usufruct is created when a testator gives a right to the income of an asset to a person, and the right of ownership (bare dominium) to someone else or retains the '*bare dominium*' for himself. It grants the usufructuary a limited interest over the asset in such a way that they may use and enjoy the

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<sup>59</sup> Cameron, B. 2005, Personal Finance magazine, 1<sup>st</sup> Quarter Ed.

fruit but may not alter the nature of the property until the usufruct expires, normal wear and tear excluded.

The holder of the bare dominium is the 'ultimate' or eventual owner of the property, but his rights are limited by the usufruct. The usufructuary, on the other hand, never becomes the owner of the property.<sup>60</sup> The usufructuary rights include any income generated by an asset, such as the produce of a farm, the annuity paid on an investment, the rental from a property or dividends from shares. It can also include the mere occupation of a property.

The usufructuary has the use of the property but may not sell, pledge or take a loan against the asset. Bare dominium or ownership of the asset lies with another person, who will acquire full ownership of the asset when the usufructuary's right ends. The bare dominium holder has no control or use of the asset until such time as the usufruct has ended. When a usufructuary dies the usufruct will revert back to the bare dominium holder who then owns the property in full and can then have the benefits and also enjoy the fruits of the property. If the bare dominium holder dies, the usufructuary does not acquire the bare dominium, unless the bare dominium holder has left the bare dominium to the usufructuary in terms of his or her will.

Once a usufruct is created it may become necessary to value the usufruct. In *C:SARS v Estate Late JM Klosser*, 2000, 63 SATC 93, the Cape Provincial Division considered what basis should be used to value a usufruct. At that time it was assumed that an asset, out of which the usufruct is created, could produce a return of 12 percent per annum.<sup>61</sup> In *C:SARS v Klosser*, a testator had bequeathed the residue of his estate, mainly shares, to his surviving spouse through a trust, but awarded a vested interest of a usufruct, in the income of the trust to his wife.

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<sup>60</sup> Abrie, W. 2009, *Deceased Estates*, 7th Ed, V&R Printing Works, Pretoria, page 74.

<sup>61</sup> Meyerowitz, D. 2007 – 2008, *The Taxpayer – Meyerowitz on Income tax*, The Taxpayer, Cape Town, paragraph 39.6.4.

The provisions of the trust deed provided that:

1. the surviving spouse was entitled to the net income of the trust until her death, and
2. the trustees could, at their sole discretion release as much of the trust capital as the spouse together with her private income required, to maintain the standard of living to which she was accustomed.

The creation of a usufruct in favour of a surviving spouse falls under section 4(q) of the Estate Duty Act. In terms of section 4(q), any benefit accruing to a spouse of the deceased is deductible from the gross estate of the deceased.

In *Klosser's* case SARS was satisfied that the share portfolio (which gave rise to the usufruct) could not reasonably yield a return of 12 percent and determined that a rate of 2, 5 percent be used and thereby reduced the value of the deduction under section 4(q).

Usufructs are considered 'property' of a person, and the value of a usufruct is calculated in accordance with section 5 of the Estate Duty Act as follows:

- a) determine the capital value of the asset,<sup>62</sup>
- b) calculate the annual value of a right equal to 12 percent of the capital value, and
- c) then capitalise the annual value of a right by discounting it over a person's life expectancy or over a specific period.

Special tables are used for calculating the value of a limited interest. Table A (see Appendix A) is used when the value of a right is based on a person's life expectation. Table B (see Appendix A) is used when the value of the right must be determined over a certain period of time. If the person's life expectancy is unknown or in the future, (for instance unborn heirs), a period of 50 years and Table B must be used.<sup>63</sup> For calculations in

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<sup>62</sup> For agricultural land, Land Bank value can be used.

<sup>63</sup> Estate Duty Act 45 of 1955, section 5(1)(b).

respect of trusts, companies and close corporations a period of 50 years must also be used.<sup>64</sup>

There is an extensive advantage of using usufructs, in that they can provide a surviving spouse with some form of security upon the death of the other spouse. The usufruct enables the surviving spouse to make use of the asset, while leaving the asset/bare dominium to the children, for example. The spouse's usufruct is deductible in the estate of the deceased and is a distinct advantage in that estate duty is reduced. The creation of a usufruct in favour of a spouse is also covered by paragraph 67 of the Eighth schedule to the Income Tax Act, in that any gain or loss arising from a bequest to a spouse is disregarded for capital gains tax purposes on death (see chapter 4).

A usufruct has an important disadvantage, in that the usufructuary will be taxed on all income derived from the asset. However, if a trust were to be created the surviving spouse could be granted the same user privileges, and it could be stipulated that a certain portion of the income is to accrue directly to the minor children at the discretion of the trustees. An important tax advantage is that you can structure the arrangement so that it applies only to a part of the trust income hence splitting the income between more than one taxpayer.

### **3.3 Bare dominium**

The bare dominium refers to the right the owner holds over the property, which is subject to a usufruct. This right is one of ownership without any other rights.<sup>65</sup> Where the person holds property which is subject to a usufructuary or other like interest, section 5(1)(f) of the Estate Duty Act provides that the value of that property, referred to as the bare dominium, shall be the amount by which the fair value of the full ownership of the property exceeds the value of such interest. Therefore the bare dominium value will be the fair market value of the full ownership of the property less the usufruct (as calculated above) or annuity (see 3.4).

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<sup>64</sup> Ibid, section 5(3).

<sup>65</sup> Huxham, K. and Haupt, P. 2009, *Notes on South African Income Tax*, 28th Ed, H&H Publications, Cape Town, South Africa, page 535.

Where the property is subject to any interest other than a usufructuary interest or an annuity charged against property, such an interest, be it a usus, habitation or grazing rights the value is determined by capitalising the amount considered by the Commissioner as reasonable as representing the yield from such an interest over the life expectancy of the person who is entitled to receive such interest, or, if it is to be held for a lesser period, over such lesser period and deducting this from the fair market value of the property.

In the case of the expectation of life of a person other than a natural person, the annual value must be capitalized over a period of fifty years.

Upon death the bare dominium interest is transmissible to the testate/intestate heirs by normal succession or bequest, unlike a usufruct interest which is not transmissible to the heirs.<sup>66</sup> Unless the usufruct on creation was to be passed on to the heirs or another usufructuary before being extinguished.

### **3.3.1 Massing of estates**

It is beyond the scope of this work to develop a full discussion on the background and legal nuances of massing.

For the present purposes a massing can be summarised as occurring when, two or more parties, in a joint will, usually spouses, consolidate their property or part of their property into one massed estate. Massing is not limited to the estates of spouses, and can take place between unrelated parties.

It is important to consider how the creation of a usufruct and a bare dominium operates in these circumstances.

(a) In essence 'massing' is an agreement between two people, generally spouses, to distribute their estates on the death of the first dying, to named beneficiaries and to create a usufructuary interest in favour of the surviving spouse. The estate of the first

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<sup>66</sup> King, R. And Victor, B. 2006/2007, *Law and Estate Planning Easiguide*, chapter 17.2.

dying is taxed as if the massing had not occurred but the bare dominium of the property passes directly to the beneficiaries, i.e. the children, in terms of the agreement.

- (b) Therefore, there is effectively a donation to the children by the surviving spouse, say the wife in this example, of her interest in the bare dominium (her part of the massed estate). This is excluded from her estate when she dies at a later date simply because it is no longer her property.

In the case of *ITC 1448*, 51 SATC 58, spouses married out of community of property massed their estates. The residue of their estates was to be held in trust to pay the surviving spouse the income during the survivor spouse's lifetime and to pay the capital to certain beneficiaries on the survivor's death. On death of the testator, the residue of his estate amounted to R508 743. The value of her, the surviving spouse's, usufruct over the massed estate was, the value of the usufruct over her estate (R215 119) plus the value of the usufruct over the testator's estate (R496 205), being the total value of the usufruct of R711 324.

The Commissioner claimed donation tax on the basis that the value of the survivor's disposition to the massed estate was the amount of R508 743 less the value of her usufruct thereon amounting to R215 119, being R293 624.

The value of this donation is generally accepted to be the difference between the value of the usufructuary interests she bequeaths to the massed estate and the value bequeathed by the deceased. The aim of massing is to ignore the value of such donation, which is effectively the difference in value of the usufructuary interests which the wife succeeds to and the market value of the property.

The usufruct value is limited for two reasons:

1. On death of the spouse, the wife's estate will be valued on the basis of the usufruct ceasing. For this calculation the life expectancies of the children will be used, subject to a capping provision in that the value may not exceed the then market

value less the value of the bare dominium. Using the massing of estates can prove tax and estate efficient because the reduced taxes paid by both spouses is within the parameters as set out in the legislation.

2. There is a capital gains tax consequence for the children in that the value of the bare dominium, inherited on the death of the first dying spouse/parent constitutes the base cost of the property/asset. If the children ever sell the property, they will incur a capital gain of the difference between the proceeds and the base cost (without the inclusion of the usufructuary value) which could have crippling consequences when calculating any capital gains tax they may have to pay.

### 3.4 Annuities

As there is no definition for ‘annuity’ in the Income Tax Act or the Estate Duty Act it was left to the courts to decide. In *ITC 761* (1952) 19 SATC 103 the court outlined the characteristics of an annuity which are:

- it provides for a fixed annual instalment (can be broken up into instalments)
- the payment is repetitive and
- it is chargeable against some person (there is an obligation to pay)

Annuities need not be paid annually, they may be paid quarterly or even monthly. Annuities which are paid by a particular person from whatsoever source, creates a personal obligation.

Where the right to an annuity is transferred by means of a donation, the value thereof is valued in the same way as for a usufruct, fideicommissum or other like interest, except that the annual value is the annual amount of the annuity over the life expectancy of the donor, or if such a right is to be held by the donee for a lesser period, the lesser period.<sup>67</sup>

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<sup>67</sup> Section 62(1)(b) of the Income Tax Act. Also see Meyerowitz, D. 2007 – 2008, *The Taxpayer – Meyerowitz on Income tax*, The Taxpayer, Cape Town, paragraphs 31.53 – 31.55.

Annuities are treated the same way as other limited interests when calculating the expectation of life of a person other than that of a natural person; the annual value will be capitalised over a period of fifty years.<sup>68</sup> In the case where the property is subject to an annuity charged upon that property; the value of the annuity is determined by capitalising the value of the annuity at twelve percent over the life expectancy of the person who is entitled to receive such an annuity.

### **3.5 Usufructuary, fiduciary or other like interests donated**

Where a donation consists of a usufructuary, fiduciary or other like interest in property, its value is calculated in accordance with the provisions of section 62 of the Income Tax Act. The Act provides that the value is to be determined by taking the value of the property (subject to the limited interest) and capitalising this amount at twelve percent per annum to arrive at the value<sup>69</sup> of such right of enjoyment to the property over which the interest was held, and to the extent to which the donee becomes entitled to such right of the enjoyment with reference to the life expectancy of the donee. However, if it is to be held for a shorter period then the factor for the lesser period can be used. This would occur where the donee is older than the donor. In terms of the provision the annual value should be capitalised to the extent to which the donee becomes entitled to such a right. Where the interest is to be enjoyed for an uncertain period, the annual value must be capitalised over the life expectancy of the donor.<sup>70</sup> If it is required that a value be calculated based on the life expectancy of a person other than a natural person, namely that of a company or trust, then the annual value should be capitalized over a period of fifty years.<sup>71</sup> Section 62(2) of the Income Tax Act provides that, should the property subject to the right of the enjoyment consists of books, pictures, statutory or other objects of art, the annual value of the right of enjoyment shall be deemed to be the average net receipts, if any, derived by the person who is entitled to such a right of enjoyment to such property during the three years immediately preceding the date on which the donation took effect.

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<sup>68</sup> Section 62(3) of the Income Tax Act.

<sup>69</sup> The annual value should be determined by reference to the value of the full ownership of the underlying property. See section 62(2) of the Income Tax Act. The underlying property should be valued in terms of the general rule. See Meyerowitz, D. 2007 – 2008, *The Taxpayer – Meyerowitz on Income tax*, The Taxpayer, Cape Town, paragraph 31.44.

<sup>70</sup> Meyerowitz, D. 2007 – 2008, *The Taxpayer – Meyerowitz on Income tax*, The Taxpayer, Cape Town, paragraph 31.41.

<sup>71</sup> Section 63 (3) of the Income Tax Act. Also see Davis, D. and others. June 2008, Juts's. *Income Tax Act*, Volume 2, paragraph 62-2.

