Comment on the First Interim Report on Estate Duty by the Davis Tax Committee, submitted by the Council of the Fiduciary Institute of Southern Africa (FISA®)

1. Executive summary

1.1. It is submitted that the conduit principle lies at the heart of the nature of a trust as legal construct and, as such, it should be retained. It can, in any event, not be abolished in the case of "bewind" trusts as the property in those cases belong to the beneficiaries and not the trustees, while the same argument can be made out in the case of ownership trusts where beneficiaries have vested rights to either income or capital (or both).

1.2. The finding by the Davis Tax Committee (the "committee) that the use of trusts leads to substantial loss of estate duty is questioned. It is submitted that the earlier collection of other taxes upon transfer of assets to a trust makes up for such "losses" if time value of money is considered.

1.3. Abolishing the conduit principle will harm the elderly and the the not-so-wealthy more than the high net worth.

1.4. The deeming provisions in section 7 has more to do with deeming income to be that of the founder rather than the beneficiary, than it has to do with keeping it away from the trust.

1.5. Proper enforcement and disclosure of income and capital gains vested in beneficiaries will stop any substantial "tax leakage" in trusts.

1.6. The current deduction for inter-spousal bequests just recognises the fact that most South Africans who die have been in a relationship at the time of death. The view that there are no pragmatic reasons for retaining this, while at the same time proposing that the standard abatement of the survivor can be used at the death of the first-dying "spouse" seems to be based on flawed logic. It is submitted that the inter-spousal bequest forms a cornerstone of providing for the survivor's financial stability.

1.7. The concern about the exemptions from donations tax in sections 56(1)(c) and

56(1)(d) of the Income Tax Act[1] seems misplaced as any donation so exempted is included in "deemed property" under sec 3(3)(b) of the Estate Duty Act.[2] Such a donation can also not be deducted as a liability under the same Act.[3] To abolish these exemptions will cause double taxation.

1.8. The proposed limitation of inter-spousal donations exemptions to exclude fixed property and shares does not take cognisance of the reasonable use of such donations for reasons of fairness between spouses.

1.9. The recommendation that the 20% flat rate for estate duty and donations tax be retained is welcomed. The effective rates should now also be equalised by changing the estate duty calculation to an inclusive tax calculation.

1.10. The proposal to tax all distributions from foreign trusts as income seems harsh and cannot be justified on the basis that it is difficult to ascertain the nature of the distribution. A rebuttable presumption can be used.

1.11. It is submitted that the authority used for the view that capital gains tax at death is not a wealth tax, is inappropriate. It remains a fact that the same event gives rise to two taxes on the same assets.

2. Recommendation: Repeal of section 25B

"The deeming provisions of section 7 and 25B insofar as they apply to RSA resident trust arrangements should be repealed"

FISA® Comment:

2.1. A trust is a conduit by nature and in common law. It is not, by nature and in common law, a separate juristic person.[4] Its primary reason for existence is, and should be, for the trustee(s) to hold the trust property for the benefit of the beneficiary(ies). To ignore this for tax purposes is to create tension between the legal nature of the figure and its tax treatment, in fact, creating a mere fiction in tax law that is not supported by the real legal nature of the trust.

2.2. In the light of the two types of trust recognised by the definition of "trust" in section 1 of the Trust Property Control Act[5], it is submitted that in the case of the so-called "bewind" in paragraph (b) of the definition the conduit principle is enshrined in the fact that the trust property belongs to the beneficiary, albeit placed under the control of the trustee. It would make no sense at all to ignore this for tax purposes.

---

[1] Act 58 of 1962.
[2] Act 45 of 1955.
[3] See section 4(b)
[4] *Land and Agricultural Development Bank of SA v Parker and others* [2004] 4 All SA 261 (SCA), at par 10.
[5] Act 57 of 1988.

