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**A STUDY OF SOME OF THE COMBINED TAX
EFFECTS OF CAPITAL GAINS TAX
AND ESTATE DUTY
AND A COMPARISON WITH
SIMILAR LEGISLATION IN THE
UNITED STATES OF AMERICA
AND THE UNITED KINGDOM**

A PAPER PRESENTED TO

**THE DEPARTMENT OF ACCOUNTING
UNIVERSITY OF CAPE TOWN**

**IN FULFILMENT OF THE REQUIREMENTS
FOR THE DEGREE OF**

MASTERS IN BUSINESS SCIENCE

BY

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AUGUST 2003

"The avoidance of taxes is the only pursuit that still carries any reward"

J M Keynes

I wish to thank Jennifer Roeleveld for her guidance and patience throughout the writing of this thesis.

In addition, I wish to thank my parents for their support and encouragement during the completion of this paper.

I certify that, except as noted above, the report is my own work and that all references used are accurately reported.

J Shev

August 2003

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CHAPTER 1

INTRODUCTION

Capital gains tax was introduced in South Africa with effect from 1 October 2001 as per the Taxation Laws Amendments Act No. 5 of 2001 (Act 5). As in the case of a number of other countries, there is no separate body of legislation for capital gains tax, but the rules are incorporated into the Income Tax Act No. 58 of 1962, as amended (the Act), via the Eighth Schedule. The Eighth Schedule was introduced into the Act for the determination of taxable capital gains and assessed capital losses. Act 5 introduced S26A into the Act, which forms the link between the Act and the Eighth Schedule, and provides that “there shall be included in the taxable income of a person for a year of assessment the taxable capital gain of that person for that year of assessment, as determined in terms of the Eighth Schedule”¹.

Since the late sixties the question of whether a capital gains tax should be introduced in South Africa has received the attention of three tax commissions. The introduction of a separate capital gains tax in South Africa was first recommended by the Franzsen Commission in 1968.

The Margo Commission (1987), in contrast, was opposed to a capital gains tax primarily because of the administrative costs involved.² The Katz Commission, in its Third Interim

¹ S26A of the Income Tax Act No. 58 of 1962 (as amended).

² Margo Commission Report of the Commission of Inquiry into the tax structure of the Republic of South Africa (1987).

Report³, referred to the low revenue potential of capital gains tax and also felt that "... by reason of the lack of capacity on the part of the tax administration, there should not be a capital gains tax in South Africa at [that] stage"⁴. Both the Margo Commission and the Katz Commission raised concerns about the effectiveness of such a tax with respect to the administrative costs involved relative to the expected revenue return. In addition, it has been argued that capital gains tax may well distort investment patterns and add to taxpayers' costs of compliance, without having much of an impact on the distribution of wealth in the country.

The South African Minister of Finance announced in his national Budget speech, on 23 February 2000, that a capital gains tax would be introduced in South Africa with effect from April 2001. He indicated that this new tax would "make the income tax more equitable", would lead to less tax avoidance and would bring South Africa's "tax dispensation in line with the systems of our major trading partners".

Due to the complexities of capital gains tax, the implementation date was extended to 1 October 2001. Nevertheless, it appears that a vast number of amendments will still be required to refine the capital gains tax legislation. This is evidenced in the Revenue Laws Amendment Act No. 74, which was promulgated in December 2002. The introduction of capital gains tax has also renewed the need to address the debate surrounding the future of estate duty and whether it is still appropriate in the current environment. This is

³ Katz Commission Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (1995) at paragraph 6.6.2.

⁴ *Ibid* at paragraph 6.7.1.

necessitated by the fact that taxpayers do not only have to deal with the issue of capital gains tax, but also with the combined effects of capital gains tax and other taxes⁵.

Due to the introduction of capital gains tax, the estate duty and donations tax rates were decreased from 25% to 20% in order to counter any perceived double taxation at death and on donation. This raises the question whether the reduction of the estate duty rate from 25% to 20% is adequate compensation for having to pay capital gains tax upon death.

It is therefore of interest to consider capital gains tax in conjunction with the position of wealth taxation in a country's tax system. In South Africa estate duty and donations tax are both taxes levied on the basis of wealth. Donations tax is imposed upon the transfer of wealth during a person's lifetime and estate duty is imposed upon the transfer of wealth on the death of a person. Estate duty has undergone some changes in respect of the rates levied as discussed below.

The Estate Duty Act⁶ replaced the Death Duties Act 29 of 1922 and applies to all deaths after 1 April 1955. Initially, a sliding scale of rates applied. The Margo Commission⁷

⁵ Other taxes include estate duty, donations tax, income tax, value added tax, transfer duty and stamp duty.

⁶ Estate Duty Act No 45 of 1955.

⁷ Margo Commission Report of the Commission of Inquiry into the tax structure of the Republic of South Africa (1987).

(1987) recommended that various changes be made to estate duty in South Africa. These recommendations included the introduction of a capital transfer tax⁸ at a flat rate of 15%⁹ to replace estate duty and donations tax. One of the changes implemented in 1988 was a flat rate of estate duty of 15%, rather than the sliding scale. The threshold abatement was also increased to R1 million per estate. From 14 March 1996, the fixed rate of estate duty was increased from 15% to 25%. More recently on 1 October 2001, the estate duty rate decreased to 20% and the abatement was increased to R1.5 million.

The Third Katz Commission Report¹⁰ (1995) proposed that donations tax and estate duty be combined under one Act¹¹. The purpose would be to create an effective system of wealth transfer tax. In March 1997, the Fourth Katz Commission Report¹² made new recommendations to the effect that the system existing at the time be retained¹³. According to the Katz Commission there did not appear to be a need on the part of the legislator to combine estate duty and donations tax¹⁴.

The United States of America has a much more complicated tax system than South Africa with respect to the transfer of wealth. In addition to the estate tax and gift tax, which have similar objectives to estate duty and donations tax respectively, there is also a generation-skipping transfer tax. A generation-skipping transfer tax is essentially

⁸ Ibid at paragraph 20.50.

⁹ Ibid at paragraph 20.53.

¹⁰ Katz Commission Third Interim Report of the Commission of Inquiry into certain aspects of the tax structure in South Africa (1995).

¹¹ Ibid at paragraph 7.4.1.

¹² Katz Commission Fourth Interim Report on Capital Transfer Tax (1997).

¹³ Ibid at paragraphs 14.1 and 14.2.

¹⁴ Ibid at paragraph 14.3.

designed to prevent the tax-free transfer of property from one generation of beneficiaries to a generation of beneficiaries who are more than one generation below the transferor's generation. Although there is no generation-skipping transfer tax in South Africa, the Margo Commission¹⁵ did recommend the introduction of such a tax. This recommendation was intended to act as a disincentive for the use of trusts as vehicles for the avoidance of capital transfer tax. The interrelationship between estate tax and generation-skipping transfer tax in the United States of America results in the need to consider whether a generation-skipping transfer tax would be appropriate in South Africa.

In order to establish whether South Africa should maintain its current estate duty legislation, it is important to examine the existing combined tax effects of capital gains tax and estate duty. There may be merit in reducing or abolishing estate duty, or at least redrafting the estate duty legislation to take into account assets which have already been subjected to capital transfer tax in the form of capital gains tax.

This paper presents a study of some of the combined effects of capital gains tax and estate duty. In addition, the current estate tax and inheritance tax situations in the United States of America and United Kingdom, respectively, are discussed in this paper for comparative purposes. The tax regimes in the United States of America and the United Kingdom are relevant to this investigation due to their ability to avoid imposing both capital gains tax and estate tax upon the same assets on the death of an individual. The generation-skipping transfer tax in the United States of America and the United Kingdom

¹⁵ *Supra* note 7 at 20.57.

inheritance tax generation-skipping provisions are also examined as they may assist to close some of the loopholes in the existing South African estate duty legislation. By closing these loopholes, the need to subject the estate assets to both capital gains tax and estate duty on the death of a person may be negated.

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CHAPTER 2

ESTATE DUTY

Differing views were presented in the report of the Margo Commission¹⁶ with respect to estate duty. Arguments were raised both for the abolition of estate duty and in favour of the retention of estate duty. The arguments were as follows:

Arguments in favour of the abolition of estate duty

- Estate duty is fiscally unproductive due to its low revenue yield.
- It inhibits capital build-up and discourages saving.
- Estate duty is imposed at an inopportune time and creates cash flow problems for heirs of the estate sometimes leading to the sale of estate assets.
- The liability for estate duty may result in a family farm or business not being retained in the family.
- Taxpayers are induced to divert funds in order to provide for the estate duty liability.
- Estate duty is inequitable and socialistic.
- It is a complex tax.
- It inhibits foreigners from settling in South Africa.
- To the extent that estate duty is imposed on donations, it is a tax on generosity.

¹⁶ Supra note 7.

Arguments in favour of the retention of estate duty

- Capital not only provides security but also the ability to consume, and therefore contributes to the taxpayer's ability to consume.
- Estate duty is needed to redistribute wealth and spread the tax burden equitably.
- Such a tax is levied on wealth which is often not the result of effort, but arises from factors such as greater relative scarcity caused by population growth.
- It is an indirect way of taxing capital gains.
- It is one way to tax farmers.
- It is not costly to administer.
- Estate duty does not unduly inhibit the taxpayer's work effort during his lifetime.
- Estate duty is valuable in terms of the information it yields in connection with the administration and collection of income taxes.

Discussion of the arguments

It is considered necessary to elaborate on some of the arguments presented above in order to obtain a better understanding of the reasons why it may be necessary to abolish or retain estate duty. The following arguments will be discussed further.

Arguments in favour of the abolition

- Estate duty is fiscally unproductive
- Estate duty inhibits investment and discourages saving
- Estate duty is imposed at an inopportune time

-
- Estate duty may result in family farms and businesses not being retained within the family
 - Estate duty is inequitable and socialistic
 - Estate duty is a complex tax

Arguments in favour of the retention

- Estate duty is an indirect way of taxing capital gains
- Value of information yielded by estate duty administration for income tax collection.

ARGUMENTS IN FAVOUR OF THE ABOLITION OF ESTATE DUTY

Estate duty is fiscally unproductive

The composition of South Africa's national revenue was published in a briefing by the National Treasury's tax policy chief directorate.¹⁷ These results are presented in Table 1, on page 10. The table shows each component of the tax revenue as a percentage of the total tax revenue.

¹⁷ National Treasury Capital Gains Tax Briefing by the National Treasury's Tax Policy Chief Directorate to the Portfolio and Select Committees on Finance (24 January 2001).

Table 1: Composition Of National Tax Revenue

	1983/84	1989/90	1994/95	1999/00	2000/01 (estimate)	2001/02 (estimate)
Tax instrument	%	%	%	%	%	%
Direct taxes						
Persons and individuals	30.1	30.9	39.6	42.8	40.7	40.4
Gold mines	8.9	1.6	1	0.1	0.1	0.1
Other mines	1	2.8	0.4	0.3	0.4	0.4
Companies (other than mines)	17.1	17	10.5	10.2	10.7	10.9
Secondary tax on Companies	0	0	1.1	1.3	1.4	1.4
Tax on retirement funds	0	0	0	2.9	3	3
Donations tax	0	0	0.1	0	0	0
Estate duty / inheritance tax	0.5	0.1	0.1	0.2	0.2	0.2
Other	1.7	0.9	1	0.3	1.2	1.9
Total - Direct taxes	59.3	53.3	53.9	58.1	57.7	58.3
Indirect taxes						
Value-added tax /						
General sales tax *	20.5	25.9	25.8	24	24.6	24.9
Excise duties	9.3	4.4	5.1	4.7	4.5	4.5
Fuel levy	0.9	6.3	7.4	7.1	7	6.8
Customs duties and import surcharges	6.9	7.4	4.8	3.2	3.7	3.1
Marketable securities tax	0.2	0.4	0.4	0.5	0.6	0.6
Transfer duties	1.7	1	1.2	0.9	1	0.8
Stamp duties and fees	1.1	1.1	0.8	0.8	0.8	0.8
Other	0.2	0.1	0.6	0.7	0.1	0.2
Total - Indirect taxes	40.7	46.7	46.1	41.9	42.3	41.7
Total tax revenue	100	100	100	100	100	100
* Value-added tax replaced the General Sales Tax in 1991.						

Revenue collected from estate duty as a percentage of total tax revenue declined from the 1983/84 tax year until the 1994/95 tax year. In 1988, following the Margo Commission's

recommendations¹⁸, a flat rate of estate duty of 15% was introduced, rather than the sliding scale. The threshold abatement was also increased to R1 million per estate. The effect on Revenue collections was significant. Whereas in the 1986/87 tax year estate duty raised approximately R147.3 million in revenue, only R75.9 million was collected in the 1989/90 tax year. The tax collected in the 1986/87 year amounted to 0.43%¹⁹ of the total tax revenue. If this percentage is applied to the total tax revenue raised in the 1989/90 year of R64,737.4 million, it can be seen that the total potential tax collections from estate duty in the 1989/90 tax year would have been R278.37 million²⁰ if a flat rate of estate duty had not been introduced and the threshold abatement had not been increased. However, due to these changes only R75.9 million was collected from estate duty. This amounts to a significant reduction in real terms and in the contribution of estate duty to the total tax collected. These results can be determined from the data derived from the 2002 Budget Review²¹ and shown in Table 2, on page 12.

¹⁸ Supra note 7.

¹⁹ R147.3 million / R34,324.7 million x 100 = 0.43%

²⁰ R64,737.4 million x 0.43% = R278.37 million

²¹ Department of Finance Budget Review, (2002).

Table 2: Estate Duty As A Percentage Of Total Tax Revenue

Year	Revenue from Estate Duty (R million)	Total Tax Revenue Collected (R million)	Estate Duty as a Percentage of Total Tax Revenue (%)
1984/85	100.4	24 120.2	0.42
1985/86	139.4	30 499.1	0.46
1986/87	147.3	34 324.7	0.43
1987/88	142.6	39 111.8	0.36
1988/89	136.5	50 518.1	0.27
1989/90	75.9	64 737.4	0.12
1990/91	82.0	71 756.2	0.11
1991/92	78.7	78 963.6	0.10
1992/93	84.9	83 703.5	0.10
1993/94	118.3	97 477.4	0.12
1994/95	125.3	113 698.9	0.11
1995/96	181.3	127 193.9	0.14
1996/97	181.8	147 211.1	0.12
1997/98	302.6	165 363.4	0.18
1998/99	256.4	184 664.4	0.14
1999/2000	304.2	200 640.7	0.15
2000/01	442.7	220 273.5	0.20
2001/02 (estimate)	440.0	252 205.5	0.17

Estate duty comprised 0.43%²² of total tax revenues in 1986/87 before the introduction of a flat rate of estate duty and the R1 million primary abatement²³ allowed as a deduction against the net value of the estate. Applying this percentage to the estimated total tax revenue collections in the 2001/02 tax year it can be concluded that the potential collections from estate duty would amount to R1,084.5²⁴ million if conditions had

²² R147.3 million / R34,324.7 x 100 = 0.43%

²³ S4A, Estate Duty Act No. 45 of 1955

²⁴ R252,205.5 million x 0.43% = R1084.5 million.

remained unchanged. This demonstrates the potential for estate duty collections in the 2001/02 tax year of almost 2.5 times the estimated actual collections of R440 million.

Revenues collections did, however, improve in the latter half of the 1990's due to an increase in the estate duty rate from 15% to 25% in 1996. But despite this change, estate duty still only amounts to between 0.1% and 0.5% of total tax revenue. This is true for all the tax years from the 1983/84 tax year up until the 2001/2002 tax year. Furthermore, estate duty collections as a percentage of total tax revenues have not attained levels above 0.2% since the 1989/90 tax year. The fact that estate duty yields such a minimal percentage of total tax revenues is partially due to the ease with which it is avoided through estate planning. However, it may also indicate that the majority of the population have limited wealth.

The Katz Commission²⁵, when discussing the possibility of a more comprehensive capital transfer tax in South Africa, indicated that the fiscus should earn a net positive yield from a capital transfer tax. A contribution to total tax revenues of approximately 1% to 1.5% was suggested as an appropriate target. At the same time, the Commission was anxious to avoid high administrative costs and expressed concerns that a capital transfer tax should not give rise to an unproductive estate planning industry.

Based on the Katz Commission's submissions, a strong argument does not exist for the view that estate duty collections are minimal in comparison with total tax revenue, as

²⁵ Supra note 10 at paragraphs 7.2.2 – 7.2.4.

every contribution to state revenue counts, and estate duty is currently generating over R400 million per annum for the state. In addition, the costs of administering estate duty are low resulting in a relatively positive cost-benefit relationship. According to a report of the Organisation for Economic Cooperation and Development (OECD) Committee on Fiscal Affairs, the fact that the revenue yield of capital taxes tends to be relatively small “is unlikely to be the dominant consideration in the introduction or retention of a capital gains tax.”²⁶

The Katz Commission’s concerns relating to an unproductive estate planning industry are relevant owing to the success of this industry evident in the minimal revenue collections from estate duty. As noted by Jennifer Roeleveld²⁷, “[r]evenue is ending up passing into the pockets of the estate planners instead of into the hands of the fiscus. It becomes quite impossible to then establish accurate statistics of what estate duty should be collected from deceased estates especially when this is coupled with the theory that in South Africa estate duty is collected from relatively few estates, those forming the pinnacle of the pyramid²⁸.”

²⁶ Report of the Organization for Economic Cooperation and Development Committee (OECD) on Fiscal Affairs *The Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals* (1979). See p. 16.

²⁷ J Roeleveld *Capital Transfer Tax Specifically related to Estate Duty and Generation-Skipping Transfer Tax A paper presented to the Department of Commercial Law, University of Cape Town, in partial fulfillment of the requirements for the Master of Laws degree* (November 1995).

²⁸ The pyramid is the progressive tax system in South Africa. The base of the pyramid comprises consumption taxes, such as value added tax, which affect the general population. The centre segment of the pyramid consists of taxes, such as income tax, which affect a large portion of the population. A relatively small portion of the population are affected by the taxes, such as estate duty and wealth taxes, which form the top segment (pinnacle) of the pyramid.