### 3.6 Usufructuary, fiduciary or other like interests on death

There are various tax implications that may arise when dealing with limited interests on death. For the person holding a limited interest, the value of the limited interest is determined, for estate duty purposes, according to the life expectancy of the person who becomes entitled to that interest.<sup>72</sup> This differs from donation in that for a donation a choice can be made to use the lesser of the donor or donee's life expectancy. The younger the successor, the greater will be the value of the interest in the estate. When creating a limited interest in the hands of the heirs nominated in a will, cognisance should be taken of the age of the parties who will be receiving such benefits. If the surviving spouse becomes a fiduciary or usufructuary in their old age upon the death of their spouse and the fideicommissary or the bare dominium holder is a natural person with a long life expectancy, such as that of a young child, grandchild, or an unnatural person, such as a trust (with a deemed life expectancy fixed at fifty years),<sup>73</sup> the estate duty consequences in the hands of the surviving spouse on death could be potentially punitive, because as the usufruct will be valued over the life expectancy of the younger person who will inherit the full value. Where such provisions are contained in a will it would be better to amend them to ensure that the complete asset without a usufructuary is left to a discretionary trust of which the desired parties are made beneficiaries. This is discussed in chapter 6.

Where a testator bequeaths property subject to fideicommissum, the value of the limited interest held by the fiduciary on his death is included in his estate,<sup>74</sup> unless the fiduciary held the interest for some lesser period or until the happening of some event which has already occurred.

The valuation of the limited interest for estate duty purposes obviously depends on the age of the successor at the date of death of the fiduciary or usufructuary. The older the successor is, the less the value of the limited interest. Therefore, the greater the saving in the estate duty will be by using this form of bequest.

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<sup>72</sup> Section 5 (1)(b) of the Estate Duty Act 45 of 1955.

<sup>73</sup> Section 5(3) of the Estate Duty Act 45 of 1955.

<sup>74</sup> In terms of section 3(2) of the Estate Duty Act.

In terms of section 11(a) of the Estate Duty Act the holder of the bare dominium to whom the advantage accrues is liable for estate duty in the event of a usufruct ceasing. Further, section 13 of the Estate Duty Act gives the executor the right to recover related estate duty from the bare dominium holder. In any economic climate individuals do not always have the available funds to pay the estate duty payable. This dilemma may be faced by many taxpayers and particularly taxpayers whose wealth is in illiquid assets, for example farmers. Individuals wish to preserve assets for their descendants, but also need to provide for their surviving spouse after their death. In situations like this a usufruct can prove to be a viable option, but it cannot be implemented in isolation. Consideration must also be given to funding of the estate duty liability that will inevitably arise on the death of the usufructuary.

### **3.7 An example of a usufruct and how it is used**

#### **Retention of a usufruct and selling of the bare dominium**

*Mr. A owns immovable property which is expected to show a substantial increase in value. Mr. A wishes to peg the value of the asset but wants to limit the costs of transferring the property into a trust as far as possible. He can achieve this through the sale of the bare dominium in the asset to the inter vivos trust and retaining the usufruct therein, either for his lifetime as the usufructuary or for a specific period, for example 15 years. The transfer duty payable on the sale is limited to the applicable rate on the bare dominium value instead of the full market value of the property as only the bare dominium is sold to the trust.*

*If, Mr A is currently 50 years old and owns a holiday home with a market value of R5 million. Should he sell the property outright to the trust, the transfer duty would be R400 000 ( $R5\,000\,000 \times 8\%$ <sup>75</sup>).*

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<sup>75</sup> For the purposes of this dissertation the transfer duty rate has been assumed to be 8% although the actual rates from 23 February 2011 for individuals and non-natural persons range from 0% on the first R600 000 to 8% on amounts above R1 500 000. If the amount was accurately calculated it would amount to R317 000. Previously disposals of immovable property were subject to a flat rate of 8% if the purchaser was a non-natural person.

*If he sells the bare dominium of the property to the trust on an interest free loan account and retains a usufruct over the property for a period of 15 years, the situation will be as follows:*

*Value of the usufruct:  $R5\,000\,000 \times 12\% \times 6,8109^{76} = R4\,086\,540$*

*Value of the bare dominium:  $R5\,000\,000 - R4\,086\,540 = R913\,460$*

*Transfer duty on the bare dominium will be:  $R73\,076 (R913\,460 \times 8\%)$*

*The trust accordingly owes Mr A R913 460 (value of the bare dominium sold to the trust)*

*The transfer duty of R73 076 is paid by the trust, as purchaser.*

*The value of the usufruct that Mr A retains is R4 086 540, and*

*The saving in transfer duty will be R326 923.<sup>77</sup>*

No donations tax will be payable as the bare dominium was sold at market value.

There will however be capital gains tax on the sale of the bare dominium which will be less than the capital gains tax on the market value if the full property had been sold. If the sale is not at market value, the market value would still be used as the proceeds because Mr A would more than likely be a 'connected person' of the trust. Capital gains tax is discussed in chapters 4 and 5.

### **Termination of the usufruct**

Should Mr A survive the 15 year period, the usufruct ends and the full ownership of the property vests in the trust. The trust is now the owner and Mr A may or may not be a beneficiary of the trust. As a result there will be no estate duty consequences in his estate except for any balance of the loan still owing to him by the trust at the date of his death.

*The termination of the usufruct will not be subject to capital gains tax as there are no proceeds and it has no market value when it comes to term.*

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<sup>76</sup> Factor per table B for 15 years.

<sup>77</sup> Calculation: market value R5 000 000 of full ownership  $\times 8\% = R400\,000$ , less the transfer duty on the bare dominium R73 076 = R326 924.

*If Mr A dies within the 15 year period, any outstanding balance on the loan account will be an asset in his estate. The value of the remaining portion of the initial 15 year term of the usufruct, calculated using the property's current market value will also be an asset in his estate.*

*By leaving the loan account and the usufruct to a surviving spouse they qualify for the section 4(q) of the Estate Duty Act deduction and the spouse will retain the usufruct for the remaining period, until the 15 year period is complete.*

*If the trustees decide to sell the property within that 15 year period, Mr A will have to agree to relinquish his right to the usufruct and should the trust not compensate him adequately for that, then the trust will be liable for donations tax on the market value less any amount paid by Mr A.*

*The trust purchased the bare dominium for R913 460 from Mr A, and that value is also the value used as the base cost for the trust. After the 15 years have expired and the full ownership in the property vests in the trust, there will have been no addition to the base cost expenditure. Should the trust decide to sell the property for R7 million then the R913 460 will remain the base cost for capital gains tax purposes.*

*The success of the plan depends on the age of Mr A, the period for which the usufruct is retained, the annual value of the growth asset and the retention of the property by the trust. (In the case of CIR v Klosser's Estate it was found; where the yield on the property has to be the actual yield over the preceding three years and if there is no income from the property the usufruct value could be zero).<sup>78</sup>*

Taxpayers are to be aware of any one-year usufructuary interest schemes.<sup>79</sup> In the Tax Proposals 2009/10, published by CSARS, the following was said:

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<sup>78</sup> Harris, D. 2009, 'Estate Planning Essentials', Glacier by Sanlam, volume 20.

<sup>79</sup> Divaris, C. 2009, 'One- year usufructs', Tax Planning Corporate & Personal, Tax Planning, Lexis Nexis, Durban, volume 23 no.1.

‘One-year usufructuary interest schemes:

A commonly known one-year usufructuary scheme exists in the market that allegedly undermines the estate duty. This scheme involves the estate duty-free transfer of a life-time usufructuary interest to a spouse, with the children receiving the bare dominium.

On the death of the spouse, the usufructuary interest is transferred with a one-year interest going to a person, after which the remaining rights transfer to the intended heirs. The scheme essentially relies on the misapplication of the 12 per cent per annum valuation presumption in the context of a one year interest. This scheme will accordingly be closed.’

Those who are currently relying on such arrangements must take careful note of recent or even forthcoming amendments.

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## CHAPTER 4

### 4. Limited Interests (Individuals) and Capital Gains Tax implications

The previous chapter examined the nature and tax effects of the various limited interests. The next two chapters will examine the capital gains tax implications of limited interests for both individuals and trusts.

#### 4.1 Individuals

The introduction of capital gains tax into our South African tax system in 2001, which provided for a deemed disposal of all the deceased's assets to his or her deceased estate at the date of death, has awakened the speculation that estate duty may be abolished in the not too distant future.

A deceased person must be treated as having a deemed disposal of his or her assets at the time of his or her death in terms of paragraph 40(1) of the Eighth Schedule to the Income Tax Act. The deceased estate is also treated as having acquired the assets at a cost equal to the market value at that date.<sup>80</sup> Although the term 'market value' itself is not defined in the Income Tax Act, part V of the Eighth schedule includes a provision that provides us with guidelines on how we can determine the market value.

Paragraph 31(1)(d) provides that the market value of 'a fiduciary, usufruct or other similar interest in any property' is: 'a amount determined by capitalizing at 12 per cent the annual value of the right of enjoyment of the property subject to that fiduciary, usufructuary or other like interest..... over the expectation of life of the person to whom that interest was granted, or if that right of enjoyment is to be held, for a lesser period than the life of that person, over the lesser period.' This valuation is the same as that used in the Estate Duty Act. When a usufruct ceases because of the death of the usufructuary the bare dominium holder attains full ownership of the property without any restrictions.

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<sup>80</sup> Paragraph 40(1) of the Eighth Schedule to the Income Tax Act.

#### 4.1.1 Paragraph 40(1) of the Eighth Schedule

In terms of paragraph 40(1) a deceased person must be treated as having disposed of his or her assets to his or her estate for proceeds equal to their market value on the date of his or her death.

Capital gains tax is payable on the difference between the base cost of the asset and its market value at the date of death in the last tax return of the deceased.

Capital gains tax implications:

Having disposed of all his or her assets on death, the deceased estate has a value equal to the market value of those assets at the time of death. The deceased estate, in turn will be treated as having acquired the asset from the deceased at cost equal to the market value, which cost must be treated as an amount of expenditure actually incurred and paid for the purpose of paragraph 20(1)(a) of the Eighth Schedule. The deceased estate is a *person* for the purpose of the Income Tax Act and will be taxed separately in its own right for capital gains tax purposes. The Eighth schedule provides a roll-over relief for spouses as mentioned in chapter 2.3 (Capital Gains Tax principles) and certain other exclusions which are beyond the scope of this dissertation.

In paragraph 40(2) of the Eighth Schedule where an asset is disposed of by a deceased estate to an heir, the deceased estate is treated as having a disposal of that asset for proceeds equal to the base cost in respect of that asset. The heir on the other hand must be treated as having acquired the asset at a cost equal to the base cost of the deceased estate in respect of the asset. The cost is treated as an amount of expenditure actually incurred and paid<sup>81</sup>. The application of paragraphs 40(1) and 40(2) are illustrated in an example in chapter 6.4 to highlight its operation.

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<sup>81</sup> See paragraph 20(1)(a) of the Eighth Schedule of the Income Tax Act no. 58 of 1962.

#### **4.1.2 Interrelationship of Estate Duty, Capital Gains Tax and Donations tax**

##### **Estate duty implications:**

The Estate Duty Act<sup>82</sup> applies to the estates of all deceased persons who are resident in South Africa at the time of their death. The Estate Duty Act also applies to non-residents to the extent that such a person has assets in South Africa.

For the purpose of the Estate Duty Act in terms of section 3(2)(a) and (b) property includes a fiduciary, usufruct or any other like interest in property. A person's estate consists of the following:

1. all property of the deceased at the date of death, and
2. all property that is deemed to be property of the deceased at the date of death.

Estate duty may arise on date of death. The deceased is also deemed to have disposed of his or her assets on the day before death, for capital gains tax purposes. Property of the deceased includes limited interests and these in turn are assets for capital gains tax purposes.

##### **Donations tax implication:**

Donation tax<sup>83</sup> is payable on property disposed of under any donation by any donor who is a resident in South Africa. Donation tax is levied at a rate of twenty per cent. An individual may make a donation of up to R100 000 per annum without attracting any donation tax. Donations of property are also subject to capital gains tax. Donations to spouses are exempt from donations tax and free from capital gains tax as the roll over rule will apply as discussed previously. Donations are therefore subject to capital gains tax and donations tax.

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<sup>82</sup> Estate Duty Act 45 of 1955.

<sup>83</sup> Donation tax was introduced in 1955 to prevent taxpayers from making donations that would have the effect of reducing the value of their estate for estate duty purposes and reducing their liability for the payment of income tax.

## 4.2 The bequest of a limited interest

Often people say that they would like their property to be bequeathed to their child, subject to their surviving spouse being able to live in the property until their death.

While usufructs and bare dominiums do provide certain continuity benefits, they also have estate duty and capital gains tax implications.

The person who sometimes suffers the most financially is the person who inherits the bare dominium and this is the very person who it was planned should benefit the most.