2.3. Similarly, in the case of an ownership trust[6] where a beneficiary (or beneficiaries) has a vested right to income, it would make no sense to ignore those rights and tax all income in the trust while the income is, in reality, paid out to the beneficiary. The same would apply to those ownership trusts where a beneficiary has a vested right to receive the capital upon termination, while the trustees only have a discretion to determine the termination date.

2.4. Ignoring the conduit principle to tax the "trust abuse" cases, will cause hardship to those who need a trust for asset protection and for the management of capital and income on behalf of financially unsophisticated or elderly individuals. Since the committee only proposes to expand the concept of "special trust" to BEE trusts, these beneficiaries will suffer as a result of a tax rate designed to tax the wealthy, while they are not wealthy.

In the case of elderly individuals, and in the absence of enduring powers of attorney in South African law, a trust is extremely useful to protect assets for the benefit of the elderly and prevent exploitation.

Anecdotally, several cases were brought to our attention where trusts such as these hold property to a total value of only a couple of million Rand, paying out income to the beneficiary or assisting the caregiver of the beneficiary to meet the beneficiary's cost of living. Real life examples are:

- A trust was created for a couple with no relatives to ensure that the survivor of the two would be protected in case of old age or infirmity. The asset value is less than R6m and would not attract estate duty. The proposals would mean that these taxpayers would be taxed at a flat 41% as if they are high net worth individuals.

- A trust was created for an individual's daughter who has a problem staying in employment and to manage her own affairs. The total asset value is less than R7m.

To use the current flat rate of 41% from the first Rand of taxable income in cases like this would be to bring a particularly blunt instrument to deal with a complex situation.

2.5. The current flaw in practice is that income flowing through a trust to beneficiaries is not always reflected as income in the hands of those beneficiaries. Inconsistencies and irregularities in this regards exists. This problem will be greatly reduced with the framework of the new tax returns for trusts (ITR12) where great emphasis is placed on the receivers of the flow through funds. SARS will now be able to scrutinize the beneficiaries' tax returns more closely.

[6] As envisaged by par (a) of the definition of "trust" in section 1 of the Trust Property Control Act, 57 of 1988.

2.6. It is also submitted that the perceived "tax leakage" as a result of the conduit principle is probably substantially overstated. The argument that property transferred to a trust is lost to the estate duty regime and therefore to wealth tax revenue, loses sight of the following:

2.6.1. Upon transfer to a trust, the collection of capital gains tax is accelerated. If the property transferred is immovable property, transfer duty is payable, which would not normally be payable upon transfer from the deceased estate to heirs. If time value of money is applied to these amounts which are now collected earlier than would be the case, or collected where no such amount would have been collected in a deceased estate, the perceived tax leakage disappears. As an example, consider the situation where immovable property to the value of R3m is transferred to a trust in 2015. Assume a base cost of R900,000[7] in 2002, and a marginal tax rate of 41% for the individual transferring the property and no other. The capital gains tax collected in 2015 will be R286,713. The transfer duty collected in 2015 will be R167,500, making the total tax collected in 2015 an amount of R454,213, against nothing if one assumes that the previous owner of the property would have lived another 15 years. In his/her deceased estate in 15 years from now, even if an outstanding loan had been donated away at the rate of R100,000 per annum, there would still be R1,5m of loan left as an asset in his/her estate.

Assuming that the whole R3m would have been left in his estate 15 years from now and would all be dutiable and assuming a 6% per annum increase in value in all cases, the present value of the collection of estate duty 15 years from now would be R600,000. The present value of the estate duty on the R1.5m remaining loan account would be R300,000 which, added to the R454,213 collected by way of capital gains tax and transfer duty in 2015 comes to R754,213. This is, in present values, 25% more than the estate duty that would have been collected 15 years from now.

Any loss in capital gains tax upon the death of the original owner of the assets will be offset by any future attribution of capital gains to beneficiaries and any actual distribution of property to the beneficiaries.