Estate duty inhibits investment and discourages saving

Estate duty rewards consumption and undermines savings. Accumulation of even modest wealth may lead to heavy taxes, while consumption of income and the resultant non-accumulation of wealth provides for relatively light taxation, thus creating an incentive for individuals to consume more or to work and save less. If individuals are aware that they will be unable to pass on their wealth at death, they may choose to simply produce less wealth or to consume their wealth.²⁹

The economic effects of the disincentive to savings and investment are quite striking, especially in light of the relatively small amounts of revenue raised by estate duty. An analysis performed by Heritage Foundation economists found that repealing the death tax in the United States of America would have a large and beneficial effect on the economy.³⁰

Specifically, the Heritage analysis found that, if the estate tax were repealed in 1998, then over the following nine years:

- The United States economy would average as much as \$11 billion per year in extra output;
- An average of 145,000 additional new jobs could be created;

²⁹ William W. Beach A Scorecard on Death Tax Reform *Backgrounder* No. 1197, 25 June, 1998. (www.heritage.org/library/backgrounder/pdf/bg_1197.pdf)

³⁰ William W. Beach The Case for Repealing the Estate Tax *Backgrounder* No. 1091, 21 August, 1996. (www.heritage.org/library/backgrounder/pdf/bg_1091.pdf)

- Personal income could rise by an average of \$8 billion per year above projections at the time; and
- The deficit would actually decline because revenues generated by extra growth would more than compensate for the meagre revenues that were being raised by the inefficient death tax.

Richard Fullenbaum and Mariana McNeill, confirmed these results in a study for the Research Institute for Small and Emerging Business.³¹ In a simulation of a death tax repeal, they found that private investment would rise by an average of \$11 billion over the seven-year period following repeal. Consumption expenditures would rise by an average of \$17 billion (after inflation), and an average of 153,000 new jobs would be created in this more buoyant economy.³²

Estate duty is imposed at an inopportune time³³

Opponents of estate duty often view death as an illogical and immoral time to impose taxes. Compounding the grief of a family with a tax seems a bit heartless. In addition, estate duty induces wealthy individuals to begin distributing their assets long before they die.

³¹ Richard F. Fullenbaum and Marina A. McNeill The Effects of the Federal Estate and Gift Tax on the Aggregate Economy Research Institute for Small and Emerging Business *Working Paper Series* 98-01 (1998). See pp. 11-15.

³² Ibid at p. 15.

³³ William G. Gale and Joel Slemrod Resurrecting the Estate Tax, Policy Brief #62, *Brookings Institution* (June 2002) (www.brook.edu/dybdocroot/comm/policybriefs/pb062/pb62.pdf)

Estate duty may result in family farms and businesses not being retained within the family

Farmers are often faced with losing their farms. This is not so much the result of competition from wealthy agricultural businesses, but more often because the government taxes heavily the deceased estates of individuals who invested most of their earnings back into their farms and accumulated only meagre liquid savings. Farmers often invest heavily in their farms. Upon the death of the farmer, the farm assets would be included in the farmer's estate resulting in an estate duty liability. This tax liability can be particularly onerous due to the continuous investment in the farm and the illiquidity of the farmer's wealth. In order to settle the tax liability, it may be necessary to sell the farm or its contributing assets. This could result in a farm no longer being passed from generation to generation within a family.

Investing in a family business is one of the many forms of saving for the future, and it is the only form for some families. For most small family businesses, every available rand goes into the business to generate income for the owners and create an asset for their children. Small family businesses also provide jobs and economic growth. The financial security that these family-owned and small businesses provide is put at risk if the owner dies with a taxable estate.³⁴

³⁴ William W. Beach *A Scorecard on Death Tax Reform Backgrounder* No. 1197, 25 June, 1998. (www.heritage.org/library/backgrounder/pdf/bg_1197.pdf)

Estate duty is inequitable and socialistic

One of the most distinguishing attributes of estate duty is the broad range of avoidance options it permits. The tax avoidance options available to the estate planner are extensive. Virtually any individual who invests sufficient time, energy and money in tax avoidance strategies is capable of escaping estate duty altogether.³⁵ It is submitted that the only reason individuals submit to the tax at all is either ignorance of the available avoidance options or due to the cost of avoidance outweighing the benefits.

The Margo Commission accepted the views expressed in a report by the Organisation for Economic Cooperation and Development³⁶ that the main rationale for taxing capital relates to social considerations, these being considerations of equity between persons within society.³⁷ The equity of a particular tax is measured along two dimensions. The first dimension is vertical equity, which refers to the progressivity of the tax. A tax is said to be progressive when individuals with fewer resources pay less taxes than those with greater resources. Horizontal equity requires that taxpayers with the same amount of resources pay the same tax.

The existence of loopholes in the estate duty legislation virtually guarantees that estate duty will violate the principles of horizontal and vertical equity. Taxpayers all along the income and wealth spectrum can eliminate or greatly reduce their estate duty liability

³⁵ As determined in *CIR v Estate Kohler* 1953 (2) SA 584 (A) 591, the taxpayer is entitled to arrange his affairs within the ambit of the law to minimize his tax liability.

³⁶ Report of the Organization for Economic Cooperation and Development Committee (OECD) on Fiscal Affairs The Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals (1979).

³⁷ *Supra* note 7 at paragraph 20.8.

with enough advance planning. Thus, an individual with an estate worth R5 million can not only pay less in estate duty than other individuals with estates worth R5 million, but can pay less than those with estates worth R1 million. This aspect of estate duty was summarized by Munnell, who wrote:

“Those people who take advantage of these [tax avoidance] opportunities will end up paying little or no tax, while those who do not plan ahead will pay significant amounts. Horizontal and vertical equity considerations have disappeared in the estate and gift area; **tax liabilities depend on the skill of the estate planner, rather than on capacity to pay.**”³⁸

The wealthy have the resources to employ estate planners and will thus be able to minimize their tax liabilities. However, the middle-income earners are more likely to be burdened by estate duty due to their lack of resources. It is evident that estate duty, which is supposedly a progressive tax, is inequitable in this way.

Estate duty is a complex tax

Estate duty is a complex tax to the extent that certain valuations, required to determine the taxable value of the estate, are complicated. However, the estate duty legislation has remained largely unchanged since its inception, illustrating the strength of this legislation.

³⁸ Alicia H. Munnell, *Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes*, *New England Economic Review* Federal Reserve Bank of Boston (November/December 1988). (Emphasis added).

ARGUMENTS IN FAVOUR OF THE RETENTION OF ESTATE DUTY

Estate duty is an indirect way of taxing capital gains

There are three possible bases for taxing an individual. These bases are income, consumption and wealth. Each of these bases deals with a different aspect of the taxpayer's ability to pay tax "and it can be argued that the fairest system will utilise them all."³⁹

It is believed by some that it is crucial for capital gains to be fully taxed at death so that capital gains tax can properly achieve its objectives. Exemption from capital gains tax at death is thought to encourage wealthy taxpayers to defer the realisation of assets until death, thus escaping capital gains tax. Furthermore, the country's resources may be wasted due to investors retaining unproductive assets which could be put to better use by others.

Although a capital gains tax, which taxes the appreciation of wealth, has similar objectives to a wealth tax such as estate duty, it is more akin to income tax. This view is shared by Cedric Sandford, the editor of a publication on tax reform⁴⁰, and suggests that there may be a need to maintain estate duty in conjunction with capital gains tax.

³⁹ Cedric Sandford (Editor) *More Key Issues in Tax Reform*, Fiscal Publication (1995). See p. 49.

⁴⁰ Ibid.

In the opinion of Jennifer Roeleveld⁴¹, if taxpayers were subject to a capital gains tax during their lifetimes then there would be no need to have an estate duty payable upon death. As an alternative Roeleveld suggests that taxes payable upon death would have to take into account capital appreciations taxed during an individual's lifetime as capital gains.

The estate duty rate was decreased from 25% to 20% when capital gains tax was introduced in South Africa. The primary justification for this reduction was to counter any perceived double taxation. On the surface this may appear to be a fair concession, however, if one looks deeper into the combined tax effects of estate duty and capital gains tax that impact upon an individual, it may be questionable whether the reduction in the estate duty rate is adequate compensation for the additional capital gains tax liability that may arise upon death.

Value of information yielded by estate duty administration for income tax collection

The information yielded by estate duty is valuable to the extent that it provides details in respect of assets that generate income. Assets in an estate, which are transferred upon death, can be tracked by the Receiver of Revenue. With the knowledge obtained, the Receiver of Revenue may endeavour to collect income generated by these assets in terms of the Income Tax Act.

⁴¹ Supra note 27. See p.8.

Conclusion

There are many arguments in favour of the retention and the abolition of estate duty. Those in favour of the abolition of estate duty suggest that estate duty may violate the basic principles of a good tax system, such as simplicity and equity. Whereas, those in favour of the retention of estate duty believe that estate duty is a crucial element of the tax system. To determine whether amendments to the current estate duty legislation are necessary, the objectives of the tax should be established.

CHAPTER 3

CAPITAL GAINS TAX

In order to understand the combined effects of capital gains tax and estate duty, it is necessary to outline certain relevant provisions of the Eighth Schedule to the Income Tax Act⁴². A key concept in the capital gains tax regime is the “disposal” of an “asset” as it is this event that triggers a potential liability for capital gains tax.⁴³ It follows that if the event in question was not a “disposal” or the subject matter was not an “asset”, no capital gains tax consequences would arise.

Asset

The term ‘asset’⁴⁴ is defined for capital gains tax purposes and includes both property and a right or interest of whatever nature to or in property. This definition includes immovable property, incorporeal property, and usufructuary and fiduciary interests in immovable property.

⁴² Act No. 58 of 1962 (as amended).

⁴³ Eighth Schedule, paragraph 2(1).

⁴⁴ The definition of ‘asset’ in paragraph 1 of the Eighth Schedule provides:

‘**asset**’ includes:

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

Disposal

The term ‘disposal’⁴⁵ is defined in the Eighth Schedule of the Income Tax Act⁴⁶ and broadly includes the creation, variation, transfer or extinction of an asset. Specifically included in the definition are a sale, donation, termination, expiry or abandonment of an asset. Paragraph 40⁴⁷ of the Eighth Schedule deals with disposals to and from a deceased estate.

⁴⁵ The definition of ‘disposal’ in paragraph 11 of the Eighth Schedule provides that ‘a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes-

- (a) the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset;
- (b) the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;
- (c) the scrapping, loss, or destruction of an asset;
- (d) the vesting of an interest in an asset of a trust in a beneficiary;
- (e) the distribution of an asset by a company to a shareholder’

⁴⁶ Hereafter referred to as the Eighth Schedule.

⁴⁷ Paragraph 40 of the Eighth Schedule provides:

“Disposal to and from deceased estate. -

- (1) A deceased person must be treated as having disposed of his or her assets, other than –
 - (a) assets transferred to the surviving spouse of that deceased person ...;
 - (b) assets bequeathed to an approved public benefit organization ...;
 - (c) a long-term insurance policy of the deceased which if the proceeds of the policy had been received by or accrued to the deceased, the capital gain or capital loss determined in respect of that disposal would be disregarded ...; or
 - (d) an interest in a pension, provident or retirement annuity fund in the Republic or a fund, arrangement or instrument situated outside the Republic which provides benefits similar to a pension, provident or retirement annuity fund which if the proceeds thereof had been received by or accrued to the deceased, the capital gain or loss determined in respect of the disposal of the interest would have been disregarded...
 to his or her deceased estate for proceeds equal to the market value of those assets at the date of that person’s death, and the deceased estate must be treated as having acquired those assets at a cost equal to the market value, which cost must be treated as an amount actually incurred and paid for the purposes of paragraph 20(1)(a).
- (2) Subject to paragraph 12(5), where an asset is disposed of by a deceased estate to an heir or legatee (other than the surviving spouse of the deceased person... or an approved benefit organization... or a trustee of a trust –
 - (a) the deceased estate must be treated as having disposed of that asset for proceeds equal to the base cost of the deceased estate in respect of that asset; and
 - (b) the heir, legatee or trustee must be treated as having acquired that asset at a cost equal to the base cost of the deceased estate in respect of that asset, which cost must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a).
- (3) For the purposes of this Schedule, the disposal of an asset by the deceased estate of a natural person shall be treated in the same manner as if that asset had been disposed of by that natural person.”

Disposal to the deceased estate

A deceased person is treated as having disposed of all his assets⁴⁸ to his deceased estate for proceeds equal to the market value of those assets at the date of death and the deceased estate is treated as having acquired those assets at a cost equal to that market value.⁴⁹ This provision was inserted into the Eighth Schedule to cater for the transfer of a deceased person's assets to the deceased estate because no proceeds arise during such a transfer. The cost of acquisition is then treated as "expenditure actually incurred in respect of the cost of acquisition"⁵⁰ of those assets for the purposes of determining the base cost of those assets for the person acquiring those assets at the date of death. This disposal upon death has the effect that both capital gains tax and estate duty may be payable upon the same assets on the death of a natural person.

One possible unintended consequence of these provisions is discussed by Stein⁵¹ in regard to farms. Since the deceased is treated as having disposed of all of his assets at market value at death, if the deceased held trading stock at the date of death it would have to be valued at market value even though it is not a capital asset. In terms of section 35(3)(a) of the Eighth Schedule, since the cost or written down value of the trading stock would also be included in his taxable income for normal tax purposes, the proceeds from the disposal of the trading stock must be reduced by:

⁴⁸ Certain assets are specifically excluded. The excluded assets are:

- assets transferred to a surviving spouse of the deceased,
- assets bequeathed to public benefit organizations approved by the Commissioner, and
- long-term insurance policies of the deceased in respect of which, if the proceeds had accrued to the deceased, the capital gain or loss would have been disregarded.

⁴⁹ Eighth Schedule, paragraph 40(1).

⁵⁰ Eighth Schedule, paragraph 20(1)(a)

⁵¹ M Stein *Stein on Capital Gains Tax*, Issue 2, *Butterworths*, at p. 10-7

“any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain”.

In the opinion of Stein this provision is particularly harsh for farmers with livestock that is accounted for in terms of the First Schedule to the Income Tax Act⁵² at the relatively miniscule standard values applicable to livestock. This is due to the standard values applicable to livestock for income tax purposes being significantly lower than the market values of the proceeds used for capital gains tax purposes. As a result the reduction of the proceeds from the disposal of the livestock, in terms of section 35(3)(a) of the Eighth Schedule, would be minimal and may result in substantial taxable capital gains arising upon death.

Distribution by the executor

In terms of paragraph 40(2) of the Eighth Schedule, assets of the estate which are transferred to an heir, legatee⁵³ or the trustee of a trust must be treated as having been disposed of for proceeds equal to the base cost of the deceased estate in respect of that asset. The heir, legatee or trustee will then be treated as having acquired those assets at that same base cost.

Where an asset of the deceased accrues to a surviving spouse upon the death of the deceased, the base cost of the asset to the deceased will be treated as the proceeds on disposal. That base cost will then be attributed to the surviving spouse if the survivor

⁵² First Schedule to the Income tax Act No. 58 of 1962, paragraph 5.

⁵³ Excluding the surviving spouse of the deceased and approved public benefit organizations.

disposes of the asset. In addition, the surviving spouse will be treated as having acquired the asset on the same date as the deceased spouse for the purpose of calculating the time apportioned base cost. Consequently, any capital gain or loss may be deferred until the disposal by the surviving spouse.

Capital gain

A person's capital gain is the amount by which the proceeds received or accrued on the disposal of an asset exceed the base cost of that asset.⁵⁴

Taxable capital gain

The taxable capital gain of a natural person or a special trust is 25% of that person's net capital gain for that year of assessment. In all other cases, except for an insurer, the taxable capital gain is 50% of the net capital gain for that year of assessment.⁵⁵

Annual exclusion

The annual exclusion of a natural person and a special trust in respect of any year of assessment is R10 000. However, this exclusion is increased to R50 000 for the year of assessment in which a person dies.⁵⁶ The deceased estate is also entitled to an annual exclusion, as discussed later in this chapter.

⁵⁴ Eighth Schedule, paragraph 3(a)

⁵⁵ Eighth Schedule, paragraph 10.

⁵⁶ Eighth Schedule, paragraph 5.

Base Cost

The problem facing the executor is the determination of the base cost of the asset for the purpose of establishing the capital gain relating to the deemed disposal at death. The base cost of an estate asset at the death of the deceased is the direct cost to the deceased of the asset and certain additional expenditure⁵⁷ as detailed in paragraph 20 of the Eighth Schedule.

Capital gains tax is intended to apply only to those appreciations in the value of an asset that arise on or after 1 October 2001. Where the deceased acquired an estate asset before 1 October 2001 the capital gains tax provisions provide alternatives for determining the value as at 1 October 2001 to which expenditure after that date may be added to determine the base cost. The alternatives are as follows:

- *Market value at 1 October 2001*

Generally, the market value of an asset is “the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arms length in an open market.”⁵⁸

⁵⁷ Some of the more common items included in the base cost are:

- transfer costs,
- stamp duty and transfer duty,
- expenditure incurred in respect of the valuation of the asset,
- relocation costs relating to the asset, and
- expenditure actually incurred for the improvement or enhancement of the value of the asset.

⁵⁸ Eighth Schedule, paragraph 31(1)(g)

- *Time-apportionment base cost*

Under the time-apportionment basis, the proceeds on disposal are apportioned on a time basis. The capital gain will then be determined using the following formula⁵⁹:

$$Y = B + \frac{[(P - B) \times N]}{(T + N)}$$

Where:

Y = the time-apportionment base cost of a pre-valuation date asset

B = expenditure before 1 October 2001, allowed in terms of paragraph 20

P = the proceeds on disposal

N = the number of years between the date that the asset was acquired and 30 September 2001. Part of a year is treated as a full year. N is limited to 20 where the expenditure allowable in terms of paragraph 20 was incurred in more than one year of assessment prior to 1 October 2001.

T = the number of 12 month periods from 1 October 2001 until the date of the disposal of the asset after that date. Part of a year is treated as a full year.

Where a portion of the expenditure allowable in terms of paragraph 20 was incurred on or after 1 October 2001, the proceeds to be used to determine the

⁵⁹ Paragraph 30(1), Eighth Schedule.

time-apportionment base cost of the asset, must be determined using the following formula⁶⁰:

$$P = R \times \frac{B}{(A + B)}$$

Where:

P = proceeds to be used in the previous formula

R = total amount of proceeds

A = expenditure allowable in terms of paragraph 20 incurred on or after
1 October 2001

B = expenditure allowable in terms of paragraph 20 incurred before 1 October
2001.

Both paragraph 30(1) and paragraph 30(2) of the Eighth Schedule, as discussed above, are subject to paragraph 30(3) of the Eighth Schedule which provides the conditions under which special formulae for determining the time-apportionment base cost in respect of certain depreciable assets will apply.

- *20 percent of the market value of the assets at the deceased's death*

Where the costs that are used to determine the base cost at 1 October 2001, in terms of paragraph 20(1) of the Eighth Schedule, are not known and no valuation

⁶⁰ Paragraph 30(2), Eighth Schedule.

at 1 October 2001 exists, the valuation date value is deemed to be 20 percent of the market value of the assets concerned at the deceased's death.