The best way to explain the impact of a usufruct and bare dominium is by determining the following:

### 1. The impact of the bequest for the deceased.

#### 1.1 Valuation of a bequest when calculating estate duty :

The creation of the usufruct in favour of the surviving spouse is covered by section 4(q); therefore the value is disregarded for estate duty. The full market value of the property is included in property and a deduction is given for the usufruct to the spouse. This means that the net result is that the value of the bare dominium bequeathed to the child will form part of the estate when determining any estate duty. However, if the deceased made no other bequests to people other than his surviving spouse and if the value of the bare dominium falls below R3,5 million then there will be no estate duty on the bequest, because of the current R3,5 million estate duty exemption.

#### 1.2 Valuation of a bequest when calculating capital gains tax:

The usufruct that was created in favour of the surviving spouse is covered by paragraph 67 of the Eighth Schedule to the Income Tax Act and any gain or loss arising from the bequest is disregarded for capital gains tax purposes, as it is regarded as a roll-over. While this seems to be an advantage in the deceased estate, it does transfer the capital gains tax liability of the estate to the surviving spouse.

However the problem here is what is the base cost rolled over? Is it nil? The reason for this question is that paragraph 40 of the Eighth Schedule to the Income Tax Act deems a disposal of the *asset* (which is the full value of the property) at date of death and this in turn is disposed of (flows through) at this same value, to the heir.

This implies that the surviving spouse has a roll-over of a limited interest, but at what base cost? Will it be with a nil base cost? This was extensively discussed by Jooste and Roeleveld<sup>84</sup> and they concluded that this may well be the case.

The vesting of the bare dominium in the child will constitute a disposal of the property. In terms of paragraph 40 of the Eighth Schedule to the Income Tax Act the value of the property from the estate is deemed disposed at a value equal to its market value at the date of death. This implies, applying the view of Jooste and Roeleveld, that it is the market value of the bare dominium only which flows out of the deceased estate. The deceased estate however has a base cost of the full market value of the property. The capital loss which occurs in the deceased estate may never be utilised if there are no capital gains against which it can be offset.

## 2. The valuation of a usufruct in the estate of the surviving spouse

### 2.1 The valuation of the usufruct when calculating estate duty:

The value of the usufruct in the hands of the surviving spouse is calculated according to the life expectancy of the person to whom the usufruct will pass. When the executor calculates the value of the usufruct in the surviving spouse's estate, the life expectancy of the inheriting child or bare dominium holder is taken into account. The younger the bare dominium holder, the greater the value of the usufruct would be in the surviving spouse/ usufructuary's estate. The expiration of the usufruct will not have any estate duty tax implications for the bare dominium holder at that point. Upon the death of the bare dominium holder the full market

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<sup>84</sup> Roeleveld, J and Jooste, R.D. 2002, '*The capital gains tax implications of the disposal of limited interests in property*', Acta juridica (University of Cape Town).

value of the property will be included in that estate as it is no longer burdened by the usufruct.

## 2.2 The valuation of a usufruct when calculating capital gains tax:

The termination of the usufructuary interest on the death of the surviving spouse should not give rise to any attribution of proceeds for capital gains tax purposes as the value at date of death should have diminished to nil.

Jooste and Roeleveld state the following;

‘Generally, when the base cost of an asset exceeds the proceeds on its disposal the resultant loss is available for set-off against the disposer’s capital gains in the year of assessment in question. However, paragraph 15(c) provides that in the case of any ‘fiduciary, usufructuary or other similar interest the value of which decreases over time’ which is ‘used for purposes other than the carrying on of a trade’, the loss must be disregarded. The same applies to a loss on the disposal of ‘any right or interest of whatever nature to or in’ such interest.<sup>85</sup>

In any event, as alluded to above, if the base cost is nil then there is no gain or loss.

## 2.3 The position for the bare dominium holder:

The problem facing the bare dominium holder is that the base cost of the property received is likely to be relatively low and this will then impact on the capital gains tax payable when the bare dominium holder eventually disposes of the said property in full.

When the bare dominium holder finally sells the property, capital gains tax will be paid on the difference between the proceeds received for the full value of the property less the base cost of the bare dominium at the date of death of the deceased.

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<sup>85</sup> Paragraph 15(f) of the Eighth Schedule to the Income Tax Act 58 of 1962.

### 4.3 The donation of a limited interest

#### Estate Duty

Donation is defined as being any gratuitous disposal of property, including any gratuitous waiver or renunciation of a right.<sup>86</sup> Property in the definition of ‘donation’ is defined as ‘any right in or to property movable or immovable, corporeal or incorporeal, wheresoever situated’.<sup>87</sup> The donation is the obvious method of shifting wealth from one person to another or from one generation to another, and hence avoiding or minimizing dying with an estate attracting estate duty. If a deceased person (in this example, the donee) received a usufruct by way of a donation, upon the donee’s death it will revert back to the donor. The usufruct will be included in the donee’s estate in terms of section 3(2)(a) of the Estate Duty Act. The value of the usufruct (received by way of donation) may be deducted from his estate in terms of section 4(g)<sup>88</sup> of the Estate Duty Act. This deduction will only apply if the deceased has obtained this right by way of a donation and will not apply if the right was obtained in any other manner, for example, by way of an inheritance.

#### Capital gains tax

The donation of a limited interest is seen as a disposal for capital gains tax purposes and the proceeds are deemed to be the market value of the asset at the date of disposal.

The donation of a limited interest is complex and is an area for further research. The complexity of this discussion was touched on by Jooste and Roeleveld<sup>89</sup>. In their article they discussed paragraph 31 (which determines ‘market value’ of a number of different assets) and whether it applied and how this application would affect the donor’s base cost. To determine the acquisition cost of the usufruct itself, we have to look at its base cost. To determine the base cost for the creation of a limited interest, the application of

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<sup>86</sup> Section 55 (1) of the Income Tax Act.

<sup>87</sup> Ibid.

<sup>88</sup> The net value of any estate shall be determined by making the following deductions from the total value of all property including there in accordance with section 3, that is to say- (g) the value of any interest included as property of the deceased under paragraph (a) of subsection (2) of section three where such interest was held by the deceased by virtue of a donation to him by the person to whom the right of enjoyment of the property in which the deceased held the interest, accrues or, where the interest consists of a right to an annuity charged upon property, by the person who is the owner of that property.

<sup>89</sup> Roeleveld, J, and Jooste, R.D. 2002, ‘*The capital gains tax implications of the disposal of limited interests in Property*’, Acta juridica (University of Cape Town).

paragraph 33 (which deals with part disposals) needs to be taken into account. 'It is possible that the donor may have acquired the limited interest by purchase, inheritance or donation. It is likely, however, that where a limited interest is an asset that is donated the donor owns the asset and donates a limited interest therein, and accordingly only such scenario will be dealt with...The statement that the usufruct has no base cost unless para 33 is applicable, must be qualified by the fact that the donations tax payable by the donor would be deductible from the market value in determining the capital gain... Again, in the absence of the application of para 33, the bare dominium will have no base cost other than any donations tax arising out of the donation.' In this article it is clear that in the absence of the application of paragraph 33, the bare dominium will have no base cost other than any donations tax that arose out of the donation made.

#### 4.3.1 The settlor as the taxpayer

As detailed in 3.5 there are various instances where the settler<sup>90</sup> who makes a donation, settlement or disposition in certain circumstances is taxed on the income arising in consequences of the settlement.

The words '*donation, settlement or other disposition*' have been interpreted in many cases to exclude any disposition of property that is wholly commercial or of a business nature, for example a sale at market value. There must be an '*element of gratuitousness*' for a transaction to fall within the ambit of the phrase 'donation, settlement or other disposition'.<sup>91</sup>

An interest free loan is regarded as a disposition in that the gratuitous element is that the trust or beneficiary does not have to pay interest.

Section 7 provides that for the income to be taxed in the hands of the settler it must be in consequence of the donation, settlement or disposition by the settler. In the case of *CIR v Widan*<sup>92</sup> the court held that the phrase 'by reason of' should be interpreted in terms of the

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<sup>90</sup> Paragraph 68 of the Eighth Schedule deems gains received by one spouse to be that of the other.

<sup>91</sup> *Joss v SIR*, 1980, (1) SA 674 (T), 41 SATC 206, and *Ovenstone v SIR* (1980) (2) SA 721 (A), 42 SATC 55.

<sup>92</sup> *CIR v Widan*, 1955, (1) SA 226 (A), 19 SATC 341, 1954, Taxpayer 224.

‘effective cause’ of income. This was also supported in *CIR v Berold*,<sup>93</sup> where an interest-free loan to a company was held to be a continuing donation of the interest that would have been raised on that loan. The income which arose for the benefit of the children was in the form of dividends, as the parent did not charge interest on the loan he had made to the company, allowing the company to earn profits which were then available for a dividend distribution to the children.

#### **4.4 The ceasing of a limited interest during a person’s life-time**

The ceasing of a usufruct constitutes a disposal for capital gains tax purposes whether the usufruct passes to another person or reverts to the bare dominium holder. Even if there is no “real” disposal, paragraph 11(1) of the Eighth to the Income tax Act provides that a disposal is any event or operation of law which would result in the creation or extinction of an asset<sup>94</sup>. The market value of the usufruct ceasing would be the same as for a usufruct ending at date of death; which would be nil as discussed in 4.2. ‘Paragraph 11(1), as mentioned above, provides that a disposal is ‘...any event ... or operation of law which results in the ... transfer or extinction of an asset...’ Also, paragraph 11(1)(b) includes within the meaning of disposal the ‘termination, ... discharge, ... [or] expiry ... of an asset’. The scope of the meaning of ‘disposal’ as indicated by this wording appears wide enough to include the lapsing of a fixed period usufruct.’<sup>95</sup>

##### **4.4.1 Paragraph 68 of the Eighth Schedule (attribution of capital gain to a spouse)**

Paragraph 68 of the Eighth Schedule provides that if a spouse has a capital gain, but that capital gain arose due to the other spouse’s trade or because of the other spouse’s donation, settlement or similar gratuitous disposition, then the gain must not be taken into account for capital gains tax purposes of the spouse who made the gain, but the gain must rather be taken into account by the spouse who carried on the trade or who made the donation, settlement or other disposition that gave rise to the gain in the first place.

Section 7(2) of the Income Tax Act deems the income of one spouse to be that of the other spouse to the extent that it is not self-earned, but arose as a result of a donation, settlement

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<sup>93</sup> *CIR v Berold*, 1962, (3) SA 748 (A), 24 SATC 729, 1962, Taxpayer 171.

<sup>94</sup> Paragraph 11(1)(b) also includes the termination or expiry of an asset.

<sup>95</sup> Roeleveld, J, and Jooste, R.D. 2002, ‘*The capital gains tax implicatiosn of the disposal of limited interests in Property*’, Acta juridica (University of Cape Town), page 93.

or disposition of that other spouse and the purpose was mainly to avoid or reduce tax.

#### **4.4.2 Paragraph 69 of the Eighth Schedule (attribution of capital gain to parent of a minor child)**

Paragraph 69 of the Eighth Schedule ensures that if a minor child receives any capital gains or assets from a trust and the calculated gain can be attributed to a donation, settlement or gratuitous disposition made by the child's parent, then the parent must account for that gain, for capital gains tax purposes, not the child. This aligns with section 7(3) of the Income Tax Act.

Section 7(3) of the Income Tax Act provides that if a minor child receives income as a result of a donation or gratuitous disposition by that child's parent, then that income is deemed to be that of the parent for income tax purposes.

#### **4.5 A loss arising on the disposal of a limited interest**

Generally when the disposal of an asset results in a loss, the loss is available to be off-set against other capital gains. However, paragraph 15(c) of the Eighth Schedule provides that in the case of any fiduciary, usufruct or other similar interest the loss on the disposal must be disregarded. However this only applies to an interest which decreases over time. Where the right or interest is used for the purpose of carrying on a trade, paragraph 15(c) will not apply as the interest does not necessarily decrease.

#### **4.6 The disposal of a limited interest by a non-resident**

The Eighth Schedule applies to the disposal of a limited range of the assets of a non-resident. Any disposal of limited interests in property by a non-resident is covered by paragraph 2 of the Eighth Schedule. Paragraph 2(1)(b) applies to the disposal by a non-resident of 'any interest or right of whatever nature of that person to or in immovable property situated in the Republic'.

A limited interest in immovable property was discussed earlier in chapter 2 and will be included as an asset for capital gains tax purposes in a non resident person's South African estate.