2.6.2. The tax leakage due to the so-called perpetual nature of family trusts is also overstated, it is submitted. The typical "family trust" very rarely lasts longer than the second generation. Necessity, and the desire to own assets individually, usually lead to an undoing of the majority of these structures every second generation.

[7] Assume no capital enhancements, only maintenance between 2002 and 2015.

2.6.3. Individuals can transfer assets to their future heirs instead of to trusts, with the same results from a tax perspective as if it had been transferred to a trust. Reasons for not doing so are where the owner of the assets need these for his/her own use and maintenance, or where such person wishes to remain in control. In the former case it is submitted that these individuals do not form part of the estate duty target high net worth group. In the latter case, the emphasis on control would be easy to identify in a trust abuse situation as discussed below.

2.6.4. Not all trust structures are set up with a tax purpose. In fact, asset protection has probably become the dominant reason for the setting up of trusts. This is also by no means a South African phenomenon only. Private bank US Trust found that more than one third of high and ultra-high-net-worth parents agreed 'strongly' that their children would not be able to handle their inheritance. A survey by Barclays bank also revealed that more than 25% of individuals in the USA with investable assets of at least $1,5m do not trust their children and step-children to protect their inheritance.

Furthermore, despite the negative capital gains tax implications (a higher inclusion rate and a flat tax rate), it can be regarded as good advice to an individual, who is about to enter into risky entrepreneurial businesses, to transfer the primary residence to a trust. The purpose is clearly not to save taxes, but to safeguard the individual's assets which should not be exposed to high risks.

2.7. The implications of the proposed tax changes are harsh and will result in less people setting up trusts to protect their families which could result in a further dependence on Government for financial assistance when the beneficiaries' inheritance was squandered.

2.8. The cases of abuse should rather be identified by way of a test based on the fundamentals of trust law as formulated in the Parker case.[8] A precedent exists for this kind of multi-factor test, in par 57 of the 8th Schedule which deals with the requirements for a capital gains tax exclusion for small business owners upon retirement.

Such a multi-factor test could include factors testing whether there is sufficient separation of control and enjoyment of the trust assets. Examples are whether the founder and/or his/her spouse are also trustees and beneficiaries, whether multiple trusts exist with the same beneficiaries, etc. Inadequate separation of control and enjoyment could then be visited with a higher tax rate or inability to utilise attribution.

[8] *Land and Agricultural Development Bank of SA v Parker and others,* at par 19.

On this basis the abuse cases could then also be excluded from the provisions of paragraph 80 of the 8th Schedule.

In so far as this recommendation is aimed at deterrence of the use of trusts to avoid estate duty, the concern is certainly overrated. In a large percentage of the cases these structures would fall foul of an abuse test and will be susceptible to isolation and punitive tax treatment without harming the legitimate and desirable use of trusts.

2.9. FISA submission:

2.9.1. We submit that the conduit principle should be retained with close monitoring to ensure that the distributed income be declared on beneficiary level. The assets kept in trust are after all held for the benefit of the beneficiaries, so why should the income generated from these assets not be taxed as such? More focus on disclosure and the monitoring of capital gain attributions under par 80[9] will also assist in preventing abuse.

2.9.2. As an alternative, retain the conduit principle but refine definitions of typical tax avoidance trusts, similar to what was done with the notion of "personal service providers". It is submitted that this definition has closed many a tax evasion and avoidance scheme. A multi-factor test as with the capital gains exclusion for small business owners upon retirement can also be utilised.

2.9.3. As a *poor third alternatively*, retain the conduit principle but, with reference to income distributions, remove the application of the primary, secondary and tertiary rebates (and the interest rebate which is currently being phased out) when distributions are made to family members (spouse, descendants and ascendants) and retain the section 7 anti-avoidance rules. With reference to capital gains distributions the annual capital gains exclusion can be removed as well as having a fixed effective capital gains tax rate (applicable to natural persons – 13,7%) be applied when distributions are made to family members (spouse, descendants and ancestors).