Relief in respect of capital gains tax paid on death

For capital gains tax purposes, a natural person is treated as having disposed of all his assets at the date of death. Capital gains tax will therefore be levied on the appreciation in the value of the assets in the hands of the deceased from 1 October 2001 until the date of death. Estate duty, on the other hand, is levied on the net value⁶¹ of the deceased estate. Consequently, cases may arise where a significant capital gains tax liability exists due to the growth in the value of the assets, but no estate duty liability exists due to the deceased estate being heavily indebted.

The Eighth Schedule⁶² grants some relief to the deceased estate where the capital gains tax liability exceeds 50 percent of the net value⁶³ of the estate for estate duty purposes, before taking into account the capital gains tax. The lack of liquidity in the estate would oblige the executor to dispose of assets in order to settle the liability. In such a situation the heirs or legatees are permitted to take possession of the assets concerned, provided

⁶¹ Determined in terms of the Estate Duty Act No. 45 of 1955. The net value of an estate for estate duty purposes is the value of the property reduced by the value of the liabilities of the estate before the section 4A primary abatement in terms of the Estate Duty Act No.45 of 1955.

⁶² At paragraph 41.

⁶³ The net value of an estate for estate duty purposes is the value of the property reduced by the value of the liabilities of the estate before the section 4A primary abatement in terms of the Estate Duty Act No.45 of 1955.

they assume the responsibility to pay that part of the tax that exceeds 50% of the net value of the deceased estate. This liability would have to be paid within a period of three years from the date the executor obtained permission to distribute the asset and would bear interest at the rate prescribed by the Minister of Finance.

Example 3.1

X passed away holding a property, which he had acquired for R200 000, but which had appreciated to R3 million by the time of his death. He had secured a cash loan of R2.5 million using this property as security. The bulk of the loan was transferred to his ex-wife in a divorce settlement and X spent the remainder of the loan prior to his death. The net value of the estate after allowable deductions (excluding the capital gains tax on the increase in value of the share portfolio) is R300 000.

Assuming that X is subject to tax at the maximum effective capital gains tax rate (10%)⁶⁴, the tax relating to the taxable capital gain is R275 000, after taking into account the increased annual exclusion of R50 000 in the year of his death. The tax of R275 000 is calculated as follows:

$$[(3\ 000\ 000 - 200\ 000) - 50\ 000] \times 10\% = 275\ 000$$

As this exceeds 50% of the net value of the estate (R150 000)⁶⁵ it may be possible for X's heir to defer payment of R125 000, calculated as follows:

$$275\ 000 - 150\ 000 = 125\ 000$$

⁶⁴ The maximum marginal rate of income tax for an individual of 40% is assumed based on the 2003/2004 income tax tables. The capital gain of the deceased is taxed at an inclusion rate of 25%. This results in the maximum effective capital gains tax rate of 10% (40 x 25% = 10%).

⁶⁵ R300 000 x 50% = R150 000

Special trust

A special trust is a trust established for a person suffering from a disability which prevents that person from earning sufficient income for their own maintenance. The 2002 Taxation Laws Amendment Act (Act No. 30 of 2002) extended this definition to include any trust created by or in terms of the will of a deceased person, solely for the beneficiaries who are relatives in relation to the deceased and who are alive on the date of the death of the deceased (including any beneficiary that has been conceived but not yet born) where the youngest of these beneficiaries is under the age of 21 years on the last day of the year of assessment. All special trusts qualify for the same inclusion rate (25%) as an individual, but only the first mentioned special trust is entitled to the annual exclusion granted to natural persons. In addition, a special trust is also entitled to the primary residence exclusion. For capital gains tax purposes, when the beneficiary of a special trust dies, the trust continues to be treated as a special trust until the earlier of:

- the date of disposal of all the assets held by the trust, or
- two years from the date of death of the beneficiary.

Primary Residence

Paragraph 45(1) of the Eighth Schedule provides that a natural person and a special trust must disregard capital gains and losses that arise from the disposal of a primary residence to the extent that they do not exceed R1 million.

The following definitions are relevant for an understanding of the primary residence provisions:

“**Primary residence**” means a residence –

- (a) in which a natural person or a special trust holds an interest; and
- (b) which that person or a beneficiary of that trust or a spouse of that person or beneficiary –
 - (i) ordinarily resides or resided in as his or her main residence; and
 - (ii) uses or used mainly for domestic purposes.⁶⁶

It is evident from the definition that a natural person or a special trust must hold an interest in the residence. If a company, close corporation or ordinary trust owns an interest in a property, it will not qualify as a primary residence. This is true even if a shareholder of the company, a member of the close corporation or a beneficiary of the trust occupies the residence. Furthermore, the residence must be occupied as the main residence by the owner (if the owner is a natural person), or by a beneficiary of a special trust, or by the spouse of either one of them. The residence must also be used primarily for domestic or private residential purposes.

Only one residence can be a “primary residence” of a natural person or a special trust at any one point in time.⁶⁷ As pointed out in a publication by Ernst and Young, ‘this is expressly provided for; notwithstanding that the word “primary” on its own would tend to suggest that conclusion.’⁶⁸

⁶⁶ Paragraph 44, Eighth Schedule

⁶⁷ Eighth Schedule, paragraph 45(3)

⁶⁸ Ernst and Young Practical Guide to Capital Gains Tax 2001, First Edition, at p. 82.

“**Residence**” means any structure including

- a boat⁶⁹, caravan or mobile home,
- which is used as a place of residence
- by a natural person,
- together with any appurtenance belonging thereto and enjoyed therewith.⁷⁰

The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2001⁷¹ points out that the type of structure envisaged is

“one of a more permanent nature where the level of facilities make that structure habitable. An underground structure or a structure built into a cliff-face would possibly qualify as a residence whereas a tent would not possibly qualify as a residence. It is clear from the proposed definitions, however, that where land is owned by a natural person, but that person lives in, for instance, a borrowed caravan, then that land would not qualify as a primary residence. A residence would mean any structure and as the person would not have an interest in the structure (the caravan), there would be no primary residence as defined. An “appurtenance” would be considered as an appendage or something forming part of the residence such as a separate garage, various outbuildings, a swimming pool or a tennis court.”

“**An interest**” means

- (a) any real or statutory right; or
- (b) a share owned directly in a share block company as defined in the Share Blocks Control Act, 1980 (Act No. 59 of 1980) or a share or interest in a similar entity which is not a resident; or
- (c) a right of use or occupation,

but excluding

⁶⁹ Per the Eighth Schedule, paragraph 1:

“**boat**” means any vessel used or capable of being used in, under or on the sea or internal waters, whether-

- (a) self-propelled or not; or
- (b) equipped with an inboard or outboard motor

⁷⁰ Paragraph 44, Eighth Schedule

⁷¹ At 77-78

-
- (i) a right under a mortgage bond; or
 - (ii) a right or interest of whatever nature in a trust, other than a right of a lessee who is not a connected person in relation to that trust.⁷²

This implies that a person may hold an interest in a residence by owning the residence, by holding shares in a share block company or even by holding a mere right to occupy the residence.

Sale of estate assets

If during the winding-up of a deceased estate assets are disposed of, the deceased estate is treated in the same manner as the deceased would have been treated if the deceased had disposed of the assets.⁷³ The effect of this provision is that the estate will be taxed at the same inclusion rate and will enjoy the same exclusions that the deceased would have enjoyed if the deceased had disposed of the assets on the day before death.

According to Huxham and Haupt⁷⁴, it is not clear how the primary residence exclusion works when an estate sells a primary residence. The deceased would be allowed the R1 million primary residence exclusion for capital gains tax purposes upon the deemed disposal of the deceased's assets to the deceased estate. However, it is questionable whether the R1 million primary residence exclusion will be allowed again with respect to the disposal by the estate. In the examples in this paper, it is assumed that the primary

⁷² Paragraph 44, Eighth Schedule

⁷³ Eighth Schedule, paragraph 40(3)

⁷⁴ K Huxham and P Haupt (2002), *Notes on South African Income Tax*, Hedron Tax Consulting and Publishing CC, at p. 592.

residence exclusion applies to a deceased estate in the same manner as it would have applied to the deceased had the deceased disposed of the primary residence.

Huxham and Haupt also point out that it is not clear whether the annual exclusion allowed to a deceased estate is R10 000 or R50 000. This confusion arises because the annual exclusion of a natural person and a special trust increases from R10 000 to R50 000 in the year of death. It is also unclear whether the R50 000 exemption may be extended to the deceased estate if it is not fully utilised by the deceased. The examples in this paper will assume that the deceased estate is allowed an annual exclusion of R10 000 if an asset is sold during the winding-up of the estate.

Transitional provisions

Many properties have traditionally been held in trusts, companies and close corporations for a variety of reasons, including wealth protection and estate planning. Since the primary residence exclusion only applies to natural persons and beneficiaries of special trusts, properties held in these structures would not have this exclusion available to them. As a result, transitional provisions were included in the Eighth Schedule⁷⁵ to provide for the transfer of a primary residence held in a corporate structure or a trust to be transferred to a natural person free of capital gains tax, transfer duty, secondary tax on companies and stamp duty. Similar provisions were introduced into the Transfer Duty Act⁷⁶.

⁷⁵ At paragraph 51.

⁷⁶ Transfer Duty Act No. 40, 1949, section 9(16) and (17)

A primary residence transferred to an individual by a company, close corporation or trust under these circumstances was treated as having been disposed of and acquired at market value on 1 October 2001, even though the actual date of disposal was after that date. As the market value of the property on 1 October 2001 was also the expenditure at 1 October 2001 for the property, no capital gain or loss arose in the hands of the company, close corporation or trust. Any capital gain or loss after 1 October 2001 will be accounted for in the hands of the individual taking transfer if the primary residence ever qualifies for capital gains tax. In order to take advantage of these provisions, a primary residence had to be transferred by 30 September 2002 and was to be registered in the individual's name by 31 March 2003.

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CHAPTER 4

ANALYSIS OF THE CUMULATIVE RATE OF CAPITAL GAINS TAX AND ESTATE DUTY

When analysing the effects of capital gains tax and estate duty on the tax liability of the deceased, it is necessary to analyse the cumulative effective rate of capital gains tax and estate duty to determine how the cumulative effective rate compares to the original rate of estate duty before the implementation of capital gains tax on 1 October 2001.

Example 4.1⁷⁷

Mr X dies and his only asset at the date of death is a block of flats. Three scenarios are analysed below. These scenarios present situations where the market value of the block of flats is 50%, 100% and 150% in excess of the base cost of the block of flats at the date of death. The base cost of the block of flats is R5 million.

Pre-Introduction Of Capital Gains Tax			
Estate Duty Calculation	50%	100%	150%
Market value – death (A)	7 500 000	10 000 000	12 500 000
Estate duty rate ⁷⁸	25%	25%	25%
Estate duty (B)	1 875 000	2 500 000	3 125 000
Effective rate (B/A)	25%	25%	25%

⁷⁷ This example ignores the section 4A primary abatement provided for in the Estate Duty Act No. 45 of 1955 and the annual exclusion provided for in the Eighth Schedule of the Income Tax Act No. 58 of 1962.

⁷⁸ Due to the introduction of capital gains tax the Minister of Finance announced a reduction in the estate duty rate from 25% to 20% from 1 October 2001.

Current Situation			
Capital Gains Tax Calculation	50%	100%	150%
Market value – death (C)	7 500 000	10 000 000	12 500 000
Base cost	<u>5 000 000</u>	<u>5 000 000</u>	<u>5 000 000</u>
Capital gain	2 500 000	5 000 000	7 500 000
Maximum effective rate ⁷⁹	10%	10%	10%
Capital gains tax (D)	250 000	500 000	750 000
<hr/>			
Estate Duty Calculation	50%	100%	150%
Market value - death	7 500 000	10 000 000	12 500 000
Less: Capital gains tax liability	(250 000)	(500 000)	(750 000)
Dutiable Estate	7 250 000	9 500 000	11 750 000
Estate duty rate	20%	20%	20%
Estate Duty (E)	1 450 000	1 900 000	2 350 000
<hr/>			
Total tax liability (F) = (D+E)	1 700 000	2 400 000	3 100 000
Effective rate = (F/C)	22.67%	24.00%	24.80%

⁷⁹ All examples assume the maximum marginal rate of Income Tax for an individual of 40% based on the 2003/2004 Income Tax tables. The capital gain of the deceased is taxed at an inclusion rate of 25% and assuming the taxpayer is subject to the maximum marginal rate of income tax, the effective rate is 10%. (40% x 25% = 10%)

The preceding example illustrates that the combined effective rate of capital gains tax and estate duty is approximately equal to the estate duty rate (25%) prior to the introduction of capital gains tax when the market value of the estate assets exceeds the base cost of those assets by 150%.

From the results in Example 4.1, it can be concluded that, generally, when the market value of an asset at the date of death exceeds the base cost of that asset by less than or equal to 100% of the base cost, the cumulative effective rate of estate duty and capital gains tax is 24% and lower. When the market value of an asset at the date of death exceeds the asset's base cost by more than 100% of the base cost, the cumulative effective rate of capital gains tax and estate duty, generally, exceeds 24%. Therefore, the higher the growth of the assets, the higher the cumulative effective rate of capital gains tax and estate duty. Furthermore, the longer the period for which assets are held the greater the capital appreciation is likely to be. This will also result in an increasing cumulative percentage tax.

Example 4.2⁸⁰

Mr Y dies and the gross value of his estate assets, which comprise a block of flats, is R20 million. An analysis is provided on page 41 based on the percentage of the gross value of the block of flats that constitutes its base cost upon the death of Mr Y. The following scenarios are presented:

- The base cost is 100% of the gross value of the estate;

⁸⁰ Supra note 76

- The base cost is 75% of the gross value of the estate;
- The base cost is 50% of the gross value of the estate;
- The base cost is 25% of the gross value of the estate; and
- The base cost is 0% of the gross value of the estate.

Table 3: Tax Payable at Death as a Percentage of the Net Estate

Base cost as a percentage of gross value of estate (%)	Effective tax rate pre capital gains tax (Estate Duty only) (%)	Effective Capital gains tax rate* (= A) (%)	Current effective rate (Estate Duty and Capital Gains Tax) ⁸¹ (%)
100	25	0	20
75	25	2	22
50	25	4	24
25	25	6	26
0	25	8	28

Base cost as a percentage of the gross value of the estate	0%	25%	50%	75%	100%
Capital gains tax payable - CGT (10%) ⁸²	2 000 000	1 500 000	1 000 000	500 000	-
Effective capital gains tax deduction against estate duty ⁸³	(400 000)	(300 000)	(200 000)	(100 000)	-
Effective capital gains tax net of deduction against estate duty (B)	1 600 000	1 200 000	800 000	400 000	-
Effective capital gains tax rate* (A) ⁸⁴	8.0%	6.0%	4.0%	2.0%	0.0%

* Net of capital gains tax deduction against estate duty

⁸¹ 20% estate duty + **A**

⁸² [20 000 000 x (100% - the base cost as a percentage of the gross value of the estate) x 10%]

⁸³ The capital gains tax liability is allowed as a deduction against the gross value of the estate in the estate duty calculation. Since estate duty is calculated at 20%, the effective capital gains tax reduction is 20% of the capital gains tax.

⁸⁴ **A** = **B** / 20 000 000

In theory, the effective tax rate on estates could increase to 28%. Table 3 illustrates that when 100% of the gross value of the estate is subject to capital gains tax, the effective capital gains tax rate is 8%. When this is combined with the estate duty rate of 20%, a cumulative effective rate of 28% is obtained. This indicates a cumulative effective rate of estate duty and capital gains tax that exceeds the estate duty rate before the introduction of capital gains tax (25%) by 3%. The greater the growth in the assets in the estate, the more significant this percentage increase would be in Rand terms. However, the estate of a wealthy individual is likely to be made up of a variety of assets some of which will be excluded⁸⁵ or partially excluded⁸⁶ from capital gains tax. This would reduce the effective cumulative rate of capital gains tax and estate duty.

Conclusion

From the preceding analysis, it can be derived that the greater the appreciation in the assets, the higher the cumulative effective rate of capital gains tax and estate duty.

In theory, the cumulative effective rate of estate duty and capital gains tax could increase to a maximum of 28%, being 3% in excess of the estate duty rate before the introduction of capital gains tax. A greater appreciation in the estate assets would result in a more significant increase in the tax liability in Rand terms.

⁸⁵ For example lumpsum benefits from pension, provident and retirement annuity funds which are not subject to CGT in terms of paragraph 54 of the Eighth Schedule.

⁸⁶ For example a "primary residence" for which a reduction of R1 million is allowed from any capital gain related thereto.

CHAPTER 5

THE TAX AND CASH FLOW EFFECTS EXPERIENCED BY AN INDIVIDUAL DUE TO CAPITAL GAINS TAX, ESTATE DUTY, TRANSFER DUTY AND SECONDARY TAX ON COMPANIES

In this chapter, some of the combined effects of capital gains tax, estate duty, transfer duty and secondary tax on companies (STC) are illustrated through examples. Specifically, the following scenarios are examined:

- 5.1) A holiday home held by an individual at death if capital gains tax had not been introduced;
- 5.2) A holiday home held by an individual at death after the introduction of capital gains tax;
- 5.3) A primary residence held by an individual at death after the introduction of capital gains tax; and
- 5.4) The membership interest of a deceased in a close corporation that holds a holiday home after the introduction of capital gains tax.

The effects of transfer duty and STC are included in the examples below in order to enhance the analysis. The estate duty, capital gains tax, transfer duty and STC liabilities are calculated under a range of assumptions and the cash flow effects relating to each situation are presented.

When capital gains tax was introduced in South Africa, there was no transfer duty on the purchase of company shares, close corporation members' interests and trust beneficiaries' interests. However, the Minister of Finance indicated in his 2002 Budget Speech that measures would be taken to deal with those situations where individuals attempted to avoid transfer duty by acquiring immovable property through a company, close corporation or trust. Transfer duty is levied in terms of the Revenue Laws Amendment Act⁸⁷, 2002, on the purchase of shares in a company, the member's interest in a close corporation or a contingent right in a trust, where the majority of the assets in the company, close corporation or trust are residential properties⁸⁸ or an indirect holding in such properties.

The definition of property in the Transfer Duty Act⁸⁹ was extended to include "a share or member's interest in a residential property company"⁹⁰. It is submitted that the amendments to the Transfer Duty Act relating to residential property companies, should have been addressed at the same time as the transitional provisions, which allowed property to be acquired by an individual from a company, close corporation or trust, free of transfer duty and capital gains tax. Taxpayers would then have been able to make

⁸⁷ Revenue Laws Amendment Act No. 74, 2002. Amendment of section 1 of Act No. 40 of 1949, at p. 4. This provision applies to property acquired on or after 13 December 2002. The date of acquisition is the date on which both parties sign an agreement.

⁸⁸ The concept of "residential property" is defined as:

- a dwelling-house, holiday home, apartment, or similar abode,
- improved or unimproved land zoned for residential use, or
- any real right to these properties.