#### **4.6.1 Paragraph 72 of the Eighth Schedule (capital vesting in a non-resident)**

Paragraph 72 of the Eighth Schedule provides that a resident must take any capital gains into account which have been vested in a non-resident, if that gain is as a result of a donation, settlement or other gratuitous disposition originally made by that resident. Paragraph 72 does not apply to a person who made a donation, settlement or any other disposition to a trust before becoming a resident. Paragraph 72 of the Eighth schedule is similar to section 7(8) of the Income Tax Act and provides that any capital gain that has vested in a non-resident must be taken into account by the resident making the donation, settlement or any other gratuitous disposition. Therefore for paragraph 72 to apply, a donation must be made by a South African resident in consequence of which a gain is received by or accrues to a non-resident.

In terms of Section 7(8) of the Income Tax Act, if a South African resident makes a donation or an interest-free loan to a local or offshore trust and the beneficiary is a non-resident, the donor, South African resident, will be taxed on any amount that arises from that donation or interest-free loan.

## CHAPTER 5

### 5. Limited Interests (Trusts) and Capital Gains Tax implications

Trusts can be made very flexible and as a result be employed in very fruitful ways in *inter vivos* planning. Their advantages in many situations are obvious and they are fairly widely used to avoid some common pitfalls, which in many cases arise, when limited interests are bequeathed. The discretionary trust will often be the preferred vehicle. The obvious question which often arises is whether by making a bequest of a bare dominium to a trust, with the surviving spouse enjoying benefits under the trust deed, it will give rise to the same effect as the surviving spouse inheriting the limited interest directly?

#### 5.1 The beneficiary as the taxpayer (the trust distributes to the beneficiary)

##### Income

The trust deed may provide that any income received or accrued, for tax purposes, is to be that of the beneficiaries and they will be taxed accordingly. In the case of *Munro's Estate v CIR* (1928) TPD 693 it was held that even if income from a trust is not paid directly to the beneficiaries, but is expended by the trustee for their benefit, that income will be taxed in the hands of the beneficiaries themselves.

Section 7(1) applies where a beneficiary has a vested right to income in a trust. Although the beneficiary is certain to get the income at some time in the future, his enjoyment thereof is postponed. It was held, in the case of *CIR v Polonsky*,<sup>96</sup> that income of an *inter vivos* trust, which was re-invested for the benefit of the beneficiaries, should be deemed to have accrued to the beneficiaries in terms of section 7(1). It therefore followed that, where income which was accumulated from investing capital of a trust fund and re-invested for the beneficiary until she attained the age of thirty, that income had accrued to her and therefore should be taxed in her, the beneficiaries hands.

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<sup>96</sup> *CIR v Polonsky*, 1942, TPD 249, 12 SATC 11.

In *Armstrong v CIR* (1938) AD 343 it was held that income received by a beneficiary from the trust retained its nature. In this case the appellant received £2000 each year and claimed the s10(1)(k) exemption for dividends on the portion distributed to her that comprised dividends. Stratford CJ stated:

‘in the simple case I am now examining, namely, that of a trio comprising a company, the intervening trustee, and the beneficiary, it is manifest that in the truest sense the beneficiary derives his income from the company, for that income fluctuates with the fortunes of the company and the trustee can neither increase nor diminish it, he is a mere ‘conduit pipe’.<sup>97</sup>

The court held that the interposition of the trustee did not preclude the beneficiary from claiming the exemption on dividends distributed by the trust. It was also confirmed that the conduit pipe principle applies in *SIR v Rosen* (1971) (1) SA 172 (A), where Trollip stated that the court: ‘... found it unnecessary to decide whether the payment was an annuity; i.e. if it was in fact an annuity that would not have affected the conclusion’

However, the court also stated that the conduit pipe principle might not always apply as Trollip JA commented:

‘Thus a trust deed may empower the trustee with the discretion to pass on dividends to the beneficiary or to retain and accumulate them. If he decides on the latter, I think (but express no firm view) that the dividends might then lose their character and identity as dividends so that if subsequently paid out to the beneficiary they might possibly no longer be dividends in his hands for the conduit pipe turned itself off at a relevant time’.<sup>98</sup>

The court confirmed that dividends retain their character when they flowed through the trust, in section 10(2)(b). This subsection accepts that portion of an annuity can constitute a dividend, as it provides that ‘the said exemptions shall not apply in respect of any portion of any annuity’.

In the *Rosen* case it was stated as follow:

‘It follows that in my view the conduit principle operates for the purpose of section 10(1)(k)(ii) when the beneficiary is a deemed shareholder as defined in the Act, i.e.: ‘entitled to all or part of the benefit of rights of

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<sup>97</sup> *Armstrong v CIR*, 1938, AD 343, 10 SATC 1.

<sup>98</sup> At 140, 32 SATC 270.

participation in the profits or income attaching to the shares' registered in the trustees' name. It is that crucial phrase that can render a trustee under a trust agreement a mere conduit pipe in our present Act'.<sup>99</sup>

This submission, about the 'conduit pipe' principle in the *Rosen* case, has become particularly relevant insofar as trusts which trade are concerned. The attitude of Revenue is that the conduit pipe principle also applies to allowances even if this results in an assessable loss in the hands of a beneficiary of a trust.

### **Capital**

A capital gain arising from the disposal of a trust asset is subject to capital gains tax either in the hands of the trust or in the hands of a beneficiary per paragraph 80 of the Eighth Schedule. Trusts, except for special trusts, are subject to capital gains tax at a higher rate than individuals as highlighted in chapter 2.

The use of a trust as part of an estate planning process can effectively ensure that both estate duty and capital gains tax are avoided on the death of a planner.

Using a family home as an example: to protect the asset for the bare dominium holder and still provide the surviving spouse with the security of living on the property, it would be best to leave the bare dominium to either an *inter vivos* trust or to a testamentary trust. The trustees will then administer and control the property which would prevent the bare dominium holder from selling the house and thereby denying the usufructuary the benefit of a place to stay. If the whole asset is bequeathed to a testamentary trust and the beneficiary who has use of the property passes away then the trustees may distribute the whole asset to another beneficiary to do as he or she pleases with it. There would also be no transfer duty payable when the fixed property is bequeathed in terms of a will.

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<sup>99</sup> At 189, 32 SATC 268.

## 5.2 The nature of income from a trust

Before discussing the nature of income from a trust we need to look at the underlining assets which generate the income.

A trust can acquire assets in the following ways:

- a) by way of a bequest of assets to an existing trust, (settlement),
- b) by acquiring assets in terms of a last will and testament of a testator who forms the trust in terms of the will, (settlement),
- c) by acquiring assets from the planner by way of a purchase and sale agreement (if acquired on loan account which is interest free, then this will fall into the category of 'disposition'), and
- d) by acquiring assets from the founder or planner by way of 'donation'.

The major advantages of the trust, as an estate planning tool, may be summarised as follows:

- a) ease of formation and maintenance,
- b) low costs of formation and relative low cost of maintenance,
- c) flexibility, particularly when couched in the form of a discretionary trust,
- d) suitability, as a vehicle for overall administration and control of an estate, particularly after the planner is deceased, and
- e) suitability, as a vehicle for freezing or pegging the value of growth assets of an individual who chooses to sell or donate such assets to a trust.

It must also be remembered that a beneficiary of a trust is a connected person in relation to a trust<sup>100</sup> and transactions between the trust and its beneficiaries must take place at market value (paragraph 38 of the Eighth Schedule).<sup>101</sup>

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<sup>100</sup> Paragraph (b)(i) of the definition of 'connected persons' in section 1 of the Income Tax Act.

<sup>101</sup> Comprehensive Guide to Capital Gains Tax, (Issue 3), 6 May 2010.

### 5.3 Taxation of trust income

Trusts are taxed on income which accrues to or is received by them in terms of section 25B of the Income Tax Act in the following possible ways:

- a) as normal gross income, in which case the trust will be taxed, or
- b) in terms of section 7, in which case the 'donor' will be taxed, and
- c) where section 7 does not apply, the trust will be taxed on the income.<sup>102</sup>

As section 25B is subject to section 7, all income falling under section 7 is not taxed in the trust.

Paragraph 80 of the Eighth Schedule to the Income Tax Act is the equivalent of section 25B of the Income Tax Act but relates to the vesting of any capital pursuant the trust deed.

This has the following effect on a trust and trust beneficiaries:

- a) A beneficiary that acquires a vested interest in a trust asset acquires an asset for capital gains tax purposes.
- b) When a trust distributes an asset to a beneficiary that has a vested interest in the asset, the beneficiary exchanges his personal right in the asset (the vested interest) for ownership.
- c) A discretionary interest that a beneficiary has in the trust assets is an asset for capital gains tax purposes.

### 5.4 Disposal of an asset by a trust

A trust will have a disposal for capital gains tax purposes in one of two ways;

- a) either by concluding a transaction for disposal with a third party or,
- b) by vesting a trust asset in a beneficiary.<sup>103</sup>

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<sup>102</sup> Pace, R.P. and Van der Westhuizen, W. M. 2005, *Wills and Trust*, Butterworths, Durban.

<sup>103</sup> See paragraph 11(1)(d) of the Eighth Schedule.

It is to be noted that the trustees could vest the asset, the gain made on disposal of the asset, or even part or all of the proceeds from disposal of the asset.

On disposal of an asset a trust will become liable for capital gains tax unless a special rule applies to divert the capital gains tax liability to another person.<sup>104</sup> Paragraph 80(1) and paragraph 80(2) are subject to paragraphs 68, 69, 71 and 72 of the Eighth Schedule of the Income Tax Act which will shift the liability for capital gains tax to the person who made a 'donation, settlement or disposition' in the first place. The trustees may choose to distribute any capital gain to a beneficiary. If such a beneficiary is an individual it would prove tax efficient in that the effective rate would be less, as in the example in footnote 37.

## 5.5 Vesting

The definition of a 'vested right' is as follow; 'Right that has accrued, or is secured, to its possessor and is not contingent on any event that may or may not occur'.<sup>105</sup>

In our tax law, 'to vest', is 'to give an immediately secured right of present or future enjoyment'. One therefore has a vested right in an asset that cannot be taken away by any third party, even though one may not yet have possession of the said asset. When the right, interest or title to the present or future possession of a legal estate can be transferred to any other party, it is called a 'vested interest'. When dealing with property, 'to vest'; is 'to create an entitlement to a privilege or a right linked to that property'.<sup>106</sup> In a trust a vested interest gives a beneficiary far more certainty, in that a beneficiary with a vested right knows exactly what he or she can expect in the way of assets, income or benefits from the trust. Beneficiaries can have a vested interest either to income or capital, or both, depending on the terms of the trust deed.

A person has a vested interest if he is the owner of such an interest. This means that he has

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<sup>104</sup> Paragraph 80(1) and 80(2). Paragraph 80(1) applies when the resident beneficiary acquires an interest in an asset and paragraph 80(2) applies when the beneficiary receives the gain and not the asset.

<sup>105</sup> Business dictionary. 'Vested right, (Online), Retrieved 15 August 2011 from:

<http://www.businessdictionary.com/definition/vested-right.html>.

<sup>106</sup> Geach, W. and Yeast, J. 2007, *Trusts Law and Practice*, Juta & Co LTD, paragraphs 2.2, 2.3 and 4.5.

all the rights of ownership including the right of enjoyment.<sup>107</sup> To vest can also be used to draw distinction between certainty and contingency. This means that it is not necessary for the vested interest to be the equivalent of ownership. A personal right against the trustee is sufficient to be a vested right. If a beneficiary only holds a contingent right to income, it is not certain that he will ever receive that income and therefore no right can be said to have been vested and the beneficiary cannot be taxed on such income.

In *ITC 1328*<sup>108</sup> the donor had created separate trusts for each of his two daughters. The trust deed determined that the trust income would vest in the beneficiaries on their twenty-first birthdays. The trustees would however still have the discretion as to whether it should be paid out to the beneficiaries or not. The beneficiaries could not be certain that they or their estate would eventually receive the income. What transpired was that some income was paid to them and some of the income was retained and reinvested on their behalf. The income was deemed to have accrued to the beneficiaries in terms of section 7(1) and taxed in their hands. Therefore *ITC 1328* serves to clarify that a beneficiary will only be taxed once he or she is certain that he or she will receive the income.

The court had to answer the question whether or not the income had vested in the beneficiaries.

As to the meaning of the word 'vest', Milne J points out that:

'It is of course, trite that the word 'vest' bears different meaning according to its context. These are referred to in the well-known passage in *Jewish Colonial Trust LTD v Estate Nathan* 1940 AD 163 at 175-6. There Watermayer JA said this:

'Unfortunately the word 'vest' bears different meaning according to its context. When it is said that a right is vested in a person, what is usually meant is that such person is the owner of that right – that he has all rights of ownership in such including, the right of enjoyment. If the word 'vested' were always used in that sense, then to say that a man owned a vested right would mean no more than a man owned a right. But the word is also used in another sense, to draw a distinction between what is certain and what is conditional, a vested right as distinguished from a contingent or conditional right. When the word 'vested' is used in this sense Austin (*Jurisprudence* vol. 2 lect. 53) points out that in reality a right of one class is not being distinguished

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<sup>107</sup> Geach, W. and Yeats, J. 2007, *Trust Law and Practice*, Juta & Co LTD, paragraph 2.3.