This alternative is labelled a poor one as, again, it does not discriminate sufficiently between trust abuse cases, on the one hand, and the legitimate use of trusts for asset protection, as well as the cases of the not-so-rich where more than one beneficiary is dependent on the same asset pool, on the other hand.

[9] Paragraph 80 of the the 8th Schedule to the Income Tax Act, 58 of 1962.

3. **Recommendation: Repeal of section 7**

Comment:

The concern about the use of section 7 to deem income to be that of the founder and prevent it from being taxed in the hands of the trust is probably misplaced. In most cases section 25B would have been used to allow the income to flow through to beneficiaries.

It would, in most cases be a choice between being taxed in the hands of the founder or the beneficiary(s) and not between the founder and the trust. If abuse of the trust form is addressed as suggested in the comment on the recommendation to repeal section 25B, this ill will also be addressed adequately.

FISA submission:

As indicated above, it is submitted that the deeming provisions of section 7 and the corresponding paragraphs in the 8th Schedule[10] should be retained.

4. **Recommendations: Repeal of section 4(q) and the increase and change of the way in which the section 4A abatement can be claimed**

Comment:

The logic applied, that there is no intellectual justification to retain the inter-spousal bequest on pragmatic grounds, while there seems to be a pragmatic reason to retain allowing the survivor to use both spouses' standard abatement, seems flawed. Surely, what is good for the goose is good for the gander.

The reality is that most adults who die in South Africa were either in a relationship at the time of death or was the survivor from a previous relationship. The further reality is that married couples have a legal duty of support towards each other. A repeal of the inter-spousal bequest deduction could lead to undesirable practices like the spouses disinheriting each other, with a claim for maintenance under the Maintenance of Surviving Spouses Act[11] following.

Also, if this repeal is done at once without phasing it in, it is again those who are too old to make use of life insurance to alleviate cash shortages caused by an inflated estate duty liability, who will suffer most. Especially asset rich, cash poor couples like farmers and owners of small to medium size businesses will be in this category. This could also impact the continued viability of these businesses. Anecdotally there is evidence of estate duty causing such family businesses to fail due to the sudden (and not planned for) capital requirement to pay estate duty. Before any changes are made here, thorough research will be necessary.

[10] 8th Schedule to the Income Tax Act, 58 of 1962.
[11] Act 27 of 1990.

The committee refers to "abuse inherent in the existing inter-spouse abatement" but no details or evidence of such abuse is given. If "abuse" does indeed occur, is it not because of the generous definition in the Estate Duty Act of "spouse"? It is submitted that the definition of "spouse" currently carries the requirement that the Commissioner must be satisfied that the union was intended to be permanent. Surely, this is a purely factual question with little scope for abuse? It remains incumbent upon the person wanting to claim this deduction to prove that there was indeed a union that was intended to be permanent.

Furthermore, where there was in fact no union, it seems far-fetched that a testator would want to leave the bulk of his estate to someone who has little or no interest in looking after the interests of such testator's family purely to save estate duty. Giving up family control over the assets to save estate duty does not seem a realistic scenario.

FISA submission:

Given the reality that most South Africans die while in some form of a life relationship, it is submitted that the repeal of the deduction for an inter-spousal bequest does not take cognisance of this reality. To avoid hardship for the elderly who may suffer as a result of this proposed repeal, it is submitted that the deduction be retained.

As an alternative the deduction could be capped at a level which will refine the attempt levy estate duty on high net worth individuals, without prejudice to surviving spouses in the middle class.

5. Recommendation: Removal of exemptions in section 56(1)(c) and 56(1)(d).

Comment:

The concern about abuse of these exemptions seems misplaced as both exemptions are countered by the inclusion in the estate of the donor of such donations as deemed property under section 3(3)(b) of the Estate Duty Act.