The intention is, however, to exclude properties held by business enterprises with substance. This is achieved by excluding –

- an apartment complex, hotel, guesthouse, or similar structure of more than five units as long as they have been rented to five or more persons unconnected to their owner, or
- any fixed property of a vendor forming part of an enterprise for VAT purposes.

⁸⁹ Act No. 40 of 1949.

⁹⁰ Revenue Laws Amendment Act No. 74, 2002. Amendment of section 1 of Act No. 40 of 1949, at p. 5.

informed decisions and could have taken full advantage of the concession to transfer their companies out of corporate structures and trusts, free of capital gains tax and transfer duty.

EXAMPLE 5.1

HOLIDAY HOME HELD BY AN INDIVIDUAL IF CAPITAL GAINS TAX HAD NOT BEEN INTRODUCED

For comparative purposes, an illustration is presented of the tax effects if capital gains tax had not been introduced at all, the estate duty rate had not been reduced from 25% to 20%⁹¹, and the primary abatement for estate duty purposes of R1 million had not been increased to R1.5 million⁹².

Y purchased a property from X for R500 000 on 1 October 2000. The market value of the property on 1 October 2001 was R1 million. On 1 October 2003, Y sold the property to Z for R2 million. On 1 October 2004, Z dies and the property is left to Z's son in terms of his will. The market value on 1 October 2004 is R2.5 million. It is assumed that the base cost of the property for capital gains tax purposes is the market value of the property at 1 October 2001.

⁹¹ The estate duty rate was reduced from 25% to 20% from 1 October 2001.

⁹² The estate duty primary rebate increased from R1 million to R1.5 million from 1 March 2002. The primary abatement is allowed as a deduction against the net estate in order to calculate the dutiable estate, and is provided for in terms of section 4A of the Estate Duty Act No. 45 of 1955.

Without the introduction of capital gains tax, the only taxes payable in the circumstances described above would have been estate duty and transfer duty. The tax liability would have been as follows:

1 October 2000

<i>Transfer duty</i> ⁹³	R
1% on the first R70 000 of the property value ⁹⁴	700
5% on the property value from R70 001 to R250 000 ⁹⁵	9 000
8% on the property value in excess of R250 000 ⁹⁶	20 000
	29 700

1 October 2003

<i>Transfer duty</i> ⁹⁷	R
5% on the property value from R140 001 to R320 000 ⁹⁸	9 000
8% on the property value in excess of R320 000 ⁹⁹	134 400
	143 400

⁹³ See Appendix A for the applicable transfer duty rates.

⁹⁴ $70\,000 \times 1\% = 700$

⁹⁵ $(250\,000 - 70\,000) \times 5\% = 9\,000$

⁹⁶ $(500\,000 - 250\,000) \times 8\% = 20\,000$

⁹⁷ The transfer duty rates were amended on 1 March 2002. See Appendix A.

⁹⁸ $(320\,000 - 140\,000) \times 5\% = 9\,000$

⁹⁹ $(2\,000\,000 - 320\,000) \times 8\% = 134\,400$

1 October 2004

<i>Estate duty</i> ¹⁰⁰	R
Gross value of estate assets	2 500 000
Gross estate liabilities	-
Dutiable estate	<u>2 500 000</u>
Estate duty at 25% (2 500 000 x 25%)	625 000

Summary

	R
Transfer duty - 1 October 2000	29 700
- 1 October 2003	143 400
Estate duty - 1 October 2004	625 000
Total tax liability	<u>798 100</u>

¹⁰⁰ All examples in this chapter will ignore the section 4A abatement allowed for estate duty purposes, as if other assets in the estate were sufficient to absorb the abatement.

The cash flow implications are as follows:

<i>Cash Flows</i>	X	Y	Z¹⁰¹	Total
Sale - 1 October 2000	500 000	(500 000)	-	-
Transfer duty - 1 October 2000	-	(29 700)	-	(29 700)
Sale - 1 October 2003	-	2 000 000	(2 000 000)	-
Transfer duty - 1 October 2003	-	-	(143 400)	(143 400)
Estate duty	-	-	(625 000)	(625 000)
Net cash inflow/(outflow)	500 000	1 470 300	(2 768 400)	(798 100)

EXAMPLE 5.2

HOLIDAY HOME HELD BY AN INDIVIDUAL AT DEATH AFTER THE INTRODUCTION OF CAPITAL GAINS TAX

This example assumes the same facts as in example 5.1, except that it takes into account the introduction of capital gains tax from 1 October 2001.

The transfer duty on the holiday home held by the individual would remain unchanged after the introduction of capital gains tax, but the capital gains tax and estate duty liabilities are affected as follows:

¹⁰¹ All of the examples in this chapter treat the cash flow implications for Z's deceased estate as being cash flows relating to Z.

1 October 2003

Capital gains tax	R
Proceeds	2 000 000
Base cost	(1 000 000)
Capital gain	<u>1 000 000</u>
Less: annual exclusion	(10 000)
Taxable capital gain	<u><u>990 000</u></u>
Capital gains tax (990 000 x 10%¹⁰²)	99 000

1 October 2004

Capital gains tax	R
Proceeds	2 500 000
Base cost (2 000 000 + 143 400)	(2 143 400)
Capital gain	<u>356 600</u>
Less: annual exclusion	(50 000)
Taxable capital gain	<u><u>306 600</u></u>
Capital gains tax (306 600 x 10%)	30 660

¹⁰² The capital gains tax inclusion rate for an individual is 25%. The maximum income tax rate for an individual is 40%. The maximum effective capital gains tax rate for an individual of 10% can be obtained by multiplying the maximum income tax rate by the capital gains tax rate for an individual (40% x 25% = 10%). The maximum effective capital gains tax rate for an individual of 10% will be used in all of the examples in this chapter.

<i>Estate duty</i>	R
Gross value of estate assets	2 500 000
Capital gains tax liability	(30 660)
Dutiable estate	<u>2 469 340</u>
Estate duty at 20% (2 469 340 x 20%)	493 868

<i>Summary</i>	R
Transfer duty - 1 October 2000	29 700
- 1 October 2003	143 400
Capital gains tax - 1 October 2003	99 000
- 1 October 2004	30 660
Estate duty	493 868
Total tax liability	<u>796 628</u>

The cash flow implications are as follows:

Cash Flows

	X	Y	Z	Total
Sale - 1 October 2000	500 000	(500 000)	-	-
Transfer duty - 1 October 2000	-	(29 700)	-	(29 700)
Sale - 1 October 2003	-	2 000 000	(2 000 000)	-
Transfer duty - 1 October 2003	-	-	(143 400)	(143 400)
Capital gains tax - 1 October 2003	-	(99 000)	-	(99 000)
Capital gains tax - 1 October 2004	-	-	(30 660)	(30 660)
Estate duty	-	-	(493 868)	(493 868)
Net cash inflow/(outflow)	500 000	1 371 300	(2 667 928)	(796 628)

The total tax liability decreases from R798 100 to R796 628 due to the introduction of capital gains tax. This is a decrease of **0.18%**¹⁰³. Although this decrease may appear to be negligible, the difference in the cash flow effects for each taxpayer is more significant. Y experiences a decrease in net cash inflow of 6.73%¹⁰⁴ (R99 000¹⁰⁵) and Z experiences a reduction in cash outflow of 3.63%¹⁰⁶ (R100 472¹⁰⁷). Furthermore, the greater the capital appreciation in the property the higher the capital gains tax liability.

EXAMPLE 5.3

PRIMARY RESIDENCE HELD BY AN INDIVIDUAL AT DEATH AFTER THE INTRODUCTION OF CAPITAL GAINS TAX

Assuming the same facts as in example 5.2, except that the property is a “primary residence” for capital gains tax purposes in the hands of each owner.

This situation produces the same transfer duty effects as when a holiday home was held by an individual at death after the introduction of capital gains tax. However, due to the property being a primary residence, the R1 000 000 primary residence exclusion leads to the capital gains tax and estate duty liabilities being different to those for a holiday home.

¹⁰³ $[(796\,628 - 798\,100)/798\,100] \times 100 = 0.18\%$

¹⁰⁴ $[(1\,371\,300 - 1\,470\,300)/1\,470\,300] \times 100 = 6.73\%$

¹⁰⁵ $1\,371\,300 - 1\,470\,300 = 99\,000$

¹⁰⁶ $[(2\,667\,928 - 2\,768\,400)/2\,768\,400] \times 100 = 3.63\%$

¹⁰⁷ $2\,667\,928 - 2\,768\,400 = 100\,472$

1 October 2003

Capital gains tax	R
Proceeds	2 000 000
Base cost	(1 000 000)
Capital gain before primary residence exclusion	<u>1 000 000</u>
Primary residence exclusion	<u>(1 000 000)</u>
Capital gain	-
Less: annual exclusion	-
Taxable capital gain	<u><u>-</u></u>
Capital gains tax (0 x 10%)	NIL

1 October 2004

Capital gains tax	R
Proceeds	2 500 000
Base cost (2 000 000 + 143 400)	(2 143 400)
Capital gain before primary residence exclusion	<u>356 600</u>
Primary residence exclusion (limited to capital gain of R356 600)	<u>(356 600)</u>
Capital gain	-
Less: annual exclusion	-
Taxable capital gain	<u><u>-</u></u>
Capital gains tax (0 x 10%)	NIL

<i>Estate duty</i>	R
Gross value of estate assets	2 500 000
Capital gains tax liability	-
Dutiable estate	<u>2 500 000</u>
Estate duty at 20% (2 500 000 x 20%)	500 000

<i>Summary</i>	R
Transfer duty - 1 October 2000	29 700
- 1 October 2003	143 400
Capital gains tax - 1 October 2003	-
- 1 October 2004	-
Estate duty	500 000
Total tax liability	<u><u>673 100</u></u>

The cash flow implications are as follows:

<i>Cash Flows</i>	X	Y	Z	Total
Sale - 1 October 2000	500 000	(500 000)	-	-
Transfer duty - 1 October 2000	-	(29 700)	-	(29 700)
Sale - 1 October 2003	-	2 000 000	(2 000 000)	-
Transfer duty - 1 October 2003	-	-	(143 400)	(143 400)
Capital gains tax - 1 October 2003	-	-	-	-
Capital gains tax - 1 October 2004	-	-	-	-
Estate duty	-	-	(500 000)	(500 000)
Net cash inflow/(outflow)	500 000	1 470 300	(2 643 400)	(673 100)

When comparing the total tax liability for a primary residence with the total tax liability for a holiday home (as illustrated in Example 5.2), after the introduction of capital gains tax, it is evident that the primary residence exclusion has a significant effect. The total tax liability is R796 623 for the holiday home in comparison to the tax liability of R 673 100 for the primary residence.

The primary residence would need to be held by a natural person or a special trust to benefit from the primary residence exclusion. It may therefore be beneficial for a taxpayer, who expects a large capital appreciation in his primary residence, to purchase that residence in his own name rather than in a corporate structure or a trust.

The maximum benefit to the deceased of holding a primary residence at death is R80 000, ignoring all exclusions, exemptions and abatements other than the primary residence exclusion. The primary residence exclusion is R1 million. The inclusion rate for the capital gain for an individual is 25 percent. 25 percent of R1 million is R250 000. The maximum marginal income tax rate is 40 percent for an individual, based on the 2003/4 tax tables. 40 percent of R250 000 is R100 000. Since the capital gains tax is deducted against the gross value of the estate for estate duty purposes and the estate duty rate is 20 percent, the R100 000 capital gains tax benefit is reduced by 20 percent to R80 000. This is the maximum possible benefit at death of the primary residence exclusion as the exclusion is limited to the capital gain before taking the exclusion into account. This benefit may be reduced if the capital gain prior to the deduction of the primary residence exclusion is less than R1 million.

EXAMPLE 5.4**MEMBERSHIP INTEREST HELD BY AN INDIVIDUAL IN A CLOSE CORPORATION THAT OWNS THE INDIVIDUAL'S HOLIDAY HOME¹⁰⁸*****Example 5.4(a)***

Y purchased the full membership interest in a close corporation from X for R500 000 on 1 October 2000. The only asset in the close corporation was a holiday home and there were no liabilities. The market value of the property and the membership interest on 1

¹⁰⁸ Stamp duty has been ignored for the purposes of the following examples.

October 2001 was R1 million. On 1 October 2003, Y sold his interest in the close corporation to Z for R2 million. On 1 October 2004, Z dies and the membership interest is left to Z's son in terms of his will. The market value on 1 October 2004 is R2.5 million. It is assumed that the base costs of the property and the membership interest, for capital gains tax purposes, are equivalent to their market values at 1 October 2001.

In this case the estate duty and capital gains tax liabilities are the same as those illustrated in example 5.2, where the holiday home was held directly by the individual. However, as shown below, the transfer duty in this situation differs from the transfer duty when the holiday home is held directly by the individual.

1 October 2000

There are no tax effects. It should be noted that in terms of the legislation existing on 1 October 2000, there was no transfer duty on the sale of a membership interest in a close corporation.

1 October 2003

<i>Transfer duty</i> ¹⁰⁹	R
5% on the property value from R140 001 to R320 000 ¹¹⁰	9 000
8% on the property value in excess of R320 000 ¹¹¹	134 400
	143 400

¹⁰⁹ The transfer duty rates were amended on 1 March 2002 and 1 March 2003. See Appendix A.

¹¹⁰ $(320\,000 - 140\,000) \times 5\% = 9\,000$

¹¹¹ $(2\,000\,000 - 320\,000) \times 8\% = 134\,400$

Summary		R
Capital gains tax	- 1 October 2003	99 000
	- 1 October 2004	30 660
Transfer duty	- 1 October 2003	143 400
Estate duty		493 868
Total tax liability		766 928

The cash flow implications are as follows:

Cash Flows	X	Y	Z	Total
Sale - 1 October 2000	500 000	(500 000)	-	-
Sale - 1 October 2003	-	2 000 000	(2 000 000)	-
Capital gains tax - 1 October 2003	-	(99 000)	-	(99 000)
Transfer duty – 1 October 2003	-	-	(143 400)	(143 400)
Capital gains tax - 1 October 2004	-	-	(30 660)	(30 660)
Estate duty	-	-	(493 868)	(493 868)
Net cash inflow/(outflow)	500 000	1 401 000	(2 667 928)	(766 928)

The total tax liability in the example above is **3.73%**¹¹² less than the liability if the property was held directly by the individual being directly attributable to transfer duty not being applicable to membership interests at 1 October 2000. Had the transfer duty amendments contained in the Revenue Laws Amendment Act No. 74, 2002, not been introduced, the R143 400 transfer duty liability in this example would not have arisen and the gap in these tax liabilities would have been far wider. The new transfer duty legislation, therefore, lessens one of the past advantages of holding property, such as a holiday home, in a corporate structure or a trust. These amendments may result in detrimental tax effects for the taxpayer. Taxpayers will need to carefully assess the advantages and disadvantages of purchasing or retaining a property in a corporate structure or trust due to the potential tax liabilities that could arise.

Example 5.4(b)

Assuming the same facts as in Example 5.4(a), except that the membership interest in the close corporation is not distributed to Z's son, but is sold to an individual 6 months after the death of Z (on 1 April 2005) during the liquidation of the estate by the executor for proceeds equivalent to its market value of R2 800 000.

The tax situation on 1 October 2000 and 1 October 2003 is the same as in Example 5.4(a). As illustrated on pages 60 and 61, the estate duty implications in this situation are different and there are additional tax implications on 1 April 2005.

¹¹² $[(766\,928 - 796\,628) / 796\,628] \times 100 = 3.73\%$

1 April 2005

<i>Capital gains tax - disposal by the deceased estate</i>	R
Proceeds	2 800 000
Base cost	(2 500 000)
Capital gain	<u>300 000</u>
Less: annual exclusion	(10 000)
Taxable capital gain	<u><u>290 000</u></u>
Capital gains tax (290 000 x 10%)	29 000
<i>Transfer duty</i> ¹¹³	R
5% on the property value from R140 001 to R320 000 ¹¹⁴	9 000
8% on the property value in excess of R320 000 ¹¹⁵	198 400
	<u><u>207 400</u></u>

¹¹³ The transfer duty rates were amended on 1 March 2002 and 1 March 2003. See Appendix A.

¹¹⁴ $(320\,000 - 140\,000) \times 5\% = 9\,000$

¹¹⁵ $(2\,800\,000 - 320\,000) \times 8\% = 207\,400$

Estate duty	R
Gross value of estate assets	2 800 000
Capital gains tax liability - disposal from the deceased to the estate	(30 660)
Capital gains tax liability - disposal by the deceased estate	(29 000)
Dutiable estate	<u>2 740 340</u>
Estate duty at 20% (2 740 340 x 20%)	548 068

If property is disposed of by a bona fide sales transaction in the course of the liquidation of the estate, such property is valued at the value realised by the sale for estate duty purposes.¹¹⁶ Therefore the gross value of the estate assets is R2.8 million in this example.

Summary	R
Capital gains tax - 1 October 2003	99 000
- 1 October 2004	30 660
- 1 April 2005	29 000
Transfer duty - 1 October 2003	143 400
- 1 April 2005	207 400
Estate duty	548 068
Total tax liability	<u>1 057 528</u>

¹¹⁶ Estate Duty Act No. 45 of 1955, section 5(1)(a).

The cash flow implications are as follows:

<i>Cash Flows</i>	X	Y	Z	Other	Total
Sale - 1 October 2000	500 000	(500 000)	-	-	-
Sale - 1 October 2003	-	2 000 000	(2 000 000)	-	-
Transfer duty – 1 October 2003	-	-	(143 400)	-	(143 400)
Capital gains tax - 1 October 2003	-	(99 000)	-	-	(99 000)
Capital gains tax - 1 October 2004	-	-	(30 660)	-	(30 660)
Capital gains tax - 1 April 2005	-	-	(29 000)	-	(29 000)
Sale 1 April 2005	-	-	2 800 000	(2 800 000)	-
Transfer duty – 1 April 2005	-	-	-	(207 400)	(207 400)
Estate duty	-	-	(548 068)	-	(548 068)
Net cash inflow/(outflow)	500 000	1 401 000	48 872	(3 007 400)	(1 057 528)

The total tax liability increases by **37.89%**¹¹⁷ if the executor sells the property rather than distributing it to the heir (as in example 5.4(a)). The majority of the increase in the total tax liability is due to the capital gains tax and transfer duty effects of the additional disposal. This demonstrates how each additional disposal impacts on the tax liability as a result of the introduction of capital gains tax and the amendments to the transfer duty legislation.