<sup>108</sup> *ITC 1328*, 1981, 43 SATC 56, Taxpayer 86.

from a right of another class but that a right is being distinguished from a chance or a possibility of a right, but it is convenient to use the well-known expressions vested right and conditional or contingent right.’

It is clear from this case that a vested right may nevertheless be vested even though in some instances enjoyment of the right may be postponed. It is also clear that it is not a necessary consequence of vesting that the beneficiary has a legal right to claim payment or that the right in this case was not conditional. There was therefore no doubt, because according to the trust deed income would be paid either to the beneficiary or to her estate.

The time of ‘vesting’ is determined by the type of trust:

- a) In the case of a discretionary trust, the time of vesting is determined by the trust deed. Vesting takes place when the beneficiary’s interest is no longer contingent. For example, if the trustees have the discretion to distribute income to a beneficiary and they make a decision to distribute, that income will vest in the beneficiary at that point in time.
- b) In the case of a testamentary trust, the date that the vesting takes place will be determined by the provisions of the will. In *Hilda Holt Will Trust v CIR*,<sup>109</sup> for instance, the testatrix directed in her will that:
  - the residue of the estate was to be held in trust, and
  - an annuity of R1000 per month was to be paid from the trust income to her housekeeper. If required the income had to be supplemented from the capital. This was, however, a very remote possibility because the trust had sufficient income.
  - Upon the death of the housekeeper any residue was to devolve upon a number of charities.

As the three charities were tax exempt institutions it was of vital importance to establish whether they had a vested or discretionary right to the residue. If they had vested rights, then the income would be exempt in their hands.

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<sup>109</sup> *Hilda Holt Will Trust v CIR*, 1992, (4) SA 661 (A), 55 SATC 1, 1993, Taxpayer 32.

The Court held that where a will clearly contemplates that there would be a residue for distribution to the ultimate beneficiaries, there was no intention to postpone vesting. The court further held that the housekeeper's interest was of a usufructuary nature, and that being the case, a presumption arose that vesting took place in favour of the ultimate beneficiaries on date of death of the testatrix. It is therefore possible for an uncertain, but ascertainable, amount in the future to vest immediately. This would hold true unless the will contained indication that there is another time of vesting.

## **5.6 The trust as the taxpayer (the income is retained in the trust)**

Income received or accrued to a trust, which is not taxable in the hands of the beneficiaries or the trust settlor, will be taxable in the hands of the trust.

### **5.6.1 Paragraph 70 of the Eighth Schedule (attribution of capital gain subject to conditional vesting)**

In terms of paragraph 70, where a person made a donation, settlement or other disposition that is subject to certain conditions imposed by that person or anyone else in terms of which the capital gain, attributed to that donation, shall not vest in the beneficiaries of that donation until the happening of some event, then that capital gain must be taken into account by the donor in the calculation of his or her tax liability.

Also see section 7(5) regarding income as previously discussed in chapter 2 (2.6.1(d)).

### **5.6.2 Paragraph 71 of the Eighth Schedule (attribution of capital gain subject to revocable vesting)**

Paragraph 71 of the Eighth Schedule ensures that when capital gains are made, any person who has retained the power to decide as to who will be awarded these gains they will have to include the gains in their income for tax purposes. This paragraph aligns with section 7(6) of the Income Tax Act.

Section 7(6) of the Income Tax Act is an anti-avoidance provision that applies when a person seeks to avoid or reduce his or her tax liability by disposing of an income-

producing asset while retaining control over the income generated from that asset.

### **5.6.3 Paragraph 73 of the Eighth Schedule (attribution of income and capital gain)**

Paragraph 73(1) provides that where both income and gains are derived by reason of or are attributable to a donation, settlement or other gratuitous disposition, the total amount of that income and gain shall not exceed the amount of the benefit derived from that donation, settlement or other gratuitous disposition. Paragraph 73 of the Eighth Schedule is therefore a limiting provision, it limits the total amount of the income that is deemed to accrue to a person who has made a disposition in terms of Section 7 of the Income Tax Act and the capital gain accrued to him or her in terms of paragraphs 68 to 72 of the Eighth Schedule.

### **5.7 The sale of an asset where there is a vested right**

If a trust asset is sold and a beneficiary has a vested interest in the asset, the beneficiary with the vested interest must take any gain into account for their capital gains tax purposes. This will even be the case if the gain is accumulated or retained in the trust, as the asset is effectively disposed of for and on behalf of the person who has the vested right.

### **5.8 Trust retains the capital gain**

If a trust asset is sold and there are no vested rights, any capital gain not distributed to the beneficiaries, will be taxed in the hands of the trust. The trust does not qualify for the annual exclusion which is available only to natural persons and special trusts.<sup>110</sup> The trust will be taxable on its income at a tax rate of 40 per cent. Paragraph 10 of the Eighth Schedule provides that a trust has an inclusion rate percentage of 50 per cent of any capital gain. Therefore, the effective rate of capital gains tax on the gain will be 20 per cent of that gain. This paragraph aligns with section 7(5) of the Income Tax Act.

### **5.9 Capital gain distributed to beneficiaries**

If any capital gain is distributed to a beneficiary who is a natural person in the same year that the gain is realised, the consequence will be as follows:

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<sup>110</sup> Paragraph 5 of the Eighth schedule.

The beneficiary as a natural person qualifies for an annual exclusion rate.<sup>111</sup> For natural persons the inclusion rate percentage is 25 per cent of the net capital gain (after deduction of the annual exclusion) and not 50 per cent as it is for trusts.<sup>112</sup>

Individuals are taxed on a sliding scale whereas trusts are taxed at a fixed tax rate of 40 per cent. Therefore, the maximum effective rate of capital gains tax on the gain for individuals will be 10 per cent.<sup>113</sup> If the beneficiary is a company or a close corporation the effective rate of capital gains tax is 14,5 per cent.

It is evident that, transferring any capital gains tax gain to an individual is always more beneficial compared to such gain being taxed in the hands of a trust or corporate entity.

### **5.10 Offshore-trusts**

Without going into detail it is appropriate to mention offshore trusts. The taxation of an offshore trust is mainly governed by section 7(8), section 7(9), section 7(10), section 25B and paragraph 72 of the Eighth Schedule to the Income Tax Act.

Assets can be transferred to an offshore trust by means of a donation or in terms of an outright sale at market value.

Section 25B<sup>114</sup> is dealt with in chapter 2.7 and 4.6.1 and paragraph 72 is dealt with in 4.6.1.

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<sup>111</sup> Paragraph 5 of the Eighth Schedule.

<sup>112</sup> Paragraph 10 of the Eighth Schedule.

<sup>113</sup> Even if the beneficiary is a natural person with a tax rate of 40 per cent, the effective rate will still be less than 10 per cent, because of the annual exclusion of R 17 500 which is applicable to a natural person per annum.

<sup>114</sup> See chapter 1 (1.9) page 36.

## CHAPTER 6

In this chapter a number of examples<sup>115</sup> are provided for clarity and to demonstrate the monetary impact of the law when applied to the said scenarios. The paragraphs referred to in these examples are from the Eighth Schedule to the Income Tax Act.

### 6.1 Comparison between a usufruct held in a trust or held by an individual

To better explain the difference between assets being held by a testamentary<sup>116</sup> income beneficiary verses the assets being held by a usufructuary, we will consider the following example:

Mr. Allie and Mr. Louw were both married out of community of property and both their estate assets comprised of a house, some furniture, a motor vehicle, shares and cash. In both Mr. Allie and Mr. Louw's case the surviving spouse was given the right of use of the assets in the estate.

In Mr. Allie's case he bequeathed his entire estate to his children, subject to the lifelong right of use for his spouse. Mr. Louw bequeathed his entire estate to his children as beneficiaries and stipulated that their inheritance be controlled by the trustees in trust, subject to the condition that his spouse would be entitled to the full income from the assets, the right to occupy the house and the right to the use of movable assets until her death.

In the estate of Mr. Allie the usufructuary is personally responsible for the payments of rates and taxes and the normal maintenance costs of the usufruct assets. The usufructuary will not be personally liable for repairs owing to normal wear and tear. The usufructuary has no right of alienation of the usufruct assets, unless this is done with the consent of the eventual heirs, the children. The risk is that the assets in the name of the usufructuary could easily become mixed up with the spouse's personal estate and at the time of her death they will then form part of her estate assets. The children would have to submit claims for their

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<sup>115</sup> Williams, R.C. 2005, *Capital gains tax – A practitioner's manual*, 2nd Ed, Juta & Co LTD, paragraph 29.1 and The ABC of Capital Gains Tax of Individuals guide by the South African Revenue service.

<sup>116</sup> The testamentary trust or the trust *mortis causa* is created on death of the individual by the will.

inheritance, which would be distributed only once her estate has been wound up. Another risk is that there might not be sufficient assets in the estate to distribute the inheritance in full.

On the other hand, in Mr. Louw's case, the estate will be handed to the trustees of a testamentary trust who will control and invest them in the name of the trust. If the spouse does not want to stay in the house, the trustees will be able to rent it out. The trustees will be responsible for paying the expenses of the trust, including any repairs and short-term insurance premiums. All such expenses can be paid from the available funds in the trust itself.

All transactions are performed by the trustees in the name of the trust. It is very important that where assets are transferred to the trust, that sufficient funds be made available to cover the expenses and the relevant fees required in operating the trust. It is also considered wise to bequeath movable assets, such as furniture, vehicles and firearms, to a specific person and not to place them in the trust because the cost of the administrative burden would outweigh any possible income from these immaterial movable assets.

In both the abovementioned cases the objective is the same. Both the spouses are entitled to the net income and to use all movable assets and occupy the property. In both cases the value of any rights may be deductible for estate duty purposes. The most important difference is that the usufructuary in the estate of Mr. Allie's will have personal control over the assets and will be liable for any possible risks; but no trust fees will be payable. In Mr. Louw's case, the major assets will be held in the trust and will be controlled by the trustees for a fee but with virtually no risk.

## **6.2 Example of the valuation of a usufructuary right when passing from one person to another**

*Facts: B held a usufructuary right to a property worth R70 000 immediately before B died. On B's death, the usufruct passes to C, who is a woman aged 39.*

Calculation:

*Annual value of property:  $12\% \times R70\ 000 = R8\ 400$*

*Present value (PV) of R1 a year for C's life, which will be turning 40 on her next birthday  
= 8.18386*

*PV of R8 400 a year for life:  $8.18386 \times R8\ 400 = R68\ 744$*

*Value in B's estate = R68 744*

*(C can be expected to live for another 20 years).*

### **6.3 Example of the value of a usufructuary right which ceases**

Facts: *X, a woman, held a usufructuary interest immediately before her death. The usufruct ceases on X's death, and Y, a male bare dominium holder, acquires full ownership. The value of the property was R35 000 when Y acquired the bare dominium, and its value was R70 000 when he acquired full ownership. X was 46 years old when she acquired the usufructuary interest. Y was 39 years old when X died.*

Calculation:

*a) First the value of the usufruct must be arrived at.*

*Annual value of property:  $12\% \times R70\ 000 = R8\ 400$*

*PV of R1 a year for Y's life, who will turn 40 on his next birthday = 8,04030*

*PV of R8 400 a year for life:  $8,04030 \times R8\ 400 = R67\ 538$*

*(Note: The capitalised value may not exceed the difference between the present market value of the property and the value of the bare dominium when it was first acquired/assume after the 1 of April 1977.)*

*b) Then the value of the bare dominium is calculated.*

*Annual value of property:  $12\% \times R35\ 000 = R4\ 200$*

*PV of R1 p.a. for X's life, who would have turn 47 on her next birthday = 8, 031 19*

*PV of R4 200 a year for life: 8, 031 19 x R4 200 = R33 731*

*Value of bare dominium when acquired: R35 000 – R33 731 = R1 269*

*Present market value of property = R70 000*

*Difference: R70 000 – R1 269 = R68 731*

*Value of usufructuary interest in X's estate = R68 731(see (b))*

The above calculations show that:

- in (a), the value of the usufruct acquired by X at the date of death of Y, is R67 538, and
- in (b), the value of the bare dominium is R68 731.

Both are approximately the same value proving that both calculations are fair in that the value of the total property (Market value less that already held by X) is close in value to the present value of future returns.