Furthermore Section 4(b) of the Act allows a deduction for estate duty purposes "all debts due by the deceased to persons ordinarily resident within the Republic (other than any debt which constitutes a claim by such person to property donated by the deceased in terms of donation which was exempt from Donations Tax under Section 56(1)(c) or (d) of the Income Tax Act 1962…..which is proved to the satisfaction of the Commissioner to have been discharged from property included in the estate)".

FISA submission:

To remove the exemptions it will effectively cause double taxation (both donations tax and estate duty).

6. **Recommendation: Retention of the inter-spouse donations tax exemptions contained in sections 56(1)(a) & (b) of the Income Tax Act, subject to section 56(1)(b) being amended to exclude all interests in fixed property or companies.**

   It is assumed that the reference to "companies" includes private and public companies and memberships in Close Corporations.

   The proposal to exclude fixed property and shares donated between spouses is problematic, because there are many legitimate reasons for spouses to make such donations. For example, a person may purchase a house and take out a mortgage bond on the house. After he gets married, his spouse contributes to the repayments on the bond, and he may therefore want to donate a share of ownership to his spouse. Similarly, a person may own a business which his spouse helps to build up and he may want to transfer a share of the business to the spouse.

   FISA submission:

   It is submitted that the proposed amendment will cause substantial unwarranted tax to individuals who merely want to treat each other fairly as spouses.

7. **Recommendation: Retention of the 20% flat rate for estate duty and donations tax.**

   Comment:

   This should be welcomed, but the opportunity should now be used to equalise the effective rates by changing estate duty calculation to an inclusive tax calculation.

   Currently, if a terminally ill or elderly taxpayer has R1m freely available, s/he can donate R833,333 and pay 20% donations tax (R166,667) on that, removing the R1m from his/her estate (assume the annual exemption is not available). If s/he dies and the R1m were to be dutiable, the estate duty on that amount would be R200,000, thus a difference of R33,333. This can be prevented by changing the calculation of estate duty to an inclusive calculation like VAT. If the R1m dutiable amount is then calculated as R1m x 20 ÷ 120, the amount of duty would equal the amount of donations tax, i.e. R33,333, or 20% of the inheritance left after deduction of the duty.

   One of the main reasons why estate duty, and especially estate duty combined with capital gains tax on death, is perceived to be harsh and unfair is the fact that these taxes often result in assets having to be sold by the executor in order to pay the taxes. Any insurance taken out to provide for these taxes will again be subject to estate duty. It is suggested that the committee considers exempting the proceeds of life insurance payable to the estate from estate duty up to the amount of estate duty payable in the estate.

8. Recommendation: All distributions of foreign trusts will be taxed as income.

Comment:

The committee's explanation for this bold move is that it is difficult to identify the components of income distributed to a beneficiary. If this is indeed the case, it would make more sense to make this proposal the default position, i.e. the distribution will be taxed as income unless the components of the distribution can be identified. In that way, a clear return of capital or distribution of capital gains will still be taxed as it currently is.

The statement that all distributions will be taxed as income is also vague – as what type of income will it be taxed?

It is further recommended that criminal charges should be brought against tax payers if they do not disclose their direct or indirect interest in offshore trusts. Often trusts are set up without a beneficiary even knowing that he/she is a beneficiary of a trust. It is unclear what level of proof will be required to prove that a beneficiary was unaware of the fact that he/she is a beneficiary in order not to be guilty of an offence.

The committee states that the difficulty in identifying whether the distribution consists of capital, capital gains and or income lies at the root of the problem.

Difficulty to identify should not lead to punitive measures just with the objective to create a disincentive with regard to offshore investments. It is any person's right to invest offshore in whichever allowable vehicle they choose. The worldwide markets are becoming more and more accessible and measures should off course be in place to protect the tax base (which there are), but to subject every such distribution to income tax is taking it a step too far.

International information sharing agreements will no doubt assist South African tax authorities to help prevent abuse.