As a result of one additional disposal by the executor, the total tax liability increases from R766 928 (as calculated in Example 5.4(a)) to R1 057 528. In this example, it is clear that R350 800¹¹⁸ (**33.17%**¹¹⁹) of the total cash outflows is attributable entirely to the

¹¹⁷ [(1 057 528 – 766 928)/766 928] x 100 = 37.89%

¹¹⁸ 143 400 + 207 400 = 350 800

¹¹⁹ [(143 400 + 207 400) / 1 057 528] x 100 = 33.17%

recent amendments to the transfer duty legislation. Under the amended legislation, Z needs to have more cash than he would have needed in order to obtain the same property in the same manner as when the sale of a membership interest in a close corporation was transfer duty free. This may mean that Z can no longer afford that property. The same would apply to the third party purchasing the property from the estate. This may result in the estate having difficulty in finding a buyer for the property.

There may be merit in including a clause in the deceased's will to the effect that the heir may opt to have the assets sold by the executor rather than accepting the distribution of the assets. The clause may read as follows:

Each beneficiary shall have the right to choose to either accept the distribution of assets from my Estate in the form and state that they exist on my death, or to request my Executors to realise and reduce such assets to cash which shall then be awarded to any of my said beneficiaries. The purpose of this provision is to provide my beneficiaries with flexibility in order to manage any liabilities for Capital Gains Taxes, Estate Duty or any similar liabilities that may otherwise arise.

If the heir intends to sell the assets within the near future, then he would have the option to not accept the distribution. By not accepting the distribution, the estate would then have to sell the assets and could benefit from the capital gains tax deduction against the assets in the estate. The capital gains tax liability that arises upon the sale of the assets by the executor during the winding-up of the estate will be allowed as a deduction against the gross estate for estate duty purposes. Whereas, the capital gains tax liability will not be allowed as a deduction against the gross estate for estate duty purposes if the heir

disposes of the assets after he inherits them. The heir could still share in the proceeds from the assets distributed by the estate, which would not be subject to capital gains tax upon distribution. This is so because the distribution would be in the form of cash and would no longer qualify as a disposal of an “asset”, as defined, for capital gains tax purposes. In this way, the heir could divest himself from any further capital gains tax and transfer duty implications that could arise if he accepted the distribution of the property.

Example 5.4(c)

Assuming the same facts as in Example 5.4(a), except that the membership interest in the close corporation is not distributed to Z’s son. During the liquidation of the estate, the executor sells the holiday home out of the close corporation to a natural person for R2.8 million on 1 April 2005. The executor then liquidates the close corporation at that date. The market value of the membership interest and the residence at the date of sale is R2.8 million.

In this case, the tax situation illustrated in example 5.4(a) remains unchanged, except for the estate duty liability. There are also additional implications at 1 April 2005, as shown on the following pages.

1 April 2005

Transfer duty¹²⁰ - disposal of property by close corporation	R
5% on the property value from R140 001 to R320 000 ¹²¹	9 000
8% on the property value in excess of R320 000 ¹²²	198 400
	<u><u>207 400</u></u>

Capital gains tax – disposal of property by close corporation	R
Proceeds	2 800 000
Base cost	(1 000 000)
Taxable capital gain	<u><u>1 800 000</u></u>
Capital gains tax (1 800 000 x 15%¹²³)	270 000

The effective capital gains tax rate used is the rate for a close corporation as the property is being sold by the close corporation and not by an individual. The annual exclusion is only allowed for natural persons and special trusts and is therefore not taken into account in calculating the capital gains tax on the disposal by the close corporation.

¹²⁰ The transfer duty rates were amended on 1 March 2002 and 1 March 2003. See Appendix A.

¹²¹ $(320\,000 - 140\,000) \times 5\% = 9\,000$

¹²² $(2\,800\,000 - 320\,000) \times 8\% = 198\,400$

¹²³ The inclusion rate for a close corporation is 50%. The income tax rate for a close corporation is 30%. $(50\% \times 30\% = 15\%)$.

The base cost of the residence is the market value at 1 October 2001. This arises because the residence was held by the close corporation. The disposal that occurred on 1 October 2003 was a disposal of the membership interest in the close corporation and not a disposal of the residence held by the close corporation. Since the residence was acquired by the close corporation prior to the introduction of capital gains tax, the base cost is the market value at 1 October 2001.

<i>Capital gains tax – liquidation of the close corporation</i>	R
Proceeds	2 800 000
Base cost	(2 500 000)
Capital gain	<u>300 000</u>
Less: annual exclusion	(10 000)
Taxable capital gain	<u><u>290 000</u></u>
Capital gains tax (290 000 x 10%)	29 000

If a company or close corporation is liquidated the shareholders are deemed to have disposed of their shares or membership interests, respectively. In this example, it is assumed that there are no liabilities or liquidation costs. The capital gains tax on the liquidation of the close corporation is calculated using the base cost at 1 October 2004. This is due to the transfer of the membership interest in the close corporation from the deceased to the deceased estate at that date. Since it is the membership interest that is

being disposed of, the base cost is dependent on the date that the membership interest was acquired.

In the 2002 Budget Review, the Minister of Finance announced that capital profits distributed on liquidation would be included in the definition of dividend. The definition of dividend¹²⁴ was amended by the Revenue Laws Amendment Act, 2002, to include certain capital profits distributed upon liquidation. Consequently, secondary tax on companies (STC) will be imposed in respect of dividends declared on or after 1 January 2003 from capital profits arising in anticipation of liquidation or deregistration of a company or close corporation, which are attributable to the period after 1 October 2001. In respect of an asset acquired before 1 October 2001, the capital profits subject to STC will be limited to the portion of the profit which would have been determined on the disposal of that asset if that asset had been acquired on 1 October 2001 at market value.

Since the property, in this example, was disposed of in anticipation of liquidation of the close corporation and the close corporation is liquidated after 1 January 2003, the capital profits arising from the disposal of the property by the close corporation will qualify as a dividend and will be subject to STC. STC is levied at 12,5% on dividends declared by a company or close corporation.

¹²⁴ Section 1, Income Tax Act No. 58 of 1962.

STC	R
Capital gain in anticipation of liquidation – disposal of property by close corporation	1 800 000
Capital gains tax liability – disposal of property by close corporation	(270 000)
	<u>1 530 000</u>

R1 530 000 represents both the liquidation distribution and STC. Since STC is 12,5% of the liquidation distribution, the liquidation distribution and STC liability will be calculated as follows:

	R
Liquidation distribution ($100/112,5 \times 1\,530\,000$)	<u>1 360 000</u>
STC ($12,5/112,5 \times 1\,530\,000$)	<u>170 000</u>

Estate duty

	R
Gross value of estate assets	2 500 000
Capital gains tax liability – deemed disposal by the deceased	(30 660)
Dutiable estate	<u>2 469 340</u>
Estate duty at 20% ($2\,469\,340 \times 20\%$)	493 868

In terms of the Estate Duty Act, if the deceased holds a membership interest in a close corporation at the date of death, such an interest is to be included in the estate of the deceased at the value of that interest at the date of death.¹²⁵ Therefore the gross value of the estate assets is R2.5 million in this example.

<i>Summary</i>	R
Capital gains tax - 1 October 2003	99 000
- 1 October 2004	30 660
- 1 April 2005 (disposal of property)	270 000
- 1 April 2005 (liquidation of close corporation)	29 000
Transfer duty - 1 October 2003	143 400
- 1 April 2005	207 400
STC	170 000
Estate duty	493 868
Total tax liability	1 443 328

¹²⁵ Estate Duty Act No. 45 of 1955, section 5(1)(a) and 5(1)(f)bis.

The cash flow implications are as follows:

Cash Flows	X	Y	Z	Other	Total
Sale - 1 October 2000	500 000	(500 000)	-	-	-
Sale - 1 October 2003	-	2 000 000	(2 000 000)	-	-
Capital gains tax - 1 October 2003	-	(99 000)	-	-	(99 000)
Transfer duty - 1 October 2003	-	-	(143 400)	-	(143 400)
Capital gains tax - 1 October 2004	-	-	(30 660)	-	(30 660)
Transfer duty - 1 April 2005	-	-	-	(207 400)	(207 400)
Capital gains tax - 1 April 2005	-	-	(270 000)	-	(270 000)
Capital gains tax - 1 April 2005	-	-	(29 000)	-	(29 000)
Sale - 1 April 2005	-	-	2 800 000	(2 800 000)	-
STC	-	-	(170 000)	-	(170 000)
Estate duty	-	-	(493 868)	-	(493 868)
Net cash inflow/(outflow)	500 000	1 401 000	(336 928)	(3 007 400)	(1 443 328)

This example shows the **cascading effects** that the use of a corporate structure may have.

If a property is held in a close corporation by an individual at death and a buyer cannot be found for the membership interest, the executor may have no choice but to sell the property out of the close corporation. The close corporation would then have to be liquidated. Each of these transactions has capital gains tax effects and the impact on the deceased estate could lead to severe liquidity problems for the estate.

The capital gains tax liability of the deceased, in this example, is R428 660¹²⁶, which is more than 2.5 times the R158 660¹²⁷ capital gains tax liability that would have arisen if

¹²⁶ 99 000 + 30 660 + 270 000 + 29 000 = 428 660

¹²⁷ 99 000 + 30 660 + 29 000 = 158 660

the executor had sold the membership interest. On the other hand, the estate duty only decreases by R54 200¹²⁸. This indicates that the estate may be subject to liquidity problems when the property is sold out of the close corporation and the close corporation is liquidated.

The total tax liability increases by a further R170 000 as a result of the amendments to the STC legislation. This is an increase of **13.35%**¹²⁹. Furthermore, transfer duty adds an additional R350 800³⁰ into the pockets of the fiscus. The total tax liability increases by R143 400 as a result of the new transfer duty legislation. This is an increase of **11.03%**¹³¹. It should be noted that the disposal of the property by the close corporation would have been subject to transfer duty irrespective of the new transfer duty legislation as this is not the sale of the membership interest in the close corporation, but the disposal of the property itself.

These increasing tax liabilities during an individual's lifetime and at death may result in even fewer estates being subject to estate duty. If the assets of an individual are reduced during his lifetime and the tax liabilities at death reduce the value of the remaining estate to below R1.5 million before taking into account the estate duty abatement of R1.5 million, then no estate duty will be payable by the estate.

¹²⁸ 548 068 – 493 868 = 54 200

¹²⁹ 170 000/(1 443 328 – 170 000) x 100 = 13.35%

¹³⁰ 143 400 + 207 400 = 350 800

¹³¹ 143 400/(1 443 328 – 143 400) x 100 = 11.03%

Conclusion

It has been shown, in the examples in this chapter, that the manner in which the deceased held his assets at death may influence the tax liability of the deceased, his estate and the beneficiaries of the estate. In addition, the examples in this chapter have demonstrated that the manner in which assets are disposed of, in terms of a will and by an executor of an estate, may have significant tax consequences.

It is clear that the combination of capital gains tax and estate duty may create severe liquidity problems for the deceased estate. Furthermore, transfer duty and STC may increase this burden if the executor has to sell the assets in the estate.

Estate planning is becoming exceedingly difficult due to the ever-changing tax legislation. The recently introduced capital gains tax legislation and transfer duty amendments bear testimony to this.

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CHAPTER 6

THE UNITED STATES OF AMERICA: ESTATE TAX AND CAPITAL GAINS TAX

Background

The treatment of estate tax and capital gains tax in the United States of America is of particular interest as it avoids levying both estate tax and capital gains tax on the same property at death as opposed to the South African situation. The situation in the United States is discussed below.

Tax Relief Reconciliation Act of 2001

On 7 June 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 came into effect in the United States of America. Included in this Act is the phasing out of the estate tax. The estate tax is to be repealed in 2010 and the repeal is only actually effective for that year. Under Congressional rules, tax changes are not permanent unless they are passed by at least 60 senators. The law relating to the repeal of the estate tax was only approved by 58 senators.¹³² The provisions under this Act are therefore “sunset provisions”¹³³ and, unless further legislation is enacted, the estate tax will be reinstated in 2011 in its original form.

¹³² Jim Arbury Estate Tax Repeal: Is it Really a Good Thing *Multi-Housing News* (October 2001).

¹³³ “Sunset provisions” are provisions that will expire.

Phase-out of estate tax

The 2001 legislation does not repeal the estate tax permanently. Instead, it reduces the estate tax rate incrementally for the 2002 to 2007 years, and increases the estate tax exemption for the 2002 to 2009 years. The estate tax is eliminated only for the year 2010. These changes to the estate tax mean that a smaller percentage of an individual's estate will be taxed, and it will be taxed at a lower rate, leaving more money for the individual's beneficiaries.

Estate Tax¹³⁴

Estate tax is imposed on the transfer of an individual's property at death and on certain deemed transfers at death. The tax is computed under a unified rate schedule applicable to both gift tax and estate tax. Under the unified rate structure, lifetime gifts and transfers at death are taxed on a cumulative basis.

When a person dies, estate tax is imposed upon the transfer of the deceased's property to his beneficiaries. A progressive rate is used to calculate the estate tax liability based upon the value of the taxable gift or estate. The 2002 estate tax rates are displayed in Table 4, on page 75, to illustrate the progressive rate of tax.

Example 6.1

Estate taxes can be estimated using the 2002 estate and gift tax rates displayed in Table 4. For example, suppose X has an estate worth \$2.1 million. Using Table 4, X's estate would fit in the \$2 million to \$2.5 million category. The estate tax would equal \$780,800 for the first \$2 million, plus 49% tax on the difference between \$2 million and \$2.1 million:

$$\text{Estate Taxes} = \$780,800 + (\$100,000 \times 0.49) = \$829,800$$

¹³⁴ American Jurisprudence, Second Edition, Volume 34A (2002)

Taxable Gift or Estate		Tentative Tax	
FROM (A)	TO (B)	Tax on (A)	Tax Rate on Excess (B-A)
\$0	\$11,000	\$0	18%
11,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	1,250,000	345,800	41%
1,250,000	1,500,000	448,300	43%
1,500,000	2,000,000	555,800	45%
2,000,000	2,500,000	780,800	49%
2,500,000	+	1,025,800	50%

The maximum estate and gift tax rates are shown in Table 5, on page 77, and demonstrate the gradual decrease in these rates from 2002 through 2007. In 2008 and 2009, the tax rate remains static and in 2010 the estate tax is repealed. If no further legislation is enacted, the tax rate will revert to the 2002 level of 50% in 2011.

"Unified Credit" Relief

Relief is granted against estate tax in the form of a "Unified Credit". The Unified Credit allows every American citizen to pass a certain amount of their estate to heirs tax-free. This credit can be used during one's lifetime, but is usually used when an individual's estate is being distributed.

With the Taxpayer Relief Act of 1997 and the Tax Relief Act of 2001, the Unified Credit has gradually been increasing. Table 5 shows a breakdown of the Unified Credit and the maximum estate tax rates from 2001 to 2013. It should be noted that, like the estate tax rate, the Unified Credit will revert to the 2002 level after the 2010 tax year unless further legislation is enacted.

Example 6.2

From Table 5 it can be derived, that in 2003 every estate holder who dies can pass \$1 million of their estate to heirs free of estate tax. The remainder will be subject to estate taxes at a maximum rate of 49%.

Year	Unified Credit	Highest Estate Tax Rate
2001	\$675 thousand	55%
2002	\$1 million	50%
2003	\$1 million	49%
2004	\$1.5 million	48%
2005	\$1.5 million	47%
2006	\$2 million	46%
2007	\$2 million	45%
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	Tax Repeal	0%
2011	\$1 million	50%
2012	\$1 million	50%
2013	\$1 million	50%

Elimination of the “stepped-up basis”

The regulations introduced in 2001 not only repeal the estate tax, but also eliminate the “stepped-up basis” in 2010. Under the old estate tax rules and under the current regulations through 2009, the assets of a deceased remaining after any federal and state estate taxes have been paid, are generally passed on to the heirs under the “stepped-up basis”. This means that the basis value (similar to “base cost” in the Eighth Schedule to the Income Tax Act 58 of 1962¹³⁵) of the deceased’s assets is stepped-up or down to its market value on the date of the deceased’s death. The “stepped-up basis” is based on the premise that inherited property has already been taxed in the deceased’s estate and it would be unfair to tax the gains again.¹³⁶

On the “stepped-up basis” capital gains that arise during one's life and are held until death are never taxed. The tax basis for assets passing through an estate is stepped-up, so that an heir selling the asset subsequently will only be taxed on the appreciation that occurs after the death of the deceased. The “stepped-up basis” has two great virtues. Firstly, it prevents double taxation of assets at death that may arise if both capital gains tax and estate tax have to be paid. Secondly, it simplifies the settling of estates by executors. Under the “stepped-up basis”, the executor only needs to calculate the value of the assets at death, and does not need to know the assets’ original purchase prices or any adjustments to those prices, such as depreciation.

¹³⁵ Paragraph 20

¹³⁶ Windsor Financial Group. LLC Prepare Now for “New” 2010 Tax on Inherited Property Perspectives (August 2001)

“Carryover basis”

As a result of the repeal of the estate tax in 2010 the “stepped-up basis” is eliminated for that year. In order to tax capital gains that would otherwise not be taxed, the “stepped-up basis” has been replaced by the “carryover basis” for the 2010 year. On the “carryover basis” the basis value of the deceased’s property will be carried over to the heir instead of being stepped-up. However, no capital gains tax is imposed until the property is actually sold.

Under the “carryover basis”, the value of assets is no longer stepped-up at death. Instead, heirs inherit the original basis value. Therefore, they would have to pay capital gains tax on inherited assets from the time the asset was originally acquired by the deceased.

Example 6.3

X buys some shares for \$10 per share and holds them until death, at which time the shares are worth \$100 per share. Y inherits the shares from X’s estate. Y later sells the shares for \$120 per share. Under the “stepped-up basis”, Y pays taxes only on the \$20 per share increase since the death of the original purchaser. Under the “carryover basis”, Y would pay taxes on the entire \$110 per share increase since the shares were originally bought.

While simple in theory, in practice the “carryover basis” proves to be a nightmare. The greatest problem is obtaining records indicating the original basis value for assets in

estates. On the assumption that such assets would be held until death and that the basis would be stepped-up, many people have not bothered to keep such records.

Even when records exist, it may be extremely difficult to accurately calculate the basis value. For example, in the case of small businesses or investment properties, the historical basis value needs to be adjusted for depreciation, renovations and other factors that may be difficult to determine. The “carryover basis” is administratively burdensome due to the complexities in calculating the basis values of the assets.

The “carryover basis” will recoup some of the revenue lost to the estate tax repeal and counters the argument that great wealth would be entirely untaxed without it. Unfortunately, it appears that the “carryover basis” regime suffers from the same complexities that led to repeal of an earlier effort in 1976 to implement such a basis.¹³⁷ The “carryover basis” which was implemented by the Tax Reform Act of 1976 was repealed in 1980 partly due to these complexities.