#### **6.4 Example where a usufruct is created on the death of a person**

The following example is extracted from the Comprehensive guide to Capital Gains Tax (Issue 3). Some adjustments to the context were made<sup>117</sup>.

In terms of paragraph 40(1) of the Eighth Schedule of the Income Tax Act, a deceased person must be treated as having disposed of his or her assets to his or her deceased estate for proceeds equal to their market value on the date of his or her death.

*The facts:*

*John Brown died and bequeaths his holiday home to his family trust subject to a usufruct in favour of his spouse over her remaining life. Mrs. Brown was 72 and has a life*

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<sup>117</sup> The ABC of Capital Gains Tax of Individuals guide by the South African Revenue service, Issue 3, chapter 24, page 499.

*expectancy of 10 years according to Table A (see appendix A), and the present value of R1 a year over her remaining life is 5,72222.*

*The base cost of the property in John's hands is R400 000 and the market value of the property at the date of John's death is R1 000 000.*

*After ten years John's wife passed away.*

For the purposes of applying the law, the following will be examined:

*What are the potential capital gains tax implications for each person over time? For:*

- 1. John (the deceased)*
- 2. John's deceased estate*
- 3. John's wife (the heir or legatee)*
- 4. The John Brown Family Trust*

#### **6.4.1 John (the deceased)**

*The components of the property are as follows:*

	<i>R</i>
<i>Market value at date of death of John</i>	<i>1 000 000</i>
<i>Usufruct (<math>R1m \times 12\% \times 5,72222</math>)</i>	<i>686 666</i>
<i>Bare dominium</i>	<i>313 334</i>

*There will be a deemed disposal of the bare dominium in John's hands, at market value, at the date of his death in terms of paragraph 40(1). Since the usufruct has been left to his spouse there is a roll-over in respect of the usufruct in terms of paragraph 40(1)(a) read with paragraph 67(2)(a).*

*The capital gain on disposal of the bare dominium will be determined as follows:*

	<i>R</i>
<i>Effective proceeds being value of the bare dominium</i>	<i>313 334</i>
<i>Less: Base cost</i>	
<i>R400 000* x 313 334/1 000 000</i>	<i><u>(125 334)</u></i>
<i>Capital gain</i>	<i>188 000</i>

(\*Base cost at acquisition, apportioned as per the ratio of bare dominium value to the total current market value).

*The base cost is apportioned in terms of the disposal rule in paragraph 33. John will be entitled to the increased R120 000 annual exclusion on death (increased to R200 000 in 2012), in terms of paragraph 5(2). At the date of death the value is that for the full property which is only split after death, therefore the question arises, what is the base cost? Paragraph 33 apportions the base cost of an asset if part of the asset is disposed. It is questionable if this can be done for a limited interest created only on death. At date of death the whole asset existed and this same asset at its fair market value moves from the last tax return, through the deceased estate to the bare dominium holder. If this is accepted then the roll over for the spouse of the usufruct has no future base cost as it is nil<sup>118</sup>. However the Eighth Schedule to the Income tax is clear in that assets disposed of to a spouse are not subject to capital gains tax on the death of the first spouse, therefore the usufruct value must be apportioned out of the full value and it is submitted that the mechanics of paragraph 33 will give the desired result. Paragraph 33 of the Eighth Schedule should be amended to include the disposal of limited interests. For the purposes of this study it will be assumed that paragraph 33 does apply.*

#### **6.4.2 John's deceased estate**

*In terms of paragraph 40(1) John's deceased estate will acquire the bare dominium at its market value of R313 334. In terms of paragraph 40(2)(b) the heir, the trust in this case,*

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<sup>118</sup> Based on the reasoning of Jooste, R.D. and Roeleveld, J. 2002, 'The capital gains tax implications of the disposal of limited interests in property', Acta juridica (University of Cape Town).

*will have acquired the bare dominium at the market value from the deceased estate for R313 334. Therefore, there is no gain or loss in the hands of the deceased estate.*

#### **6.4.3 John's spouse – the usufructuary**

*John's spouse, the usufructuary, acquires the usufruct at a rolled-over base cost of R274 666 (R400 000 – R125 334). (Being the value on acquisition less the pro-rata base cost on John's death). When she passes away, there is a disposal in terms of paragraph 11(1)(b) on expiry or termination of the usufruct without any proceeds. She cannot claim the capital loss of R274 666 if she used the property for non-trade purposes.<sup>119</sup> Assuming that she let the property, she would be entitled to the capital gains tax loss on the grounds that the asset was used for the purpose of carrying on a trade. If she let the property and used it for a holiday home for part of a year, the capital gains tax loss would be time adjusted. Paragraph 15(c) only limits the loss to the extent that the usufruct is not used for the purposes of carrying on a trade.*

*The capital gains tax treatment of an expiring usufruct differs from that which applies for estate duty purposes. Under section 5(1)(b) of the Estate Duty Act when a usufructuary dies, the value of the usufruct based on the life expectancy of the person who takes over the right of the use is included in the usufructuary's estate the second dying spouse then has property in her estate, the usufruct which is subject to estate duty.*

#### **6.4.4 The John Brown Family Trust – the bare dominium holder**

*The base cost of the property in the hands of the trust is R313 334 (being the market value at date of death of John less the usufruct gain to John's spouse). This is the market value of the bare dominium at date of death of John. Assuming that the property values remain constant, the property will grow in value each year as the usufruct heads towards expiry. On expiry the property will have regained its full value in the hands of the trust. When the trust subsequently disposes of the holiday home for R1 000 000 (the market value at date of John's death and assuming property values were static) it will have a capital gain of*

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<sup>119</sup> Paragraph 15(c) read with paragraph 53(3)(f) of the Eighth Schedule.

R686 666 (R1 000 000 – R313 334 market value less the usufruct). The base cost remains unchanged at R313 334 and is not affected by the expiry of the usufruct.

Some have even suggested that the bare dominium holder should be granted an increase in base cost as a result of the enhancement in value caused by the expiry of the usufruct. At the date of acquisition of the bare dominium it was worth the 'low' value because of the encumbrance of the usufruct. The enhanced value was obtained for no additional consideration. When a usufruct ends it simply ceases to exist and is incapable of being transmitted to another.

The reconciliation below demonstrates that the overall capital gain (R600 000 see below) is the same when, in the alternative the full property is been disposed of by the deceased on the day before he dies:

Reconciliation of the capital gains tax gains over time when a usufruct is created at the date of death and assuming, that paragraph 33 applies.

	<b>John</b>	<b>John's estate</b>	<b>John's spouse</b>	<b>John's trust</b>	<b>Total net gain</b>
	R	R	R	R	R
<i>Proceeds</i>	313 334	313 334	-	<u>1000 000</u>	
<i>Base cost</i>	<u>(125 334)</u>	<u>(313 334)</u>	<u>(274 666)</u>	<u>(313 334)</u>	
<i>Gain</i>	188 000	-	(274 666)	686 666	600 000
<i>Tax</i>	188 000	-	-	137 333	-

1. Assuming that John's spouse let out the holiday day house from day one.
2. Assuming all exclusions for estate duty are already utilised.
3. Assuming John marginal tax rate is 40%.

If the property had been sold to a trust created for this purpose on the day before the death of John, the capital gain realised would be  $R1\ 000\ 000 - R400\ 000 = R600\ 000$  and the capital gains tax would be R60 000 assuming John's marginal rate is 40%..

The reconciliation above shows that over time the total gain of the four taxpayers/entities is the same. The advantage being that it is spread over time by the value of the usufruct passing on to John's spouse and ultimately to the trust. However, it must be noted that if John's spouse was unable to claim the capital loss of R274 666 then the total gain between the various parties would be R874 666 (R188 000 + R686 666) making the alternative of selling to the trust before death more attractive.

### **6.5 Usufruct created by the trust after death**

If John had bequeathed the entire property to the trust, which in turn created the usufruct in favour of his spouse the position would be as follows:

#### **6.5.1 John**

John would have a capital gain of R600 000 ( $R1\ 000\ 000 - R400\ 000$ ) in his last tax return.

#### **6.5.2 John's estate**

The property simply flows in and out of the estate at the same value for capital gains tax purposes and no capital gain or loss arises in the deceased estate. This is because of paragraph 40 of the Eighth Schedule as previously discussed in chapter 3. Estate Duty would be payable on the full market value of R1000 000 less a deduction of the usufruct in favour of the surviving spouse in terms of section 4q of the Estate Duty Act.

#### **6.5.3 The trust**

The trust's base cost is the same as that of the deceased estate, namely R1 000 000. By passing the usufruct over the property, the trust effects a disposal. The base cost of the bare dominium remaining in the trust would be R313 334. The trust and its beneficiaries are

connected persons in relation to each other.<sup>120</sup> As a result, the trust is deemed to have disposed of the usufruct at its market value of R686 666 (R1 000 000 – R313 334) in terms of paragraph 38(1)(a), which in the scenario given is the same as the base cost. The granting of the usufruct therefore results in no gain or loss relating to the usufruct in the trust, because the usufruct takes on the value in John's last tax return, John's estate and John's spouse's calculations leaving the gain in the trust to be that of the market value at the date of John's death less the value of the bare dominium only. This is only if there has been no increase in the market value. If there is an increase in market value the usufruct value would have to be recalculated resulting in a gain in the trust as the base cost does not change. Once the usufruct expires the value of the property returns to its full value of R1 000 000 (assuming no change in price levels) and if the trust sold the property at this value it would realise a capital gain of R686 666 which will result in tax of R137 332( R686 666 x 50% x40%).

#### **6.5.4 John's spouse**

John's spouse is a connected person in relation to the trust. In terms of paragraph 38(1)(b)<sup>121</sup> she is deemed to have acquired the usufruct at a base cost equal to its market value, namely R686 666. When she dies she will have a capital loss equal to the base cost.

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<sup>120</sup> See paragraph (b) of the definition of 'connected person' in section 1 of the Income Tax Act.

<sup>121</sup> Paragraph 38(1) of the Eighth Schedule to the Income Tax Act – Disposal by way of donation, consideration not measurable in money and transactions between connected persons not at an arm's length price. (b) – the person who acquired that asset must be treated as having acquired that asset at a cost equal to that market value, which cost must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a).

Reconciliation of the capital gains tax gain over time when a usufruct is created after death.

	<i>John</i>	<i>John's estate</i>	<i>John's spouse</i>	<i>John's Trust</i>	<i>Total net gain</i>
	<i>R</i>	<i>R</i>	<i>R</i>	<i>R</i>	<i>R</i>
<i>Proceeds</i>	<i>1 000 000</i>	<i>1 000 000</i>	<i>-</i>	<i>1 000 000</i>	
<i>Base cost</i>	<i><u>400 000</u></i>	<i><u>1 000 000</u></i>	<i><u>(686 666)</u></i>	<i><u>313 334</u></i>	
<i>Gain</i>	<i>600 000</i>	<i>-</i>	<i>(686 666)</i>	<i>686 666</i>	<i>600 000</i>
<i>Tax</i>	<i>25% x 18% to 40%</i>			<i>50% x 40%</i>	

The above table demonstrates that the capital gain, when a usufruct is created after death, is also the same net gain of R600 000, although the capital gains tax itself is payable in the hands of different taxpayers.

If John, however left the usufruct to anyone else, other than his spouse<sup>122</sup>, then paragraph 40(1)(a) would not have been applicable and the usufruct would not have been excluded for the deemed disposal of the deceased estate.

## 6.6 Summary

The examples in chapter 6 above shows that the use of a trust remains the better option because the capital gains tax is deferred by using the trust mechanism gaining advantage of the deteriorating value of money. 'Tax delayed is money saved'. The trust allows for both the flexibility as discussed previously in chapter 5 and the best way of 'using' the time value of money in the interest of the deceased and his or her family. This consequence is dependent on the likelihood of the spouse being able to claim the capital loss as discussed in 6.4. If not, the total gain would be R1 286 666 (R600 000 + R686 666).

<sup>122</sup> 'Spouse' as defined in section 1 of the Income Tax Act.

In view of the above the tax planner needs to consider the impact of estate duty and abatements and any capital gains tax exclusions. The age of the taxpayer also play a fundamental role in determining the limited interest values. It is very clear that different outcomes are possible, depending on the ages of the various parties to the arrangement.

Assuming John left the usufruct to his girlfriend, as opposed to his spouse, then paragraph 40(1)(a) would not apply and the usufruct would not have been excluded from the deemed disposal to the deceased estate. It is submitted that paragraph 33, read with paragraph 31(1)(d) and (e) will find application in this instance. On donation of a limited interest Paragraph 31 of the Eighth Schedule, as discussed earlier, determines the valuation method.

The question that is raised when dealing with usufructs and bare dominium's is whether there is actually a part disposal of the asset as opposed to a disposal of one thing.