FISA submission:

It is submitted that should be sufficient to place the onus of proof in the hands of the beneficiary to prove that he received a distribution consisting of, for example, 40% income and 60% capital. A rebuttable presumption can be created to the effect that a distribution to the resident beneficiary will be deemed to consist of the income generated in that trust first and if the distribution exceeds the income generated, the balance will be treated as capital.

The taxpayer can rebut the presumption by providing clear statements from the investment institution detailing the composition of the distribution. It is also recommended that SARS should specify what information it will deem to be appropriate to verify the nature of a distribution.

9. Recommendation: Donations of foreign property interests

The committee recommends the repeal of section 56(1)(g) on the basis that South Africa has a residence based system of taxation and this provision dates back to a time when South Africa had a sourced based system of taxation. No mention is made of the corresponding estate duty deduction contained in section 4(e) of the Estate Duty Act.[12]

The recommendation also seems to lose sight of the beneficial side of the exemption and deduction, i.e. the fact that it incentivises donations and bequests of offshore property from a non-resident to a resident, from whose estate such property will in future yield donations tax or estate duty if it is, in future, donated by the resident or forms part of his/her deceased estate.

Comment

It is submitted that the committee should reconsider this proposal on the basis that the foreign assets in question have been sourced legitimately abroad, and will increase the assets base of the resident for the calculation of tax on future transfers.

10. Capital gains tax and estate duty

The committee responded to the claims that capital gains tax and estate duty are both wealth taxes and therefore amount to double taxation. They state that capital gains tax is widely regarded as income tax on capital income and not a wealth tax and that there is accordingly no double taxation.

This argument does not hold water. Calling capital gains tax an income tax on capital income does not change the fact that it is a tax levied on the same assets on which estate duty is levied on death. It does therefore amount to double taxation.

In chapter 7 of the committee report reference is made to a paper published by Professor J Roeleveld of the University of Cape Town recommending abolishment of either capital gains tax on death or estate duty as a taxable event on death in view of the fact that South Africa is the only country in the world levying capital gains tax and estate duty on basically the same assets on death of a person. The committee rejected this argument on the basis that, according to them, capital gains tax is an income tax on capital and not a wealth tax. To rule out double taxation on the basis of the type of tax where two different taxes are levied on the same asset and on the same event is, with respect, artificial. The committee refers to a review on tax on wealth and transfers of wealth in the European Union where the following was said:

"Capital Gains Taxes are not wealth taxes and therefore not included in the report. They are taxes on deferred Income Gains. <u>These taxes do not aim to tax the sole possession or transfer of certain assets, because tax is only due when the possession or transfer of the assets results in realization of income. Wealth taxes on the other hand are typified by the</u>

[12] Act 45 of 1955.

fact that the transfer of possession itself is taxed regardless of whether income is realized". *(our emphasis)*

It is difficult to see how this can be viewed as authority for the committee's viewpoint. It is submitted that it is authority for the exact opposite. It should be borne in mind that South Africa is the only country in the world levying capital gains tax and estate duty on death of a person and therefor the European Union most probably did not comment on the levying of capital gains tax on death. The wording of the quote specifically states that their view is based on the fact that capital gains tax is levied when the transfer of assets results in realization of income.

Wealth taxes on the other hand are typified by the fact that the transfer of possession itself is taxed regardless of whether income is realised. It is submitted that this is exactly what happens when assets are subjected to capital gains tax the death of the owner of such assets.

11. Conclusion

While it is understandable that a country like South Africa cannot afford a perception that the tax system fails to tax the rich adequately on their wealth, great care should be taken to avoid hurting the middle class and future high net worth individuals. Incorrect application of taxes upon death could also prejudice surviving spouses, especially those who may be vulnerable from a cash flow point of view despite having substantial value locked up in illiquid assets.

It appears that, as indicated above, further research is desperately needed in some areas before final decisions are taken.

The FISA Council

September 2015