The key to making the “carryover basis” successful will be having well documented records on the basis of all inherited property. This becomes more difficult the longer the time to sale, or the more complicated the determination of the basis value.

¹³⁷ Bruce Bartlett, TownHall.com Columnists, [Which Tax to Cut?](http://www.townhall.com/columnists/brucebartlett/archive.shtml), 17 May 2001, <http://www.townhall.com/columnists/brucebartlett/archive.shtml>

In the opinion of Bruce Bartlett, “the goal of eliminating the estate tax is a good one, but replacing it with carryover basis is a bad one.”¹³⁸

Revenue collected from estate and gift taxes

In table 6, the estate and gift taxes are shown as a percentage of the total tax revenue in the United States of America.

Table 6: Estate and gift taxes as a percentage of total tax revenues in the United States of America¹³⁹

Fiscal year	Total Internal Revenue collections	Estate and gift taxes	Estate and gift taxes As a percentage of total revenue collections
	\$ 000's	\$ 000's	%
1990	1 056 365 652	11 761 939	1.11
1991	1 086 851 401	11 473 141	1.06
1992	1 120 799 558	11 479 116	1.02
1993	1 176 685 625	12 890 965	1.10
1994	1 276 466 776	15 606 793	1.22
1995	1 375 731 835	15 144 394	1.10
1996	1 486 546 674	17 591 817	1.18
1997	1 623 272 071	20 356 401	1.25
1998	1 769 408 739	24 630 962	1.39
1999	1 904 151 888	28 385 607	1.49
2000	2 096 916 925	29 721 620	1.42
2001	2 128 831 182	29 247 916	1.37

¹³⁸ Bruce Bartlett, National Centre for Policy Analysis, 7 June 2000.
<http://www.ncpa.org/oped/bartlett.html>

¹³⁹ Internal Revenue Services, IRS Data Book, FY 2001, Publication 55b.

It is notable that the combined revenue from estate and gift taxes comprises less than 1.5% of total tax revenues in the United States of America. Similarly to estate duty in South Africa, the United States estate tax generates a very small percentage of total tax revenues. Considering the miniscule percentage of the total tax revenues that the estate and gift taxes generate, applying the United States legislation to the South African situation may not be desirable. It may be more efficient and effective in South Africa to simply abolish estate duty rather than amending the existing legislation to avoid imposing both capital gains tax and estate duty on the same property at death.

Conclusion

Currently, both the value of the property in an estate and capital gains relating to that property are being taxed in South Africa. To a certain extent, it can be argued that this results in double taxation. However, it is evident from the United States situation that it is possible to have a tax system that either taxes the capital gains on property in the estate or the total wealth in the estate at death.

Two different methods of achieving these ends have been demonstrated in the legislation from the United States of America. Firstly, a “stepped-up basis” could be used, for capital gains tax purposes, so that appreciations in the value of property held at death, to the extent that the appreciation occurred during the deceased’s lifetime, would not be subject to capital gains tax. Alternatively, estate taxes could be abolished so that property in an estate would only be subject to capital gains tax upon a person’s death.

CHAPTER 7

THE UNITED STATES OF AMERICA: GENERATION-SKIPPING TRANSFER TAX

The current estate duty and donations tax legislation in South Africa is not as complicated as similar legislation in the United States of America. The United States of America has three different types of capital transfer taxes. These taxes are as follows:

- Gift tax
- Estate tax
- Generation-skipping transfer tax

The key difference between these taxes is timing. Gift tax¹⁴⁰ applies to transfers made before death, estate tax¹⁴¹ (as discussed in Chapter 6) relates to transfers at death, and generation-skipping transfer tax¹⁴² applies to transfers intended well after death by skipping a generation and leaving assets to a generation of beneficiaries who are more than one generation below the transferor's generation.

A single transfer may be subject to the gift tax and the generation-skipping transfer tax or the estate tax and the generation-skipping transfer tax. Ordinarily, the same transfer is not subject to both the gift tax and the estate tax.

¹⁴⁰ Gift tax is comparable to donations tax in South Africa.

¹⁴¹ Estate tax is comparable to estate duty in South Africa.

¹⁴² There is no tax comparable to generation-skipping transfer tax in South Africa.

Although there is no generation-skipping transfer tax in South Africa, the Margo Commission¹⁴³ did recommend the introduction of such a tax. It was recommended that all generation-skipping devices such as trusts be subject to the tax after a lapse of a certain period of time to the extent that the beneficiaries have not obtained vested rights. The period proposed was 15 years. These recommendations were intended to act as a disincentive for the use of trusts as vehicles for the avoidance of capital transfer tax.

A discussion of generation-skipping transfer tax in the United States of America is presented below. Although there is no generation-skipping transfer tax in South Africa, it is relevant to the South African situation as a gap exists in the legislation in this regard. This gap results from South African taxpayers avoiding wealth transfer taxes through the use of trusts. The introduction of a generation-skipping transfer tax in South Africa could act as an anti-avoidance measure in this regard. Furthermore, due to the manner in which the wealth transfer taxes are interrelated in the United States, the generation-skipping transfer tax has a bearing on the estate tax.

GENERATION-SKIPPING TRANSFER TAX¹⁴⁴

The federal generation-skipping transfer tax is primarily designed to prevent the tax-free transfer of property from one generation of beneficiaries to a generation of beneficiaries who are more than one generation below the transferor's generation. The generation-skipping transfer tax is a separate tax and is vital in estate planning which involves dispositions of property to younger generations of beneficiaries.

¹⁴³ *Supra* note 7 at 20.57.

¹⁴⁴ American Jurisprudence, Second Edition, Volume 34A (2002)

“Generation-skipping transfer”

Generation-skipping transfer tax is imposed on every “generation-skipping transfer”, which is an event that is either:

- A taxable termination,
- A taxable distribution, or
- A direct skip.

A generation-skipping transfer does not include any transfer which, if made during an individual’s life, would not be treated as a taxable gift because it was made for educational or medical expenses of the transferee. In addition, a generation-skipping transfer does not include any transfer to the extent that

- The property transferred was subject to an earlier generation-skipping transfer tax,
- The transferee in the earlier transfer was in the same or a lower generation than the transferee in the current transfer, and
- The transfer does not have the effect of avoiding the generation-skipping transfer tax.

“Skip person”

A skip person is a:

- Natural person assigned to a generation which is one or two generations below that of the transferor, or
- A trust if
 - all interests in the trust are held by skip persons, or

- no person holds an interest in the trust, and at no time after transfer can a distribution be made to a person other than a skip person.

“Taxable termination”

A taxable termination occurs upon the expiration of an interest in property held in a trust if, after the termination, all such interests are held by skip persons.

Example 7.1¹⁴⁵

X creates an irrevocable trust¹⁴⁶ under which income is to be paid to X's child, Y, for Y's life. Upon the death of Y, the trust principal¹⁴⁷ is to be paid to X's grandchild, Z. If Y dies and is survived by Z, a taxable termination occurs at the time of Y's death because Y's interest in the trust terminates and thereafter the trust property is held by a skip person who occupies a lower generation than Y.

“Taxable distribution”

A taxable distribution is any distribution from a trust to a skip person, other than a taxable termination or a direct skip. The distribution is subject to generation-skipping transfer tax if it is made out of trust income or capital.

¹⁴⁵ Supra note 137.

¹⁴⁶ An irrevocable trust is the same as a non-discretionary trust in South Africa. The beneficiary has a vested right to the income of such a trust.

¹⁴⁷ The trust principal is the capital that X invested in the trust in order to generate income for Y and Z.

Example 7.2¹⁴⁸

X creates an irrevocable trust under which the income is payable to X's child, Y, for Y's life. When X's grandchild, Z, attains 35 years of age, Z is to receive half of the principal held in the trust. The remaining principal will be distributed to Z on Y's death. Assume that Y survives Z's 35th birthday. When the trustee distributes half of the principal to Z at that date, the distribution is a taxable distribution because it is a distribution to a skip person and is neither a taxable termination nor a direct skip.

“Direct skip”

A direct skip is a transfer of an interest in property to a skip person that is subject to gift or estate tax. Only one direct skip occurs when a single transfer of property skips two or more generations. If property is transferred to a trust, the transfer is a direct skip only if the trust is a skip person.

Example 7.3¹⁴⁹

X gratuitously transfers a property to his grandchild. This transfer would be subject to a gift tax. Since the transfer is a transfer to a skip person of property subject to federal gift tax, it is a direct skip.

¹⁴⁸ Supra note 137.

¹⁴⁹ Ibid.

Exemptions from generation-skipping transfer tax

Each individual is allowed an exemption from generation-skipping transfers of \$1 million, plus inflation-indexed increases. Any increase over \$1 million applies only to generation-skipping transfers made during or after the calendar year of the increase. Before 2004, the \$1 million generation-skipping transfer exemption may be increased by an inflation adjustment.

The increase in the exemption due to the inflation adjustment is calculated as follows:

- \$1 million multiplied by
- the percentage by which the consumer price index (CPI) for the preceding calendar year exceeds the CPI for the 1997 calendar year.

For the 2004 to 2009 calendar years, every individual will be allowed a generation-skipping transfer exemption, for any calendar year, equal to the “applicable exclusion amount” for the relevant calendar year. The “applicable exclusion amount” is the amount exempted from estate tax by the unified credit. The applicable exclusion amount will be increased to \$3.5 million on a phase-in schedule. It should be noted that the phase-in of the increase in the applicable exclusion amount begins in 2002 for estate tax purposes, but the phase-in for the generation-skipping transfer exemption, based on the applicable exclusion amount will not begin until 2004. In 2002 and 2003, the exemption equivalent of the unified credit against estate tax will be \$1 million as adjusted for inflation. Both the estate tax and the generation-skipping transfer tax will be repealed in 2010.

The generation-skipping transfer exemption can be used during the individual's life and at death. The exemption may be allocated by the individual, or his executor, to any property with respect to which the individual is the transferor. Furthermore, every individual may select to which of his generation-skipping transfers he wishes to allocate his generation-skipping transfer exemption. However, once an allocation is made it is irrevocable.

If property is held in trust, the allocation of the generation-skipping transfer exemption is made to the trust in its entirety rather than to specific trust assets. Once a generation-skipping transfer is designated as exempt, all later appreciations in the value of the property are also exempt from generation-skipping transfer tax.

Example 7.4¹⁵⁰

In 2001 a grantor transfers \$1.06 million to a trust for the benefit of his children and grandchildren. The inflation adjusted generation-skipping transfer exemption amounted to \$1.06 million in 2001. If the grantor allocates the \$1.06 million exemption to the trust, no part of the trust will ever be subject to generation-skipping transfer tax. This will be the case even if the property in the trust were to appreciate to \$10 million or more.

On the other hand, if only \$530 thousand of the generation-skipping transfer exemption was allocated to the trust, half of all the distributions to the grandchildren will still be subject to the generation-skipping transfer tax and half of the trust property will be subject to generation-skipping transfer tax upon the termination of the children's interest.

¹⁵⁰ Supra note 137.

If generation-skipping transfers are made by a married couple, the spouses may each elect to treat the transfer as if half of it was made by each spouse.

Deemed allocation of generation-skipping transfer exemption to lifetime direct skips

If an individual makes a lifetime direct skip, any unused portion of his generation-skipping transfer exemption will be allocated to the property transferred to the extent necessary to make the “inclusion rate” zero, or if the direct skip exceeds such unused portion, the entire unused portion will be allocated to the property transferred.

The unused portion of an individual’s generation-skipping transfer exemption is that portion of the exemption that has not previously been allocated by the individual, or treated as allocated to an earlier direct skip or certain earlier “indirect skips”¹⁵¹. An individual may elect not to have this provision apply to a transfer. If the transferor does not elect otherwise, in the case of a direct skip, a portion of the transferor’s unused exemption is automatically allocated to the transferred property.

“Inclusion ratio”

The inclusion ratio is determined by subtracting the “applicable fraction” from one. The applicable fraction is rounded to the nearest one-thousandth from one.¹⁵² The numerator

¹⁵¹ An “indirect skip” is defined as:

- not a direct skip,
- subject to gift tax, and
- made to a generation-skipping transfer trust.

¹⁵² In rounding the applicable fraction to the nearest one-thousandth, any amount that is midway between one-thousandth and another one-thousandth is rounded up to the higher of these two amounts.

of the applicable fraction is the amount of the generation-skipping transfer exemption allocated to the trust or to the property transferred in a direct skip.

The denominator of the applicable fraction is:

- the value of property transferred to the trust (or involved in the direct skip), reduced by
- the sum of:
 - any federal estate tax and state death tax attributable to and recovered from the property, and
 - any charitable deduction, in respect of estate tax or gift tax, allowed in relation to the property.

Automatic allocation of the generation-skipping transfer exemption after the transferor's death

Any portion of the deceased's generation-skipping transfer exemption that has not been allocated by his executor at the time his estate tax return is due will be automatically allocated as follows:

- first to direct skips that occur at the deceased's death, and
- thereafter to trusts of which the deceased is the transferor and from which a taxable distribution or a taxable termination might occur at or after death.

Computation of generation-skipping transfer tax

The generation-skipping transfer tax is imposed at a flat rate equal to the maximum federal estate tax rate in effect at the time of the generation-skipping transfer. The amount subject to the generation-skipping transfer tax depends on the type of generation-skipping transfer involved. Another consideration is whether any of the generation-skipping transfer exemption has been allocated to the property involved in such transfer. The person liable for the generation-skipping transfer tax is also determined based on the type of generation-skipping transfer involved.

Taxable distributions

The taxable amount is the value of the property received by the transferee reduced by any expense incurred by the transferee in connection with the determination, collection or refund of the generation-skipping transfer tax with respect to such distribution.

The generation-skipping transfer tax is payable by the transferee of the property. Therefore, if any of the generation-skipping transfer tax imposed is paid out of the trust, that amount is treated as an additional taxable distribution.

Taxable terminations

The taxable amount is the value of all property in respect of which termination has occurred reduced by certain allowed deductions. The tax is payable by the trustee.

Direct skips

The taxable amount is the value of the property received by the transferee. The tax is paid by the trustee in the case of an *inter vivos* direct skip¹⁵³. The trustee is also liable for the generation-skipping transfer tax where there is a direct skip from the trust or with respect to property that continues to be held in trust. The tax is payable by the executor in the case of a direct skip, other than a direct skip from a trust or with respect to property that continues to be held in a trust, if the transfer is subject to estate tax.

Valuation of a property subject to generation-skipping transfer tax

Property subject to generation-skipping transfer tax is valued at the time of the generation-skipping transfer. The value of the property will be reduced by any consideration rendered for the property by the transferee. If the property transferred in a direct skip is included in the transferor's gross estate, the value of such property for generation-skipping transfer tax purposes will be the same as its value for estate tax purposes.

¹⁵³ Other than a direct skip from a trust

Example 7.5¹⁵⁴

A transferor creates a \$4 million trust under his will. His daughter is to receive the income from the trust for life and her son will receive the balance. Assuming the amount of the generation-skipping transfer exemption allocated to the trust is \$1 million, the applicable fraction is 0.25, which is calculated as follows:

$$\frac{1\,000\,000}{4\,000\,000} = 0.25$$

The inclusion ratio is 0.75 and is calculated as follows:

$$1 - 0.25 = 0.75$$

Assuming the daughter dies in 2001, a taxable termination occurs. The inclusion rate is applied to the maximum estate tax rate in order to calculate the applicable rate of generation-skipping transfer tax. The maximum estate tax rate was 55% in 2001. The applicable rate of generation-skipping transfer tax is 41.25%, calculated as follows:

$$55\% \times 0.75 = 41.25\%$$

The generation-skipping transfer tax imposed is \$1.65 million, which is derived from the following calculation.

$$\$4\,000\,000 \times 41.25\% = \$1\,650\,000$$

¹⁵⁴ Supra note 137.

Had the \$4 million trust been included in the transferor's estate, incurring federal and state estate taxes, the amount of the generation-skipping transfer tax payable on the taxable termination, upon the transferor's death, would be reduced as illustrated below.

Assuming federal and state estate taxes amounted to \$2 million, the applicable fraction would now be 0.5, calculated as follows:

$$\frac{1\,000\,000}{4\,000\,000 - 2\,000\,000} = 0.5$$

The inclusion ratio will be 0.5, calculated as follows:

$$1 - 0.5 = 0.5$$

Using the same maximum estate tax rate of 55%, the tax payable is \$550 000, as shown below.

$$55\% \times 0.5 \times \$2\,000\,000 = \$550\,000$$

This implies that property, which is subject to federal and state estate tax, is taken into account again if it is the subject of a generation-skipping transfer, but the estate tax itself is taken into consideration in order to arrive at a reduced applicable percentage for calculating the generation-skipping transfer tax.

Multiple skips

If a single trust provides for transfers to more than one generation of skip persons (for example, income to the transferor's grandchild for life and the balance to the transferor's great-grandchild), the property is subject to generation-skipping transfer tax when it is transferred to the grandchild and again when it is transferred to the great-grandchild. However, generation-skipping transfer tax can only be imposed once per generation level.

The preceding result is achieved by providing that, if there is a generation-skipping transfer of any property, and immediately thereafter such property is held in trust, for the purpose of applying the generation-skipping transfer tax to later transfers from the portion of the trust attributable to such property, the trust will be treated as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the generation-skipping transfer.

Example 7.6¹⁵⁵

X makes a direct skip transfer to a trust for his grandchildren. The direct skip is subject to generation-skipping transfer tax. Later transfers to the grandchildren are not subject to generation-skipping transfer tax because X is considered to be only one generation higher than his grandchildren. Therefore the later distributions are not being made to skip persons.

¹⁵⁵ Supra note 137.

Administration of generation-skipping transfer tax

The Internal Revenue Services have specific requirements that must be met in terms of the submission of tax returns and the payment of generation-skipping transfer tax. The person who is responsible for the payment of the tax is generally responsible for filing the required tax return. For example, when a taxable distribution takes place the transferee of the property would be required to submit the return and would be liable for the tax.

Conclusion

The generation-skipping transfer tax in the United States is interlinked with other wealth transfer taxes such as estate tax. The success of the generation-skipping transfer tax in the United States may suggest that there is a gap in the South African wealth transfer tax system. However, the success of the generation-skipping transfer tax in the United States lies within the legislation and the administration of the tax.

The generation-skipping transfer tax is fairly complicated and comes with an extensive administrative burden. It is questionable whether the resources are available in South Africa to administer an additional tax such as a generation-skipping transfer tax. However, such a tax may be vital for the creation of a more efficient wealth transfer tax system.