Paragraph 33(1) provides that:

“..... where part of an asset is disposed of, the proportion of the expenditure attributable to the part disposed of is an amount which bears to the expenditure allowable in terms of paragraph 20 in respect of the entire asset the same proportion as the market value of the part disposed of bears to the market value of the entire asset immediately prior to the disposal”.

It appears that paragraph 33 is aimed at the disposal of ownership of part of an asset and the retention of ownership of the other part. It is doubtful whether this paragraph is aimed at the splitting of ownership into two limited interests. An example of a typical paragraph 33(1) situation is where a person purchases a piece of land and then sells part of that land. Paragraph 40(2), requires the market value at the date of death and not the date of disposal to the heirs be taken into account in determining the base cost for the heirs. In paragraph 33(1) it seems that the values placed on the usufruct and the bare dominium is that at the date of distribution, which is immediately after death. The asset would have to be

apportioned between the usufruct and the bare dominium in the ration of the values of the usufruct and the bare dominium respectively bear to the market value at that time.

## CHAPTER 7

### **Thoughts on some different usufructs**

There remain some usufructs which require fair and consistent tax treatment but they present a challenge for valuation purposes and particularly over what time period? Further, the capital gains tax implications of these are not certain?

In this chapter examples of some of these usufructs are discussed without necessarily providing a final solution as to their tax treatment. The valuation method must first be established before deciding whether the trust or individual will have the most advantage in saving tax.

The definition of a usufruct is provided again because it must be borne in mind when considering each of the examples discussed in this chapter. A usufruct may be defined as ‘a real right in terms of which the owner of the property or asset confers on the usufructuary the right to use and enjoy the movable or immovable thing to which the usufruct relates’. The usufructuary may be obliged to preserve the substance of the property or asset, fair wear and tear accepted and all rates and taxes. The usufructuary is also bound to maintain the asset, including repairs and maintenance costs, to keep it in a good order and condition. Should any usufructuary make improvements to the asset they are not entitled to compensation?

The following different usufructs have been selected for discussion.

### **Mining scenario:**

In section 1 of the Minerals Act no. 50 of 1991 the word ‘minerals’ is defined as follows:

‘Any substance, whether in solid, liquid or gaseous form, occurring naturally in or on earth, in or under or in tailing and having been formed by or subjected to geological process, excluding water, but including sand, stone, rock, gravel and clay, as well as soil, other than topsoil.’

Further, minerals are deemed property of the State who issues right to prospectors and /or miners to exploit the said mineral. The mineral may be below the surface of land owned by someone else other than the miner who has acquired the right to mine. It is universally accepted that mineral rights are real rights and the courts have consistently described them as ‘quasi-servitudes’ and usually as ‘personal quasi-servitudes’.

Often the land in question is owned privately by a farmer. Traditionally farmers are reluctant to sell their family farms and typically bequest the farm to the next generation of the family or hold it in a trust for the benefit of the family beneficiaries.

Further, the subdivision of Agricultural Land Act, No. 70 of 1970 prohibits the subdivision of agricultural land, or the leasing of a portion of land for a period exceeding ten years without the prior consent of the Minister of Agriculture and leases exceeding ten years need to be registered against the title deed of such land.

Regulation 41(1) of the Deeds Registries Act 47 of 1937 reads as follows: ‘Where it is sought to mortgage land held under special conditions limiting rights of the owner, the Registrar may require those conditions to be set out in the bond or a suitable reference made thereto’. Regulation 41(1) should be used for onerous conditions such as mineral reservations, pre-emptive rights, and usufructs.

Only portion of the land may be required for mining and the balance, which is often the larger portion, still remains for sustainable farming operations.

While the State pays some compensation to the farmer, the life of a mine often exceeds ten years and although the right/concession holder is obliged to rehabilitate the land this sometimes does not happen or it takes a long time for nature to recover.

When granting the usufruct to the miner and throughout the period numerous questions arise:

1. What is the value of the land when the usufruct is granted? Land bank value or fair market value?
2. How long will the usufruct be in place? The life of the mine/ its economic viable operating time depends on many factors mainly volume and quality of the minerals being mined, the feasibility of extracting the minerals and the market value of the mined minerals.
3. These uncertain factors, the value of the land and the period of the usufruct, create difficulty in valuing the usufruct and the residual property.
4. The portion of land over which the usufruct is granted may be the better agricultural land thus affecting the value and sustainability of the farming operations.
5. What loss in production (revenue) or value of asset (capital) may the farmer incur and how best should these be dealt with?
6. Should the land not be rehabilitated properly, particularly if open cast mining methods are employed, then the farmer could incur a long term reduction in his asset value – a capital loss?

It is suggested that any loss of production income would be recovered, year on year, in the farmers taxable income calculation. Any compensation received for granting the right, or the income flow from the usufruct agreement would likewise be raised, year after year, in the farmer's income. But, any permanent reduction in the value of the bare dominium, during or at the end of the mining operation should be allowed as a capital gains tax loss in term of the Eighth Schedule to the Income Tax Act and it should be included immediately such capital loss is identified.

The above discussion is also applicable to gas and oil rights.

### **Securing land for the development of renewable energy projects:**

Obvious projects would include generating energy from wind, water and solar energy sources. All such projects require optimal geographical positioning, often rural, and on someone's land.

The same problems as discussed under mining above would present themselves in calculating the value of any usufruct and the resultant bare dominium. These new technology type projects are equally difficult to assess as to their life of operations.

How best should the bare dominium holder be fairly dealt with including any capital gains implications? And, when? At initiation, or termination, of the project? What would the value be at date of death of the bare dominium holder or after date of disposal?

### **Natural infrastructure – roads, railways, waterways:**

While large infrastructures such as harbours and airports are of a long term nature and the land is usually purchased or expropriated, other infrastructures such as roads and railways require servitudes through third parties property.

While the bare dominium holder may receive full or some compensation at the time of construction, a usufruct could also be granted. Again valuing the usufruct could prove difficult. The servitude itself may not be a large portion of land but it could have a serious impact on the viability of the use of the land and resultant economic benefits. Also, how long is the servitude required? Maybe a statutory limit of fifty or ninety-nine years should be set to assist valuers?

Just as for mining and renewable energy sources how is the bare dominium holder to be fairly compensated, when, and what tax allowances or deductions are to be available in such circumstances?

### **Sustainable Development and Environmental Conservation:**

The motivation of, and fair reward for, sustainable development and environmental conservation are large topics outside the scope of this dissertation, but deserve comment here.

To encourage the urgent attention needed in these areas further steps must be taken to encourage public, private, and public-private partnership, investment capital ultimately to address the challenge of climate change impacting on the environment.

Again, landowners, many of them farmers, will need to be encouraged to donate or enter into easement agreements to allow for best management of environmental conservation. These may be implementation of servitudes, particularly road access, and granting of usufructs over all or part of their land to best manage easements for the conservation of bio-diversity.

Such development and conservation will probably exceed any one person's life span introducing again the challenge of dealing with the fair value of a usufruct and bare dominium. This will be further complicated by the management of conservation easement which will probably be public-private partnerships managed by an appropriately qualified conservation team/organisation.

### **Landfill and Waste sites:**

The increasing need for and geographical position of, landfills and waste sites will continue to impact on a landowner and neighbours.

If a said landowner decides to sell land or grant a usufruct over some land for landfill or waste sites, that decision could well impact negatively on his neighbours. This is particularly true for the disposal of nuclear waste. The disposal/storage of nuclear waste is long term. In what way could neighbours to such a site be fairly compensated for the reduction in capital value of their land? Whether, a real or perceived risk, the marketability

and value of neighbours land will be greatly reduced. Should these neighbours be granted an immediate capital gains tax loss?

**Tribal land:**

There are important instruments which deal with indigenous rights over land and resources. The International Convention on Civil and Political rights deals with the rights of indigenous people to enjoy their culture, which include rights to land, resources, subsistence and participation. Following the 1997 land law amendments communities again have legally recognized rights over areas used in common that are integral parts of their livelihood strategies and farming systems.

The South Africa's Communal Property Association Act of 1996 provides for the recognition of customary tenure regimes, which in turn provides a tool by which groups may assert joint ownership of land.

The common areas include among other, grazing land, wood lots, and access to water. Such access to and the use of these assets may result in a usufruct arising and again the difficulty of valuing the usufruct and the underlying bare dominium.

The same could be applicable to heritage sites, particularly when they are on privately owned property.

**Divorce scenario:**

Often the tax implications of a divorce settlement are not given proper consideration by the divorcing parties, nor their legal advisors. This can bring some harsh unforeseen tax consequences on either or both parties.

There have been a number of cases where the judgements have extended the past interpretation of section 7(2) of the Divorce Act 70 of 1979 to include the payment of

capital sums and the transfer of assets, including immovable property and limited rights, such as usufructs and the right of use, to meet the maintenance needs of the one spouse.

An example of such judgements is where the transfers of assets were awarded to meet the maintenance needs of the one spouse. A spouse (usually the husband) can agree in a divorce settlement or be ordered by the court to purchase an immovable property of the spouse's choice, in addition to paying the wife's monthly maintenance sum and grant a usufruct over the immovable property for her lifetime. The property will be registered in the husband's name at his sole cost. The usufruct could be for life without any condition.

The lapsing or termination of a limited interest, such as a usufruct constitutes a "disposal" for capital gains tax purposes, irrespective of whether the usufruct will be passed to another person or reverts back to the husband or bare dominium holder.

In terms of *SBI v Jordaan* 1967 (3) SA 329 (A), 29 SATC 81, the person obtaining the benefit of the cessation of the limited interest does not have to obtain the identical or even a similar interest; the enquiry is merely whether or not any advantage accrues to any person as a result of the death of the deceased.

The granting of limited interests such as usufructuary rights as part of a settlement maintenance obligation could result in a capital gains tax liability for either or both former spouses.

### **Retirement schemes:**

In South Africa there are three main methods of establishing retirement homes. They are the use of sectional title schemes, share block companies and the so-called 'life-rights'.

Under sectional title schemes and in share block companies the housing unit or the shares are sold on the open market and the investor has full rights to the asset and any capital profits or losses are taxed in the normal way. A 'life-right' links the property occupied by

the investor to his or her life span. Upon the death of the holder of such “life-right”, the property/unit reverts back to the developer at the price at which the investor originally paid for the property/unit. The investor will have paid annual levies for the usufruct while living in the unit and to maintain it in reasonable condition. Initially this type of investment usually requires that an interest-free loan be made to the developer or grantor of the life-right, which is repayable on termination of the life right agreement. The developer should be taxed on the profit or loss on sales and the variance in the value of the usufruct at date of acquisition, and date of disposal upon death of, the investor. Is this gain of a revenue or capital nature? And, what is the actual business of the developer / bare dominium holder?

This chapter has merely highlighted more complex types of limited interests for the purposes of further consideration or study.

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## CHAPTER 8

### Conclusion

In this dissertation the Capital Gains Tax consequences for an individual were considered where a limited interest is held by an individual directly in their own capacity, compared to where the limited interest is held in a trust.

An attempt has been made to provide an overview and discussion of the nature and the use of limited interests in the context of the Income Tax Act including capital gains tax.

The impact of a limited interest being held either by a trust or an individual was also explored.

In Chapter 1 the tax principles appropriate to Capital Gains Tax and who should hold the limited interest was discussed.

In Chapter 2 the income tax legal concepts and principles relating to individuals and trusts was discussed in order to highlight the different tax treatments.

In Chapter 3 different types of limited interests were presented and the valuation of those interests was discussed in order to inform the rest of the dissertation. Against the background set in Chapters 1 to 3, the different applications appropriate to different events effecting both individuals (Chapter 4) and trusts (Chapter 5) were discussed and a comparison drawn to evaluate the preferred most tax efficient option.

To illustrate the application of alternatives monetary examples were shown in Chapter 6 highlighting the differences and their financial results.

It is evident from the above that there are advantages and disadvantages of holding the limited interest in both an individual capacity and in a trust. As mentioned in the discussion, usufructs are a great tool for continuity purposes, but they do have a considerable downside and the person who suffers the most is the person inheriting the bare dominium, the person you actually wanted to benefit the most from your estate

planning. In making use of the valuation principles in 4.3 the tax planner can substantially reduce the value on which donation tax is levied.

By applying the John Brown principle as discussed, in the John Brown example, in chapter 6 the tax planner can use a usufruct as an estate planning tool.

The conclusion reached by the author of this dissertation based on the data therein, is that it is most beneficial to hold the limited interest in a trust. The use of a limited interest in tax planning can provide an effective estate and tax planning saving tool, but the use of such a strategy requires very careful consideration of the application of our tax legislation. Trusts can also provide for continuity beyond an individual's life span; they may be used as a conduit pipe<sup>123</sup> for the distribution of income earned through the limited interest; and trusts may also allow for the distribution of its capital, in cash or kind. While individuals to hold the limited interest does have certain advantages; particularly, the annual exemption factor and the exemption on the initial portion of the capital gains tax gain for a primary residence, currently being R1 500 000<sup>124</sup>.

Capital gains tax implications are complex and it is clear that careful consideration must be given to both tax and estate planning. It is not possible to simply consider that there may be a future estate duty saving without the consideration of the immediate possibility of donation and or capital gains tax implications. The life expectancy of the various parties also needs to be taken into account as to deciding which strategy to use, if any at all.

The outcome from both tax and estate planning purposes must be evaluated for all parties, under each and every scenario, from initiation to date of death and beyond. While individuals should not attempt to 'rule from the grave' sound planning will benefit the person and their families both subjectively and monetarily.

As professor HR Hahlo in SALJ 1952 at 349 said: 'When it comes to trusts in our law, even the most elementary propositions can not be regarded as being settled.....'

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<sup>123</sup> The application of this principle, read together with section 25B of the Income Tax Act, in respect of income, and paragraph 80(2) of the Eighth Schedule, in respect of capital gains, can provide further tax efficiencies in the form of the so-called income and gain splitting under appropriate circumstances.

<sup>124</sup> Exclusion for a primary residence, used for domestic or private residential purposes by a natural person.

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**LIFE EXPECTANCY TABLE (TABLE A)****APPENDIX A**

The expectation of life and the present value of R1 per annum for life capitalised at 12 per cent over the expectation of life of males and females of various ages.

Age Expectation Present value of R1 Age Expectation Present value of R1  
of life per annum for life of life per annum for life

	<u>Expectation on life</u>		<u>Present value of R1 per annum for life</u>	
	<u>Male</u>	<u>Female</u>	<u>Male</u>	<u>Female</u>
0	64,74	72,36	8,327 91	8,331 05
1	65,37	72,74	8,328 28	8,331 14
2	64,50	71,87	8,327 76	8,330 91
3	63,57	70,93	8,327 14	8,330 64
4	62,63	69,97	8,326 44	8,330 33
5	61,69	69,02	8,325 67	8,329 99
6	60,74	68,06	8,324 80	8,329 61
7	59,78	67,09	8,322 71	8,328 69
9	57,83	65,14	8,321 46	8,328 15
10	56,85	64,15	8,320 07	8,327 53
11	55,86	63,16	8,318 49	8,326 84
12	54,87	62,18	8,316 73	8,326 08
13	53,90	61,19	8,314 80	8,325 22
14	52,93	60,21	8,312 65	8,324 27
15	51,98	59,23	8,310 29	8,323 20
16	51,04	58,26	8,307 70	8,322 03
17	50,12	57,29	8,304 89	8,320 71
18	49,21	56,33	8,301 80	8,319 26
19	48,31	55,37	8,298 41	8,317 64
20	47,42	54,41	8,294 71	8,315 84
21	46,53	53,45	8,290 61	8,313 83
22	45,65	52,50	8,286 13	8,311 61
23	44,77	51,54	8,281 17	8,309 12
24	43,88	50,58	8,275 64	8,306 33
25	43,00	49,63	8,269 59	8,306 26
26	42,10	48,67	8,262 74	8,299 81
27	41,20	47,71	8,255 16	8,295 95
28	40,30	46,76	8,246 77	8,291 71
29	39,39	45,81	8,237 37	8,286 97
30	38,48	44,86	8,226 94	8,281 70
31	37,57	43,91	8,215 38	8,275 83
32	36,66	42,96	8,202 57	8,269 30
33	35,75	42,02	8,188 36	8,262 10
34	34,84	41,07	8,172 62	8,254 00
35	33,94	40,13	8,155 36	8,245 09
36	33,05	39,19	8,136 47	8,235 17
37	32,16	38,26	8,115 58	8,224 26
38	31,28	37,32	8,092 74	8,211 99

39	30,41	36,40	8,067 81	8,198 66
40	29,54	35,48	8,040 30	8,183 86
41	28,69	34,57	8,010 67	8,167 62
42	27,85	33,67	7,978 44	8,149 83
43	27,02	32,77	7,943 44	8,130 12
44	26,20	31,89	7,905 47	8,108 81
45	25,38	31,01	7,863 80	8,085 27
46	24,58	30,14	7,819 24	8,059 56
47	23,79	29,27	7,771 09	8,031 19
48	23,00	28,41	7,718 43	8,000 26
49	22,23	27,55	7,662 36	7,966 17
50	21,47	26,71	7,602 01	7,929 50
51	20,72	25,88	7,537 13	7,889 67
52	19,98	25,06	7,467 48	7,846 46
53	19,26	24,25	7,393 87	7,799 65
54	18,56	23,44	7,316 31	7,748 34
55	17,86	22,65	7,232 34	7,693 55
56	17,18	21,86	7,144 14	7,633 63
57	16,52	21,08	7,051 78	7,568 96
58	15,86	20,31	6,952 25	7,499 27
59	15,23	19,54	6,850 04	7,423 21
60	14,61	18,78	6,742 06	7,341 35
61	14,01	18,04	6,630 10	7,254 57
62	13,42	17,30	6,512 32	7,160 20
63	12,86	16,58	6,393 01	7,060 46
64	12,31	15,88	6,268 22	6,955 37
65	11,77	15,18	6,137 89	6,841 61
66	11,26	14,51	6,007 26	6,723 93
67	10,76	13,85	5,871 65	6,598 93
68	10,28	13,20	5,734 03	6,466 35
69	9,81	12,57	5,591 82	6,328 18
70	9,37	11,96	5,451 65	6,184 66
71	8,94	11,37	5,307 75	6,036 07
72	8,54	10,80	5,167 44	5,882 78
73	8,15	10,24	5,024 37	5,722 22
74	7,77	9,70	4,878 76	5,557 43
75	7,41	9,18	4,734 90	5,388 93
76	7,07	8,68	4,593 54	5,217 27
77	6,73	8,21	4,446 63	5,046 79
78	6,41	7,75	4,303 09	4,870 92
79	6,10	7,31	4,158 98	4,693 89
80	5,82	6,89	4,024 40	4,516 47
81	5,55	6,50	3,890 51	4,343 99
82	5,31	6,13	3,768 02	4,173 15
83	5,09	5,78	3,652 76	4,004 82
84	4,89	5,45	3,545 46	3,839 88
85	4,72	5,14	3,452 32	3,679 21
86	4,57	4,85	3,368 64	3,523 71
87	4,45	4,58	3,300 66	3,374 26
88	4,36	4,33	3,249 07	3,231 75

89	4,32	4,11	3,225 97	3,102 96
90	4,30	3,92	3,214 38	2,989 12

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**ANNUITY TABLE (TABLE B)**

Present value of R1 per annum capitalised at 12 per cent over fixed periods

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<i>Years</i>	<i>Amount</i>	<i>Years</i>	<i>Amount</i>	<i>Years</i>	<i>Amount</i>	<i>Years</i>	<i>Amount</i>	<i>Years</i>	<i>Amount</i>
1	0,892 9	21	7,562 0	41	8,253 4	61	8,325 0	81	8,332 5
2	1,690 0	22	7,644 6	42	8,261 9	62	8,325 9	82	8,332 6
3	2,401 8	23	7,718 4	43	8,260 8	63	8,326 7	83	8,332 6
4	3,037 4	24	7,784 3	44	8,276 4	64	8,327 4	84	8,332 7
5	3,604 8	25	7,843 1	45	8,282 5	65	8,328 1	85	8,332 8
6	4,111 4	26	7,895 7	46	8,288 0	66	8,328 6	86	8,332 8
7	4,563 8	27	7,942 6	47	8,292 8	67	8,329 1	87	8,332 9
8	4,967 6	28	7,984 4	48	8,297 2	68	8,239 6	88	8,333 0
9	5,328 2	29	8,021 8	49	8,301 0	69	8,330 0	89	8,333 0
10	5,650 2	30	8,055 2	50	8,304 5	70	8,330 3	90	8,333 0
11	5,937 7	31	8,085 0	51	8,307 6	71	8,330 7	91	8,333 1
12	6,194 4	32	8,111 6	52	8,310 4	72	8,331 0	92	8,333 1
13	6,423 6	33	8,135 4	53	8,312 8	73	8,331 2	93	8,333 1
14	6,628 2	34	8,156 6	54	8,315 0	74	8,331 4	94	8,333 1
15	6,810 9	35	8,175 5	55	8,317 0	75	8,331 6	95	8,333 2
16	6,974 0	36	8,192 4	56	8,318 7	76	8,331 8	96	8,333 2
17	7,119 6	37	8,207 5	57	8,320 3	77	8,332 0	97	8,333 2
18	7,249 7	38	8,221 0	58	8,321 7	78	8,332 1	98	8,333 2
19	7,365 8	39	8,233 0	59	8,322 9	79	8,332 3	99	8,333 2
20	7,469 4	40	8,243 8	60	8,324 0	80	8,332 4	100	8,333 2

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**TAX RATES FOR INDIVIDUALS (2010)**

The tax rate of natural persons and persons other than companies and trusts, are as follow:

<u>Taxable income</u>	<u>Rate of tax</u>
0 – 132 000	0 + 18% of each R1
132 001 – 210 000	R23 760 + 25% of the amount by which the taxable income exceeds R132 000
210 001 – 290 000	R43 260 + 30% of the amount by which the taxable income exceeds R210 000
290 001 – 410 000	R67 260 + 35% of the amount by which the taxable income exceeds R290 000
410 001 – 525 000	R109 260 + 38% of the amount by which the taxable income exceeds R410 000
Exceeds R525 000	R152 960 + 40% of the amount by which the taxable income Exceeds R525 000

The maximum exempt interest income amounts are; R21 000 per annum for all taxpayers under the age of 65 years of age, and R30 000 per annum for all taxpayers who are 65 years or older. This must be reduced by an amount of up to R3 500 of foreign dividend income received by or accrued to a natural person, in terms of section 10(1)(i)(xv) of the Income Tax Act.

## TAX RATES FOR INDIVIDUALS (2011)

The tax rate of natural persons and persons other than companies and trusts, are as follow:

<u>Taxable income</u>	<u>Rate of tax</u>
0 – 140 000	0 + 18% of each R1
140 001 – 221 000	R25 200 + 25% of the amount by which the taxable income exceeds R140 000
221 001 – 305 000	R45 450 + 30% of the amount by which the taxable income exceeds R221 000
305 001 – 431 000	R70 650 + 35% of the amount by which the taxable income exceeds R305 000
431 001 – 525 000	R114 750 + 38% of the amount by which the taxable income exceeds R431 000
Exceeds R552 000	R160 730 + 40% of the amount by which the taxable income Exceeds R552 000

The maximum exempt interest income amounts are; R22 300 per annum for all taxpayers under the age of 65 years of age, and R32 000 per annum for all taxpayers who are 65 years or older. This must be reduced by an amount of up to R3 700 of foreign dividend income received by or accrued to a natural person, in terms of section 10(1)(i)(xv) of the Income Tax Act.

**Summary of the paragraphs 68 to 72 of the Eighth Schedule**

<b>Paragraph</b>	<b>Essential provisions</b>	<b>Who is or will be taxed?</b>
Paragraph 68	<ul style="list-style-type: none"> <li>(2) donation by spouse</li> <li>(3) causation (by reason of)</li> <li>(4) receipt or accrual of gain by other spouse.</li> </ul>	Gain is deemed to be that of the donor spouse. It will be included in his or her tax calculation for capital gains tax purposes.
Paragraph 69	<ul style="list-style-type: none"> <li>(1) donation by the parent (includes disposition below market value)</li> <li>(2) causation (by reason of)</li> <li>(3) receipt or accrual of a gain by minor child or accumulation on behalf of the minor child.</li> </ul>	Gain is deemed to be that of the parent who made the donations and will be included in that parent's tax calculation for capital gains tax purposes.
Paragraph 70	<ul style="list-style-type: none"> <li>(1) donation by any person</li> <li>(2) there is a condition to the effect that the beneficiaries shall not receive gain until the happening of an event.</li> </ul>	The gain that would accrue to or vest in the beneficiary is deemed to be that of the donor.
Paragraph 71	<ul style="list-style-type: none"> <li>(1) donation by any person</li> <li>(2) the right to receive a gain may be revoked or conferred upon another person.</li> </ul>	The gain is deemed to be that of the person who retains those powers and who conferred that right. It will only apply if the gain vests in a beneficiary.

Paragraph 72	(1) donation by a South African resident (2) in consequence of which a gain is received by or accrues to a non-resident.	The South African resident donor will include the gain in his or her tax calculation.
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