CHAPTER 8

THE UNITED KINGDOM: INHERITANCE TAX

Background¹⁵⁶

Prior to the introduction of capital transfer tax in 1975, estate duty was levied in the United Kingdom (UK). Capital transfer tax was introduced by the Finance Act 1975 to overcome the alleged defects of estate duty by taxing transfers of accumulated wealth more effectively. Capital transfer tax was charged on gifts made during an individual's lifetime and also on the estate of a deceased person. The Finance Act 1975 and subsequent amendments were consolidated into the Capital Transfer Tax Act 1984. As such, capital transfer tax was relatively short lived, as via the Finance Act 1986 the tax charged became known as Inheritance Tax and the Capital Transfer Tax Act 1984 was cited as the Inheritance Tax Act 1984.

Interaction between inheritance tax and capital gains tax

Sale

A capital gains tax liability may arise upon an arms length sale between persons who are not connected persons, however such a disposal will not be subject to inheritance tax.

¹⁵⁶ [Inheritance tax manual](#)

(www.voa.gov.uk/instructions/Chapters/inheritance_tax_ch_1b/sections/section_2/s2_01.htm#TopOfPage)

Gift

Capital gains tax and inheritance tax may both be imposed on a disposal made by way of a gift.

*Death*¹⁵⁷

An inheritance tax liability arises on the death of an individual, as there is a deemed transfer of a person's estate on death. However, no capital gains tax is payable on death. When a person dies and their assets pass on to their personal representatives¹⁵⁸, this is not treated as a disposal for capital gains tax purposes. Additionally, personal representatives do not have to pay capital gains tax when they distribute the estate assets to the legatees. This is in contrast to the South African situation where a disposal is deemed to occur for capital gains tax purposes when a deceased's assets are passed on to the deceased's estate. However, similarly to South Africa, the United Kingdom legislation provides that for capital gains tax purposes, the beneficiaries of a deceased person's estate are treated as if they had acquired the assets of the deceased at their market value upon the death of the deceased.

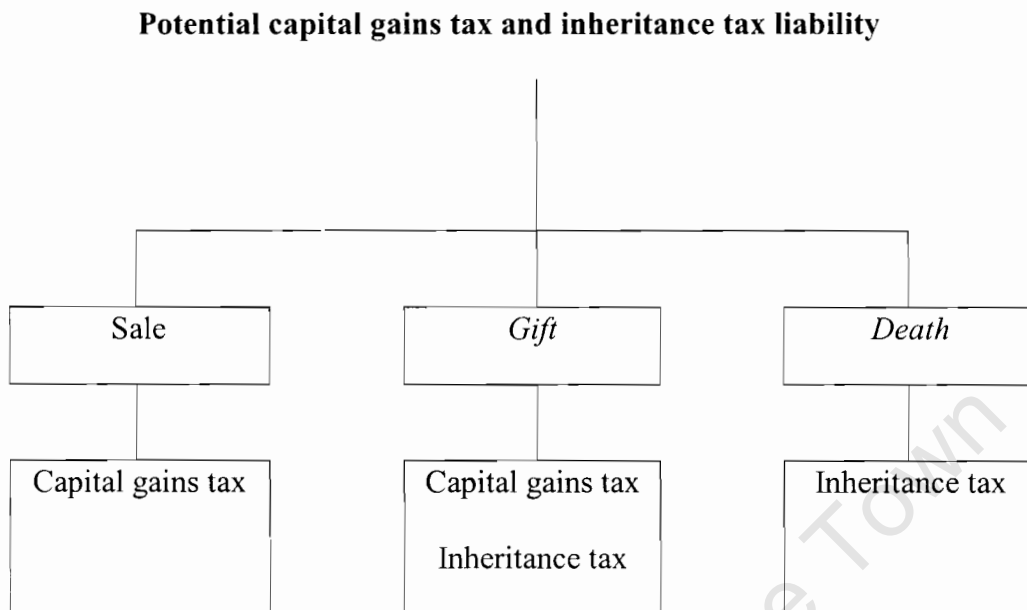
Personal representatives are, however, liable to pay capital gains tax on any gain made when estate assets are disposed of other than to the legatees. The acquisition cost used to calculate the gain is the market value of the asset at the date of death. Personal

¹⁵⁷ Inland Revenue *Capital Gains Tax – An Introduction*, Section 2 : *Assets and Disposals*, (www.inlandrevenue.gov.uk/pdfs/cgt1_2.htm). Accessed 15 February 2003.

¹⁵⁸ Personal representatives are equivalent to executors of estates in South Africa.

representatives are entitled to the same annual exemption as individuals for the year of death and the following two years. Thereafter, no annual exemptions are allowed.

This can be illustrated as follows:



Revenue from inheritance tax in the United Kingdom

Table 7, on page 101, shows the percentage of total tax revenues that the UK inheritance tax generated in recent years. It is evident that, like estate duty in South Africa, the UK inheritance tax generates a very small percentage of the total tax revenues collected in any tax year. From table 7, it can be derived that the inheritance tax did not rise above 1.72% of total UK tax revenues throughout the last decade. This once again raises the question of whether a death tax is necessary at all.

Table 7: Inheritance tax as a percentage of total inland revenue¹⁵⁹

Fiscal Year	Inheritance tax (£ million)	Total Inland Revenue (£ million)	Inheritance tax as a percentage of total inland revenue (%)
1989-90	1,232	76,559	1.61
1990-91	1,262	82,464	1.53
1991-92	1,299	79,676	1.63
1992-93	1,211	76,108	1.59
1993-94	1,333	77,469	1.72
1994-95	1,411	87,336	1.61
1995-96	1,518	96,932	1.57
1996-97	1,558	103,745	1.50
1997-98	1,684	117,441	1.43
1998-99	1,805	128,086	1.41
1999-2000	2,047	139,291	1.47
2000-01	2,221	148,860	1.49
2001-02	2,349	149,211	1.57

Calculating tax on an estate¹⁶⁰

To determine whether any inheritance tax is payable on the death of an individual, it is necessary to:

- Identify everything in the estate
- Reduce this by any exempt items included in the estate

¹⁵⁹ Inland Revenue, (www.inland-revenue.gov.uk/stats/tax_receipts/g_t02_1.htm#top)

¹⁶⁰ Inland Revenue *Inheritance tax. How to calculate the liability*, *Capital taxes office series*, (August 1996).

- Add any non-exempt gifts made within seven years of the deceased's death and any gifts in which the deceased had retained an interest
- Value the items that form the taxable estate
- Deduct any allowable deductions
- Apply the inheritance tax threshold to the value of the taxable estate and calculate the tax on any excess above the threshold.

This chapter continues with a further examination of the elements of the inheritance tax calculation.

What is an estate?

An individual's estate includes:

- Every asset owned in that individual's name
- His share of any jointly owned assets
- Assets held in trust from which he receives a personal benefit (eg. an income)
- Gifts from which he retains some benefit (eg. A house given as a gift, but still occupied by the transferor).

How does domicile¹⁶¹ affect inheritance tax?

Individuals domiciled, or deemed to be domiciled, in the UK are generally subject to inheritance tax on their worldwide property¹⁶², though relief may be given for death taxes paid in other countries. Non-UK domiciled individuals are generally only subject to inheritance tax on their UK property.

Types of transfer

Transfers can take one of three forms. They may be immediately chargeable transfers, exempt transfers, or potentially exempt transfers. All non-exempt gifts made by a person within seven years of death must be added to the estate to calculate the tax charge.

Immediately chargeable transfers

Transfers into discretionary trusts and transfers involving companies attract inheritance tax immediately upon transfer. These transfers are referred to as immediately chargeable transfers. Additional inheritance tax may be chargeable if the transferor dies within seven years of the transfer.

¹⁶¹ Domicile is a concept of UK general law. Broadly speaking, an individual is domiciled in the country of that individual's permanent home. For the purposes of inheritance tax, there is a concept of deemed domicile. Even if an individual is not domiciled in the UK under general law, that individual is treated as domiciled in the UK at the time of transfer if:

- That individual was domiciled in the UK within the three years immediately preceding the transfer, or
- That individual was resident in the UK in at least seventeen of the twenty income tax years of assessment ending with the year in which the transfer was made.

¹⁶² The term property includes all forms of property and is similar to the definition of property in the South African Estate Duty Act.

Exempt Transfers

Certain gifts are completely free from inheritance tax even if an individual makes them within the seven years before his death. These are called 'exempt transfers'.

Gifts or bequests are exempt if they are made to any of the following:

- The person's spouse unless
 - The donor spouse is domiciled in the UK and the donee spouse is not UK domiciled. In this case the exemption is limited to £55,000.
 - The gift or bequest is not immediately in favour of the spouse, or is dependent upon a condition which is not satisfied within a year. (This exemption does not apply if the condition is simply that the spouse survives the donor for a specified period of time.)
- A charity established in the UK
- A UK political party
- A national museum, university, or certain other bodies established for national purposes or for public benefit.

Gifts and bequests are not exempt if they are incomplete or conditional. They are also not exempt if they can later be used for purposes that are non-charitable or for other non-exempt purposes.

Potentially exempt transfers

During the seven years after they were made, non-exempt gifts are called 'potentially exempt transfers'. That means they are potentially free from inheritance tax, but if the transferor dies within seven years of making a gift, potentially exempt transfers become chargeable transfers.

Example 8.1

On 1 January 1997 Mr X gave a flat worth £55,000 to Mr Y. If Mr X is still alive on 1 January 2004 there will never be any inheritance tax to pay on that gift, but until January 2004, the gift is a potentially exempt transfer.

The main types of potentially exempt transfers are:

- gifts to other individuals
- gifts to an accumulation and maintenance trust, a disabled person's trust or an interest in possession trust.

Can lifetime gifts be exempt?

The exempt transfers mentioned previously apply equally to lifetime gifts and to transfers upon death. In addition, the following exemptions apply to lifetime gifts.

- Gifts made by an individual up to a total value of £3,000 in any one tax year, plus any unused balance of the £3,000 exemption from the previous tax year.
- Gifts in any tax year up to a total of £250 to any recipient. This exemption only applies if the total given to any one person in any tax year is not more than £250.

- Within certain limits, lifetime marriage gifts are exempt. The gift must be to either one or both of the parties to the marriage. The exemption varies according to the relationship between the donor and the marriage couple. For example, an exemption of £5,000 is allowed if the donor is a parent of one of the marriage couple.
- Gifts for the maintenance of an individual's spouse, former spouse and dependent relatives are exempt. In addition, a gift for the education of the donor's child or a child of the donor's spouse are exempt, provided that the exemption only applies until the child is eighteen years of age or until the completion of full-time education.
- Gifts out of normal expenditure such as birthday gifts, Christmas gifts and anniversary gifts are exempt provided the gifts are unconditional and sufficient income is maintained by the donor to maintain his usual standard of living.

Transfers of value

A "transfer of value" occurs when an individual makes a transfer that reduces the value of his estate. Inheritance tax is charged on transfers of value. Therefore, inheritance tax may be charged on a transfer that is not an outright gift because the value of the estate is reduced. As stated earlier, a person is treated as having made a transfer of the entire estate immediately prior to death, for inheritance tax purposes. The following are some common examples of transfers of value.

- If an individual takes out a life insurance policy on his own life and for his own benefit it will form part of his estate. Therefore, a transfer of value would occur when the individual dies or makes a gift of the policy.
- If a transfer is not a potentially exempt transfer and contains some element of a gift (ie. a transfer at less than full market value), inheritance tax will be immediately chargeable.
- If an individual releases another person from debt, this may be considered as a transfer of value.

Gifts in which the donor retains an interest

A gift made by an individual may be treated as forming part of his estate on death if he has retained an interest in it. Such a gift is called a “gift with reservation”. An example is where a donor makes a gift of property but then continues to live in it rent-free. However, if the donor enjoys the benefits of the asset in exchange for the payment of a market price or rental, the gift may not be treated as a gift with reservation.

If a reservation on a gift comes to an end during the lifetime of the donor, the gift is treated as a potentially exempt transfer from the time of that event and the gift will be subject to inheritance tax if the donor dies within seven years from that time. If the reservation on the gift still exists upon the death of the donor, the property will be treated as part of the donor’s estate.

Generally, the exemption rules apply to gifts with reservation. However, the exemption for normal expenditure out of income and the annual exemption of £3,000 do not apply to gifts with reservation.

Valuation of transfers

Generally, inheritance tax is charged on the market value of the asset at the time of the transfer. The market value of the property is the price that can reasonably be obtained in the open market between a willing buyer and seller at the time of the lifetime gift or death. Variations to these rules exist where the property consists of shares, securities, unit trusts, life insurance policies and annuities.

Deductions from the value of the estate

Debts imposed by law or incurred for money are deducted when valuing an estate. A debt which is specifically charged on a particular item of property is, as far as possible, set off against the value of that item of property. If a person enters into a voluntary covenant to make future payments, these liabilities are not deducted from the value of the estate.

Inheritance tax is due on transfers made if the transferor pays the tax on the gift. The loss to the estate includes the gift and the tax on it. If the tax is paid by the transferor, it will not increase or reduce the value transferred. However, if the transferor dies owing inheritance tax, the liability will be deducted from the value of the estate as if the tax were actually paid out of the estate.

If a transferor pays any capital gains tax due on a gift, the payment is ignored for valuation purposes. However, if the transferee pays the capital gains tax, the tax is deducted from the value transferred. Capital gains tax may be deferred in certain circumstances until the transferee makes a later disposal. In these circumstances, an allowance exists for any inheritance tax paid on the gift when calculating the capital gains tax liability on the later disposal of the asset.

A deduction is allowed for expenses incurred by the estate in administering or realizing assets outside the UK. Deductions may also be made from the deceased's estate for reasonable funeral expenses.

Rates of inheritance tax (6 April 2002 – 5 April 2003)¹⁶³

Inheritance tax is charged on the open market value of all assets in a person's estate immediately before death. The first £250,000 ("the nil rate band") is charged at 0%, and the balance at 40%. Inheritance tax is charged at 20% on lifetime transfers (e.g. transfers to discretionary trusts) where the gross cumulative transfers exceed £250,000.

Most lifetime gifts are potentially exempt transfers. Where a donor dies within seven years of making a potentially exempt transfer, the gift is brought back into account for calculating the inheritance tax due on his death. The rate of tax is reduced depending on the interval between the gift and the date of death. If the gift, when aggregated with the

¹⁶³ Osborne Clarke *An introduction to UK inheritance tax (IHT)*, *Legal Update*, (April 2002).

value of all other transfers in the previous seven years, is less than the nil rate band the reduction does not apply. This reduction in tax is commonly known as 'taper relief'.

Taper relief applies as follows:

Years between transfer and death	% of tax rate
Not more than 3	100
More than 3 but not more than 4	80
More than 4 but not more than 5	60
More than 5 but not more than 6	40
More than 6 but not more than 7	20

For example, if you die within three years of making the gift, the full amount of any inheritance tax on the gift will be payable. If you die between three and four years later, only 80% of that amount will be due, and so on. It should be remembered that inheritance tax is payable on lifetime gifts only if the total value of all chargeable transfers is more than the tax threshold of £250,000.

Taper relief cannot reduce tax on death below what has already been paid. If the tax due on death is less than the tax already paid, no further tax will be due, nor will a repayment be available.

Example 8.2

This example demonstrates that even when no tax is payable on gifts made by a person, they can affect the amount of tax that has to be paid on that person's estate.

In May 1997, Mr B made a gift of £103,000 to his son. This gift was worth £100,000 after deducting the £3,000 annual exemption. In June 2002 (when the tax threshold was £250,000) Mr B died leaving an estate worth £340,000. As less than seven years had passed since Mr B made the gift, it was no longer exempt from inheritance tax and had to be added to the value of his estate.

	£
Lifetime gift	100,000
Value of Mr B's estate at the time of his death	<u>340,000</u>
Total	440,000
Less the threshold at the date of death	<u>(250,000)</u>
Total chargeable estate	<u>190,000</u>

Inheritance tax on £190,000 at 40% is **£76,000**.

The inheritance tax of £76,000 is payable on Mr B's estate by his executors. No tax is payable on the gift itself because it does not exceed the threshold. Even though Mr B had died more than three years after making the gift, there is no taper relief. This is due to the fact that taper relief applies only to the tax payable on a lifetime gift. If no tax is payable there is no taper relief.

Settled property¹⁶⁴

For inheritance tax purposes, settled property includes property held in a trust

- For successive beneficiaries
- For any individual, but subject to a contingent event (eg. attaining a specified age)
- Under which the income is payable at someone's discretion or has to be accumulated.

An interest in possession in settled property is the immediate right to

- use or enjoy the property, or
- receive any income arising from it.

An interest in possession in settled property is similar to a vested interest in the income of a trust or a fiduciary interest in property in South Africa. Usually, trusts under which there is no individual with an immediate right to an interest in possession are referred to as 'discretionary trusts'. For example, when the settled property is held in trust to accumulate the income or to apply the income at the trustees' discretion, with or without the power to accumulate any surplus.

How is tax charged when there is an interest in possession?

Inheritance tax is charged if an interest in possession comes to an end, or is disposed of, within seven years before the death of the individual entitled to it. When the interest comes to an end on the death of that individual, the property is taxed as part of the estate as though he or she had transferred the property as absolute owner. The tax is charged on

¹⁶⁴ Inland Revenue IHT 16 – Inheritance Tax – Settled Property (February 2002)

the value of the property and is normally payable by the trustees out of the settled property. If the value is greater when valued together with other property of the deceased or spouse then the higher value is taxed.

What happens if the interest is disposed of or comes to an end in the lifetime of the person entitled to it?

If the interest is disposed of or comes to an end during the lifetime of a person, the individual is treated as having made a transfer of the settled property, which is valued in isolation. This will usually be a potentially exempt transfer. Not every lifetime disposal or termination of an interest in possession is treated as a potentially exempt transfer. For example, there may be an immediate charge to inheritance tax if the property goes into a discretionary trust.

The tax due on settled property in these circumstances will be payable by either

- the trustees, or
- the transferee.

How is inheritance tax charged on settled property?

Inheritance tax is generally charged on the value of settled property in a discretionary trust every ten years after the creation of the trust. However, inheritance tax may be

charged before a ten-year anniversary if the trustees make a disposition¹⁶⁵ which reduces the value of the settled property in the trust or if the property in the discretionary trust ceases to be relevant property. For example, an individual may become beneficially entitled to an interest in possession in the settled property. Undistributed income of discretionary trusts is not relevant property until it is accumulated.

The rate of the ten-yearly tax charge is 30% of the 20% rate applicable to lifetime transfers. If inheritance tax has to be paid for a portion of a ten-year period, the amount of the proportionate charge is the amount by which the value of the relevant property in the trust is decreased as a result of the event giving rise to the charge, that is, the loss to the trust. If the tax payable is paid out of any relevant property remaining in the trust, the loss will be grossed up so that the amount chargeable includes the tax. The rate of the proportionate charge is a fraction of the last ten-year anniversary. The fraction is calculated as one-fortieth for each complete quarter that has passed since that anniversary. If the general rates of tax have decreased since that time, the current lower rates are used in the calculation.

¹⁶⁵ A 'disposition' is an action or a failure to exercise a right.

Example 8.3

At the last ten-year anniversary, tax of £1,800¹⁶⁶ was charged on the £30,000 relevant property in the trust. Four years (that is, sixteen quarters) later, £20,000 is distributed to a beneficiary. Assuming no changes in the general rates of tax since the last ten-yearly charge, the £20,000 will be taxed at the fraction of 16/40 of the rate of 1,800/30,000.

$$\frac{16}{40} \times £20,000 = £8,000$$

$$\frac{1,800}{30,000} \times £8,000 = £480$$

So £480 inheritance tax will be payable.

Conclusion

Inheritance tax is different to estate duty in that it taxes what is received from an estate irrespective of the size of that estate, whereas estate duty is charged on the wealth in the estate. Inheritance tax is, therefore, able to satisfy one of the prime objectives of death taxation by reducing the inequality in wealth that is perpetuated by large inheritances.

¹⁶⁶ $30\% \times 20\% \times 30\,000 = 1\,800$

Inheritance tax in the UK operates during a person's lifetime and at death, and is similar to the South African tax system when estate duty is coupled with donations tax. However, unlike the South African tax system, the UK tax system manages to avoid imposing both inheritance tax and capital gains tax on the same assets at death. This is achieved by not charging capital gains tax when the assets pass from the deceased to his estate. It may be wise for South Africa to follow suit to avoid imposing both capital gains tax and estate duty upon the same assets.

An interesting aspect of the UK inheritance tax system is that it includes a mechanism to tax settled property in discretionary trusts every ten years. The lack of such a mechanism in South Africa could be addressed by introducing a generation-skipping transfer tax. Furthermore, since South Africa already has a capable estate duty and donations tax system, it seems unnecessary to change to an inheritance tax system.

CHAPTER 9

APPLICATION OF THE UNITED STATES OF AMERICA AND UNITED KINGDOM LEGISLATION TO THE SOUTH AFRICAN SITUATION

Examples will be presented in this chapter in order to illustrate the impact that an application of the United States or the United Kingdom legislation would have on the South African situation. These examples will address the current inability of the existing South African tax legislation to avoid imposing both capital gains tax and estate duty on the same property at death. The potential for a generation-skipping transfer tax will not be considered in these examples. In addition, transfer duty and STC will be ignored in order to isolate the capital gains tax and estate duty effects.

The examples address the following situations:

- 9.1) Current situation in South Africa
- 9.2) Application of the United States “stepped-up basis” to the South African situation
- 9.3) Application of the United States “carryover basis” to the South African situation
- 9.4) Abolition of estate duty
- 9.5) Application of the United Kingdom legislation to the South African situation

Scenario

X buys a holiday home on 1 October 2001 at its market value of R1 million. On 1 October 2002, X dies when the market value of the property is R2 million. The property is distributed to the heirs of the estate in terms of X's will.

Example 9.1: Current situation in South Africa**1 October 2002**

<i>Capital gains tax – deemed disposal upon death</i>	R
Proceeds	2 000 000
Base cost	(1 000 000)
Capital gain	<u>1 000 000</u>
Less: annual exclusion	(50 000)
Taxable capital gain	<u><u>950 000</u></u>
Capital gains tax (950 000 x 10%)	95 000

<i>Estate duty</i> ¹⁶⁷	R
Gross value of estate assets	2 000 000
Capital gains tax liability	(95 000)
Dutiable estate	<u>1 905 000</u>
Estate duty at 20% (1 905 000 x 20%)	381 000

Therefore the total tax liability is **R476 000**¹⁶⁸.

Example 9.2: Application of the United States “stepped-up basis” to the South African situation

On the “stepped-up basis” capital gains that arise during the deceased’s life and are held at death are never taxed. Therefore, a deemed disposal would not arise upon death and the deceased estate would not be liable for capital gains tax when the assets passed from the deceased to his estate. An heir to the estate would also not be subject to capital gains tax when the assets passed from the estate to the heir. Furthermore, the tax basis for assets passing through an estate is stepped-up or down to its market value so that an heir selling the assets subsequently will only be taxed on the appreciation that occurs after the death of the deceased.

¹⁶⁷ All examples in this chapter will ignore the section 4A abatement allowed for estate duty purposes, as if other assets in the estate were sufficient to absorb the abatement.

¹⁶⁸ R95 000 + R381 000 = R476 000

1 October 2002

<i>Estate duty</i>	R
Gross value of estate assets	2 000 000
Capital gains tax liability	-
Dutiable estate	<u>2 000 000</u>
Estate duty at 20% (2 000 000 x 20%)	400 000

Therefore, the total tax liability would be **R400 000**. In comparison to the current South African situation, this is a decrease in the tax liability of R76 000, which amounts to a **decrease of 15.97%**¹⁶⁹.

Example 9.3: Application of the United States “carryover basis” to the South African situation

On the “carryover basis” the basis value of the deceased’s property will be carried over to the heir instead of being stepped-up. The heir inherits the original basis value of the property to the deceased and will therefore be liable for capital gains tax on inherited assets from the time the asset was originally acquired by the deceased.

¹⁶⁹ $[(476\ 000 - 400\ 000) / 476\ 000] \times 100 = 15.97\%$

1 October 2002

<i>Estate duty</i>	R
Gross value of estate assets	2 000 000
Capital gains tax liability	-
Dutiable estate	<u>2 000 000</u>
Estate duty at 20% (2 000 000 x 20%)	400 000

Assuming the heirs sell the holiday home for R2 million after inheriting it:

Date of sale by heirs

<i>Capital gains tax – when the property is disposed of by the heir</i>	R
Proceeds	2 000 000
Base cost	(1 000 000)
Capital gain	<u>1 000 000</u>
Less: annual exclusion	(10 000)
Taxable capital gain	<u><u>990 000</u></u>
Capital gains tax (990 000 x 10%)	99 000

The “carryover basis” is not an attractive alternative for South Africa as it simply passes the capital gains tax liability at death on to the heirs of the estate. In addition, the capital gains tax liability would also not be allowed as a deduction against the value of the estate for estate duty purposes, as it would not be a liability of the estate. Furthermore, the annual exemption available to the heir would only be R10 000 as opposed to the R50 000 annual exemption that would be allowed if the capital gain was taxed in the hands of the deceased in the year of death under the existing South African legislation. The total tax liability for the estate may only be R400 000, but the burden of the capital gains tax liability is passed on to the heirs of the estate and must be taken into consideration. The total tax liability is, therefore, **R499 000**¹⁷⁰, which exceeds the liability levied in terms of the current legislation by R23 000¹⁷¹. This is an **increase of 4.83%**¹⁷².

¹⁷⁰ 400 000 + 99 000 = 499 000

¹⁷¹ 499 000 – 476 000 = 23 000

¹⁷² [(499 000 – 476 000) / 476 000] x 100 = 4.83%

Example 9.4: Abolition of estate duty

If estate duty were abolished there would be no estate duty liability upon the death of an individual.

1 October 2002

<i>Capital gains tax – deemed disposal upon death</i>	R
Proceeds	2 000 000
Base cost	(1 000 000)
Capital gain	<u>1 000 000</u>
Less: annual exclusion	(50 000)
Taxable capital gain	<u><u>950 000</u></u>
Capital gains tax (950 000 x 10%)	95 000

If estate duty were to be abolished, the total tax liability would comprise the capital gains tax liability and would amount to **R95 000**. This is a **decrease of 80.04%**¹⁷³ when compared to the existing South African legislation.

¹⁷³ $[(476\ 000 - 95\ 000)/476\ 000] \times 100 = 80.04\%$

Example 9.5: Application of the United Kingdom legislation to the South African situation

In the United Kingdom, an inheritance tax liability arises on the death of an individual, but no capital gains tax is payable on death. Since South Africa has a capable estate duty and donations tax system, it seems unnecessary to change over to an inheritance tax system. Therefore, this example will apply the United Kingdom legislation to estate duty as opposed to inheritance tax. Similarly to the United States “stepped-up basis”, the United Kingdom legislation avoids taxing capital appreciations in property held at death, which arise during the deceased’s lifetime. This results in the tax implications being the same as those demonstrated in example 9.2 where the United States “stepped-up basis” was applied to the South African situation.

Conclusion

By applying the United States of America and United Kingdom estate tax and capital gains tax legislation to the South African situation, it is evident that there are more favourable opportunities for the taxpayer than provided for in the existing South African legislation. This can be demonstrated by an application of the United States “stepped-up basis” and the United Kingdom legislation. It is also notable that the United States “carryover basis” provides a less favourable tax situation than the existing estate duty and capital gains tax legislation in South Africa.

CHAPTER 10

AREAS FOR FURTHER RESEARCH

The combined effects of estate duty and capital gains tax are far broader than the issues that were isolated for investigation in this paper. Further research could be performed to answer the questions listed below.

Trusts

Capital gains tax is levied on trusts at a maximum effective rate of 20%, while the maximum effective rate for an individual is 10%. Trusts are also not entitled to the exclusions, such as the primary residence exclusion and the annual exclusion, which are allowed to natural persons and special trusts. Furthermore, trusts are not subject to estate duty. These differing factors raise a number of questions.

- If the estate of a person will consist of high growth assets, is it still preferable to retain these assets in a trust? What if one of these assets is a primary residence?
- What additional tax effects would arise if an asset were transferred to a trust after the implementation of capital gains tax?
- What are the tax effects if the deceased owns a share in a company which owns an interest in a trust holding the deceased's residence?

Limited Interests

This paper only examined the case where a full ownership interest was held in a property. However, the case may arise where a limited interest is held in a property. Some examples of limited interests are a usufructuary interest, a bare dominium or a fiduciary interest. These limited interests would have different consequences to a full ownership interest. The following are some of the areas that may be of interest:

- For capital gains tax purposes, what is the market value of the relevant limited interest at death?
- How are the combined estate duty and capital gains tax effects different for a limited interest in comparison to full ownership of a property at death?
- What are the effects of the primary residence exclusion on a limited interest?
- How do the estate duty and capital gains tax effects impact on a non-resident with a limited interest in an immovable property situated in South Africa at death?

Non-residents

The capital gains tax and estate duty implications for residents and non-residents differ. Further research could be carried out to obtain answers to the following questions:

- What tax effects will a non-resident experience if he holds immovable property in South Africa upon his death?

- What would the tax implications be if a deceased non-resident holds an interest in a South African company, close corporation or trust which owns an immovable property?

Companies

As demonstrated in this paper, significant tax liabilities may arise from holding a property in a close corporation. Holding a property in a company may have similar effects and may also have additional effects. Some topics of interest may be:

- What are the resulting tax effects if the deceased has an interest in a holding company which has a number of different levels of subsidiaries and the lowest level of subsidiary owns the deceased's residence at death, and the executor has to wind-up all of these companies upon the deceased's death?
- What possible additional tax effects may arise from other taxes such as Secondary Tax on Companies and Stamp Duty?
- When a company or a group of companies owns a property, how does the tax situation compare to the other manners in which a property could be held at death?

Conclusion

The areas for future research mentioned above were beyond the scope of this paper. They are just some of the numerous areas related to the topic discussed, which hold potential for further research.

CHAPTER 11

CONCLUSION

Principles of a good tax system

In deciding what changes need to be made to the estate duty and capital gains tax legislation, it is important to establish what the system aims to accomplish. These goals should be established by applying the following widely accepted general tax principles:

- Neutrality
- Efficiency
- Certainty and Simplicity
- Equity

Neutrality

An individual's decisions are generally motivated by a combination of factors, rather than simply by the tax considerations. Therefore, similar transactions should be treated similarly for tax purposes. This paper examined the broad range of tax consequences that an immovable property may be exposed to, simply due to the manner in which it is held and the manner in which it is disposed of by a deceased estate. This may result in the tax considerations becoming the overriding decision making factor.

Efficiency

Efficiency means that compliance costs should be kept to a minimum. The administration of the system should also be practical. As noted in Chapter 6, it may not

be administratively practical to have a system that requires supporting documentation to be maintained through multiple generations.

Certainty and Simplicity

Taxpayers should be able to anticipate the tax consequences of entering into a transaction in advance. Legal certainty is vital to the tax system as it enables transactions to be carried out in an environment where tax obligations are clear, transparent and predictable. This reduces the risk of unforeseen tax liabilities and disputes.

The existing capital gains tax legislation still contains uncertainties that may result in confusion. In addition, the tax system in South Africa is constantly changing. Capital gains tax was introduced in October 2001 and adjustments were made to other taxes, such as estate duty and transfer duty, to cater for this new tax. Based on these amendments, many taxpayers made decisions relating to the manner in which they intended to hold their assets. Nevertheless, further amendments were made to the transfer duty legislation, which may result in significant tax consequences attributable to those decisions.

Equity

Both horizontal and vertical equity should be taken into account in a good tax system. Based on the effects of the current tax system, it is questionable whether these principles are being applied. Vertical equity may not be achieved due to the growing estate planning industry, which the wealthy use to their advantage in order to reduce or eliminate any tax liability that may arise at death, while the middle-income earner

remains burdened by the tax liability. Horizontal equity may not be achieved due to the complications inherent in the combination of taxes that may be payable. Due to the complications, two taxpayers in the same wealth bracket with similar assets may be exposed to vastly different liabilities at death. As illustrated in this paper, the tax liabilities may differ because of the manner in which an asset is held or disposed of by the estate.

Objectives of the tax system

The objectives of the tax system must be determined in order to establish a tax system that will achieve its goals. The amendments to be made to the current tax system in respect of the taxes payable by a deceased person will be dependent on the objectives of the tax system.

In order to reduce the concentration of wealth, which is one of the prime objectives of a death tax system, the estate duty primary abatement could be increased further and the tax rate could be maintained. This would reduce the number of people who pay estate duty, but it would also reduce the revenues collected.

Possible solutions

Relief could be allowed from capital gains tax until the asset was actually disposed of by the beneficiary of the estate. This would avoid any immediate capital gains tax burden at death. However, there may be an incentive to pass an asset from generation to generation in order to reap tax benefits similar to those of an outright exemption. By

passing the asset through multiple generations without actually selling the asset, capital gains tax will never be incurred. Furthermore, this approach would result in administrative difficulties due to the record keeping requirements because supporting documentation would have to be maintained to establish the base cost of the asset for capital gains tax purposes. If an asset has been passed through many generations these records may not be available. The pitfalls of this approach may be avoided by drawing on the experience in the United States of America and the United Kingdom.

Drawing on experience from the United States of America and the United Kingdom

Currently, property in a deceased estate is being subjected to both capital gains tax and estate duty in South Africa. It can be argued that this results in double taxation. However, it is evident from the situation in the United States of America and the United Kingdom that this need not be the case.

The United States legislation includes two different methods of achieving these ends. Firstly, a “stepped-up basis” could be used, for capital gains tax purposes, so that appreciations in the value of property held at death, to the extent that the appreciation occurred during the deceased’s lifetime, would not be subject to capital gains tax. Secondly, estate taxes could be abolished so that property in an estate would only be subject to capital gains tax upon a person’s death.

The United Kingdom has an inheritance tax as opposed to the estate duty and donations tax, applicable in South Africa. Since the South African estate duty and donations tax

provide a capable system, it does not appear to be necessary for South Africa to change to an inheritance tax system. However, the United Kingdom tax regime is of interest as it avoids imposing both capital gains tax and inheritance tax on property in a deceased estate by not levying capital gains tax when the deceased's assets are passed on to the estate. In addition, the beneficiaries of a deceased estate are treated as if they had acquired the assets of the deceased estate at their market value upon the death of the deceased for capital gains tax purposes. In a similar manner to the United States "stepped-up basis", the United Kingdom legislation does not subject capital appreciations in the value of a property held at death to capital gains tax to the extent that the appreciations occurred during the deceased's lifetime.

Loopholes in the existing legislation

If the estate duty legislation is to be amended, loopholes in the current legislation should also be addressed. As pointed out earlier in this paper, it may be necessary to consider introducing legislation to address the use of tax avoidance devices such as trusts. The United Kingdom addresses the issue of tax avoidance devices by including provisions in its inheritance tax legislation that tax settled property in discretionary trusts every 10 years. In the United States of America a separate tax exists, in the form of a generation-skipping tax, which closes this loophole. It is questionable whether South Africa has the administrative abilities to introduce such a tax. However, it may be possible to amend the existing legislation in South Africa without introducing a separate body of legislation to address these matters. Narrowing the gaps in the current legislation may even generate

sufficient revenue to negate the need to impose both capital gains tax and estate duty upon the deceased.

Maintenance or abolition of estate duty

Estate duty can play an important role in the tax system. Many of the arguments in favour of maintaining or abolishing the current estate duty system are plausible. Those in favour of estate duty must distinguish between the potential benefits in principle and the design problems that arise in practice. If estate duty generates significant benefits, then an argument could be made to justify its existence.

Currently, the combination of estate duty and capital gains tax appears to be violating the basic principles of simplicity and equity, which are elements of a good tax system. The most radical reform would be to repeal estate duty. From the experience in the United States of America and the United Kingdom, it is clear that it is possible to avoid levying both capital gains tax and estate duty at death. In light of these considerations, following the example of the United States of America or the United Kingdom may be the lifeblood of a more effective South African tax system for the future.

APPENDIX A

TRANSFER DUTY RATES

TRANSFER DUTY, IF PROPERTY IS PURCHASED BY NATURAL PERSONS

1 April 1999 – 28 February 2002

- 1% on the first R70 000 of the property value
- 5% on the property value from R70 001 to R250 000
- 8% on the property value in excess of R250 000

From 1 March 2002

- 0% on the first R100 000 of the property value
- R10 000 on the property value from R100 001 to R300 000
- 8% on the property value in excess of R300 000

From 1 March 2003

- 0% on the first R140 000 of the property value
- 5% on the property value from R140 001 to R320 000
- 8% on the property value in excess of R320 000

TRANSFER DUTY IF PROPERTY IS PURCHASED BY COMPANIES, CLOSE CORPORATIONS OR TRUSTS

From 1 April 1999

- Flat rate of 10% of the property value

THE ACQUISITION OF A CONTINGENT RIGHT IN A TRUST, SHARES IN A COMPANY OR A MEMBER'S INTEREST IN A CLOSE CORPORATION, WHICH OWNS RESIDENTIAL PROPERTY COMPRISING MORE THAN 50% OF ITS CAPITAL GAINS TAX ASSETS, WILL ATTRACT TRANSFER DUTY AS FOLLOWS:

From 13 December 2002

- At the rates applicable to natural persons if a natural person makes the acquisition.
- At a flat rate of 10% of the property value if a company, close corporation or trust makes the acquisition.

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